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Larry R. Soward, *Commissioner*  
Martin A. Hubert, *Commissioner*  
Glenn Shankle, *Executive Director*



## TEXAS COMMISSION ON ENVIRONMENTAL QUALITY

*Protecting Texas by Reducing and Preventing Pollution*

TEXAS  
COMMISSION  
ON ENVIRONMENTAL  
QUALITY  
2007 JUL 25 PM 4:16  
CHIEF CLERKS OFFICE

July 25, 2007

LaDonna Castañuela  
Office of the Chief Clerk  
Texas Commission on Environmental Quality  
P.O. Box 13087 MC-105  
Austin, Texas 78711

Re: SOAH Docket Nos. 582-05-2770, 582-05-2771;  
TCEQ Docket Nos. 2004-1120-UCR, 2004-1671-UCR  
Application by Aqua Utilities Inc. d/b/a Aqua Texas, Inc. to Change its Water and Sewer  
Tariffs and Rates in Various Counties

Dear Ms. Castañuela:

Enclosed for filing in the above referenced matter, please find the Executive Director's Response to Order No. 49 and the Executive Director's Exceptions to the PFD.

Thank you for your attention to this matter.

Sincerely,

A handwritten signature in cursive script that reads "Todd Galiga".

Todd Galiga  
Staff Attorney  
Environmental Law Division

Enclosures

cc: Mailing List

APPLICATION BY AQUA UTILITIES, §  
INC. d/b/a AQUA TEXAS, INC. TO §  
CHANGE ITS WATER AND SEWER §  
TARIFFS AND RATES IN VARIOUS §  
COUNTIES, AND APPEAL OF RATE- §  
MAKING ACTIONS OF VARIOUS §  
CITIES DENYING REQUESTED §  
CHANGES TO WATER AND SEWER §  
TARIFFS AND RATES §

BEFORE THE TEXAS  
COMMISSION ON  
ENVIRONMENTAL QUALITY

2017 JUL 25 PM 4:17  
CHIEF CLERK'S OFFICE  
ON ENVIRONMENTAL QUALITY  
TEXAS COMMISSION

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**THE EXECUTIVE DIRECTOR'S RESPONSE TO ORDER NO. 49 (REQUIRING SUBMISSION OF RATE SETTING DATA) AND THE EXECUTIVE DIRECTOR'S EXCEPTIONS TO THE PROPOSAL FOR DECISION**

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TO THE HONORABLE COMMISSIONERS OF THE TCEQ:

**COMES NOW** the Executive Director of the Texas Commission on Environmental Quality (TCEQ or Commission) and files the following rate calculations in response to Order No. 49 and the Executive Director's Exceptions to the Administrative Law Judges' (ALJs) Proposal for Decision (PFD) in the above captioned matter.

**I. RESPONSE TO ORDER NO. 49**

The Court requested in Order No. 49, which accompanied the ALJs' PFD, that the Executive Director calculate and submit rates consistent with the recommendations contained in the PFD. The Executive Director has calculated the following rates in accordance with the ALJs' directive:

ED's Rate Calculations Based on the PFD

	Un-phased Water Base Rate	Un-phased gallonage rate	Un-phased sewer rate flat
North Region	33.41	3.27	71.93
SE Region	18.99	2.95	58.46
SW Region	36.86	3.61	82.49

These rates represent the nonphased rates for each region. Using these rate calculations, the Executive Director has also calculated the over/under collections resulting from Aqua Texas' phased rates from the effective date of the application up to July 13, 2007 for each region. The Executive Director used the number of customers Aqua Texas included in its test-year for these projections. The Projected Over/Under collections are as follows:

**Aqua Texas Phased in Rate:**

North	15197 cust. Water	Gal rate	Projected	730 cust. Sewer	Projected	Projected	Projected	
			Under/Over Collect		Under/Over Collect	Under/Over Collect-Water	Under/Over Collect-Sewer	
7/13/2004	29.26	3.27	4.15 under	41.40	30.53 under		756,811	
7/13/2005	34.05	3.27	0.64 over	50.84	21.09 under		(116,713)	
7/13/2006	38.17	3.27	4.76 over	58.92	13.01 under		(868,053)	
7/13/2007	41.61	3.27	8.20 over	65.64	6.29 under		(623,077)	
						Total	(851,032)	589,117
<b>SE Region:</b>		<b>14927 cust.</b>		<b>7,654 cust.</b>				
7/13/2004	24.05	2.95	5.06 over	37.95	20.51 under		(906,367)	
7/13/2005	26.77	2.95	7.78 over	46.60	11.86 under		(1,393,585)	
7/13/2006	29.1	2.95	10.11 over	54.01	4.45 under		(1,810,944)	
7/13/2007	31.05	2.95	12.06 over	60.17	1.71 over		(900,098)	
						Total	(5,010,994)	3,316,402
<b>SW Region</b>		<b>9627 cust.</b>		<b>1,851 cust.</b>				
7/13/2004	30.21	3.61	6.65 under	43.70	38.79 under		768,235	
7/13/2005	36.71	3.61	0.15 under	53.66	28.83 under		17,329	
7/13/2006	42.28	3.61	5.42 over	62.20	20.29 under		(626,140)	
7/13/2007	46.94	3.61	10.08 over	69.29	13.20 under		(485,201)	
						Total	(325,778)	2,074,823
<b>Total Customers</b>	<b>39,751</b>			<b>10,235</b>	<b>Grand Total</b>		<b>(6,187,804)</b>	<b>5,980,342</b>

The total projected over-collection for water is approximately \$6 million and the projected under-collection for sewer is also approximately \$6 million.

## II. THE EXECUTIVE DIRECTOR'S EXCEPTIONS TO THE PFD

### **A. SUMMARY**

The Executive Director will now address issues and concerns with various sections of the PFD; however, the main exceptions the Executive Director will address include: (1) the treatment/allowance of an \$8 million regulatory asset/deferred expense; (2) the allowance for "bad debt" expense; (3) the rate case expenses charged for the services of Mathias Jost, Peter Marek, and Severn Trent; and (4) the removal of certain corporate allocation charges that have been double charged to rate case expenses. Any issues not mentioned by the Executive Director can be deemed consented to by the Executive Director.

### **B. EXCEPTIONS/COMMENTS**

#### **1. Adjustments for Settled Customers<sup>1</sup>**

The ALJ discusses the Executive Director's adjustments to the rate base whereby the Executive Director removed the assets of those systems that negotiated settlements with Aqua Texas and withdrew from the hearing and removed a pro rata share of the allowable expenses for these systems from consideration in the regional rates. The Executive Director began removing settled systems initially to negate the impact these systems would have on the rate calculations for the remaining systems. The Executive Director continued to remove settled systems throughout the hearing to maintain consistency with how other settled systems had been treated. However, when the hearing began the Executive Director did not anticipate the number of systems that would eventually

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<sup>1</sup> PFD, Section VI, p. 45-47

settle, thereby requiring numerous revised calculations to account for the additional settled systems. The Executive Director now concurs with the ALJs' recommendation that removing the settled systems unnecessarily increased the complexity of this case, and agrees that the settled systems should not be removed from the rate calculations. The Executive Director included the settled systems in the calculations performed for Section I of this brief. The settled systems will pay the rates they negotiated with Aqua Texas in the settlement agreements, regardless of what regional rates are ultimately approved.

## **2. Expense Disallowances<sup>2</sup>**

### **a. ED's Disallowance for Purchased Water Expenses<sup>3</sup>**

The ALJs correctly identified the Executive Director's concern with certain "purchased water" expenses. Aqua Texas had Commission approval to charge a pass-through charge to customers for increased purchase water costs. Aqua Texas then sought to include these costs in the base rates charged to the customers, which could potentially result in a double charge to the customers for the same expense if Aqua Texas continued to charge the pass-through to the customers. The Executive Director wished to remove this charge from the base rate because Aqua Texas failed to adequately show that it had stopped charging the pass-through charge when the new rates went into effect. The ALJs' proposed "Conclusion of Law" No. 22<sup>4</sup> partially addresses the Executive Director's concerns regarding a double charge because it requires Aqua Texas to refrain from charging the pass through charge into the future. However, the Executive Director is still not certain whether Aqua Texas has ceased charging this expense to the customers since the effective

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<sup>2</sup> PFD, Section VII, begins p. 47

<sup>3</sup> PFD, Section VII(B), p. 50

date of the rate change. The Executive Director does not object to the ALJs' proposal on this issue, but requests that a provision be added to the Order which requires Aqua Texas to refund any pass-through charges collected for purchased water expenses since the effective date of the rate change.

**b. ED's Disallowance of Bad Debt Expense<sup>5</sup>**

It is the Executive Director's contention that Aqua Texas' bad debt expense should not exceed 1% of its total water revenue. Aqua Texas listed bad debts of approximately 1.6% in its original application, but the Executive Director found the amount to be closer to 0.8% and recommended a 1% allowance. Aqua Texas has stated that it accepts the Executive Director's recommendation. However, the ALJs' approval of \$329,376.00 is significantly higher than 1% of the water revenue calculated by Aqua Texas in its schedule attached to its response to Order No. 48.<sup>6</sup> Exhibit A from Aqua Texas' response shows Aqua Texas is seeking \$28,018,095.00 in water revenue. One percent of that total would be approximately \$280,000.00. The Executive Director recommends that the final amount approved by the Commission for bad debt expense should equal no more than 1% of the total annual water revenue requirement that is approved. If this recommendation is adopted it will result in an overall reduction in bad debt expense of \$54,048, which results in a reduction of bad debt expense by region of: North Water - \$16,528; North Sewer - \$771; SW Water - \$10,470; SW Sewer - \$1,956; SE Water - \$16,234; SE Sewer - \$8,088.

This change results in the following recommended rates for each region:

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4 ALJ's Proposed Order, Conclusion of Law No. 22, p. 19

5 PFD, Section VII(C), p. 51

6 Footnote (2) in Exhibit A, attached to AT's response to Order No. 48, claims a \$332,336.00 allowance for bad debts results from the ED's recommendation, however the ALJ states that the amount is \$329,376. It is unclear to the ED where the ALJ's number is derived. The ED recommends that the bad debts simply be reduced until they are 1% of the total annual revenue requirement.

ED's Rate Calculations Based on Revised Bad Debt

	Un-phased Water Base Rate	Un-phased gallonage rate	Un-phased sewer rate flat
North Region	33.32	3.27	71.85
SE Region	18.91	2.95	58.40
SW Region	36.77	3.61	82.44

### 3. Rate Base Issues<sup>7</sup>

#### a. Deferred Expense/ Regulatory Asset

As noted in the PFD, one of the main issues in this hearing resulted from Aqua Texas' request to create a regulatory asset to reflect the deferred expenses resulting from Aqua Texas' decision to phase in the rate increase over a period of three years. The Executive Director agrees with the ALJs' conclusion that no regulatory asset should be included in the rate base due to the possibility for Aqua Texas to over-recovery deferred expenses, and the improper shifting of costs to later ratepayers. As correctly noted by the ALJs, Aqua Texas' request to create a regulatory asset as the vehicle to recover deferred expenses resulting from phased rates results in higher rates for Aqua Texas' customers than under a nonphased rate structure. The higher rates remain in effect until Aqua Texas decides to file a new rate increase application, thereby creating the possibility for a substantial overcollection if the rates which include the regulatory asset remain in effect after all deferred expenses have been fully recovered.

The PFD discusses an alternative method for recovery of deferred expenses, namely a surcharge similar to that used to recover valid rate case expenses. However, the Executive Director is unclear as to what extent that the ALJs are recommending approval of Aqua Texas' claim for deferred expense reimbursement through a surcharge. The ALJs never explicitly state that they

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<sup>7</sup> PFD, Section VIII, begins p. 52

recommend granting Aqua Texas' requested amount of \$8,000,000.00 in deferred expenses. However, the PFD's proposed Order has a finding of fact that Aqua Texas' expense deferrals during the 7 year term of its deferral/recovery plan is \$8,000,000.00, and refers to an Aqua Texas Brief which discusses the recovery of \$8,000,000 in deferred expenses through a monthly surcharge.

The Executive Director is not opposed to a utility recovering its reasonable deferred expenses, as long as the utility adequately demonstrates that the amount it seeks to recover is appropriate and reasonable. In this case, Aqua Texas has not shown that \$8,000,000.00 is an appropriate amount to recover. Aqua Texas argues that the fact that it deferred an average of \$8,000,000 in expenses demonstrates that this is the recoverable amount. As discussed in the Executive Director's Closing Brief, this argument ignores a vital step, namely that the recoverable amount of deferred expenses must be calculated by comparing the utility's phased-in rates to the final approved rates, not to the utility's requested rates. The fact that an expense was deferred, or incurred for that matter, does not automatically render the expense recoverable. The Executive Director's position is that the recoverable amount of deferred expenses incurred due to phased-in rates is the amount that must be deferred to offset the difference between the rates that were charged and the utility's final justified rates.

As stated by Aqua Texas during the hearing, the regulatory asset (deferred expense) is essentially the deferral of the revenues that would be received had the rates not been phased in.<sup>8</sup> The \$8,000,000 which Aqua Texas seeks to recover is the average of the difference between what it charged to its customers during the three year phase-in of its rate increase and the nonphased rate it

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<sup>8</sup> Clarifying Examination of Rick Hugus by Judge Vickery; Transcript, p. 986, 16 – 20:

Q. Just so we're clear though, the regulatory asset that is being created is essentially the deferral of the revenues that would be received had the rates not been phased in. Correct?

A. Yes, it is.

proposed in its application. To the extent that the TCEQ's final approved nonphased rates are lower than Aqua Texas' nonphased rates proposed in the application, the amount of recoverable deferred expenses must also be reduced; otherwise, the utility will be recovering expenses that are not reasonable.

When establishing the rates for water and sewer service, Texas Water Code Section 13.183(a) requires the Commission to fix the overall revenues of the utility at a level that will permit the utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service to the public over and above its **reasonable and necessary operating expenses**. (emphasis added) The requirement that operating expenses be reasonable and necessary does not distinguish between deferred and non-deferred expenses, therefore, the same standard applies to both categories. For deferred expenses that are calculated based on the difference between the phased-in rates and a nonphased rate, the calculation should be based on the nonphased rate that is supported by the evidence, not the rate requested by the utility in its application.

The Executive Director has calculated nonphased rates for each region based on the directives provided in the PFD in Section I of this brief. With the exception of the minor change recommended by the Executive Director in Section 2.b. above, these rates are the rates supported by the evidence presented during the hearing. A comparison of the nonphased rates calculated by the Executive Director to Aqua Texas' phased rates for each region demonstrates that the recovery of \$8,000,000 in deferred expenses is not warranted because Aqua Texas began charging rates which exceeded the supportable nonphased rate in year two of the phase-in.

The Executive Director has calculated the over and under collections resulting from the difference between the nonphased rates which are supported by the evidence and the rates which

Aqua Texas has been charging for the last 3 years. The Executive Director projects that the total over collection for water service is around \$6 million and the total under collection for sewer service is also around \$6 million dollars. Therefore, the Executive Director requests that the Commission reject Aqua Texas' request to recover \$8 million dollars in deferred expenses and modify the Order to reflect this change.

**b. Appropriate Rate Base Numbers to Use in Setting Rates<sup>9</sup>**

The PFD discusses a difference between the rate base totals provided by Aqua Texas and the Executive Director. The ALJs' found that a discrepancy of \$2.8 million dollars existed even when the \$8 million dollar deferred asset was taken into account. The Executive Director cannot state with certainty where the entire discrepancy lies, however, the Executive Director can state that \$2,058,034.00 of the \$2.8 million can be accounted for as working capital allowance that is not included in the figures the ALJs have listed for the Executive Director's recommendation. The Executive Director concurs with the ALJs' recommendation that the Commission use the Executive Director's recommended total rate base figure for setting rates.

**III. RATE CASE EXPENSES<sup>10</sup>**

**A. Miscellaneous Rate Design Expenses**

The Executive Director had recommended the disallowance of \$93,559.52 in rate case expenses sought by Aqua Texas for the services of Severn Trent, Mattias Jost, and Peter Marek. Severn Trent provided projected 'pro forma' accounting for Aqua Texas to project the second half of

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9 PFD, Section VIII(C), p. 59

10 PFD, Section X(3), p. 72

its test year expenses. The Executive Director recommended disallowance of this expense because ultimately the Executive Director required, and Aqua Texas agreed, to use the 2004 actual numbers in the Executive Director's review. The ALJs discuss Aqua Texas' claim that the pro forma numbers were accurate within \$10,000 of the actual numbers. The Executive Director challenges this assertion and finds that the difference is much greater than that claimed by Aqua Texas. In any event, the Executive Director believes that it is not reasonable or necessary to charge the customers for work which ultimately proved not to be useful in determining their rates.

Mattias Jost and Peter Marek also provided services in the rate application filing which were not shown to be useful for the purposes of this application. The Executive Director believes that work which is performed but not used is per se not reasonable or necessary. For that reason, the Executive Director requests that these expenses not be charged to the customers of Aqua Texas.

#### **B. Corporate Charges – Double Billing**

The Executive Director had recommended the disallowance of \$62,015.61 in corporate charges allocated from the salaries of corporate Aqua America employees for their work related to Aqua Texas. Specifically, the Executive Director found several billing statements from Aqua America which requested remittance of payment for services from Aqua Texas. *See AT-19, bates no. 104518 and 104635.* Although, the ALJs found the testimony of Aqua Texas' representatives that they were not double collecting from Aqua Texas and its customers compelling, the Executive Director believes that these corporate charges, which were collected by Aqua America, should have had a corresponding journal entry to reverse the corporate salaries to rate case expenses. Once Aqua Texas paid these amounts, it was expended into "Salaries and Wages." Aqua Texas' journal entry

should have reflected a credit to "Salaries and Wages" and a debit to "Rate Case Expense." Since this journal entry was not in Aqua Texas' ledger, Aqua Texas has not meet its burden to show that these charges were not included in the cost of service and in rate case expenses. The Executive Director recommends that Aqua Texas' allowable rate case expenses be reduced by \$62,015.61.

### **C. Allocation of Rate Case Expenses**

The Executive Director does not have any exceptions to the ALJs' recommendations for the allocation of recoverable rate case expenses, and agrees with the PFD that the portion of the allowable rate case expenses for the customers which settled with Aqua Texas should not be shifted to the other customers. The Executive Director requests the addition of a requirement that Aqua Texas submit an annual report detailing the amount of rate case expenses collected to the TCEQ's Water Supply Division.

## **IV. CONCLUSION**

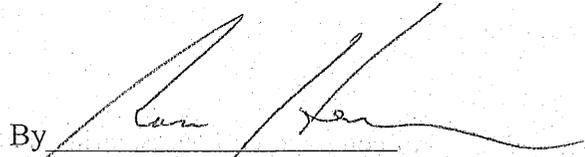
The Executive Director respectfully requests that these exceptions be adopted and that the Commission issue an Order consistent with these recommendations.

Respectfully submitted,

Glenn Shankle  
Executive Director

Robert Martinez, Director  
Environmental Law Division

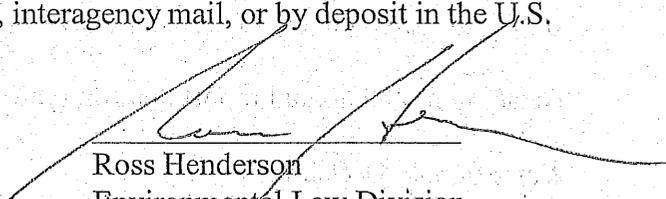
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**CERTIFICATE OF SERVICE**

I hereby certify that on this 25<sup>th</sup> day of July, 2007 a true and correct copy of the foregoing document was delivered via facsimile, hand delivery, interagency mail, or by deposit in the U.S. Mail to all persons on the attached mailing list.

  
Ross Henderson  
Environmental Law Division

**Service List**  
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**SOAH Docket No. 582-05-2770, 582-05-2771**  
**TCEQ Docket No. 2004-1120-UCR, 2004-1671-UCR**

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