

**BEFORE THE TENNESSEE PUBLIC UTILITY COMMISSION
NASHVILLE, TENNESSEE**

July 12, 2018

IN RE:)
)
TENNESSEE WASTEWATER SYSTEM, INC.) **Docket No. 18-00071**
COMPLAINT REVIEW)

**NOTICE OF FILING BY THE UTILITIES DIVISION OF THE TENNESSEE
PUBLIC UTILITY COMMISSION**

Pursuant to Tenn. Code Ann. §§ 65-4-104, 65-4-111 and 65-3-108, the Utilities Division of the Tennessee Public Utility Commission ("TPUC" or the "Commission") hereby gives notice of its filing of the Compliance Report for Tennessee Wastewater Systems, Inc. (the "Company" or "TWSI") in this docket and would respectfully state as follows:

1. As set forth in the *Final Order Denying Petition* entered in Docket No. 16-00139 on November 2, 2017, the present docket was opened by the Commission to examine the Company's billing and accounting records and practices and to report the results of this examination to the Commissioners.

2. On January 24, 2018, the Utilities Division submitted its preliminary findings and recommendations to the Company. Final findings and recommendations were submitted to the Company on June 27, 2018. The Company made preliminary responses on January 31, 2018 and final responses on July 6, 2018. The Company's final responses have been

incorporated into the Report. The Report is attached hereto as Exhibit A and is fully incorporated herein by this reference.

3. The Utilities Division hereby files its Report with the Tennessee Public Utility Commission for deposit as a public record and hereby requests approval of the Report and the findings and recommendations contained therein.

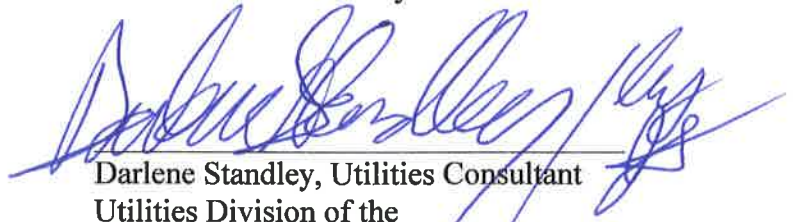
Respectfully submitted,



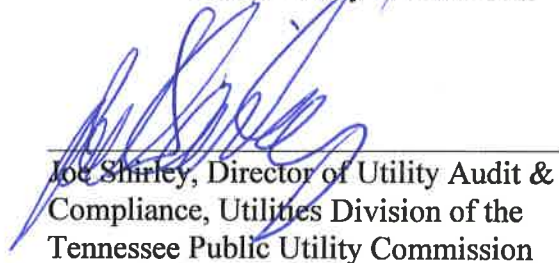
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CERTIFICATE OF SERVICE

I hereby certify that on this 12th day of July 2018, a true and exact copy of the foregoing has been delivered via electronic mail to the following persons:

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COMPLIANCE REPORT
OF
TENNESSEE WASTEWATER SYSTEMS, INC.

DOCKET NO. 18-00071

PREPARED BY
TENNESSEE PUBLIC UTILITY COMMISSION

UTILITIES DIVISION

JULY 12, 2018

EXHIBIT A

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I. INTRODUCTION

Staff of the Tennessee Public Utility Commission (“Commission” or “TPUC”) has conducted a compliance review of Tennessee Wastewater Systems, Inc. (“TWSI” or “Company”). The purpose of the review was to examine the Company’s billing and accounting records for compliance with TPUC requirements and to report the results of the examination to the Commission. The review resulted in eighteen findings and recommendations which are contained in section VI and summarized in section VII of this report. Except as discussed in the findings and recommendations, staff is of the opinion that the Company’s billing and accounting records and practices for the review period substantially complied with relevant Commission rules and regulations.

II. BACKGROUND

TWSI provides wastewater services to approximately 3,090 customers throughout 23 counties in Tennessee. Although the Company operates decentralized wastewater systems spread over a large geographic area throughout the State, it is regulated as one, centralized utility for ratemaking purposes, with aggregation of financial data to determine uniform service rates by customer class that are generally applicable to all systems.

On November 2, 2017, the Commission entered an order denying the Company’s petition to increase service rates.¹ The Commission also denied the Company’s petition to terminate its escrow account by including escrow surcharges and related expenses in the calculation of base service rates and to recover an alleged shortfall in the escrow account through a monthly surcharge to all customers over three years.²

During the hearing of the rate case petition, issues were raised concerning some of the Company’s billing and accounting practices for utility ratemaking purposes; primarily the propriety of treating certain developer income as unregulated revenue; documentation of increased escrow charges; computation of depreciation expense; and billing of certain customer accounts in accordance with authorized rates set forth in the Company’s tariff.³ The Commission found that these issues warranted further review and directed staff to examine the billing and accounting records and practices of TWSI and to report the results of the examination to the Commission.⁴

III. AUTHORITY

The Commission has general supervisory and regulatory power and control over the public utilities subject to its jurisdiction. T.C.A. § 65-4-104 states:

¹ *In re: Petition of Tennessee Wastewater Systems, Inc. for Approval of Adjustment of its Rates and New Tariff*, Docket No. 16-00139, *Final Order Denying Petition* (Nov. 2, 2017).

² *Id.*

³ *Id.*, pp. 10-15.

⁴ *Id.*, p. 23.

The [Commission] has general supervisory and regulatory power, jurisdiction, and control over all public utilities, and also over their property, property rights, facilities, and franchises, so far as may be necessary for the purpose of carrying out the provisions of this chapter.

Further, T.C.A. § 65-4-105(a) grants the same powers to the Commission with reference to public utilities within its jurisdiction as chapters 3 and 5 of Title 65 have conferred on the Department of Transportation's oversight of railroads or the Department of Safety's oversight of transportation companies, which includes the power to examine. T.C.A. § 65-3-108 states:

The department is given full power to examine the books and papers of the companies, and to examine, under oath, the officers, agents, and employees of the companies and any other persons, to procure the necessary information to intelligently and justly discharge its duties and carry out the provisions of this chapter and chapter 5 of this title.

The Utilities Division staff is responsible for examining the energy, water and wastewater utilities under the Commission's jurisdiction. Division staff assigned to this examination were Michelle Mairs, Patsy Fulton, Darlene Standley and Joe Shirley.

IV. OBJECTIVE

The purpose of this examination is to determine whether the Company's billing and accounting records and practices comply with the Commission's requirements. The Commission's regulatory billing and accounting requirements are set forth in its rules and orders. With regard to billing, the Commission requires each regulated utility to file a tariff setting forth authorized rates and terms of public utilities services. For wastewater companies such as TWSI, Rule 1220-4-13-.04(1)(a) provides that "a copy of the public wastewater utility's tariff as specified in Rule 1220-4-1-.02 that includes the rates, rules, terms and conditions, and that describes the policies and practices in rendering service that conform to all applicable rules and regulations, shall be filed with the [Commission]." Rule 1220-4-1-.03 provides that "rules and regulations of the utility that in any manner affects the rates charged or to be charged or that define the extent or character of the service to be given shall be included with each tariff." Rule 1220-4-1-.07 requires the filing and approval of special contracts for rates, services, and practices not covered by or permitted in the general tariffs.

With regard to regulatory accounting and reporting requirements, the Commission generally requires all public utilities within its jurisdiction to follow a prescribed uniform system of accounting. Due to its industry and size, Rule 1220-4-1-.11(1)(h) requires TWSI to adhere to the "Uniform System of Accounts for Class A Wastewater Utilities" ("USOA") as adopted and amended by the National Association of Regulatory Utility Commissioners ("NARUC"). The USOA delineates prescribed accounting definitions, accounting instructions and descriptions of accounts. In addition, Commission rules require TWSI to file monthly surveillance reports and

an annual financial report consistent with the USOA format.⁵ Additional regulatory accounting and reporting policies and requirements are set forth in the Commission's orders.⁶ The Company utilizes QuickBooks as its primary accounting software to record its transactions and converts this information to the USOA reporting format.

V. SCOPE

Commission staff reviewed the Company's books and records for the period January 1, 2016 through June 30, 2017. The scope of the review included examination of the following areas:

- | | |
|----------------------------|-----------------------------------|
| - General Ledger | - Annual Report |
| - Customer Billing | - Wastewater Service Revenue |
| - Developer Income | - Operation & Maintenance Expense |
| - Affiliate Transactions | - Depreciation Expense |
| - Utility Plant in Service | - Taxes Other Than Income Taxes |
| - Escrow Charges | |

Review procedures were designed to:

- Reconcile the general ledger, profit and loss, annual report and federal income tax return;
- Determine if customers' bills and corresponding charges rendered by the utility billing system agree with approved service tariffs;
- Determine if wastewater service revenue reconciles to the utility billing system and is properly recorded and documented;
- Determine if developer revenue is properly recorded and documented;
- Determine if operations and maintenance expenses are classified and recorded accurately and that proper supporting documentation is maintained;
- Determine whether transactions with affiliates are classified and recorded accurately and that supporting documentation reflecting the reasonableness of such transactions is maintained;
- Determine if property taxes are accurately posted and supported;
- Determine if franchise and excise taxes are accurately posted and supported;
- Determine if utility plant accounts and associated contributions in aid of construction are properly classified and recorded and that related depreciation and amortization are correctly computed and recorded; and
- Determine if amounts recorded to the escrow account are accurately classified and properly supported.

⁵ See Rule 1220-4-1-.10.

⁶ See, e.g., *In re: Petition of Tennessee Wastewater Systems, Inc. for Approval of Adjustment of its Rates and New Tariff*, Docket No. 16-00139, *Final Order Denying Petition* (Nov. 2, 2017); *In re: Petition of Tennessee Wastewater Systems, Inc. for Approval of Special Contract*, Docket No. 16-00015, *Order Affirming and Clarifying Previous Order* (Jan. 10, 2017); *In re: Joint Petition of Cartwright Creek, LLC and TRA Staff (As a Party) to Increase Rates and Charges*, Docket No. 16-00127, *Order Approving Rate Increase* (Jan. 10, 2017); *In re: Petition of Tennessee Wastewater Systems, Inc. for Approval to Amend Its Rates and Charges*, Docket No. 08-00202, *Order Approving Revised Settlement Agreement* (July 8, 2009).

VI. FINDINGS

A. Customer Billing And Wastewater Service Revenue Findings

The Company uses the Utility Maintenance System (“UMS”) to bill customers for monthly wastewater service. The UMS billing information properly reconciled to the wastewater service revenue accounts maintained in the general ledger. A sample of customer accounts from UMS for the period of January 1, 2016 through June 30, 2017 was selected for review. The sample included residential, commercial cabins, condominiums, and commercial with and without food accounts. Based upon the test work completed, no material errors in mathematical or billing rates were revealed; however, as explained below, some areas were detected where the tariff should be revised to clarify and assist outside personnel in determining the billing methodology for certain categories of bills. The recommended clarifications will assist the reconciliation of individually billed charges to the authorized service rates and terms contained in the Company’s tariff. The Company has agreed to implement the recommended tariff clarifications.

Finding No. 1 – Tariff Should Be Clarified For Certain Commercial Accounts

Background: Section 6 of the current tariff contains rate bands for commercial accounts. If a commercial customer exceeds the highest listed rate band or usage falls between two bands, the rates are calculated according to the introductory usage paragraph starting at zero rather than starting with the highest rate band of their usage and adding the excess usage per the introductory paragraph. The tariff language should be clearer regarding this calculation.

Observation: Based upon current tariff language one is unable to determine the steps taken to calculate commercial account bills, without assistance from Company personnel, when usage exceeds the highest rate band or falls between rate bands.

Recommendation: The tariff should be clarified to state bills for commercial customers exceeding the highest rate band or with usage between rate bands will not be calculated using the rate bands. Rather they will be calculated in the following manner: (List the methodology stated in the introductory paragraph.) “A minimum of XXX per month will be charged for up to the first 300 gallons per day of design flow expected. For each additional 100 gallons per day of design flow expected, up to a total of 1,000 gallons per day, an additional charge of XXX per month per 100 gallons will be levied. For design flows expected over 1,000 gallons per day, the monthly rate will be XXX per 1,000 gallons of daily flow.”

Company Response: The Company agrees with Commission staff’s recommendation and will modify its tariff accordingly to provide a more complete explanation of how the commercial bills are calculated.

Finding No. 2 – Customer Billing Policies Should Be Strengthened

Background: Commercial accounts are billed according to their contracted gallons per day (GPD) with or without food. The GPD rate schedule is contained in the current tariff.

Observation: For Paris Landing/U.S. Coast Guard, Billing Account 0619, staff was unable to compute the May 31, 2016 bill in the amount of \$262.44 from the tariff Commercial Rate Sheet without food. A special contract was not provided for this customer.

Recommendation: The Company should put in place billing policies ensuring customer bills are computed according to the tariff rate schedules or pursuant to a special contract approved by the Commission.

Company Response: The Company agrees all customers are to be billed according to the correct tariff schedules or pursuant to a special contract approved by the Commission. For the May 31, 2016 billing, Paris Landing/U.S. Coast Guard Billing Account 0619, the customer was billed the correct amount of \$262.24, not \$262.44 as incorrectly stated above.

TWSI bills this customer for use of 1100 gallons per day of capacity. Using the 2015 TWSI tariff which was the effective tariff at that time, the Company calculated the customer's rate based on Tier 2.7 of the Commercial without Food tariff for the use of up to 1000 gallons per day. Since over 1000 gallons was billed, a prorated amount of the Additional Tier level (\$157.95) is added to the Tier 2.7 charge. An additional 100 gallons per day was billed. As 100 is 10% of 1000, the additional charge is 10% of the \$157.95 or \$15.80. The Customer's bill is calculated as follows: \$246.44 for Tier 2.7 plus \$15.80 for 10% of the Additional Tier charge. This results in a customer bill for \$262.24, which is what the Customer was correctly billed on its May 31, 2016 statement.

Moving forward the Company in response to this and another audit recommendation, will modify its tariff accordingly to provide a more complete explanation as to how the commercial bills are calculated.

Finding No. 3 – Tariff Should Be Updated Periodically For Flow-Through Charges

Background: The current tariff contains language stating Residential Class 9 customer's bills will include a pass-through charge for wastewater treatment by the City of Clarksville.

Observation: The current flow through rate is outdated and accordingly may not reflect actual pass through costs. Residential Customers in Rate Class 9 are billed a pass-through charge based upon a 2013 calculated rate.

Recommendation: The tariff should state that the Company will periodically calculate a new pass through rate. It should state periodic dates that the pass through will be recalculated, e.g., quarterly, semi-annually, or annually, etc.

Company Response: The Company agrees with Commission staff's recommendation and will modify its tariff to state the pass-through rate will be periodically recalculated. For sake of this finding, the Company would like to point out that an updated flow through rate was submitted to Commission staff in August of 2017 and at the time of answering this finding, the Company has yet to receive approval of the updated rate.

Finding No. 4 – Residential R-1 Rates Should Be Billed To Individual Customers

Background: Residential condominium complexes are provided one bill rated at the number of units in the development times the R-1 rate band.

Observation: The current tariff contains no language on how condominiums will be rated and billed.

Recommendation: Each residential condominium unit should be billed the R-1 rate. Tariff should be clarified to state each condominium unit will be individually billed at the R-1 Rate.

Company Response: The Company agrees with Commission staff's recommendation and will clarify in its tariff that each condominium will be billed individually at the R-1 Rate.

B. Developer Income Findings

The Company receives payments from developers pursuant to contracts relating to the construction and operation of certificated wastewater systems. During the review period, three types of such payments were received: (1) per-lot fees for capacity development; (2) per-lot fees for recovery of certain legal, regulatory and inspection costs; and (3) per-lot fees to return dormant portions of the regional Eudaily system to operational status. The Company bills the fees in accordance with the contract at the time it signs the development plat as the utility provider. In the *Order Affirming and Clarifying Previous Order* entered in Docket No. 16-00015 on January 10, 2017, the Commission clarified that the Company should record the per-lot capacity development fees as contributions in aid of construction pursuant to Account No. 271 of the Uniform System of Accounts (USOA) and the per-lot fees for recovery of certain expenses as guaranteed revenues pursuant to Account No. 530 of the USOA.

Finding No. 5 – An Accounting Policy Should Be Established For Developer Income

Background: Developer contracts and related income were examined for the review period. For the year ended 2016, the Company billed and recorded \$161,828 of developer payments, which was recorded as follows: \$150,800 into Developer Income-Other Account No. 421.5; \$4,228 into Eudaily Reserve Account No. 265.4; and \$6,800 into Inspection Costs Account No. 265.1. The amount recorded in the developer income account was reported in the 2016 annual report as nonutility income and was excluded from the computation of regulated net operating income.

Observation: A review of developer contracts and invoices indicated that, according to the Commission's clarifying order, \$144,000 of the \$161,828 of developer payments for 2016 should have been recorded as guaranteed revenues, with the remaining balance recorded as contributions in aid of construction. The guaranteed revenues should have been reported in the 2016 annual report as regulated income pursuant to the USOA.

Further review for the period January through June 2017 indicated the Company received developer payments totaling \$158,468, which were recorded as \$123,800 of other developer

income in Account No. 421.5 and \$34,668 of Eudaily reserves in Account No. 265.4. This accounting is also inconsistent with the Commission's clarifying order.

During the examination, Company management expressed concern that recording the per-lot fee for recovery of certain expenses as guaranteed revenues for inclusion in the calculation of regulated net operating income would result in a mismatch of revenues and expenses. According to management, some expenses related to such revenues have not been recorded in the utility's accounts but have been incurred by affiliates and never charged fully to the regulated utility's books.

Recommendation: The Company should develop an accounting policy to record developer income and all related expenses into the accounts of the appropriate entity such that any mismatch between reported developer income and related expenses between the utility's books and the books of its affiliates is eliminated. This accounting policy should be consistent with the Commission's clarifying order regarding the accounting of payments from developers.

Company Response: For over a decade, the Company has recorded developer income as part of its nonutility income. This policy was set in place by agreement between Charles Pickney, then president of TWSI, and Darlene Stanley, then utility director for TPUC. The underlying reason for this policy was because the developer income received by TWSI then, as it is now, was received to offset costs incurred by the Company related to the utility's non-regulated functions, such as engineering plans review, regulatory expenses, legal expenses, and system and tank inspections. It was understood that these functions did not directly impact the ratepayer nor relate to the regulated activities of the Utility. This practice was known to the Commission and the Commission never attempted to require the Company to treat the revenue otherwise until the filing of the special contract in Docket 16-00015.

The Commission's clarifying order in Docket 16-00015 is specific to the contract presented for approval in that docket. If the Commission intended by its Order in that docket for TWSI to begin recording all developer income on its books as regulated revenue, such a unilateral, wholesale change to the agreed upon, existing, and accepted practice of treating developer income as nonutility income should have required a hearing on that issue. Since the Company's position is the order in Docket 16-00015 is specific to that contract, all other developer income has continued to be recorded as nonutility income.

It is important to note that all wastewater utilities receive developer income, but not all handle it the same way. There are wastewater utilities that require developer income to fund the operation of their system for a certain period of time. This income has a direct impact on regulated activities and should be recorded as regulated revenue. As noted above, TWSI receives developer income pre-customer and for non-regulated functions which is why it has been recorded as nonutility income.

While the Company still believes the developer income it receives should continue to be recorded as nonutility income, if the Commission now desires to regulate the developer income, the Company agrees to develop an accounting policy consistent with the staff recommendation

so long as it is able to attribute the associated expenses to offset the revenue (this was the issue in the most recent rate case).

Finding No. 6 – Developer Charges Should Be Supported By Tariffs or Contracts

Background: During the review period, the Company received payments from developers for future capacity development and recovery of certain legal, regulatory and inspection costs.

Observation: The Company received a total of \$16,000 from two developers in 2016 for which no contract or tariff was provided. During the period January through June 2017, the Company received a total of \$18,200 from three developers for which no contract or tariff was provided.

Recommendation: The Company should take steps to ensure that all payments received from developers are supported by written contracts approved by the Commission or by authorized tariffs on file with the Commission.

Company Response: The amounts received from developers or lot owners as stated above were deemed by the Company to be unregulated developer revenue and/or contributions in aid of construction and not subject to the Commission's rules and regulations requiring an authorized tariff or Commission approved contract for the fees.

C. Operations And Maintenance Expense Findings

Finding No. 7 – Documentation For Credit Card Transactions Should Be Improved

Background: Credit card statements listing the transaction details are paid upon receipt.

Observation: Employees of TWSI are provided credit cards for miscellaneous expenses while performing job duties. A review of paper credit card statements revealed they do not have all receipts supporting each transaction listed and paid.

Recommendation: All receipts supporting credit card transaction should be provided to the home office and be reconciled and attached to the bank card statement prior to making payment.

Company Response: The Company agrees with Commission staff's recommendation. Company credit card policy requires employees to provide receipts supporting credit card transactions. This policy has been restated to and reinforced with all company employees.

Finding No. 8 – Adjustments To Accounts Should Be Properly Posted

Background: Materials and Supplies are purchased and placed in truck inventory or in service. Transactions recorded to the Materials and Supplies account were traced back to ensure proper supporting documentation.

Observation: Examination of Materials and Supplies Account No. 720 revealed a check to Adenus Tech in the amount of \$2,592. Staff was unable to find a related invoice. TWSI's

accountant found an invoice in the amount of \$2,346 and an adjustment of \$613 to support this payment. The \$613 adjustment was not posted to the Materials & Supplies Account.

Recommendation: The Company should ensure that all adjustments are posted to the proper accounts.

Company Response: The Company agrees with the Commission staff's recommendation. In this instance, the \$613 adjustment was simply overlooked.

Finding No. 9 – Adjustments For Out-of-Period Expenses Should Be Made

Background: Annual permit fees are paid to the Tennessee Department of Energy Conservation for each wastewater site.

Observation: Transactions in Quick Books recorded to Licenses and Permits Account No. 775.3 were reviewed and traced to supporting detail. Staff found there were 87 payments recorded during 2016 applicable to the year of 2015. One payment was \$1,380 and the remaining 86 payments were for \$350 each. The double recording of payments was due to two annual payments being recorded in the same year.

Recommendation: The Company should ensure payments are made timely thus avoiding the recording of out-of-period payments in the current year. Further adjusting entries should be made to remove any out-of-period payments prior to completion of the annual report.

Company Response: The Company agrees with the Commission staff's recommendation. The 2015 TDEC permit fees were not billed to TWSI until 2016 (TDEC was late in sending them out). The bills were then paid upon receipt.

D. Affiliate Transactions Findings

During the review period, the Company used affiliated entities as suppliers for certain goods and services. For the year ended 2016, TWSI paid the following amounts to affiliates:

<u>Entity Name</u>	<u>2016 Amount</u>	<u>General Business Purpose</u>
Adenus Technologies	\$575,884	System components, materials & supplies
Adenus Operations	\$258,594	Management fees and fuel charges
DRT Services	\$188,663	Contract labor and equipment rental
Adenus Technologies	\$157,838	Telemetry monitoring of systems
Adenus Group	\$52,936	Information technology services
Barrell Investments	\$30,000	Commercial office rent – East Tennessee
Aviation Parkway LP	\$24,000	Commercial office rent – Middle Tennessee

Affiliate transactions were reviewed for the year ended 2016 to determine if such transactions were for an appropriate business purpose, supported by proper documentation, charged to the utility at reasonable amounts for the goods or services provided, and recorded correctly into the utility's accounts.

Finding No. 10 – Documentation of Adenus Technologies Payments Should Be Improved

Background: Adenus Technologies supplied the utility with wastewater system components, equipment and supplies during the review period, with related charges being recorded in the utility's general ledger to Sewer System Replacement Account No. 265.2; Plant Materials & Supplies (Inventory) Account No. 151; and Materials & Supplies Expense Account No. 720.

Observation: Although the amounts charged to TWSI by Adenus Technologies for wastewater system components, equipment and supplies were supported by vendor invoices, the invoices alone did not provide adequate documentation of the reasonableness of the related transactions. Staff was generally unable to identify through the invoice or other supplemental information the wastewater system construction, repair or maintenance project related to the materials billed by the affiliate.

Recommendation: The Company should strengthen and improve its documentation of amounts paid to Adenus Technologies for purchase of system components, equipment and supplies. At a minimum such documentation should include identification of the specific wastewater system and the associated project or work order for which the materials were used.

Company Response: The Company agrees that in some circumstances, documentation of the expenses can be improved. That said, transactions related to a specific project, site, or system are noted on the invoices for the purchased equipment. If a pump is purchased to be installed at Black Bear, the invoice will state "Black Bear".

Often, materials and supplies are needed by TWSI personnel to have on hand in the field or as general inventory so that materials and supplies are readily available when needed and time is not regularly wasted by making long, repeated trips to the tech warehouse or waiting for orders to arrive via another delivery method. In this situation, there is no tracking notation on an invoice. The good is just booked into inventory. Using the pump example again, TWSI personnel may purchase 6 pumps to keep on hand at the Eudaily Treatment Facility and add those 6 to the 2 pumps that are, hypothetically, currently in inventory at the facility. If three of those pumps are needed at Stagg's Leap, there will be an invoice generated noting that three pumps were taken out of inventory and used at Stagg's Leap. However, there is no way to specify which three pumps were used and tie it back to an original invoice from Adenus Tech. The Company cross references the ticket generator which is used by the Company's maintenance personnel to identify what work is done at a particular site and adjusts those items identified on a ticket out to the appropriate location where the item is used or installed. These details are included in the 2017 escrow report provided to the Commission and will be made available going forward.

Finding No. 11 – Documentation of DRT Services Payments Should Be Improved

Background: DRT Services provided labor and equipment to TWSI for construction, repair and maintenance of its wastewater systems which were recorded in the utility's general ledger to Sewer System Replacement Account No. 265.2; Contract Maintenance Account No. 736.02; Fuel Expense Account No. 750.1; and Equipment Rental Expense Account No. 775.26.

Observation: Although the amounts charged to TWSI by DRT Services for contract labor and equipment were supported by vendor invoices, the invoices alone did not provide adequate documentation of the reasonableness of the related transactions. Staff was generally unable to identify through the invoice or other supplemental information the wastewater system construction, repair or maintenance project related to the contract labor and equipment billed by the affiliate.

Recommendation: The Company should strengthen and improve its documentation of amounts paid to DRT Services for contract labor and equipment. At a minimum such documentation should include identification of the specific wastewater system and the associated project or work order for which the labor and equipment were used.

Company Response: The Company agrees with Commission staff's recommendation and has begun to implement more detailed documentation practices related to DRT Services incorporating Commission staff's minimum documentation suggestions.

Finding No. 12 – Procedures For Verifying Management Fees Should Be Strengthened

Background: Adenus Operations allocated management fees and fuel costs to TWSI. Management fees were based on the allocation of time spent by Adenus Utilities Group employees on TWSI work. Fuel costs were allocated based on actual costs used by TWSI operators and maintenance personnel's vehicles.

Observation: For the period January 2016 through June 2017, staff reviewed the Management Fees Account No. 736.12 and the Fuel Cost Account No. 750.1 in the general ledger, and recorded amounts were reconciled to the timesheets of Adenus Group shared employees and fuel invoices. Upon reviewing the timesheets of Adenus Group shared employees, staff noted that the Company understated management fees by \$115,092 during the review period.

Recommendation: Staff recommends implementing additional procedures to ensure that management fees are verified to time records and properly recorded in the general ledger.

Company Response: The formula used on the spreadsheet to calculate management fees was incorrect. It has since been updated with corrected formulas and hourly wage rates. Further, the Company's Comptroller now double checks the journal entries to ensure they match what is on the spreadsheet.

Finding No. 13 – Affiliate IT Fees Should Be Correctly Recorded And Classified

Background: Adenus Group provided information technology services to TWSI. To reduce capital spending and minimize the liability of security breaches to systems and customer data, Adenus Group outsources certain information technology services to Network Solutions Group, with allocations to TWSI for its portion outsourced IT costs.

Observation: Staff reviewed IT Expense Account No. 736.13; Website and Internet Hosting Account No. 775.21; and Licenses & Permits Account No. 775.3 recorded in the general ledger. Amounts were reconciled to the contract and invoices for the period of January 2016 through June 2017. Upon reviewing the general ledger to invoices to determine if IT expenses were recorded accurately and properly documented, staff found that the Company inconsistently booked monthly computer license fees into different accounts and that IT expenses were misstated as follows: (a) for January 2016, the Company did not record Invoice No. 36837 for \$1,765 resulting in an understatement of expense; (b) for February 2016, the Company recorded an out-of-period amount of \$23,441 it paid to upgrade technology in November and December 2015 resulting in an overstatement of expense; and (c) for May 2017, the Company incorrectly calculated and booked TWSI's portion of allocated IT expense from Invoice No. 40249 resulting in an understatement of expense of \$154.

Recommendation: Staff recommends implementing additional procedures to ensure all IT expenses are consistently and correctly recorded in the general ledger.

Company Response: The Company now uses account number 736.13 for the IT bills. Further, to avoid confusion, expenses are now posted to the correct billing period rather than the invoice date of the bill. For example, NSG bills in advance for its services each month (i.e. NSG will send the invoice for its March billing in February). The Company used to record this invoice in February, when it was received, and then pay in March. The Company now records the invoice in March to correspond to when the expense is actually incurred.

E. Taxes Other Than Income Taxes Findings

Finding No. 14 – Property Taxes Should Be Paid Timely And Recorded To The Proper Accounting Period

Background: Property taxes are due annually during the period of October 1 to February 29.

Observation: Examination of the Property Taxes Account No. 408.1 revealed the following: (a) some payments are not made timely resulting in interest and penalties of approximately \$7,500; (b) a journal entry made to reverse a double recording of Robertson County taxes was made but the entry did not properly correct the duplicative error; and (c) there was a double accounting of the Williamson County property taxes.

Recommendation: The Company should pay all property taxes on a timely basis to avoid penalties and interest and payments should be recorded in the proper accounting period. Further

adjusting entries should be made to remove any out-of-period payments prior to completion of the annual report.

Company Response: (a) The referenced interest and penalties of approximately \$7500 was for the Cross Plains facility. The system was not timely transferred into the Company's name by the developer, so the Company never received the property tax bills for the property. The then listed property owner notified the Company as to delinquent tax bills, the Company promptly paid the bills, and the system placed on the Company's ad volarem report. The charges are not related to late tax payments. (b) This was a simple bookkeeping error. (c) Williamson County property taxes were not double booked for 2016. The Company accrued \$48,000 on December 31, 2016 for estimated taxes it had not received. The property tax bills were received in 2017 and were higher than the estimate. The \$48,000 estimate was reversed in two entries; one in January and the other in February. Otherwise, the Company agrees with the Commission staff's recommendation.

Finding No. 15 – Franchise Taxes Should Be Paid Timely And Recorded To The Proper Accounting Period

Background: Franchise and Excise Taxes are paid quarterly.

Observation: When reviewing the Franchise Tax Account No. 408.3 it was found that the fourth quarter for the 2015 year (\$13,580) and the second and third quarters for the 2016 year (\$13,330 for each year) were recorded to this account in 2016.

Recommendation: The Company should ensure that all Franchise and Excise payments are made on a timely basis and recorded in the proper accounting period. Further adjusting entries should be made to remove any out-of-period payments prior to completion of the annual report.

Company Response: Fourth quarter Franchise Taxes are not due until January 15 of the following year. The fourth quarter 2015 Franchise Tax payment was made according to its due date in first quarter 2016. The second and third quarter payments for 2016 were appropriately made during the 2016 calendar year. Otherwise the Company agrees with Commission staff's recommendation.

F. Utility Plant in Service and Depreciation Expense Findings

The Company's utility plant in service accounts were examined for the review period. The general ledger amounts are supported by subsidiary records maintained electronically by the Company in the fixed asset module (FAM). The utility plant in service reported in the Company's 2016 annual report was reconciled to the general ledger without any discrepancies, and the plant accounts reported in the general ledger were reconciled to the FAM with an immaterial difference of only \$9 being noted.

Most of the Company's utility plant is acquired through contributions in aid of construction. For the year ended 2016, the Company reported total utility plant in service of \$23,057,126, as well as related contributions in aid of construction of \$22,604,452, resulting in non-contributed plant

of \$452,674. The Company records contributed plant separately in its books as contributions in aid of construction in accordance with the Uniform System of Accounts. Contributed plant consists primarily of wastewater collection and treatment system plant. The contributed plant is amortized over its economically-useful life, with contributed wastewater collection system plant being amortized over fifty years and contributed treatment and disposal equipment being amortized over twenty-six years. Non-contributed plant consists primarily of transportation equipment, furniture and fixtures, and other miscellaneous equipment. The non-contributed plant accounts are depreciated over their economically useful lives.

Finding No. 16 – Straight-Line Depreciation Should Be Used For Regulatory Purposes

Background: Amortization and depreciation for the year ended 2016 were recomputed and compared to the amounts reported in the FAM, general ledger and annual report. No material discrepancy was noted in the amortization of contributions in aid of construction. With respect to depreciation of non-contributed plant, annual depreciation expense was computed to be \$71,637, whereas the Company reported \$111,639, a difference of \$40,002.

Observation: For the period ended 2016, the Company used accelerated depreciation methods to compute and report its annual depreciation expense for most of its non-contributed plant. For regulatory accounting purposes, the straight-line method should have been used to compute depreciation expense. As a result, the Company overstated its reported depreciation by \$40,000, or 56%, for the year ended 2016. Prior to the end of fieldwork, the Company changed the depreciation rates maintained in the FAM to reflect the straight-line depreciation method for all depreciable plant accounts.

Recommendation: The Company should ensure that the straight-line method is used to compute annual depreciation expense for all depreciable plant accounts.

Company Response: The Company agrees with this recommendation. As stated above, prior to the end of fieldwork, the Company changed the depreciation rates maintained in the FAM to reflect the straight-line depreciation method for all depreciable plant accounts.

Finding No. 17 – A Uniform Capitalization Policy Should Be Developed And Implemented

Background: Review of escrow and operating expense account activities revealed that the Company made significant expenditures for rehabilitation of at least thirteen wastewater systems during the review period. For the year ended December 31, 2016, individual system rehabilitation expenditures ranged from nearly \$18,000 (Wyndsong) to over \$100,000 (Smokey Cove), and the aggregate rehabilitation expenditures for all systems totaled more than \$500,000. Further review indicated significant amounts were expended for certain rehabilitation projects that should be capitalized in the Company's plant accounts, such as construction, installation or replacement of system control panels, Arkal filters, certain pumps, equipment sheds, and drip field repairs.

Observation: The original cost of the purchase or construction of plant and equipment owned and used by the Company in its utility operations, and having an expected service life of more

than one year from the date of installation, should be capitalized as utility plant in service in accordance with Account No. 101 of the Uniform System of Accounts, as well as the subsidiary plant accounts described in Account Nos. 351 through 398. The Company does not have a written capitalization policy, and it did not record any of the reviewed system rehabilitation expenditures as utility plant in service.

Recommendation: The Company should develop a written capitalization policy setting a threshold, above which qualifying expenditures are recorded as utility plant in service, consistent with the accounting instructions set forth in the Uniform System of Accounts.

Company Response: The Company agrees with the Commission staff's recommendation and will develop a written capitalization policy in accordance with the recommendation.

G. Escrow And Developer Income Related Finding

During staff's review of escrow charges and developer income it was noted that in some instances developers, affiliates or other parties maintain the right to sell unused system capacity after the system has been transferred to TWSI. Staff ascertained that these capacity rights may be maintained by other parties for years after transfer of the system and that no allocations of system costs were made to the holders of these rights. Staff attempted to study this issue further by requesting information concerning the amount of unused capacity for each TWSI system, as well as the holders of the rights to sell such unused capacity. This information, however, was unavailable.

Finding No. 18 – Holders Of Capacity Rights Or Other Interests Should Be Identified

Background: Most of the wastewater systems acquired by TWSI are contributed to it by developers, affiliates, or other parties who either construct or fund the construction of the system. In some cases the wastewater system conveyed to TWSI is designed and built larger than required to provide sewer service to regulated customers; consequently, such systems have sufficient fallow capacity to serve additional future customers. According to the Company, the parties investing in the construction of such contributed systems retain the right to sell any unused capacity to future customers as a means of recouping their investment. The sale of such unused capacity may occur several years after the system has been constructed or expanded. Thus, parties other than TWSI, including in some cases Company affiliates, maintain an economic interest in a contributed wastewater system long after ownership of the system has been transferred to the Company.

Observation: TWSI pays the costs of maintaining and refurbishing wastewater systems after they have been transferred to the Company. Such costs may be incurred for non-routine maintenance, such as extra-ordinary maintenance to replace damaged system components, as well as capital additions and improvements to the system. These projects may include, for example, the installation of control panels required to commence or enhance electronic monitoring of system performance to assure compliance with environmental, health and safety regulations, or the installation or replacement of system components such as drip fields, pump houses and equipment sheds. None of these costs are shared by the parties who hold rights to

unused capacity. Although such expenditures serve the interests of both used and unused capacity, they are borne by regulated ratepayers. Staff was unable to obtain specific information regarding the present holders of capacity rights and the existing amount of unused capacity for each of TWSI's wastewater systems.

Recommendation: Where regulated ratepayers bear the cost of operating, maintaining, or improving a wastewater system and any party other than TWSI receives or retains an economic interest in the system, including capacity rights, the Company should be required to specifically identify such parties and their interests prior to the construction, expansion, or acceptance of the system. With this information, the Commission will be in a position to appropriately weigh the interests of nonregulated parties in its consideration of such systems.

Company Response: While not expressly stated in this finding or recommendation, it is presumed by the Company that the Commission staff is interested in exploring whether anyone holding an economic interest in a system, including capacity rights, should be required to bear some of the costs of operating, maintaining, or improving the wastewater system. As a regulated entity (by both TPUC and TDEC), the Company has an obligation to keep its systems maintained. System maintenance and repair are a function of use not for the preservation of an interest in the wastewater system. When a wastewater system is put into operation, the full system is operational. A system is not used proportionally based on the amount of flow the system receives relative to the available capacity. As the system is used whether it is by ten customers or a hundred, parts eventually wear out and need to be replaced, systems break down and need repair. Maintenance and repairs are performed to ensure customers receive the services they need and so that the Company maintains compliance with the various laws, rules, and regulations to which it is subject.

Facility improvements are generally made to enhance the service customers receive and/or to address new regulations put upon the Company. An example of this is the effort undertaken by the Company to upgrade the control panels that operate its systems to allow for telemetry monitoring of the systems. TDEC changed their permit requirements a few years back to require site visits every fourteen days to each system, unless the sites were monitored by telemetry. Those sites monitored by telemetry only need to be visited once a month. Economically for all involved (company and ratepayer), it was better for the Company to upgrade its sites to allow for telemetry monitoring than hire the personnel necessary (along with associated costs such as trucks and equipment) to perform site visits every fourteen days. Improvements, such as this one, are a function of regulation and have no correlation to any benefit to a nonparty holding an interest in a system. Any benefit received by a holder of an interest in a system due to maintenance, repair, and improvements is purely incidental. The Company does not undertake maintenance, repair, or improvement activity to maintain someone's interest in a system or in any excess capacity.

TWSI owns all the wastewater systems it operates with a few exceptions where it maintains a 99-year lease on the system or the utility is the contract operator for a system. Any interest held by third-parties is essentially related to excess capacity in a given system. Most systems are built by a developer to meet the specific requirements of the developer's project. The Company's position is if the developer pays to build the system and contributes it to the utility, the developer

owns the capacity in that system. If a system is built larger than a developer requires than whoever invests to build the excess owns the extra capacity and is entitled to recoup that investment through the sale of taps related to the excess capacity. Systems may be built larger than a developer requires where the developer plans to develop an odd number of lots and it cannot be constructed within the standard unit size in which the treatment plant is scaled (i.e. sand filter at 30,000 gallons per day). It would be much more expensive to custom build the treatment plant as opposed to utilizing the standard sizing. The third party, whether it's the Company, an affiliate, or another entity, takes a risk that additional development will happen, and that their investment will eventually be recouped. The third-party has no claim or interest in the system itself other than the additional capacity.

The Company has no issue with the Commission staff's recommendation to identify any parties and any interest they may hold in future wastewater systems. However, the Company requests that the Commission provides guidance as to what it believes constitutes an economic interest in a wastewater system, including how excess capacity is to be defined and determined. Further, if the Commission wishes to weigh the interests of nonregulated parties in consideration of such systems (again, presumably to determine whether those parties should share in the some of the costs of operating, maintaining, or improving a system) the Commission should promulgate rules addressing this intent so that utilities, developers and any third parties interested in making an investment in the development of a wastewater system are fully aware of any additional obligations and/or costs they may be required to bear and so that those obligations and/or costs can be addressed up front at the time the parties contract for services so as not to be unresolved until the Commission acts upon specific requests.

Staff Response: Staff agrees with the Company that the economic interests retained by nonregulated parties in any wastewater system transferred or proposed to be transferred to TWSI should be identified and defined as clearly as possible. Staff, however, does not agree that a rulemaking proceeding is necessary or required prior to the Commission's evaluation of these interests in its consideration of such systems.

VII. SUMMARY AND CONCLUSION

Based on review and analysis of TWSI's books and records, as well as reconciliations of financial data and testing of sample transactions, staff is of the opinion that, except as discussed in the findings and recommendations set forth in section VI above, the Company's billing and accounting records and practices for the review period substantially complied with the Commission's rules and regulations. The Company's annual financial report reconciled to the general ledger and tax returns, and the general ledger transactions and balances examined by staff appeared to be accurately recorded, properly classified for reporting purposes, and supported by sufficient documentation, except as otherwise discussed herein. Staff's examination resulted in eighteen findings and recommendations.

A. Chief Areas Of Concern

Developer Income. As discussed in section VI.B, Finding No. 5, staff determined that certain revenues received from developers, as well as related expenses, were not properly recorded in

the utility's accounts. Staff therefore recommended that TWSI develop and implement an accounting policy to record developer revenues and matching expenses in accordance with the Commission's *Order Affirming and Clarifying Previous Order* entered in Docket 16-00015, which clarified the accounting requirements for such transactions. Although the Company maintains its disagreement with treating such developer income as regulated income, it agreed to develop an accounting policy consistent with staff's recommendation. Further, while the Company maintains that developer income should be unregulated, staff recommended that all such payments received from developers be supported by authorized service tariffs or special contracts approved by the Commission, as discussed in section VI.B, Finding No. 6.

Documentation of Affiliate Transactions. Staff reviewed transactions with affiliates to determine if amounts charged to the utility for goods and services were reasonable and that payments to affiliates were sufficiently documented. Based on review and testing of affiliate charges, staff did not find that amounts charged by affiliates were unreasonable. Staff, however, concluded that documentation should be strengthened and improved for affiliate charges related to wastewater system materials and supplies provided by Adenus Technologies and contract labor and equipment rental provided by DRT Services. These recommendations, which are discussed in section VI.D, Finding Nos. 10 and 11, state that, at a minimum, such documentation should identify the specific wastewater system and associated project or work order related to the charge. The Company agreed that, in certain instances, documentation of charges by these affiliates could be improved and stated that it had begun to implement more detailed documentation practices for DRT Services.

Identification of Holders of Capacity Rights. As more fully set forth in section VI.G, Finding No. 18, during review of developer income and escrow charge transactions, staff ascertained that developers, affiliates, or other parties maintain the right to sell capacity to future customers in certain systems after ownership has been transferred to the Company. The sale of such capacity may occur years after the system has been transferred to TWSI, and TWSI does not receive any revenues from such sales. Further, once the system is transferred to TWSI, the Company's ratepayers bear the costs of system maintenance and capital additions and improvements. Although other parties besides TWSI may retain an economic interest in the system through their right to sell system capacity to future customers, none of the costs associated with extra-ordinary maintenance or capital additions and improvements incurred after the system's transfer to TWSI is allocated to them. Staff is of the opinion that such arrangements should be examined more closely to appropriately weigh the interests of all parties. Staff therefore recommended that the Company be required to specifically identify anyone retaining an economic interest in a system prior to its construction, expansion or acceptance by TWSI. After fully explaining its position on the issue of retention of capacity rights by other parties, the Company stated it had no issue with identifying such parties but requested that the Commission provide guidance on how such economic interests should be defined, and it stated further that the Commission should promulgate rules if it wishes to weigh the interests of nonregulated parties in its consideration of such systems. While the economic interests retained by nonregulated parties in any wastewater system transferred or proposed to be transferred to TWSI should be identified and defined as clearly as possible, staff is not of the opinion that a rulemaking proceeding is necessary or required for the Commission to evaluate such interests in its consideration of proposals to construct, expand, or accept conveyance of such systems.

Capitalization of Utility Plant. As explained in section VI.F, Finding No. 17, staff noted during its examination of escrow charges and operations and maintenance expenses that certain material expenditures related to system rehabilitation projects were not capitalized. In staff's opinion, such expenditures should have been recorded to the appropriate utility plant account. The Company does not have a written capitalization policy; accordingly, staff recommended that the Company implement a written capitalization policy consistent with the Uniform System of Accounts setting forth the qualifying expenditures to be recorded as utility plant in service. The Company agreed with staff's recommendation and stated it would develop such a policy.

Clarification of Service Tariff. Staff made four recommendations for clarification of the Company's service tariff so that the authorization and accuracy of charges billed to customers may be more clearly determined from the face of the tariff that is approved and maintained by the Commission. These recommendations are detailed in section VI.A, Finding Nos. 1 through 4. The Company agreed with staff's recommendations and stated it would implement the recommended tariff clarifications.

B. Other Areas Of Concern

Staff also made findings and recommendations in the areas of operations and maintenance expense, depreciation expense, affiliate charges, and taxes other than income taxes. As detailed in section VI.C, Finding Nos. 8 and 9; section VI.D, Finding No. 13; and section VI.E, Finding Nos. 14 and 15; staff recommended that the Company strengthen its review of accounting classifications and adjustments for certain accounts to improve the accuracy of financial reporting. With certain explanations of particular circumstances, the Company agreed with staff's recommendations.

Staff noted in section VI.C, Finding No. 7, that receipts supporting employee-issued credit card transactions were not sufficiently maintained, and that the Company should strengthen its procedure for obtaining and reconciling such receipts to bank card statements prior to payment. The Company agreed with staff's recommendation and stated it had restated and reinforced its credit card policy with all employees.

Staff found in section VI.D, Finding No. 12, that the Company should improve its procedure for verifying and recording affiliate management fees. Based on the documentation reviewed, staff determined that the current procedure materially understated management fees for the review period. The Company agreed with staff's recommendation and stated it had corrected the formula for allocation of management fees and instituted additional review procedures.

Finally, in section VI.F, Finding No. 16, staff determined that the Company's depreciation expense for the review period was materially overstated for regulated accounting purposes because accelerated depreciation methods were used. Staff recommended the Company use the straight-line depreciation method to compute and report depreciation expense to the Commission. The Company agreed with staff's recommendation and changed its depreciation rates accordingly.