

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

Application of Tennessee Water Service,  
Inc. for Adjustment of Rates and Charges,  
Approval of a Qualified Infrastructure  
Investment Program, and Modification to  
Certain Terms and Conditions for the  
Provision of Water Service

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Docket No. 19-00028

**SECOND SUPPLEMENTAL TESTIMONY  
of  
WILLIAM H. NOVAK**

ON BEHALF OF

**THE CONSUMER ADVOCATE UNIT  
OF THE  
FINANCIAL DIVISION  
OF THE  
OFFICE OF THE TENNESSEE ATTORNEY GENERAL**

*October 7, 2019*

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

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

6

7 ***Q2. ARE YOU THE SAME WILLIAM H. NOVAK WHO PRESENTED PRE-***  
8 ***FILED AND SUPPLEMENTAL TESTIMONY IN THIS DOCKET?***

9 A2. Yes.

10

11 ***Q3. WHAT IS THE PURPOSE OF YOUR SECOND SUPPLEMENTAL***  
12 ***TESTIMONY?***

13 A3. In accordance with the Hearing Officer's Order of September 13, 2019 in this  
14 Docket, the purpose of my second supplemental testimony is to address "...the  
15 singular issue of the appropriate amount of regulatory liability, if any, in light of  
16 the Company's admission that it failed to properly insure the destroyed [water  
17 utility] assets."<sup>1</sup>

18

19 ***Q4. WHAT DOCUMENTS HAVE YOU REVIEWED IN PREPARATION OF***  
20 ***YOUR SECOND SUPPLEMENTAL TESTIMONY?***

21 A4. In addition to the documents reviewed in preparation of my direct and prior  
22 supplemental testimony, I have now also reviewed the hearing transcript of

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<sup>1</sup> Tennessee Public Utility Commission, Docket No. 19-00028, Order on Status Conference and Establishing Procedural Schedule for Supplemental Hearing, Page 4, September 13, 2019.

1 September 9, 2019 in this Docket. I've also reviewed the supplemental testimony  
2 of Tennessee Water Service (TWS or Company) witnesses DeStefano and  
3 Mendenhall that was filed with the Commission on September 16, 2019. Finally,  
4 I've reviewed the Company's responses to the Consumer Advocate's sixth  
5 discovery request that was filed with the Commission on September 27, 2019, as  
6 supplemented by the Company.

7  
8 ***Q5. MR. NOVAK, DID YOU ADDRESS THE CONSUMER ADVOCATE'S***  
9 ***POSITION ON THE AMOUNT OF REGULATORY LIABILITY IN YOUR***  
10 ***DIRECT TESTIMONY?***

11 ***A5.*** Yes. In my direct testimony, I proposed that the Commission establish a  
12 regulatory liability equal to \$757,006 along with an annual amortization of  
13 \$11,619 in order to offset the impact for the Chalet Village replacement costs that  
14 TWS had failed to properly insure.<sup>2</sup>

15  
16 ***Q6. DID THE COMPANY AGREE WITH YOUR PROPOSAL FOR THE***  
17 ***ESTABLISHMENT OF A REGULATORY LIABILITY?***

18 ***A6.*** Not entirely. The Company has agreed with the proposal for the establishment of  
19 a regulatory liability, but at an amount equal to \$382,016 with an annual  
20 amortization of \$5,730.<sup>3</sup>

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<sup>2</sup> Tennessee Public Utility Commission, Docket No. 19-00028, Direct Testimony of William H. Novak, Page No. 38, Line Nos. 4-13, July 12, 2019.

<sup>3</sup> Tennessee Public Utility Commission, Docket No. 19-00028, Pre-Filed Direct Supplemental Testimony of Dante M. DeStefano, Page No. 5, Line Nos. 19-20, September 16, 2019. Also note the Company's response to the Consumer Advocate's discovery request No. 6-1.

1

2 ***Q7. WHAT IS THE COMPANY'S BASIS FOR ADJUSTING THE AMOUNT OF***  
3 ***THE REGULATORY LIABILITY AND ASSOCIATED AMORTIZATION?***

4 ***A7.*** According to the Company, "...disasters such as the Gatlinburg wildfire can  
5 create a premium on the reconstruction of [damaged] assets due to supply/demand  
6 pressures on contractor labor and materials."<sup>4</sup>

7

8 ***Q8. DOES THE COMPANY OFFER ANY SUPPORT FOR THIS CLAIM?***

9 ***A8.*** No. The Company is asking the Commission to rely solely on Company witness  
10 Mendenhall's unsupported assertion that the Gatlinburg wildfire created a  
11 premium on reconstruction of damaged assets due to supply/demand pressures on  
12 contractor labor and materials that are relevant to the reconstruction of a utility.<sup>5</sup>  
13 While Mr. Mendenhall's conclusions regarding construction cost escalations after  
14 the Gatlinburg wildfire may or may not be true for utility infrastructure  
15 replacement, the Company has presented no evidence to authenticate this  
16 assertion.<sup>6</sup>

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<sup>4</sup> Tennessee Public Utility Commission, Docket No. 19-00028, Rebuttal Testimony of J. Bryce Mendenhall, Page Nos. 5-6, Line Nos. 9-11, August 16, 2019.

<sup>5</sup> It is worth noting that, from the record, it appears that the Company has never engaged a Tennessee contractor for a major infrastructure replacement project since the original water utility plant was first constructed in 1983. In a practical sense, this supports the position that the Company appears to have failed to have readily available utility contractors after the Gatlinburg wildfire.

<sup>6</sup> Such evidence could have included, for example, a multi-time period side-by-side comparison of the individual material and labor cost components for the Chalet Village (and potentially Sugar Mountain) Projects.

***Q9. WHAT ALTERNATIVE POSITION HAS THE COMPANY TAKEN FOR  
THE REGULATORY LIABILITY CALCULATION?***

**A9.** The Company is proposing to use the installed cost of a separate project in North Carolina (the Sugar Mountain Project) for \$216,008 as a proxy for each of the project replacement costs in Gatlinburg.<sup>7</sup> In essence, the Company is arguing that this \$216,008 amount should be treated as the amount for which the Company insured each of the Chalet Village assets – even though the Company intentionally insured only one Chalet Village asset for a replacement value of \$24,000, with a \$50,000 deductible on that asset.<sup>8</sup>

The Company’s total proposed regulatory liability of \$382,016 is calculated as shown below in Table 1. In addition, the Company proposes the same 66.67-year period used by the Consumer Advocate to amortize its proposed regulatory liability by \$5,730 annually.<sup>9</sup>

<b>TABLE 1 – TWS Proposed Regulatory Liability Calculation<sup>10</sup></b>	
<b>Item</b>	<b>Amount</b>
Proxy Cost for Piney Butt Tank & Booster Station	\$216,008
Proxy Cost for Clubhouse Well & Booster Station	216,008
<b>Total Proxy Cost</b>	<b>\$432,016</b>
Less Hypothetical Insurance Deductible	-50,000
<b>TWS Proposed Regulatory Liability</b>	<b>\$382,016</b>

<sup>7</sup> Tennessee Public Utility Commission, Docket No. 19-00028, Rebuttal Testimony of J. Bryce Mendenhall, Page No. 7, Line Nos. 4-7, August 16, 2019.

<sup>8</sup> See the Company’s response to Consumer Advocate Discovery Request 5-2f and the Hearing Transcript of September 9, 2019 in this Docket, at Page No. 63, Line Nos. 12-23.

<sup>9</sup> Tennessee Public Utility Commission, Docket No. 19-00028, Rebuttal Testimony of J. Bryce Mendenhall, Page No. 7, Line Nos. 16-19, August 16, 2019.

<sup>10</sup> Tennessee Public Utility Commission, Docket No. 19-00028, Rebuttal Testimony of J. Bryce Mendenhall, Page No. 7, Line Nos. 10-19, August 16, 2019.

1 The Company then goes on to assert that a reasonable utility would have only  
2 insured each of the destroyed Chalet Village assets for \$216,008 since this was  
3 the most recently incurred cost to replace a similar utility asset which then results  
4 in TWS' total proposed regulatory liability of \$382,016 after insurance  
5 deductibles.

6

7 ***Q10. HAS THE COMPANY PROVIDED ANY REGULATORY PRINCIPLES OR***  
8 ***LITERATURE IN SUPPORT OF THIS ALTERNATIVE APPROACH?***

9 ***A10.*** No. The Company does not provide any citations or other documentation from  
10 regulatory principles or literature that would support its desire to use a proxy asset  
11 from another utility instead of focusing on what the Company actually did (or did  
12 not do) with the two assets in Tennessee.

13

14 ***Q11. MR. NOVAK, DO YOU AGREE WITH THE COMPANY'S PROPOSAL TO***  
15 ***USE THE SUGAR MOUNTAIN PROJECT AS A PROXY FOR THE***  
16 ***CHALET VILLAGE WATER PLANT REPLACEMENT?***

17 ***A11.*** No. The Company's proposal to treat, in essence, the amounts expended in an  
18 *unrelated* project in another State as the *deemed* amounts for which utility assets  
19 were insured in Tennessee is a diversionary argument.<sup>11</sup> This argument was set

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<sup>11</sup> Another argument raised by the Company involves the effect of a regulatory liability on the Company's return on equity. See Supplemental Testimony of Company witness DeStefano filed on September 16, 2019, at Page No. 3, Line Nos. 15-21. Essentially, under this proposal, the Company is seeking a bonus return. The bonus return would arise because at the point that the Company failed to adequately insure its assets, that business decision (and its associated risk) resulted in the Company incurring costs that there is no basis to recover from ratepayers. In other words, the Company had the opportunity to earn a fair return, but made a business decision that cost it the reduction on the actually earned return on equity. It should be

1 up to shift the discussion from the Company's failure to obtain adequate insurance  
2 to a discussion about what amount a hypothetical reasonable utility would insure  
3 the Chalet Village assets for.

4

5 And it is worth noting that the use of assets owned by one utility – in this case the  
6 Sugar Mountain assets – to show what another utility should be deemed to have  
7 insured its assets for – in this case the Chalet Village assets -- is not supported by  
8 regulatory principles or literature, and is not supported in the testimony or  
9 responses to the Consumer Advocate's discovery requests in this Docket.

10

11 Focusing on the facts in this case, it would be neither prudent nor reasonable for a  
12 utility to insure its critical assets for anything other than their replacement cost.

13 In this case, the Company erred – and it admits the error – in intentionally  
14 obtaining inadequate insurance.<sup>12</sup> The Company's unreasonableness and lack of  
15 prudence are consequently self-evident.

16

17 Taking the Company's unreasonableness and lack of prudence into account, it  
18 must be emphasized that it makes no difference that the utility was able to find  
19 another project in its system at a cost that the Company now wants to hold out as  
20 a proxy (or cost of that proxy) for what the Company should have done. There is

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noted that the Company acknowledges that a utility is not guaranteed a return on its investment in its response to the Consumer Advocate's discovery request 6-33. The bonus return proposal by the Company should be rejected by the Commission.

<sup>12</sup> See the Hearing Transcript of September 9, 2019 in this Docket, at Page No. 63, Line Nos. 12-23, and the Company's response to Consumer Advocate Discovery Request 6-29.

1 no basis for using that other project or the cost of that project. From the  
2 Company's testimony, it is clear that the Company is simply offering up what is  
3 essentially a diversion for the Commission's consideration, instead of focusing on  
4 the actual facts of this case.<sup>13</sup> Those facts clearly show that the utility was solely  
5 responsible for its own intentional failure to obtain adequate insurance.<sup>14</sup> Based  
6 on those facts, the utility should be held solely responsible for replacing the assets  
7 and the resulting regulatory liability should reflect the full cost of these assets.

8

9 ***Q12. PLEASE PROVIDE YOUR RECOMMENDATION TO THE COMMISSION***  
10 ***REGARDING THE AMOUNT OF REGULATORY LIABILITY TO REFLECT***  
11 ***IN THE COMPANY'S RATE CASE.***

12 ***A12.*** I would urge the Commission to reject the Company's unsupported assertion that  
13 the Gatlinburg wildfire created a premium on reconstruction of damaged assets  
14 due to supply/demand pressures on contractor labor and materials that are relevant  
15 to the reconstruction of a utility. Likewise, I would urge the Commission to reject  
16 the Company's unsupported proposal to use the Sugar Mountain Project as a  
17 proxy for the Chalet Village assets and, further I would urge the Commission to

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<sup>13</sup> Another diversionary argument raised by Company witness Heigel in the hearing on September 9, 2019, at Page No. 54, Line Nos. 13-18 (and Page No. 55, Line Nos. 9-17), was that ratepayers have been paying a "much lower [insurance] premium based on the fewer assets that were covered." The Company's responses to the Consumer Advocate's Discovery Request 6-23 and 6-24 indicate that either the Company does not actually have support for Ms. Heigel's statement or that her statement is not accurate in view of the insurance allocation to ratepayers currently (\$216.48) when compared to the allocation described by Mr. Mendenhall in his Rebuttal Testimony (\$528.50) at Page No. 5, line 12. Note that the amount insured currently (\$877,000) is much higher than the amount insured previously (\$24,000, less a \$50,000 deductible). See the Company's responses to Consumer Advocate discovery requests 5-2f and 6-24.

<sup>14</sup> From my perspective, the replacement cost set by TWS when it obtained insurance should have considered the geography and potential challenges that a reasonable utility could foresee in replacing its critical assets in a situation like the wildfires. That is, after all, why utilities carry insurance in the first place.



1 reject the Company's proposal to use the Sugar Mountain asset costs as the  
2 amount for which the Company should be treated as having insured each of  
3 Chalet Village assets. Instead, I reaffirm my original recommendation that the  
4 Commission adopt the actual replacement cost of \$757,006 as the appropriate  
5 amount for a regulatory liability along with an annual amortization of \$11,619.  
6

7 ***Q13. DO YOU RECOMMEND THAT THE COMMISSION ADJUST THE***  
8 ***REGULATORY LIABILITY FOR THE INSURANCE DEDUCTIBLE AS THE***  
9 ***COMPANY HAS DONE IN TABLE 1 ABOVE?***

10 ***A13.*** No. As shown in Table 1, the Company has applied a hypothetical insurance  
11 deductible to a hypothetical insurance policy. As described in my direct  
12 testimony, through its own oversight the Company effectively had no insurance  
13 coverage on its water utility assets in Tennessee.<sup>15</sup> As a result, it would be  
14 inappropriate to adjust the regulatory liability for the deductible on a non-existing  
15 insurance policy.  
16

17 ***Q14. DOES THIS COMPLETE YOUR SECOND SUPPLEMENTAL TESTIMONY?***

18 ***A14.*** Yes, it does. However, I reserve the right to incorporate any new information that  
19 that may subsequently become available.

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<sup>15</sup> Tennessee Public Utility Commission, Docket No. 19-00028, Direct Testimony of William H. Novak, Page No. 36, Line Nos. 4-7, July 12, 2019.