

Bryan W. Shaw, Ph.D., *Chairman*  
Carlos Rubinstein, *Commissioner*  
Toby Baker, *Commissioner*  
Zak Covar, *Executive Director*



Blas J. Coy, Jr., *Public Interest Counsel*

## TEXAS COMMISSION ON ENVIRONMENTAL QUALITY

*Protecting Texas by Reducing and Preventing Pollution*

October 4, 2012

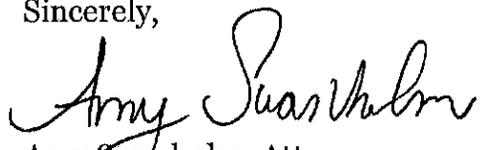
Bridget Bohac, Chief Clerk  
Texas Commission on Environmental Quality  
Office of the Chief Clerk (MC-105)  
P.O. Box 13087  
Austin, Texas 78711-3087

**RE: COTTONWOOD ENERGY COMPANY LP  
TCEQ DOCKET NO. 2012-1562-MIS-U**

Dear Ms. Bohac:

Enclosed for filing is the Office of Public Interest Counsel's Response to Appeal of Negative Use Determination in the above-entitled matter.

Sincerely,

  
Amy Swanholm, Attorney  
Assistant Public Interest Counsel

cc: Mailing List

Enclosure



**TCEQ DOCKET NO. 2012-1562-MIS-U**

<b>IN THE MATTER OF THE APPEAL</b>	<b>§</b>	
<b>BY COTTONWOOD ENERGY</b>	<b>§</b>	<b>BEFORE THE</b>
<b>COMPANY LP OF NEGATIVE USE</b>	<b>§</b>	<b>TEXAS COMMISSION ON</b>
<b>DETERMINATION</b>	<b>§</b>	<b>ENVIRONMENTAL QUALITY</b>
<b>NOs. 15505, 16410, 16411, 16412,</b>	<b>§</b>	

**OFFICE OF PUBLIC INTEREST COUNSEL'S  
RESPONSE TO APPEAL OF NEGATIVE USE DETERMINATION**

**TO THE HONORABLE MEMBERS OF THE TEXAS COMMISSION ON  
ENVIRONMENTAL QUALITY:**

The Office of the Public Interest Counsel (OPIC) files this response to Cottonwood Energy Company LP's (Cottonwood or Appellant) appeal of the negative use determination issued by the Executive Director (ED).

**I. INTRODUCTION**

In July 2011, Cottonwood submitted a Tier III use determination application to the Texas Commission on Environmental Quality (TCEQ) and supplemented this application three times in December 2011. Cottonwood sought use determinations for four thermally efficient heat recovery steam generators (HRSG) associated with electric power generation at the Cottonwood Energy Center in Deweyville, Newton County, Texas. The applications describe the property as using natural gas-fueled, combined-cycle technology to power four combustion turbines. The heat produced by the combustion of natural gas in the turbines is captured by the HRSGs, which produce steam used to turn steam turbines and generate additional electricity. As required in a

Tier III application, Cottonwood calculated the pollution control percentage for the four HRSGs, resulting in their request for 42.99% tax exemption in each of the four applications. On July 10, 2012, the ED issued a negative use determination for Cottonwood's facilities. The ED stated that HRSGs are used solely for production and are not considered pollution control equipment. On July 31, 2012, Cottonwood appealed the ED's negative use determination for the four HRSG units.

Cottonwood argues that the TCEQ failed to review the use determination application within the statutory deadlines, and that the negative determination violated the Equal and Uniform Tax Clause of the Texas Constitution.<sup>1</sup> In addition, Cottonwood argues that the TCEQ did not have authority to issue a negative use determination and issuing a negative determination violated the Texas Administrative Procedures Act. Finally, Cottonwood argues that the administrative record supports a positive use determination. It requests that the appeal be granted and that the matter be remanded to the ED for a positive use determination.

## **II. APPLICABLE LAW**

### **A. Legislative History**

On November 2, 1993, Texas voters approved a constitutional amendment exempting certain pollution control property/equipment from property taxation. This amendment added Section (§) 1-1 to Article 8 of the Texas Constitution. Legislation to implement the amendment was approved in House Bill (HB) 1920, 73rd Texas Legislature, 1993. This legislation added the new section 11.31 to the Texas Tax Code.

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<sup>1</sup> TEX. CONST. art. VIII, § 1(a).

The intent of the constitutional amendment was to ensure that capital expenditures undertaken to comply with environmental rules did not increase a facility's property taxes.

The 77th Texas Legislature, 2001, amended §11.31 to require the TCEQ to adopt specific standards for evaluating applications and create a formal procedure to allow applicants or appraisal districts to appeal a final determination.

The 80th Legislature, 2007, amended §11.31 by adding three new subsections. The first change required the TCEQ to adopt a nonexclusive list of property/equipment that included a list of 18 different categories, i.e., the Expedited Review List that is specified in §17.17(b) of the Texas Administrative Code. The second change required that the list be reviewed at least once every three years and established a standard for removing property/equipment from the list. The third change established a 30-day review period for applications that contain only property/equipment listed on the Expedited Review List.

The 81st Texas Legislature, Regular Session, 2009, passed House Bills 3206 and 3544, amending §11.31 by adding two new sections. New section (g-1) requires that applications containing property/equipment adopted under §11.31(k) be reviewed using the methods and standards adopted under §11.31(g). New section (n) requires the establishment of a permanent advisory committee that is charged with advising the commission on the implementation of §11.31. In addition, the legislation corrected the agency's name in the statute and allowed for electronic appraisal district notifications as required by §11.31(d).

On November 18, 2010, the TCEQ adopted changes to 30 Tex. Admin. Code Chapter 17 to establish procedures and mechanisms for obtaining a use determination

required to implement the amendments to §11.31 by House Bills 3206 and 3544, 81st Texas Legislature, Regular Session, 2009.

### **A. 30 Texas Administrative Code Chapter 17**

The rules state that to obtain a positive use determination, “the pollution control property must be used, constructed, acquired, or installed wholly or partly to meet or exceed laws, rules, or regulations adopted by any environmental protection agency of the United States, Texas, or a political subdivision of Texas, for the prevention, monitoring, control, or reduction of air, water, or land pollution.” 30 TAC § 17.4(a). Chapter 17 contains a list of items (the Tier I Table), predetermined as used wholly for pollution control purposes. 30 TAC § 17.14. In addition, there are three different types of use determination applications;

Tier I-An application which contains property that is in Part A of the figure in §17.14(a) or that is necessary for the installation or operation of property located on the Tier I table; 30 TAC § 17.2(8)

Tier II- An application for property that is used wholly for the control of air, water, and/or land pollution, but is not located on the Tier I Table in §17.14(a); 30 TAC § 17.2(9)

Tier III- An application for property used partially for the control of air, water, and/or land pollution and that does not correspond exactly to an item on the Tier I Table in §17.14(a); 30 TAC § 17.2(10)

In addition, a Tier III partial use determination “submitted for all property that is either not on the Tier I Table located in §17.14(a) of this title (relating to Tier I Pollution Control Property), or does not fully satisfy the requirements for a 100% positive use determination.” 30 TAC § 17.17(a). To calculate partial use for Tier III applications, the cost analysis procedure (CAP) in 30 TAC § 17.17(c) must be used. *Id.* If the cost analysis

procedure produces a negative number or a zero, the property is not eligible for a positive use determination. 30 TAC § 17.17(d).

Under § 17.25, an appellant has 20 days to appeal a use determination issued by the ED. 30 TAC § 17.25(a)(2)(A) and (B); 30 TAC § 17.25(b). Upon a timely appeal, the Commission may either “deny the appeal and affirm the ED’s use determination” or “remand the matter to the ED for a new determination.” 30 TAC § 17.25(d)(2). The general counsel may remand a matter from the commission's agenda to the executive director if the executive director or the public interest counsel requests a remand. 30 TAC § 17.25(d).

Should the Commission remand the use determination, the ED shall conduct a new technical review and issue a new use determination. 30 TAC § 17.25(f)(A) and (B).<sup>2</sup> This determination may be appealed. 30 TAC § 17.25(f)(2). If the Commission denies the appeal and affirms the use determination, this decision is final and appealable. 30 TAC § 17.25(e)(3).

### III. TIMELINESS

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<sup>2</sup> OPIC finds that the rules and statutes in effect when the Appellant submitted its application should be applied. The Code Construction Act states that “a statute is presumed to be prospective unless expressly made retrospective.”<sup>2</sup> TEX. GOV’T CODE § 311.022. And the Texas Attorney General has clarified that “the same general principles [in TEX. GOV’T CODE § 311.022] also apply to agency rules.”<sup>2</sup> Op. Tex. Att’y Gen. No. GA-0655 (2008) (citing *R.R. Comm’n v. Lone Star Gas Co.*, 656 S.W.2d 412, 425 (Tex. 1983)). Further, House Bills 3206 and 3544 “specifically [do] not apply to applications filed prior to January 1, 2009, or to applications filed after January 1, 2009, that received final determinations prior to September 1, 2009.”<sup>2</sup> 35 Tex. Reg. 10965. See also Tex. H.B. 3206, 81st Leg., R.S. (2009).

Appellant submitted its application in July and December of 2011, therefore HB 3206 and HB 3544 as well as the 2010 amendments to Chapter 17 abolishing Tier IV would apply to this application. If appeal of the 2012 negative use determination is granted and this matter is remanded to the ED for a new use determination, the ED should process this application as a Tier III application.

Under § 17.25, an appellant has 20 days to appeal a use determination issued by the ED.<sup>3</sup> The Appellant submitted its appeal of the ED's July 10, 2012 use determination and its request for reversal within the 20 day deadline. Therefore these appeals are timely and may be considered by the Commission.

#### IV. ARGUMENT

##### A. Whether the ED complied with the timeline in TTC § 11.31(m)

The Tax Code sets out the process for appealing a use determination issued by the ED. TTC § 11.31(m) states that when a use determination application for an item on the subsection (k) list is submitted, the TCEQ shall, within 30 days, make a determination on the application. If a timely appeal is filed, "the Commission shall consider the appeal at the next regularly scheduled meeting of the commission for which adequate notice was given."<sup>4</sup> The Commission's statutorily designated actions are to either "remand the matter to the [ED] for a new determination or deny the appeal and affirm the [ED's] determination."<sup>5</sup>

OPIC acknowledges that the ED did not issue its use determination within 30 days of the application's submittal. OPIC further notes that the issue of whether HRSGs are eligible for tax exemption under TTC § 11.31 is an issue that the TCEQ has been evaluating for several years. The TCEQ has taken a logical approach in waiting to issue many HRSG-related use determinations. While not meeting the statutory deadline, the

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<sup>3</sup> *Id.* at § 17.25(a)(2)(A), (b).

<sup>4</sup> TEX. TAX CODE § 11.31(e).

<sup>5</sup> *Id.*

TCEQ has taken the time necessary to ensure consistency and uniformity in its most-recently issued HRSG-related use determinations.

Furthermore, there is no specific remedy provided by statute or rule for the failure to comply with the timeline in TTC § 11.31. Therefore OPIC knows of no other course for the Commission to follow other than to proceed with the consideration of Cottonwood's appeal.

### **B. Equal and Uniform Taxation Clause**

Appellant asserts that the ED's decision to issue a negative use determination for HRSGs violates the Texas Constitution's Equal and Uniform Taxation Clause<sup>6</sup> because the TCEQ has previously issued positive use determinations to similarly situated HRSGs. OPIC disagrees. Further, this is the wrong forum for Appellant to challenge to the constitutionality of 30 TEX. ADMIN. CODE Chapter 17 generally.

An administrative agency may change its interpretation of a taxation scheme, insofar as that new interpretation does not contradict the statute and rules under which the scheme is administered.<sup>7</sup> "Uniformly enforc[ing] a statute until a certain date and then uniformly enforc[ing] the statute in a different manner does not mean there is a constitutional violation . . . . [T]axpayers do not acquire a right to pay less in taxes . . . because a tax policy was incorrectly implemented."<sup>8</sup>

The Equal and Uniform Taxation Clause does not prohibit the ED from changing positions on whether HRSGs provide any pollution control, or are purely production equipment. OPIC defers to the ED's technical determination on this issue, and

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<sup>6</sup> TEX. CONST. art. VIII, § 1(a).

<sup>7</sup> *First Am.*, at 306.

<sup>8</sup> *Id.* at 313.

anticipates that the ED will explain, through briefing and Agenda presentation, the basis for its changed position.

**C. Whether the ED's determination that HRSGs are "Production Equipment" was proper.**

Appellant argues the ED's negative use determination is incorrect because it disregards statutory authority and is arbitrary and capricious insofar as it is inconsistent with prior use determinations on HRSGs and that any change in position should have been addressed through rulemaking. OPIC disagrees and defers to the ED's technical determination that HRSGS are solely used for production.

**1. The statutory framework charges the ED with determining pollution vs. production capacity.**

Property used solely for production purposes is not eligible for tax exemption under Tax Code § 11.31.<sup>9</sup> The ED determined that the Appellant's HRSG equipment is used solely for production, and has issued a negative use determination. The ED has authority, subject to an appeal, to determine if a facility, device, or method is used wholly or partly as a facility, device, or method for the control of air, water, or land pollution.<sup>10</sup> TCEQ's rules implementing § 11.31 must allow for determinations that distinguish between pollution control property (which is eligible for a tax exemption) and equipment, or the portion of equipment, that is attributed to production.<sup>11</sup>

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<sup>9</sup> TEX. TAX CODE § 11.31(a), (b). The legislation enacting 11.31 provided that this tax exemption applies only to pollution control property that is constructed, acquired, or installed after January 1, 1994. *See* Act of May 10, 1993, 73d Leg., R.S., ch. 285, § 5(b), 1993 Tex. Gen. Laws 1322, 1325. Op. Tex. Att'y Gen. No. JC-0372 at 2 (2001).

<sup>10</sup> TEX. TAX CODE § 11.31(d).

<sup>11</sup> *Id.* at § 11.31(g)(3).

The legislative intent of TTC § 11.31, as stated in the recently-issued *Mont Belvieu* case, is “to limit the pollution-control property exemption solely to capital investment made to comply with state or federal environmental regulation that does not yield productive benefits and would thus otherwise be irrational economically.”<sup>12</sup>

The ED clearly has authority to issue a negative use determination where it has determined that equipment is used solely for production, as opposed to pollution control. Even in situations where the equipment is listed in § 11.31(k), it is not a foregone conclusion that the equipment will receive a positive use determination.<sup>13</sup>

Whether the equipment at issue is used partially for pollution control or solely for production is, ultimately, an inquiry conducted by the ED’s technical staff with specific expertise in this area. The ED has concluded that “[HRSGs] are used solely for production.”<sup>14</sup> OPIC also anticipates that the ED’s response brief will provide further explanation of this conclusion. At this time, without contrary compelling information showing that the ED was incorrect, OPIC defers to the ED’s conclusion.

## **2. Consistency with previous decisions.**

Appellant argues that the TCEQ would be contradicting itself if it were to approve the ED’s negative use determination, because the TCEQ has issued positive use determinations for HRSGs in the past. This, Appellant argues, would amount to an arbitrary and capricious use of agency authority.

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<sup>12</sup> *Mont Belvieu Caverns LLC v. Texas Comm’n on Env’tl. Quality*, No. 03-11-00442-CV, 2012 WL 3155763, at \*19 (Tex. App.-Austin, Aug. 3, 2012).

<sup>13</sup> 35 Tex.Reg. 10964.

<sup>14</sup> Letter from Chance Goodin, Team Leader, Air Quality Division, TCEQ, to Greg Maxim, Director, Duff and Phelps, LLC (July 10, 2012).

The issue of whether an administrative agency has acted arbitrarily and capriciously is a standard reserved generally for an appellate court's review of an agency action. The Commission is not limited in its review of a use determination.<sup>15</sup> Therefore any discussion of the "arbitrary and capricious" nature of the ED's use determination is premature. OPIC provides a brief discussion of this issue, though, as it may provide guidance for the Commission when determining whether to approve or deny the appeal of the ED's use determination, and because any appeal arising from the Commission's final action may be evaluated by reviewing courts as to whether the decision is arbitrary and capricious.

An administrative agency has acted arbitrarily and capriciously where it does not follow the clear, unambiguous language of its own regulation.<sup>16</sup> It also acts arbitrarily and capriciously if it fails to consider a factor that the Legislature has directed it to consider, considers an irrelevant factor, considers relevant factors but still reaches a completely unreasonable result, makes a decision without regard to facts, relies on findings not supported by evidence, or with rational connection between the facts and the decision.<sup>17</sup>

In addition, to determine an agency's proper exercise of its authority, "[s]tatutory exemptions from taxation," like the pollution-control exemption, "are subject to strict construction because they undermine equality and uniformity by placing a greater

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<sup>15</sup> Chapter 17 provides no standard by which the Commission may review the ED's use determination. It provides actions that the Commission may take upon evaluating a use determination appeal, but requires no deference to the ED's use determination, as would be necessary were the Commission evaluating the ED's use determination under an "arbitrary and capricious" standard of review.

<sup>16</sup>*Mont Belvieu*, 2012 WL 3155763, at \*11 (quoting *Rodriguez v. Service Loyds Ins. Co.*, 997 S.W.2d, 248, 245--55 (Tex. 1999)).

<sup>17</sup> *City of Waco v. Texas Comm'n on Env'tl. Quality*, 346 S.W.3d 781, 819 (Tex. App.—Austin 2011, pet. denied) (citing *City of El Paso v. Pub. Util. Comm'n*, 883 S.W.2d 179, 184 (Tex. 1994)).

burden on some taxpaying businesses and individuals rather than placing the burden on all taxpayers equally.”<sup>18</sup> All doubts are resolved against granting an exemption.<sup>19</sup>

Although the Executive Director has changed its position on the issue of whether HRSGs offer pollution control, this does not necessarily mean that the Commission would be acting arbitrarily and capriciously by affirming the negative use determination. And the record on which a reviewing court would evaluate the arbitrary and capricious nature of TCEQ’s action is not complete at this time.

First, the ED’s position on HRSGs has evolved over time. Initially the ED issued 100% positive use determinations for HRSGs filing Tier IV applications.<sup>20 21</sup> However, in responding to several appraisal districts’ appeals of these use determinations, the ED stated that it initially issued 100% use determinations for the first set of applications it adjudicated under the (then) new Tier IV application.<sup>22</sup> Subsequently, the ED established through a workgroup that 61% would be more appropriate for HRSG’s, to account for the production gain and increased efficiency associated with the installation of HRSGs at a combined cycle power plant.<sup>23</sup>

Before the Commission could consider the ED’s position on this matter at the February 25, 2009 Agenda, the ED requested, in an uncontested brief, additional time to evaluate its recommendation. While the matter was on hold, the TCEQ promulgated

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<sup>18</sup> *Mont Belvieu*, 2012 WL 3155763, at \*11 (quoting *N. Alamo Water Supply Corp. v. Willacy County Appraisal Dist.*, 804 S.W.2d 894, 899 (Tex. 1991).

<sup>19</sup> *Id.*

<sup>20</sup> See *Executive Director’s Response Brief to Rusk County, Freestone, Central, Hutchinson County, Fort Bend Central, Brazoria County, and Wharton County Appraisal Districts’ Appeals of the Executive Director’s Use Determinations*, 2008-0830-MIS-U; 2008-0831-MIS-U; 2008-0832-MIS-U; 2008-0849-MIS-U; 2008-0850-MIS-U; 2008-0851-MIS-U, December 3, 2008 (hereinafter *ED’s 2008 Consolidated Appeals Brief*).

<sup>21</sup> These applications were filed under TCEQ rules implementing HB 3732, effective February 7, 2009. The Tier IV application process was later abolished by TCEQ’s rulemaking implementing HB3206 and HB 3544. See 33 Tex.Reg 932 (Feb. 1, 2008); 35 Tex.Reg 10965 (Dec. 10, 2010).

<sup>22</sup> *ED’s 2008 Consolidated Appeals Brief*, at 9.

<sup>23</sup> *ED’s 2008 Consolidated Appeals Brief*, at 10.

rules abolishing the Tier IV application and establishing that items on the TTC § 11.31(k) list must use a new Tier III application. Appellant applied for a use determination using this Tier III application. On July 10, 2012, the ED issued a negative use determination for the Appellant's HRSGs. The ED stated that HRSGs are used solely for production, and therefore not eligible for a positive use determination.

Appellant argues that the Commission cannot issue a negative use determination on this HRSG because the Commission has already issued several positive use determinations on similar equipment. OPIC again must defer to the review by the ED's technical staff with expertise in this area.

OPIC does note that the Commission is not bound by prior decisions, as a reviewing court would be.<sup>24</sup> But an administrative agency may be called upon to "explain its reasoning when it appears...that an agency has departed from its earlier administrative policy or there exists an apparent inconsistency in agency determinations."<sup>25</sup> An agency may also change its interpretation of a statutory tax scheme, as long as the new interpretation is not in conflict with a statute or formally promulgated rule.<sup>26</sup>

The record is not complete at this time, and will not be complete until the Commissioners issue a final order. The appeals process, as laid out in 30 TEX. ADMIN. CODE Chapter 17, affords the opportunity for the ED to provide more information to the public on how it reached its determination, and for the Commissioners to consider this information before making a determination. Although the July 10, 2012 letter provides no information as to why the ED no longer considers HRSGs pollution control

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<sup>24</sup> *Flores v. Employees Ret. Sys. of Texas*, 74 S.W.3d 532, 544-45 (Tex. App.—Austin 2003, pet. denied) (quoting *City of El Paso v. El Paso Elec. Co.*, 851 S.W.2d 896, 900 (Tex.App.—Austin 1993, writ denied).

<sup>25</sup> *Id.*

<sup>26</sup> *First Am. Title Ins., Co. v. Strayhorn*, 169 S.W.3d 298, 306 (Tex. App.—Austin 2005).

equipment, OPIC defers to the ED on this technical issue and anticipates that the ED's response brief will provide adequate explanation. Further explanation from the ED as well as the Commission's Agenda discussion and subsequent order memorializing the Commissioners' decision on this matter will serve to complete the record.

## V. CONCLUSION AND RECOMMENDATION

For the above reasons, OPIC recommends the Commission affirm the ED's negative use determination.

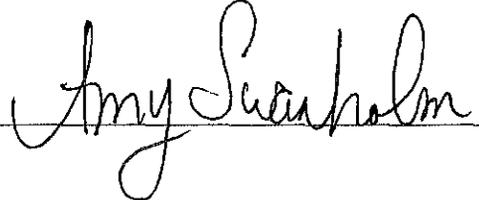
Respectfully submitted,

Blas J. Coy, Jr.  
Public Interest Counsel

By   
Amy Swanholm  
Assistant Public Interest Counsel  
State Bar No. 24056400  
P.O. Box 13087, MC 103  
Austin, Texas 78711  
phone: (512) 239-6363  
fax: (512) 239-6377

## CERTIFICATE OF SERVICE

I hereby certify that on October 4, 2012, the original and seven true and correct copies of the foregoing document were filed with the TCEQ Chief Clerk, and copies were served to all parties listed on the attached mailing list via hand delivery, facsimile transmission, inter-agency mail, or by deposit in the U.S. Mail.

  
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Amy Swanholm

MAILING LIST  
COTTONWOOD ENERGY COMPANY LP  
TCEQ DOCKET NO. 2012-1562-MIS-U

Mike Nasi  
Jackson Walker L.L.P.  
100 Congress Ave., Suite 1100  
Austin, Texas 78701  
512/236-2216 FAX 512/391-2194  
[mnasi@jw.com](mailto:mnasi@jw.com)

Cottonwood Energy Company LP  
Cottonwood Energy Center  
976 County Road 4213  
Deweyville, Texas

Greg Maxim  
Duff & Phelps, LLC  
919 Congress Ave., Suite 1450  
Austin, Texas 78701  
512/671-5580 FAX 512/671-5501  
[gregory.maxim@duffandphelps.com](mailto:gregory.maxim@duffandphelps.com)

Chief Appraiser  
Newton County Appraisal District  
109 Court St.  
Newton, Texas 75966  
409/379-3710 FAX 409/379-4020

Chance Goodin  
TCEQ Office of Air MC 206  
P.O. Box 13087  
Austin, Texas 78711-3087  
512/239-6335 FAX 512/239-6188

Steve Hagle, Deputy Director  
TCEQ Office of Air MC 122  
P.O. Box 13087  
Austin, Texas 78711-3087  
512/239-2104 FAX 512/239-3341

Robert Martinez  
Daniel Long  
TCEQ Environmental Law Division  
MC 173  
P.O. Box 13087  
Austin, Texas 78711-3087  
512/239-0600 FAX 512/239-0606

Docket Clerk  
TCEQ Office of Chief Clerk MC 105  
P.O. Box 13087  
Austin, Texas 78711-3087  
512/239-3300 FAX 512/239-3311

Kyle Lucas  
TCEQ Alternative Dispute  
Resolution Program MC 222  
P.O. Box 13087  
Austin, Texas 78711-3087  
512/239-0687 FAX 512/239-4015

