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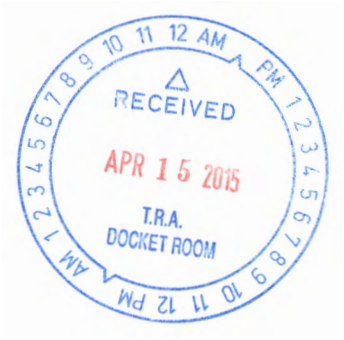
April 15, 2015




**VIA ELECTRONIC FILING**

Hon. Herbert H. Hilliard, Chairman
c/o Sharla Dillon
Tennessee Regulatory Authority
502 Deaderick Street, 4th Floor
Nashville, TN 37243

**RE:** ***Petition of Tennessee American Water Company Regarding the 2015 Investment and Related Expenses Under Qualified Infrastructure Investment Program Rider, the Economic Development Investment Rider, and the Safety and Environmental Compliance Rider*, TRA Docket No. 14-00121**

Dear Chairman Hilliard:

Attached for filing please find *Tennessee American Water Company's Pre-Hearing Brief* in the above-captioned matter.

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

Very truly yours,

BUTLER SNOW LLP

Valeria E. Gomez

VEG/mjb
Attachments

cc: Deron Allen, President, Tennessee-American Water Company
Wayne Irvin, Assistant Attorney General, Consumer Advocate and Protection Division
Vance Broemel, Assistant Attorney General, Consumer Advocate and Protection Division
Frederick L. Hitchcock, Counsel for City of Chattanooga

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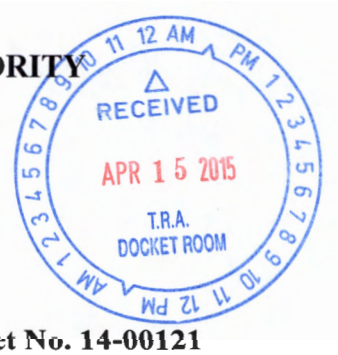
**BEFORE THE TENNESSEE REGULATORY AUTHORITY**
**NASHVILLE, TENNESSEE**

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| **IN RE:** | ) | |
| | ) | |
| **PETITION OF TENNESSEE-AMERICAN** | ) | |
| **WATER COMPANY REGARDING THE** | ) | |
| **2015 INVESTMENT AND RELATED** | ) | |
| **EXPENSES UNDER THE QUALIFIED** | ) | **TRA Docket No. 14-00121** |
| **INFRASTRUCTURE INVESTMENT** | ) | |
| **PROGRAM RIDER, THE ECONOMIC** | ) | |
| **DEVELOPMENT INVESTMENT RIDER,** | ) | |
| **AND THE SAFETY AND** | ) | |
| **ENVIRONMENTAL COMPLIANCE RIDER** | ) | |

## PRE-HEARING BRIEF OF TENNESSEE-AMERICAN WATER COMPANY

Pursuant to the March 23, 2015, Order and Procedural Schedule, the Petitioner, Tennessee American Water Company ("Tennessee-American" or "the Company"), respectfully submits its Pre-Hearing Brief in the above-captioned matter. The *Petition of Tennessee-American Water Company Regarding the 2015 Investment and Related Expenses Under the Qualified Infrastructure Investment Program Rider, the Economic Development Investment Rider, and the Safety and Environmental Compliance Rider* (the "*Petition*") is consistent with Tenn. Code Ann. § 65-5-103 *et. seq.* and the Tennessee Regulatory Authority's ("TRA" or "Authority") approval of the Amended Petition in TRA Docket 13-00130 and the approved tariffs submitted therein. Accordingly, and for the reasons set forth below, Tennessee-American respectfully requests that the *Petition* be approved.

## I.

## BACKGROUND

### A. *Tennessee-American Water Company*

Tennessee-American, a Tennessee corporation authorized to conduct a public utility business in the State of Tennessee, is a public utility as defined in Tenn. Code Ann. § 65-4-101. Tennessee-American provides residential, commercial, industrial, and municipal water service, including public and private fire protection service, to Chattanooga and surrounding areas, including approximately 75,840 customers. Tennessee-American is subject to the jurisdiction of the Authority pursuant to Chapter 4 and Chapter 5 of Title 65 of the Tennessee Code Annotated. Tennessee-American also serves customers in North Georgia.

### B. *Tenn. Code Ann. § 65-5-103*

Tennessee Governor Bill Haslam signed House Bill 191, now Tenn. Code Ann. § 65-5-103, into law on April 19, 2013. Among other things, this legislation authorized the TRA to implement alternative regulatory methods to allow public utility rate reviews and cost recovery mechanisms in lieu of a general rate case proceeding before the agency. In general, the statute is intended to reduce the need for general rate cases, lessen the occurrence of consumer rate shock, support the maintenance and improvement of essential infrastructure, ensure safety and reliability, aid economic development, and allow for more efficient, streamlined regulation.

By its own terms, § 65-5-103(d) establishes a two-step review process. First, any petition submitted under this statute must comply with the language and intent of the statute. Second, the petition must be found by this Authority to be in the public interest. By establishing this two-prong process, the Tennessee General Assembly, consistent with Tennessee courts, recognized that the Authority's experience, knowledge, and expertise should be given appropriate deference

in the area of utilities and utility regulation.[1] It is well-settled that the Authority and its staff have "in their grasp practical knowledge in the field of utilities regulation not possessed by either the courts or laymen in general."[2]

### *C. The TRA's Order Approving Tennessee-American's Capital Riders in TRA Docket No. 13-00130*

On October 4, 2013, Tennessee-American submitted a Petition in TRA Docket No. 13-00130 (the "*October 2013 Petition*") seeking approval of four (4) proposed alternative regulatory methods and mechanisms as permitted under Tenn. Code Ann. § 65-5-103, *et seq.* Specifically, the Company sought approval for a Qualified Infrastructure Investment Program Rider ("QIIP"),[3] an Economic Development Investment Rider ("EDI"),[4] a Safety and Environmental Compliance Rider ("SEC"),[5] and a Pass-Throughs Mechanism for Fuel, Purchased Power, Chemicals, Purchased Water, Wheeling Water Costs, Waste Disposal, and TRA Inspection Fee ("PCOP").[6][7] One of the primary regulatory concepts underlying the then-proposed Capital

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[1] *See, e.g., Tennessee Am. Water Co. v. Tenn. Regulatory Auth.*, No. M2009-00553-COA-R12-CV, 2011 Tenn. App. LEXIS 51, at *63 (Tenn. Ct. App. Jan. 28, 2011) ("[W]e accord the Commission great deference in reviewing its decisions.") (*quoting CF Industries v. Tennessee Pub. Serv. Comm.*, 599 S.W.2d 536, 541 (Tenn. 1980)). *See also, e.g., CF Industries*, 599 S.W.2d at 543 (The Commission "may superimpose upon the entire transaction its own expertise, technical competence and specialized knowledge.").

[2] *Tennessee Am. Water Co.*, 2011 Tenn. App. LEXIS 51, at *64.

[3] The QIIP Rider is designed, in part, to mitigate regulatory lag, to accelerate the timeframe of essential infrastructure updates and replacements, and to produce safer and more reliable water distribution and production system for ratepayers. Additionally, this mechanism has many other customer benefits and protections, including the lessening of the occurrence of "rate shock" associated with Base Rate increases.

[4] The EDI Rider is designed, in part, to promote the public interest by supporting and enhancing Tennessee-American's ability to serve both growing and new businesses and by permitting the Company to prudently promote economic development, growth, and expansion in its service area.

[5] Generally, the SEC Rider supports the Company's ability to serve the public interest by providing safe and reliable drinking water. The current regulatory environment, coupled with aging infrastructure, will require a larger investment in safety and environmental compliance not previously recognized by the Company's rates. Hence, one of the benefits of this rider is avoiding "rate shock" by permitting smaller, more gradual rate increases over time.

[6] The PCOP is designed to streamline the recovery process by permitting Tennessee-American to recover the largest non-labor related component of the Company's operations and maintenance expenses in a more timely manner, as

Riders and PCOP was to allow—with the requisite safeguards to serve the public interest—smaller, gradual increases in rates, thereby lessening the occurrence of "rate shock." One of the many benefits of this new, more streamlined recovery approach would be the likelihood of less frequent rate case filings.[8]

On January 10, 2014, Tennessee-American and the Attorney General and Reporter for the State of Tennessee, through the Consumer Advocate and Protection Division ("CAPD"), submitted a Stipulation in TRA Docket No. 13-00130 (the "*Stipulation*"), resolving the contested issues presented and offering the *Stipulation* to the Authority for its review, consideration, and approval.

Considering the *Stipulation* and the supporting documentation as an *Amended Petition*, the Authority approved the Capital Riders and the PCOP on April 14, 2014.[9] In reviewing the *Amended Petition*, the Authority, as it is required to do, employed the two-step inquiry established in § 65-5-103. First, the agency analyzed the *Amended Petition* for compliance with § 65-5-103, *et seq.*[10] Second, the Authority conducted a public interest inquiry to determine whether the *Amended Petition* satisfied § 65-5-103's public interest test.[11] After this analysis, the

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increases in these essential and non-discretionary expenses (such as chemicals and power) are outside the control of the Company's management.

[7] For ease of reference, the QIIP, the EDI, and the SEC are referred to collectively herein as the "Capital Riders."

[8] Tennessee-American has requested the Authority to take judicial notice of the record in TRA Docket No. 13-00130. Detailed explanations of the Capital Riders and the PCOP, along with underlying supporting documentation, are set forth in the *Direct, Rebuttal, and Supplemental Testimony of Gary M. VerDouw* in TRA Docket No. 13-00130.

[9] *Transcript of Proceedings*, *In the Matter of Tennessee Regulatory Authority Conference*, TRA Docket No. 13-00130, p. 14-16 (April 14, 2014) (excerpt) (hereinafter "*Hearing Tr.*"). The agency has not issued the order memorializing its decision in this docket.

[10] *Hearing Tr.*, pp. 14-15. (The Authority found that "[T]he amended petition and specifically the tariffs . . . meet the requirements of . . . § 65-5-103.")

[11] Specifically, the Authority held:

> I have reviewed the filings and evidence presented in this docket, along with the review of the calculations for the qualified infrastructure investment program, economical [sic] development investment rider, safety and environmental compliance, and the production costs and other pass-through rider, and find them reasonable.

Authority determined that the Capital Riders both comported with the requirements of Tenn. Code Ann. § 65-5-103 and were in the public interest.

***D. Tennessee-American's Petition in TRA Docket No. 14-00121***

The tariffs establishing the Capital Riders were submitted by the Company on March 25, 2014, and approved by the Authority on April 14, 2014. Accompanying the *Amended Petition* and consistent with the approved tariffs were certain categories of capital expenditures covering the investment period of 2014.[12] Subject to, and consistent with, the approved tariffs, on October 29, 2014, Tennessee-American filed its *Petition* to provide the required information and supporting documentation for the 2015 investment period in compliance with the Capital Riders.[13] The information provided in support of the Company's *Petition* is consistent with Tenn. Code Ann. § 65-5-103, *et seq*. and the Authority's April 14, 2014 approval of the Capital Riders.

**II.**

**THE *PETITION* COMPLIES WITH THE TRA'S APRIL 14, 2014, DECISION IN TRA DOCKET NO. 13-00130**

In submitting its requests for approval of the Capital Riders and the PCOP in the *Amended Petition*, Tennessee-American fully complied with Tenn. Code Ann. § 65-5-103, *et seq*.[14] As explained above, among the Authority's findings was a determination that the

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> I find that the three proposed investment riders not only allow the timely recovery of costs of necessary infrastructure, but also will aid in avoiding or delaying expensive rate cases. Further, the recovery of expenses—of expense changes via the pass-through mechanism from year to year should aid in delaying or avoiding rate cases.
>
> Accordingly, I find the amended petition to be in the public interest.

*Hearing Tr.*, p. 15.

[12] *Petition*, Direct Testimony of Tennessee American President Deron E. Allen, p. 4, L4 through p. 5,L9, TRA Docket No. 14-00121 (Oct. 29, 2014)

[13] *Id.* at p. 7, LL 5-9.

[14] *Hearing Tr.*, TRA Docket No. 13-00130, pp. 14-16.

*Amended Petition* and the related tariffs serve the public interest.[15] Further, the Capital Riders approved on April 14, 2014 expressly embraced several safeguards and oversight measures to guard the public interest.[16]

### *A. Within its challenge of the Petition, the City of Chattanooga seeks, in part, to overturn the Capital Riders approved by the Authority in TRA Docket No. 13-00130.*

The City of Chattanooga's (the "City") assertion that the approved Capital Riders are not in the public interest essentially constitutes a request for the Authority to modify, or even overturn in full, the Capital Riders it has already approved.[17] Notably, Tennessee-American's *Petition* does not seek to revise the Capital Riders already approved by the Authority. Instead, as explained herein, Tennessee-American's *Petition* and supporting documentation complies with the alternative regulatory mechanisms set forth in the TRA-approved Capital Riders by providing the relevant information for the 2015 investment period and otherwise complying with the approved tariffs.[18] In effect, the *Petition* is nothing more than an application of the Capital Riders previously approved by the Authority in TRA Docket No. 13-00130. As such, the gravamen of the City's position seems to request, at least in part, a reversal of the Authority's April 14, 2014 approval of the *Amended Petition*.

To the extent the City is challenging the Company's *Petition* for adherence to the approved Capital Riders, Tennessee-American's *Petition* and accompanying documentation will

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[15] *Id.*

[16] *See, e.g., Revised Tariffs*, TRA Docket No. 13-00130 (Mar. 25, 2014). *See also, e.g., Supplemental Testimony Gary M. VerDouw*, TRA Docket No. 13-00130 (Jan. 17, 2014).

[17] *See City of Chattanooga's Petition to Intervene*, TRA Docket No. 14-00121, p. 2, ¶ 5 (Feb. 11, 2015) ("As discussed herein and as will be shown at the hearing, TAWC's proposed tariffs (i) violate Tenn. Code Ann. § 65-5-103(d) in that they are manifestly not in the public interest and (ii) violate Tenn. Code Ann. § 65-5-103(d)(5), §§ 65-5-103(d)(3) and (d)(4), and § 65-5-103(d)(2) in that they seek recovery of expenses and investments not authorized by the alternative regulatory methods described in those subsections."); *see also Pre-filed Direct Testimony of City of Chattanooga Witness Nick Wilkinson*, p. 7, L 22 through p. 8, TRA Docket No. 14-00121 (Apr. 6, 2015); *City of Chattanooga Witness Donald Lee Norris*, p. 6, LL 20-28, TRA Docket No. 14-00121 (Apr. 6, 2015).

[18] *Petition*, Direct Testimony of Tennessee American President Deron E. Allen, p. 7, LL 5-9, TRA Docket No. 14-00121 (Oct. 29, 2014).

withstand such scrutiny. To the extent, however, the City is attempting to challenge the Capital Riders as approved, its allegations are, at best, misplaced.

### *B. The Authority Should Not Require Special Certifications for this Filing or Any Subsequent Filings Under the Approved Capital Riders.*

In approving the Capital Riders, the Authority concluded that these already contained sufficient safeguards to protect the public interest.[19] The public interest would not be advanced by requiring that Tennessee-American make pre-filing certifications, thereby modifying the minimum filing requirements already approved by the Authority. Rather, modifying the approved Capital Riders under the approach pursued by the City to require special certifications would lead to the kind of unnecessary delay and additional expense that Tenn. Code Ann. § 65-5-103 was designed to avoid.[20] The requisite safeguards to protect the public interest were established by the Authority in TRA Docket No. 13-00130. In light of the established safeguards, the City has not sufficiently demonstrated that such special certifications are warranted.

#### 1. Additional EDI Rider Certifications

Specifically, the Authority should not require certification by Tennessee-American that the operational expenses or capital costs sought to be recovered under the EDI Rider will fund infrastructure that will directly provide opportunities for economic development benefits because there is no objective formula for determining "opportunities for economic development."[21] As approved, the requirements of the EDI Rider already satisfy any aim of such special

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[19] *Hearing Tr.*, TRA Docket No. 13-00130, pp. 14-16; *see also Revised Tariffs*, TRA Docket No. 13-00130 (Mar. 25, 2014).
[20] *See Rebuttal Testimony of Tennessee-American Witness Linda C. Bridwell*, TRA Docket No. 14-00121, p. 6, L 21 through p. 7, L 10; p. 8, LL 7-14; and p. 9, LL 5-19 (Apr. 10, 2015).
[21] *Id.* at p. 6, L 21 through p.7, L10.

certification.[22] In some instances, it may be inappropriate for the Company to attempt to quantify specific and direct economic benefits for any such specific investment. Given the very nature of economic development, some subjectivity by the City and the Company may be employed. Establishing such a rigid threshold may result in significant additional expense on all future parties involved.[23] The fostering of economic development and investment is propelled by a number of incalculable factors; new residents, new business opportunities, expanding business opportunities, new taxes, and enhanced services are among the components that aid economic development in the Chattanooga area.[24] Here, the agency may apply its scrutiny and regulatory expertise to weigh any such investments and interested parties may intervene as well.

**2. SEC Rider Certifications**

The SEC Rider does not require that Tennessee-American provide certification that operational expenses and capital costs recovered under the SEC Rider are actually mandated by safety requirements imposed by the state or federal government. The structure of the approved SEC Rider ensures that the expenses to be recovered under the SEC Rider are those related to investments that provide safe drinking water to the public or environmental compliance that is for the protection of drinking water sources, as required by state and federal requirements.[25] The reconciliation process set forth in the approved SEC Rider ensures that Tennessee-American must provide the Authority the relevant information regarding the need for any investment item

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[22] *See Revised Tariffs*, Original Sheet No. 12-EDI-9, TRA Docket No. 13-00130 (Mar. 25, 2014) ("The Company will include in its Annual EDI Percentage Rate Filing . . . (d) statements demonstrating how each projected capital investment comprising the Forecasted EDI Investment Amount and each projected operational expense comprising the Forecasted Economic Development Operational Expenses meet the requirements for recovery under this Rider. . . .")

[23] *Rebuttal Testimony of Linda C. Bridwell*, p. 6, L 21 through p.7, L10.

[24] *Id.*

[25] *See Revised Tariffs*, TRA Docket No. 13-00130 (Mar. 25, 2014); *Rebuttal Testimony of Linda Bridwell*, p. 9, LL 11-19.

made under the SEC Rider pursuant to such federal and state requirements.[26] Because the Authority has already found that this alternative regulatory mechanism adequately protects the public interest, and as this rider currently includes safeguards, modification of the SEC Rider to include additional certification requirements is unnecessary. Again, the agency will employ the necessary review and application of its regulatory expertise in reviewing the Company's submissions under this rider.

### *C. Tennessee-American does not repeatedly request recovery for the same capital expenditures in successive rate cases.*

Tennessee-American does not repeatedly request recovery for the same capital expenditures in successive rate cases. The Company's capital expenditures set forth in its *Petition* have not been previously recovered in previous rate cases. Tennessee-American, like many water and wastewater utilities, has many more needs for capital investments than can prudently be made in any given year. As such, the Company prioritizes projects based on a number of factors.[27] In its *Data Requests*, the City identified two projects that had been partially included in the capital expenditures in TRA rate case Docket Nos. 10-00189 and 12-00049.[28] However, as indicated in Tennessee-American's response, Tennessee-American justifiably delayed and re-worked those projects to ensure that the most cost-effective, appropriate projects were moving forward to construction. As such, the capital expenditures made in relation to these projects have not yet been recovered. The two identified projects are now being implemented.[29]

While Tennessee-American seeks to deploy projects consistent with regulatory authorizations, from time to time, capital planning requires some level of flexibility to ensure

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[26] *Rebuttal Testimony of Linda Bridwell*, p. 9, LL 14-19.
[27] *Rebuttal Testimony of Linda Bridwell*, p. 10, L1 – p. 11, L6.
[28] *See, e.g., City of Chattanooga's First Discovery Requests to Tennessee-American*, Request No. 10, TRA Docket No. 14-00121 (Mar. 18, 2015).
[29] *Rebuttal Testimony of Linda Bridwell*, p. 10, LL 5-8.

that the utility is making the most prudent, cost-effective capital investments for the benefit of its customers.[30] The complete regulatory elimination of any such justifiable, prudent and transparent flexibility will be coupled with unintended consequences to the detriment of the ratepayers. There is no attempt at "double recovery" here. To be sure, the Authority is certainly not without the authority or the tools to review, reconcile and even challenge any such actions of the Company in this regard.

### *D. The equipment and infrastructure costs sought under the EDI Rider promote economic development within the Tennessee-American service area and are in the public interest.*

Tennessee-American's *Petition* includes recovery under the EDI Rider for investments undertaken to promote economic development in its service area.[31] Included herein are amounts for new meters and new services. Investment in new meters and new services are vital to ensure continued economic development in Chattanooga. New meters and new services are driven specifically from requests made from new or expanding companies, from new residents, or from companies and residents that are re-locating to developing areas within the Company's service area.[32] Further, the development of new services and the installation of meters result in community jobs (such as, for example, construction jobs) and additional tax revenue from the taxes paid during construction.[33] As the Environmental Protection Agency ("EPA") has recognized, "(m)aking these investments in water infrastructure has immense returns for

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[30] *Id.*, p. 11, LL 21-23.
[31] For Tennessee-American's response to the sole issue submitted by the CAPD in the *Parties' Joint Statement of Issues*, TRA Docket No. 14-00121 (Mar. 30, 2015), see the *Supplemental Testimony of Linda Bridwell*, TRA Docket No. 14-00121 (Dec. 29, 2014). To the extent that additional briefing on the issue is necessary, Tennessee-American will address the CAPD's issue in its Post-Hearing Brief.
[32] *Rebuttal Testimony of Linda Bridwell*, p. 6, LL 7-20.
[33] *Id.*

communities. Clean, reliable water brings not only public health and environmental benefits but also fuels the economy, creates jobs, and increases the quality of life in communities."[34]

Investment in new hydrants and valves also fosters economic development of the community. New valves and hydrants promote economic development by providing more reliable water service, new fire service in developing areas, or enhanced fire service in currently served areas.[35] As the City flourishes under a new wave of re-development, improved infrastructure and reliable fire protection are key to attracting new businesses and fostering economic growth.[36] These items must be prevalent, widespread and readily available to attract new business opportunities and to encourage expansion by existing businesses.

Moreover, as concerning the City's allegations that a utility should not be able to recover expenses from the purchase of alternative fuel vehicles, the record clearly reflects that the Authority, in approving the EDI Rider in TRA Docket No. 13-00130, already authorized such recovery.[37] In fact, the annual recurring investment amounts in 2014 for the purchase of alternative fuel vehicles were included in the *October 2013 Petition*.[38] The City's position that Tenn. Code Ann. § 65-5-103 does not authorize recovery for vehicles fueled by alternative fuels is unsupported[39] and unfounded.[40]

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[34] *Tennessee-American's Responses to the First Discovery Request of the City of Chattanooga*, Response No. 19, TRA Docket No. 14-00121 (Mar. 25, 2015) (quoting http://water.epa.gov/infrastructure/waterfinancecenter.cfm).
[35] *Rebuttal Testimony of Linda Bridwell*, p. 6, LL 7-20.
[36] *Id.*
[37] *Id.*, p. 7, LL 11-18; *see also Revised Tariffs*, Original Sheet No. 12-EDI-2, TRA Docket No. 13-00130 (Mar. 25, 2014) (approving recovery for "infrastructure designed *to utilize* alternative fuels.") (emphasis added). The EDI Rider specifically accounts for recovery for "Transportation Equipment." *See Revised Tariffs*, Original Sheet No. 12-EDI-3, TRA Docket No. 13-00130 (Mar. 25, 2014).
[38] *Id.* The City received a courtesy copy of the *October 2013 Petition* on October 4, 2013.
[39] Although the City raised this issue in the *Joint Statement of Issues*, TRA Docket No. 14-00121 (Mar. 30, 2015), the City has provided no testimony or other evidence to support its assertion.
[40] This exact issue was already addressed in TRA Docket No. 13-00130. In his rebuttal testimony, Tennessee-American witness Gary VerDouw discussed in detail how the purchase of vehicles fueled by alternative fuels was contemplated by Tenn. Code Ann. § 65-5-103. *See Rebuttal Testimony of Gary VerDouw*, p. 4 L6 through p.8, L10, TRA Docket No. 13-00130 (Dec. 30, 2013). Specifically, Mr. VerDouw testified:

### *E. The operational and investment costs sought under the SEC Rider are mandated by local, state and federal regulations, and recovery for these are in the public interest.*

The City's argument that the Company's Wastewater Improvement Project is not required by safety requirements imposed by the state or federal government ignores the fact that the City's wastewater discharge permits are issued pursuant to federal and state laws concerning public safety.

#### 1. The City of Chattanooga issues wastewater discharge permits in order to comply with State and Federal water safety regulations.

The City has an "Approved POTW Pretreatment Program" as the term is defined in federal EPA regulations found in 40 C.F.R. § 403.3(d).[41] To receive wastewater discharge permits under the City's Pretreatment program, industrial users[42] must agree to comply with all applicable substantive and procedural requirements promulgated by the EPA and the State of Tennessee.[43] Tennessee-American cannot operate without such a City-issued wastewater discharge permit, and to keep its permit, it must follow the requirements outlined in these permits. If the City operates without a wastewater discharge permit or otherwise fails to comply with the City's Pretreatment Program, Tennessee-American's discharge would no doubt be considered an illegal discharge. This would subject Tennessee-American not only to

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Infrastructure and equipment expenditures that only add alternative vehicle fueling stations do little overall good, and have very limited impact, if there are not increasing numbers of alternative fuel vehicles deployed to make use of those fueling stations. For this reason, among others, the Company included, in its EDI Rider, planned investments in the purchase and retrofit of utility vehicles to operate on alternative motor vehicle transport fuel.

*Id.*, p. 7, LL 3-8.

[41] *See Rebuttal Testimony of Linda Bridwell.*, p. 3, LL 1-7.

[42] Tennessee-American is an industrial user because the Tennessee-American water treatment plant backwashes water and sludge from the removal of sediment and particles from the Tennessee River. *Rebuttal Testimony of Brent O'Neill*, p. 3, LL 9-10.

[43] *Id.*

enforcement measures from the City, but also those of the State of Tennessee and the federal government.[44]

On April 24, 2013, the City entered into a consent decree with the EPA, the State of Tennessee, and the Tennessee Clean Water Network.[45] Through the consent decree, the parties agreed to significantly reduce, and where possible, eliminate, sanitary sewer overflows, to consistently monitor water quality, and to improve the overall operations of Chattanooga's sewer system.[46]

On May 15, 2013, the City issued Tennessee-American Wastewater Discharge Permit No. 74.[47] The permit's cover letter informed Tennessee-American that, in order to comply with the requirements of Wastewater Discharge Permit No. 74, the Company would have to design and construct a pretreatment system. The letter made clear that these new requirements were necessary to ensure that the City complied with the EPA consent decree and federal regulations:

> The permit includes a compliance schedule (page 5) for the design and construction of a pretreatment system/compliance monitoring system to effectively lower the concentrations of regulated metals in the Tennessee American Water discharge. This requirement is necessary due to the following:
>
> 1.) EPA Consent Decree issued to City of Chattanooga requiring improvements to the sanitary sewer system.
>
> 2.) To ensure protection of the Publicly Owned Treatment Works (POTW). Also to ensure the City's continued compliance with EPA 40 CFR Part 503 – Standards for the Use Or Disposal of Sewage Sludge regarding biosolids currently being land applied.
>
> 3.) To ensure process wastewater discharged from Tennessee American Water consistently meets pretreatment standards.[48]

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[44] *Id.* at p. 3, L17 through p.4, L2.
[45] *See* Consent Decree, *United States, et al. v. the City of Chattanooga*, No. 1:12-cv-00245 (E.D. Tenn. Apr. 24, 2013) (attached as Exhibit 2 to *Rebuttal Testimony of Brent O'Neill*).
[46] *Rebuttal Testimony of Brent O'Neill*, p. 1, LL 16-23.
[47] *Rebuttal Testimony of Brent O'Neill*, p. 4, LL 6-13.
[48] *Id.*, Ex. 2 at p.2.

The City's May 15, 2013 communications to the Company also included a one-page Pretreatment Facts message from the City of Chattanooga that explained the benefits of the City's Pretreatment Program.[49] In the Pretreatment Facts page, the City indicates that the City's Pretreatment Program and the issuance of wastewater discharge permits is mandated by the EPA through the National Pollutant Discharge Elimination System ("NPDES") permit program. The NPDES permit program controls water pollution by regulating point sources that discharge pollutants into waters of the United States by the Clean Water Act.[50] Because the City's Moccasin Bend Water Treatment Plant cannot operate without an EPA-issued NPDES permit, and because Tennessee-American's wastewater discharge eventually ends up in the Moccasin Bend Water Treatment Plant, Tennessee-American must comply with the City's Pre-Treatment Program to ensure that the City meets its obligations under its NPDES permit.[51]

**2. The City's New Wastewater Discharge Permit Requirements Mandate that Tennessee-American Construct the Sludge Removal Processes.**

As referenced herein above, pursuant to the EPA consent decree, the City's new wastewater discharge permits have changed the amounts of arsenic, chromium, copper, and zinc that Tennessee-American's wastewater discharge may contain before being transported to the City's Moccasin Blend Water Treatment Plant.[52] Currently, the wastewater discharge from Tennessee-American's water treatment plant exceeds the maximum zinc level permitted by the new pre-treatment standards. Wastewater Discharge Permit No. 74 indicates that Tennessee-American has a two-year exception in which to implement processes to reduce its wastewater

[49] *See id.*, Ex. 2 at p. 3.
[50] *Id.*, p. 5, LL 1-14.
[51] *Rebuttal Testimony of Brent O'Neill*, p. 5, L 20 through p.6, L 15.
[52] *Id.* at p. 7, L 22 through p.8, L 8.

discharge's zinc levels in accordance with the City's new standards.[53] If Tennessee-American does not meet the zinc levels indicated in Wastewater Discharge Permit No. 74, the Company will receive a Notice of Violation from the City of Chattanooga based on local, state, and federal regulations.[54] A Notice of Violation could result in a subsequent Enforcement Action against Tennessee-American if the violation is not corrected. More importantly, however, the receipt of Notice of Violation means that Tennessee-American has failed to meet its primary mission of providing water that is safe and reliable for its customers, the environment, and public health.[55]

Tennessee-American has chosen the zinc-removal process that most comports with the public interest. The Company considered three options to ensure that it complied with the City's wastewater discharge standards: (1) Discharging the wastewater directly into the river, which would require that Tennessee-American acquire its own NPDES permit; (2) Continuing to discharge its wastewater to the City's Moccasin Bend Water Treatment Plant, which would require a City-issued wastewater discharge permit; or (3) Establishing a pre-sedimentation process, which would involve treating the water before it reached Tennessee-American's water treatment plant.[56] The last option (the pre-sedimentary process) would be inherently more expensive than the two other options, for it would require the Company to treat up to 65 million gallons of water a day, compared to the relatively smaller volume of sludge that would have to be treated under the other options.[57] Because of the higher costs associated with the pre-sedimentary process option, Tennessee-American chose not to pursue that option.

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[53] *Id.*
[54] *Id.* at p. 8, LL 9-16. Tennessee-American has consistently complied with the City's water treatment permit requirements. To this day, the City has not issued Tennessee-American a single Notice of Violation for its treatment of water. *Id.* at p. 9, LL 17-19.
[55] *Id.* at p. 9, LL 1-16.
[56] *Id.* at p. 13, LL 4-16.
[57] This is because only the pre-sedimentary process takes place before water treatment. The other two options treat the sludge *after* the water treatment process, which reduces the volume to be treated. *Id.*

The other two options—discharge into the river via an NPDES permit or discharge into the City's water treatment plant via a City-issued wastewater discharge permit—are relatively similar and would require the same type of facilities and the same level of investment.[58] Tennessee-American chose to continue discharging its wastewater discharge through the City's Moccasin Bend Water Treatment Plant for a number of reasons. First, this option allows the Company to continue partnering with the City to ensure safe discharge to the river and the protection of the environment. In addition, the connection to the City's wastewater system provides a redundancy which, in case of emergencies, could provide an alternative route for sludge discharge to the City should Tennessee-American's facilities experienced difficulties.[59] The water treatment process selected by the City allows the City to comport with its obligations under the EPA consent decree and federal and state regulations and serves the public interest.

## III.

## TENNESSEE-AMERICAN WATER HAS COOPERATED WITH THE CITY OF CHATTANOOGA AS CONTEMPLATED BY THE COMPANY'S NOVEMBER 25, 2013, LETTER

Tennessee American's *Petition* does not constitute a retreat from its intent to cooperate with the City as contemplated in the Company's November 25, 2013 letter (the "*Letter*") to the City. Rather than confirming any intended failure on the part of Tennessee-American, the *Letter* evidences the Company's willingness to work cooperatively with the City.

The *Letter* was drafted in response to communications by the City, which set forth the City's requests for voluntary additional information regarding the Tennessee-American's *October 2013 Petition*.[60] In its *Letter*, Tennessee-American outlined the voluntary, cooperative

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[58] *Id.* at p. 14, LL 6-18. The precise sludge-removal process used and improvements required by both post-treatment options are discussed in detail in the *Rebuttal Testimony of Brent O'Neill* at p. 14, L 19 through p.15, L 16.
[59] *Id.* at p. 15, LL 17-22.
[60] *See Direct Testimony of Nick Wilkinson*, Exs. A and B.

efforts it would pursue with the City in relation to subsequent filings made under the Capital Riders.[61] Specifically, the *Letter* summarized a number of steps that Tennessee-American was willing to take to ensure and foster cooperation with the City as the Company made investments for qualified infrastructure, economic development, and safety and environmental compliance.[62]

### A. *Tennessee American provided the information and reports contemplated in the Letter.*

#### 1. The Annual Investment Plans

In its *Letter*, Tennessee-American offered to provide annual investment/improvement plans for investments made under the approved QIIP Rider.[63] Contrary to the City's assertions, Tennessee-American has provided those annual plans. Tennessee-American filed its 2014 Investment Plan as a part of the *October 2013 Petition* filed in TRA Docket No. 13-00130. In the spirit of cooperation, Tennessee-American provided the City with a courtesy copy of the *October 2013 Petition* and its supporting documents on the same day that the *October 2013 Petition* was filed with the Authority.[64] In other words, the City received Tennessee-American's 2014 Investment Plan before it received Tennessee-American's *Letter*.

Because the *Letter* was sent after the *October 2013 Petition* was filed but before the Authority approved the Capital Riders in TRA Docket No. 13-00130, Tennessee-American believed that the annual investment plan provided to the City of Chattanooga provided the City ample notice of its 2014 Investment Plan.[65] Tennessee-American did not receive any indication

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[61] *See id.* at Ex. B.
[62] *Id.*
[63] *Id.*
[64] The Company was under no obligation to do this. *Rebuttal Testimony of Linda Bridwell*, p. 1, LL 13-22.
[65] *Id.* at p. 2, LL 1-7. This investment plan provided the City with notice of the Company's expenditures for meters, services, valves, and hydrants, as well as its intent to purchase alternative fuel vehicles. *Id.* at p. 5, LL 12-23; p. 7, LL 11-18.

before the City's *Petition to Intervene* in the present matter that the City expected additional information or details concerning the 2014 Investment Plan.[66]

Tennessee-American also provided its 2015 Investment Plan to the City. This was presented to City officials on October 22, 2014, during a discussion between Tennessee-American and the City regarding upcoming projects, the 2015 Investment Plan, and the scheduling of quarterly meetings to address specific quarterly changes.[67]

**2. Quarterly Reports**

Tennessee-American's *Letter* also offered to provide quarterly reports showing: (1) the Company's progress on annual infrastructure investments and improvements under the approved QIIP Rider; and (2) that the environmental compliance costs sought under the SEC Rider were consistent with Tenn. Code Ann. § 65-5-103(d)(2).[68] Tennessee-American provided the City with these quarterly reports.

The Company provided the first quarterly report in a meeting on July 18, 2014. The first quarterly report was prepared at the direction of Linda Bridwell, who asked for a face-to-face meeting with the City to provide the City with the quarterly report, to review the quarterly report with the City, and to provide any necessary clarifications or explanations of the information. Ms. Bridwell did not receive any objections or questions concerning the quarterly report after the July 18th meeting.[69]

Tennessee-American provided the second quarterly report to City officials on September 8, 2014. Ms. Bridwell again offered to provide clarification or explanations of the information contained in the report. The City's only feedback regarding the September 8th quarterly report

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[66] *Id.* at p. 2, LL 1-7
[67] *Id.* at p.4, LL 14-19.
[68] *See Direct Testimony of City of Chattanooga Witness Nick Wilkinson*, Ex. 2.
[69] *Rebuttal Testimony of Linda Bridwell*, p. 2, LL 8-17.

was a general comment that it might be helpful to revisit the format and substance of the quarterly report. In a good-faith attempt to respond to the City's general comment, Tennessee-American reworked the form and substance of the report by simplifying the report while continuing to provide the information contemplated by the *Letter*.[70] On January 23, 2015, Tennessee-American provided the reworked and more user-friendly third quarter report. Tennessee-American did not receive any questions, requests for clarification, or requests for additional information related to the third quarter report.[71]

Finally, in February 2015, the City provided more specific feedback regarding the desired format for Tennessee-American's quarterly reports. The City requested that the quarterly reports include a comparison of capital expenditures. Tennessee-American subsequently reworked the format of the quarterly report once more pursuant to the the City's request.[72] As evidenced by the fact that the Company undertook three iterations of a quarterly report in this first year to provide user-friendly information to the City, Tennessee-American would have modified the quarterly reports in a good-faith attempt to cooperate with the City in the spirit of the *Letter* if the City had indicated concerns with the quarterly reports.

The City's assertion that Tennessee-American prepared the quarterly reports for the Authority is incorrect. Tennessee-American developed and prepared the quarterly reports solely for the City. In producing and providing the quarterly reports, Tennessee-American followed-through in a good-faith attempt to cooperate with the City.[73] In September 2014, Tennessee-

[70] *Id.* at p. 2, L 18 through p. 3, L 3.
[71] *Id.* at p. 3, LL 3-6.
[72] *Id.* at p. 4, LL 7-13.
[73] *Id.* at p. 3, LL 7-11.

American eventually did provide copies of the first and second quarterly reports to the Authority and the CAPD at their request.[74]

**3. Quarterly Utility Coordination Meetings and Other Communications**

Since May 2013, Tennessee-American has met with the City on at least five occasions to discuss compliance with Wastewater Discharge Permit No. 74's new requirements and to provide information regarding the level and status of improvements, the level of investments required, and a schedule for compliance with the permit.[75] As briefly addressed above, Tennessee-American also proposed the establishment of quarterly utility coordination meetings between the Company and the City to allow for discussions regarding capital investments by Tennessee-American.[76] The first and second utility coordination meetings have taken place on December 10, 2014, and March 11, 2015, respectively.[77]

As the General Assembly's passage of Tenn. Code Ann. § 65-5-103, *et seq.* and the Authority approved tariffs in TRA Docket No. 13-00130 are fairly new, so too are the Company's and the City's cooperative efforts to exchange information and to have ongoing dialogue with respect to the same. If the purposes of the *Letter* have not reached their full potential, and the exchange of information and ongoing dialogue have not met expectations, such shortcomings likely rest with both the Company and the City. Additionally, any improvement on, and resolution of, those shortcomings lie solely with both the Company and the City. The Company is committed to any necessary improvements.

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[74] *Id.* at p. 4, LL 7-13.
[75] *Rebuttal Testimony of Brent O'Neill*, p. 16, LL 6-13.
[76] *Id.* at p. 17, L 10 through p. 18, L 6.
[77] *Id.*

### B. *The Letter is not an Agreement that was Intended to be Subject to Adjudication by the Authority.*

The *Letter* represents a voluntary, good-faith effort by both the Company and the City to work cooperatively together. The *Letter* itself, however, is not a formal agreement between parties and was never intended to be a matter subject to adjudication by the TRA. Therefore, any claims or allegations based upon the *Letter* are beyond the subject matter jurisdiction of the Authority and should not be a basis for denying the Company's *Petition*.[78]

## IV.

## CONCLUSION

On April 14, 2014, the Authority approved the Capital Riders at issue in this *Petition.* In so doing, the Authority found that these were in the public interest. These Capital Riders should not be modified to remove specific items or require additional certifications. As evidenced by the *Stipulation* and the *Amended Petition*, the Capital Riders, as approved in TRA Docket No. 13-00130, were developed by the Company and the CAPD and submitted to careful consideration and deliberation by the Authority in accordance with the recent legislation passed by the Tennessee General Assembly. Accordingly, Tennessee-American Water Company respectfully requests that the Authority grant its *Petition.*

This the 15th day of April, 2015.

[78] *See Consumer Advocate Div. v. Tenn. Regulatory Auth.*, No. M1999-01170-COA-R12-CV, 2001 Tenn. App. LEXIS 387, at *19 (Tenn. Ct. App. May 30, 2001) (affirming the TRA's dismissal of a breach of contract claim for failure to state a claim when the claim was based on a document that was not binding on either party) (attached hereto);

Respectfully submitted:

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

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This the 15th day of April, 2015.

Valeria Gomez

# Tenn. Am. Water Co. v. Tenn. Regulatory Auth.

Court of Appeals of Tennessee, at Nashville

August 30, 2010, Session; January 28, 2011, Filed

No. M2009-00553-COA-R12-CV

**Reporter**
2011 Tenn. App. LEXIS 51; 2011 WL 334678

TENNESSEE AMERICAN WATER COMPANY, v. THE TENNESSEE REGULATORY AUTHORITY, et al.

**Subsequent History:** Appeal denied by, Motion denied by *Tenn. Am. Water Co. v. Tenn. Regulatory Auth., 2011 Tenn. LEXIS 550 (Tenn., May 25, 2011)*

**Prior History:** [*1] *Tenn. R. App. P.3* Appeal as of Right; Judgment of the Tennessee Regulatory Authority Affirmed in Part and Reversed in Part. Appeal from the Tennessee Regulatory Authority. No. 08-00039.

**Disposition:** Judgment of the Tennessee Regulatory Authority Affirmed in Part and Reversed in Part.

## Core Terms

audit, rate case, management fee, expenses, final order, methodology, Consumer, forecast, Company's, attrition, costs, rates, service company, services, customers, test period, requirements, utilized, projected, normalization, cases, material evidence, allocated, prudent, usage, contends, residential, financial statement, rate-making, calculating

## Case Summary

### Overview

Appellant water company petitioned appellee regulatory authority to approve a revision to the existing rates it charges its customers for water. The regulatory authority authorized a revision in the existing tariffs but made several rulings adverse to the water company. The appellate court affirmed all rulings except one that only allowed the water company to recover one-half of the rate case expenses since that ruling was arbitrary. The authority was required to pay the full amount of the rate case expenses claim.

### Outcome

Judgment affirmed in part and reversed in part.

## LexisNexis® Headnotes

Energy & Utilities Law > Utility Companies > Rates > General Overview

***HN1*** A public utility is required to obtain approval from the Tennessee Regulatory Authority before implementing an increase in the rates it charges its customers, *Tenn. Code Ann. § 65-5-103(a)*. The rates must be set forth in tariffs filed with and approved by regulatory authority and the utility can only charge the rates set forth in a duly filed and effective tariff, *Tenn. Code Ann. § 65-5-102*; Tenn. Comp. R. & Regs. 1220-4-1-.03. If the utility wants to implement a rate increase due to increased expenses or investments or decreased revenues or for any other reason, it is required to file a revision to the existing tariffs and a petition asking the regulatory authority to approve the revision to the existing rates, *Tenn. Code Ann. § 65-5-103*; Tenn. Comp. R. & Reg. 1220-4-1-.03 to 1220-4-1-.06.

Administrative Law > Judicial Review > Standards of Review > General Overview

Administrative Law > Judicial Review > Standards of Review > Abuse of Discretion

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review

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

Energy & Utilities Law > Utility Companies > Rates > General Overview

***HN2*** Appellate review of the Tennessee Regulatory Authority's actions is confined to the record, *Tenn. Code Ann. §4-5-322(g)*. The standard of review to be employed is provided by *Tenn. Code Ann. §4-5-322(h)*.

Administrative Law > Judicial Review > Standards of Review > General Overview

Administrative Law > Judicial Review > Standards of Review > Abuse of Discretion

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review

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

Energy & Utilities Law > Utility Companies > Rates > General Overview

***HN3*** See *Tenn. Code Ann. § 4-5-322(h)*.

Administrative Law > Judicial Review > Standards of Review > General Overview

Administrative Law > Judicial Review > Standards of Review > Abuse of Discretion

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review

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

Energy & Utilities Law > Utility Companies > Rates > General Overview

***HN4*** Appellate court review of the Tennessee Regulatory Authority's (TRA) actions is for the very limited purpose of determining whether the Commission has acted arbitrarily, or in excess of jurisdiction, or otherwise unlawfully. Review is restricted to the record and the TRA's finding may not be reversed or modified unless arbitrary or capricious or characterized by an abuse, or clearly unwarranted exercise of discretion and must stand if supported by substantial and material evidence. The criteria by which the TRA should be guided have received only generalized comments in the reported decisions. This is proper because the courts are playing a limited role in reviewing actions which essentially are legislative in character. Rate making is not a judicial function and appellate courts accord the TRA great deference in reviewing its decisions. On fixing rates in general, courts have spoken in terms of what is just and reasonable under the proven circumstances, of regard to all relevant facts and to a rate in the zone of reasonableness.

Administrative Law > Judicial Review > Standards of Review > General Overview

Energy & Utilities Law > Utility Companies > Rates > General Overview

***HN5*** An appellate court will not disturb a reasonable decision of an agency with expertise, experience and knowledge in the appropriate field. There is also a presumption that the rates so established are correct and any party who attacks the Commission's findings has the burden of proving that they are illegal or unjust and unreasonable. When the rates set by the agency are attacked there is a heavy burden on those who attacked them to make a convincing showing that the rates are invalid.

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review

***HN6*** The standards of review in *Tenn. Code Ann. § 4-5-322(h)(4)* and *(h)(5)* are narrower than the standard of review normally applicable to other civil cases. They are also related but are not synonymous. Agency decisions not supported by substantial and material evidence are arbitrary and capricious. However, agency decisions with adequate evidentiary support may still be arbitrary and capricious if caused by a clear error in judgment. A reviewing court should not apply *§ 4-5-322(h)(4)*'s arbitrary and capricious standard of review mechanically. In its broadest sense, the standard requires the court to determine whether the administrative agency has made a clear error in judgment. An arbitrary decision is one that is not based on any course of reasoning or exercise of judgment, or one that disregards the facts or circumstances of the case without some basis that would lead a reasonable person to reach the same conclusion.

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

***HN7*** A reviewing court should not apply *Tenn. Code Ann. § 4-5-322(h)(5)*'s substantial and material evidence test mechanically. Instead, the court should review the record carefully to determine whether the administrative agency's decision is supported by such relevant evidence as a rational mind might accept to support a rational conclusion. The court need not reweigh the evidence, and the agency's decision need not be supported by a preponderance of the evidence. The evidence will be sufficient if it furnishes a reasonably sound factual basis for the decision being reviewed. The substantial and material evidence standard has been described as requiring something less than a preponderance of the evidence but more than a scintilla or glimmer.

Administrative Law > Judicial Review > Standards of Review > De Novo Standard of Review

Energy & Utilities Law > Utility Companies > Rates > General Overview

Evidence > Inferences & Presumptions > Presumptions

***HN8*** The Tennessee Regulatory Authority's conclusions of law are subject to a de novo review without a presumption of correctness. A fundamental tenet of the legislative function of ratemaking requires the balancing of the utility's interest

in performing its public duties and earning a reasonable return on investment. Rates are set for the future, and the estimated effect of all reasonably expected changes affecting the rate of return, including increases in expenses and investments, must be taken into consideration in the establishment of a rate. Thus, a rate should be reasonable not only when it is first established but also for a reasonable time thereafter.

Administrative Law > Judicial Review > Standards of Review > General Overview

Energy & Utilities Law > Utility Companies > Rates > General Overview

***HN9*** A necessary component of utility ratemaking is the authority of the Tennessee Regulatory Authority to "fix" just and reasonable rates, not simply to approve or deny a utility's request. The legislature has recognized that a public utility may set its own rates, subject to the power to suspend the rates for a certain period of time while it makes the utility prove that the rates are just and reasonable. If the utility fails to carry that burden, the agency has the additional authority to fix rates that meet the just and reasonable criteria. In ratemaking proceedings, the burden of showing the proposed rates are just and reasonable rests with the utility seeking the change in rates, *Tenn. Code Ann. § 65-5-103(a)*. The administrative body is and must be free to change its mind and, if there is substantial and material evidence to justify the change, the courts have no reason to overturn the new holding.

Energy & Utilities Law > Utility Companies > Rates > General Overview

***HN10*** The Tennessee Regulatory Authority (TRA) has the discretion to utilize an historical test period, a forecast period, a combination of these where necessary, or any other accepted method of rate making necessary to give a fair rate of return. There is no statutory nor decisional law that specifies any particular approach that must be followed by the Commission. Fundamentally, the establishment of just and reasonable rates is a value judgment to be made by the Commission in the exercise of its sound regulatory judgment and discretion. Accordingly, neither the courts nor the legislature has established any precise method or formula in setting rates, and the TRA is not bound by any particular approach. The TRA is not limited to adopting one specific test period in order to make known and measurable adjustments to produce just and reasonable rates. There is simply no requirement that the TRA utilize the specific test period proposed by a public utility.

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review

***HN11*** In its broadest sense, the arbitrary and capricious standard requires an appellate court to determine whether the administrative agency has made a clear error in judgment or a decision not based on any course of reasoning or exercise in judgment.

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review

***HN12*** The arbitrary and capricious standard requires an appellate court to determine whether the administrative agency has made a clear error in judgment or a decision not based on any course of reasoning or exercise in judgment.

Administrative Law > Judicial Review > Standards of Review > General Overview

Energy & Utilities Law > Utility Companies > Rates > General Overview

***HN13*** The courts are playing a limited role in reviewing actions which essentially are legislative in character. Rate making is not a judicial function and courts accord the Commission great deference in reviewing its decisions. On fixing rates in general courts have spoken in terms of what is just and reasonable under the proven circumstances, of regard to all relevant facts and to a rate in the zone of reasonableness. The Uniform Administrative Procedures Act authorizes the agency to take notice of generally recognized technical and scientific facts within the agency's specialized knowledge, and in the evaluation of evidence the agency is specifically authorized to utilize its experience, technical competence, and specialized knowledge, Tenn. Code Ann. § 4-5-1097.

Energy & Utilities Law > Utility Companies > Rates > General Overview

***HN14*** The Public Service Commission in rate making and design cases is not solely governed by the proof although, of course, there must be an adequate evidentiary predicate. The Commission, however, is not hamstrung by the naked record. It may consider all relevant circumstances shown by the record, all recognized technical and scientific facts pertinent to the issue under consideration and may superimpose upon the entire transaction its own expertise, technical competence and specialized knowledge. Thus focusing upon the issues, the Commission decides that which is just and reasonable. This is the litmus test nothing more, nothing less.

Administrative Law > Judicial Review > Reviewability > General Overview

Energy & Utilities Law > Utility Companies > Rates > General Overview

*HN15* The impact of the Administrative Procedures Act on the review of the decisions made by state boards, commissions and agencies, including the Public Service Commission, is massive and it casts upon the Commission the heavy burden of a sound, reasoned, and judicious approach in the exercise of its jurisdiction. Neither the legislature nor the courts have established any precise formula or yardstick to guide the Commission. The process of setting rates is not required to follow any particular course, so long as the end result does not violate the just and reasonable requirement. The Commission is not bound by a single formula or a combination of formulas in fixing rates and none is exclusive or more favored than the others. There is no precise statutory or court announced basis for determining the justness or reasonableness of class rate level structures or relationships. Generally, rate making is the responsibility of a regulatory commission effectively exercising its discretion upon sufficient evidence before it.

Administrative Law > Judicial Review > Reviewability > General Overview

Energy & Utilities Law > Utility Companies > Rates > General Overview

*HN16* It must be presumed that the members of the commission itself, with their supporting staff, have in their grasp practical knowledge in the field of utilities regulation not possessed by either the courts or laymen in general. The commission, in order to carry out its mandate from the legislature to establish just and reasonable rates, must be able to draw on its own internal sources of knowledge and experience. As with the legislature itself, it is assumed that it does so in each instance and that courts ought not to interfere unless it should clearly exceed its statutory powers.

Energy & Utilities Law > Utility Companies > Rates > General Overview

*HN17* The Tennessee Regulatory Authority (TRA) is not required to follow a particular methodology it has used in the past as long as the methodology it chooses allows it to arrive a determination of a rate that is just and reasonable. Moreover, the TRA is not limited to considering just what is in the record as it may consider, in addition to the proof, recognized technical and scientific facts pertinent to the issue and may superimpose its own expertise, technical competence and specialized knowledge. The TRA is only required to use its regulatory judgment and exercise its discretion to decide what is a just and reasonable rate.

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David C. Higney, Chattanooga, Tennessee, and Henry M. Walker, Nashville, Tennessee, for the Appellee, Chattanooga Manufacturers Association.

**Judges:** HERSCHEL PICKENS FRANKS, P.J., delivered the opinion of the Court, in which CHARLES D. SUSANO, JR., J., and. D. MICHAEL SWINEY, J., joined.

**Opinion by:** HERSCHEL [*2] PICKENS FRANKS

## Opinion

The Tennessee American Water Company petitioned the Tennessee Regulatory Authority to approve a revision to the existing rates it charges its customers for water. The Authority authorized a revision in the existing tariffs but made several rulings adverse to the plaintiff. Plaintiff has appealed numerous issues. On appeal, we affirm the rulings of the Authority, except its ruling which only allowed plaintiff to recover one-half of the rate case expenses. We hold that ruling was arbitrary and we require the Authority to pay the full amount of the rate case expenses claim.

### OPINION

#### Background

Appellant, Tennessee American Water Company (TAWC), is an investor-owned public utility that provides water service to residential, industrial, commercial and municipal

customers in the City of Chattanooga, Tennessee and area. It is a wholly owned subsidiary of American Water Works Company, Inc. (Parent Company). Parent Company is a holding company that owns numerous operating subsidiaries providing water services in locations across the United States.

*HN1* TAWC, is required to obtain approval from the Tennessee Regulatory Authority (TRA or Authority), before implementing an increase in the [*3] rates it charges its customers. Term. Code Ann. *§ 65-5-103(a)*. TAWC's rates must be set forth in tariffs filed with and approved by TRA and TAWC can only charge the rates set forth in a duly filed and effective tariff. *Tenn. Code Ann. § 65-5-102*; Tenn. Comp. R. & Regs. 1220-4-1-.03. If TAWC wants to implement a rate increase due to increased expenses or investments or decreased revenues or for any other reason, it is required to file a revision to the existing tariffs and a petition asking TRA to approve the revision to the existing rates. *Tenn. Code Ann. § 65-5-103*; Tenn. Comp. R. & Reg. 1220-4-1-.03 to .06.

On March 14, 2008, TAWC filed its petition (2008 Rate Case) with the TRA in which it sought approval of "customer rates that will produce an overall rate of return of 8.514% on a rate base of $119,881,506". Along with the petition, TAWC filed the pre-filed testimony of nine witnesses, a Management Report and documentary evidence in support of the requested rate increase. This petition was TAWC's fourth such filing within a five year period.

On April 7, 2008, the TRA panel initially assigned to the 2008 Rate Case voted to suspend the proposed tariff from April 13, 2008 to July 11, [*4] 2008 and to convene a contested case proceeding and appoint a Hearing Officer for the purpose of preparing the matter for hearing before the panel.

On April 1, 2008, the Consumer Advocate and Protection Division of the Office of the Attorney General (Consumer Advocate or CAPD) filed a petition to intervene. The Chattanooga Manufactures Association (CMA) filed a petition to intervene, and the City of Chattanooga (the City) likewise filed a petition to intervene. There was no opposition to the petitions to intervene and the TRA permitted the interventions.

Between May 12, 2008 and mid-August 2008 extensive discovery was conducted by the parties and multiple motions were filed regarding discovery disputes. The hearing on the 2008 Rate Case commenced in Chattanooga on August 18, 2008 and continued there until August 22, 2008. The hearing was then reconvened in Nashville on August 26, 2008 and concluded on August 27, 2008.

The TRA panel held public deliberations on September 22, 2008. The TRA made numerous determinations of TAWC *s revenues, expenses, rate base and rate of return for the attrition year and concluded that TAWC had a revenue deficiency of $1,655,541. Accordingly, the TRA granted [*5] a rate increase to increase the revenue by $1,655,541. The TRA also ordered a "Request for Proposal" for an extensive management audit by an independent certified accountant of the management fees incurred by the TAWC from American Water Works Service Company (Service Company). The Request for Proposal was to be filed with the TRA no later than September 28, 2008.

On January 13, 2009, TRA entered the final order in the 2008 rate case, and TAWC filed a petition for direct review of numerous aspects of the TRA's decision pursuant to Term. Code Ann. *§ 4-5-322(b)(1)(B)(iii)* with the Middle Section of this Court. The Appellant, separately filed a motion to transfer the appeal of this case to the Eastern Section of the Court, which was granted.

**Summary of Evidence Before the Authority**

In ruling on TAWC's petition in the 2008 Rate Case, the TRA was required to make determinations on a number of complex components that must be considered when fixing just and reasonable rates and the Final Order of January 13, 2009 reflects those determinations. TAWC has sought review of the following contested issues that were a part of the multiple factors considered by the TRA: The selection of the test period; [*6] revenues, specifically Weather Adjustment Normalization; management fees, including the cost of the Management Audit performed by TAWC; fuel and power expenses, specifically the establishment of an unaccounted-for water loss percentage; and regulatory expense.

TAWC contends that TRA erred in applying more than one test year to TAWC's expenses, revenues and rate base. A "test period" or "test year" is a measure of a utility's financial operations and investments over a specific twelve month period. A test year is used to build an "attrition year", which is the forecast used to set rates. In this rate case TAWC urged TRA to use an historical test year ending on November 30, 2007 and the Consumer Advocate used a test year ending March 31, 2008. Both TAWC and the Consumer Advocate utilized an attrition year ending August 31, 2009. The issue of utilizing only TAWC's proposed test year was contested. In its final decision, the TRA utilized portions of

both test years for different determinations. The agency utilized the test period which it found to best fit the individual item being forecasted. Although TAWC contends that it was the policy of TRA in past rate cases to apply only one test [*7] period to all issues, the Consumer Advocate correctly pointed to the evidence that TRA had utilized multiple test year periods in the 2006 rate case.

TAWC described management fees as follows:

> Management fees are the charges from American Water Works Service Company ("AWWSC") for services provided under the 1989 Service Company contract. Those services consist of services related to accounting, administration, communication, corporate secretarial, engineering, finance, human resources, information systems, operations, rates and revenue, risk management, water quality and other services as agreed by the Company. These services are billed at cost to TAWC.

In the 2008 Rate Case, TAWC sought in its initial filing $4,335,190 for management fees.

In order to address this issue on appeal, a review of a portion of the Final Order in the 2006 Rate Case is required. As part of the 2006 Rate Case, TAWC initially requested management fees in the amount of $4,064,421. The Consumer Advocate requested that management fees be set in the amount of $3,021,111. The City and the CMA argued that the TRA should not approve any management fees as TAWC had not met its burden of proof on the issue. The TRA concluded [*8] that management fees for the attrition period should be $3,979,825. The TRA also ordered that TAWC have a management audit performed. The Final Order from the 2006 Rate Case specified the requirement of a management audit as follows:

> TAWC should have a management audit performed in compliance with Sarbanes-Oxley requirements and submit the results to the Authority in one year or, if the audit is not complete in one year, submit a status report on the audit in one year. This audit should determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and should address the reasonableness of the methodology used to allocate costs to TAWC.

TRA had directed TAWC to submit the results of a management audit or a status report on the management audit within one year of deliberations in the 2006 Rate Case, which occurred on May 15, 2007. However, less than a year later, on March 14, 2008, TAWC filed its Petition in this case, the 2008 Rate Case, and with the Petition, it submitted a report prepared by the management consulting firm Booz Allen Hamilton (Booz Allen). This report was entitled and referred to by a Booz Allen vice-president, [*9] Joseph Van den Berg, who sponsored the report as an "Independent Cost Assessment Report". Mr. Van den Berg testified that the report was prepared in compliance with the 2006 Rate Case Final Order's requirement that a management audit be submitted to the TRA.

TAWC supported its request for management fees with the Booz Allen Report and Mr. Van den Berg's testimony as well as with testimony from TAWC officers and employees. TAWC offered evidence regarding the amount of projected management fees in the attrition year and attributed the increase in fees since the 2006 Rate Case to factors such as labor and benefits costs. TAWC further presented evidence that because the Service Company's costs and benefits are shared by all American Water subsidiaries, TAWC is able to deliver more prompt and reliable service to its customers. There was evidence that the Service Company offers a wide range of services to TAWC, including a customer call center, accounting, operations, rates and revenues, administration, auditing, information systems, communications, human resources, risk management, finance, legal, water quality and engineering. The Company witnesses offered testimony that all of these services [*10] were necessary for TAWC to provide a high quality of service to its customers and that if the Service Company was not employed, TAWC would have to obtain the same services elsewhere. TAWC provided evidence that if it shifted the services provided by the Service Company to the local level, the cost to TAWC would be higher because TAWC would have to hire full-time employees and outside contractors who would not bill at cost as the Service Company does.

The Company presented evidence to show that the Service Company was able to achieve cost savings based on its model that allows TAWC and other American Water subsidiaries to share in the cost of employing specialists, some of whom would not be needed in a full-time basis at a single utility. The Booz Allen consultant, Mr. Van den Berg, stated that in his opinion the service company model is a cost-effective way to operate utilities. Michael Miller, treasure/comptroller of the Company, attempted to explain the increase in management fees between 2004 and 2008. He stated that in 2004 and 2005 the Parent Company had instituted a company-wide reorganization that had shifted a number of fulltime positions from TAWC to the Service

Company. He [*11] claimed that this action resulted in a reduction in the growth of local labor costs that by 2008 had actually offset the increase in management fees by $1,239,713.

This evidence was presented in support of TAWC's initial request for management fees of $4,335,190. The Consumer Advocate arrived at a forecasted amount of $3,453,233 for the attrition period. The other intervenors, the City and the CMA, did not provide an alternative amount for management fees to the TRA, but rather the City urged that no management fees, including the cost of the management audit, be allowed until TAWC obtained a proper audit which would be reviewed in a later proceeding.

After review of the testimony, a majority of the TRA panel concluded that the management fees for the attrition period should be set at $3,529,933. This amount was based on the Company's forecasted 2005 management fee amount with an annual customer growth/inflation factor.

The TRA panel's decision on the amount of management fees was split two to one. All of the panel members, however, agreed that the Booz Allen Report submitted by TAWC did not comply with the TRA's directive in the 2006 Rate Case Final Order and did not support approval [*12] of TAWC's request to recover management fees in the 2008 Rate Case.

The deliberations of the members of the panel on this issue offer insight as to why the panel did not accept TAWC's management fees for the attrition year and why the panel rejected the Booz Allen Report. Director Roberson, as part of a motion, stated that he had no doubt that the Service Company had incurred legitimate expenses, but he had a problem determining whether the amount of management fees requested by the Company to pay the Service Company was "a just and reasonable amount based on prudent expenditures." He went on to state that the audit the TRA had ordered TAWC to conduct and provide to the TRA in the 2006 Rate Case could have answered this important question "if it had been conducted properly." He noted that the evidence presented showed that in the five and a half years from 2004 to the forecasted attrition period in the 2008 Rate Case, management fees had increased by 73%. The Director also addressed the testimony of Michael Miller regarding the company-wide reorganization that had shifted positions from TAWC in Chattanooga to the Service Company. He stated that there was less than $26,000 in efficiency [*13] gained by the reorganization since 2004 and that he had expected greater efficiency. He also stated that he looked forward to reviewing the conclusions of the comprehensive audit that was ordered in the 2006 Rate Case once it was properly prepared. He stressed that if the management audit shows that the management fees are prudent, the TRA will revisit the matter of management fees on its own motion or on motion of a party. He then explained his methodology for arriving at the management fees he approved.

Chairman Hargett voted in favor of Director Roberson's motion and added to the deliberations regarding the management audit ordered in the 2006 Rate Case. First the Chairman recapped the Final Order which required TAWC to submit a management audit to TRA: "The audit was to determine whether all costs allocated to [TAWC] were incurred as a result of prudent or imprudent management decisions by [the Service Company]." He then noted that the audit was to address the reasonableness of the methodology used to allocate costs to TAWC. Chairman Hargett expressed dissatisfaction with the Booz Allen Report as it did not meet those stated guidelines. He also expressed skepticism that Booz Allen [*14] was an independent company for purposes of conducting the audit as Mr. Van Den Berg, who oversaw the audit for Booz Allen, "frequently provides testimony for American Water Works Company in rate cases in other states." Finally the Chairman stated that he agreed with the methodology employed by the Director in arriving at the management fee figure of $3,529,933.

Director Freeman did not vote in favor of the management fees as proposed by Director Roberson and support by Chairman Hargett as he found that the Booz Allen Report submitted by TAWC did "not lend the evidence to support an increase in management fees from the last [2006] case." Based on this lack of evidence, Director Freeman stated that the management fees amount granted in the 2006 Rate Case should be adopted in the 2008 Rate Case.

> The Final Order in the 2008 Rate Case addressed the Booz Allen report as follows: Based on its evaluation, the City recommended disallowance of all costs related to the Booz Allen Report and all [the Service Company's] management fees and allocated cost until the Company obtains an audit that conforms to the specifications of the TRA and the new audit report is examined in a later proceeding. The [*15] City claimed, in part, that Booz Allen is not an independent public accounting firm; Booz Allen did not conduct an "audit" as required by the TRA or SOX [Sarbanes-Oxley regulations]; and Booz Allen did not conduct an audit in conformance with the rules of the Public Accounting Oversight Board....

The Final Order concluded:

> The record shows that from 2004 to the Company's forecasted attrition period in this docket, management fees have increased seventy-three percent during the five and one-half year time period. There was a fifty-nine percent increase between the 2004 fees and the fees approved in Docket No. 06-00290 [the 2006 Rate Case]. Therefore, a majority of the panel voted to set the Management Fee attrition year expense amount at $3,529,933. This amount was based on the Company's forecasted 2005 Management Fee amount from Docket No. 04-00288 [2005] as used by the Consumer Advocate in this docket. The majority of the panel voted to change the growth factor to include all customer growth instead of one-half of customer growth, as used by the Consumer Advocate.
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> Because of unresolved questions regarding management fees assessed by the service company and requested by TAWC in Docket [*16] No. 06-00290 [the 2006 Rate Case], the TRA ordered TAWC to perform a management audit to determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and to address the reasonableness of the methodology used to allocate cost to TAWC.

The Authority's June 10, 2008 Order in Docket no. 06-00290 stated at pages 26-27:

> TAWC should have a management audit performed in compliance with Sarbanes-Oxley requirements and submit the results to the Authority in one year or, if the audit is not complete in one year, submit a status report on the audit in one year. This audit should determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and should address the reasonableness of the methodology used to allocate costs to TAWC.

A majority of the panel found that the management audit performed did not adequately address the issue of prudency of the management fees, and that the audit was not an independent audit as ordered in Docket No. 06-00290. The Booz Allen witness, Joe Van den Berg, who performed the management audit required by the TRA also provided [*17] testimony on behalf of TAWC in other dockets, both before the TRA and other utility commissions. For this reason, the panel determined that the independence of the selected audit firm was impaired. Further, the audit did not address the primary concerns of the Authority that the costs were the result of prudent management decisions.

Based on the foregoing findings regarding the Booz Allen Report, the TRA excluded amortization of the cost of the Booz Allen Report from the management fees. The Final Order also stated that because TAWC had not developed a Request For Proposal (REF) for a comprehensive management audit by an independent certified public accountant, as ordered in the 2006 Rate Case Final Order, TAWC had not complied with TRA's directive. The 2008 Rate Case Final Order provided specific criteria for a new audit:

> The REF for the audit shall include, but not limited to, an investigation of [the Service Company's] management performance and decisions relating to internal processes and internal controls with an attestation and recommendations of any needed management changes and implementation thereof Further, the audit shall evaluate and attest to the charges allocated to TAWC, [*18] including efficiency of processes and/or functions performed on behalf of TAWC, as well as the accuracy and reasonableness of the allocation factors utilized. This REF should be filed in this docket no later than six months from September 22, 2008.

On appeal, TAWC contends that the evidence presented to the TRA showed that the Booz Allen Report featured an in-depth analysis of the prudence of management decisions and cost allocation to TAWC by employment of management audit methodology and definition of prudence that has been used and accepted in multiple other jurisdictions. TAWC contends that Booz Allen examined and determined the prudence of TAWC's management decisions by examining seven aspects of the relationship between the Service Company and the Company and showed that the Service Company's costs per customer were less than most other utility companies that use a service company. Based on this finding, the report concluded that TAWC receives fair, reasonable and competitive charges from the Service Company.

Further, TAWC contends on appeal that the Booz Allen Report was in complete compliance with the applicable provisions of the Sarbanes-Oxley requirements as mandated by the [*19] 2006 Rate Case Final Order. Mr. Van den Berg stated in his pre-filed testimony that the Booz Allen report

and his testimony were intended to address the part of the Final Order of the 2006 Rate Case that 'TAWC have a management audit performed in compliance with Sarbanes-Oxley requirements'". Mr. Van den Berg also testified at the hearing on the issue of compliance with Sarbanes-Oxley. He stated that it was his understanding that the only Sarbanes-Oxley requirement that pertains to a management audit, as opposed to a financial audit, was that the firm conducting the management audit be independent from the company that it audited. Mr. Van den Berg claimed that the audit Booz Allen conducted was an independent audit, but on cross-examination, admitted that he had done consulting work for TAWC on the previous rate case and that in the past several years he had done consulting work and testified in rate cases for subsidiaries of the Parent Company in Minnesota, Missouri and Indiana.

Appellees find multiple faults with the Booz Allen Report and Mr. Van den Berg's testimony. For instance, appellees argue that Mr. Van den Berg did not undertake any analysis of whether the level of administration [*20] services, audit services, communication services and legal services that were charged by the Service Company to TAWC were the right level or quantity. Appellees claim Mr. Van den Berg did not undertake any independent analysis to determine whether the Service Company was actually providing the services it was billing to TAWC. An example of this allegation provided by appellees is that Mr. Van den Berg testified that he believed the charges for accounting services billed to TAWC were appropriate merely because the category of accounting services was included in the service agreement between the Service Company and TAWC. There was no evidence that he had examined the actual accounting services provided.

Appellees also assert that Booz Allen further did not undertake to study or determine whether amounts paid by TAWC for services were for the correct quantity or volume of service. The allegation is based on Mr. Van den Berg's testimony that other than having discussions with TAWC management, Mr. Van den Berg did not consider whether the services provided by the Service Company overlapped or duplicated activities conducted by TAWC employees nor did he consider the labor and benefits expense [*21] that TAWC was incurring locally. Appellees point to numerous other examples in the Booz Allen Report and in Mr. Van den Berg's testimony where there was no analysis of whether the services delivered to TAWC were necessary, reasonable and prudent. They also point out that the Booz Allen Report did not define prudence, imprudence or reasonableness.

The City offered the testimony of economic consultant Michael Majoros, Jr. as to why the Booz Allen Report was not a management audit, why it did not comply with Sarbanes-Oxley requirements and why it otherwise did not meet the requirements set forth in the Final Order of the 2006 Rate Case.

Mr. Majoros described the Sarbanes-Oxley Act of 2002:

> Sarbanes-Oxley(SOX) is an Act co-authored by Senator's [sic] Sarbanes and Oxley and signed into law by President George W. Bush. It emanates from the ENRON and other corporate scandals in [the] early part of President Bush's first term. SOX requires detailed audits by independent certified public accountants. The purpose of the law is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes.

Mr. Majoros was then [*22] asked how an "audit" is defined by Sarbanes-Oxley. In response he quoted Section 2(a)(2) of the Act as defining an audit as: "An examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission (or, for the period preceding the adoption of applicable rules of the Board under section 103, in accordance with then-applicable generally accepted auditing and related standards for such purposes), for the purpose of expressing an opinion on such statements". In Mr. Majoros' opinion, the Booz Allen Report was not an audit, as described by Sarbanes-Oxley, but an "assessment" and he noted that Mr. Van den Berg never referred to the report as an audit. [1] Mr. Majoros provided three principal reasons that the Booz Allen Report was not a management audit: (1) the report did not determine and apply definitions of prudence, imprudence, or reasonableness; (2) it did not determine whether the internal controls at the Service Company were designed to catch imprudent costs; and (3) its conclusions were subjective and were not based on objective audit tests or standards. He also explained that there were well-defined [*23] standards for preparation of a management audit of a utility as provided in the National Association of Regulatory Utility Commissioners publication, "Fundamental of Management Audits, Vol. I" and that Booz Allen had not

[1] As noted above in footnote 2, Mr. Van den Berg testified that although he had referred to the report as a "cost assessment" he used the term "assessment" synonymously with audit. In fact, the Booz Allen report also refers to "report" and "audit" interchangeably in the first paragraph.

utilized these standards.

Mr. Majoros further detailed twelve deficiencies in the Booz Allen Report, referenced as BAH, that caused it to be non-compliant with Sarbanes-Oxley (SOX)requirements:

> BAH is not an independent public accounting firm. [2] BAH did not conduct an "audit" as specified by SOX. BAH did not conduct an audit in conformity with or even cite to the rules of the Public Company Accounting Oversight Board. BAH did not cite to professional standards and did not comply with stringent standards SOX requires. BAH's report did not include a concurring or second partner review and approval of such report. BAH's report did not contain any management attestations. BAH's report is not [*24] independent, it was reviewed and edited by management. BAH's report did not describe the scope of the auditor's testing of the internal control structure and procedures required by section 404(b) Internal Control Evaluation and Reporting. BAH's report did not present the findings of the auditor from such testing. BAH's report did not provide an evaluation of whether AWWSC's [the Service Company's] internal control structure and procedures include maintenance of records that in reasonable detail accurately and fairly reflect the transactions reported to BAH by AWWSC. BAH' report did not provide an evaluation of whether such internal control structure and procedures provide reasonable assurance that transactions are recorded as necessary to permit calculation of costs conforming to TRA requirements, and that receipts and expenditures underlying those costs are being made only in accordance with authorizations or management and directors in conformance with TRA rules. BAH's report did not contain a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.

Mr. Majoros summarized his opinions as follows:

> BAH did not conduct a management audit in compliance with Sarbanes-Oxley requirements to determine whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and the reasonableness of the methodology used to allocate costs to TAWC, as TRA specified in Docket No. 06-00290. The BAH Report is merely an expansion of the type of study Mr Baryenbruch submitted in Docket no. 06-00290 which led to the TRA's Sarbanes-Oxley requirement. BAH did not conclude audit test work of specific transactions to determine if they were the result of prudent or imprudent management decisions. Nor did he determine or verify if AWWSC's internal controls were designed to catch imprudent and unreasonable costs. The BAH Report is not useful for ratemaking purposes. None of the costs of the BAH Report should be charged to ratepayers in any way. Furthermore, I recommend disallowance of all AWWSC management fees and allocated costs until the originally specified audit is conducted and examined in a later proceeding.

TAWC offered the testimony of Mark Manner, [*26] an attorney and purported expert on the Sarbanes-Oxley requirements, in rebuttal to Mr. Majoros' opinions. Mr. Manner provided an overview of the Sarbanes-Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002. According to Mr. Manner, the Act was designed to improve existing safeguards for protecting investors in public companies from corporate accounting fraud, primarily by improving the accuracy and reliability of public company disclosures and by strengthening the independence of accounting firms auditing those disclosures. Mr. Manner first gave a definition of a management audit:

> [A] "management audit" is a broad and general term. It is often used to describe management consulting services that are used to assist in the evaluation of the performance of a company's management or operations. The precise scope of a "management audit" is generally subject to additional description or definition by the party requesting such an audit.

Mr. Manner went on to distinguish a "management audit" from a "financial statement audit" which he defined as an "evaluation or assessment of a [c]ompany's balance sheet, income statement, cash flow statement, [*27] and related notes. A financial statement audit leads to an audit report providing an opinion as to whether the financial statements of a company fairly present the financial positions and results of operations of a company in accordance with

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[2] Booz Allen Hamilton refers to itself as a "Strategy [*25] and Technology Consulting Firm" on its website.

generally accepted accounting principles. He explained that the word "audit" for purposes of Sarbanes-Oxley is defined narrowly as an "examination of the financial statements of any issuer by an independent public accounting firm . . . . " Therefore, when Sarbanes-Oxley addresses "audit" requirements and standards it applies to financial statement audits of publically traded companies and does not apply to a "management audit". In Mr. Manner's pre-filed testimony, he was asked the question "what does Sarbanes-Oxley require for a "management audit" or for any other types of non-financial statement audits?" His response to this question is key to understanding his and TAWC's position regarding the 2006 Rate Case Final Order's requirement that TAWC's management audit be compliant with Sarbanes-Oxley:

> Sarbanes-Oxley makes it clear that the independent public accounting firm that audits the AWWC [the Parent Company] financial statements, in this case [*28] PricewaterhouseCoopers ("PWC"), is prohibited from providing certain services that Sarbanes-Oxley defines as "non-audit" services" such as the management audit. This prohibition requires an independent third-party, other than AWWC's independent public accounting firm, to conduct the management audit. This requirement of independence for the management audit can be fulfilled by having another party, accounting firm or otherwise, conduct the management audit. AWWC complied with this requirement by hiring Booz Allen to conduct the management audit.
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> Otherwise,... Sarbanes-Oxley sets forth requirements for financial statement audits rather than management audits or other types of audits. This becomes obvious upon reviewing the Sarbanes-Oxley definition of "audit" that covers "an examination of the financial statements . . . for the purpose of expressing an opinion on such statements" and the definition of "non-audit services," which covers professional services "other than those provided in connection with an audit or other review of the issuer's financial statement."
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> * * * *
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> Although Sarbanes-Oxley's applicability to management audits is limited to independence as discussed above, I note [*29] that the management audit filed in this case pursuant to the TRA Order is based on financial information underlying the financial statements of AWWC that were prepared and audited in compliance with applicable Sarbanes-Oxley provisions, and was from a company that was in compliance with applicable Sarbanes-Oxley provisions.(emphasis supplied, citations omitted).

Mr. Manner stated that the TRA Final Order in the 2006 Rate Case specified that the management audit should be performed in compliance with Sarbanes-Oxley, which Mr. Majoros incorrectly interpreted as requiring a financial audit process. It was Mr. Manner's opinion that the correct interpretation of the Order is that it was a "clear request that the management audit be prepared by an independent firm." He also reiterated that "the Booz Allen management audit incorporates and is underpinned by financial information from a Sarbanes-Oxley compliant company that flows from financial statements prepared and audited [by PWC] in compliance with Sarbanes-Oxley", thus the Booz Allen report satisfied the TRA's mandate that it be compliant with Sarbanes-Oxley.

Mr. Manner did not address Mr. Majoros's primary opinion the Booz Allen Report [*30] did not address whether all costs allocated to TAWC were incurred as a result of prudent or imprudent management decisions by TAWC's parent and the reasonableness of the methodology used to allocate costs to TAWC.

The Final Order contains the following discussion of how the panel determined attrition period revenues:

> The panel adopted attrition period Revenues of $38,934,309. In doing so, the panel used a combination of the Company's, the Consumer Advocate's, and its own forecasts. The panel found neither the Company's nor the Consumer Advocate's methodology for forecasting residential and commercial average usage persuasive and instead performed its own analysis, examining average usage trends for the residential and commercial classes over the four years ended March 31, 2005, 2006, 2007 and 2008. The Authority adopted residential class attrition period revenues based on this methodology and the Company's forecasted number of bills. For commercial class, the analysis produced a result almost identical to the Company's forecast; therefore, the Authority adopted TAWC's commercial class attrition period revenue forecast.

The TRA, in addressing weather normalization adjustment (WNA) in the [*31] Final Order, noted that TAWC had inaccurately represented that the agency had previously adopted the model the Company used in forecasting

residential and commercial average usage. The Order states:

> In earlier TAWC rate case dockets, Docket Nos. 03-00118 and 04-00288, TAWC's revenues were settled. Although the parties in those dockets settled on the amounts proposed by TAWC, the settlements did not mention any agreed upon methodology for calculating those revenues. The Company's revenue forecast was adopted in Docket No. 06-00290; however, the Authority did not adopt or endorse TAWC's WNA model. In this docket, the panel did not adopt the Company's entire revenue forecast or the Company's WNA model. Nevertheless, the Authority adopted the Company's commercial class attrition period revenue in this docket because despite disagreeing with the Company's methodology, the result was reasonable.

TAWC projected Regulatory Expenses of $543,384 in its Petition. This amount included the unamortized portion of the 2006 Rate Case regulatory expenses and the estimated cost of the 2008 Rate Case. The Consumer Advocate estimated $341,868 for Regulatory Expenses for the attrition period and the CMA [*32] projected Regulatory Expenses in the amount of $287,111. The expenses incurred in this case were higher than the 2006 Rate Case due, according to TAWC, to contentious discovery and multiple pre-hearing motions and hearings. TAWC, in its brief, claims that the reasonableness of the Rate Case expenses was uncontested. This statement is not borne out by the filings and testimony of the intervenors on this issue. In fact, the intervenors argued that the attorneys' fees claimed by TAWC as part of its regulatory expense were not reasonable and should not be approved by the TRA. The TRA rejected the arguments of the intervenors, but did look at whether the expense of regulatory proceedings should be apportioned and determined that it would be appropriate for TAWC shareholders to bear a portion of the Company's rate case expense as follows:

> The panel noted that in the future the Authority should closely examine the costs associated with rate case filings to determine the portions to be recovered from rate payers and shareholders. The panel voted to allow one-half of this docket's rate case expense of $275,000 in the calculation of the Regulatory Expense. The panel voted to have one-half of [*33] the rate case expense, the cost of the service study, the cost of the depreciation study, and the unamortized balance of the previous case amortized over a three year period. Thus, the panel adopted $194,852 as the Regulatory Expense for the attrition period.

In any water system, some water is lost through leaks or waterline breaks. Also, a portion of water provided to customers is not billed, for example water used in fighting fires and used in leak detection. The lost or unbilled water is referred to as unaccounted-for water (UfW). TAWC presented testimony that its UfW for the attrition year was 19.97 % which is approximately 5% higher than the industry standard for acceptable UfW of 15%. The Consumer Advocate and CMA, through expert testimony, cross-examination of TAWC witnesses and post-hearing briefs, made the argument that the amount of TAWC's chemical and fuel and power costs incorporated in rates should be adjusted by 15% to provide incentive for the Company to maintain its water system more efficiently and prevent wasted costs for non-revenue producing treated water.

TAWC presented testimony that although all water systems have UfW, a system located in a mountainous area, such [*34] as Chattanooga, or that has older infrastructure, as does TAWC, may have more UfW than otherwise situated or newer systems. Based on these circumstances, TAWC argued that the 15% UfW industry standard should not apply to TAWC. The Company also presented evidence regarding its effort to reduce the level of UfW by introducing a non-revenue water program, increasing leak detection in the system and conducting a water audit.

There was also testimony a UfW standard of 15% has been generally accepted by at least two regulatory agencies in other states and is generally accepted in the water utility industry. In fact, Mr. Watson, the president of TAWC, admitted that the Company itself sets a 15 % UfW target for itself and that the 15% standard is a good industry average. CMA witness Michael Gorman recommended that an acceptable UfW standard should be no more than 15%. He based his recommendations on two studies relied upon by the water utility industry. The TRA determined in the Final Order that the 15% standard should apply to TAWC to encourage conservation of natural resources.

The issues presented for review are:

> A. Did the TRA err when it employed a rate-making methodology that utilized more [*35] than one test year?
>
> B. Whether the TRA's determination of management fees was arbitrary and capricious or in violation of *Tenn. Code Ann. § 65-5-103*?

1. Whether the TRA's decision to disallow recovery of the expense of a TRA ordered management audit was arbitrary and capricious?

C. Whether the TRA properly normalized revenues using a reasonable weather normalization adjustment methodology?

D. Whether the decision to reduce the recovery of rate case expense was a lawful exercise of discretion supported by material and substantial evidence?

E. Whether the TRA's decision to cap unaccounted-for water at 15% was a lawful exercise of discretion supported by material and substantial evidence?

***HN2*** This Court's review of the TRA's actions is confined to the record. *Tenn. Code Ann. §4-5-322(g)*. The standard of review to be employed by the Court is provided by *Tenn. Code Ann. §4-5-322(h)* as follows:

***HN3*** The court may affirm the decision of the agency or remand the case for further proceedings. The court may reverse or modify the decision if the rights of the petitioner have been prejudiced because the administrative findings, inferences, conclusions or decisions are:

(1) In violation of constitutional or statutory [*36] provisions;

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

(3) Made upon unlawful procedure;

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

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

(B) In determining the substantiality of evidence, the court shall take into account whatever in the record fairly detracts from its weight, but the court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact.

***HN4*** This Court's review is for the 'very limited purpose of determining whether the Commission has acted arbitrarily, or in excess of jurisdiction, or otherwise unlawfully." *CF Indus. v. Tennessee Pub. Serv. Comm'n, 599 S.W.2d 536, 540 (Tenn. 1980)*(citing *City of Whitwell v. Fowler, 208 Tenn. 80, 83, 343 S.W.2d 897, 899 (1961)*). Review is restricted to the record and the TRA's finding may not be reversed or modified unless arbitrary or capricious or characterized by an abuse, or clearly unwarranted exercise of discretion and must stand if supported by substantial and material evidence. *Id*. The Tennessee Supreme [*37] Court discussed the degree of deference the reviewing court should give to the administrative agency as follows:

> The criteria by which the [Authority] should be guided have received only generalized comments in our reported decisions. This is proper because the courts are playing a limited role in reviewing actions which essentially are legislative in character. Rate making is not a judicial function and we accord the [Authority] great deference in reviewing its decisions. On fixing rates in general the Court has spoken in terms of what is just and reasonable "under the proven circumstances," of "regard to all relevant facts" and to a rate "in the zone of reasonableness."

*C. F. Indust. at 542 (citing Southern Bell T. & T Co. v. Tennessee Public Serv. Com'n., 202 Tenn. 465, 304 S.W.2d 640 (1957))*.

Moreover, ***HN5*** this Court will not disturb a reasonable decision of an agency with expertise, experience and knowledge in the appropriate field. *S. Ry. Co. v. State Bd. of Equalization, 682 S.W.2d 196, 199 (Tenn. 1984)*(citing *Griffin v. State, 595 S.W.2d 96, 99 (Tenn. Crim. App. 1980)*). There is also a presumption that the rates so established are correct and any party who attacks the Commission's [*38] findings has the burden of proving that they are illegal or unjust and unreasonable. *CF Indus. at 540* (citing *Southern Bell T. & T. Co., 202 Tenn. 465, 304 S.W.2d 640 (1957)*). When the rates set by the agency are attacked there is a heavy burden on those who attacked them to make a convincing showing that the rates are invalid. *S. Bell Tel. & Tel. Co., 304 S.W.2d at 649*.

This Court discussed the standards of review for *Tenn. Code Ann. § 4-5-322(h)(4)* and *Tenn. Code Ann. § 4-5-322(h)(5)* in *Jackson Mobilphone Co., Inc. v. Tennessee Pub. Serv. Comm'n*, 876 S.W.2d 106, 110-11 (Tenn. Ct. App. 1993) with specificity, as follows:

> ***HN6*** The standards of review in *Tenn. Code Ann. § 4-5-322(h)(4)* and *Tenn. Code Ann. § 4-5-322(h)(5)* are narrower than the standard of review normally applicable to other civil cases. They are also related but are not synonymous.

Agency decisions not supported by substantial and material evidence are arbitrary and capricious. *CF. Indus., Inc. v. Tennessee Public Serv. Comm'n, 599 S.W.2d 536, 540 (Tenn.1980)*; *Pace v. Garbage Disposal Dist., 54 Tenn. App. 263, 390 S.W.2d 461, 463 (1965)*. However, agency decisions with adequate evidentiary support may [*39] still be arbitrary and capricious if caused by a clear error in judgment. *Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc., 419 U.S. 281, 284, 95 S. Ct. 438, 441-42, 42 L.Ed.2d 447 (1974)*; *Girard v. City of Glenn Falls, 173 A.D.2d 113, 577 N.Y.S.2d 496, 499 (1991)*; 5 Kenneth C. Davis, *Administrative Law Treatise* § 29:7, at 358 (2d ed. 1984).

A reviewing court should not apply *Tenn.Code Ann. § 4-5-322(h)(4)*'s "arbitrary and capricious" standard of review mechanically. In its broadest sense, the standard requires the court to determine whether the administrative agency has made a clear error in judgment. *American Paper Inst. v. American Elec. Power Serv. Corp., 461 U.S. 402, 413, 103 S.Ct. 1921, 1928, 76 L.Ed.2d 22 (1983)*; Citizens to *Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 416, 91 S.Ct. 814, 823-24, 28 L.Ed.2d 136 (1971)*. An arbitrary decision is one that is not based on any course of reasoning or exercise of judgment, *State ex rel. Nixon v. McCanless, 176 Tenn. 352, 354, 141 S.W.2d 885, 886 (1940)*, or one that disregards the facts or circumstances of the case without some basis that would lead a reasonable person to reach the same conclusion. *Wagner v. City of Omaha, 236 Neb. 843, 464 N.W.2d 175, 180 (1991)*; [*40] *Ramsey v. Department of Human Servs., 301 Ark. 285, 783 S.W.2d 361, 364 (1990)*.

Likewise, ***HN7*** a reviewing court should not apply *Tenn.Code Ann. § 4-5-322(h)(5)*'s "substantial and material evidence" test mechanically. Instead, the court should review the record carefully to determine whether the administrative agency's decision is supported by "such relevant evidence as a rational mind might accept to support a rational conclusion." *Clay County Manor v. State Dep't of Health & Environment, 849 S.W.2d 755, 759 (Tenn.1993)*; *Southern Ry. v. State Bd. of Equalization, 682 S.W.2d 196, 199 (Tenn. 1984)*. The court need not reweigh the evidence, *Humana of Tennessee v. Tennessee Health Facilities Comm'n, 551 S.W.2d 664, 667 (Tenn. 1977)*, and the agency's decision need not be supported by a preponderance of the evidence. *Street v. State Bd of Equalization, 812 S.W.2d 583, 585 (Tenn.App. 1990)*. The evidence will be sufficient if it furnishes a reasonably sound factual basis for the decision being reviewed. *Wayne County v. Tennessee Solid Waste Disposal Control Bd., 756 S.W.2d 274, 279 (Tenn.App. 1988)*.

*Jackson Mobilphone* at 110-111.

The substantial and material evidence standard has been described as [*41] requiring "something less than a preponderance of the evidence . . . but more than a scintilla or glimmer."" *Bd. of Prof'l Responsibility v. Allison, 284 S.W.3d 316, 322 (Tenn.2009)*(citing *Jones v. Bureau of TennCare, 94 S.W.3d 495, 501 (Tenn.Ct. App.2002)*).

***HN8*** The TRA's conclusions of law are subject to a *de novo* review without a presumption of correctness. *Tennessee Envtl. Council, Inc. v. Tennessee Water Quality Control Bd., 254 S.W.3d 396, 402 (Tenn. Ct. App. 2007)*.

A fundamental tenet of the legislative function of ratemaking requires the balancing of the utility's interest in performing its public duties and earning a reasonable return on investment. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W.Va., 262 U.S. 679, 691 - 693, 43 S. Ct. 675, 67 L. Ed. 1176 (1923)*. Rates are set for the future, and the estimated effect of all reasonably expected changes affecting the rate of return, including increases in expenses and investments, must be taken into consideration in the establishment of a rate. *Am. Asss'n. of Retired Persons v. Tenn. Pub. Sev. Comm'n., 896 S.W.2d 127, 133 (Tenn. Ct. App. 1995)*. Thus, "a rate should be reasonable not only when it is first established but also for a reasonable time [*42] thereafter." *Southern Bell Tel. & Tel., 304 S.W.2d at 647*(citing *McCardle v. Indianapolis Water Co., 272 U. S. 400, 47 S. Ct. 144, 71 L. Ed. 316 (1926)*).

***HN9*** A necessary component of utility ratemaking is the authority of TRA to "fix" just and reasonable rates, not simply to approve or deny a utility's request. This Court, in *Consumer Advocate Div. v. Bissell*, noted:

> [T]he legislature has recognized that a public utility may set its own rates, subject to the PSC's power to suspend the rates for a certain period of time while it makes the utility prove that the rates are just and reasonable. *Cumberland Tel. & Tel. Co. v. Railroad and Public Utilities Commission, 287 F. 406 (M. D.Tenn. 1921)*. If the utility fails to carry that burden, the **agency has the additional authority to fix** rates that meet the just and

> reasonable criteria. *CF Industries v. Tennessee Public Service Commission, 599 S.W.2d 536 (Tenn.1980)*.

*Bissell, No. 01-A-01-9601-BC00049, 1996 Tenn. App. LEXIS 528, 1996 WL 482970 at * 2 (Tenn. Ct. App. Aug. 28, 1996)*(emphasis added).

In ratemaking proceedings, the burden of showing the proposed rates are just and reasonable rests with the utility seeking the change in rates. (*Tenn. Code Ann. § 65-5-103(a)*.

TAWC argues that TRA's use of multiple [*43] test years was an arbitrary change of its policy unsupported by substantial and material evidence. In support of this argument it cites *United Cities Gas Co. v. Tennessee Public Serv. Com'n, 789 S.W.2d 256 (Tenn. 1990)*. That case, however, held that "the administrative body is and must be free to change its mind and, if there is substantial and material evidence to justify the change, the courts have no reason to overturn the new holding. *Id. at 259* (citing *Public Service Commission v. General Telephone Company, etc., 555 S.W.2d 395 (Tenn.1977)*).

TAWC and TRA both set out the rate making methodology employed by the TRA in their briefs. TAWC, relying in part on the testimony of the Consumer Advocate's witness, Terry Buckner, explained that in rate cases, TRA uses a standard methodology to determine if the rates proposed by a utility are just and reasonable. The utility selects a historical "test period" which is usually a recently completed twelve month period. Detailed information regarding the utility's revenues, expenses, rate base and cost of capital for the selected test year is then analyzed. Based on the data from the selected test period, a forecast of revenues, expenses, rate [*44] base, and cost of capital is created for the "attrition period" or "attrition year", usually a twelve month period commencing approximately at the anticipated conclusion of the rate case. The attrition period is to be representative of the period of any rate adjustment and is also viewed as the first year during which the TRA's rate order will be applied. Mr. Buckner explained that the selection of the test year is quite important:

> The selection of the timing of the test year may be the most significant single factor in the rate-making process. The more outdated the test year levels operations, the more critical is the need for significant restatement to produce representative levels of future conditions.

Mr. Buckner went on to explain that in the 2008 Rate Case TAWC used a test year that ended November 2007 and an attrition year ending August 2009, whereas the Consumer Advocate used a test year ending March 2008 and its attrition year ending August 2009. He explained that the Consumer Advocate used the later test year "[i]n an effort to eliminate outdated financial information and to shorten the forecast window . . . . " (*Id.* at 0647).

The TRA stated in the Final Order that it is "not [*45] limited to adopting one test period for use throughout the case" and that both TAWC's and the Consumer Advocate's tendered test periods were acceptable and that it voted to use "the test period which best fits the individual items being forecasted." In addition, the TRA performed its own analysis for revenues and examined average usage trends over the four years ended March 2005, 2006, 2007 and 2008. The TRA then used this resulting revenue forecast to determine chemical and fuel expenses and it decided not to use a test period analysis when calculating management fees. TAWC contends that TRA's use of multiple test years in the 2008 Rate Case was a departure from its prior policy and that TRA had "expressly rejected the use of multiple test years in the 2006 Rate Case. TAWC claims that in the 2006 Rate Case, TRA stated that it rejected the multiple test periods utilized by Consumer Advocate and accepted TAWC's uniform test period. However, TAWC's contention that TRA rejected the use of multiple test periods is not born out by the June 10, 2008 Order in the 2006 Rate Case. That Order states as follows:

> The Company selected a historical test period of the twelve months ended June 30, [*46] 2006 and an attrition period of the twelve months ending February 29, 2008....
>
> The CAPD used a test period of the twelve months ended December 31, 2006 for Revenues. The CAPD used a test period of the twelve months ended October 31, 2006 for the majority of Operations and Maintenance Expenses. For labor related expenses, the CAPD adopted the Company's actual employee level as of January 31, 2007. The CAPD forecast the Plant in Service and Accumulated Depreciation was based on actual balances at December 31, 2006 plus monthly additions and retirements as provided by the Company. The attendant depreciation expense was calculated upon resulting balances
>
> The panel rejected the multiple test periods utilized by CAPD to forecast Revenues and Expenses and accepted the Company's uniform test period of the twelve months ended June 30, 2006 for Revenues and Expenses, except in the instance of Insurance

> Other Than Group where abnormal monthly bookings were noted. Further, the panel voted to accept the test period of the twelve months ended June 30, 2006 for Revenues and Expenses, except in the instance of Insurance Other Than Group where abnormal bookings were noted. Further the panel voted to [*47] accept the test period of the twelve months ended June 30, 2006 for Rate Base components to which the Company and the CAPD agree in their projections. For Rate Base components to which there was dispute among the Parties, the panel adopted the actual average thirteen month ending at December 31, 2006....

(Final Order, TRA Docket No. 06-00290, June 10, 2006, pp. 19 - 20 (2006 Rate Case)).

The foregoing excerpt from the Final Order from the 2006 Rate Case shows that while TRA did not accept the specific multiple test periods advocated by CAPD for various factions of the rate case, it did not reject the use of multiple test periods when it found them appropriate. In fact, TRA specifically rejected TAWC's test period of the twelve months ending on June 30, 2006 for the Rate Base components that were in dispute among the parties, and instead, applied a test period ending December 31, 2006. *Id.*

Accordingly, TAWC's contention that TRA's use of multiple test periods in the 2008 Rate Case was an arbitrary change of policy that is unsupported by the substantial and material evidence fails, as the Final Order from the 2006 Rate Case clearly shows that TRA utilized more than one test year in that [*48] case. [3]

We note that the TRA's discretion with regard to setting rates and the manner in which the agency utilizes test periods is settled law. ***HN10*** The TRA has the discretion to utilize an historical test period, a forecast period, a combination of these where necessary, or any other accepted method of rate making necessary to give a fair rate of return. *Powell Tel. Co. v. Tennessee Pub. Serv. Comm'n, 660 S.W.2d 44, 46 (Tenn. 1983)*; *Am. Ass'n of Retired Persons v. Tennessee Pub. Serv. Comm'n, 896 S.W.2d 127, 133 (Tenn. Ct. App. 1994)*. The Supreme Court in *Powell* noted that "there is no statutory nor decisional law that specifies any particular approach that must be followed by the Commission. Fundamentally, the establishment of just and reasonable rates is a value judgment to be made by the Commission in the exercise of [*49] its sound regulatory judgment and discretion." *Powell at 46* (citing *CF Industries., 599 S.W.2d at 542*.

Accordingly, neither the courts nor the legislature has established any precise method or formula in setting rates, and the TRA is not bound by any particular approach. *CF Industries, 599 S.W.2d at 543*. As the TRA noted in the Final Order of the 2008 Rate Case, it is not limited to adopting one specific test period in order to make known and measurable adjustments to produce just and reasonable rates. There is simply no requirement that the TRA utilize the specific test period proposed by a public utility.

TAWC contends that the TRA's Final Order in the 2008 Rate case regarding management fees was arbitrary and capricious and violated *Tenn Code Ann. § 65-5-103* as it was not supported by substantial and material evidence, did not allow recovery for reasonably expected expenses and was based on the TRA's disregard of overwhelming undisputed evidence. TAWC also contends that the TRA was in error when it rejected TAWC's projected attrition year management fees of $4,335,190 and, instead, set the management fees for the attrition year at $3,529,933. TAWC finds fault with the TRA's setting [*50] of management fees based on the amount TAWC forecasted for 2005 in a 2004 Rate Case, which TRA then adjusted upward for inflation and customer growth.

While TAWC contends that its request for management fees of $4,335,190 was supported by "overwhelming undisputed evidence" this is not supported by the record. The record shows that the City and Consumer Advocate presented a vast amount of substantial and material evidence that not only contradicted the evidence put forth by TAWC but supported the final decision made by the TRA. The issue of the management fees requested by TAWC and the Booz Allen Report are inextricably intertwined in the reasoning and Final Order of the TRA in this case. The City and the Consumer Advocate produced extensive evidence regarding the deficiencies of the Booz Allen Report, some of which are detailed heretofore. The TRA was obviously persuaded by this evidence as it concluded in the Final Order that the Booz Allen Report did not adequately address the prudency of the charges imposed on TAWC by the Service Company.

The record in this case demonstrates that the TRA did not act arbitrarily in limiting the amount of management fees

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[3] The City of Chattanooga appealed the decision of the TRA in the 2006 Rate Case. TAWC, as appellee, did not raise the issue of whether TRA's use of more than one test period in the 2006 Rate Case was an arbitrary derivation from standing TRA policy. *See City of Chattanooga v. Tennessee Regulatory Auth.*, M2008-01733-COA-R12-CV, 2010 Tenn. App. LEXIS 459, 2010 WL 2867128 (Tenn. Ct. App. July 21, 2010).

for TAWC. ***HN11*** In its broadest sense, [*51] the arbitrary and capricious standard requires this Court to determine whether the administrative agency has made a clear error in judgment or a decision not based on any course of reasoning or exercise in judgment. *Jackson Mobilphone*, 876 S.W.2d at 110-11. The TRA's decision to reject the Booz Allen Report and other evidence submitted by TAWC to substantiate its projected management fees is supported by material and substantial evidence submitted by the intervenors that a "rational mind might accept to support a rational conclusion". Thus, TAWC did not meet its "heavy" burden of proof that it was entitled to recover $4,335,190 for management fees. Accordingly, we affirm the TRA's decision to award a lessor amount for management fees than requested by TAWC, which was an appropriate exercise of the agency's discretion.

TAWC also appeals the TRA's finding that Booz Allen did not conduct an independent audit as required by the Final Order in the 2006 Rate Case. The TRA found that Mr. Van den Berg, who sponsored the Booz Allen Report, was not independent of TAWC because he had testified on behalf of the Company before the TRA and in other states as an expert witness on behalf of the Parent [*52] Company. TAWC contends that the independence imposed by TRA in its Final Order in the 2008 Rate Case was never required in the Final Order in the 2006 Rate Case. This argument is contrary to the testimony of two of TAWC's own witnesses. The Final Order in the 2006 Rate Case mandated that the management audit be in compliance with Sarbanes-Oxley requirements. Mr. Van den Berg and Mr. Manner testified that the only requirement contained in Sarbanes-Oxley that pertains to a management audit or a non-financial audit was that the audit be conducted by an independent firm. As the Final Order in the 2006 Rate Case required compliance with Sarbanes-Oxley and Sarbanes-Oxley requires a nonfinancial auditor to be independent of the company being audited, the Final Order mandated independence. We find this argument without merit.

There is, however, a valid question as to whether the TRA's finding that Booz Allen was not independent of TAWC was correct. Mr. Manner and Mr. Van den Berg, testifying on behalf of TAWC, both stated that the independence requirement in Sarbanes-Oxley as to non-financial statement audits means that such an audit could not be conducted by the financial auditors who conducted [*53] financial audits for a company. They both interpreted this provision to mean only that PricewaterhouseCoopers, the financial auditors for TAWC, could not have conducted the management audit of TAWC under the independence requirement of Sarbanes-Oxley. Thus, TAWC takes the position that if independence had been required by the Final Order, then Booz Allen was an independent auditor as it was never TAWC's financial auditor. The TRA and the other appellees contend that because Mr. Van den Berg had acted as an expert witness for TAWC and its Parent Company in other matters, he was an advocate for the company and could not be independent. The TRA also points to the testimony of Mr. Van den Berg that he submitted a draft of the Booz Allen Report to TAWC to review and make corrections before he put it in final form as proof that he did not conduct an independent audit. In fact, Mr. Van den Berg stated that TAWC did make some changes to the facts presented in the draft report but made no modification of the analysis. However, we have already affirmed the TRA's rejection of TAWC's requested management fees on another basis, i.e., that TAWC did not meet its burden of proof to show that the charges [*54] it requested were prudent.

TAWC also appeals the TRA's setting the projected management fees for the attrition year at $3,529,933 based on the management fees forecasted for 2005 with an upward adjustment for inflation and customer growth. This methodology was advanced by the Consumer Advocate and accepted by the TRA only after the agency determined that the Booz Allen Report and the other evidence presented by TAWC was insufficient to meet TAWC's burden of proof as to the prudency of the Service Company's charges to TAWC.

This issue was addressed by the TRA panel at the hearing. Director Roberson stated that he had no doubt that the Service Company had incurred legitimate expenses, but he could not determine whether the amount of management fees requested by the Company was "a just and reasonable amount based on prudent expenditures" from the Booz Allen Report. He then recommended adopting the methodology advanced by the Consumer Advocate as a way to include management fees in the rate. Director Roberson made it clear that once TAWC had a properly prepared comprehensive management audit done, the TRA would revisit the matter of management fees if the audit showed that the management [*55] fees requested were prudent. Accordingly, the Final Order left the 2008 Rate Case open so that TAWC could have the opportunity to obtain a properly conducted management audit in compliance with the Order and submit it to the TRA for consideration. This audit was to be filed within six months of September 22, 2008. Until such time as a management audit was submitted to the TRA, the agency, in recognition that TAWC had incurred some management fees, set the management fees at

$3,529,933. [4]

TAWC objects to the TRA utilizing the methodology proposed by the Consumer Advocate on the basis that the agency had rejected the same methodology, which had also been proposed by the Consumer Advocate, in the 2006 Rate Case. TAWC contends that the TRA's use of this methodology was not supported by the record, failed to give substantial weight to the TRA's 2006 Order and was made without good cause and prior notice to the parties. TAWC maintains that the 2005 forecast made in 2004 Rate Case is not material and there is substantial [*56] evidence to support such a decision on management fees in the 2008 Rate Case.

Based on the Authority's finding as to the inadequacy of the Booz Allen Report, there was no substantive evidence before the TRA to support the reasonableness, necessity and prudence of the increase in management fees sought by TAWC. The transcript of the panel's deliberations makes clear that the members accepted that some management fees had been incurred by TAWC. Left with such an evidentiary vacuum, caused by TAWC, the agency used its discretion and arrived at its own value judgment based on its findings in the 2004 Rate Case. The management fees set by the TRA were to be revisited within six months upon a filing of an appropriate management audit by TAWC. The setting of just and reasonable rates is a value judgment to be made by the TRA in the exercise of its sound regulatory judgment and discretion. *CF Indus. 599 S.W.2d at 542*. The TRA recognized the need to set management fees but found that it was provided with inadequate proof as to the prudence of the fees requested by TAWC. Using the fees from 2005 was a reasonable, temporary solution to the dilemma until TAWC could submit a proper management audit. [*57] As noted, ***HN12*** the arbitrary and capricious standard requires this Court to determine whether the administrative agency has made a clear error in judgment or a decision not based on any course of reasoning or exercise in judgement. *Jackson Mobilphone*, 876 S.W.2d at 110-11. We hold this action was not arbitrary and capricious and the use of the 2005 management fees, under the circumstances, was not error.

TAWC argues that the TRA erred when it disallowed TAWC's request to recover $285,000 it paid for the preparation of the Booz Allen Report. To support this position, TAWC makes the same argument it made regarding its argument that the TRA erred when it did not accept the findings of the Booz Allen Report. The TRA panel concluded that the Booz Allen Report did not comply with the Final Order in the 2006 Rate Case because it did not adequately address the prudency of the management fee and because Mr. Van den Berg, the sponsor of the Report, was not independent as required by Sarbanes-Oxley. Based on this finding, the TRA declined to include the cost of the Report in the requested rate. As noted, we find that there was substantial and material evidence in the record to support the TRA's finding [*58] that the Booz Allen Report was inadequate because it did not sufficiently address whether the costs allocated to TAWC were incurred as a result of prudent management decisions. We hold the TRA did not abuse its discretion when it declined to accept the management fees requested by TAWC. We also find that as the Booz Allen Report could not be used by the TRA to determine whether the requested fees were prudent and necessary, the rate payers should not be required to pay for the cost of the Report. The TRA's disallowance of the cost of the report is affirmed.

TAWC claims, that in calculating revenues, the TRA departed from its long-standing practice by rejecting the use of a weather normalization adjustment (WNA) methodology based on data collected over an extended number of years without substantial and material evidence to justify the change. The Consumer Advocate, in its brief, explained "normalization" in the rate-making context: "In setting just and reasonable rates, it is standard practice to attempt to "normalize" or adjust projections of revenues and expenses for a variety of know and measurable changes. If such adjustments are not made, revenues and expenses may dramatically [*59] exceed or drastically fall short of expectations with a variety of consequences for consumers and TAWC." The revenues of a water utility can be effected by the amount of precipitation experienced in the utility's area. A drought may cause consumers to use more water for watering their lawns and a period of excessive rain may cause the consumers to use less water. In rate-making the forecasting of revenues is an essential element in the process. If revenues are projected to be lower in the future and expenses are expected to rise, the revenue requirement, and thus the rates, will be higher. Therefore, if water usage per customer is predicted to decrease, rates will need to be higher to cover expenses. Here, TAWC's proposed WNA methodology projected a reduction in revenue of approximately $1.3 million dollars.

As part of the 2008 Rate Case, TAWC introduced testimony from its expert witness, Dr. Edward Spitznagle, a professor

[4] The record does not establish whether a management audit was submitted within the six month period or, if one was presented to the TRA, or whether the management fees were adjusted.

of mathematics and statistics. Dr. Spitznagle explained that he tested several models for weather normalization and concluded that soil moisture was the most accurate predictor of future water consumption. Dr. Spitznagle employed a set of soil moisture data that was [*60] complied over the past thirty years to normalize the forecast and is set out in the Palmer Drought Severity Index (PDSI). The Company's projected attrition period Revenues was $37,142,460. The Consumer Advocate forecasted revenue for the attrition period at a higher level, $39,492,768 and made no normalizing adjustments. The TRA panel adopted attrition period revenues of $38,934,309 by using a combination of the Company's, the Consumer Advocate's, and its own forecast. In its Final Order, the TRA explained that it "found neither the Company's nor the Consumer Advocate's methodology for forecasting residential and commercial average usage persuasive and instead performed its own analysis, examining average usage trends for the residential and commercial classes over the four years ended March 31, 2005, 2006, 2007 and 2008." The TRA explained that it adopted residential class attrition period revenues based on this methodology and the Company's forecasted number of bills. For the commercial class, the TRA's analysis produced almost the identical result the TAWC had arrived at, thus it adopted the TAWC's commercial class attrition period forecasted revenue.

TAWC claims that TRA had consistently [*61] approved the use of weather normalization for forecasting revenue in prior rate cases. The TRA, however, rejected this claim explicitly in the Final Order when it stated:

> As to the weather normalization adjustment ("WNA"), the Company made representations that the model it used in forecasting residential and commercial average usage had be previously adopted by the Authority. Not withstanding an occasional concurrence by Intervenor witnesses, this assertion is incorrect. In earlier TAWC rate case dockets, Docket Nos. 03-00118 and 04-00288, TAWC's revenues were settled. Although the parties in those dockets settled on the amounts proposed by TAWC, the settlements did not mention any agreed upon methodology for calculating those revenues. The Company's revenue forecast was adopted in Docket No. 06-00290; however, the Authority did not adopt or endorse TAWC's WNA model. In this docket, the panel did not adopt the Company's entire revenue forecast or the Company's WNA model. Nevertheless, the Authority adopted the Company's commercial class attrition period revenue in this docket because despite disagreeing with the Company's methodology, the result was reasonable.

TAWC responds to the TRA's [*62] denial in the Final Order that it had "adopted" WNA methodology by stating that the TRA's incorporation of TAWC's WNAs into the orders approving settlement in Docket Nos. 03-00118 and 04-00288 and express adoption of TAWC's revenue adjustments in the 2006 Rate Case [Docket No. 06-00290] undermines the TRA's denial that it had adopted the WNA methodology. TAWC argues that "it is clear that the TRA has in practice routinely accepted and reinforced the use of WNA methodology in attrition year revenue projections, and the TRA's rejection of the WNA methodology in the instant matter departs from this precedent." TAWC goes on to claim, without citation to statute or case law, that under Tennessee law, the TRA may not alter its long-standing policy of using WNA for revenue projections unless there is substantial and material evidence supporting and justifying the decision. TAWC claims that the TRA did not make its decision to reject the methodology supported by TAWC based on substantial and material evidence and did not explain why it rejected the methodology. Tennessee law, however, does not provide that the TRA is bound to follow rate-making methodology it has employed in the past. The [*63] Tennessee Supreme Court discussed in detail the process of rate-making in *CF Indus. v. Tennessee Pub. Serv. Comm'n, 599 S.W.2d 536 (Tenn. 1980)* and explained why the TRA's predecessor, the Tennessee Public Service Commission, was not bound by any one rate-making methodology as follows:

> The criteria by which the Commission should be guided have received only generalized comments in our reported decisions. This is proper because the ***HN13*** courts are playing a limited role in reviewing actions which essentially are legislative in character. Rate making is not a judicial function and we accord the Commission great deference in reviewing its decisions. On fixing rates in general the Court has spoken in terms of what is just and reasonable "under the proven circumstances," of "regard to all relevant facts" and to a rate "in the zone of reasonableness." *Southern Bell Telephone & Telegraph Co. v. Tennessee Public Service Com'n., 202 Tenn. 465, 304 S.W.2d 640(1957)*.
>
> The Uniform Administrative Procedures Act authorizes the agency to take notice of "generally recognized technical and scientific facts within the agency's specialized knowledge," and in the evaluation of evidence the agency is specifically

[*64] authorized to utilize its "experience, technical competence, and specialized knowledge." Section 4-5-1097, T.C.A.

Thus, ***HN14*** the Public Service Commission in rate making and design cases is not solely governed by the proof although, of course, there must be an adequate evidentiary predicate. **The Commission, however, is not hamstrung by the naked record. It may consider all relevant circumstances shown by the record, all recognized technical and scientific facts pertinent to the issue under consideration and may superimpose upon the entire transaction its own expertise, technical competence and specialized knowledge. Thus focusing upon the issues, the Commission decides that which is just and reasonable. This is the litmus test nothing more, nothing less.**

In *United Inter-Mountain Telephone Co. v. Public Service Com'n*, 555 S.W.2d 389 (Tenn. 1977), this Court noted that ***HN15*** "(t)he impact of the Administrative Procedures Act on the review of the decisions made by state boards, commissions and agencies, including the Public Service Commission, is massive " (emphasis supplied), and pointed out that "(i)t casts upon the Commission the heavy burden of a sound, reasoned, and judicious approach in the [*65] exercise of its jurisdiction." *555 S.W.2d at 392*.

> We reiterate that neither the legislature nor the courts have established any precise formula or yardstick to guide the Commission. As pointed out by the Georgia Supreme Court in *Allied Chemical Corp. v. Georgia Power Co., 236 Ga. 548, 224 S.E.2d 396 (Ga. 1976)*: The process of setting rates is not required to follow any particular course, so long as the end result does not violate the "just and reasonable requirement" requirement . . . . *224 S.E.2d at 399*.

*The Oklahoma Supreme Court, in Application of Arkansas Louisiana Gas Co., 1976 OK 192, 558 P.2d 376 (Okl.1976)*, pointed out:

> Commission is not bound by a single formula or a combination of formulas in fixing rates and none is exclusive or more favored than the others, (citation omitted) There is no precise statutory or court announced basis for determining the justness or reasonableness of class rate level structures or relationships, the Court generally holding that rate making is the responsibility of a regulatory commission effectively exercising its discretion upon sufficient evidence before it. *558 P.2d at 379*.

Finally, we adopt the concise and correct conclusions of the *Minnesota Supreme Court in St. Paul Area Chamber of Commerce v. Minnesota Public Service Com'n., 312 Minn. 250, 251 N.W.2d 350 (1977)*:

> ***HN16*** (W)e [*66] must presume that the members of the commission itself, with their supporting staff, have in their grasp practical knowledge in the field of utilities regulation not possessed by either the courts or laymen in general.
>
> The commission, in order to carry out its mandate from the legislature to establish "just and reasonable" rates, must be able to draw on its own internal sources of knowledge and experience. As with the legislature itself, we assume that it does so in each instance and that we ought not to interfere unless it should clearly exceed its statutory powers. *251 N.W.2d at 354*.

We cannot say on this record that the Commission exceeded its regulatory judgment and discretion in acting without a cost of service study in a rate design case. The imposition of this requirement would be an unwarranted intrusion into the rate making process.

*CF Indus., 599 S.W.2d. at 542-43*(emphasis added); *see also Powell Tel Co., 660 S.W.2d at 46*.

Based on the Supreme Court's pronouncements in *CF Industries*, ***HN17*** the TRA is not required to follow a particular methodology it has used in the past as long as the methodology it chooses allows it to arrive a determination of a rate that is just and reasonable. Moreover, [*67] the TRA is not limited to considering just what is in the record as it may consider, in addition to the proof, "recognized technical and scientific facts pertinent to the issue" and may "superimpose . . . its own expertise, technical competence and specialized knowledge."

TAWC's contention that the TRA must use WNA as part of its revenue projection methodology is without merit. The TRA is only required to use its regulatory judgment and exercise its discretion to decide what is a just and reasonable rate.

The TRA's rejection of TAWC's proposed use of WNA calculations is amply supported by material and substantial evidence in the record. The consistency and end result of the

proposed WNA was challenged by the intervenors, particularly the Consumer Advocate. Terry Buckner, testifying for the Consumer Advocate, explained that in the 2006 Rate Case, the impact of Dr. Spitznagle's WNA was a $221,000 downward adjustment to the projected revenue for the attrition year. This projection, when examined in retrospect, was incorrect as TAWC's revenues after the 2006 Rate Case actually increased. Mr. Buckner went on to explain that notwithstanding this result, a year later, Dr. Spitznagle's WNA revenue [*68] adjustment jumped downward again from $221,000 to $1.36 million in the 2008 Rate Case.

According to Mr. Buckner, after little more than updating the model to include a slightly different 30 year picture of PDSI data, the WNA's calculation resulted in a rate adjustment six times greater than the adjustment proposed in the 2006 Rate Case. *Id.*

The Consumer Advocate's witness also stated that the final result of the WNA model relied on by Dr. Spitznagle produced a result that defied common sense. His model calculated that residential consumers will use 141 gallons of water per day. Based on the WNA model's projections, TAWC would sell less water to residential customers than it did in 2004 when customers were estimated to use 146 gallons of water a day. According to PDSI data in the record, 2004 was the fourth wettest year in Chattanooga out of 113 years. Thus, the WNA model relied on by TAWC projected that the Company would sell less water under "normal weather conditions" than it did during one of the wettest years on record. The Consumer Advocate concluded that given that 2004 was an exceedingly wet year and that the record shows that TAWC was delivering water to 3,000 more residential [*69] customers in 2008 than it did in 2004, "the end result of Dr. Spitzenagel's WNA mode defies economic reality" and is not reasonable and credible.

Dr. Spitzenagel testified that while his WNA models had been used in three rate cases before the TRA filed since 2003, he had only reviewed the accuracy of these WNA forecasts by comparing them to the actual revenue for one of those years. A retrospective comparison of the models' results with the real revenues would have been a simple exercise to demonstrate the accuracy or inaccuracy of the Company's WNA forecasts. The record also shows that TAWC relied on Dr. Spitznagle's analysis that showed a marked decline in water usage over the past thirty years. However, the intervenors showed that, in fact, water usage over ten-year, five-year and three-year average periods show the decline in usage has ended.

Evidence was introduced at the hearing that called into question the value of the PDSI, the drought index employed by Dr. Spitznagle to calculate the WNA. In a publication by the National Academy of Sciences, the water regression analysis used by Dr. Spitznagle was addressed and the limitations of the use of the PDSI was noted with references [*70] to specific academic criticism of the PDSI. This publication was introduced into evidence and after the hearing, the TRA formally took administrative notice of the publication. There was further evidence in the record that the use of the PDSI for normalizing water usage by public utilities is not widespread.

When the TRA rejected the weather normalization methodology sponsored by TAWC, its decision was clearly supported by substantial and material evidence in the record. As explained in the Final Order, after considering the testimony of the expert witnesses presented by the parties, the TRA exercised its discretion and utilized its own experience, knowledge and expertise in its determination of the weather normalization adjustment to project revenues. The TRA conducted its own analysis based an examination of average usage trends for the residential and commercial classes over a four-year period. The years used in this analysis, 2005 - 2008, included periods of drought and high amounts of rainfall. The TRA's use of an average of usage trends over the four year period took into account the impact of weather as well as other impacting factors is accounted for and built into the consumer [*71] usage utilized in the analysis. The TRA took the results of this methodology and adopted normalized revenues for the residential customers that was independent of the forecasts proposed by both the Company and the Consumer Advocate. *Id.* The results arrived at by the TRA for the commercial customers was almost identical to that proposed by TAWC, thus the TRA adopted the Company's forecast for that class of consumers. *Id.* There was evidence to show that the methodology used by the TRA based on years of actual consumer usage is a common method of normalizing revenues for water utilities. Based on the foregoing, the methodology utilized by the TRA was a common and accepted practice, based on material and substantial evidence and was within the TRA's sound regulatory judgment.

TAWC contends that the TRA's decision to reduce the Company's recovery of Rate Case Expenses was an unlawful exercise of discretion and unsupported by material and substantial evidence. The Company argues that the award of $275,000, only half of its projected expenses, should be reversed because: (1) the decision represents a change in policy without substantial and material evidence to support the change; (2) the [*72] decision disregards the facts and circumstances of the case without providing any rationale or explanation that might lead a reasonable person to draw the

same conclusion; and (3) the decision violates *Tenn. Code Ann. § 65-5-103*'s "just and reasonable" standard by failing to take into consideration the estimated effect of reasonably expected expenses".

In support of its contention that the TRA departed from its usual policy and custom of allowing utilities recovery of rate case expenses, the Company cites to the following three cases where such an award was made. In the 2006 Rate Case, In *In re Aqua Utilities Co.*, and *In re Chattanooga Gas Co.*

TAWC contends that by disallowing one half of the Company's proposed rate case expenses, the TRA "made and abrupt and unexpected change in the sound policy of allowing full recovery of rate case expenses without any explanation or substantial and material evidentiary support for the change." TAWC further argues that the change in "policy" was particularly inappropriate because the TRA concluded that a rate increase was needed, although the approved increase was less than the Company had requested.

TAWC states that the expense of the rate case was [*73] reasonable, necessary and conservative given how highly contentious and heavily litigated the 2008 Rate Case was. We acknowledge that extensive discovery, multiple motions and multiple hearings occurred in the pre-hearing phase of the 2008 Rate Case. At the hearing itself multiple witnesses filed prepared testimony and testified before the panel. The record on appeal consists of sixty-two volumes and 9319 pages, the hearing transcript is contained in twenty-two volumes and is 2240 pages. We recognize and accept that this work was generated at considerable expense.

TAWC states that no substantial and material evidence was offered that the rate expenses sought were unreasonable and that the evidence offered by TAWC regarding the reasonableness of the expenses was not contradicted by any party. The Company cites the Consumer Advocate's witness, Mr. Buckner, as testifying that the number of issues being contested and the complexity of those issues necessarily increases the costs of rate cases.

On appeal, the TRA does not dispute that reasonable and properly incurred expenses associated with a rate case should be recoverable by a utility. In support of this concept, the TRA cites to *W. Ohio Gas Co. v. Pub. Utilities Comm'n of Ohio, 294 U.S. 63, 68, 55 S. Ct. 316, 319, 79 L. Ed. 761 (1935)* [*74] wherein the United States Supreme Court held that a public utility cannot include negligent or wasteful losses among its operating charges in a rate proceeding and only property and necessary expenses should be recovered. The TRA acknowledges that it is through the rates approved by the TRA and paid by the utility's customers that TAWC recovers all of its necessary operating expenses. However, TRA takes the position that the ability of a utility to recover its expenses is not "absolute nor immutable" and it is "neither arbitrary or capricious when, in the exercise of its judgment and discretion, the Authority disallows recovery of expenses that it deems unnecessary, improvident, or improper."

The TRA goes on to justify its decision to allow only one-half of the rate case expenses proposed by TAWC and leave the remaining half to be paid by the Company's shareholders by providing details of the costs of the "four labor-intensive utility cases [filed] in the five years spanning 2003 through 2008". According to the agency, the total requested rate case expenses associated with those four cases was $1,325 million although the actual expenses were estimated to be in excess of $1 million each [*75] for the 2006 and 2008 rate cases. The TRA, in its brief expresses its growing concern that TAWC has developed a distinct pattern of filing "increasingly frequent and progressively more costly rate cases . . . in rapid succession . . . . " The TRA states in its brief, "particularly in light of its poor history of substantiating the requests [for regulatory expenses] that it makes, demonstrating little restraint, the Company's expectation of passing on larger and larger rates case expenses year over year to its ratepayers, is inexplicable and untenable."

The TRA makes clear in its appellate brief that it disapproves of the TAWC's trend of filing frequent, increasingly expensive and litigious rate cases and even went as far as to contend that "in light of the Company's history and pattern of filing unsubstantiated rate cases, particularly evident in this case, the inordinate costs involved here are unreasonable. However, the record and Final Order are devoid of the foregoing accusations made by the TRA about TAWC. The record and Final Order do not explain what specific expenses the TRA deemed unnecessary, improvident, or improper or that the Authority closely examined the costs associated [*76] with the rate case to determine the portion to be recovered from rate payers and the portion to be born by the shareholders. Such an examination should have taken place and its results included in the record and Final Order. Based on the lack of such findings, the TRA's decision to only include one half of the cost of the rate case in the rate was arbitrary. Accordingly, we reverse the Commission of the TRA on this issue and award TAWC the full amount of its proposed rate case expenses.

Finally, the TAWC contends that the TRA'S decision to cap UfW at 15% was an abuse of discretion and unsupported by

material and substantial evidence. The Company takes the position that the TRA has historically taken into consideration all of TAWC's costs for fuel, power, and chemicals in determining TAWC's forecasted expenses. The Company explained that these costs directly relate to the treatment and pumping of all water in the distribution system whether it is water delivered and billed to customers or UfW. The Company states on appeal that TRA "has historically allowed TAWC to recoup the mil costs of treating and providing all of its water regardless of the volume of UfW in the system." TAWC claims [*77] that TRA "broke" from this historical policy in its final order when it capped the percentage of UfW it could include in the forecast for fuel, power and chemical costs to 15%. The Final Order states that "[r]ecognizing the importance of conserving water, which is one of the state's most valuable natural resources, the panel established a baseline efficiency standard. Based on the evidence presented, the panel limited the unaccounted-for-water percentage to fifteen percent." TAWC contends that the TRA could not have based this decision on the evidence as it clearly showed that TAWC's attrition year UfW would be 19.97% and that this level is reasonable based on the age of the water system and its geographical location in a mountainous area.

First, as to the historical precedent argument made by TAWC, while the TRA may not have ever set a 15% standard for UfW in a rate case brought by TAWC, it has recently imposed such a standard in other rate cases involving other TRA regulated water utilities. The Authority points to the 2006 rate case *In re Aqua Utilities Co.*, TRA Docket No. 06- 00187. In that case, while establishing a standard UfW percentage for ratemaking purposes, the panel said:

> Generally, [*78] the Authority finds a ten percent (10%) unaccounted-for-water level, as recommended by the American Water Works Association, is the proper percentage for purposes of setting rates, *absent good cause shown.* (Emphasis provided).

The TRA found that Aqua Utilities had shown good cause to increase the standard UfW percentage in that case to 15%. TRA claims that its decision in *Aqua* "pioneered" the Authority's policy concerning UfW and the reasonableness of utilizing a 15 % UfW standard was likewise included in a later settlement agreement between the parties in a rate case filed by Hickory Star Water Co., and approved by the TRA on December 30, 2008. [5]

The record demonstrates there was material and substantial evidence presented to the TRA regarding the use of the 15% standard. The president of TAWC, Mr. Martin, agreed that the 15% standard is used internally [*79] at TAWC and that it is a "good industry average." The TRA's use of the 15% UfW standard was based on material and substantial evidence and was not arbitrary. We affirm the TRA's order as to UfW.

In conclusion, we affirm the ruling of the TRA's except for its ruling excluding one-half of the expenses TAWC sought to recover as rate case expenses.

In our discretion we assess 80% of the costs of the appeal to Tennessee American Water Company, and 20% of the expenses on appeal to the Tennessee Regulatory Authority.

/s/ Herschel Pickens Franks

HERSCHEL PICKENS FRANKS, P.J.

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[5] *See In re Aqua Utilities Co.*, TRA Docket No. 06-00187, *Final Order*, 2007 WL 4812199 at *5 (Tenn. Reg. Auth. Nov. 27, 2007); *In re Petition of Hickory Star Water Co. LLC for Approval of Adjustment of its Rates and Charges*, TRA Docket No. 08-00051, *Order Approving Settlement Agreement*, Ex. A, Proposed Settlement Agreement (Dec. 30, 2008).

# *Consumer Advocate Div. v. State Regulatory Auth. & Bellsouth Telcoms*

Court of Appeals of Tennessee, Middle Section, at Nashville

May 30, 2001, Filed

No. M1999-01170-COA-R12-CV

**Reporter**
2001 Tenn. App. LEXIS 387; 2001 WL 575570

CONSUMER ADVOCATE DIVISION, ON BEHALF OF TENNESSEE CONSUMERS v. TENNESSEE REGULATORY AUTHORITY AND BELLSOUTH TELECOMMUNICATIONS, INC.

**Prior History:** [*1] An Appeal from the Tennessee Regulatory Authority. No. 99-00391. Sara Kyle, Director.

**Disposition:** Tenn. R. App. P. 12 Petition for Review from the Tennessee Regulatory Authority; Judgment of the Tennessee Regulatory Authority is Affirmed.

## Core Terms

Consumer, tariff, services, price regulation, directory, issues, proposed agreement, declaratory order, rates, contested case, Telecommunications, applicability, declaratory relief, telephone company, telephone, charges, convene, basic service, incumbent, fail to state a claim, settlement agreement, proposed settlement, approving, effective, non-basic, agency's, sections, argues

## Case Summary

### Procedural Posture

Appellee phone company filed a proposed tariff with appellee regulatory agency to charge for directory assistance calls. Appellant consumer agency intervened for declaratory orders and injunctive relief to deny the tariff and filed a breach of contract action. Appellee phone company filed an amended proposed tariff. Appellee regulatory agency dismissed appellant's actions and approved the amended tariff. Appellant challenged the decision.

### Overview

After appellee phone company's application for price regulation was approved by appellee regulatory agency, appellee phone company sought a tariff for directory assistance calls. Appellant contended that under Tenn. Code Ann. §§ 65-5-208(a), 65-5-209, appellee phone company was precluded from increasing its rate for directory assistance for four years after appellee phone company became subject to price regulation. Appellee regulatory agency denied the petition because it determined that the issues raised therein had been determined in previous cases. It also dismissed a breach of contract complaint by appellant for failure to state a claim. On appeal, the court found no error in appellee regulatory agency's dismissal of the breach of contract claim for failure to state a claim, and no abuse of discretion in the decision not to issue declaratory relief as to the proposed tariff.

### Outcome

Appellee regulatory agency's decision to dismiss the petition for declaratory relief and to dismiss the breach of contract claim for failure to state a claim were affirmed.

## LexisNexis® Headnotes

Business & Corporate Compliance > ... > Federal Versus State Law > Intrastate Communications > State Regulation of Intrastate Communications

Energy & Utilities Law > Administrative Proceedings > General Overview

Energy & Utilities Law > Regulators > Public Utility Commissions > Authorities & Powers

Energy & Utilities Law > Utility Companies > General Overview

***HN1*** The Tennessee Regulatory Authority is vested with general supervisory and regulatory power, jurisdiction, and control over all public utilities. *Tenn. Code Ann. § 65-4-104*.

Communications Law > ... > Telephone Services > Local Exchange Carriers > General Overview

***HN2*** See Tenn. Code Ann. § 65-5-208(a).

Communications Law > ... > Regulated Entities > Telephone Services > General Overview

Communications Law > ... > Telephone Services > Local Exchange Carriers > General Overview

*HN3* See Tenn. Code Ann. § 65-5-209.

Administrative Law > Judicial Review > Standards of Review > General Overview

*HN4* Tenn. Code Ann. § 4-5-322(h) (1998) sets forth the standard of review for the decision of an administrative agency.

Administrative Law > Judicial Review > Standards of Review > General Overview

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review

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

*HN5* See Tenn. Code Ann. § 4-5-322(h) (1998).

Communications Law > ... > Regulated Entities > Telephone Services > General Overview

Communications Law > ... > Telephone Services > Local Exchange Carriers > General Overview

*HN6* Tenn. Code Ann. § 65-5-209(f) precludes increasing rates on a basic service for four years after a local exchange telephone company becomes subject to price regulation.

Communications Law > ... > Regulated Entities > Telephone Services > General Overview

Communications Law > ... > Telephone Services > Local Exchange Carriers > General Overview

*HN7* See Tenn. Code Ann. § 65-5-209(f).

Administrative Law > Agency Adjudication > Decisions > Contents

Administrative Law > Judicial Review > Reviewability > Factual Determinations

*HN8* An agency, when issuing a final order, must provide a concise and explicit statement of the underlying facts supporting the agency's findings. Tenn. Code Ann. § 4-5-314(c). Findings of fact made by the agency should be based exclusively on the evidence of the record and on matters noted in the proceeding. Tenn. Code Ann. § 4-5-314(d) . Exactness in form and procedure is not required; rather, the findings based on the evidence need only be specific and definite enough so that a reviewing court may determine the pertinent questions of law and whether the agency's general findings should stand, particularly when the findings are material facts at issue.

Administrative Law > Judicial Review > Reviewability > Factual Determinations

*HN9* The sufficiency of an agency's findings of fact must be measured against the nature of the controversy and the intensity of the factual dispute.

Administrative Law > Judicial Review > Reviewability > Factual Determinations

*HN10* In order to comply with the requirements of Tenn. Code Ann. § 4-5-314, an agency need only set forth facts sufficient to support its legal conclusions and to afford an appellate court an effective review of its findings.

Communications Law > Federal Acts > Telecommunications Act > Tariffs

Business & Corporate Compliance > ... > Federal Versus State Law > Intrastate Communications > State Regulation of Intrastate Communications

Communications Law > ... > Telephone Services > Local Exchange Carriers > General Overview

*HN11* The classification of services in the 1995 Tennessee Telecommunications Act, Tenn. Code Ann. § 65-5-201 et seq., supersedes classifications in any prior agreements or tariffs.

Administrative Law > Agency Adjudication > Hearings > General Overview

*HN12* The Tennessee Regulatory Authority has the discretion to decide whether to convene a contested case to consider complaints filed with the agency.

**Counsel:** Paul G. Summers, Attorney General & Reporter; Michael Moore, Solicitor General; and L. Vincent Williams, Assistant Attorney General, for the appellant, Consumer Advocate Division.

J. Richard Collier and Julie Woodruff, Nashville, Tennessee, for the appellee, Tennessee Regulatory Authority.

Guy M. Hicks and Patrick W. Turner, Nashville, Tennessee, for the appellee, BellSouth Telecommunications, Inc.

**Judges:** HOLLY KIRBY LILLARD, J., delivered the opinion of the court, in which W. FRANK CRAWFORD, P.J., W.S. and ALAN E. HIGHERS, J., joined.

**Opinion by:** HOLLY K. LILLARD

## Opinion

This is an appeal from an order by the Tennessee Regulatory Authority. The Tennessee Regulatory Authority denied the Consumer Advocate Division's request for a declaratory order as to the applicability of Tennessee Code Annotated §§ 65-5-208(a) and 65-5-209 to a telephone company's proposed tariff. It also denied the Consumer Advocate [*2] Division's request for a declaratory order as to the applicability of a previous order by the Authority approving the telephone company's application for price regulation, dismissed its claim for breach of contract, and denied its request for injunctive relief. Consequently, the proposed tariff was approved. The Consumer Advocate Division appeals. We affirm.

This case is an appeal of an order by the Tennessee Regulatory Authority. The appellant, the Consumer Advocate Division (the "Consumer Advocate"), is a division of the Office of the Attorney General & Reporter which represents the interests of Tennessee consumers of public utilities. ***See*** *Tenn. Code Ann. §§ 65-4-118(c)*, 65-5-210(b) (Supp. 2000). ***HN1*** The appellee Tennessee Regulatory Authority ("Authority")is vested with "general supervisory and regulatory power, jurisdiction, and control over all public utilities." *Tenn. Code Ann. § 65-4-104*. The predecessor to the Authority was the Tennessee Public Service Commission ("Commission"). BellSouth Telecommunications, Inc. ("BellSouth") [*3] is a public utility providing telecommunication services in Tennessee.

In October 1994, BellSouth filed with the Commission a proposed tariff. BellSouth sought to amend its existing tariff to include a charge for directory assistance. The Consumer Advocate filed a petition to intervene, in opposition to the tariff. The Consumer Advocate's petition to intervene was granted by the Commission. On January 5, 1995, the Commission approved BellSouth's proposed tariff, on the condition that BellSouth file an amended tariff meeting certain conditions by February 1, 1995. BellSouth failed to file the amended tariff by the required date. Consequently, the Commission voted to reconsider the January order conditionally approving the tariff.

Before the Commission reconsidered BellSouth's proposed tariff, BellSouth and the Consumer Advocate entered into a settlement agreement altering the proposed directory assistance charge so that the net effect of the charges would be as close to zero as possible. The proposed settlement agreement stated that the agreement would be presented and recommended to the Commission, and recognized that the Commission had "the authority to approve or disprove tariffs, [*4] rates, and related issues." On February 3, 1995, BellSouth and the Consumer Advocate submitted to the Commission the settlement agreement and the revised tariff. They asked that the agreement be placed on the agenda for the Commission's next conference. The Commission, however, took no further action on the proposed agreement and revised tariff.

In June 1995, the Tennessee Legislature enacted new legislation, The 1995 Tennessee Telecommunications Act, which substantially altered the manner in which public utilities in Tennessee are regulated. ***See*** 1995 Tenn. Pub. Acts, ch. 408; *Tenn. Code Ann. § 65-5-201 et seq*. The Act created a new procedure by which companies such as BellSouth could elect price regulation. It also terminated the Commission effective June 30, 1996 and created the Authority effective July 1, 1996. ***See*** 1995 Tenn. Pub Acts, ch. 305. As a result, on June 28, 1996, the Commission entered a general order terminating all pending business effective June 30, 1996. This included BellSouth's proposed settlement agreement and revised tariff.

On July 18, 1996, the new Authority entered an administrative order accepting recommencement [*5] of cases pending at the sunset of the Commission. However, the Consumer Advocate did not recommence BellSouth's case. In August 1996, the Authority sent a letter to BellSouth informing BellSouth that its 1994 filing seeking approval of the directory assistance tariff was closed and "**will not** become effective." (emphasis in original).

Citing changes in the regulatory landscape, BellSouth sent a letter dated May 30, 1996 to the Consumer Advocate, informing the Consumer Advocate that its October 1994 tariff had been withdrawn. [1] The letter asserted that changes in the regulatory environment and the withdrawal of the tariff now made the settlement agreement between the

[1] As the Authority points out in its brief, it is unclear whether BellSouth notified the Commission of the withdrawal of the tariff. There is nothing in the record confirming the withdrawal of the tariff, and, in its complaint the Consumer Advocate alleges "that no hearing or motion withdrawing the tariff was ever held."

parties "moot." The letter stated that BellSouth had no immediate plans to make a similar filing, and that before it made such a filing, it would contact the Consumer Advocate "to discuss [the] matter in a manner consistent with the negotiation procedure which produced the draft settlement agreement."

[*6] Meanwhile, in June 1995, BellSouth filed an application with the Commission for price regulation. Its application for price regulation was finally approved in December 1998 [2] [*8] . Subsequently, on June 1, 1999, BellSouth filed a proposed tariff to begin charging $ 0.29 for each directory assistance call. On June 15, 1999, the Consumer Advocate filed a petition with the Authority seeking declaratory orders and injunctive relief. In the petition the Consumer Advocate sought a declaratory order as to the applicability of Tennessee Code Annotated sections 65-5-208(a) [3] [*9] and 65-5-209 [4] to BellSouth's proposed tariff, as well as a declaratory order as to whether the Authority's order approving BellSouth's application for price regulation was applicable to the 1995 settlement agreement between the Consumer Advocate and BellSouth. The Consumer Advocate alleged that, under sections 65-5-208(a) and 65-5-209, directory assistance is a basic service for price regulation purposes, and, therefore, under the statutes, BellSouth was precluded from increasing its price for a period of four years after BellSouth became subject to price regulation. The petition also alleged [*7] that BellSouth breached a contract with the Consumer Advocate by failing to contact the Consumer Advocate before BellSouth filed the 1999 proposed tariff, pursuant to the 1995 settlement agreement. The complaint requested that the charge for directory assistance be enjoined until

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[2] The Commission had tentatively approved BellSouth's application to elect price regulation in January 1996 with the condition that BellSouth reduce its rates by fifty-six million. BellSouth appealed. In ***BellSouth Telecommunications, Inc. v. Greer***, 972 S.W.2d 663 (Tenn. Ct. App. 1997) (*perm. to appeal denied* June 15, 1998), the Court of Appeals reversed the Commission and remanded the cause for approval of the application. ***Id.*** at 682. On remand the Authority approved the price regulation plan. The Authority's order was subsequently affirmed on appeal. ***See*** *Consumer Advocate Div. v. Tennessee Regulatory Auth.*, 2000 Tenn. App. LEXIS 11, No. M1999-02151-COA-R12-CV, 2000 WL 13794 (Tenn. Ct. App. Jan. 10, 2000), *reh'g denied* Feb. 11, 2000.

[3] Section 65-5-208(a) provides:

> ***HN2*** (a) Services of incumbent local exchange telephone companies who apply for price regulation under § 65-5-209 are classified as follows:
>
> (1) "Basic local exchange telephone services" are telecommunications services which are comprised of an access line, dial tone, touch-tone and usage provided to the premises for the provision of two- way switched voice or data transmission over voice grade facilities of residential customers or business customers within a local calling area, Lifeline, Link-Up Tennessee, 911 Emergency Services and educational discounts existing on June 6, 1995, or other services required by state or federal statute. These services shall, at a minimum, be provided at the same level of quality as is being provided on June 6, 1995. Rates for these services shall include both recurring and nonrecurring charges.
>
> (2) "Non-basic services" are telecommunications services which are not defined as basic local exchange telephone services and are not exempted under subsection (b). Rates for these services shall include both recurring and nonrecurring charges.

[4] Section 65-5-209 states in pertinent part:

> ***HN3*** (f) Notwithstanding the annual adjustments permitted in subsection (e), the initial basic local exchange telephone services rates of an incumbent local exchange telephone company subject to price regulation shall not increase for a period of four (4) years from the date the incumbent local exchange telephone company becomes subject to such regulation. . . .
>
> (h) Incumbent local exchange telephone companies subject to price regulation may set rates for non- basic services as the company deems appropriate, subject to the limitations set forth in subsections (e) and (g), the non-discrimination provisions of this title, any rules or orders issued by the authority pursuant to § 65-5-208(c) and upon prior notice to affected customers. . . .

resolution of the Consumer Advocate's breach of contract claim.

After receiving the Consumer Advocate's petition, the Authority suspended BellSouth's tariff for thirty days. The Authority then considered the Consumer Advocate's petition at its regularly scheduled July 27, 1999 conference. [*10] After hearing oral arguments, the Authority deferred action on the tariff, expressing concern about charging elderly persons for directory assistance. Subsequently, BellSouth filed an amended proposed tariff. Thereafter, on July 29, 1999, the Authority dismissed the Consumer Advocate's petition and complaint, *sua sponte*, and approved BellSouth's amended tariff .

In its July 29 order, the Authority found that there was no basis for granting the declaratory relief sought by the Consumer Advocate. The Authority concluded that "the classification of BellSouth's tariff to implement a charge for directory assistance as a 'non-basic' service [was] consistent with [section] 65-5-208(a)(1)" as determined in the Authority's prior decision in ***United Telephone-Southeast, Inc. Tariff No. 96-201, To Reflect Annual Price Cap Adjustment***, Docket No. 96-01423 (Sept. 4, 1997). [5] [*12] In this prior decision, the Authority concluded that directory assistance was a non-basic service under section 65-5-208(a). In the July 29 order, the Authority also declined to a convene a contested case, asserting that the Consumer Advocate had already litigated the same issues in two cases previously decided [*11] by the Authority, and which were pending at that time before the Court of Appeals. [6] The Authority found that the proposed settlement agreement was not binding on either the Consumer Advocate or BellSouth because it was never approved by the Commission, it pre-dated the 1995 Tennessee Telecommunications Act, and because the Consumer Advocate did not recommence the action regarding the proposed agreement after the Commission ceased to exist. The Authority concluded, therefore, that there was no basis for issuing a declaratory order as to the applicability of the proposed agreement to the tariff. From this order, the Consumer Advocate now appeals.

Our review of this case is governed by ***HN4*** *Tennessee Code Annotated section 4-5-322(h)*, which sets forth the standard of review for the decision of an agency such as the Tennessee Regulatory Authority:

> ***HN5*** The court may affirm the decision of the agency or remand the case for further proceedings. The court may reverse or modify the decision if the rights of the petitioner have been prejudiced because the administrative findings, inferences, conclusions or decisions are:
>
> (1) In violation of constitutional or statutory provisions;
>
> (2) In excess of the statutory authority of the agency;
>
> (3) Made upon unlawful procedure;
>
> (4) Arbitrary or capricious or characterized by an abuse of discretion [*13] or clearly unwarranted exercise of discretion; or
>
> (5) Unsupported by evidence which is both substantial and material in the light of the entire record.
>
> In determining the substantiality of evidence, the court shall take into account whatever in the record fairly detracts from its weight, but the court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact.

*Tenn. Code Ann. § 4-5-322(h)*(1998).

On appeal, the Consumer Advocate argues that the Authority did not properly interpret Tennessee Code Annotated sections 65-5-208(a) and 65-5-209 as they relate to charges for directory assistance under an incumbent local exchange telephone company price regulation plan. The Consumer Advocate contends that, under the statutes, BellSouth was precluded from increasing its rate for directory assistance for four years after the company became subject to price

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[5] This case arose out of a tariff filed by United Telephone-Southeast, Inc. seeking to increase in rates for non- basic services. At issue was the methodology used by United Telephone-Southeast to determine the amount of the proposed increase. The Authority found that the method used by United Telephone-Southeast complied with the section 65-5-209(e) and approved the tariff. The Consumer Advocate appealed, and in *Consumer Advocate Division v. Tennessee Regulatory Authority*, 2000 Tenn. App. LEXIS 687, No. M1999-01699-COA-R12-CV, 2000 WL 1514324 (Tenn. Ct. App. Oct. 12, 2000) (hereinafter ***United Telephone***), this Court affirmed.

[6] In both cases the Authority's decision was affirmed. ***See Consumer Advocate Div.***, 2000 WL 13794 at *3; *United Telephone*, 2000 WL 1514324 at *5 & n.3.

regulation, [7] because directory assistance is a basic service as defined in section 65-5-208(a), and the ordinary and natural meaning of the terms "usage," "provision," and "recurring and nonrecurring charges" include [*14] directory assistance.

In the order which is the subject of this appeal, the Authority did not reach the merits of the issues raised by the Consumer Advocate. Instead, the Authority denied the Consumer Advocate's petition seeking declaratory relief and declined to convene a contested case because it determined [*15] that the issues raised by the Consumer Advocate had been determined in previous cases. The order also dismissed the Consumer Advocate's complaint, *sua sponte*, for failure to state a claim. The Consumer Advocate does not argue, under *Tennessee Code Annotated § 4-5-322(h)* that the Authority's decision was in violation of constitutional or statutory provisions, in excess of its statutory authority, made by unlawful procedure, or that it is unsupported by substantial material evidence. Therefore we surmise that, by our statutory standard of review, the issue on appeal is whether the Authority's decision to decline to grant declaratory relief, decline to convene a contested case, and to dismiss the complaint for failure to state a claim was an abuse of the Authority's discretion.

The Consumer Advocate argues first that the Authority's order should be reversed because the Agency failed to provide a sufficient statement of the underlying facts to support its findings, as required by *Tennessee Code Annotated § 4-5-314(c)*. The Consumer Advocate argues that the Authority failed to detail facts regarding why directory assistance is [*16] not a basic service as defined in section 65-5-208(a); what the terms usage, provision, or charges mean as they relate to local basic exchange service; whether the United Telephone-Southeast tariff in the Authority's prior decision was sufficiently similar to the BellSouth tariff so that the Authority's decision in that matter would be applicable in this case; the relevant issues and part of the decision in the two cases named by the Authority in its order related to this case; and why the 1995 agreement was not binding.

***HN8*** An agency, when issuing a final order, must provide a concise and explicit statement of the underlying facts supporting the agency's findings. *Tenn. Code Ann. § 4-5-314(c)*. Findings of fact made by the agency should be based exclusively on the evidence of the record and on matters noted in the proceeding. Tenn. Code Ann. *§ 4-5-314(d)*. Exactness in form and procedure is not required; rather, the findings based on the evidence need only be specific and definite enough so that a reviewing court may determine the pertinent [*17] questions of law and whether the agency's general findings should stand, particularly when the findings are material facts at issue. ***See Levy v. State of Tennessee Bd. Of Exam'rs for Speech Pathology and Audiology, 553 S.W.2d 909, 911-12 (Tenn. 1977)*** (quoting ***State Bd. of Med. Exam'rs v. Gandy, 248 S.C. 300, 149 S.E.2d 644, 646 (S.C. 1966)).*** ***HN9*** "The sufficiency of an agency's findings of fact must be measured against the nature of the controversy and the intensity of the factual dispute." ***CF Industries v. Tennessee Pub. Serv. Comm'n, 599 S.W.2d 536, 541 (Tenn. 1980)***.

***HN10*** Therefore, in order to comply with the requirements of *section 4-5-314*, an agency need only set forth facts sufficient to support its legal conclusions and to afford the Court an effective review of its findings. In denying the Consumer Advocate's petition, the Authority asserted that there was no basis for issuing the requested declaratory order as to the applicability [*18] of sections 65-5-208 and 65-5-209 or for convening a contested case because the issues raised by the Consumer Advocate had been addressed by the Authority in prior decisions. The Authority stated that it had previously ruled in ***United Telephone-Southeast*** that directory assistance was classified as a non-basic service, rejecting the same argument the Consumer Advocate now advances in this proceeding, namely, that directory assistance is a basic service under the statutory term "usage." The Authority then dismissed the Consumer Advocate's claim for breach of contract, finding that it failed to state a claim, based on the following facts: that the proposed agreement had required, but never received, approval of the Commission; the Consumer Advocate's failure to preserve the docket which included the agreement; and the fact that the 1995 Tennessee Telecommunications Act expressly

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[7] ***HN6*** Section 65-5-209(f) precludes increasing rates on a basic service for four years after a local exchange telephone company becomes subject to price regulation:

> ***HN7*** (f) Notwithstanding the annual adjustments permitted in subsection (e), the initial basic local exchange telephone services rates of an incumbent local exchange telephone company subject to price regulation shall not increase for a period of four (4) years from the date the incumbent local exchange telephone company becomes subject to such regulation. . . .

established what constituted basic and non-basic services and superseded any pre-existing agreement or tariff which classified services to the contrary. The Authority noted that since the agreement was not binding, it had no effect on BellSouth's proposed tariff. Under these circumstances, the Authority's [*19] decision was supported by a sufficient statement of the underlying facts that served as the basis for its decision.

We next address whether the Authority abused its discretion by refusing to issue the requested declaratory relief and by refusing to convene a contested case. The decision of whether to issue a declaratory order is within an agency's discretion. *Tenn. Code Ann. § 4-5-223(a)(2)* (1998). Upon an agency's refusal to issue a requested declaratory order, an affected person may file a lawsuit in the Chancery Court of Davidson County. *Tenn. Code Ann. § 4-5-225* (1998).

As noted above, the Authority based its decision not to issue a declaratory order as to the applicability of sections 65-5-208 and 6-5-209 on the fact that the Consumer Advocate sought a ruling on issues that had been addressed by the Authority in a previously contested case, ***United Telephone-Southeast***. Under these circumstances, we cannot conclude that the Authority abused its discretion in refusing to issue the requested declaratory relief.

The Consumer Advocate also sought a declaratory order as to the applicability of the 1995 proposed settlement [*20] agreement between the parties. The Authority's refusal to grant declaratory relief as to the applicability of the proposed settlement stems largely from its determination that the proposed agreement was not binding on either party. The Authority found that the proposed agreement was contingent upon its approval by the Commission, approval which was never granted. The proposed agreement expressly contemplated acceptance by the Commission, and acknowledged that the Commission had the authority to "approve or disprove tariffs, rates, and related issues." Moreover, ***HN11*** the classification of services in the 1995 Tennessee Telecommunications Act supersedes classifications in any prior agreements or tariffs. In addition, the proposed agreement did not survive the dismissal of the 1994 tariff docket. ***See*** ***Sandstrom v. Chemlawn Corp., 904 F.2d 83 (1st Cir. 1990)***; ***Frank Rudy Heirs Assoc. v. Sholodge, 967 S.W.2d 810 (Tenn. Ct. App. 1997)***. The Consumer Advocate argues that the May 30th letter shows that BellSouth contemplated the sunset of the Commission and [*21] indicates that BellSouth would negotiate regarding future filings. Regardless, the proposed agreement was expressly contingent on the approval of the Commission. Consequently, we find no error in the Authority's dismissal of the Consumer Advocate's breach of contract claim for failure to state a claim, and we find no abuse of discretion in its decision not to issue declaratory relief as to the applicability of the proposed agreement on the 1999 tariff.

Finally, the Consumer Advocate argues that the Authority erred in refusing to convene a contested case. ***HN12*** The Authority has the discretion to decide whether to convene a contested case to consider complaints filed with the agency. ***See*** ***Consumer Advocate Div. v. Greer, 967 S.W.2d 759, 763-64 (Tenn. 1998)***. The Authority's decision in this case was based on its finding that the issues presented by the Consumer Advocate in its petition had been previously decided by the Authority, and that the Consumer Advocate's breach of claim contract failed to state a claim because the proposed agreement was based on a contingency that [*22] never occurred. Under these circumstances, we find no abuse of discretion in the Authority's decision.

In sum, we affirm the Authority's decision to refuse to issue the requested declaratory relief, the dismissal of the breach of contract claim for failure to state a claim, and the decision to decline to convene a contested case. All other issues raised in this appeal are pretermitted.

The decision of the Tennessee Regulatory Authority is affirmed. Costs are taxed to the appellant, the Consumer Advocate Division and its surety, for which execution may issue if necessary.

HOLLY K. LILLARD, JUDGE