BAKER BOTTS L.L.P

98 SAN JACINTO BLVD.
SUITE 1500
AUSTIN, TEXAS
78701-4078

TEL +1 512.322.2500
FAX +1 512.322.2501
BakerBotts.com

ABU DHABI
AUSTIN
BEIJING
BRUSSELS
DALLAS
DUBAI
HONG KONG
HOUSTON
LONDON
MOSCOW
NEW YORK
PALO ALTO
RIYADH
WASHINGTON

October 30, 2012

Whitney L. Swift
TEL +1 512.322.2672
FAX +1 512.322.8339
whitney.swift@bakerbotts.com

VIA HAND DELIVERY

Ms. Bridget Bohac
Chief Clerk
Texas Commission on Environmental Quality
12100 Park 35 Circle
Building F, 1st Floor
Austin, TX 78753

Re: TCEQ Docket No. 2012-1650-MIS-U
Appeal of Negative Use Determination
Tax Relief for Pollution Control Property Program
Application No. 12271; Midlothian Energy Plant, Ellis County

Dear Ms. Bohac:

Please find enclosed *Midlothian Energy Limited Partnership's Reply to the Response Briefs filed by the Executive Director and Public Interest Counsel* in the above-referenced matter.

Midlothian Energy Limited Partnership hopes that an agreed resolution of the dispute regarding the appropriate tax relief for heat recovery steam generators ("HRSGs") can be achieved, and requests a meeting with the Executive Director's staff to discuss the treatment of HRSGs under Chapter 17.

If you have any questions concerning this filing, please do not hesitate to contact me at the number above.

Sincerely,

Whitney L. Swift

Enclosures

cc: Service List

AUS01:645488.1

TCEQ Docket No. 2012-1650-MIS-U

APPEAL OF THE EXECUTIVE DIRECTOR'S USE DETERMINATION ISSUED TO MIDLOTHIAN ENERGY LIMITED PARTNERSHIP	§	**BEFORE THE TEXAS COMMISSION**
	§	
	§	**ON**
	§	
	§	
APPLICATION NUMBER 12271; TRACKING NUMBER 08-RC-MEL 2008	§	**ENVIRONMENTAL QUALITY**
	§	

APPEAL OF THE EXECUTIVE DIRECTOR'S NEGATIVE USE DETERMINATION

MIDLOTHIAN ENERGY LIMITED PARTNERSHIP'S REPLY TO THE RESPONSE BRIEFS FILED BY THE EXECUTIVE DIRECTOR AND PUBLIC INTEREST COUNSEL

TO THE HONORABLE COMMISSIONERS AND GENERAL COUNSEL OF THE TEXAS COMMISSION ON ENVIRONMENTAL QUALITY:

Midlothian Energy Limited Partnership ("Midlothian Energy") submits this Reply to the Response Briefs filed by the Texas Commission on Environmental Quality's ("TCEQ's") Executive Director ("ED") and Office of Public Interest Counsel ("OPIC") in Midlothian Energy's appeal of the ED's negative use determination issued under the TCEQ's Tax Relief for Pollution Control Property Program, also known as the "Proposition 2" program. For the reasons set forth below and in Midlothian Energy's Appeal of the Executive Director's Negative Use Determination filed August 2, 2012, Midlothian Energy respectfully requests that the Commission overturn the ED's negative use determination for the six heat recovery steam generators ("HRSGs") and 12 enhanced steam turbines installed at the Midlothian Energy Plant and remand the matter to the ED for a new, positive use determination that recognizes the significant air quality benefits and pollution reductions achieved by Midlothian Energy's HRSGs.

BACKGROUND

Midlothian Energy filed an "Application for Use Determination for Pollution Control Property" on April 25, 2008, seeking a partial positive use determination for six HRSGs and 12 enhanced steam turbines that had been installed at the Midlothian Energy Plant located in Ellis County ("the Application"). A copy of the Application is included as **Exhibit A**. The

Application sought a Tier IV partial use determination for the HRSGs and the steam turbines, which had been installed at the plant in 2001 and 2002.

On April 29, 2008, the ED sent a letter to Midlothian Energy's designated contact stating that the Application had been declared administratively complete.[1] A copy of that administrative completeness determination letter is included as **Exhibit B**. The ED assigned the Application number 07-12271 and tracking number 08-RC-MEL 208. The ED notified the Ellis County Appraisal District of the Application. On May 1, 2008, the ED issued a number of 100% positive use determinations for HRSGs under the Proposition 2 program. Midlothian Energy subsequently supplemented the Application with an updated cost analysis seeking a 100% positive use determination. Midlothian Energy submitted the application supplement and updated cost analysis in response to the ED's decision to award a 100% positive use determination to the 25 applications seeking Proposition 2 determinations for similar HRSGs. A copy of that application supplement is included as **Exhibit C**.

County appraisal districts filed notices of appeal for six of the 25 Proposition 2 HRSG applications for which the ED had granted a full 100% positive use determination. The ED's response brief in the 2008 appraisal district appeal, which is included as **Exhibit D**, describes the ED's efforts to develop a uniform use determination percentage for HRSGs. The ED assembled a Workgroup comprised of HRSG applicants, appraisal district representatives and other interested parties. *See* **Exhibit D**, ED's 2008 Response Brief, at 10-11. Based on the Workgroup's efforts, the ED recommended a 61% positive use determination for HRSGs in a combined cycle facility like those at the Midlothian Energy plant. *Id.* at 11.

The ED's 2008 response brief gives no indication that the ED or its Workgroup challenged whether HRSGs are used for pollution control purposes. In fact, the Workgroup reached the following conclusions with regard to HRSGs:

> A comparable combined cycle power plant produces less air emissions than the same size simple cycle power plant. The reduced emissions are attributed to reduced combustion. The installation of the HRSGs lead to the reduced emissions.

---

[1] Based on the date of application submittal and the administrative completeness determination, Midlothian Energy's application should be governed by the version of Chapter 17 that became effective on February 7, 2008, which included Tier IV applications. Neither the ED nor OPIC dispute this issue regarding rule applicability. *See* ED Response Brief at 3; OPIC Response Brief at 4.

> The pollution control aspect of the combined cycle power plant relates solely to the installation of the HRSGs. However, installation of HRSG also results in increased efficiency and production gain.

Id. at 10. Similarly, the ED's recommended partial positive use determination must be based on a determination that HRSGs meet Proposition 2 standards for providing an environmental benefit. The Commission did not act on the 2008 appeal, however, and the 6 HRSG applications that were the subject of the appeal remained pending until July 2012. For 19 of the ED's initial 25 HRSG 100% positive use determinations, however, the ED's determination was final and remains in effect. Copies of those 19 final positive use determination letters for HRSGs are included as **Exhibit E**.

Midlothian Energy's application was not part of the initial group of applications for which the ED issued a positive use determination, nor was it part of the 2008 appeal process. The ED did not act on Midlothian Energy's application until July 10, 2012.[2] Over four years after Midlothian Energy filed its Proposition 2 application, the ED issued a "Notice of Negative Use Determination" for the HRSGs and the steam turbines in the Application, included as **Exhibit F**. The Notice of Negative Use Determination asserted, as the basis for the determination, that "[h]eat recovery steam generators and steam turbines are used solely for production; therefore, are not eligible for a positive use determination." The Notice included no technical support document or other information or materials in support of the ED's determination.

On August 2, 2012, Midlothian Energy timely filed an appeal of the ED's negative use determination in accordance with 30 TEX. ADMIN. CODE ("TAC") § 17.25(b). The

---

[2] Under 30 TAC § 17.12, *Application Review Schedule*, the ED was required to complete the technical review of the Application (submitted as a Tier IV application) within 30 days of receipt of the required application materials. *See* 30 TAC § 17.12(3) (effective February 7, 2008); *see also* 30 TAC § 17.12(3) (current). Even if the Commission issues a positive use determination for the Midlothian Energy Plant HRSG/combustion turbine installation in response to this appeal, the delay in the ED's ruling on the Application will have prejudiced Midlothian Energy by depriving Midlothian Energy of the full tax reduction benefit flowing from the determination from 2009 to present -- particularly when compared to other applicants who filed applications for use determinations for similar HRSG installations in early 2008 and were granted full positive use determinations by the ED in May 2008. The Ellis County Appraisal District has granted Midlothian Energy partial tax relief for the HRSGs in the Application prior to the ED's determination, but Midlothian Energy has not received the full tax relief granted to those HRSG owners with full positive use determinations.

TCEQ's General Counsel subsequently established a briefing schedule for the Proposition 2 HRSG appeals, and the ED and OPIC filed briefs in response to Midlothian Energy's appeal on October 4, 2012. Given the overlapping nature of the HRSG tax appeals, the ED filed a single, consolidated brief for all of the pending HRSG appeals. Midlothian Energy files this Reply Brief in accordance with the General Counsel's briefing schedule and as a supplement to its Application and August 2, 2012 appeal filing.

ARGUMENT

The ED's negative use determination for Midlothian Energy's HRSG application represents a complete and unexpected reversal of ED policy. The determination ignores the significant environmental benefits provided by HRSGs that the ED had previously recognized. Rather than make a determination that recognizes both the pollution control benefit and the production value of HRSGs, the ED has defaulted to a position that is contrary to the plain language of the Texas Tax Code and made a decision that runs contrary to Texas constitutional principles of fair and uniform taxation. The Commission should overturn the ED's negative use determination and remand the Application to the ED for a determination that recognizes the pollution reduction benefits of Midlothian Energy's HRSGs.

I. HRSGs Reduce Air Pollution in Texas

The ED's change in position and this appeal present a key issue for the Commission's determination: is tax relief under the Proposition 2 program limited to add-on emissions control equipment, or will the TCEQ grant relief under the program for devices like HRSGs that do not "control" emissions, but clearly "prevent" emissions by generating additional power *without* increasing emissions?

The ED asserts, contrary to statute,[3] and to his own prior statements on the subject, and to and common sense, that "HRSGs do not provide an environmental benefit." OPIC defers to the ED in its response brief, but notes that the negative use determination letter provides no information as to why the ED no longer considers HRSGs to be qualifying pollution control equipment.

---

[3] As discussed in greater detail in section III below, the Texas Tax Code includes HRSGs on its "list of facilities, devices, or methods for the control of air, water, or land pollution." TEXAS TAX CODE § 11.31(k).

HRSGs use waste heat to reduce emissions of oxides of nitrogen ("NOx"), sulfur dioxide ("SO_2") and other pollutants from power generation activities on a pound-per-kilowatt hour basis. As the ED stated in his 2008 HRSG appeal response brief,

> A HRSG acts as a fuel substitute in a typical combined-cycle installation. . . . This process eliminates the need for the additional burning of coal or other hydrocarbon based fuel in order to obtain the same increase in electrical energy generation output at the site.

Exhibit E, ED's 2008 Response Brief, at 6. It cannot be reasonably disputed that the use of a HRSG in power generation is an emissions-reducing process for generating power. The ED, however, now asserts that this is not an "environmental benefit." In doing so, the ED appears to make a distinction not found in the Texas Tax Code or Chapter 17 between "add-on" emissions control devices and a device like a HRSG that, through efficiency gains, will allow for more power generation with the same amount of air pollution.[4]

The Proposition 2 program is designed to provide tax relief for "personal property that the person owns and that is used wholly or partly as a facility, device, or method for the control of air, water, or land pollution." TEXAS TAX CODE § 11.31(a). Nothing in the Texas Tax Code or the Commission's Chapter 17 rules preclude devices like HRSGs from qualifying for tax relief -- as evidenced by the ED's decision to grant a number of full (100%) positive use determinations for HRSGs *after* the date that Midlothian Energy filed its application. The Executive Director was correct in 2008 to acknowledge that HRSGs provide an environmental benefit by reducing the amount of air pollution resulting from power generation as a "fuel substitute." The ED continued to recognize the environmental benefit of HRSGs in the stakeholder process that followed, as the ED worked with interested appraisal districts and HRSG owner/operators to identify a partial positive use determination amount for HRSGs -- work that *presumed* an environmental benefit from HRSGs.

---

[4] The United States Environmental Protection Agency ("EPA") has long recognized energy efficiency as a form of pollution prevention. *See* EPA Memorandum from F. Henry Habicht II, Deputy Administrator, *EPA Definition of "Pollution Prevention"* at p. 3 (May 28, 1992) <http://epa.gov/region07/air/nsr/nsrmemos/pollprev.pdf >. More recently, EPA recognized the pollution control benefits of HRSG operation in commenting on a state permitting authority's best available control technology ("BACT") analysis. In a 2012 letter to the Wisconsin Department of Natural Resources, EPA ordered state officials to consider combined cycle turbines (which incorporate a HRSG) as part of the BACT review for a proposed simple cycle gas-fired electric generating unit (which did not incorporate a HRSG). *See* EPA Region 5, Letter to Wisconsin Department of Natural Resources (March 15, 2012) <http://epa.gov/nsr/ghgdocs/20120315Milwaukee.pdf>. EPA stated that the combined cycle unit should be considered because "[c]ombined cycle turbines are generally more energy efficient than simple cycle turbines."

The ED's 2012 reversal shocked Midlothian Energy and other HRSG owners who had submitted Proposition 2 applications to the TCEQ. Equally surprising is the ED's new assertion that HRSGs do not provide an environmental benefit. HRSGs *do* provide an environmental benefit, by reducing fuel consumption and by reducing the amount of NOx, SO_2 and other pollutants emitted by the generation that powers Texas.

II. The Role that a HRSG Plays in Production Does Not Preclude a Positive Use Determination

The ED states in his July 10, 2012 Negative Use Determination Letter to Midlothian Energy that HRSGs are not eligible for a positive use determination under the Proposition 2 program because they "are used solely for production." The ED maintains that position in his Response Brief. OPIC defers to the ED in its response brief. Midlothian Energy acknowledges that HRSGs generate power. That production benefit, however, does not preclude HRSGs from qualifying for tax relief under the Proposition 2 program.

A HRSG generates additional power *without increasing air pollution* from the gas-fired turbine to which it is attached. The ED's 2012 position on HRSGs takes an all-or-nothing approach that ignores both the emissions reduction benefit of a HRSG *and* the clear direction in the Texas Tax Code that the TCEQ should, for equipment that has a production benefit, distinguish the proportion of the property that is used for production from the "proportion of property that is used to control, monitor, prevent, or reduce pollution." TEXAS TAX CODE § 11.31(a).

The ED cites Attorney General Opinion JC-0372 in his response brief. In JC-0372, the Attorney General confirmed that both add-on pollution control devices *and* methods of production that limit pollution are entitled to a tax exemption under the Proposition 2 program. Texas Attorney General Opinion No. JC-0372 (2001). In that opinion, the Attorney General states,

> Next, we consider whether section 11.31 excludes from its scope pollution-reducing production equipment. Significantly, the statute applies to property used "wholly or partly" for pollution control. . . . The term "partly," however, embraces property that has only *some* pollution-control use. This broad formulation clearly embraces more than just add-on devices. Furthermore, that statute clearly embraces not only "facilities" and "devices" but also

> "methods" that prevent, monitor, control, or reduce pollution. "Methods" is an extremely broad term that clearly embraces means of production designed, at least in part, to reduce pollution.
>
> Based on its plain language and the common meaning of the terms "wholly," "partly," and "method," we conclude that section 11.31 clearly extends to, in your words, "equipment . . . that is used to make a product and by its design limits pollution.

Id. at 5 (references omitted) (emphasis added). The ED misreads JC-0372 in arguing that it simply reiterates the ED's role in distinguishing the proportion of property that is used to reduce pollution from the proportion of property that is used to produce goods or services. While the ED has that role in the Proposition 2 program, *see* TEXAS TAX CODE § 11.31(g)(3), the ED's Response Brief mischaracterizes JC-0372 and fails to recognize the Attorney General's endorsement of Proposition 2 tax exemptions for "pollution-reducing production equipment."

Midlothian Energy's HRSGs are pollution-reducing production equipment. The HRSGs generate power, but do so without burning additional fuel and without adding to the emissions generated by the gas turbine, allowing for greater energy production for the same amount of combustion emissions. Use of the HRSGs decreases air pollution on a pound-of-emissions-per-kilowatt basis, and the fact that the HRSGs have a production component does not preclude that property from qualifying for tax relief under the Proposition 2 program.

III. The Executive Director has Incorrectly Dismissed the Importance of HRSGs Being Listed in Texas Tax Code § 11.31(k)

The ED and OPIC argue that the inclusion of HRSGs in the Texas legislature's list of methods for the control of air, water, or land pollution does not entitle HRSGs to a positive use determination. The legislature's decision to include HRSGs on the list does not guarantee a 100% positive use determination, but it does reflect the legislature's determination that HRSGs are either "wholly or partly" used for control of air pollution.

Texas Tax Code § 11.31(k) directs the TCEQ to develop rules establishing a list "of facilities, devices, or methods for the control of air, water, or land pollution" and states that the list must include HRSGs. *See* TEXAS TAX CODE § 11.31(k) & (k)(8). The list of devices in § 11.31(k), which was then codified at Figure: 30 TAC § 17.14(a), Part B, is known as the

Expedited Review List.[5] Tax Code § 11.31(m), which the ED quoted in his Response Brief, establishes the ED's obligations when a Proposition 2 application is filed for HRSGs or any other of the Expedited Review List items from the statute. The ED "shall determine that the facility, device, or method described in the application is used *wholly or partly* as a facility, device, or method for the control of air, water or land pollution." *Id.* § 11.31(m). The ED is *not* directed to determine "whether or not" the devices listed in § 11.31(k) are used as for pollution control purposes; rather, the inquiry is *how much* of the device should be considered to be for pollution control. *See id*; *see also* 30 TAC § 17.17(d) (2008 version) ("For applications containing only property falling under a category listed in Part B of the Equipment and Categories List, located in § 17.14(a) of this title (relating to Equipment and Categories List), *a use determination must be calculated.*") (emphasis added).

The legislature selects the words, phrases, and expressions in statutes deliberately and purposefully. *See Texas Lottery Comm'n v. First State Bank of DeQueen*, 235 S.W.3d 628, 635 (Tex. 2010); *Shook v. Walden*, 304 S.W.3d 910, 917 (Tex. App.--Austin 2010, no pet.). Under the Code Construction Act, "the entire statute is intended to be effective." TEX. GOV'T CODE § 311.021(2). By issuing a negative use determination for Midlothian Energy's HRSGs, the ED has acted in a way that is inconsistent with how the legislature classified HRSGs for purposes of the Proposition 2 program, and is inconsistent with how the legislature intended the Texas Tax Code to operate.

The ED, in implementing the Proposition 2 program on behalf of the TCEQ, does not have any power inconsistent with the powers that the legislature delegated to the TCEQ. *Public Utility Comm'n v. City Pub. Serv. Bd.*, 53 S.W.3d 310, 312 (Tex. 2001). The TCEQ's primary objective must be to give effect to the legislature's intent, via the statutory text. *State v. Shumake,* 199 S.W.3d 279, 284 (Tex. 2006); *Lexington Ins. Co. v. Strayhorn*, 209 S.W.3d 83, 85 (Tex. 2006). The legislature included HRSGs on the § 11.31(k) list of devices for the control of pollution, and directed the ED to determine if such devices are "wholly or partly" used for pollution control. *See* TEXAS TAX CODE § 11.31(k) & (m). The ED has acted outside the clear direction of the legislature in its treatment of HRSGs. As such, its treatment of HRSGs is

---

[5] The Expedited Review List is currently codified at 30 TAC § 17.17(b), Figure: 30 TAC § 17.17(b).

arbitrary and capricious. *See Rodriguez v. Service Lloyds Ins. Co.*, 997 S.W.2d 248, 254-55 (Tex. 1999).[6]

The ED cites statements in the regulatory history of the Proposition 2 program in support of its discretion to issue a negative use determination for Expedited Review List devices that are governed by sections 11.31(k) and (m) of the Texas Tax Code. Those statements, and the ED's conclusion in this matter that HRSGs are neither wholly *nor* partly used for air pollution control, contradict the plain language of the Texas Tax Code. The TCEQ must give effect to the unambiguous language of the Texas Tax Code and remand this matter to the ED for a new determination consistent with the governing legislation.

IV. Midlothian Energy Cited Valid and Applicable Regulations in its Application

The ED argues in its Response Brief that Midlothian Energy and the other HRSG applicants failed to cite a qualifying environmental regulation in their Proposition 2 applications. In fact, the ED -- for the first time, over four years since Midlothian Energy filed its Proposition 2 applications -- issues a wholesale rejection of every rule cited in every HRSG application, arguing that none of the cited regulations require the installation of a HRSG.

Midlothian Energy cited the following TCEQ rules in its Proposition 2 application: 30 TAC § 106.512(6)(B), 30 TAC § 111.111(a), 30 TAC § 111.151(a), and 30 TAC § 111.153(b). These rules satisfy Midlothian Energy's obligation to identify a qualifying rule under the Proposition 2 program. Under 30 TAC § 17.4, 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 . . . for the prevention, monitoring, control, or reduction" of pollution. 30 TAC § 17.4(a). The rules cited in Midlothian Energy's application include the permit-by-rule ("PBR") that authorized the construction of the facilities,

---

[6] The ED's decision also runs afoul of Texas Tax Code § 11.31(l) requirements regarding the removal of an item from the Expedited Review List. Under § 11.31(l), the TCEQ is directed to update the Expedited Review List at least once every three years, and can remove an item from the Expedited Review List. See TEX. TAX. CODE § 11.13(l); *see also* 30 TAC § 17.17(b). However, deleting an item from the Expedited Review List must be accompanied by a Commission finding of "compelling evidence to support the conclusion that the item does not provide pollution control benefits." *Id.* No such finding has been made with regard to HRSGs, and the TCEQ has not removed HRSGs from the Expedited Review List or initiated procedures to remove HRSGs from the Expedited Review List. If HRSGs provide no pollution control benefit, as now alleged by the ED, they should have been removed from the Expedited Review List. That has not happened, because HRSGs *do* provide a pollution control benefit.

which incorporates federal New Source Performance Standard ("NSPS") Subpart GG requirements and the emission limits in the PBR general rules, as well as applicable Chapter 111 limits on visible emissions and emissions of total suspended particulate ("TSP").

In support of its wholesale rejection of Midlothian Energy's (and every other HRSG applicants') cited regulations, the ED argues that there is "an insufficient nexus" between the HRSG and the cited rules, because those rules do not require the installation of the HRSG. The ED's new "nexus" requirement is not part of the statutory Proposition 2 program or the TCEQ's implementing regulations, and inserting this requirement is unfair and arbitrary when compared to other Proposition 2 HRSG applications.

Midlothian Energy's gas turbines and HRSGs are authorized by and subject to the Chapter 106 PBR and the cited rules that govern visible emissions and TSP from the unit. Midlothian Energy uses the HRSG increase to the power generating output of the gas turbine while still complying with the applicable air pollution control requirements of the PBR authorization and Chapter 111. More importantly, nothing in the Texas Tax Code or Chapter 17, or in any Attorney General Opinion or case addressing the Proposition 2 program, includes the ED's new requirement that the application specify a rule "that requires the installation" of the specific pollution control equipment. This "nexus" requirement is simply not found anywhere but in the ED's Response Brief.

The ED's move to raise an alleged deficiency in Midlothian Energy's application at this stage of the process also runs afoul of Chapter 17. Under Chapter 17 in effect at the time that Midlothian Energy submitted the Application, if an application was deficient, the ED was to inform the application that the application is *not* administratively complete and that it is deficient within three days of receipt of the application. *See* 30 TAC § 17.12(2).[7] The applicant is then provided an opportunity to correct the deficiency. *Id.* § 17.12(2)(A). In this case, however, the ED informed Midlothian Energy that its application *was* administratively complete, as shown by **Exhibit B**. Midlothian Energy had no indication that its application was deficient based on the rules cited in the application, or for any other reason, until receipt of the negative use determination in July 2012. The ED's rejection of Midlothian Energy's application based on the

---

[7] The current version of § 17.17(2) requires that the applicant be informed of any deficiency "as soon as practicable."

alleged failure to provide a qualifying regulation is invalid and further grounds for the Commission's remand of the decision.

V. The Texas Constitution Prohibits the Executive Director's Reversal on HRSGs under the Proposition 2 Program

The ED claims that its reversal in the treatment of HRSGs under the Proposition 2 program does not violate the uniform taxation requirements of the Texas Constitution or the Texas Tax Code. The cases cited by the ED do not establish or support the ED's change in interpretation here, because the ED's new position is inconsistent with the requirements of the Texas Tax Code.

Article VIII, Section I of the Texas Constitution states that "[t]axation shall be equal and uniform." TEX. CONST. art. VIII, § 1(a). The legislature incorporated that same constitutional principle into the laws establishing the Proposition 2 program, directing the TCEQ to adopt rules to implement the program and stating that the rules must "be sufficiently specific to ensure that determinations are equal and uniform." TEX. TAX CODE § 11.31(g)(2). In the *Hurt v. Cooper* case cited by the ED, the Texas Supreme Court held that a tax must treat taxpayers within the same class alike, and that classifications may not be unreasonable, arbitrary, or capricious. *Hurt v. Cooper*, 110 S.W.2d 896, 901 (Tex. 1937). A two-part test is used to determine if taxation is equal and uniform: "(1) whether the tax's classification is reasonable; and (2) whether, within the class, the legislation operates equally." *R.R. Comm'n of Tex. v. Channel Indus. Gas*, 775 S.W.2d 503, 507 (Tex. App.--Austin 1989, writ denied). The ED's negative use determination results in unequal and unfair operation of the Proposition 2 program within the class of HRSG owners. The Commission has granted 100% positive use determinations to the owners of 19 HRSGs that are substantively identical to and have the same air pollution reduction benefits as the HRSGs identified in Midlothian Energy's Proposition 2 application.

The ED explains that it issued the prior HRSG positive use determinations "in error" and that the disparate treatment of HRSG owners under Proposition 2 does not violate constitutional uniform taxation principles, because the ED is correcting that prior error. OPIC states that the ED's position "evolved over time." The cases cited by the ED, however, do not support the ED in the present matter.

The ED is correct that the Commission can change its interpretation and enforcement of a rule. However, in the *Grocer's Supply* case cited by the ED, the Austin Court of Appeals made a pointed distinction between (A) the Comptroller's substitution of one interpretation of a rule for another and (B) a change that contravenes of one of the Comptroller's existing rules. *Grocer's Supply Co., Inc. v. Sharp*, 978 S.W.2d 638, 642 (Tex. App.--Austin 1998, pet. denied). The ED's new position on HRSGs under Proposition 2 contravenes both Chapter 17 *and* the Texas Tax Code, which establishes that the question to be determined for HRSGs under Proposition 2 is whether they are "wholly or partly" used for air pollution control. *See* TEXAS TAX CODE § 11.31(k) & (m). The *Grocer's Supply* court would not grant deference to or uphold the ED's change in position. Moreover, the *Grocer's Supply* court notes that statements made in the Texas Register at the time of rule adoption are not part of the rule itself and do not get the same deference as rule language. *Grocer's Supply,* 978 S.W.2d at 642 n.6. Nothing said in the rule preamble would make the ED's change-of-position regarding HRSGs equivalent to the "substitution of interpretation" that was approved by the *Grocer's Supply* court, given that the change contravenes the treatment of HRSGs in the Tax Code.

The circumstances in *First American Title v. Strayhorn* can also be distinguished from the ED's treatment of HRSGs under Proposition 2. *First Am. Title Ins. Co. v. Strayhorn*, 169 S.W.3d 298 (Tex. App.--Austin 2005), *aff'd on other grounds sub nom First Am. Title Ins. Co. v. Combs*, 258 S.W.3d 627 (Tex. 2008). The ED describes the Austin Court of Appeals as upholding the Comptroller's right to change her interpretation of a statutory tax scheme -- *as long as the new interpretation does not contradict the statute or a formally promulgated rule.* Here, as stated above and described more fully in Section III, the ED's new position on HRSGs *does* contradict the governing statute. The law does not grant the ED the right to shift positions on a tax issue like this one where the decision contravenes the Tax Code. *See Texas Citrus Exch. v. Sharp*, 955 S.W.2d 164, 170 (Tex. App.--Austin 1997, no pet.).

VI. Formal Rulemaking Is Necessary to Remove HRSGs from Proposition 2 Consideration

The ED argues that a rulemaking was not necessary to issue the HRSG negative use determinations, and characterizes his action in making a sweeping decision regarding HRSGs under Proposition 2 as the result of case-by-case review of each pending application. The ED's argument ignores the fact that this change is not just a series of coincidentally timed

individual denials, but rather an across-the-board policy change that has, without formal rulemaking, removed HRSGs from the Expedited Review List in Chapter 17.

HRSGs are listed in Texas Tax Code § 11.31(k) and, as a result, in the Expedited Review List in Chapter 17. *See* Figure: 30 TAC § 17.14(a), Part B (2008 version) & Figure: 30 TAC § 17.17(b) (current). Both the Texas Tax Code and Chapter 17 recognize the TCEQ's authority to remove an item from the Expedited Review List. *See* TEX. TAX CODE § 11.13(l); 30 TAC § 17.17(b) (current). However, such a removal must be accompanied by a Commission finding of "compelling evidence to support the conclusion that the item does not provide pollution control benefits." *Id.* No such finding has been made with regard to HRSGs, and the TCEQ has not removed HRSGs from the Expedited Review List or initiated the procedures to remove HRSGs from the Expedited Review List.

Removing HRSGs from the Expedited Review List in Chapter 17 requires formal rulemaking. The ED's across-the-board actions regarding HRSGs contravene the requirements of the Texas Tax Code, Chapter 17 *and* the Administrative Procedure Act ("APA"). Under Texas's APA, a rule is any "state agency statement of general applicability that . . . implements, interprets, or prescribes law or policy." TEX. GOV'T CODE § 2001.003(6). The TCEQ must promulgate new rules through formal rulemaking, including public notice and comment, submitting to legislative review, and the Commission entering an order to adopt the rule change. TEX. GOV'T CODE §§ 2001.023; 2001.29; 2001.032-.033. Agencies must provide notice of a proposed rule with sufficient information so that interested persons can determine whether it is necessary for them to participate in order to protect their legal rights and privileges. *Tex. Workers' Comp. Comm'n v. Patient Advocates*, 136 S.W.3d 643, 650 (Tex. 2004).

The ED's decision effectively removed HRSGs from the Chapter 17 Expedited Review List, and that decision is invalid because it did not follow the procedures that the Texas Tax Code, Chapter 17 and the APA require for such a change. And because the ED's across-the-board decision regarding HRSGs contravenes the Tax Code and Chapter 17, the cases cited by the ED in his response brief do not support the ED's authority to make this change.

The agency action upheld by the Austin Court of Appeals in the *Texas Mutual* case cited by the ED can be distinguished from the ED's treatment of HRSGs, because the agency action in *Texas Mutual* did not contravene an existing agency rule. *Texas Mutual Ins.*

Co. v. Vista Community Medical Center, LLP, 275 S.W.3d 538, 555 (Tex. App.--Austin 2008, pet. denied). In *Texas Mutual*, the court held that a staff report of the Division of Workers' Compensation was not subject to APA as a rule "because it did not change or amend Rule 134.401; it simply mandated internal consistency when applying the rule." *Texas Mutual*, 275 S.W.3d at 556. Unlike the action taken by the Division of Workers' Compensation in *Texas Mutual*, the ED's across-the-board policy shift on HRSGs *does* change an agency rule -- the general determination regarding HRSGs directly contradicts the Tax Code and Chapter 17's Expedited Review List, and effectively deletes HRSGs from that existing TCEQ rule.

The ED's reliance on *WBD Oil & Gas* is also misplaced. The ED cites *WBD Oil & Gas* for the proposition that agency policies or rules that are *not* rules of "general applicability" are not subject to the APA. The ED's statewide HRSG determination is clearly a decision with general applicability. In *WBD Oil & Gas*, the Texas Supreme Court held that Railroad Commission field rules are not rules of general applicability, but rather "are an adjudication of the individual interests principally affected." *Railroad Comm'n v. WBD Oil & Gas Co.*, 104 S.W.3d 69, 79 (Tex. 2003). The court made that determination based on a comparison of field rules detailing spacing and proration requirements *in a specific reservoir and its own peculiar geologic formations* to Railroad Commission statewide rules that govern the entire oil and gas industry. *Id.* The ED's decision regarding HRSGs, like Railroad Commission statewide rules, is a rule of general applicability. The ED's new HRSG position is not limited in geographic or any other scope. And while the ED states that his decision "affects a limited number of applicants for a use determination," his decision affects *every* current or potential future Proposition 2 HRSG applicant in the State of Texas. The ED's across-the-board rejection of HRSGs under Proposition 2 governs all Texas industry, and is distinct from the field rules that the Texas Supreme Court found to be exempt from APA requirements. The ED cannot make a statewide determination of general applicability that contravenes Chapter 17 on its face without complying with the procedures set forth in the Texas Tax Code, Chapter 17 and the APA.

VII. Midlothian Energy's Enhanced Steam Turbines also Qualify for Proposition 2 Relief

The Executive Director notes that Midlothian Energy timely appealed the ED's negative use determination for the steam turbines identified in the Application. The ED asserts that the steam turbines do not qualify for Proposition 2 tax relief for the same reasons: their role

in production, lack of environmental benefit, and Midlothian Energy's failure to identify a qualifying environmental regulation.

Midlothian Energy acknowledges that the steam turbines in the Application are not in the same procedural posture as the HRSGs. Where the ED's negative use determination for the HRSGs represents an arbitrary and unexpected reversal of agency policy, the ED has not previously granted a positive use determination to the steam turbines associated with a HRSG.

Midlothian Energy requests that the Commission remand the negative use determination regarding steam turbines to the Executive Director, for many of the same reasons cited in this reply brief for HRSGs. Most importantly, enhanced steam turbines are included in Texas Tax Code § 11.31(k) and in the Chapter 17 Expedited Review List. Midlothian Energy does not deny that the steam turbines have a production purpose, but the turbines are part of the HRSG/steam turbine combination that generates the additional power without the consumption of additional fuels or emitting the pollutants associated with that additional fuel firing. HRSGs use the steam turbines to produce that pollution-free energy. The Application cited regulations that govern the emissions from the HRSG and steam turbines, and the steam turbines helps Midlothian Energy produce the additional power while not increasing emissions and staying in compliance with those emission limits.

Until the ED has formally removed enhanced steam turbines from the Expedited Review List in Chapter 17, the evaluation of a Proposition 2 application for enhanced steam turbines should focus on determining how to apportion the production and emissions reduction value of the steam turbines, not on whether or not the turbines qualify for a positive use determination.

VIII. Conclusion and Prayer

For these reasons, Midlothian Energy respectfully requests that the Commission overturn the ED's negative use determination for the six HRSGs and 12 enhanced steam turbines installed at the Midlothian Energy Plant and remand the matter to the ED for a new, positive use determination that recognizes the significant air quality benefits and pollution reductions achieved by Midlothian Energy's HRSG/steam turbine installations.

Respectfully submitted,

BAKER BOTTS L.L.P.

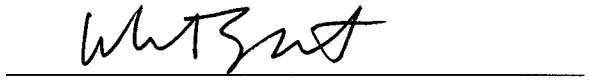
By: _____

Pamela M. Giblin
State Bar No. 07858000
Whitney L. Swift
State Bar No. 00797531
98 San Jacinto Blvd.
Suite 1500
Austin, Texas 78701-4039
Tel: 512.322.2500
Fax: 512.322.8339

ATTORNEYS FOR MIDLOTHIAN ENERGY LIMITED PARTNERSHIP

CERTIFICATE OF SERVICE

I hereby certify that I have served a true and correct copy of the foregoing *Midlothian Energy Limited Partnership's Reply to the Response Briefs Filed by the Executive Director and Public Interest Counsel* on the following parties via U.S. Mail on this 30th day of October, 2012.



Whitney Swift

Sydney Free
Midlothian Energy Limited Partnership
Midlothian Energy Plant
4601 Brookhollow Drive
Midlothian, Texas 76065
713-636-1608

Greg Odell
Ryan, Inc.
13155 Noel Road
12th Floor, LB 72
Dallas, Texas 75240

Chief Appraiser
Ellis County Appraisal District
P. O. Box 878
Waxahachie, Texas 75165-0878
972-937-3552
972-937-1618 Fax

Les Trobman, General Counsel
Office of General Counsel (MC-101)
Texas Commission on Environmental Quality
P. O. Box 13087
Austin, Texas 78711-3087
512-239-5500
512-239-5533 Fax

Chance Goodin
Office of Air (MC-206)
Texas Commission on Environmental Quality
P. O. Box 13087
Austin, Texas 78711-3087
512-239-6335
512-239-6188 Fax

Steve Hagle, Deputy Director
Office of Air (MC-122)
Texas Commission on Environmental Quality
P. O. Box 13087
Austin, Texas 78711-3087
512-239-2104
512-239-3341 Fax

Robert Martinez
Environmental Law Division (MC-173)
Texas Commission on Environmental Quality
P. O. Box 13087
Austin, Texas 78711-3087
512-239-6335
512-239-6188 Fax

Blas Coy
Office of Public Interest Counsel (MC-103)
Texas Commission on Environmental Quality
P. O. Box 13087
Austin, Texas 78711-3087
512-239-6363
512-239-6377 Fax

Kyle Lucas
Alternative Dispute Resolution Program (MC-222)
Texas Commission on Environmental Quality
P. O. Box 13087
Austin, Texas 78711-3087
512-239-0687
512-239-4015 Fax