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July 5, 2007

Derek Seal
General Counsel
Texas Commission on Environmental Quality
PO Box 13087
Austin Texas 78711-3087

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

Dear Mr. Seal:

The above-referenced matter will be considered by the Texas Commission on Environmental Quality on a date and time to be determined by the Chief Clerk's Office in Room 201S of Building E, 12118 N. Interstate 35, Austin, Texas.

Enclosed are copies of the Proposal for Decision and Order that have been recommended to the Commission for approval. Any party may file exceptions or briefs by filing the original documents with the Chief Clerk of the Texas Commission on Environmental Quality no later than July 25, 2007. Any replies to exceptions or briefs must be filed in the same manner no later than August 6, 2007.

This matter has been designated **TCEQ Docket Nos. 2004-1120-UCR and 2004-1671-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771**. All documents to be filed must clearly reference these assigned docket numbers. Copies of all exceptions, briefs and replies must be served promptly on the State Office of Administrative Hearings and all parties. Certification of service to the above parties and an **original and eleven copies** shall be furnished to the Chief Clerk of the Commission. Failure to provide copies may be grounds for withholding consideration of the pleadings.

Sincerely,

Craig R. Bennett
Administrative Law Judge

CRB/ls
Enclosures
cc: Mailing List

SOAH DOCKET NOS. 582-05-2770 and 582-05-2771
TCEQ DOCKET NOS. 2004-1120-UCR and 2004-1671-UCR

APPLICATION BY AQUA DEVELOPMENT COMPANY AND AQUA UTILITIES, INC. d/b/a AQUA TEXAS, INC. TO CHANGE WATER AND SEWER TARIFFS AND RATES IN VARIOUS COUNTIES	**§ § § § § § §**	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

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SOAH DOCKET NOS. 582-05-2770 and 582-05-2771
TCEQ DOCKET NOS. 2004-1120-UCR and 2004-1671-UCR

APPLICATION BY AQUA DEVELOPMENT COMPANY AND AQUA UTILITIES, INC. d/b/a AQUA TEXAS, INC. TO CHANGE ITS WATER AND SEWER TARIFFS AND RATES IN VARIOUS COUNTIES	§ § § § § §	**BEFORE THE STATE OFFICE** **OF** **ADMINISTRATIVE HEARINGS**

PROPOSAL FOR DECISION

I. INTRODUCTION

Aqua Development Company (Aqua Development) and Aqua Utilities, Inc. (Aqua Utilities) are two separate utilities that are owned by the same parent company, Aqua America. Both utilities provide water and sewer service in Texas under the d/b/a of Aqua Texas, Inc (Aqua Texas).[1] Together, the Aqua Texas companies provide water service to more than 100,000 customers and wastewater service to more than 38,000 customers in Texas, through 335 water and wastewater systems. In this case, the Aqua Texas companies have joined together to file a request with the Texas Commission on Environmental Quality (TCEQ or Commission) to change the rates of their water and sewer customers. In their applications, these two utilities seek to consolidate their systems by region for purposes of water and sewer tariffs, with regional rate structures governing the separate systems owned and operated by the two utilities. Numerous groups of protesting ratepayers have appeared in this case, opposing the applications. The Executive Director (ED) of the TCEQ and the Office of Public Interest Counsel (OPIC) have each appeared and participated in this case.

After considering the issues and evidence presented, the Administrative Law Judges (ALJs) recommend that the Commission grant the applications and establish the water and sewer rates requested, except as adjusted by the recommendations contained in this proposal for decision.

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[1] When referenced together, Aqua Development and Aqua Utilities are referred to as either "Aqua Texas" or the "Aqua Texas companies."

II. PROCEDURAL HISTORY

On May 14, 2004, the Aqua Texas companies initially filed their joint request to change water and sewer rates for their various systems. Because they also provide service within various municipalities, they were required to file separate applications within those cities and submit to the cities' original jurisdiction. When the municipalities did not grant their requested rate relief, the Aqua Texas companies appealed to the Commission. When numerous parties opposed the applications and requested a hearing, the Commission referred all of the matters to the State Office of Administrative Hearings (SOAH).

On March 1, 2005, a consolidated preliminary hearing was held in the various cases. The ALJs consolidated the various appeals with the applications over which the Commission had original jurisdiction. After that, and prior to the hearing, the appeals were resolved with the municipalities, and those cases were severed and remanded to the ED. Moreover, many of the protesting ratepayers also settled with Aqua Texas.

After the case was referred to SOAH, a number of legal questions arose. The ALJs certified three questions to the Commission, two of which the Commission answered. In particular, the Commission determined that two or more utilities could file a joint tariff application to consolidate their systems under a single tariff. Further, the Commission found that the utilities did not have to make a showing in their application that the systems to be consolidated were substantially similar; rather, that showing need only be made through the hearing process.

The hearing on the merits convened on August 14, 2006, at SOAH's offices at 300 West 15th Street, Austin, Texas. It was recessed and began again on August 21, 2006, and continued until August 28, 2006, and was recessed again. Thereafter, the remaining parties engaged in mediation, but were unsuccessful in settling this case in its entirety. The hearing reconvened on February 16, 2007, and concluded on February 19, 2007. The record closed on May 18, 2007, after final written arguments and proposed rate-setting data were filed.

III. OVERVIEW

A. Background and Summary

This is a case of first impression, involving an effort by a large, national utility company to undertake large-scale regionalization of water and sewer service within Texas. Aqua America is the parent company of the Aqua Texas companies. Aqua America, either directly or through its affiliated companies, provides water or wastewater service to approximately 2.5 million customers in 13 states. In 2003, Aqua America acquired the stock of AquaSource Utility, Inc. and AquaSource Development Company. Those two AquaSource companies had previously acquired many smaller utilities in Texas and made efforts toward regionalization in a prior Commission docket. That case was settled and regionalized rates were implemented as a result of that settlement.

Aqua America changed the names of the two AquaSource companies after it acquired them, and obtained the d/b/a of "Aqua Texas" for both. Further, Aqua America continued the system upgrade efforts that were previously started by the AquaSource companies. Immediately prior to their acquisition by Aqua America, the AquaSource companies had entered into compliance agreements with the TCEQ to modernize and upgrade systems to bring them into compliance with applicable statutes and TCEQ rules. Combined, the AquaSource companies and Aqua Texas spent nearly $80 million on system improvements in Texas between approximately 2001 and 2006 as part of their efforts to upgrade the different systems and bring them into compliance with applicable standards.

Aqua Texas instituted this rate case to further effect regionalization and to implement rates that reflected the significant investments made into the various systems. In preparing this rate case, Aqua Texas grouped its systems into four geographic regions in Texas for which it seeks tariffs. Each region has a single proposed tariff for water service and a single proposed tariff for

sewer service.[2] These tariffs are supported by regional data encompassing the systems in each region, but are not supported by specific system-by-system cost of service data.

This case involves a number of issues, divided into two main categories. The first category involves the preliminary question of whether it is appropriate to allow Aquas Texas to obtain consolidated tariffs for the different systems covered by the applications. This category has two component issues—one is whether Aqua Texas has standing to file the applications and the other is whether Aqua Texas has shown the necessary predicate for regionalization. The legislature has adopted statutory criteria for determining when a utility may consolidate more than one system under a single tariff. So, the ALJs first address whether Aqua Texas has proper standing to bring the applications and whether it has shown compliance with the statutory criteria for consolidating systems into regional tariffs. If the applicable legal requirements are not met, then the entirety of this rate case fails—because it is predicated upon the Commission issuing consolidated tariffs, based on regional groupings of systems. In that scenario, the Commission would be compelled to simply deny the requested rates and could not set alternate rates.

Ultimately, as discussed in detail in the subsequent sections of this PFD, the ALJs conclude that Aqua Texas has standing to bring the rate change applications and has met the requirements for consolidating different systems under the regional tariffs. Thus, the ALJs recommend that the Commission approve the regional tariffs requested. Such promotes regionalization and provides efficiencies and other benefits for customers. If the Commission agrees with the ALJs' recommendation, finds it appropriate to allow Aqua Texas to have consolidated tariffs, and approves the groupings chosen by Aquas Texas, then this case becomes essentially a standard rate case. As such, the next category of issues to address involves those typically associated with rate cases: determinations of allowable expenses, rate base, rate of return, rate design, *etc*. Because the ALJs recommend approval of the regional tariffs, they address these other issues and make recommendations for adjustments to the rate-setting data. Ultimately, the ALJs' recommendations result in a revenue requirement that is lower than that sought by Aqua Texas.

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[2] Sewer tariffs are sought only for three regions.

B. Rate Case Data Issues

1. Aqua Texas' Rate Case Data

In one sense, this matter is more complex than a typical rate case because it involves both water and sewer rates and also involves separate tariffs for four different regions. As such, it is akin to having numerous rate cases combined into one proceeding. By necessity, this means that this case involves a significant amount of rate case data. To put it into context, ED technical witness Kamal Adhikari testified that he had worked on nearly 60 water or sewer rate cases in his tenure at TCEQ and this case was approximately *25 times larger* than the next largest case on which he had worked.[3]

In addition to being larger and involving numerous tariffs, this case is different from a standard rate case in another way—namely, in the manner in which Aqua Texas has presented its rate case data. In compiling its 2003 test year data to support its rate change application, Aqua Texas did three things which have a significant impact on this case. First, because Aqua Texas acquired the AquaSource companies in the middle of 2003, the accounting and bookkeeping for the systems included data from the time when the systems were operated by the AquaSource companies, in addition to data for the time they were operated by Aqua Texas. However, because the AquaSource companies used different utility accounting procedures, Aqua Texas concluded that attempting to use the AquaSource companies' data would result in unreliable calculations. So, instead of combining the different companies' data, Aqua Texas used the partial test year data it kept, and then used budgeted (*i.e.*, anticipated) data for 2004 to replace the AquaSource test year data. Aqua Texas contends that using budgeted costs actually saved consumers money, because budgeted expenses were $2.3 million less than if AquaSource's actual 2003 data were used, and revenues increased by $1.8 million under the budgeted figures. Accordingly, Aqua Texas claims that this resulted in a net savings to consumers of more than $4 million.

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[3] See Tr. Vol. 4, at 816 (this case involves approximately 51,000 connections, whereas the next largest rate case handled by Mr. Adhikari involved 1,500 to 2,000 connections.)

Second, Aqua Texas maintains its books and records in a manner different than that utilized by the TCEQ in reviewing water and sewer utilities. Specifically, Aqua Texas utilizes NARUC[4] utility accounting for its systems. In Texas, the TCEQ has a proprietary system that it uses for evaluating utility expenses. Because Aqua Texas' data was entered according to NARUC accounting standards, the ED's staff requested that it be presented in a different format to assist the ED's cost of service evaluation. Accordingly, this resulted in essentially a different set of data being reviewed by the ED in comparison to that presented by Aqua Texas in its rate change applications.

Third, and perhaps most significant, in its rate change application data, Aqua Texas has not attempted to break out the costs of service by system, but rather has aggregated its data by region. Aqua Texas has presented no cost of service studies for any of the individual systems, nor has it presented any system-by-system analysis to support its regional costs of service. Instead, it has presented all such data in aggregated amounts by region. Many of the different issues raised by the Protestants in this case arise out of this method of presenting the data. Among other things, the Protestants argue that it is impossible to determine the appropriate cost of service for the different regions without system-specific data. Because Aqua Texas' method of data collection and presentation is such a key issue and an ongoing theme in many of Protestants' arguments, the ALJs find it appropriate to address it now at the outset of this PFD.

2. ALJs' Analysis of Aqua Texas' Rate Case Data

Ultimately, despite Protestants' concerns to the contrary, the ALJs believe that Aqua Texas' method of presenting its rate case data is acceptable and that the data is reliable for use by the Commission in setting rates.

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[4] NARUC is the acronym for National Association of Regulatory Utility Commissioners.

First, the decision to use budgeted numbers, instead of the full test year data was reasonable and resulted in a more accurate representation of the utility's actual expenses going forward. Under 30 TEX. ADMIN. CODE § 291.31(b), only a utility's "historical test year expenses as adjusted for known and measurable changes" may be considered in determining allowable expenses. The decision to use budgeted numbers when the actual numbers contain many expenses that will not be incurred going forward is essentially an adjustment for "known and measurable changes." While the Commission may be wary to set a precedent allowing budgeted numbers to be used instead of actual test year data, this seems to be an appropriate method of accounting for known and measurable changes under the unique circumstances of this case.

After Aqua Texas acquired ownership of the AquaSource companies, it was faced with a choice in preparing its rate change application for those utilities: (1) either use the AquaSource companies' data, which had not been kept according to the rate regions that had been approved by the Commission in the 2002 Order and was not consistent with the accounting method used by Aqua Texas; or (2) calculate the expected expenses for Aqua Texas for the additional seven months necessary to have a full test year of data according to Aqua Texas' method of accounting and anticipated expenses. Had Aqua Texas chosen the first method, it would have had to spend a significant amount of resources to organize the data in a consistent manner and also would have had to then go through all of AquaSource's expenses, item by item, and show which expenses would be different going forward under ownership by Aqua Texas. To avoid this, Aqua Texas chose the second option—to use budgeted data.

Aqua Texas' decision appears prudent for a couple of reasons. First, by using budgeted data, Aqua Texas ended up with $2.3 million less in expenses than the actual AquaSource data reflected during the test year. Similarly, Aqua Texas' budgeted revenue projections resulted in more than $1.8 million in additional anticipated revenues than AquaSource data showed during the test year. As such, the decision to use budgeted data provided a net benefit to ratepayers of more than $4 million.[5]

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[5] Ex. AT-1, at 19.

Second, the budgeted data proved to be extremely accurate. When the actual data came in for the budgeted time period, the total cost of service discrepancy between budgeted costs and actual costs was approximately $10,000.[6] This shows that the anticipated "known and measurable changes" reflected by the budgeted numbers were very reliably measured and predicted. As such, the use of budgeted numbers by Aqua Texas was really just a large scale adoption of known and measurable changes.[7] In most cases, it would not be appropriate to allow a utility to make such changes without justifying each separate change. But, in a situation like that presented here—involving hundreds of systems, data from two different companies using different accounting methods, and a net benefit to ratepayers—the ALJs believe it was reasonable for Aqua Texas to use budgeted data to make wholesale "known and measurable changes." The ED agreed and did not take issue with this method used by Aqua Texas.

Also, the ALJs do not find any problem with Aqua Texas' decision to use NARUC accounting and to support its rate change application with data compiled under that accounting method. Upon the ED's request, Aqua Texas compiled and presented its data in a different format for the ED's technical staff's review. The data was thoroughly reviewed by the ED's staff, who determined that the data was accurate and reliable and sufficiently established the requested rate change, except for the adjustments those staff members propose. The mere fact that Aqua Texas supported its application with data compiled under NARUC accounting does not impact the reliability or accuracy of the data.

Moreover, when the ED's staff reviewed the actual documentation to support the rate change calculations, it found the identified expenses to be well-supported by receipts and other acceptable documentation. Elsie Pascua testified that she and a number of the ED's staff members

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[6] Ex. AT-1, at 19.

[7] Essentially, what Aqua Texas did is not much different than when a utility incurs an expense during the test year that it reasonably anticipates will not be incurred in following years: it removes it from allowable expenses for rate-setting purposes.

spent several weeks reviewing approximately 55 boxes of documents and invoices.[8] From that, she concluded that they had reviewed 90 to 95 percent of the documents supporting the numbers contained in Aqua Texas' application, and she was "pretty much confident" that the data contained in the application was supported.[9] ED technical staff Kamal Adhikari was similarly comfortable with the documentation of Aqua Texas, based on his extensive review.[10] By necessity, the ALJs must rely on the technical expertise of the ED's staff and party witnesses who actually review supporting documentation and physical assets. In this case, the ED's staff has a high level of confidence in the data supporting Aqua Texas' cost of service numbers, and none of the other parties have shown those numbers to be unreliable. Accordingly, the ALJs find no basis for overall concern with Aqua Texas' cost of service calculations, except as specifically set forth in regard to certain delineated items discussed elsewhere in this PFD.

Lastly, the ALJs turn to the decision by Aqua Texas to compile its cost of service data by region, rather than system. When identifying the rate base assets, Aqua Texas did identify the plant and equipment by system, but when determining overall cost of service, it relied instead on regional calculations. The ALJs find this approach to be appropriate. In 2002, the Commission issued an order allowing regional rates to be charged customers of different systems. Therefore, from that point forward it was appropriate to calculate cost of service on a regional basis in accordance with that Commission order. While a system-by-system breakdown might make it easier to audit the data, it is not essential. In order to have regional tariffs, Aqua Texas is required to determine its cost of service on a regional basis, and not a system-by-system basis. So, requiring Aqua Texas to compile and present its numbers on a system-by-system basis—in addition to a regional basis—would just add another step to the process and would likely increase the rate case expenses borne by ratepayers. Therefore, the ALJs conclude that Aqua Texas' failure to present system-by-system cost of service information is not fatal to its application, but is proper under the circumstances. Now the ALJs turn to the first category of disputed issues in this case.

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[8] Tr. Vol. 4, at 767 and 793-794.

[9] Tr. Vol. 4, at 767 and 793-794.

[10] Tr. Vol. 4, at 810.

IV. AQUA TEXAS' STANDING AS APPLICANT

Protestants dispute that Aqua Texas has standing to even bring the rate change request at issue in this case, contending that Aqua Texas (1) has no debt, equity, or capital for which it could seek to recover in this case, and (2) was required to submit a sale-transfer-merger (STM) application and get it approved before seeking to change rates for the systems involved in this case. The ALJs dismiss the first contention, noting that Aqua Texas is the entity that owns the CCNs for the systems in issue. Moreover, Aqua Texas is wholly owned by Aqua America. As discussed in the "rate of return" section of this PFD, the ALJs conclude that Aqua America's capital structure is the most appropriate one to use for determining a rate of return. However, if that were not the case, the evidence is that Aqua America obtained 100% of the stock of Aqua Texas. Therefore, because it is wholly owned by Aqua America and has no debt in its name, Aqua Texas is fully capitalized by equity. However, because the evidence is sufficient to connect Aqua America's debt directly to Aqua Texas, it is best for ratepayers to use Aqua America's capital structure instead of a 100% equity structure. Regardless, Protestants' first contention—that Aqua Texas has no debt, equity, or capital on which to bring a rate case—clearly fails.

Protestants are correct, though, that Aqua Texas has not filed a STM application for the systems in issue. Instead, Aqua America acquired ownership of 100% of the stock of the AquaSource companies and changed their names. It is these newly named companies that filed the rate change applications in this case. Protestants argue that this cannot be done.

Aqua Texas responds by pointing out that it obtained Commission approval of the stock acquisition prior to its completion. Specifically, Aqua America notified the Commission of its proposal to purchase 100% of the stock of the AquaSource companies, and submitted stock purchase applications to the Commission. By letter dated September 10, 2003, Michelle Abrams (an Acting Team Leader in the Commission's Water Supply Division) indicated that the stock purchase applications were approved, Aqua America owned 100% of the stock of the AquaSource

companies, and the applications would be closed.[11] Ms. Abrams further indicated that the CCNs would remain in the names of the AquaSource companies until a STM application was filed.

This is a purely legal issue that is within the Commission's discretion to decide. It is undisputed that STM applications have never been filed for the utilities in issue. Similarly, it is undisputed that a stock purchase application was submitted and approved by the Commission. The only remaining question—which is purely a question of law—is whether a STM application is necessary where the operating utilities remain the same, but their ownership has changed through a stock acquisition. Aqua Texas argues that the stock purchase application required by TEX. WATER CODE § 13.302 is all that is necessary, and no STM application under TEX. WATER CODE § 13.301 is required. Protestants disagree.

Although it is the Commission which is granted the authority to interpret applicable environmental laws, the ALJs also understand their role as requiring them to recommend an interpretation to the Commission. In that regard, the ALJs recommend that the Commission find that, when an acquisition is accomplished purely through a stock purchase, a STM application is not necessary unless the purchasing entity seeks to transfer the CCNs to another utility. Rather, the stock purchaser should only be required to show compliance with TEX. WATER CODE § 13.302.

Although there is no specific authority that is dispositive on the issue, an analysis of the relevant statutes appears to indicate that STM applications are not required for purely stock acquisitions. First, TEX. WATER CODE § 13.302 establishes separate application requirements for the purchase of stock in a public utility. The terms of this provision mirror, in several significant ways, those of TEX. WATER CODE § 13.301, which requires a STM application for a list of other transactions. Both sections of the Water Code use identical language to describe the criteria for

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[11] Ex. AT-5. The letter indicates the stock purchaser is Philadelphia Suburban Corporation, which is actually Aqua America's previous name. In 2004, Philadelphia Suburban changed its name to Aqua America to reflect its nationwide scope of service. Ex. AT-1, at 3.

granting the respective applications. For both STM and stock acquisition applications, the Commission may require that the applicant "demonstrate adequate financial, managerial, and technical capability for providing continuous and adequate service to the requested area and any areas currently certificated to the person."[12] Further, each of those sections of the Water Code requires that the Commission determine whether the proposed transaction would serve the public interest, and provides for a public hearing if it is necessary to make this determination.[13]

Given the similarities in the analysis applied to stock acquisitions and STM applications, it seems clear that the legislature intended to establish a separate application process for stock acquisitions of water utilities that protects the public interest using the same safeguards as the STM requirements. This would indicate that a stock acquisition is not a "sale, acquisition, lease, or rental," or a "merger or consolidation," and, therefore, does not necessitate a STM application under TEX. WATER CODE § 13.301(a). To construe the statutes otherwise would be to duplicate the process unnecessarily and would be wasteful of state resources. Essentially, if a stock acquisition necessitated an STM application, the application, investigation, and hearing process would be duplicated for a single transaction. This would not be logical nor efficient, and the ALJs see no basis for requiring the process to be repeated. As such, the ALJs believe that, in a given situation, if approval has been granted under TEX. WATER CODE § 13.302, then no further application is necessary under TEX. WATER CODE § 13.301 unless an actual transfer of the CCN is sought.

As the letters from the Commission indicate, Aqua America obtained the necessary approval prior to the 2003 stock acquisition as required by TEX. WATER CODE § 13.302. After this legal transaction, the CCNs remained in the name AquaSource Utility and AquaSource Development Company, which subsequently changed their names to Aqua Utilities and Aqua Development, both

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[12] TEX. WATER CODE §§ 13.301(b) and 13.302(b).

[13] TEX. WATER CODE §§ 13.301(d)-(e) and 13.302(d) and (f).

of which do business as Aqua Texas.[14] As Protestants point out, the names of both of these companies appear on the rate increase application. Since both of these companies possesses a valid CCN, and they are permitted under the Water Code to file a single rate filing application, it was not necessary for Aqua America or any of its subsidiaries to file a STM application. Therefore, the ALJs conclude that Aqua Texas has standing to file the applications. Now, the ALJs turn to the most significant issue in this case—whether the proposed consolidated tariffs are appropriate.

V. CONSOLIDATED TARIFFS/REGIONALIZATION

A. Legislative Preference for Regionalization

The most significant issue in this matter is whether Aqua Texas should be permitted to consolidate its systems into regions, with each region having separate regional tariffs for water and sewer rates. Although the parties disagree over the extent of the Legislative preference for regional tariffs, the ALJs conclude that Chapter 13 of the Water Code expresses a strong legislative preference for regionalization in the form of a mandate to the Commission to develop policies promoting the consolidation of systems under regional tariffs.[15] There is a tension, however, between that preference for regionalization and the provisions of TEX. WATER CODE § 13.145, which was enacted in 2001 and limits a utility's ability to consolidate more than one system under a single tariff.[16] In particular, TEX. WATER CODE § 13.145(a) states:

> MULTIPLE SYSTEMS CONSOLIDATED UNDER TARIFF.
>
> (a) A utility may consolidate more than one system under a single tariff only if:
>
> (1) the systems under the tariff are substantially similar in terms of facilities, quality of service, and cost of service; and

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[14] Ex. AT-A, at 9.

[15] See, *e.g.*, TEX. WATER CODE §§ 13.182(d), 13.183(c), and 13.241(d).

[16] TEX. WATER CODE § 13.145.

(2) the tariff provides for rates that promote water conservation for single-family residences and landscape irrigation.[17]

Thus, Chapter 13's preference for regionalization is limited to systems that are substantially similar. Moreover, a consolidated tariff must promote water conservation. This tension between the preference for regionalization and the terms of TEX. WATER CODE § 13.145 provides the backdrop for the parties' different arguments.

Regionalization is the Legislature's and the Commission's response to the problem of small, underfinanced water and sewer systems that lack the resources to meet regulatory requirements.[18] Historically, small "mom and pop" operations and developers received water and sewer system permits.[19] The operation of water and wastewater utilities is very capital intensive, though, and many stand-alone systems find it difficult to raise the capital for improvements and maintenance, in addition to the strain of passing this expense on to system customers.[20] As a result, many owners of these smaller systems have no access to capital and often fail to invest in or maintain these stand-alone systems.[21]

In response to the problem of failing water and sewer systems, the Legislature enacted Senate Bill 1 in 1997, which reflected a preference for the consolidation of systems under regional tariffs.[22] Senate Bill 1 encouraged the development of regional water systems through loan forgiveness and a requirement that CCN applicants provide evidence of regionalization in developing water systems.[23] The benefit of regionalization is that the high costs of necessary

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[17] TEX. WATER CODE § 13.145.

[18] Ex. AT-E, at 14-17; Tr. Vol. 6, at 1062-1068.

[19] Tr. Vol. 6, at 1062-1063.

[20] Exs. AT-A at 27, and 31-32; Ex. AT-24; Ex. AT-25; Tr. Vol. 6, at 1063, 1069-1070.

[21] Tr. Vol. 6, at 1063, 1069-1070; Ex. AT-A at 31-32.

[22] Ex. AT-27 [HOUSE RESEARCH ORGANIZATION, BILL ANALYSIS, S.B. 1, 75th Leg., R.S. 24, 36, 37 (1997)].

[23] Id.

capital improvement and maintenance for one system can be spread over all the systems in the region, resulting in revenue stability for the utility and the avoidance of rate shock for customers.[24]

The Legislature's desire for regionalization is discussed as a mandate in the 2005 bill analysis of SB 1063, which states " . . . all other utilities would be *required* to establish regional rates. This rate system is consistent with current law."[25] TEX. WATER CODE § 13.241(d) even requires CCN applicants for a stand-alone system to demonstrate that consolidation with another utility is not feasible before it will be granted.[26] This strong preference for regional tariffs is reflected in TEX. WATER CODE § 13.183(c), which reads:

> The Commission by rule *shall* establish a *preference* that rates under a consolidated tariff be consolidated by region. The regions under consolidated tariffs must be determined on a case-by-case basis. [Emphasis added].

The TCEQ complied with this legislative mandate, and in 2003, issued a policy statement that offered guidance to new and existing utilities on the TCEQ's regionalization policy.[27] Therefore, the ALJs analyze the parties' arguments in light of the clear preference by the Legislature and the Commission for regional tariffs.

B. Aqua Texas' Regionalization Efforts

Before addressing the ultimate issue of consolidated tariffs, it is necessary to discuss background information about Aqua Texas and its systems. As noted previously, Aqua Texas provides water service to some 100,000 customers and wastewater service to approximately

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[24] Tr. Vol. 6, at 1063, 1069-1070; Ex. AT-A, at 31- 32.

[25] Ex. AT-28 [HOUSE COMM. ON NATURAL RESOURCES, BILL ANALYSIS, Tex. S.B. 1063, 79th Leg., R.S. (2005) (emphasis added)]; AT-29 [SENATE COMM. ON NATURAL RESOURCES, BILL ANALYSIS – AUTHOR'S/SPONSOR'S STATEMENT OF INTENT, Tex. S.B. 1063, 79th Leg., R.S. (2005)].

[26] TEX. WATER CODE § 13.241(d).

[27] Ex. AT-26 [TCEQ, RG-357 *The Feasibility of Regionalizing Water and Wastewater Utilities: A TCEQ Policy Statement* (Jan. 2003)].

38,000 customers in 50 Texas counties.[28] The company has divided its Texas customers into four service regions (but a total of seven water and sewer regions within those four geographic regions), and seeks to consolidate all of the systems in each region under a single water or sewer tariff.[29] The four water regions are the North, Southeast, Southwest and Ingram Regions. There are only three sewer regions because Aqua Texas does not provide sewer service to the Ingram Region.

Aqua Texas' headquarters are located in Pflugerville, Texas, but it maintains offices in seven different areas to facilitate service and maintenance.[30] Aqua Texas employs 109 personnel in Texas.[31] The company's water systems primarily consist of small neighborhood-oriented systems that meet average demands.[32] Although there are a few commercial customers, their demands are similar to Aqua Texas' residential systems, which form a large percentage of the company's customer base.[33]

The predecessor to Aqua Texas was AquaSource. The regions at issue in this matter were originally developed in AquaSource's 2000 rate case, in which AquaSource initially sought a single, state-wide tariff.[34] The Commission's 2002 order in that case resulted from settlement negotiations between AquaSource, the protesting parties, and the ED, and created a regional tariff structure.[35] In July of 2003, Aqua America acquired AquaSource, and Aqua Texas inherited AquaSource's regional tariff structure. In this case, Aqua Texas has carried forward the

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[28] Ex. AT-A, at 11.

[29] Ex. AT-B, at 7-8.

[30] Ex. AT-B, at 10 and 13-16.

[31] Ex. AT-B, at 13.

[32] Tr. Vol. 1, at 159.

[33] Ex. AT-B, at 31; Tr. Vol. 5, at 938.

[34] Tr. Vol. 3, at 592; Ex. AT-2; Ex. AT-G, at 11. Aqua Texas refers to the AquaSource rate case as a 2001case, and the ED and Protestants refer to it as a 1999 case. The ALJs refer to it as a 2000 case because the Application was filed on June 13, 2000. Ex. AT-2, at 2.

[35] Ex. AT-2, Ex. A at 7; Ex. AT-G, at 11.

AquaSource regional structure, except that the former Northeast and Northwest Regions have now been combined into the North Region.[36] The regional structure as adopted by Aqua Texas is based on geography, geology, and Aqua Texas' internal categories of systems according to facilities, quality of service, and cost of service.[37]

Aqua Texas brought this rate case as a result of rising costs and capital expenditures of approximately $80 million it made to upgrade its systems.[38] Due to the substandard state of many of its systems, AquaSource had entered into numerous compliance agreements with the Commission requiring improvements to its systems throughout the state.[39] In fact, AquaSource entered into four compliance agreements just prior to its acquisition by Aqua America, with the result being that Aqua Texas was required to engage in substantial capital expenditures to achieve compliance under those agreements.[40] Aqua Texas hired a former TCEQ engineer to oversee compliance with the agreements, and provided and continues to provide various data, studies, plans for approval and status reports to the Commission.[41] In addition to all of the required upgrades, Aqua Texas expended $20.6 million in non-mandated, but needed, capital improvements to its systems.[42]

C. Overview of the Parties' Arguments on Regionalization/Consolidated Tariffs

As a preliminary matter, Aqua Texas argues that TEX. WATER CODE § 13.145 (referred to hereafter as simply Section 13.145) does not even apply in this case because it seeks several

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[36] Ex. AT-A, at 22 and 29.

[37] Ex. AT-B, at 31and 34-36; Tr. Vol. 3, at 503.

[38] Ex. AT-A, at 16 and 24.

[39] Exs. AT-35 through AT-39.

[40] Ex. AT-36 through AT-39; Ex. AT-A, at 16 and 24.

[41] Ex. AT-B, at 39-40; Ex. AT-E, at 10-12; Exs. AT-40 to AT-58.

[42] Ex. AT-B, at 9.

regional tariffs—not a "single" statewide tariff.[43] The ED disagrees with this interpretation of the statute, but argues that Section 13.145 applies only to the systems that were not already consolidated in AquaSource's 2000 rate case. Regardless, both the ED and Aqua Texas conclude the company has made the necessary showing to establish regional tariffs.

Both Aqua Texas and the ED subscribe to the view that the goal of regionalization requires that systems be compared to one another in a broad context *over time*. When viewed over time, the ED and Aqua Texas conclude that all of Aqua Texas' systems within a region are substantially similar to one another in terms of cost of service, quality of service, and facilities. Their analysis includes a prospective component, considering whether the systems, going forward, will be substantially similar. In taking this approach, they assume that all facilities will require investment and maintenance at some point in time, and conclude that no two systems should be considered dissimilar simply because one system requires investment in a given year while another does not. Also, the ED and Aqua Texas argue that the tariffs promote water conservation because they start at zero gallonage and use inclining block rates.

In contrast, OPIC and the Protestants flatly disagree that Aqua Texas has met its burden to establish consolidated tariffs. Protestants' initial argument is that there is no legislative preference for regionalization. As set forth above, the ALJs reject that argument. Next, both OPIC and the Protestants focus on Section 13.145 and its requirement that systems may only be consolidated if they are substantially similar and promote water conservation. They argue that the regions must be compared as if a snapshot were taken of the test year, not over time. In essence, they argue for a retrospective analysis of substantial similarity. Thus, the difference between the prospective and retrospective approaches is best described like this: the ED and Aqua Texas assert that the systems must be substantially similar going forward, in how they will be operated once consolidated; Protestants and OPIC argue they must be substantially similar to each other prior to the consolidation, before they can even be consolidated.

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[43] Aqua Texas' Initial Brief, at 16-26.

The Protestants focus on Aqua Texas' failure to produce system-specific information or cost of service studies so that an actual system-by-system comparison could be conducted. As a result, they argue that Aqua Texas has failed to meet its burden of establishing that the systems are substantially similar.[44] Protestants point out that many differences exist between systems within each region, such as:

- Some were existing systems and some were developed systems;
- There are systems that have water delivered instead of pumped;
- The systems are of varying size, age, and quality;
- Some systems use surface water and others use groundwater;
- The systems are governed by a wide range of local regulatory authorities, each with their own pass-through costs;
- One third of the systems are the subject of Commission compliance orders while others require little to no investment;
- Numerous systems within the regions have settled this matter making them dissimilar to those that have not; and
- Mr. Loy, a witness for Aqua Texas admits that if a cost of service study had been conducted, there would be differences between the systems.[45]

In addition to attacking the substantial similarity of the systems within the regions, the Protestants dispute that the regional tariffs promote water conservation. Specifically, Protestants argue that nearly all water consumers within the Southeast and Southwest Regions do not exceed the initial tier for block pricing. Therefore, the proposed inclining block rates have no effect and do nothing to promote water conservation.

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[44] Protestants' Initial Brief, at 22-23.

[45] Protestants' Initial Brief, at 24-32.

D. ALJs' Analysis on Regionalization/Consolidated Tariffs

1. Section 13.145 Applies to Regional Tariffs

Initially, Aqua Texas argues that Section 13.145 does not apply to regional tariffs, but rather only to utilities seeking a single, statewide tariff. The ALJs disagree and find that the statute applies to any tariffs under which more than one system is being consolidated, including regional tariffs. Aqua Texas' argument was set forth in a motion for summary disposition early in this case and that motion was denied by the ALJs in Order No. 20. The Commission also appeared to reject it during the Commission's deliberations at the open meeting on certified questions in this case.

Aqua Texas argues that Section 13.145(a) conflicts with the Legislature's preference for regionalization. That is, if there is a preference for regionalization then surely Section 13.145 was never meant to limit that goal. While the ALJs might agree with that in principle, by its plain language Section 13.145(a) applies to any utility that seeks to consolidate two or more systems under a single tariff: "A utility may consolidate more than one system under a single tariff only if . . ." With the exception of the word "single," nothing limits the application of this section to a single *statewide* or *universal* tariff. And, the ALJs conclude that the term "single" does not implicitly mean "statewide" or "universal." Rather, the ALJs find that plain meaning of the statute is that any time more than one system is consolidated together with other systems under the same individual tariff, then Section 13.145 applies. This is supported by the legislative history.

When Section 13.145 was amended in 2005, the Legislative Bill Analysis noted that there was only one investor-owned utility in Texas that had statewide rates, and all other utilities were required to establish regional rates. Specifically, the Bill Analysis stated:

> S.B. 1063 requires all investor owned utilities operating in Texas to adhere to a single regulatory scheme, with exception to the application of a single tariff system. One IOU would be allowed to continue collecting a universal rate while all other utilities would be required to establish regional rates. The rate system is consistent with current law.[46]

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[46] Ex. AT-28; Ex. AT-29.

So, regardless of which utility was the sole utility allowed to operate under a statewide "universal" rate, if all other utilities are required to establish regional rates—and if that was the law as of 2005 (as reflected in the Bill Analysis)—then Section 13.145 *must* apply to regional rates.

2. Regions Established by Prior Commission Order are Presumed Proper

The ED contends that, because the regions in this case were already approved by a Commission Final Order in the settlement of the 2000 AquaSource rate case, the 269 systems already consolidated should be exempt from any additional analysis under Section 13.145.[47] The Protestants counter that the regions were established for "convenience" and cite the ALJs to ordering paragraph one in the 2002 rate order in the AquaSource case, which states:

> This Order, and the documents attached to it do not: . . . (3) establish whether ASU will file future rate cases based upon system-wide, regional or system specific rate, or a combination of system-wide, regional and system-specific rates . . .[48]

Accordingly, the Protestants contend that the Commission's analysis starts anew and all of the systems must be individually considered for consolidation in a given region—with the burden on Aqua Texas to show that the requirements of Section 13.145 are met for each of those systems.

The ALJs disagree with Protestants' contention. Although the Protestants correctly cite part of the Commission's 2002 Final Order in the AquaSource rate case, they ignore the provision that followed it. That provision states that the Commission's order did not:

> . . . (4) preclude regulatory authorities from establishing rates in future cases based upon system-wide rates, regional rates, or system specific rates, or a combination of system-wide, regional and system-specific rates; . . .[49]

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[47] The number of systems is found in Ex. AT-G, at 5. To a certain extent this issue is irrelevant, because both Aqua Texas and the ED offered evidence that all of the systems in each region are substantially similar to one another.

[48] Ex. AT-2, at 8.

[49] Ex. AT-2, at 8.

In other words, the ALJs read subsections 3 and 4 together to indicate that the order does not require a certain rate structure in the future, nor does it preclude the Commission from continuing or altering the rate structure in the future. Neither subsection indicates that the regional structure was one of mere *convenience*, as argued by the Protestants. What is clear is that Aqua America acquired AquaSource with the current regional structure intact and decided to carry it through to this rate case.

Although the AquaSource regional tariffs were not binding on Aqua Texas, the settlement agreement was adopted and the 2002 rate order was signed by the Commission. In a situation where the Commission has already approved a consolidated tariff—whether by settlement or after deciding a contested case—the ALJs believe that the Commission need not reweigh the merits of consolidation of those same systems under a single tariff. Rather, only the new systems that Aqua Texas seeks to include in the existing regions should be compared to the systems already consolidated to determine whether they are substantially similar and belong together.

However, the ALJs recognize that, under exceptional circumstances, it might be appropriate to modify a regional structure if the nature of one or more of the systems has so radically changed as to no longer be similar to the others under the same tariff. In that situation, the parties are certainly free to argue for alterations to the regional structure. However, the ALJs believe that a prior Commission Order should be given presumptive weight that the systems already consolidated into regions should remain undisturbed. Accordingly, the burden would be on the party challenging the previously consolidated systems to show they no longer belong together. In this case, the evidence supports a finding that the consolidated systems belong together, so this analysis is not necessarily dispositive. But, if the Commission disagrees with the ultimate findings by the ALJs on the overall similarity of the systems, the Commission would need to address the applicable burden to be applied to previously-consolidated systems.

3. Substantial Similarity of the Consolidated Systems

a. The Applicable Analysis for Substantial Similarity

Section 13.145 permits a utility to consolidate more than one system under a single tariff only if the systems under the tariff are substantially similar in terms of facilities, quality of service, and cost of service. The parties have adopted two distinct, but rational approaches to determining whether the systems within each region are substantially similar. Each approach practically compels the outcome sought. The ALJs find that the approach most consistent with the Legislature's goal of regionalization is that offered by the ED and Aqua Texas. If that approach is adopted, then the evidence supports approving the consolidated tariffs. If, however, the Commission disagrees with the ALJs and determines that OPIC and the Protestants offer a better method, the record would mandate a finding that Aqua Texas has not met the requirements of Section 13.145 for consolidation under that method.

Aqua Texas and the ED subscribe to the view that the substantial similarity inquiry must compare the systems over time (including prospectively) to determine the similarity of the maintenance, investment, and depreciation of assets. As Aqua Texas indicates:

> The amount of capital expenditures needed to bring Aqua Texas' facilities into compliance with the TCEQ's rules can vary in the short run due to their individual age and condition, but these costs distribute themselves evenly over time because those systems all require the same types of capital expenditures.[50]

In addition, and as explained more fully below, Aqua Texas notes that from a broad perspective, all of its systems are substantially similar in that they are all small, neighborhood-oriented systems designed to meet average demands.[51]

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[50] Ex. AT-B, at 32.

[51] Tr. Vol. 1, at 159.

In contrast, the Protestants take a snapshot approach that essentially compares each system to the others within that region based on the state of the system at the time the snapshot is taken. The result is that differences between the systems are highlighted. For instance, almost one-third of all of Aqua Texas' systems are under TCEQ compliance orders.[52] Naturally, those systems appear dissimilar to systems which require little to no investment during the test year.

The problem with Protestants' approach is that it fails to recognize that, during any given test year, every system will be at specific point in the range of its facilities' life. Arguably, as a facility's assets change from year to year, a single facility would be dissimilar to itself in prior years.[53] So Protestants' approach guarantees that systems within a region will be dissimilar to one another based solely on the age of their facilities.

The ALJs, however, believe that the test year/snapshot approach is inconsistent with the Legislature's strong preference for regionalization, because it would make it exceedingly difficult to consolidate tariffs. TEX. WATER CODE § 13.183(c) places the goal of "encouraging regionalization" on par with the most fundamental rate-setting goals of the Commission—ensuring high quality, affordable, reliable water and sewer service, and the financial integrity of the state's utilities. These goals are so important that Section 13.183(c) authorizes the Commission to facilitate them through ratemaking methodologies beyond the normal parameters for ratemaking.

It is significant that regionalization is mentioned as equivalent with the Commission's fundamental goals in water and sewer ratemaking, because the Protestants have argued that any legislative preference for regionalization does not include the concept of spreading system costs over all customers in the region. Specifically, the Protestants contend that Section 13.145 ". . . was

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[52] Ex. AT-B, at 9.

[53] Ex. AT-F, at 35-36.

enacted to ensure that no system would effectively be subsidizing another system."[54] As authority for this proposition, the Protestants cite the Bill Analysis for House Bill 1281. The ALJs have carefully reviewed the bill analysis quoted and find there is nothing in the text that supports the proposition that regional tariffs should not have the goal of spreading system costs over the region. If the Protestants are correct, and cost sharing is *not* a goal of regionalization, they have failed to offer an alternative explanation for the Legislature's preference for regional tariffs.

As pointed out by the ED, the Commission's policy of consolidating systems under a single regional tariff predates the adoption of Section 13.145. The ED and Aqua Texas assert that the sharing of high costs of investment and maintenance by all the systems in a region is exactly the point of regionalization, resulting in revenue stability for the utility and the avoidance of rate shock for customers.[55] The ALJs find that such cost-sharing is consistent with the goals of rate-setting outlined in TEX. WATER CODE § 13.183(c): improved water and sewer quality, affordability, reliability, and financially and technically stable utilities. The Commission's regionalization policy, promulgated pursuant to TEX. WATER CODE §§ 13.182 and 13.183(c), provides:

> This document states the TCEQ's policy for evaluating applications for new systems to determine whether regionalization - the consolidation of the operations, physical systems, or both of two or more existing or proposed water or domestic wastewater systems - is a viable option for the proposed new system. The goal of this policy is to achieve the best service to the consumer at rates that will ensure that the system is maintained for the long term.
>
> * * *
>
> Why this Policy?
>
> > By encouraging the regionalization of water and wastewater systems, we hope to protect the health, safety, and welfare of Texans by ensuring a long-term supply of safe water at affordable rates and by maintaining the quality of water in the state.

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[54] Protestants' Initial Brief, at 22.

[55] Tr. Vol. 6, at 1063, 1069-1070; Ex. AT-A, at 31- 32.

> The ultimate goal of regionalization is to provide timely and cost-effective solutions for achieving quality service. Drinking water and wastewater systems are facing an ever-increasing demand on their resources to stay in compliance with provisions of the federal Safe Drinking Water Act and federal Clean Water Act. *The costs associated with compliance are higher per person as the system size decreases*.
>
> In applying this policy, we are ensuring a steady decrease in the number of Texans who are being served by systems that are unable to sustain the financial, managerial, and technical capabilities necessary to provide continuous and adequate service. And we are ensuring that fewer new systems will encounter the same financial, managerial, and technical problems being faced by existing weak systems.
>
> Whenever the formation of a regional system is the *least expensive long-term solution for providing quality service*, we will *require* proponents of new systems to form a regional system instead. Only a system with adequate financial, managerial, and technical capacity can reliably provide good quality drinking water in sufficient quantities and basic sanitation service that meets regulatory standards. [Emphasis added.][56]

An expert witness for Aqua Texas, Stephen Blackhurst, P.E., was formerly a manager at the Commission and he assisted in drafting SB 1 and the Commission's Rules on regionalization.[57] Mr. Blackhurst explained that, in satisfying the Compliance Agreements, Aqua Texas is implementing the cost-sharing goal of regionalization:

> . . . While some of the financial costs of these required improvements may not seem significant at first glance, it is necessary to consider the potential rate impact that each improvement will have. For those systems serving a large number of customers, the financial costs may only result in a fractional increase in a monthly water bill. But most of the systems covered under the terms of the Amended Compliance Agreements are smaller systems that serve only a few customers, and financial costs of what might otherwise be considered a relatively minor improvement, such as replacing a hydro tank at a cost of $22,000, may result in a

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[56] Ex. AT-26 (RG-357 at 1 and 3-4).

[57] Ex. AT-D, at 14-15. Senate Bill 1 became TEX. WATER CODE §§ 13.183(c) and 13.241(a)-(d); the Commission's rules on regionalization are found at 30 TAC §§ 291.93 and 291.102.

> significant rate impact for those systems. In fact, many if not all of the corrective actions required under the terms of the Amended Compliance Agreements were put off in part by the former owners because of their significant financial cost.[58]

The ALJs agree with the ED and Aqua Texas that, in determining whether systems are substantially similar, Section 13.145 must be harmonized with Chapter 13's clear, mandated preference for regionalization. This means that investment in the systems must be viewed in the long term, not just during the test year, and with an understanding that all systems within a region will incur maintenance, improvement, and replacement costs over time. As discussed below, this results in a broader, sometimes less specific approach that views the systems within the context of the region, compares costs on a per-customer basis, and uses the TCEQ's minimum quality standards as a yardstick for substantial similarity. With that in mind, the ALJs now turn to whether the consolidated systems are substantially similar.

b. Broad Grounds for Substantial Similarity (encompassing multiple elements)

At the outset, it should be noted that only three of the seven regional tariffs are contested in this case.[59] Nevertheless, the regionalization analysis that the Commission adopts here will apply to future consolidated tariffs sought under Water Code Chapter 13. As noted already, the ALJs presume the substantial similarity of the 269 systems within the existing AquaSource regions,[60] but those regional systems must nevertheless be compared to the new systems to establish they are substantially similar to one another. Ultimately, the ALJs conclude that Aqua Texas has met its burden to consolidate all of the systems in issue under the regional tariffs proposed.

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[58] Ex. AT-D, at 27.

[59] The three regional tariffs are Southeast Water, Southeast Wastewater, and Southwest Water. Protestants argue, at page 29 of their initial brief, that settled systems are not substantially similar to systems remaining in this litigation. The ALJs do not believe this argument has merit in that it proposes a solution that would strongly discourage settlements in general, and especially in any case involving a regional tariff. Furthermore, the existence of settled systems in no way hinders the analytical basis for the ALJs' conclusions.

[60] Ex. AT-G at 5.

Section 13.145 states that, to consolidate multiple systems under a single tariff, the utility must show that "the systems under the tariff are substantially similar in terms of facilities, quality of service, and cost of service." Therefore, the statute identifies three elements in the substantial similarity analysis: (1) cost of service, (2) facilities, and (3) quality of service. The statute is not clear on whether a utility must show substantial similarity in all three elements, or whether the elements are simply the considerations to look at in attempting to determine whether, overall, the systems are substantially similar. For example, because the statute uses the term "substantially similar," it could be argued that systems that are very similar on two of the three identified elements are substantially similar to each other, even if they are not similar on one element. Because there is no guidance on this issue, the ALJs break out their analysis into separate parts. In this first part, the ALJs discuss the evidence of substantial similarity that relates to more than one element. Then, in the sections below, the ALJs identify evidence that relates more specifically to each of the individual elements (cost of service, facilities, quality of service).

There are many broad similarities among the systems that support the ALJs' conclusion that the systems within each region are substantially similar. Within the universe of possible water and sewer systems, Aqua Texas' systems are of the same basic type and deliver similar service. In addition, there are some very general distinctions between the regions, which results in intra-region systems being more similar to one another than to systems in other regions.

All of the systems share common origins and characteristics, even though there are differences in age, size, and condition. As the testimony reflects:

> Aqua Texas has small neighborhood-oriented systems. Whether they are called rural or semi-suburban or even part of municipal context, at one time, they existed on a stand-alone basis in a neighborhood structure with their own – with its own source of supply for whatever reason, and for whatever the circumstances are today. The systems are designed to meet average demands. There is a minimum standard water supply requirement on a per-household basis which has to be achieved in order to license the water system.[61]

[61] Tr. Vol. 1, at 159.

The systems themselves are "very simple, rudimentary" and do not offer options like superfiltration or, in general, surface water treatment facilities.[62] These systems offer only the bottom tier of what is typically known as "municipal services."[63] Because Aqua Texas offers only the bottom tier of municipal services, none of its systems use expensive elevated tanks or the heavy duty piping required to handle such water pressure. Instead, all of the systems use underground hydropneumatic tanks to maintain pressure at peak periods and, generally, the systems use only six inch mains and have no large diameter transmission mains.[64] The few commercial customers in Aqua Texas' systems have service demands that are generally comparable to residential demands.[65] The facilities are also substantially similar in terms of construction, and in the future the systems are likely to be the same because Aqua Texas builds the same type of pump house and system in every remodel.[66] The wastewater systems also use similar facilities within each region, serve the same types of areas, and almost all of Aqua Texas' sewer facilities are considered small systems that handle less than one million gallons per day.[67]

The regional structure adopted by Aqua Texas uses parameters that groups systems based on regional distinctions. The regions are based on operational, geographic, and geologic differences.[68] Each region is served by its own regional office and regional personnel.[69] Salaries for operations personnel are based on regional market factors, with salaries highest in the Southeast Region.[70] Regional staff do not cross into other regions to provide service, limiting

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[62] Tr. Vol. 1, at 161-162, 1021.

[63] Tr. Vol. 1, at 162-163.

[64] Tr. Vol. 1, at 160, 162-163.

[65] Ex. AT-B, at 31.

[66] Ex. AT-A, at 35-36; Tr. Vol. 2, at 236.

[67] Ex. AT-B, at 34-35.

[68] Ex. AT-B, at 34-36; Tr. Vol. 1, at 159-160; Tr. Vol. 3, at 503.

[69] Ex. AT-B, at 32.

[70] Ex. AT-B, at 34.

travel time.[71] Local regulation is an issue that Protestants complain of as rendering systems dissimilar, but Aqua Texas points out that local regulation varies by region, sometimes due to regional differences in geology:

> . . . local regulation that affects Aqua Texas' operations varies between regions. For instance, in the Southeast Region, Aqua Texas must comply with the requirements of the Harris-Galveston Subsidence District. This differs from the local regulations that affect groundwater withdrawals in the Southwest Region, which are affected by the rules of the Barton Springs-Edwards Aquifer Conservation District and other local groundwater conservation districts. Such local regulation affects the cost of providing service in each of the regions.[72]

Geographic and geologic distinctions play a major role in separating the systems into regions – and result in similar costs of service for systems within each region. The majority of the Company's systems use groundwater, but each region uses separate aquifers.[73] As a result, the wells differ by geographic region, with the Southwest Region using medium depth, high yield wells. The North Region's wells are both shallow and deep, but low yield. The Southeast Region uses shallow, high yield wells.[74] The depth and productivity of wells has a direct impact on the cost of service in each region.[75]

The quality of the water is also largely a function of the local groundwater in each region.[76] Repair costs and line replacements are generally highest in the Southwest Region due to rocky ground, such as limestone. Yet, line replacements in the Southwest Region also have a longer lifespan than in the Southeast Region where there are subsidence problems due to clay in the soil, not present in other regions, resulting in a higher cost of service for that region.[77]

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[71] Ex. AT-B, at 32.

[72] Ex. AT-B, at 33.

[73] Ex. AT-B, at 32-34; Ex. AT-D, at 31-32.

[74] Tr. Vol. 1, at 159-160; Ex. AT-B, at 32-34.

[75] Ex. AT-B at 33.

[76] Ex. AT-B, at 31.

[77] Ex. AT-B, at 33-34; Tr. Vol. 2, at 223.

Many of the same factors that justify distinctions between water tariff regions also exist for sewer regions; each region has its own personnel, differences in local regulation, and in geography and geology.[78] Wastewater systems also use similar facilities within each region, serve the same types of areas and almost all of Aqua Texas' sewer facilities are considered small systems that handle less than one million gallons per day. These systems use conventional sewage technology and expandable steel tank facilities.[79] Mr. Blackhurst summed-up his opinions that Aqua Texas water and sewer systems are substantially similar as follows:

> If you get down to the nuts and bolts of systems, no two systems are ever exactly the same. There are always minor differences in terrain, numbers of customers, length of distribution or collection lines, sizes of pumps, etc. However, based on my experience at TCEQ regulating investor owned utilities for over 15 years, I believe the Aqua Texas systems are all similar within the obvious meanings of the statutes and rules. In contrast to a typical municipal water system, our systems are typically smaller, predominantly groundwater and primarily serve residential customers. They typically use smaller line sizes out in the distribution and are primarily PVC. We do not provide fire protection.[80]

The ED agrees that Aqua Texas has met the requirements for substantial similarity under Section 13.145.[81] Kamal Adhikari testified that the ED's technical staff inspected 30 water and wastewater systems in the Southwest region, roughly 45 systems in the Southeast region and about 55 systems in the North region.[82] The ED's technical staff was unable to inspect all 335 systems, so the staff limited its review to systems that were not included in the AquaSource rate case and/or had the highest asset values claimed.[83]

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[78] Ex. AT-B, at 36.

[79] Ex. AT-B, at 34-35.

[80] Ex. AT-D, at 32.

[81] Ex. ED-B, at 16.

[82] Ex. ED-B, at 6.

[83] Ex. ED-B, at 6.

The Protestants make a valid complaint that the ED's selective screening lends itself to a determination that the systems within a region are substantially similar. Perhaps it would have been better had the ED inspected a random sample from all of the systems. However, as noted above, those systems previously consolidated together are presumed similar to each other and require a less extensive review. Further, the ED's technical staff conducted an extensive record review of all of the systems to further compare similarity.[84] Mr. Adhikari reviewed improvements or upgrades to existing systems.[85] Considering the volume of AquaSource systems under compliance orders, that review was fairly comprehensive. He testified that:

> The systems in each region vary in size, but are similar in terms of their source of water and the components of each water system. A very small number of systems purchase water and/or wastewater treatment capacity from neighboring utilities, but those are only a few systems compared to approximately 335 active water and wastewater systems. So, all the systems in each region for Aqua Texas may not be identical, but are similar in terms of facilities and quality of service.[86]

Mr. Adhikari also found that the quality of service, although not identical, was similar from system to system because the service meets the TCEQ's minimum standards – the benchmark that the ED proposes as determinative of substantial similarity.[87]

The ALJs found the ED's and Aqua Texas' witnesses to be credible. In fact, because the opposing parties have taken differing approaches to argue substantial similarity, this case involved relatively few factual disputes; rather, the disputes hinge on how to view the facts presented. As set forth above, Aqua Texas' systems fall within one category of system so that they are substantially similar compared to other types of systems. Furthermore, the regional distinctions result in grouping systems by similar characteristics. Many of the other similarities flow from

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[84] Ex. ED-B, at 4-5.

[85] Ex. ED-B, at 4-5.

[86] Ex. ED-B, at 9.

[87] Ex. ED-B, at 5.

these general conditions. So, in looking at the elements in a broad manner, the ALJs believe the systems are substantially similar. But, now the ALJs also look at the evidence that more directly relates to the individual elements of the substantial similarity analysis under Section 13.145.

c. More Specific Evidence on Cost of Service Similarity

When Aqua Texas inherited the regional structure from AquaSource, it also inherited an administrative system that had ceased tracking information at the system level.[88] Aqua Texas decided to carry forward that structure, with the result being that there is a lack of system-by-system cost of service information.[89] Aqua Texas does not keep books on a system-by-system basis, thus making it very expensive to create a cost of service study for each of the 335 systems.[90] Richard Hugus, President of the Southern Division of Aqua America, Inc. testified that to create a cost of service study for each system:

> Each of the regional systems – each of the regional tariffs would have to be disaggregated, as far as its accounting. Every invoice, every hour spent in time and the like, every single aspect of it would have to be broken apart . . . .[91]

Because of this expense, Aqua Texas did not conduct cost of service studies—which, at roughly $5,000 each, would have cost approximately $1,675,000 for the 335 systems.[92] Aqua Texas expressed concern that such an expense would not be viewed as reasonable and necessary.[93] The ED agreed with this decision, noting that it would annul the very efficiencies sought in regional tariffs for Aqua Texas to track, generate, and analyze system specific data every time a

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[88] Ex. AT-F, at 34.

[89] Ex. AT-F, at 34.

[90] Tr. Vol. 1, at 155.

[91] Tr. Vol. 1, at 155.

[92] Tr. Vol. 4, at 662-663.

[93] Ex. AT-F, at 34.

rate case is filed and a new system is added to a region.[94] Finally, Aqua Texas correctly notes that neither the Water Code nor the Commission's rules requires a cost of service study for each system.

As a result of Aqua Texas' adoption of the AquaSource regional structure and its decision not to conduct cost of service studies for its 335 systems, there is little system-specific information on the factors in Section 13.145(a)(1). It is for this reason that the Protestants and OPIC generally argue that Aqua Texas failed to meet its burden under that statute.[95] Whether cost of service studies were conducted is somewhat moot, though, because Aqua Texas admits that many systems would appear dissimilar if they had done so and compared the systems as Protestants propose.[96] Even more telling, Protestants' own expert acknowledged that using cost of service studies would render the same system substantially different from itself from year to year.[97] As noted previously, the ALJs believe that it is not appropriate to look at a snapshot to determine substantial similarity, but rather the Commission should look at the systems over time, including prospectively. When utilizing this approach, it appears that the systems will have substantial similarity in cost of service going forward.

The Commission's definition of cost of service is found in 30 TAC § 291.31. That rule indicates that the components of cost of service are: allowable expenses and return on invested capital. Allowable expenses include operations and maintenance; depreciation; assessments and taxes other than income taxes; federal income taxes; reasonable expenses for ordinary advertising, contributions and donations; and membership expenses in professional and trade associations.[98] Operations and maintenance are expenses that are incurred in the normal provision of service.[99]

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[94] ED's Initial Brief, at 3

[95] Protestants' Initial Brief, at 32.

[96] Ex. AT-F, at 35-36; Tr. Vol. 2, at 318 and 323.

[97] Tr. Vol. 4, at 676-678.

[98] 30 TAC § 291.31(b)(1).

[99] Ex. AT-G, at 17-18.

Although general factors that impact the similarity of Aqua Texas' cost of service are addressed above, there are additional factors that tend to make the cost of service uniform, without reference to the systems specifically. At the national and national-regional levels, there are costs such as federal income tax that are "distributed uniformly and proportionally on a customer-by-customer basis across the United States."[100] In addition to shared national costs, Aqua Texas customers benefit from Aqua America's organization, which provides some of the efficiencies sought in regionalization, such as competitive rates for purchased electricity and unsecured financing, which is then passed along to Aqua Texas' systems.[101]

At the state level, Aqua Texas operates its sole call center in Austin, the costs of which are shared by all Texas ratepayers.[102] All of the systems "share the same management, operations personnel, accounting systems, customer information and billing systems, work equipment and purchasing policies."[103] Materials like pipe, chemicals, and other supplies are purchased in bulk and all systems are charged the same rate for them, and contracts for services like fleet maintenance, lab testing and the like are entered into at the regional level.[104] Also at the regional level, management, administrative personnel, technical personnel, customer support and offices are located so as to service all systems within a region with the minimum of personnel and maximum similarity of costs.[105]

Further, Aqua Texas' wastewater systems are substantially similar in terms of cost of service because "[t]he cost of operating [Aqua Texas'] conventional sewer facilities is generally the same in terms of dollars per 1,000 gallons of treated effluent regardless of the region in which

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[100] Tr. Vol. 1, at 156-157.

[101] Tr. Vol. 1, at 165.

[102] Tr. Vol. 1, at 157.

[103] Ex. AT-F, at 33.

[104] Ex. AT-F at 33.

[105] Ex. AT-F, at 33; Ex. AT-G, at 17-18; Tr. Vol. 1, at 157.

they are located."[106] The use of regional staff and statewide purchasing of materials contribute to this cost similarity.[107] Wastewater discharge monitoring requirements vary by watershed, which does impact the types of facilities and costs, but not within a particular region.[108]

As for depreciation, the rates are set by the TCEQ and are uniform across systems. Because the systems have similar facilities and the depreciation rate is exactly the same, depreciation costs are substantially similar in this regard.[109] While there are local variations in property taxes, groundwater district assessments, and similar charges, these taxes usually span more than a single system and are a very small component of cost of service.[110] In addition, the very concept of regionalization requires systems within a region to cover more than one taxing authority, so that the requirement of substantial similarity in cost of service should not be defeated by the existence of varying taxes and assessments due to differing local authorities within a region. Federal income taxes, advertising expenses, contributions, and donations, and expenses for membership in professional and trade associations are all allocated on a company-wide basis, so that they are not incurred by any system with specificity. As a result, these items are "essentially identical" and are substantially similar on a regional basis.[111]

The ED agrees that the cost of service for systems within each region are substantially similar. Elsie Pascua testified that across systems in each region, Aqua Texas' components of cost of service are basically the same and they have the same categories of accounting classification that are prescribed on the Commission's application.[112]

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[106] Ex. AT-B, at 35.

[107] Ex. AT-B, at 35.

[108] Ex. AT-G, at 18.

[109] Ex. AT-G, at 19.

[110] Ex. AT-G, at 19.

[111] Ex. AT-G, at 20.

[112] Tr. Vol. 4, at 727-728.

d. More Specific Evidence on Facilities Similarity

Aqua Texas established that its regions are based on regional differences in facility requirements, geography, and geology. Typically, the systems "consist of one or more on-site water wells that pump into ground storage tanks after disinfection with chlorine."[113] Distribution lines are underground and usually PVC pipe of two-inch to six-inch diameter.[114] In the future, the systems are likely to be nearly the same, because with every remodel, Aqua Texas builds the same type of pump house and system.[115] The testimony reflects that:

> [i]n the North Region for example, Aqua Texas has begun installing the same shop built pump house, pumps and chlorination facilities at systems as improvements are needed. While not every system currently has one of these facilities yet, what they have is very similar in basic design and construction. When TCEQ inspects the systems where we have these units, they are tempted not to even stop at each plant because they are so similar. For many of our systems they are truly almost identical . . . this is also a significant cost savings for our customers as well.[116]

Sewer systems also use similar facilities within each region, serve the same types of areas, and almost all of Aqua Texas' sewer facilities are small—handling less than one million gallons per day. Aqua Texas uses domestic wastewater plants, most of which are "package plants, fairly small type units" with "primarily residential customers." These systems use conventional sewage technology such as underground collection lines and transmission mains, normally gravity lines or force mains.[117] The systems use expandable steel tank facilities, and when growth-related upgrades are necessary, larger capacity concrete tankage plants are used.[118] Throughout the state, Aqua Texas' systems use an "aerobic system . . . an activated sludge type unit."[119]

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[113] Ex. AT-B, at 31.

[114] Ex. AT-B, at 31.

[115] Ex. AT-B, at 35-36; Tr. Vol. 2, at 236.

[116] Ex. AT-D, at 32-33.

[117] Ex. AT-B, at 34.

[118] Ex. AT-B, at 34-35.

[119] Tr. Vol. 6, at 1023.

The Protestants argue that some of the systems service commercial customers. The services provided to those customers, however, do not differ substantially from those provided to residential customers. For instance, the TCEQ offers various wastewater permits, yet all of Aqua Texas' permits are municipal—there are no commercial or industrial permits for wastewater.[120] In fact, the wastewater from commercial operations is very similar to that of residential customers, involving wastewater from bathrooms, kitchens, and breakrooms.[121]

Mr. Adhikari testified that, from his inspection of more than 30 systems in the Southwest region and his review of other data, he determined that all of the systems reviewed were substantially similar in terms of facilities.[122] In fact, all of the systems he personally inspected—even across regions—were substantially similar to one another in their facilities.[123]

The ALJs recognize that there are differences between systems. Some systems have newer facilities and some have older facilities, possibly under a compliance order. Some facilities have water storage and treatment, while others purchase water. Some facilities serve mobile home parks, while others serve large, expensive neighborhoods. Yet, despite these differences, the totality of the evidence indicates that the systems are more similar than dissimilar. Within the concept of regionalization, it is implicit that systems of varying ages and states of repair will be consolidated together; otherwise the idea of cost sharing and the avoidance of rate shock would be of little value. The broader timeline approach recommended by the ALJs takes into consideration the reality that all systems require maintenance and investment over time. Ultimately, when viewed in terms of the universe of potential system types, Aqua Texas' facilities are substantially similar in that they are designed to offer the bottom tier of "municipal services."

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[120] Tr. Vol. 6, at 1023-1024.

[121] Tr. Vol. 6, at 1024.

[122] Tr. Vol. 5, at 868.

[123] Tr. Vol. 4, at 809.

e. More Specific Evidence on Quality of Service Similarity

Aqua Texas contends that its water and wastewater systems are substantially similar in terms of quality of service. Aqua Texas primarily relies on the conclusion that quality of service essentially means that the service is continuous and adequate under the TCEQ standards.[124] However, there are regional variations in the untreated water quality: "[w]ithin regions, they typically pull from the same or similar aquifers . . . The initial raw water quality does vary in different parts of the state, but is very similar within regions."[125] Also, there are variations in water pressure from customer to customer.[126] But, Aqua Texas contends this is simply a fact of life in providing service, and it is not limited to between systems, but is true even between customers in the same system. Regarding its sewer service, Aqua Texas asserts that it "consistently meets or exceeds permit parameters throughout the state . . ."[127] According to Aqua Texas, there are no Aqua Texas systems that are substandard, nor substantially below the TCEQ's minimum standards.[128]

The ED asserts that, as long as water and sewer systems meet the minimum requirements of the TCEQ, they are substantially similar in quality of service.[129] According to the ED, it matters little whether the water is produced on-site or delivered, or the sewage is treated on site, so long as the service meets the minimum standards.

In attempting to analyze the similarity of systems in regard to quality of service, the ALJs have been struck by the difficulty in fashioning a clear workable standard. Unlike the evaluation

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[124] See Ex. AT-B, at 31.

[125] Ex. AT-D, at 31-32.

[126] Ex. AT-D, at 31-32.

[127] Ex. AT-B, at 35.

[128] Tr. Vol. 6, at 1022.

[129] Ex. ED-B, at 5 and 8-9; Tr. Vol. 5, at 810-811; ED's Initial Brief, at 4.

of cost of service or facilities (which are objective in nature), quality of service is fraught with subjectivity. There are no clear parameters for distinguishing "excellent" service from merely "good" service, or even "poor" service. While one could look at past violations, there are no bright line standards for distinction even then. Do you only look at the number of violations, or do you also have to account for the types of violations and when they occurred? Also, if violations are older, should they really be considered part of a utility's current "quality of service" for purposes of Section 13.145? Similarly, factors like water pressure or mineral content can vary from customer to customer within a system and at different times.

In considering the methods for determining similarity of quality of service, the ALJs conclude the ED's proposed method is best. The ALJs agree with the ED that meeting the Commission's minimum standards is an objective, workable yardstick to determine substantial similarity.[130] Accordingly, when systems are providing continuous and adequate service within the requirements of the Commission's rules, the systems should be deemed to be substantially similar in terms of quality of service. However, this raises a problem: how do you treat systems that are currently under compliance orders and working toward meeting minimum standards?

Approximately one-third of Aqua Texas' systems are under compliance orders.[131] Once those systems meet the Commission's minimum standards, they will be substantially similar to other systems within the region. The Protestants have argued that those systems under compliance orders are not substantially similar to currently compliant systems. Even under the ED's method of determining the similarity of quality of service, the Protestants argument has some force.

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[130] ED's Initial Brief, at 4.

[131] Ex. AT-B, at 9.

Paradoxically, though, the whole concept of regionalization is aimed at exactly these types of systems. Given the goal of providing continuous and adequate water service for the citizens of the state, the ALJs believe that Section 13.145 should not be read as saying that non-compliant systems can only be grouped with other non-compliant systems. Also, it seems counter to the cost-sharing goals of regionalization to require a non-compliant system to first spend the resources on getting to compliance before it can be grouped in with other systems. So, there is a tension in attempting to discern what the Legislature means in indicating that quality of service is one of the elements to review in the substantial similarity analysis.

Ultimately, the ALJs come down on the side of reading Section 13.145(a) consistently with the goals and purposes of regionalization.[132] If substantial similarity meant that all systems must be compliant at the time the application is filed, then the benefit of regionalization would be denied to non-compliant systems—a result that is at odds with the policy. The ALJs conclude that, as long as the remaining non-compliant systems are being brought into compliance with state and federal minimum standards pursuant to an existing compliance order, and the evidence shows that the utility is working diligently toward that goal, then non-compliant systems may be considered substantially similar to other systems under the regional tariff in regard to quality of service standards. In this case, the evidence shows that to be true, so the ALJs conclude that the systems under Aqua Texas' regional tariffs are substantially similar in terms of quality of service.

Moreover, this is consistent with the ALJs' prior statements that substantial similarity is reviewed over time, including prospectively. The evidence in this case all supports the conclusion that Aqua Texas is undertaking massive efforts to streamline its systems and bring them to uniform standards, not only in regard to facilities and cost of service, but also in regard to quality of service.

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[132] *Helena Chem. Co. v. Wilkins*, 47 S.W.3d 486, 493 (Tex. 2001).

4. The Consolidated Tariffs Promote Water Conservation

Under Section 13.145(a)(2), Aqua Texas must also establish that "the tariff provides for rates that promote water conservation for single-family residences and landscape irrigation." Aqua Texas contends that the tariffs meet this requirement because they include inclining-block rates and zero gallons in the base rate. The ED agrees that tiered rates and zero gallons in the base rate promote water conservation by requiring that customers pay for all the water they use.[133] In contrast, the Protestants counter that water usage rarely exceeds the first tier in any of Aqua Texas' systems, so inclining block rates have little or no effect.

The ALJs agree that the inclining block rates will likely do little to promote water conservation because the evidence indicates that nearly all customers will not exceed the first tier water amounts. Despite this, the rate structures still *promote* water conservation, because they contain zero gallons in base rates. Thus, there is a direct incremental cost to customers for all water usage. Protestants' expert, Jay Joyce, agreed that an inverted block rate structure and a zero gallonage in the base rate generally promotes water conservation.[134] Accordingly, even if the inclining block rates themselves may not do much to promote water conservation, the inclusion of zero gallons in the base rate will promote conservation. So, the ALJs agree with Aqua Texas and the ED that, coupled together, inclining block pricing and zero gallons in the base rate promote water conservation for single-family residences and landscape irrigation.

5. Conclusion on Consolidated Tariffs/Regionalization

The Protestants and OPIC have pointed out a wide range of differences between the systems. But the ALJs do not believe that substantial similarity means that you line up the systems next to each other, each test year, and that they must all be "practically the same." There will always be differences between systems; it is a matter of whether they are substantial differences

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[133] Ex. ED-B, at 16 and 20; Tr. Vol. 5, at 937.

[134] Tr. Vol. 4, at 653-654.

under Section 13.145. If the Commission finds that these systems are not substantially similar, then it becomes difficult to find a workable rate structure that would promote regionalization. In their briefing, the Protestants have proposed what would amount to a series of "sub-regions," based on seventeen proposed categories and considerations that not only destroy the goal of regionalization, but are essentially unworkable, such as:

- Average per capita daily demand of customers within each system;
- Level of income – more affluent will use more water and be willing to pay for it;
- Lot size – large lots have irrigation demands, and possibly larger house sizes and more water demands;
- Type of use – are system customers residential, industrial, mixed, etc.;
- Distribution system size – are there differences between systems to be consolidated;
- Age of systems – maintenance requirements will vary: higher costs, more man hours, how automated are the systems; and
- Are the system's improvements used and useful primarily to the system to which they are made, or is there a secondary "ripple effect" benefit to any other system, much less systems proposed to be consolidated.[135]

For the ALJs, this final "ripple effect" issue reveals the primary nature of Protestants' overall dispute—namely they oppose regionalization and its attendant sharing of costs. As noted by the following quote from their initial brief, the Protestants appear hostile to the idea that systems of varying affluence, size, and water usage should be grouped together and share costs:

> In this rate case, Aqua Texas has attempted to combine these compliant and non-compliant facilities, and adjust the rates for the regions, in a manner that causes ratepayers in the systems not under enforcement to subsidize the upkeep of those under enforcement.[136]

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[135] Protestant's Reply Brief, at 5-6.

[136] Protestants' Initial Brief, at 31.

If distinctions based on system size and usage are recognized at this level, then the smaller mobile home systems would be established as a sub-region, separate from the medium-sized systems, still separate from the smaller, higher usage estate systems. If one compares regionalization to standard municipal services within a city, municipalities cannot offer a different rate based simply on whether the customer lives in an affluent or less affluent part of town. This would be preferential and discriminatory. Regionalization is no different in that regard. Although Protestants acknowledge the sharing of resources is a relevant issue, there is the possibility that their proposal would result in a mobile-home system under a separate tariff from an estate system, regardless of their proximity to one another within a region, regardless of shared resources at the national, state, and regional level, and regardless of shared infrastructure such as piping, treatment facilities, or shared natural resources such as the aquifer from which the water is pumped. This would create subregions, which the ALJs expect would come with a host of administrative costs and inefficiencies, not to mention the potential specter of discriminatory ratemaking.

Most important, if Protestants' snapshot/test year view of substantial similarity is adopted, systems would differ from themselves from year to year and shift to different groups/tariffs with each rate case. Under cross examination, Protestants' expert witness, Mr. Jay Joyce testified that if you look only at the cost of service for each system within a test year and if from year one to year two, the system undergoes plant investment:

> If you were filing a rate case one year and then you filed a rate case the next year, that system would probably be grouped with a different group of systems.[137]

Shifting systems to different tariffs based on capital improvements is contrary to the goal of regionalization. Such a scheme fails to recognize such fundamentals as depreciation over time, or at what point a system would have paid enough of its capital investment to shift back to a group with a lower tariff. Finally, the Protestants failed to cite any provision in the Water Code that authorizes the creation of subregions.

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[137] Tr. Vol. 4, at 677-679. Although Mr. Joyce immediately qualified this position, he ultimately reiterated it on page 679.

Ultimately, the ALJs conclude that Aqua Texas has met its burden to establish the substantial similarity of its systems within the four regions for consolidation under regional tariffs. The broad view adopted by the ALJs is consistent with the intent of the Legislature to promote regionalization. Although Mr. Blackhurst is an employee of Aqua Texas, the ALJs found him to be very credible and value his prior experience with the Commission. Mr. Blackhurst's testimony, in part, summarizes the ALJ's determination that Aqua Texas' tariff institutes the goal of regionalization:

> While I was at TNRCC and involved in developing the regionalization policy, we were hoping that [AquaSource], now Aqua Texas, would do exactly what it did. Historically non-compliant, under-capitalized small systems were acquired by a professionally operated, well-capitalized organization. [AquaSource] was admittedly somewhat of a startup and struggled at first, but Aqua Texas is part of a strong, professionally operated investor-owned utility that has been providing service for over 100 years. Without such an effort, many of the systems we now operate would have been placed in receivership and may have never gotten the needed improvements.[138]

For all of the reasons stated above, the ALJs find that Aqua Texas has satisfied the requirements of Section 13.145 for establishing consolidated tariffs. So, the ALJs now turn to the issues related to the establishment of rates.

VI. ADJUSTMENTS FOR SETTLED CUSTOMERS

For purposes of determining rates, the ED recommends a reduction to both rate base and allowed expenses to account for ratepayers who have settled and are no longer involved in this case. Specifically, the ED made calculations to reduce the amount of allowed expenses and used and useful assets on a pro-rata share for customers who have settled, and then also concurrently reduced the customer count for those regions. The ALJs disagree with the ED's approach and recommend that the Commission make no adjustments for settling parties.

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[138] Ex. AT-D, at 16.

The crux of the ED's argument is that it is inappropriate to calculate rates by including ratepayers who have settled with Aqua Texas, because they have reached an agreement on rates and are essentially no longer a part of this rate case. To address this, the ED would simply treat it as if those settled ratepayers are entirely excluded from this proceeding and the Commission is only setting rates for the remaining non-settling ratepayers. However, the ED's approach is untenable for a number of reasons.

First, the ED's approach assumes that all settlements reached with customers would allow them to be removed from this rate case. The record does not support such an assumption, which may or may not be true.[139] It is certainly conceivable that customers could settle for consideration other than specified rates (for example, certain customer service accommodations could be granted to customers as incentives for them to withdraw their opposition to a rate case). To be able to fairly implement the ED's approach, it would be necessary for the Commission to evaluate each of the settlements and determine the basis for the settlement, including whether it established rates for customers, as opposed to simply guaranteeing some concession in exchange for that party withdrawing its opposition to the rate case. This would add a significant new burden on the Commission in rate cases.

Further, the ED's approach cuts against the regionalization that is at the heart of this case and that offers the customer benefits sought by Aqua Texas. Essentially, the ED's approach would result in a number of different rate-setting approaches for the different customer groups. However, part of the reason the Commission would approve regional tariffs in this case is to benefit customers from the economies of scale that come from regionalization. If you remove settling customers and systems from the tariff, then you lose some of that benefit.

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[139] The full terms of the various settlement agreements are not in the record.

Finally, there is simply no specific legal basis—either in statute or rule—for removing settled customers from a rate case. From the legal contested case standpoint, what happens in a settlement is that the ratepayer withdraws its protest to the rate change application. At that point, a settling ratepayer is no different than a ratepayer who never challenged the rate case in the first place. Without the benefit of reviewing the settlements, there is no basis for distinguishing settling ratepayers from ratepayers that have never opposed the case. However, ratepayers who have never opposed the rate change application are clearly included in setting rates for customers. Therefore, ratepayers who have settled should also be included, and the effect of any contractual agreement that Aqua Texas reached with settling ratepayers should be borne by the utility and should not be calculated into rates.

Therefore, the ALJs conclude that it is most appropriate to calculate rates as presented in the application—based upon the test year data and including all ratepayers and systems in a region that are to be governed by the same rate structure and tariff.[140] If, because of a separate agreement, Aqua Texas charges settling ratepayers less, than that loss will be borne by the utility, but outside the regulatory process. With that in mind, the ALJs now turn to the specific expense disallowances.

VII. EXPENSE DISALLOWANCES

Protestants have generally not attempted to identify specific expense disallowances, but instead argue that Aqua Texas' method of presenting its data has made it impossible for Protestants to verify the legitimacy of Aqua Texas' cost of service. As such, Protestants argue for a total denial of the rate change applications. In contrast, the ED has identified a number of specific expense disallowances. Below, the ALJs first address Protestants' general argument as to the totality of the cost of service data. Then, the ALJs address the ED's proposed adjustments.

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[140] This includes the City of Dayton, which the ED has attempted to carve out for a number of reasons. However, the ALJs find no basis for carving out any systems, either for settlement or other reasons. Therefore the City of Dayton and all settled systems should be included in the tariffs.

However, the ALJs discuss only those adjustments that appear to be currently disputed by Aqua Texas; adjustments not disputed by Aqua Texas are not discussed, but are accepted as simply agreed upon by the parties.

In response to post-hearing Order No. 48, Aqua Texas revised many of its revenue requirement numbers to accept certain changes the ED had made. Based on Aqua Texas' revised numbers, it appears there are just a few expense disallowances that remain in dispute. Mostly, the remaining differences relate to the ED's decision to exclude settled systems from the expense and rate base calculations. Because the ALJs reject the decision by the ED to exclude settled systems, the ALJs generally use Aqua Texas' revised revenue requirement calculations as the basis for the ALJs' recommendation on the various revenue requirement issues. To simplify matters and to assist the parties in conducting their number-running in response to this PFD, the ALJs attach partial revenue requirement sheets at the end of the PFD, showing most of the revenue requirement numbers the ALJs find appropriate to use in determining rates.

A. Protestants' Challenge to Aqua Texas' Cost of Service Information

The Protestants contend that Aqua Texas—because it conducted no system-specific cost of service studies—has failed to correctly allocate cost of service and establish reliable revenue requirement data to justify the rates it seeks in this case. Protestants point out that Aqua Texas has not presented evidence showing the apportionment of debt to the various systems, nor the amounts to purchase the specific systems. Protestants argue that this information is necessary to adequately evaluate the cost of service for the systems. The ALJs addressed this generally above, but now address Protestants' specific legal arguments in more detail.

Protestants cite to *Texas Water Commission v. Lakeshore Utility Company, Inc.*,[141] as authority for its contention that Aqua Texas' failure to offer debt allocation and cost of service by system means that it cannot support its rate change request. In the *Lakeshore* case, the utility had received loans from its parent company to help it cover shortfalls in the cost of providing water service to its customers. The utility then sought to recover the interest expenses to cover this debt. The Texas Water Commission disallowed recovery, in part because the utility could not show precisely how the loan proceeds had been spent and that the proceeds were spent solely for the benefit of the systems involved in that rate case. Protestants argue that the same result should occur in this case, because Aqua Texas cannot show exactly how any debt has been allocated by system or region, or what its cost of service is by system. Without this information, Protestants argue that the Commission cannot evaluate whether the money was spent reasonably and necessarily.

The ALJs disagree with Protestants' contentions. Ultimately, the ALJs do not believe that either a system-specific cost of service study or a specific debt allocation is necessary in this case. Unlike in the *Lakeshore* case, Aqua Texas is not seeking a specific amount for debt service or interest. Aqua Texas has no debt specifically. Rather, its parent company has infused cash into the utility to make all the necessary upgrades and capital improvements over the past 5-10 years. For purposes of establishing a rate of return, the debt structure of Aqua Texas' parent company is used, but Aqua Texas is not actually seeking to recover debt service on any loans in this case. Further, the primary concern in the *Lakeshore* case was with the validity of the expenses and whether they were incurred for the purpose of providing utility service. In this case, the ED's technical staff reviewed voluminous boxes of documents to verify the identified expenses and found them supported. As such, this is not a case where we lack confidence that the expenditures were for the provision of utility service. Ultimately, the evidence supports the conclusion that the expenses in issue were for the purpose of providing utility service and did not need to be apportioned by system.

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[141] 877 S.W.2d 814 (Tex.App.–Austin 1994, writ denied).

B. ED's Disallowance of Purchased Water Expenses

For each of the three regions, the ED has proposed to disallow some amount of purchased water expenses.[142] The basis of the ED's recommendation is that Aqua Texas' calculated purchased water expenses include costs that Aqua Texas is already recovering through a separate pass-through that the Commission previously approved. Specifically, the Commission has given Aqua Texas authority to recover some of its increased purchased water costs through a $1.00 per connection, per month pass-through charge. Aqua Texas collected this pass-through in 2003 and 2004. However, in bringing this rate case, Aqua Texas asserts that it rolled the pass-through into its rates and now proposes to recover those costs in its base rates, rather than in the pass-through charge. So, when Aqua Texas implemented its new rates, pursuant to this rate change application, it allegedly stopped collecting the pass-through charge. The relevant tariffs would still contain a pass-through clause that would allow Aqua Texas to approach the Commission in the future if needed, but no pass-through charges are currently being collected.

The ALJs disagree with the ED's proposed disallowance. Although it would be "double-dipping" to allow Aqua Texas to recover both the pass-through charge and increased rates that include all purchased water expenses, that is not what is occurring in this case. Aqua Texas asserts that it has not collected the pass-through charges since the implementation of its new rates. At the hearing, the ED's witness essentially agreed that no disallowance for purchased water costs would be necessary if Aqua Texas was not collecting the approved pass-through charges.[143] The ED's primary concern appears to be with Aqua Texas' ability to continue to collect the pass-through charges in the future. However, the Commission can alleviate this concern by reflecting in its final order in this case that no pass-through charges may be collected without prior Commission approval. With such an ordering provision, there is no need to disallow purchased water costs previously associated with the pass-through charges.

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[142] The ED's proposed disallowances are $23,532 for the North region; $10,272 for the Southeast region; and $8,940 for the Southwest region (these adjustments are exclusive of disallowances for settled systems, which the ALJs indicate elsewhere in this PFD should not be made).

[143] Tr. Vol. 4, at 742-743.

C. ED's Disallowance of Bad Debt Expenses

The ED proposes to disallow more than $500,000 in bad debt expenses. Aqua Texas responded in its briefing that this disallowance was in error, because it was not seeking to recover the disallowed bad debt expenses in this case anyway. In fact, Aqua Texas contends that it was originally seeking only approximately $200,000 in bad debt expense, so a disallowance of more than $500,000 would be nonsensical (*i.e.*, you cannot disallow more than is being sought in the first place).

However, this issue now appears to be moot. Although the ED proposes a disallowance of more than $500,000 for bad debt, it appears that Aqua Texas is correct in that these amounts were not initially included in the rate case in the first place. However, since the filing of the rate case, both the ED and Aqua Texas have revised the test year numbers to replace the budgeted numbers from 2004 with the actual numbers. Along with those changes, Aqua Texas has accepted the ED's disallowance, to the extent that now the total bad debt is reflected as $329,376. Therefore, it appears there is no longer a dispute on this issue. If, however, the ED disagrees with total bad debt expenses of $329,376, it should so note in its exceptions to this PFD.

D. ED's Disallowance of Improper Expenses

The ED disallowed amounts it deemed unrelated to the provision of water or sewer service, including costs for pizza, sandwiches, dog food, soft drinks, coffee, bottled water, and similar such items. At the hearing, Aqua Texas presented evidence showing *how* soft drinks and dog food can be used in a sewer system. However, Aqua Texas failed to show that these items *were specifically necessary and used by Aqua Texas for such purposes* during the relevant time periods. Moreover, Aqua Texas failed to address how other items categorized similarly (such as sandwiches, pizza, *etc.*) would be useful in providing water or sewer service. Given the potential for abuse, and the identification of numerous items by the ED which obviously are not necessary for water or sewer

service, the ALJs conclude that Aqua Texas has failed to persuasively show the disallowed items were reasonably useful and necessary to provide service. Therefore, the ALJs agree with the ED's disallowance for these expenses. Specifically, the ALJs recommend the following disallowances: (1) North Water - $7,431; (2) North Sewer - $277; (3) Southeast Water - $3,418; (4) Southeast Sewer - $225; (5) Southwest Water - $1,654; and (6) Southwest Sewer - $245.[144]

Except as discussed above, it appears there are no other specific disputed expenses for which a disallowance is still being sought. Therefore, the ALJs now turn to rate base issues.

VIII. RATE BASE ISSUES

A. Requested Rate Base Amounts

The ED has recommended numerous rate base adjustments. As part of its review of the applications, the ED's staff inspected many of the systems that are part of this rate change case. As a result of these inspections, the ED determined that some of the items claimed in rate base were not used and useful in providing service. For example, some systems were not in service. In other instances, items listed as assets could not be located or verified. All told, as a result of staff inspections of the systems involved, the ED adjusted rate base downward and depreciation schedules accordingly.

Other than Aqua Texas, the ED has provided the most exhaustive and thorough analysis of the appropriate rate base amounts. Before addressing the various issues related to rate base, the ALJs find it appropriate to set forth the different amounts proposed by the ED and Aqua Texas regarding rate base, to provide some context:

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[144] It is unclear whether Aqua Texas has already agreed to some of these disallowances. In its briefing, Aqua Texas opposes the disallowances, but the disallowance amounts it seeks to have re-included are less than the disallowances the ED seeks for these specific expenses. For example, on Ex. B to its response to Order No. 48, Aqua Texas seeks to have $6,358 of disallowed expenses added back in for the North region - water; however, the ED's total disallowance for these expenses is $7,431. It is not clear why Aqua Texas provides a different number or whether that indicates partial agreement to the disallowance. This discrepancy is shown for all of the regions.

Region	Aqua Texas' Proposed Rate Base[145]	ED's Proposed Rate Base[146]
North (Water)	$34,955,354	$31,241,017
Southeast (Water)	$26,842,962	$23,541,572
Southwest (Water)	$25,229,894	$22,262,046
North (Sewer)	$1,902,381	$1,845,931
Southeast (Sewer)	$19,905,448	$19,254,440
Southwest (Sewer)	$5,830,016	$5,713,843

The differences in proposed rate base amounts arise from two primary areas: (1) the ED's method of determining rate base is different from the NARUC accounting used by Aqua Texas; and (2) Aqua Texas' decision to include a regulatory asset in rate base results in a much greater rate base amount. Those two reasons account for the vast majority of differences in rate base, because Aqua Texas has agreed to most of the ED's recommendations for removing plant and equipment that was not used and useful.

B. Inclusion of a Regulatory Asset in Rate Base

By far, the most significant rate base issue arises from Aqua Texas' decision to phase-in its proposed rate increases over a four-year period. Initially, Aqua Texas would not recover from ratepayers all of its proven expenses. To remedy this, Aqua Texas deferred the accounting for

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[145] See Ex. E to *Aqua Texas' Rate-Setting Data Responsive to Order No. 48.* Aqua Texas presents two different sets of data—one based on its own NARUC accounting method (Ex. A), and the other based upon the methodology used by the ED (Ex. E). The ALJs find it appropriate to rely on the methodology used by the ED, as that is the accepted method of review relied upon by the Commission and other utilities in past water rate cases.

[146] The ED has proposed both unmodified rate base numbers and modified rate base numbers. The modified rate base numbers have been reduced to remove the value of settled systems. As discussed elsewhere in this PFD, the ALJs do not find it appropriate to remove settled systems; therefore, the ALJs rely upon and present the ED's unmodified rate base numbers in this PFD. See ED Data Sheet KA-1, attached to the ED's *Response to Order No. 48* in this case. Although these rate base numbers do not specifically identify necessary adjustments—such as for contribution in aid of construction—to reach a final rate base, it appears that such adjustments *are* included in the rate base numbers reflected in Data Sheet KA-1. If that is not correct, the ED may advise accordingly in exceptions to the PFD.

some of its expenses to later years. Because it had already paid for these expenses, however, it created a regulatory asset in an average amount of $8,000,000 to reflect the deferred expense amounts it expected it would be entitled to recover later.[147] It then added this regulatory asset to its rate base and seeks to recover a rate of return on it.

Essentially, Aqua Texas made a loan to its customers (in the average amount of $8,000,000) to keep their rates low, but wants to collect interest on the loan in perpetuity (or until later modified by a Commission Order). All other parties dispute this decision by Aqua Texas to create a regulatory asset and include it in rate base. After considering the arguments and evidence, the ALJs recommend that the Commission ***not*** phase-in rates for Aqua Texas customers. Rather, the Commission should simply implement flat rates as calculated in this proceeding, and then authorize any undercollection to be recovered through a surcharge. If the Commission agrees with this recommendation, then Aqua Texas' decision to defer expenses is unnecessary and there is no reason to include a regulatory asset in rate base. The bases for this conclusion are set out below.

First, the ALJs find it necessary to distinguish between deferred revenues and deferred expenses, because the parties appear to have some confusion regarding this in their briefing. What is in issue in this case is not simply Aqua Texas' decision to defer recovery of rate revenues. The regulatory asset created by Aqua Texas in this case is <u>not</u> the difference between the amount it was entitled to start charging customers and the amount it actually did charge customers. Rather, once Aqua Texas made the decision to phase-in rates, it shifted the accounting for some of its expenses to later years, so that, from an accounting standpoint, those expenses may be recovered from customers in later years. In contrast, deferred revenues are generally revenues that the utility is entitled to recover now based upon expenses already incurred and accounted for, but which the utility will not recover until a future date. This distinction is subtle, but necessary for the evaluation of this issue.

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[147] See Ex. AT-81 for the full amortization schedule of the deferred asset. Aqua Texas deferred $8,082,000 the first year; $5,388,000 the second year; and $2,694,000 the third year. In capitalizing this, Aqua Texas used the amount of $8,000,0000 to include in rate base, because it represented the average deferred cost.

All parties appear to agree that this is the first instance in which a regulatory asset, in the form of deferred recovery of expenses, has been requested for inclusion in a proceeding before the TCEQ. However, Aqua Texas points out that regulatory assets have been approved in PUC proceedings and are recognized under NARUC accounting principles. In fact, Aqua Texas relied upon NARUC accounting in preparing its books and records for the utilities in issue. NARUC accounting provides the following definition for a regulatory asset:

> "Regulatory Assets and Liabilities" are assets and liabilities that result from rate actions of regulatory agencies. Regulatory assets and liabilities arise from specific revenues, expenses, gains or losses that would have been included in determination of net income in one period under the general requirements of the Uniform System of Accounts but for it being probable that 1) such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility services; or (2) in the case of regulatory liabilities, the refunds to customers, not provided for in other accounts, will be required. Regulatory assets and liabilities can also be created in reconciling differences between the requirements of generally accepted accounting principles, regulatory practice and tax laws.[148]

Aqua Texas claims it satisfies the requirements for creating a regulatory asset because, if it had not deferred expenses, it would have adopted much higher rates initially, resulting in possible rate shock to customers. Therefore, by deferring expenses, it could charge lower rates and recover the full total of the deferred expenses gradually. Because the Commission prefers to avoid rate shock to customers, Aqua Texas argues that it was reasonable for it to implement the phased rates and to defer expenses, thus resulting in the creation of the regulatory asset. Further, Aqua Texas obtained approval from the ED prior to capitalizing the deferred expenses.[149]

The creation of a regulatory asset is not unreasonable *per se* and, in fact, it is a practice that has been recognized by other regulatory bodies. However, because it provides the potential for abuse, the ALJs believe it is a regulatory accounting tool that should be used sparingly. And, ultimately, the ALJs believe it is a tool that should not be used in this case.

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[148] See Attachment A to Protestants' Response Brief.

[149] Ex. AT-60.

Despite Aqua Texas' arguments to the contrary, the primary concern with using phased rates and creating a regulatory asset is that it creates the real possibility for Aqua Texas to have an over-recovery. Essentially, Aqua Texas is making a loan to its customers and seeking a guaranteed return on it. Many utilities would probably like the opportunity to choose the amount on which it is entitled to earn a rate of return. However, in general, utility rate-making principles dictate that a return is allowed on the used and useful assets of the utility. Thus, a utility does not have the freedom to include any assets it likes into rate base to try to earn a return on them. Rather, only those assets reasonably necessary for providing service. So, the Commission should generally be wary about allowing phased rates and the creation of regulatory assets.

In this case, by including a regulatory asset of $8 million in rate base, and phasing in its rates to recover the deferred expenses associated with the regulatory asset, Aqua Texas' final phased rates are higher than what they would have been if simple, unphased rates were used. While the phased rates would be less than unphased rates in the first two years, beginning in year 3, the phased rates are higher than what unphased rates would have been.[150] And, these higher rates continue indefinitely into the future. This creates the potential opportunity for Aqua Texas to have excess recovery over a period of time, if its expenses remain relatively unchanged or go down. The ALJs understand that, in general, inflation causes expenses to rise over time so the possibility of an excess recovery may not be significant. But, because phased-in rates present that possibility nonetheless, the ALJs believe that unphased rates are generally preferable.

Moreover, phased rates may improperly shift the cost of providing service to later ratepayers. For example, any customers who leave the system before the end of the first two years will pay less than their "fair" share, while customers who do not come on the system until after the first two years will pay more than their "fair" share. Using unphased rates helps to avoid this cost-shifting.

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[150] This is reflected on all of the proposed rate sheets contained in the application. See, *e.g.*, Ex. AT-1, at AT 103287, *et seq.*

The changing of Aqua Texas' customer base reflects another area for Aqua Texas to improperly benefit and over-recover through its phased rate structure. Specifically, if Aqua Texas' customer base in its current systems grows, the portion of rates charged those customers that is attributed to "paying off" the deferred expenses will be a windfall to Aqua Texas. This is because Aqua Texas has calculated the recovery amount based on its current number of customers. New customers paying rates that include an amount to recover the deferred expenses will be in addition to the amounts needed to fully recover the deferred expenses. Although Aqua Texas asserts that such expenses can be "trued-up" in later rate case proceedings or through Commission oversight, both require additional regulatory efforts later—an outcome that should be avoided, for efficiency sake.

Finally, it is relevant that no parties other than Aqua Texas support the use of phased rates. Phased rates are designed to benefit ratepayers and prevent rate shock, yet none of the ratepayers (nor OPIC or the ED) support using phased rates. This is even further reason to avoid using phased rates in this case, because certainly the parties most likely to benefit should have some input into the use of rare regulatory mechanisms designed to protect them.

Ultimately, then, the ALJs conclude that phased rates should not be used in this case. Based on that, the ALJs conclude that it was unnecessary for Aqua Texas to create a regulatory asset in this case. Accordingly, the ALJs recommend that the Commission reject Aqua Texas' request to create a regulatory asset and include it in rate base. If the Commission adopts the ALJs' recommendation, then a surcharge may be implemented to recover the deferred expenses (similar to the manner in which other later-recognized expenses—such as rate case expenses—are recovered). Aqua Texas' brief recognizes how this can be implemented and, in fact, that is the approach recommended by the ALJs, with one exception discussed below.

In proposing how a surcharge could allow recovery of the deferred expense regulatory asset, Aqua Texas calculates the current balance by including accrued interest at the 8.44% rate of return. The ALJs believe that the rate of return should not be the basis for interest calculations on the deferred expense regulatory asset. Rather, the Commission should utilize whatever interest rate it adopts for recovery of rate case expenses, and that interest rate should be used from the time of filing to calculate the current balance of the regulatory asset and the proper surcharge amount and period of recovery. If the Commission declines to allow interest on recovery of rate case expenses, then the ALJs would similarly recommend that interest not be allowed on recovery of the deferred expense regulatory asset. While the ALJs recognize this presents some potential unfairness to Aqua Texas, because it legitimately was entitled to collect the money sooner, this represents a risk it took in attempting to phase-in rates.

Alternately, the Commission could choose to include the deferred amounts in the cost of service for the test year and calculate the rates as if the expenses had never been deferred. Then, the flat rates implemented by the Commission would be designed to recover the expenses, and any over- or under-recovery could be handled as it is in any other rate case, and a separate surcharge for recovery of the deferred expense regulatory asset would be unnecessary.

C. Appropriate Rate Base Numbers to Use in Setting Rates

The other issue highlighted above in regard to the rate base calculations relates to the different accounting methods used by Aqua Texas and the ED. As noted previously, the ALJs believe it is appropriate to use the accounting method utilized by the ED because that provides consistency with the Commission's treatment of water rate cases. Although this results in different rate base numbers than those requested by Aqua Texas, the difference is relatively small. For example, under its method of accounting, Aqua Texas seeks a total rate base of $114,902,105 for all utilities in issue.[151] In working off the ED's method, Aqua Texas calculated its requested rate

[151] See Ex. A to *Aqua Texas' Response to Order No. 48*.

base to be $114,666,054.[152] The difference, therefore, is only $236,051 out of a rate base of more than $100 million. At the hearing and in their briefing, the parties did not address in detail the differences in accounting methods or provide any detailed explanations as to why one method is more accurate than the other. Under these circumstances, the ALJs believe consistency by the Commission warrants using the ED's methodology and rate base numbers.

In using the ED's proposed rate base method, and after deducting the regulatory asset from rate base, there still remains a discrepancy of approximately $2.8 million between the ED's proposed rate base and that proposed by Aqua Texas.[153] The cause of this discrepancy is not entirely clear. It could be attributed to many different smaller discrepancies across various sub-components of rate base, such as CIAC, accumulated depreciation, or working capital. Unfortunately, the ALJs are not able to discern the basis of the difference and, thus, cannot evaluate specifically which rate base number is more reliable. Because Aqua Texas has the overall burden of proof and because the ALJs find the ED's witnesses and calculations to be generally reliable—the ALJs find it appropriate to use the ED's proposed rate base figures.

In carrying its burden of proof, it is incumbent on Aqua Texas to not only present evidence supporting its requested outcome, but also to resolve any disputes or controversies that might arise related to its data. The ALJs believe that any discrepancies, if not adequately explained, reflect a failure of the party with the burden of proof to carry its burden on those discrepancies. Further, because the ED's witnesses are credible, objective, and disinterested, the ALJs believe it is generally appropriate to defer to their position in regard to unresolved discrepancies, unless the ED's position is shown to be wrong. So, the ALJs recommend that the Commission utilize the ED's total rate base figure of $103,858,849 in setting rates.

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[152] See Ex. E to *Aqua Texas' Response to Order No. 48.*

[153] If the $8 million regulatory asset is deducted from Aqua Texas' requested rate base of $114,666,054 (under the ED's method), the resulting rate base is $106,666,054. In contrast, the ED proposes a total rate base of $103,858,849. The difference between the two is $2,807,205.

D. Protestants' Rate Base Adjustments

The Protestants also request certain adjustments to rate base. In their briefing, they identify five categories of disallowances. The ALJs now address these.

Protestants first challenge a number of items that ED witness Kamal Adhikari could not fully explain in his testimony. Protestants' counsel questioned him about a number of items and some potential inconsistency in the booking of assets. At the hearing, Mr. Adhikari did not always have an explanation for certain assets and conceded that it is possible there were items that should have been removed, but were not.[154] Protestants seek to have all of these items excluded from rate base.

However, Mr. Adhikari's failure to fully explain individual items across 335 systems does not establish that the items were not used and useful, nor properly verified. Protestants rely on innuendo, rather than evidence. While it is possible that Mr. Adhikari made mistakes (in fact, in a case of this size, it would be surprising if there were not a few minor mistakes), the ALJs find the best evidence to be the ED technical staff's overall calculations of rate base. So, without evidence showing a mistake was made, the ALJs do not recommend adjustments simply because of questions Mr. Adhikari could not answer at the hearing.

Second, the Protestants request additional adjustments for settled systems. Because the ALJs recommend no adjustments for settled systems, the ALJs also do not support this category of adjustments raised by Protestants.

Third, Protestants point out that a number of systems are included as new additions to the rate base (from the prior AquaSource case), but these systems were charged rates pursuant to the

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[154] Tr. Vol. 5, at 881-888.

AquaSource settlement. Therefore, Protestants argue these systems could not be "new additions." Protestants' allegations are not supported by evidence. Moreover, Protestants allegations related to past rates charged those customers is a matter for another proceeding, not this case. The systems in issue are properly included in rate base and there is no evidence in the record indicating they have been included more than once for rate base purposes. So, the ALJs do not support this category of adjustments.

Finally, in their fourth and fifth categories of rate base adjustments, Protestants seek to exclude certain systems from rate base they consider to be dissimilar from others in their region. This argument is merely a restatement of the Section 13.145 challenge to the substantial similarity of the systems in each region. Having determined that the systems are substantially similar, the ALJs do not recommend that any be removed for rate base purposes.

In summary, then, the ALJs recommend that the Commission adopt the rate base calculations presented by the ED, with none of the adjustments requested by Protestants.

IX. RATE OF RETURN

Aqua Texas requests that the Commission allow it to earn an overall weighted rate of return of 8.44%, which is based upon (1) a proposed capital structure consisting of 50% debt and 50% equity; (2) a cost of debt of 4.87%; and (3) a return on equity of 12%. The ED supports this requested rate of return. The ALJs agree.

Protestants oppose the requested 8.44% return, and instead propose a rate of return of 6.8%, which was the benchmark Moody's BAA Utility Bond Yield for 2003.[155] Protestants argue

[155] From Protestants' briefing, it appears they are requesting the overall rate of return be 6.8%, without the imputation of any hypothetical capital structure. However, if the hypothetical capital structure of 50% debt and 50% equity is used, they propose the weighted rate of return would then be 5.84%.

that this benchmark yield provides the most appropriate rate of return for utilities like Aqua Texas. Protestants argue that the decision by the ED or the Commission to use 12% as the standard return on equity in these types of cases represents illegal *ad hoc* rulemaking in violation of the Administrative Procedures Act. Further, Protestants disagree that it is appropriate to use an imputed capital structure for Aqua Texas.

Ultimately, after considering the evidence and arguments of the parties, the ALJs recommend that the Commission allow Aqua Texas to earn the requested overall weighted rate of return of 8.44%. The proper method for determining the appropriate overall weighted rate of return involves combining and averaging Aqua Texas' cost of debt (*i.e.*, the interest rate paid on debt) and the rate of return shareholders are entitled to earn on common equity in the company. In this case, it is not straightforward to determine Aqua Texas' capital structure, because the operating utilities are wholly owned subsidiaries of a parent company. They have no debt or equity in their own names. Rather, they propose to use the capital structure of their parent corporation in calculating a rate of return in this case. The ALJs find this is appropriate.

The evidence in the record established that Aqua America—the parent company of Aqua Texas—has taken on significant debt and spent significant amounts of money to modernize and upgrade the various systems in issue in this case. Approximately $90 million in debt, although not in the name of Aqua Texas, was incurred for the benefit of the utility systems and their customers.[156] Under circumstances like this, where the utilities in issue are wholly owned by a parent company and have no debt or capital structure in their own name, the ALJs conclude it is appropriate to impute a capital structure for the purpose of determining a proper rate of return.[157]

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[156] Tr. Vol. 1, at 122-123. It is unclear from the record how much, if any, of that $90 million has been retired.

[157] In fact, if an imputed capital structure is not used, it could be argued that Aqua Texas is 100% equity financed by its parent company, thus leading to a higher rate of return—because any reasonable rate of return on equity used by the Commission would undoubtedly be higher than Aqua America's low cost of debt of 4.87%.

The record evidence establishes that Aqua America's actual capital structure is 50% debt and 50% equity.[158] In the absence of a specific capital structure for Aqua Texas, it seems most appropriate to use the capital structure of the parent company. Although Protestants challenge Aqua America's capital structure, they have not refuted it with any persuasive evidence. Rather, they simply attack it as not sufficiently supported. While it may not be as supported as Protestants might like, it was clearly supported by the testimony of Aqua America's Southern Division President, Mr. Hugus. In the absence of controverting evidence, Mr. Hugus' testimony is persuasive and sufficient to establish Aqua America's capital structure, and it is this capital structure the ALJs deem most appropriate to use in determining an overall rate of return.

So, having decided upon the capital structure, the ALJs now turn to the two remaining components: cost of debt and return on equity. Aqua Texas' imputed cost of debt is 4.87%. No parties have seriously disputed this, nor would they be expected to. That is a very favorable interest rate for debt and is certainly beneficial to customers. Therefore, the ALJs agree that, in determining the overall weighted rate of return in this case, the cost of debt rate is 4.87%.

On the other hand, the rate of return on equity is hotly contested. Aqua Texas and the ED both propose that a 12% return on equity is appropriate. Protestants disagree, arguing that it is too high in comparison to the 6.8% Moody's BAA Utility Bond Yield for 2003. Protestants argue that a return of 12% on equity would include a risk premium of 5.2%,[159] which is too high in light of the fact that Aqua America is a large and profitable utility company. Instead, Protestants argue that the Commission should simply use the 6.8% benchmark for the Moody's BAA Utility Bond Yield as the rate of return.

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[158] Tr. Vol. 1, at 95-96.

[159] In essence, a 12% return on equity is equal to the 6.8% Moody's BAA Utility Bond Yield plus an additional 5.2% yield.

The ALJs disagree with Protestants' approach because it does not provide for any risk premium. Bonds, by virtue of their secured nature, are inherently less risky as a class than invested equity. Accordingly, any attempt to determine an equity return by using bond returns as the benchmark must also account for the risk differential. Although Protestants claim that 5.2% is too great of a risk premium, they have provided no actual expert financial analysis to demonstrate this to be true from an equity market or other economic viewpoint. In the absence of clear evidence to the contrary, the ALJs look to the Commission's precedent in regard to risk premiums.

The Commission has consistently allowed a 12% return on equity on the basis that it is similar to the returns available from other investments of similar risk.[160] Although Protestants argue that the use of a benchmark 12% return by the Commission is tantamount to *ad hoc* rulemaking, the ALJs do not agree. The ED's practice of using a benchmark 12% return on equity when reviewing rate applications is not the equivalent of a rule or policy. Rather, it is a practice that is not specifically binding on the outcome of any given case. Instead, as is occurring in this case, the parties may challenge the proper rate of return to be used, and the Commission will review the evidence to determine whether a 12% return on equity is appropriate.

Ultimately, in light of the testimony showing that a 12% rate of return on equity is comparable to the return available for investments of similar risk,[161] the ALJs see no reason why a different return on equity should be utilized for Aqua Texas in this case. Moreover, given the low cost of debt for Aqua America, using a 12% rate of return on equity results in a total weighted rate of return of 8.44%—which is very reasonable. For these reasons, the ALJs recommend that, in setting rates in this case, the Commission utilize an overall weighted rate of return of 8.44%.

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[160] See *Aqua Texas, Inc.'s Response to Closing Arguments*, at 23, fn. 8, for a listing of many past TCEQ water or sewer ratemaking actions in which the Commission allowed a 12% return on equity.

[161] Ex. AT-A, at 4; Ex. AT-F, at 20-23; and Ex. ED-A, at 19-20.

X. RATE CASE EXPENSES

A. Recoverability of Rate Case Expenses

Aqua Texas seek to recover all reasonable and necessary expenses associated with preparing, filing, and litigating this rate case. As of February 19, 2007, Aqua Texas asserts that it had incurred $2,723,092.46 in reasonable and necessary rate case expenses. Among those expenses are attorney's fees and consulting fees. Further, Aqua Texas seeks to recover for attorney's fees incurred by municipalities that settled with it. As noted by Aqua Texas, this rate case has taken almost three years to try, involved two novel issues of law—the interpretation of TEX. WATER CODE § 13.145, and whether Aqua Texas may include in rate base a deferred expense regulatory asset—and is considered to be the largest and most complex rate case ever filed with the Commission by an investor-owned utility in Texas.[162] Given all of that, it should be noted that the ED presented the only witness (Elsie Pascua) to controvert any of Aqua Texas' rate case expense testimony. Ms. Pascua does not address the reasonableness of Aqua Texas' total amount sought, but rather takes issue with specific expenses as discussed in more detail below.[163]

Instead of presenting controverting witnesses, Protestants presented various arguments regarding the recovery of rate case expenses. First, Protestants argue that there is no statutory authority allowing for recovery of any rate case expenses by Aqua Texas. Specifically, Protestants point to TEX. WATER CODE § 13.185(h)(3) which provides that the following may not be included as an allowable expense for ratemaking purposes: "any expenditure found by the regulatory authority to be unreasonable, unnecessary, or not in the public interest, including . . . legal expenses . . . ." The Commission's rules contain similar language at 30 TEX. ADMIN. CODE § 291.31(b)(2)(I). Protestants assert that this language precludes recovery for attorney's fees as rate case expenses in proceedings like this.

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[162] Tr. Vol. 8, at 1290; Tr. Vol. 9, at 1327-1328 and 1331-1334.

[163] Ex. ED-EP-35, at 17; Tr. Vol. 1365.

The ALJs disagree. Those provisions cited by Protestants specifically prohibit allowing recovery of expenses that are "unreasonable, unnecessary or not in the public interest." While the argument can be made that the identification of legal expenses within the statute is intended to be an example of expenses that are patently "unreasonable, unnecessary or not in the public interest," this argument is not consistent with Commission precedent or rules. And, in the absence of a court determination to the contrary, the Commission's rules and precedent govern.

Specifically, the Commission has regularly allowed the recovery of attorney's fees as a component of rate case expenses in water and sewer rate proceedings.[164] Further, the Commission's rules establish that this is proper; 30 TEX. ADMIN. CODE § 291.28(7) states "[a] utility may recover rate case expenses, including attorney fees, incurred as a result of a rate change application only if the expenses are reasonable, necessary, and in the public interest." (Emphasis added). Accordingly, it is clear that the Commission allows recovery of attorney's fees as rate cases expenses—provided those fees are reasonable, necessary, and in the public interest. So, the ALJs now turn to the specific expenses to determine whether they should be allowed.

B. Overview of Incurred Rate Case Expenses

As noted above, Aqua Texas seeks total rate case expenses in the amount of $2,723,092.46, as of February 19, 2007.[165] The general breakdown is: $954,028.18 in consulting expenses, $1,419,052.65 in legal expenses, $106,218.98 in municipal reimbursements, and $243,792.65 in uncategorized expenses.[166] Mr. Hugus has been in the water business and involved in rate cases for 40 years, and he testified that the total amount sought as expenses in this proceeding is reasonable, necessary and considerably less than the expenses incurred in the 2000 AquaSource case.[167]

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[164] See, e.g., *Application of North Orange Water & Sewer LLC to Change Water and Sewer Rates, Certificates of Convenience and Necessity Nos. 11642 and 20564*, TCEQ Docket No. 2003-0597-UCR (2004).

[165] Ex. AT-85; Tr. Vol. 8, at 1114 and 1213.

[166] Ex. AT-85; Tr. Vol. 8, at 1109-1113.

[167] Tr. Vol. 8, at 1260.

Kurt Scheibelhut, Assistant Controller for Aqua Texas, personally reviewed the invoices for all of the expenditures, insured that they were properly coded and not duplicated, and that only authorized personnel approved the invoices and assigned them to the rate case.[168] Similarly, Aqua Texas' internal controls comply with Sarbanes-Oxley for reconciliation, avoidance of duplicate invoice entries, and certainty that expenses are entered only by those with personal knowledge of the work performed.[169]

Charles Loy of GDS Associates, Inc. (GDS), whose experience includes assisting with almost 20 Class A water rate cases, testified that he is familiar with recoverable rate case expenses, with rates charged in those cases, and that he compared Aqua Texas' expenses to expenses recovered in other rate cases.[170] Mr. Loy testified that the $2.7 million sought does not include time spent by company personnel gathering data and responding to discovery.[171] He noted that there were 23 intervenors, over 750 requests for information and documents, a lengthy and thorough audit by the ED's staff, and that this case took well over two years to litigate as compared to the typical 10-15 months.[172] Nevertheless, rate case expenses were "substantially" less than those incurred in the AquaSource case, which settled.

According to Mr. Loy, the hourly rates sought by consultants and counsel were in the "midrange" of rates typically charged and that the overall amounts were comparable to customary amounts for similar services in similar cases.[173] In his opinion, Aqua Texas' rate case expenses are comparable to those in other rate cases he has worked on, are reasonable and necessary in preparing the application and litigating this matter, and would not have been incurred but for this

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[168] Tr. Vol. 8, at 1115-1117, 1174-1175, and 1176-1179.

[169] Tr. Vol. 8, at 1176-1179 and 1240-1241.

[170] Ex. AT-86; Tr. Vol. 8, at 1215-1216.

[171] Tr. Vol. 8, at 1230.

[172] Tr. Vol. 8, at 1229-1231.

[173] Tr. Vol. 8, at 1216.

rate case.[174] With the exception of the specific disallowances analyzed below, the ALJs find that the testimony of Aqua Texas' witnesses on rate case expenses establishes that they are reasonable, necessary and in the public interest.

C. The ED's Requested Rate Case Expense Disallowances

Only the ED presented a witness to controvert the company's rate expense request. In addition to Aqua Texas' witnesses, the ALJs rely on Ms. Pascua's recommendation that (except for her specific disallowances) Aqua Texas' rate case expenses are reasonable, necessary and in the public interest.[175] After considering the evidence presented, the ALJs recommend a total rate case expense disallowance of $230,688.97. The ED's requested disallowance amounts, and the ALJs recommendations, are discussed below.

1. Legal Expenses

Lead counsel for Aqua Texas, Paul Terrill of the law firm of Hazen & Terrill, testified that the following legal expenses were reasonable and necessary:

Hazen & Terrill	$893,421.16
Law offices of Andy Barrett	$341,132.08
Mark Zeppa	$50,918.13
Lloyd Gosselink	$87,829.89
Catherine Webking	$7,832.00
Total	$1,381,133.26[176]

[174] Ex. AT-86; Tr. Vol. 8, at 1196-1197, 1198-1199, and 1212-1213.

[175] ED's Initial Brief, at 30; Ex. ED-EP-35; Tr. Vol. 8, at 1310-1311. Ms. Pascua's total recommended disallowance is $413,138.12. See ED's Initial Brief, at 29-32.

[176] Ex. AT-85; Tr. Vol. 8, at 1284-1285.

Mr. Terrill testified regarding the various roles Aqua Texas' legal counsel played in developing and litigating this matter. In addition, Aqua Texas seeks $37,919.39 in expenses for copy services and court reporters, bringing the total legal expenses to $1,419,052.65. Based on his experience in trying water rate cases, Mr. Terrill concluded that the total legal expenses in this matter are reasonable and necessary.[177] Mr. Terrill based his opinion on the "highly contested nature of the case, its many complex legal issues, extensive discovery, and other factors . . ."[178]

With regard to legal invoices for Hazen & Terrill, the ED recommends disallowance of $7,708.78 for the firm's charges for providing unredacted invoices when they should have been provided initially.[179] The same argument is extended to similar billings for the firm of Lloyd, Gosselink, Blevins, in the amount of $1,293.25; Andy Barrett, in the amount of $11,562.50; and Mark Zeppa, in the amount of $115.62. The ALJs agree with the ED and recommend disallowance of those expenses as not reasonable, necessary, or in the public interest.

Expenses stemming from Ms. Webking's services should be allowed because Mr. Terrill established that she assisted through her expertise regarding regulatory assets and that she also analyzed the TCEQ's authority to create a regulatory asset through a deferred rate increase.[180]

The ED recommends the disallowance of Mr. Barrett's retainer fees in the amount of $88,000. Mr. Terrill established that Mr. Barrett assisted Aqua Texas significantly in this case.[181] Ms. Pascua testified that his work generally is an allowable rate case expense.[182] However, in addition to his hourly rates, Mr. Barrett also charged a $4,000 per month retainer, which the ED

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[177] Tr. Vol. 8, at 1289-1290 and 1292.

[178] Tr. Vol. 8, at 1289-1290 and 1292.

[179] ED's Initial Brief, at 30; Ex. ED-EP-35; Tr. Vol. 8, at 1319-1320.

[180] Tr. Vol. 8, at 1291.

[181] Tr. Vol. 8, at 1295-1296.

[182] Tr. Vol. 9, at 1431-1432.

opposes as not being directly related to this rate case and not reasonable, necessary, or in the public interest. The ALJs agree that a retainer does not appear to be reasonable and necessary for retention of legal counsel in a case of this nature. Therefore, the ALJs recommend disallowance of Mr. Barrett's retainer total of $88,000.[183]

The ALJs recommend no additional disallowances for legal expenses. Therefore, the total of legal fees and expenses to be disallowed is $108,680.15.

2. GDS Consulting Expenses

GDS, also a consultant in AquaSource's 2000 rate case, assisted Aqua Texas with discovery responses and in providing data to the ED, including asset tariff reports. In the AquaSource case, GDS gathered, analyzed, and organized plant data for each system, resulting in total expenses in excess of $2 million.[184] In this matter, GDS' expenses are considerably less: $801,123.62.[185]

Protestants argue that GDS' work in this matter was designed to shore up Aqua Texas' application, which they contend should have been done prior to its filing.[186] However, it is hardly clear in a large case of this size what items must be done prior to filing and those that are constantly being worked on even after filing. For example, one of the most significant issues in this case relates to the substantial similarity of the various systems to be consolidated. On certified questions, the Commission rejected the contention that Aqua Texas was required to include all of that information in its rate change application. Rather, it could present it through the contested case process. The ALJs believe this is generally true with a lot of information that comes into

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[183] Tr. Vol. 8, at 1294-1297 and 1316-1317.

[184] Tr. Vol. 9, at 1502.

[185] Ex. AT-85, at 1.

[186] Protestants' Initial Brief, at 56-57; Tr. Vol. 2, at 303-304.

dispute in rate cases. While Mr. Loy testified at the hearing that part of GDS' services included ". . . just generally supporting the application," there is also uncontroverted testimony that GDS assisted with litigation and responding to the ED's information requests, not to mention the creation of the asset tariff reports.[187] Based on this uncontroverted testimony, the ALJs conclude that GDS did much more than simply "rework the application" after it was filed.

OPIC seeks the disallowance of time billed by Mr. Loy and Mr. Freitag. OPIC offered an example of the simplistic nature of Mr. Freitag's opinions in this matter based on cross-examination of Mr. Freitag.[188] But taking "45 seconds" to boil down Mr. Freitag's opinions in an admittedly simplistic form, does not controvert testimony regarding the extent of Mr. Freitag's endeavors in reaching his opinions, in litigation assistance, in the asset tariff review process, or in assisting in non-legal analysis in this case.[189] Much the same argument applies to OPIC's criticism of Mr. Loy's work on this matter,[190] and the ALJs conclude that OPIC's characterization of GDS' work in this regard lacks evidentiary foundation.

The ED recommends disallowance of $73,474.18 claiming that there were (1) excessive meetings among GDS staff, and (2) excessive travel expenses to review information that "should have been available in the Pflugerville office" and thus, not necessitated travel.[191] Aqua Texas responds that Ms. Pascua's criticism assumes that the records should have been kept at the Pflugerville office when, in fact, Commission rules require certain plant-related records to be kept at the plant.[192] In this case, Aqua Texas' plants are located throughout the state. When the ED requested all invoices, Aqua Texas reasonably assumed that the request included records kept at

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[187] Ex. AT-F, at 15-18; Tr. Vol. 2, at 303-304; Tr. Vol. 9, at 1465 and 1505.

[188] OPIC Initial Brief, at 5 (discussing Tr. Vol. 3, at 418-419).

[189] *See generally* Ex. AT-H.

[190] *See generally* Ex. AT-F; Ex. AT-87; Tr. Vol. 9, at 1491-1493, 1501, and 1505.

[191] ED's Initial Brief, at 29-30 (citing Tr. Vol. 8, at 1319; Tr. Vol. 9, at 1367-1375).

[192] 30 TEX. ADMIN. CODE § 290.46(f).

those plants.[193] Because Aqua Texas' consultants were integrally involved in the compilation and reformatting of data for the ED's review, it is reasonable for them to travel to obtain and review data in preparation of its production to the ED. This explanation is supported by evidence and the ALJs recommend that Aqua Texas recover for these travel expenses.

As for Ms. Pascua's complaint of excessive meetings, the ALJ's understand that this was a very large and complex case involving the consolidation of 335 water and sewer systems, in which Aqua Texas worked closely with the ED to develop issues relevant to all of Aqua Texas' ratepayers–and yet GDS provided its services for less than half of its billings in the AquaSource case. There has been no testimony offered as to the yardstick for an appropriate number of meetings in a case of this magnitude and the ALJs found GDS' witnesses to be credible. Ms. Pascua was very credible as well, acknowledging adjustments based on testimony at the rate case hearing. Considering that Ms. Pascua allowed for half of the charges at those meetings, the issue is whether the ALJs should substitute Ms. Pascua's judgment for the testimony of GDS' employees. The ALJs decline to do so and recommend that Aqua Texas recover all of GDS' billings in this matter as reasonable, necessary, and in the public interest.

3. Miscellaneous Expenses

The ED recommended disallowance of rate case expenses Aqua Texas incurred from Mattias Jost, Peter Marek and Severn Trent. Aqua Texas established that Mr. Jost and Mr. Marek conducted billing analysis and played a distinct role in developing the rate design in this matter.[194] Severn Trent developed a billing system that was used in developing the "pro forma level of revenue" in this matter.[195] The ALJs find that invoices from Mr. Jost and Mr. Marek represent allowable services that are directly related to this rate case.

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[193] Tr. Vol. 8, at 1231-1232.

[194] Tr. Vol. 8, at 1119-1122, 1137-1138, 1156, 1166-1167.

[195] Tr. Vol. 8, at 1248-1251, 1515.

Ms. Pascua recommended various other disallowances that the ALJs believe have been shown to be legitimate rate case expenses. Aqua Texas established that North Point Consulting assisted in developing the history of the AquaSource Rate Case and how best to proceed in this rate case.[196] LK Jordan was a temporary service that assisted in records review and those expenses were incurred as a direct result of the rate case.[197] The ALJs recommend the allowance of these expenses because they would not have been incurred but for the filing of this rate case.

Ms. Pascua recommended the disallowance of charges by Affiliated Reporters for House and Senate hearing transcripts.[198] Hearing transcripts were cited by Aqua Texas in its briefing and by the ALJs in this Proposal for Decision. Thus, the ALJs recommend allowance of these expenses.

The ED recommended disallowance of charges for Voinis Communications.[199] Voinis conducted "public affairs consulting" on behalf of Aqua Texas prior to and after this rate case was filed.[200] This consulting involved setting up meetings with county officials in anticipation of Aqua Texas' application.[201] Although this work was related to this rate case, the ALJs do not believe that it was necessary work. Although public relations work may benefit the utility and help smooth the process, it is hardly a necessary expense. Therefore, the ALJs recommend disallowance of the $12,022.20 in fees sought.

Ms. Pascua recommended disallowance of $62,015.61 in corporate charges that she described as duplicate charges by Aqua Texas because it appeared to her that Aqua Texas was also

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[196] Tr. Vol. 8, at 1118-1119, 1188, and 1219-1220.

[197] Tr. Vol. 8, at 1136.

[198] ED's Initial Brief, at 30; Ex. ED-EP-35 at 7.

[199] ED's Initial Brief, at 31; Ex. ED-EP-35.

[200] Tr. Vol. 8, at 1121, 1167-1168, and 1245-1246; Tr. Vol. 9, at 1441-1442.

[201] Tr. Vol. 9, at 1441-1442.

seeking to recover them through its cost of service as regular expenses.[202] However, Aqua Texas explained that the accounting entries Ms. Pascua saw were simply intermediate accounting entries between various Aqua America companies that were not actually passed on in the requested cost of service.[203] In light of the credible testimony presented by Aqua Texas, the ALJs conclude these charges are not being double-collected and, therefore, should be allowed.

The ED recommended disallowance of $33,603.12 billed by American Productivity Quality Center (APQC).[204] APQC was hired to assist Aqua Texas in this rate case by obtaining customer service data and providing metrics for that data.[205] Aqua Texas established that APQC was reimbursed for creating a system that revealed qualitative and quantitative improvements in Aqua Texas' handling of customer service issues over its predecessor, AquaSource.[206] Although customer service was an issue in the AquaSource rate case, it was not raised specifically in this matter. At the hearing, Ms. Pascua testified that if Aqua Texas undertook the improvements in customer service in relation to a rate case or as ancillary to a rate case and the cost of those improvements was non-recurring, then the utility should recover that cost as a rate case expense.[207] The evidence shows this is exactly what the APQC charges were, so the ALJs recommend allowance of these expenses.

The Protestants challenged the recovery of rate case expenses incurred by settled cities and reimbursed by Aqua Texas. Ms. Pascua testified that the disallowance of these reimbursed

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[202] ED's Initial Brief, at 31; Ex. AT-18, Ex. AT-19; Ex. ED-EP-35; Tr. Vol. 9, at 1483-1486.

[203] Ex. AT-18; Ex. AT-19; Tr. Vol. 9, at 1516-1522.

[204] Ex. ED-EP-35 reflects an amount of $39,603.12. Aqua Texas is only seeking reimbursement of $33,603.12, which Ms. Pascua agreed was the appropriate amount for disallowance.

[205] Ex. AT-B, at 11-12; Tr. Vol. 9, at 1439-1441, 1446, and 1449-1452.

[206] Ex. AT 34; Tr. Vol. 8, at 1245; Tr. Vol. 9, at 1439-1441.

[207] Tr. Vol. 9, at 1421-1422.

expenses would be appropriate.[208] The ALJs agree with Protestants that expenses incurred by settling parties should not be recovered by Aqua Texas as rate case expenses, even if Aqua Texas agreed to reimburse them through a settlement agreement. The amounts to be disallowed are:

City of Woodcreek	$79,610.05
City of Ingram	$14,797.46
City of Houston	$11,811.47
Total	$106,218.98

Although TEX. WATER CODE § 13.084 allows the utility to recoup such costs through rates, the ALJs believe those costs should be recouped in the proceeding in which they were incurred. As noted previously, the municipal Appeals have all been resolved by settlement and those separate dockets have been remanded back to the Commission. Therefore, this remaining docket is not the place to recoup those costs incurred in municipal appeals. Therefore, those expenses should be disallowed.[209]

In regard to a number of smaller, miscellaneous disallowances, the ALJs conclude that Ms. Pascua's testimony adequately establishes that they should be disallowed. These additional disallowances are:[210]

Bill Dugat	$260.00
Bob Laughman	$2,376.33
Danny Edwards	$71.31
Capital Printing – business cards	$300.00
Pro Staff – data entry	$760.00
Total	$3,767.64

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[208] Tr. Vol. 9, at 1461-1462.

[209] The ALJs recognize that this same principle would apply and necessitate disallowance of Aqua Texas' rate case expenses that are tied to the settled municipal appeals. However, the evidence provides no way for the ALJs to reasonably divide Aqua Texas' expenses to the settled appeals. Further, any unfairness is mitigated if rate case expenses are divided among all customers, so that settled customers are apportioned their share of expenses.

[210] Tr. Vol. 8, at 1317-1319 and 1474; Ex. ED-EP-35.

D. Summary of ALJ's Rate Case Expense Disallowances

To summarize, the ALJs recommend a total rate case expense disallowance of $230,688.97. This includes the following specific disallowances:

Legal Expenses:	$108,680.15
Voinis Fees:	$ 12,022.20
Municipal Legal fees:	$106,218.98
Miscellaneous:	$ 3,767.64

In all other respects, the ALJs recommend that Aqua Texas recover its rate case expenses.

E. Allocation of Rate Case Expenses

Aqua Texas recommends apportionment of its rate case expenses to the non-settling parties, arguing that it would be unjust to assign the expenses to other groups. This argument has two problems. First, it assumes that the benefit of Protestants' challenge to the application is limited to those parties that contested Aqua Texas throughout the hearing process. The ALJs disagree with this assumption, finding that the nature of the Protestants arguments—mainly seeking to defeat the entirety of the rate change—are designed to benefit all customers. Second, it assumes that of the systems represented by Protestants, everyone within those systems have protested. This has not been shown to be true. Clearly, even within many of the systems represented by Protestants, not all customers have protested. It is no more unfair to assess rate case expenses against settling or non-protesting systems than it is to assess them against non-protesting customers who are in one of the systems represented by the Protestants in this case.

Therefore, the ALJs recommend that Aqua Texas recover the allowed rate case expenses from all of the company's systems. While it might be ideal to track rate case expenses precisely to the parties causing them to be incurred, such is not feasible. Undoubtedly, many of the rate case expenses were incurred fighting parties who have settled, but it would be virtually impossible to

properly connect the incurred rate case expenses to all of the parties that participated in this case. Instead, the ALJs believe that all of the company's customers stood to benefit by the Protestants' actions in this case, as the Protestants' positions were not tied simply to their systems but were aimed at the entirety of Aqua Texas' case. Therefore, rate case expenses should be apportioned across all systems.

If Aqua Texas has, through settlement, agreed not to recover expenses from certain customers, then that loss must be borne by it—and not the other ratepayers. Accordingly, the ALJs also recommend that the Commission's Order in this case establish a specific monthly surcharge amount that Aqua Texas is allowed to recover per customer, and set a time limit on its recovery. The surcharge amount and time period should be based on the premise that Aqua Texas is recovering its rate case expenses from all customers. That way, any rate case expenses that Aqua Texas has agreed not to recover from settling parties will not be shifted to other customers, but rather will be borne by the utility.

The length of the surcharge period is left to the discretion of the Commission, and may depend on whether the Commission will allow Aqua Texas to recover interest on the rate case expenses. The ALJs take no position on whether interest should be allowed. However, consistent with the ALJs' recommendation previously, if interest is allowed, that same interest rate should be applied to recovery of the deferred expense regulatory asset.

XI. TRANSCRIPTION COSTS

By prior order in this case, the ALJs required Aqua Texas to pay the costs associated with the preparation of the transcript of the hearing, subject to a possible allocation of the costs at the conclusion of the case. Aqua Texas has not submitted a request for allocation of the transcription costs to other parties, and the ALJs decline to make any recommendation that transcription costs be assessed to any other eligible parties.

XII. RECOMMENDATION ON RATE-SETTING PROCEDURES

Along with the issuance of this Proposal for Decision, the ALJs are issuing an order requiring the ED to prepare revised number-running reflecting the ALJs' recommendations contained herein. This information can then be used by the Commission at its open meeting to determine how the ALJs' recommendations affect rates. Part of that number-running should include the calculation of proper surcharge amounts and the time for those surcharges to be implemented.

The ALJs understand it is quite possible—if not likely—that the Commission will not be able to fully decide this case at a single open meeting. Rather, depending on the Commission's decisions on the various issues raised, the ALJs expect it will be necessary for the Commission to allow additional number-running after the Commission's open meeting and prior to the adoption of a final order in this case. If needed, the ALJs will be available to assist in the process of ensuring that the Commission's decisions on the disputed issues are properly translated into rate-setting numbers by the parties. The Commission has previously used ALJs in this fashion.[211]

XIII. CONCLUSION

In conclusion, the ALJs recommend that the Commission approve the applications (as modified by the recommendations herein), adopt the regional rate structures proposed by Aqua Texas, and establish rates consistent with the ALJs' recommendations in this Proposal for Decision. The Commission should not include a regulatory asset in rate base, but should allow recovery of deferred expenses through a surcharge. Similarly, the Commission should also allow recovery of reasonable rate case expenses through a surcharge, allocating all surcharges across all

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[211] In one prior rate case, after resolving contested issues, the Commission continued its consideration of the rate change application to allow the parties to run the numbers in light of the Commission's decisions and to prepare the rate calculations for implementation. The Commission requested that the ALJ work with the parties to resolve issues that might arise and to be prepared to make a recommendation at the second open meeting for the precise rates to be adopted, the rate structure, the surcharge amounts, etc. That process worked fairly well. See *Application of North Orange Water & Sewer LLC to Change Water and Sewer Rates, Certificates of Convenience and Necessity Nos. 11642 and 20564*, TCEQ Docket No. 2003-0597-UCR (2004).

customers in the regions governed by the tariffs in issue in this case. Transcription costs should be borne by Aqua Texas and should not be allocated to any other parties. Along with this Proposal for Decision, the ALJs are providing the Commission with a Proposed Order consistent with the ALJs' recommendations.

SIGNED July 5, 2007.

CRAIG R. BENNETT
ADMINISTRATIVE LAW JUDGE
STATE OFFICE OF ADMINISTRATIVE HEARINGS

TRAVIS VICKERY
ADMINISTRATIVE LAW JUDGE
STATE OFFICE OF ADMINISTRATIVE HEARINGS

The following pages represent the data sheets referenced on page 48 of this PFD. These sheets do not identify all expense components or necessary elements for determining revenue requirements; rather these are simply intended to address the primary contested areas and the regions in which it appears the parties are still presenting alternate calculations. These sheets are intended to simply aid the ED and Commission in determining proper rates in this case

PARTIAL REVENUE REQUIREMENT SHEET - NORTH REGION

North Water

Salaries:	$1,461,349
Contract Services:	$ 607,711
Purchased Water:	$ 251,863
Chemicals and Treatment:	$ 121,365
Utilities:	$ 828,722
Repairs and Maintenance:	$ 242,371
Office Expenses:	$ 242,380
Accounting and Legal:	$ 96,845
Insurance:	$ 30,801
Miscellaneous:	$ 837,533

North Sewer

Salaries:	$ 87,511
Contract Services:	$ 28,102
Purchased Sewer:	$ 35,064
Chemicals and Treatment:	$ 11,546
Utilities:	$ 71,527
Repairs and Maintenance:	$ 8,031
Office Expenses:	$ 0
Accounting and Legal:	$ 4,284
Insurance:	$ 2,462
Miscellaneous:	$ 54,082

PARTIAL REVENUE REQUIREMENT SHEET - SOUTHEAST REGION

Southeast Water

Salaries:	$1,220,685
Contract Services:	$ 537,787
Purchased Water:	$ 131,276
Chemicals and Treatment:	$ 138,312
Utilities:	$ 533,070
Repairs and Maintenance:	$ 189,272
Office Expenses:	$ 180,248
Accounting and Legal:	$ 96,619
Insurance:	$ 33,167
Miscellaneous:	$ 716,548

Southeast Sewer

Salaries:	$ 471,011
Contract Services:	$ 500,717
Purchased Sewer:	$ 611,064
Chemicals and Treatment:	$ 41,639
Utilities:	$ 521,412
Repairs and Maintenance:	$ 30,031
Office Expenses:	$ 0
Accounting and Legal:	$ 39,687
Insurance:	$ 22,520
Miscellaneous:	$ 368,288

PARTIAL REVENUE REQUIREMENT SHEET - SOUTHWEST REGION

Southwest Water

Salaries:	$1,377,130
Contract Services:	$ 589,831
Purchased Water:	$ 326,676
Chemicals and Treatment:	$ 63,065
Utilities:	$ 423,436
Repairs and Maintenance:	$ 200,583
Office Expenses:	$ (31,066)
Accounting and Legal:	$ 138,037
Insurance:	$ 215,684
Miscellaneous:	$ 991,911

Southwest Sewer

Salaries:	$ 190,482
Contract Services:	$ 132,351
Purchased Sewer:	$ 132,209
Chemicals and Treatment:	$ 39,759
Utilities:	$ 127,036
Repairs and Maintenance:	$ 20,036
Office Expenses:	$ 0
Accounting and Legal:	$ 26,853
Insurance:	$ 43,323
Miscellaneous:	$ 202,994

TEXAS COMMISSION ON ENVIRONMENTAL QUALITY

AN ORDER Approving the Applications of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc. to Change Water and Sewer Rates; TCEQ Docket Nos. 2004-1671-UCR and 2004-1120-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771.

On _____, the Texas Commission on Environmental Quality (Commission) considered the applications of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc., for water and sewer rate/tariff changes and for recovery of rate case expenses through imposition of a surcharge on water and sewer customers. Administrative Law Judges (ALJs) Craig R. Bennett and Travis Vickery of the State Office of Administrative Hearings (SOAH) presented a Proposal for Decision (PFD) recommending that the Commission approve the requested rate changes, with modifications. After considering the PFD, the Commission adopts the following Findings of Fact and Conclusions of Law:

FINDINGS OF FACT

General and Procedural Findings

1. Aqua Utilities, Inc. (Aqua Utilities), and Aqua Development, Inc. (Aqua Development), hold Water and Sewer Certificates of Convenience and Necessity (CCN) Nos. 11157, 12902, 20453, and 20867.

2. Aqua Utilities and Aqua Development both do business in Texas as Aqua Texas, Inc. (Collectively, Aqua Utilities and Aqua Development are referred to simply as "Aqua Texas").

3. Aqua Texas is wholly owned by Aqua America, Inc. (Aqua America); Aqua America previously went by the name of Philadelphia Suburban Corporation (PSC).

4. PSC acquired 100% of the stock of AquaSource Utility, Inc. and AquaSource Development Company in a transaction approved by the Commission on December 6, 2002, and completed on September 10, 2003.

5. AquaSource Utility, Inc., is now Aqua Utilities and AquaSource Development, Inc., is now Aqua Development.

6. On May 14, 2004, Aqua Texas submitted its Application to Change Water and Sewer Tariffs and Rates in Various Counties (Application) to the Commission, and simultaneously filed the Application with the various municipalities that exercise original jurisdiction over Aqua Texas' water and sewer rates within those municipalities.

7. Aqua Texas' proposed water and sewer rate/tariff changes included increased retail water and sewer rates and changes to miscellaneous non-rate fees and charges.

8. Aqua Texas timely and properly provided notice of the proposed rate changes to its ratepayers and affected persons.

9. On June 25, 2004, the Commission declared the Application administratively complete.

10. Under the Applications, the proposed rate increases were effective in non-municipal service areas on July 13, 2004.

11. Within 60 days of the effective date of the proposed rate changes at least ten percent of Aqua Texas' non-municipal customers filed protests to the rate changes. In addition, several municipalities denied Aqua Texas' proposed rate changes.

12. The Commission referred Aqua Texas' Application and its appeals of rate-making actions of various municipalities (collectively, the Appeals) to the State Office of Administrative Hearings (SOAH) for a contested case hearing. Those proceedings were styled and numbered as follows:

    a. TCEQ Docket No. 2004-1671-UCR/SOAH Docket No. 582-05-2771; Water Rate/Tariff Change Application of Aqua Texas, CCN Nos. 11527 & 12902 in various Counties, Texas; Application No. 34610-R; Sewer Rate/Tariff Change Application of Aqua Texas, CCN Nos. 20453 & 20867 in various Counties, Texas;

    b. TCEQ Docket No. 2004-1120-UCR/SOAH Docket No. 582-05-2770; Appeal by Aqua Texas from the Ratemaking Actions of the City of Dayton and Motions for Immediate Interim Rate Relief and Consolidation, Application No. 34649-A;

    c. TCEQ Docket No. 2005-0112-UCR/SOAH Docket No. 582-05-4184; Appeal by Aqua Texas from the Ratemaking Actions of the City of Houston and Motions for Immediate Interim Rate Relief and Consolidation, Application No. 34825-A;

    d. TCEQ Docket No. 2005-0113-UCR/SOAH Docket No. 582-05-4181; Appeal by Aqua Texas from the Ratemaking Actions of the City of Woodcreek and Motions for Immediate Interim Rate Relief and Consolidation, Application No. 34824-A;

    e. TCEQ Docket No. 2005-0114-UCR/SOAH Docket No. 582-05-4182; Appeal by Aqua Texas from the Ratemaking Actions of the City of Ingram and Motions for Immediate Interim Rate Relief and Consolidation, Application No. 34823-A; and

    f. TCEQ Docket No. 2005-2122-UCR/SOAH Docket No. 582-05-3745; Appeal by Aqua Texas from the Ratemaking Actions of the Village of Wimberley and Motions for Immediate Interim Rate Relief and Consolidation, Application No. 34808-A.

13. Notice of the hearing in this docket was provided to all affected persons.

14. On March 1, 2005, a preliminary hearing convened in this docket, at which time the Application and Appeals set forth above were consolidated for all prehearing and hearing purposes. Further, the following parties were admitted and designated: Aqua Texas; the Executive Director (ED) of the Commission; the Office of Public Interest Counsel (OPIC); the City of Houston; the City of Woodcreek; the Village of Wimberley; the City of Ingram; Lake Palestine Associates LP; Eagles Bluff Community Association; Briarcreek Home Owners Association (HOA); Kendall Pointe HOA; Estates of Shady Hollow HOA; Cherokee Point Owners Association; Eagle Creek Ranch Owners Association; Barton Creek Lakeside Property Owners Association (POA); David Phillips; Lake Cliff POA; Travis Lakeside HOA; Gary Craig; Crighton Group; Southeast Region Homeowners Groups; Southwest Region Homeowners Groups; and numerous individual customers aligned with these groups.

15. On May 20, 2005, the ALJs submitted three certified questions to the Commission in this matter.

16. On September 1, 2005, the Commission entered an Order answering the certified questions as follows:

    a. Certified Question No. 1: "Does Chapter 13 of the Water Code allow two or more utilities wholly owned by the same parent company to file a single rate filing application to consolidate multiple systems under a single tariff?" Answer: "Yes."

    b. Certified Question No. 2: "Must a rate filing application initiating a change in rates and proposing to consolidate more than one system under a single tariff contain information showing the systems are substantially similar and the rate promotes water conservation?" Answer: "No."

    c. Certified Question No. 3: "May the rate filing application be rejected and the effective date of the rate be suspended as provided by 30 TEX. ADMIN. CODE §§ 291.8(a) and 291.26(a) if the applicant has failed to include information in its application necessary under TEX. WATER CODE § 13.145 to support a single tariff consolidating more than one system?" Answer: "Set aside" [because of determination of Question No. 2].

17. Prior to the hearing on the merits, Aqua Texas settled with numerous protestants and municipalities. The settling parties were dismissed from this docket and/or Aqua Texas dismissed its appeals of those municipalities' decisions. Those settlements and dismissals included the following:

a. Aqua Texas settled its appeal of the ratemaking decision of the City of Houston in SOAH Docket No. 582-05-4184 and TCEQ Docket No. 2005-0112-UCR. That appeal was dismissed by the ALJs on January 18, 2006, and by the TCEQ on March 1, 2006.

b. Aqua Texas settled its appeal of the ratemaking decision of the Village of Wimberley in SOAH Docket No. 582-05-3745 and TCEQ Docket No. 2004-2122-UCR. That appeal was dismissed by the ALJs on October 31, 2005, and by the TCEQ on March 1, 2006.

c. Aqua Texas settled its appeal of the ratemaking decision of the City of Woodcreek in SOAH Docket No. 582-05-4184 and TCEQ Docket No. 2005-0113-UCR. That appeal was dismissed by the ALJs on October 31, 2005, and by the TCEQ on March 1, 2006.

d. Aqua Texas reached a settlement with its customers in the Pine Trails residential development in the Southeast Region, and those customers moved to withdraw their protest on February 20, 2006. The ALJs granted that request on March 3, 2006, and the settlement rates and terms were approved by the TCEQ on January 24, 2007.

e. Aqua Texas settled its appeal of the ratemaking decision of the City of Ingram in SOAH Docket No. 582-05-3745 and TCEQ Docket No. 2004-2122-UCR. On May 11, 2006, Aqua Texas and Ingram filed a Joint Motion for Approval of Settlement and for Severance of the Ingram Region. On May 24, Mr. Gary Craig, the sole party representing the Ingram environs, advised the Court he had no objection to the proposed settlement. The ALJs then severed the Ingram Region, remanded that portion of this matter to the TCEQ and dismissed the Ingram Appeal on June 7, 2006. The TCEQ approved the Ingram region settlement and dismissed the Ingram appeal on January 24, 2007.

f. Aqua Texas reached a settlement with Eagles Bluff Community Association and Lake Palestine Associates, L.P. in the North Region. Those protestants moved to withdraw their protests on May 26, 2006. The ALJs granted that motion on June 7, 2006.

18. On August 14, 2006, the hearing on the merits was convened and preliminary and procedural issues were addressed. At that time, Aqua Texas, the ED, OPIC, the Southeast and Southwest Region Homeowners Groups, Eagle Creek Ranch Owners Association, Barton Creek Lakeside POA, and Briarcreek Owners Association appeared and participated. All non-appearing parties were dismissed for failure to appear; further, the Briarcreek Owners Association was dismissed at its request based upon its settlement with Aqua Texas. After addressing procedural and prehearing matters, the hearing was recessed.

19. The hearing reconvened on August 21, 2006, and continued from day to day thereafter, until it was recessed again on August 28, 2006. Aqua Texas appeared through its attorneys, Paul Terrill, Howard Slobodin, Amanda Cagle, and Mark Zeppa. The ED appeared through staff attorneys Todd Galiga and Ross Henderson. OPIC appeared through staff attorney Scott Humphrey. The Southeast and Southwest Region Homeowners Groups appeared through their attorneys, Sheridan Gilkerson and Ed McCarthy. Eagle Creek Ranch Owners Association appeared through its representative, Linda Lamberth; and the Barton Creek Lakeside POA appeared through its representative, Byron Zinn.

20. The hearing on the merits was reconvened on September 27, 2006, but was recessed so the parties could engage in mediation.

21. The hearing on the merits reconvened on February 16 and 19, 2007, for purposes of taking evidence related to rate case expenses. Aqua Texas appeared through its attorneys, Paul Terrill and Amanda Cagle. The ED appeared through staff attorneys Todd Galiga and Ross Henderson. OPIC appeared through staff attorney Scott Humphrey. The Southeast and Southwest Region Homeowners Groups appeared through their attorneys, Sheridan

Gilkerson and Ed McCarthy. The Eagle Creek Ranch Owners Association appeared through its representative, Linda Lamberth.

22. The record closed on May 18, 2007, after the parties submitted written closing arguments and proposed rate-setting data.

Rate Case Data Findings

23. Aqua Texas provides water service to more than 100,000 customers and wastewater service to more than 38,000 customers in Texas, through 335 water and wastewater systems.

24. Aqua Texas acquired the AquaSource companies in the middle of 2003.

25. The AquaSource companies used different utility accounting procedures than Aqua America.

26. If Aqua Texas had attempted to use the AquaSource companies' data for purposes of the test year data for this rate change application, it would have had to spend a significant amount of resources to organize the data in a consistent manner and to go through all of AquaSource's expenses, item by item, and show which expenses would be different going forward under ownership by Aqua Texas; this would have been a significant burden and would have likely resulted in unreliable calculations.

27. In submitting its rate change application, it was reasonable for Aqua Texas to use the partial test year data it kept along with budgeted data for 2004 to replace the AquaSource test year data.

28. Budgeted costs were $2.3 million less than AquaSource's actual costs during the test year, and revenues increased by $1.8 million using the budgeted figures.

29. Aqua Texas' budgeted figures were very accurate; Aqua Texas' actual 2004 expenses were within 0.1% of its test year budgeted figures, indicating that the budgeted figures were a reliable forecast of anticipated expenses.

30. Aqua Texas utilizes National Association of Regulatory Utility Commissioners (NARUC) utility accounting for its systems.

31. Aqua Texas reformatted its data and provided it to the ED in a manner that complies with the TCEQ's proprietary system for evaluating utility expenses.

32. Aqua Texas has not presented its cost of service data by system, but rather by region.

33. The ED's technical staff has reviewed the actual documentation to support the rate change calculations and found the identified expenses to be well-supported by receipts and other acceptable documentation.

34. Because the Commission had previously issued an order allowing regional rates to be charged, it was reasonable for Aqua Texas to calculate cost of service on a regional basis, rather than on a system basis, and to present its data in that format.

35. Aqua Texas' rate case data adequately supports its application to change rates.

Consolidated Tariffs/Regionalization

36. On June 13, 2000, AquaSource Utility, Inc. filed an application for a single statewide tariff with the Texas Natural Resource Conservation Commission.

37. On September 1, 2001, TEX. WATER CODE § 13.145 became effective.

38. On September 17, 2002, the Commission issued an order in the AquaSource Utility, Inc., rate case establishing regions and approving regional tariffs (water and sewer) for each region.

39. Aqua Texas divides its service territory into four regions across the state: North, Southeast, Southwest, and Ingram. Those four operations regions correspond to the four tariff regions proposed in the Application. These are based on the same regions approved in the AquaSource rate case, except that the former Northeast and Northwest Regions have now been combined into the North Region.

40. The regional tariffs in the Application cover each separate region, broken down by water and sewer: North Water; North Sewer; Southeast Water; Southeast Sewer; Southwest Water; and Southwest Sewer; and Ingram Water.

41. The benefits of regional tariffs include:

    a. reduced costs resulting from economies of scale;

    b. lower administration and regulatory costs;

    c. increased efficiency;

    d. sharing of expenses between systems resulting in reduced waste;

    e. prevention of dramatic cost/rate increases when repairs are needed because costs are shared over a larger number of customers; and

    f. revenue and expense stability.

42. Regional tariffs help to ensure system viability and compliance with applicable laws because the economies of scale, increased efficiency, and sharing of expenses across larger numbers of customers facilitates capital investment as needed in those systems.

43. The regional water tariffs reflect regional differences in the depth of groundwater, system and regulatory requirements, and physical characteristics such as regional geology.

44. Aqua Texas' water system facilities within each tariff region are substantially similar for reasons including, but not limited to, employees who operate strictly within a region, their sources of water, the components of each system, the types of piping, the design and construction of the systems, facilities, the types of systems, and the types of customer usage that they serve.

45. Aqua Texas' water systems within each tariff region provide substantially similar quality of service, including, but not limited to the following:

    a. all use state-approved technologies and facilities;

    b. all provide service, or are being brought into compliance with a level of service, that achieves TCEQ and EPA drinking water standards; and

    c. all provide water treatment, or are being brought into compliance with a level of service, that achieves TCEQ and EPA drinking water standards.

46. Aqua Texas' water systems' costs of service are substantially similar within each tariff region for reasons including, but not limited to, the following:

    a. all systems share operations and maintenance costs that are either identical or at least substantially similar on a per customer basis;

    b. Costs within each region are affected by intra-regional similarities such as regional hydrology and geology and similar intra-regional regulatory requirements; and

    c. all systems' capital components are substantially similar, resulting in substantially similar repair and replacement costs over the life of those components on a per customer basis.

47. Aqua Texas' sewer system facilities within each tariff region are substantially similar for reasons including, but not limited to, the following:

a. all utilize identical or at least substantially similar methods of treatment;

b. all utilize identical or at least substantial similar system components and piping; and,

c. all serve substantially similar types of customers.

48. Aqua Texas' sewer systems within each tariff region provide substantially similar quality of service, including, but not limited to the following:

a. all use state-approved technologies and facilities;

b. all provide service, or are being brought into compliance with a level of service, that achieves TCEQ discharge standards; and

c. all provide sewage treatment, or are being brought into compliance with a level of treatment, that achieves TCEQ standards.

49. Aqua Texas' sewer systems' costs of service are substantially similar within each tariff region for reasons including, but not limited to the following:

a. all systems share operations and maintenance costs that are either identical or at least substantially similar on a per customer basis;

b. Costs within each region are affected by intra-regional similarities such as regional geology and similar intra-regional regulatory requirements; and,

c. all systems' capital components are identical or at least substantially similar, resulting in substantially similar repair and replacement costs over the life of those components on a per customer basis.

50. Aqua Texas' water tariffs promote water conservation because zero gallons are included in the base rate, and they are structured in inclining block tiers with rates that increase for higher usage.

Cost of Service

51. Aqua Texas' proposed rates are based on a twelve month test year ending December 31, 2003, as adjusted for known and measurable changes based upon its budgeted expenses for 2004.

52. Aqua Texas had reasonable and necessary expenses, as reflected by the test year data and as adjusted for known and measurable changes, for each tariff region as set forth on attached Exhibit A (entitled "Aqua Texas Rate-Setting Data").

53. The expenses set forth in Exhibit A are reasonable and necessary to provide service to Aqua Texas' ratepayers.

    a. The expenses are based on Aqua Texas' test year expenses as adjusted for known and measurable changes.

    b. The expenses are related to, and necessary for, the provision of water and sewer service.

    c. The amount of the costs and expenses is reasonable.

Rate Base

54. In its application, Aqua Texas proposed a four-year phased-in rate increase as part of a seven year expense deferral/recovery plan.

55. Aqua Texas sought and received authorization from the ED to account for certain expenses consistent with Statement of Financial Accounting Standards No. 71 ("FAS No. 71"), entitled "Accounting for the Effects of Certain Types of Regulation," in regard to amounts it undercollected in the early years of its four year phase-in period, *i.e.* when the rates it charged were below rates based on a cost of service basis.

56. After obtaining approval from the ED, Aqua Texas implemented its phased rate increase and capitalized certain expenses as a regulatory asset in association with its phased-in rate increases.

57. Aqua Texas deferred expenses consistent with SFAS No 71, creating a commensurate regulatory asset.

58. The average value of Aqua Texas' expense deferrals during the seven year term of its Deferral/Recovery Plan is $8,000.000.00.

59. Aqua Texas included the calculated average $8,000,000 balance of its expense deferrals in rate base in its Application and assigned the overall rate of return of 8.44% to it.

60. Using phased-in rates and creating a regulatory asset creates the possibility for Aqua Texas to have an over-recovery.

61. By including a regulatory asset in rate base and phasing in its rates to recover the deferred expenses associated with the regulatory asset, Aqua Texas' proposed final phased rates are higher than what they would have been if simple, unphased rates were used. These higher rates are implemented after year two of the phase-in and continue indefinitely into the future.

62. It is not reasonable nor necessary for Aqua Texas to include a deferred expense regulatory asset in rate base.

63. Aqua Texas' net adjusted test year rate base consists of the following elements: utility plant at original cost, less accumulated depreciation, less contributions in aid of construction, plus cash working capital.

64. Aqua Texas' total net adjusted test year rate base broken down by regional tariff is set forth in attached Exhibit B.

65. The total net adjusted test year rate base figures for each region set forth in Exhibit B do not include amounts for deferred expense regulatory assets.

Acquisition Adjustment

66. The Commission's order in the prior AquaSource rate case provided that an approximately $7.4 million Acquisition Adjustment be addressed in a subsequent rate proceeding.

67. Due to the magnitude of the rate increase in this proceeding, Aqua Texas has proposed to exclude the Acquisition Adjustment from rates in this case, but requests that this amount be held in abeyance until Aqua Texas exercises its right to pursue recovery in a later rate case.

68. The Acquisition Adjustment was not addressed in this proceeding, and it is reasonable to allow Aqua Texas to carry forward the $7.4 million Acquisition Adjustment from the previous rate case to the next rate case because doing so avoids two harms: rate shock to the customers and damage to the financial health of Aqua Texas.

Rate of Return

69. Aqua Texas has no debt, but its parent company, Aqua America, does. Aqua Texas benefits from Aqua America's debt financing.

70. It is reasonable to impute a 50/50 debt-equity structure to Aqua Texas based on Aqua America's debt financing.

71. A 12% return on equity is reasonable in light of Aqua Texas' risk and the capital-intensive nature of water and sewer utilities and is consistent with the returns available from other investments of similar risk.

72. Aqua Texas' imputed 4.87% cost of debt is based on Aqua America's cost of debt and is significantly lower than the cost of debt that a small utility could obtain. It also represents the lowest interest rate paid by Aqua America for its debt.

73. Aqua Texas' requested total rate of return of 8.44% based on an imputed 50/50 debt-equity structure and a 12% return on equity and a 4.87% cost of debt is reasonable in light of the risk inherent in the operation of water and sewer utilities and is consistent with the returns available from other investments of similar risk.

74. Aqua Texas' requested total rate of return of 8.44% is also reasonable in light of Aqua Texas' management.

Rate Case Expenses

75. As of February 19, 2007, Applicant incurred reasonable and necessary rate case expenses in this matter in the amount of $2,492,403.49 for preparation of the Applications, including deriving the original plant and equipment costs, developing the proposed rate/tariff changes, filing fees, notice costs, and participation by experts and counsel in the contested case hearing.

76. Rate case expenses in this case were not a normal, recurring expense of operation.

77. It is reasonable and appropriate for Aqua Texas to recover its reasonable rate case expenses as a monthly surcharge.

CONCLUSIONS OF LAW

General and Procedural Conclusions

1. Aqua Texas is a public utility as defined in TEX. WATER CODE ANN. §13.002(23).

2. The Commission has jurisdiction to consider Aqua Texas' Application for a rate increase pursuant to TEX. WATER CODE §§ 13.181, 13.042, and 13.043.

3. The ALJs conducted a contested case hearing and issued a proposal for decision on Aqua Texas' proposed water and sewer rate/tariff changes under TEX. GOV'T CODE ch. 2003, TEX. WATER CODE ch. 13, and 30 TEX. ADMIN. CODE chs. 80 and 291.

4. Proper notice of the Application was given by Aqua Texas as required by TEX. WATER CODE §§ 13.187 and 13.043; 30 TEX. ADMIN. CODE §§ 291.22 and 291.28; and TEX. GOV'T CODE §§ 2001.051 and 2001.052.

Rate Case Data

5. The application, rate-filing information, and rate case data submitted by Aqua Texas in this case is adequate to support its rate change application and complies with the applicable statutes and rules.

Aqua Texas' Standing

6. TEX. WATER CODE § 13.302 establishes the application requirements for the purchase of stock in a public utility.

7. TEX. WATER CODE § 13.301 establishes the requirements for a sale, transfer, or merger (STM) of a utility.

8. For both STM and stock acquisition applications, the Commission may require that the applicant "demonstrate adequate financial, managerial, and technical capability for providing continuous and adequate service to the requested area and any areas currently certificated to the person." TEX. WATER CODE §§ 13.301(b) and 13.302(b).

9. For both STM and stock acquisition applications, the Commission must determine whether the proposed transaction would serve the public interest and provide for a public hearing if it is necessary to make this determination. TEX. WATER CODE §§ 13.301(d)-(e) and 13.302(d) and (f).

10. A stock acquisition is not a "sale, acquisition, lease, or rental," or a "merger or consolidation," and, therefore, does not necessitate a STM application under TEX. WATER CODE § 13.301(a).

11. Because an application was filed under TEX. WATER CODE § 13.302 prior to the 2003 stock acquisition of the AquaSource companies by PSC, and the ED approved the transaction, no STM application was required under TEX. WATER CODE § 13.301.

12. Aqua Texas has standing to bring the application for rate changes at issue in this proceeding.

Consolidated Tariffs/Regionalization

13. Chapter 13 of the Water Code expresses a strong legislative preference for regionalization in the form of a mandate to the Commission to develop policies promoting the consolidation of systems under regional tariffs. TEX. WATER CODE §§ 13.182(d), 13.183(c), and 13.241(d).

14. Because Aqua Texas has applied for regional water and sewer tariffs, TEX. WATER CODE § 13.145 applies to Aqua Texas' Application.

15. The systems in each of Aqua Texas' seven regional tariffs are substantially similar in terms of facilities, quality of service, and cost of service within the meaning of TEX. WATER CODE § 13.145.

16. Aqua Texas' regional tariffs promote water conservation for single-family residences and landscape irrigation within the meaning of TEX. WATER CODE § 13.145.

17. Aqua Texas has satisfied the requirements of TEX. WATER CODE § 13.145.

Revenue Requirements

18. The invested capital amounts set forth in the Findings of Fact above and attached exhibits are based on the original cost of property used by and useful to Aqua Texas in providing service, less depreciation, in accordance with TEX. WATER CODE ANN. § 13.185.

19. The revenue requirements presented in the Applications, after being adjusted for the modifications required by the above Findings of Fact and as ultimately shown in the attached exhibits, are based on Aqua Texas' reasonable and necessary operating expenses, within the meaning of TEX. WATER CODE ANN. §§ 13.183 and 13.185.

20. The revenue requirements presented in the Applications, as adjusted by the Commission in this proceeding and reflected in the attached exhibits, are sufficient to provide Aqua Texas with a reasonable opportunity to earn a fair and equitable return on its invested capital while preserving its financial integrity, within the meaning of TEX. WATER CODE ANN.§§ 13.183 and 13.184.

21. The rates and fees to be charged by Aqua Texas, as approved by the Commission in this Order, are just; reasonable; not unreasonably preferential, prejudicial, or discriminatory; sufficient; equitable; and consistent in application to each class of customer in accordance with TEX. WATER CODE ANN. §§ 13.182, 13.189, and 13.190.

Termination of Purchased Water Pass-Through

22. With the approval of the application and the adoption of rates in this case, it is no longer appropriate for Aqua Texas to recover any purchased water expenses through a monthly pass-through amount (previously recovered in the amount of $1.00 per customer, per month), except upon later Commission approval.

Deferred Expenses Regulatory Asset

23. Aqua Texas may recover its deferred expenses that have been capitalized as a regulatory asset through a monthly surcharge in the amount of $_____ per customer for _____ months.

Rate Case Expenses

24. Rate case expenses in the amount of $2,492,403.49 through February 19, 2007, were reasonable and necessary expenses within the meaning of TEX. WATER CODE §§ 13.043, 13.084, 13.183(a)(1) & 13.185(d) and (h), and 30 TEX. ADMIN. CODE § 291.31(b).

25. Aqua Texas may recover its rate case expenses through a monthly surcharge of $_____ per customer for _____ months. Recovery of rate case expenses through such a

surcharge complies with 30 TEX. ADMIN. CODE § 291.21(k) for collection of revenues over and above the usual cost of service.

26. Rate case expenses are allocated among all of Aqua Texas' systems equally on a per-customer basis.

NOW, THEREFORE, BE IT ORDERED BY THE TEXAS COMMISSION ON ENVIRONMENTAL QUALITY THAT:

1. The Applications of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc., for water and sewer rate/tariff change are granted as modified by and to the extent set forth in the above Findings of Fact and Conclusions of Law.

2. The request of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc., to apply a surcharge to recover rate case expenses in the amount of $2,492,403.49, to be recovered as a monthly surcharge in the amount of $ _____ to each water and sewer customer for _____ months is approved.

3. Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas are given approval to apply a surcharge to recover the deferred expense regulatory asset in the amount of $_____ that was not allowed in rate base. This shall be recovered as a monthly surcharge in the amount of _____ to each water and sewer customer for _____ months or until fully paid. The surcharge shall be discontinued at such time as the amount of $_____ is recovered.

4. Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas are to discontinue the collection of any pass-through charges from customers for the recovery of purchased

water expenses. No additional purchased water pass-through charges are permitted for the systems covered by this order, except through later Commission approval.

5. Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas shall file a tariff reflecting the rates approved by the Commission within ten days of the date of this Order.

6. Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas shall notify customers by mail of the final rate structure within 30 days of the date of this Order and shall include the statement required by 30 TEX. ADMIN. CODE § 291.28(5) along with the first bill to customers implementing the rates approved by this Order.

7. The effective date of this Order is the date the Order is final, as provided by TEX. GOV'T CODE ANN. §2001.144 and 30 TEX. ADMIN. CODE § 80.273.

8. All other motions, requests for entry of specific Findings of Fact or Conclusions of Law, and any other requests for general or specific relief not expressly granted herein, are hereby denied for want of merit.

9. The Chief Clerk of the Texas Commission on Environmental Quality shall forward a copy of this Order and tariff to the parties.

10. If any provision, sentence, clause, or phase of this Order is for any reason held to be invalid, the invalidity of any portion shall not affect the validity of the remaining portions of the Order.

Issue Date:

TEXAS COMMISSION ON
ENVIRONMENTAL QUALITY

_____

Kathleen Hartnett White, Chairman