SOAH DOCKET NO. 582-08-0698
TCEQ DOCKET NO. 2007-1708-UCR

APPLICATION OF DOUBLE DIAMOND UTILITIES CO. CCN 12087, TO CHANGE ITS WATER RATES AND TARIFF IN HILL, PALO PINTO, AND JOHNSON COUNTIES	§ § § § §	**BEFORE THE STATE OF OFFICE OF ADMINISTRATIVE HEARINGS**

DOUBLE DIAMOND UTILITIES CO. EXCEPTIONS TO THE ALJ'S PROPOSAL FOR DECISION

TO THE HONORABLE COMMISSIONERS:

COMES NOW Double Diamond Utilities Co. ("DDU"), applicant in an Application for Rate/Tariff Change, and files these its exceptions to the Administrative Law Judge's Proposal for Decision ("PFD") in the above captioned matter, and in support hereof would respectfully show the following:

I. Multiple Systems Consolidated Under One Tariff and Rate Design

Double Diamond Utilities ("DDU") takes exception to the ALJ's agreement with White Bluff Subdivision Ratepayers ("WBSR"), the Office of Public Interest Council ("OPIC"), and the Executive Director ("ED") that DDU did not meet the burden of proof with regards to the consolidation of the White Bluff and Retreat water systems under one tariff.[1] DDU disagrees with this finding and asserts that the ALJ has not only ignored clear evidence in the record which supports consolidation, but the ALJ also departs from previous Commission precedent and legislative mandate on this matter.

Texas Water Code ("TWC") § 13.145(a) states that 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 (2) the tariff provides for rates

[1] Proposal for Decision, pg. 18

that promote water conservation for single-family residences and landscape irrigation." Based on TWC §13.145(a) there is a four part test that must be met before two systems can be consolidated under a single tariff:

1. The systems must be similar in terms of facilities;
2. The systems must have a similar quality of service;
3. The systems must have a similar cost of service; and
4. The proposed rates must promote water conservation.

According to testimony on behalf of the ED, DDU has clearly met three of the four above tests in support of consolidation. The ED's witness, Mr. Brian Dickey, states that the White Bluff and Retreat water systems "do appear to have substantially similar facilities and quality of service. Both systems utilize ground water, pressure tanks, ground storage tanks, and distribution lines. Both systems have certified operators on staff to operate and repair the systems. . . . Both systems have an inclining block rate, which generally promotes water conservation for single family residences and landscape irrigation."[2] As such, the record clearly indicates that White Bluff and the Retreat have similar facilities and provide a similar quality of service. Additionally, the current and requested rate designs promote water conservation.

A. Similarity in Cost of Service

In determining similarity in Cost of Service, it is necessary to review prior Commission precedent on what constitutes such similarity. In TCEQ Docket Nos. 2004-1120-UCR and 2004-1671-UCR, 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 ("Aqua Texas Case"), the Commission determined, in Finding of Fact No. 47, that "Aqua Texas' water systems' costs of service are substantially similar within each tariff region . . ."[3] In the Proposal for Decision, which is the basis for the Commission's decision on the matter,

[2] Direct Testimony of Brian Dickey, pg. 4 of 17, lines 13-19
[3] Final Order, pg. 10, FOF 47, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR

the ALJ makes several statements which are important to the consideration of similarity in cost of service.

In the Aqua Texas Case, the Applicant and the ED argue that "the goal of regionalization requires that systems be compared to one another **in a broad context over time**"[4] (emphasis added). In contrast, the Protestants in the proceeding ascribed to a "test year / snapshot" basis which "compares each system to the others within that region based on the state of the system at the time the snapshot is taken."[5] Ultimately, the ALJ concludes 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. TWC § 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 . . . 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 of ratemaking" (emphasis added).[6] The Commission ultimately agrees with the ALJ when they find that "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 . . ."[7]

In direct contrast to the ED's position in the Aqua Texas Case, which is the position which was recommended by the ALJ and ultimately approved by the Commission, in determining substantial similarity in cost of service for DDU, the ED's witness, Ms. Elsie Pascua, uses a test-year / snapshot basis to compare the cost of service per meter equivalent for the White Bluff and the Retreat systems, finding a cost of service per meter equivalent at White Bluff and the Retreat of $30.08 and $77.35, respectively.[8] She then draws the

4 Proposal for Decision, pg. 18, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
5 Proposal for Decision, pg. 24, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
6 Ibid
7 Final Order, pg. 10, FOF 43, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
8 Direct Testimony of Elsie Pascua, pg. 4 of 18, lines 12-13

conclusion that "because the costs of service for the two systems are so different, DDU has not met the section 291.21(m)(1) requirements."[9]

In agreeing with Ms. Pascua's findings, the ALJ has clearly ignored the Commission's precedent in viewing cost of service similarity in a **broad context over time**. It has been clearly illustrated in the record that the Retreat and White Bluff are at different stages of development. The ALJ states in the Proposal for Decision that "the Retreat is a relatively new development with few ratepayers paying the expenses of a system designed to serve more connections."[10] As such, DDU is of the opinion that in order to determine similarity in cost of service over time, one cannot simply examine cost of service per meter equivalent at one point in time to arrive at the appropriate conclusion. A simple example demonstrates this argument:

Table 1

	White Bluff	The Retreat
Permitted Production Capacity (MGD)[11]	0.78	0.72
Permitted Production Capacity (GPM)[12]	541.67	500.00
Original Cost of Plant[13]	$1,167,269	$603,709
Meter Equivalents[14]	679	67
Cost per GPM of Capacity[15]	$2,155	$1,207
Cost per Meter Equivalent[16]	$1,719	$9,015

As seen above, when utilizing the ED's proposed method of examining the cost of system investment on a per meter equivalent basis, the cost is vastly different, with the Retreat's cost per meter equivalent substantially higher than White Bluff. This is the natural result of the two resorts varying stages of development **at this point in time**. White Bluff is more developed and thus has more customers over which to spread costs, resulting in a lower unit

[9] Direct Testimony of Elsie Pascua, pg. 4 of 18, lines 14-15
[10] Proposal for Decision, pg. 19
[11] Exhibit WBSR-20, Line 20
[12] (Capacity in MGD x 1,000,000)/ (24 hours * 60 minutes)
[13] Proposal for Decision, pg. 32
[14] Proposal for Decision, pg. 96
[15] Original Cost of Plant / Permitted Production Capacity (GPM)
[16] Original Cost of Plant / Meter Equivalents

rate. However, when the original cost of the plant is viewed on a gallon per minute ("GPM") of production capacity basis, the result is exactly the opposite. White Bluff, which is more developed and in which more dollars of investment have been made, has a higher cost per unit than the Retreat.

The cost of investment in a system directly correlates to the system's total cost of service in that the fixed costs of the system are a direct result of the plant investment. For example, as plant investment is made, more insurance is necessary to mitigate the risks on that plant investment, greater depreciation expense is incurred, more repair and maintenance will be required, and the return granted the utility will be greater as a result of the greater level of investment. However, as the system grows to serve more customers, the level of fixed costs can be spread over a larger number of customers, driving down the level of fixed cost per customer which results in lower customer rates. Further, due to the similarity in facilities and similarity in the type and quality of service provided, the variable costs of the two systems will also always be similar on a per unit basis. Given the above, because of the similarity in facilities and similarity in the quality of service between White Bluff and the Retreat, which the ED recognizes, when viewed over time, the cost of service for the two facilities will naturally be substantially similar.

As found by the Commission in the Aqua Texas Case, cost of service similarity must be viewed **in a broad context over time**, which the ALJ has clearly failed to do in this proceeding. In the Aqua Texas Case, the ALJs ultimately states that they "do not believe 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 <u>**always**</u> be differences between systems . . ."[17] (emphasis added). Such is the case when comparing White Bluff and the Retreat. The differences claimed by the ED are simply the result of time, not in overall substantial similarity.

Further in the proposal for decision, the ALJ also contends that "by combining the Retreat and White Bluff water systems under one rate, an older, established development

[17] Proposal for Decision, pg. 42, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR

would be subsidizing the newer development. This would not result in water rates that are just and reasonable for the White Bluff ratepayers."[18] However, in the Aqua Texas Case, the Commission found such sharing of costs to be one of the benefits of regionalization. Specifically, in Finding of Fact 42, the Commission found that:

> The benefits of regional tariffs include:
> - Reduced costs resulting from economies of scale;
> - Lower administration and regulatory costs;
> - Increased efficiency;
> - Sharing of expenses between systems resulting in reduced waste;
> - Prevention of dramatic cost / rate increases when repairs are needed because costs are shared over a larger number of customers; and
> - Revenue and expense stability[19]

The Commission further declared in Finding of Fact No. 43 that "[r]egional 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."[20] The ALJ in the Aqua Texas Case further states that "the benefit of regionalization is that the high costs of necessary 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."[21]

In the case of the Retreat, recognizing that denying consolidation of White Bluff and the Retreat will result in significant rate shock, the ALJ states that he "appreciates the position of the McCartneys that the ratepayers at the Retreat may pay higher rates if the Commission requires different rates for the Retreat and White Bluff water systems."[22] However, the ALJ ultimately determines that the very benefits of system consolidation cited by the Commission in the Aqua Texas Case, and desired by the legislature through the passage of Senate Bill 1, are insufficient. DDU believes the ALJ's conclusion to deny consolidation and placing the

[18] Proposal for Decision, pg. 20
[19] Final Order, pg. 9, FOF 42, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
[20] Final Order, pg. 10, FOF 43, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
[21] Proposal for Decision, pgs. 14-15, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
[22] Proposal for Decision, pg. 19

concerns of one ratepayer group over another will ultimately lead to greater financial harm for both ratepayers and the utility and is a direct violation of legislative mandate, stated Commission policy, and Commission precedent.

II. Developer Contributions and the Effect on Invested Capital

The ALJ recommends denial of DDU's application on the grounds that it incorrectly includes developer contributed capital in the calculation of its requested return on invested capital. [23] While DDU admits the record is less than clear on this issue, DDU takes exception to the ALJ's finding that simply because DDU's October 2008 rate application identified developer contributions of $1.9 million, this is sufficient evidence to prove that DDU's level of invested capital in the current proceeding incorrectly includes developer contributions and that the magnitude of this inclusion is so significant as to deny the application on this issue alone.

While 30 TAC § 291.31(c)(3)(A)(iv) & (v) prohibits the inclusion of developer contributions in the requested level of invested capital, depreciation expense on such capital is permitted under 30 TAC § 291.31(b)(1)(B). In this proceeding, DDU did not include developer contributed capital in determining its total net book value in accordance with Table III.B, on page 10 of the rate application.[24] As such, the annual depreciation calculated in this table and requested by DDU does not include depreciation on developer contributed capital, an item to which the utility is entitled to under TCEQ rules.[25] As DDU did not include developer contributions in its calculation of net book value, then there is not a corresponding deduction that needs to occur on Table IV.E, Line E, on page 13 of the application, which explains DDU's entry of $0 on this table.[26] This clearly explains why DDU admits in the record it is the recipient of developer contributions, but at the same time did not remove developer contributions from the requested level of invested capital.

[23] Proposal for Decision, pg. 24-25
[24] DDU Exh. 30
[25] 30 TAC § 291.31(b)(1)(B)
[26] DDU Exh. 30

The ED states that because $1.9 million in developer contributions is included in DDU's October 2008 application, this proves that DDU has failed to remove developer contributions in the current proceeding.[27] However, the ED, and ultimately the ALJ, have failed to compare the two applications on an apples-to-apples basis, resulting in this mischaracterization of DDU's treatment of developer contributed capital. The table below illustrates the proper comparison of these applications:

Table 2		
	August 2007 Application	October 2008 Application
Net Book Value[28]	$1.7 million	$ 3.3 million
Developer Contributions[29]	$ 0	$ 1.9 million
Subtotal	$1.7 million	$ 1.4 million
Less: Additional Depreciation[30]	*$ 0.2 million*	*$ 0*
Subtotal	**$ 1.5 million**	**$ 1.4 million**

As illustrated above, the level of invested capital requested in the 2008 application is similar to the level of invested capital in the August 2007 application, particularly when you consider that to compare the applications on an apples-to-apples basis, an additional year's worth of depreciation must be recognized to compare the applications within the same timeframe.

As previously stated, DDU did not request additional depreciation expense on developer contributions, an amount to which it is entitled. Because of taking the action to exclude developer contributions and requesting a lesser amount of annual depreciation than DDU is entitled, the ALJ proposes to deny DDU's entire application. It is the opinion of DDU that this is a contradiction which inappropriately penalizes DDU. Further, it is DDU's opinion that had the ALJ not relied solely upon a single calculation from a separate rate application as

[27] Proposal for Decision, pg. 24
[28] Proposal for Decision, pg. 32, DDU Rate Application dated Oct. 24, 2008, pg. 10
[29] DDU Exh. 30
[30] DDU Rate Application dated Oct. 24, 2009, pg. 10

justification, the ALJ would have come to a vastly different conclusion and determined that DDU's level of invested capital was just and reasonable.

III. Rate of Return / Return on Invested Capital

With regards to DDU's return on invested capital, the ALJ recommends "that the Commission adopt the methodology utilized by the ED in calculating the invested capital, ROR, and return on invested capital."[31] Notwithstanding DDU's disagreement with the ALJ's recommendation regarding developer contributions and its impact on invested capital as previously discussed, DDU also takes exception to the ALJ's recommendation to utilize the ED's return on invested capital methodology given that the ED has committed serious errors in its methodology and calculations which results in an unjust and unreasonable return on invested capital to DDU.

i. Calculation of Separate Rates of Return for Each Resort

In determining the return on invested capital, the ED has calculated three individual rates of return for each individual resort: 9.75%, 2.34%, and 3.65%, for the Retreat, the Cliffs, and White Bluff, respectively.[32] The ED believes this analysis is necessary as DDU did not demonstrate how the water systems at the Retreat and White Bluff were substantially similar, a belief which DDU refutes and has previously discussed in our response. DDU further believes that this individual calculation is discriminatory and violates previous Commission precedent with regards to regionalization.

In TCEQ Docket Nos. 2004-1120-UCR and 2004-1671-UCR, previously referred to herein as the Aqua Texas Case, the Commission states in Finding of Fact No. 75 that "Aqua Texas' requested **total** rate of return of 8.44% . . . is reasonable in light of the risk inherent in the operation of water and sewer utilities and is consistent with the returns

[31] Proposal for Decision, pg. 51
[32] Prefiled Testimony of Elsie Pascua, Attachment R

available from other investments of similar risk"[33] (emphasis added). It is important to note that in the Aqua Texas Case, <u>three</u> individual water and <u>three</u> individual wastewater revenue requirements are calculated corresponding to the three regions approved by the Commission.[34] However, in the Aqua Texas Case, the ED calculated, and the ALJ recommended, an **overall** rate of return which was applied to the level of invested capital calculated for each region, a methodology approved by the Commission.[35] Yet for DDU, the ALJ recommends the ED's methodology of calculating individual rates of return for each system. Had such a methodology been approved by the Commission in previous cases, then individual rates of return would have been calculated for each individual region approved in the Aqua Texas Case.

As testified to by Mr. Randy Gracy, Double Diamond Utilities is a company which operates public water and wastewater systems in Texas.[36] This is similar to the Commission's findings with regards to Aqua Texas.[37] Double Diamond Utilities maintains a single balance sheet and all utilities contribute to the financial position of the Company.[38] Further, DDU only has one source of debt and equity capital, not multiple sources. However, while the Commission has previously approved an overall rate of return for Aqua Texas, the ALJ recommends individual rates of return for each system operated by Double Diamond. This recommendation is unreasonably discriminatory against Double Diamond, does not recognize the structure, operation, and financial circumstances of Double Diamond Utilities, and is in direct violation of Commission precedent.

ii. Cost of Debt

The ED disagrees with DDU's requested 10% cost of debt under the claim that "DDU's loan transaction was with an affiliated company and with an affiliated interest

[33] Final Order, pg. 15, FOF 75, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
[34] Final Order, pg, 14, FOF 66, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
[35] Proposal for Decision, pg. 62, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR; Final Order, pg. 15, FOF 75, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
[36] Prefiled Testimony of Randy Gracy, pg. 1, Line 13
[37] Final Order, pg. 1-2, FOF 1, 2 and 3, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
[38] Prefiled Testimony of Kevin Shea, pg. 1, Line 24-29

and was not an arm's length transaction."[39] The ED goes on to state that an interest rate of 4.87% is reasonable; however, the ED does not provide any justification as to why this rate should be considered reasonable.[40] No calculation of this rate is provided, nor is any citation offered in the record to the genesis of this rate. While DDU recognizes that the burden of proof is on the utility, the ALJ appears to be content to disregard the Company's request in favor of a random number which is significantly lower. DDU would also note that this rate is lower than the current Baa public utility bond average of 6.48%.[41] On its surface, this recommendation by the ALJ appears to be unreasonable and discriminatory.

iii. Return on Equity

The ED also disagrees with DDU's requested 12% return on equity and recommends 10.48% for the Retreat and 8.48% for the Cliffs and White Bluff.[42] Notwithstanding DDU's disagreement on the need for individual rates of return for each system, DDU believes that the granting of a return on equity below 12% violates clear precedent set by the Commission. While Ms. Pascua utilized the rate of return worksheet to calculate the recommended return rates, she admitted in the record that in a previous case, when utilizing the rate of return worksheet as in this proceeding, despite the result of the calculation she still recommended a 12% return.[43] The ED's actions of calculating a lower rate of return but recommending a higher rate of return for one utility, while not performing the same action for DDU, appears on its surface to be unreasonable and discriminatory.

Further, the Commission previously found in the Aqua Texas Case that "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."[44] Further, in the Proposal for Decision in the Aqua Texas

[39] Proposal for Decision, pg. 47
[40] ibid
[41] Prefiled Testimony of Elsie Pascua, Attachment R
[42] Prefiled Testimony of Elsie Pascua, Attachment R
[43] Hearing on the Merits Transcript, Volume 1, Monday, February 23, 2009, pg. 194, Lines 16-19
[44] Final Order, pg. 15, FOF 73, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR

Case, the ALJ cites a listing of **many** past TCEQ water or sewer ratemaking actions in which the Commission allowed a 12% return on equity[45] (emphasis added). The ALJ concludes from this list that "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"[46] (emphasis added). It is abundantly clear that while the ALJ does not agree with a 12% return on equity, the Commission has consistently upheld this level of return as consistent with the risk involved in the water utility business.

iv. Calculation of Weighted Average Return

As previously mentioned, the ALJ recommends that the Commission adopt the ED's recommended rate of return for the three individual water systems.[47] However, in the ED's calculations for the Cliffs and White Bluff, the ED has inappropriately reduced the rate of return and not allowed sufficient return for the utility to recover the cost of its debt. For example, the following calculation is provided by the ED for The Cliffs:

Table 3[48]

	Capital Structure			
	Amount	%	Cost of Capital	Weighted Average Cost of Capital
Debt	$112,550	170.18%	4.87%	8.29%
Equity	$ -46,414	- 70.18%	8.48%	-5.95%
Total	$ 66,136	100.00%		2.34%

In the above example, if this calculation is utilized as is recommended by the ALJ, the utility is being punished for having negative equity; negative equity meaning the utility owes more than what it owns. If the Commission approves the above calculation, the utility will not even cover its cost of debt (i.e., the interest cost on the amount borrowed). As an example, assuming the ED's proposed level of total invested capital for The Cliffs, $66,136, and unreasonably low cost of debt, 4.87%, then the interest cost

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[45] Proposal for Decision, pg. 64, footnote 160, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR; Final Order, Pg 15, FOF 75, TCEQ Docket No. 2004-1120-UCR and 2004-1671-UCR
[46] Ibid, pg. 64
[47] Proposal for Decision, pg. 51
[48] Prefiled Testimony of Elsie Pascua, Attachment G

of the Utility's debt for this system is approximately $3,221 ($66,136 * 4.87%). However, because the ED applied a positive return on equity to a negative equity number and reduced the overall rate of return, the utility would only recover $1,548 ($66,136 * 2.34%) in total return, which is over 50% less than what it needs to recover just the interest cost of its borrowings. In essence, the ALJ's recommendation would make it impossible for the utility to pay even the interest cost on the money it has borrowed even at the ED's proposed cost of debt, a situation which is unconscionable for a utility that has already demonstrated for the record that it has been operating at a loss for the last several years.[49] The ALJ's recommendation to follow the ED's methodology is a clear violation of 30 TAC §291.31(c)(1)(A) which allows a utility the reasonable opportunity to earn a reasonable rate of return to assure confidence in the financial soundness of the utility. The ALJ's recommendation would make it impossible for the utility to attract capital by failing to give the utility even the opportunity to recover the cost of its borrowings. Under this recommendation, the Utility would be unable to maintain and support its credit and would further be unable to raise the money necessary for the proper discharge of its public duties.

IV. Operation and Maintenance Expenses

The two components of cost of service, upon which rates are based, are allowable expenses and return on invested capital.[50] Allowable expenses include, but are not limited to (i) operations and maintenance expense incurred in furnishing normal utility service and maintaining plant used by and useful to the utility in providing that service and (ii) depreciation expense based on original cost.[51]

DDU takes exception to the allocation of costs by both the ED and the ALJ which leads to the reduction in expenses attributable to water service, as will be described in detail below.

A. <u>Salary or Contract Services / Payroll Taxes</u>

[49] Proposal for Decision, pg. 92
[50] Tex. Admin Code §291.31(a).
[51] Tex. Admin. Code §291.31(b)(1)(A)-(B).

DDU believes that the ALJ and ED recommended excessive reductions in salary and wage expense. The Water Code does not prescribe a single method for allocating expense between water and wastewater systems. The ALJ and ED rely on a 60/40 split based upon division of labor statistics cited in DDU's discovery responses.[52]

However, an examination of DDU's statement of operations[53] demonstrates that the reduction in salary expenses recommended by the ALJ and ED were excessive. Mr. Gillespie testified, where one is not able to calculate exactly, an applicant may use an allocation process that is representative.[54] In this particular case applicant used the ratio of billings from wastewater and the billings from the water utility.[55]

If this method is applied to DDU statement of operations it gives a more representative view of allowable expenses incurred by DDU. For example, the ratio of billings used by Mr. Gillespie was 77.6% for the water system as compared to the wastewater system. The DDU Statement of Operations for the test year 2006 lists total actual compensation for DDU in the amount of $229,575. This amount may be reduced properly for allocation between water and wastewater systems by Mr. Gillespie's methodology by multiplying this amount by 77.6%, resulting in $178,510.20. As Mr. Gillespie testified to this methodology at hearing, DDU believes that this is the minimum amount that should be used for its allowable salary expense should the Commission not accept the application on its face.

B. <u>Purchased Water</u>

DDU has no exceptions to the ALJ recommendation as it pertains to purchased water.

C. <u>Chemicals</u>

[52] Proposal for Decision, pg. 60
[53] ED Exh. 1, Att. S
[54] Instructions, Application for a Rate/Tariff Change, pg 3
[55] Hearing on merits, Tr. Pg.97 lns. 5-12

It is not in dispute that DDU had $14,853.65 in water expenses.[56] Both the ALJ and ED allocated this amount equally between water and sewer. As discussed above, DDU believes that if the Commission does not accept the application as submitted, if a relative billings allocation is used it is a more representative depiction of water expenses. This would result in an allowed water expense of $11,526.71 ($14,584 x 77.6%).

D. <u>Utilities (Electricity)</u>

DDU has no exceptions to the ALJ recommendation as it pertains to utilities(electricity).

E. <u>Repairs/Maintenance/Supplies</u>

DDU disagrees with the ALJ's recommendation that the Commission utilize the ED's analysis regarding allowable expense for repairs, maintenance, and supplies. In examples presented below, DDU believes the ALJ's analysis ignores evidence in the record demonstrating unreasonable expense deductions by the ED. Testimony by ED at hearing demonstrates a varying standard, which the ALJ fails to adequately address in the PFD. The ALJ cites to DDU's closing then elects not to address the specific points raised by DDU.[57]. Throughout the hearing, ED testimony demonstrates the unreasonable standard applied to certain expenses supported by invoice or other documentation. It appears from analysis of ED that there is a presumption of deceit in corporate accounting practices of an applicant. For example:

- The Cliffs: Toray membranes installed: $12,046 invoice, but ED Ms. Pascua stated that despite the supporting documentation provided that she needed further explanation because, "I don't know what this is for."[58] The supporting documentation is there, but

[56] Proposal for Decision, pg. 63

[57] Proposal for Decision, pg. 70-71; ALJ summarizes specific arguments raised by DDU in objecting to specific expense reductions by ED, then uses DDU Exhibit 38 to refute these arguments. DDU Exhibit 38 is a "generalization" document that was entered into evidence during rebuttal to give a broad overview of the scope of expense reductions by ED. Exhibit 38 is completely unrelated to the arguments re: specific line items cited by the ALJ.

[58] Hearing on Merits, Tr. Pg.183, Ln. 9-11

ED and the ALJ both completely discount the judgment of utilities and accounting personnel in categorizing this expense and ignores the preponderance of evidence.

- The Cliffs: Shelco Filter housing: $11,158 invoice, but ALJ and ED both contend that the invoice did not demonstrate whether this was an expense or an asset.[59] Again, despite the fact that the invoice matches the amount claimed as expense by DDU, the ALJ and ED completely discount the judgment of utilities and accounting personnel in categorizing this expense. DDU contends that this is an unreasonable standard applied to supporting documentation and ignores the preponderance of evidence.

- White Bluff: Repairs and maintenance, water plant, pull and inspect motor pipe - $14,581.95.[60] Ms. Pascua testified that she concurred with the engineer and that this amount should be moved to the asset schedule and depreciated over time.[61] DDU contends the physical act of "pulling and inspecting" constitutes an expense and not a depreciable asset.

- White Bluff: Electrical Bid for ratio control; front wells- $3,550 invoice.[62] Again, despite a matching invoice and ledger supporting this expense, the ALJ and ED completely discount the judgment of utilities and accounting personnel in categorizing this expense. DDU contends that this is an unreasonable standard applied to supporting documentation and ignores the preponderance of the evidence.

These four examples above alone constitute $41,335.95 which should be reinstated into DDU's allowed R&M expenses in the application, raising it at a minimum to an amount of $149,144. Both the ALJ and ED applied an unreasonable standard to the supporting documentation presented by DDU.

59 Proposal for Decision, pg. 68
60 Ex. ED-1, Pg. 67; Hearing on Merits Tr. Pg.187, Ln. 4-22
61 Hearing on Merits, Tr. Pg. 187, Ln. 19-22.
62 ED Exh. 1, pg. 14, ln. 14-16; Att. V, pg. 4.

Alternatively, an examination of DDU's statement of operations under the relative billings method it gives a more representative view of allowable expenses incurred by DDU than that recommended by the ALJ and ED. For example, the ratio of billings used by Mr. Gillespie was 77.6% for the water system as compared to the wastewater system. In this instance DDU's Statement of Operations shows R&M expenses of $204,161 for the test year 2006.

Category	Amount	77.6% Adjusted
R&M Water Plant (100% water)	$177,300	$177,300
R&M distribution lines (100% water)	$16,253	$16,253
R&M Equipment (77.6% water)	6,773	$5,256
R&M building (77.6% water)	$179	$139
Water tests (100% water)	$3,656	$3,656
	TOTAL	$202,604

DDU believes that if the Commission does not accept its application as submitted, that $202,604 is a more representative depiction of allowable R&M expenses than those recommended by the ALJ and ED.

F. Office Expenses

DDU does not have any exceptions to recommendation of the ALJ as it pertains to office expenses.

G. Insurance

DDU does not have any exceptions to recommendation of the ALJ as it pertains to insurance expenses.

H. Rate Case Expense

The ALJ and ED conclude that DDU is not entitled to any rate case expense since they recommend a rate that results in less than 51% of the revenue that the rates proposed by

DDU would generate.[63] DDU believes that by these exceptions to the PFD it has demonstrated a number of unjustified reductions taken by the ED and recommended by the ALJ, and that reinstating such reductions would increase the revenue raised significantly, making such rate case expense recoverable under Tex. Admin. Code §291.28(8).

I. Payroll Taxes:

The ALJ and ED both recommend that DDU recover nothing for payroll expense.[64] However, if one applies the relative billings method to the test year statement of operations payroll burden, it results in payroll taxes of $22,413. ($28,883 x 77.6%). DDU concedes that the application is in error regarding payroll taxes and contends that $22,413 is a more representative expense amount.

J. Federal Income Taxes

As discussed elsewhere in these exceptions, DDU has demonstrated that its calculations of return, total invested capital, and weighted cost of debt capital are proper and that the ALJ and ED were incorrect in their analysis and recommendations regarding the same. However, the ALJ states that DDU did not meet its burden of proof on these items and relies upon this to recommend reducing this expense from $5,206 to $2,121, which matches the ED recommendation.[65] The ALJ's analysis is erroneous regarding return, total invested capital, and weighted cost of debt capital, as DDU argued in prior sections of these exceptions, and as such any reductions in federal income tax expense are unwarranted.

K. Annual Depreciation and Amortization

As part of its application, DDU completed the TCEQ promulgated depreciation schedule for General Items and each resort (White Bluff, Retreat, and Cliffs). In addition, as part of its prefiled testimony DDU included its internal depreciation schedule for the company as a

[63] Proposal for Decision, pg. 78.
[64] Proposal for Decision, pg. 80-81.
[65] Proposal for Decision, pg.87

whole.[66] The ED recommended a number of reductions in total claimed original cost. In such instances ED stated that no documentation was provided, or the documentation provided was insufficient. The ALJ agreed with the recommendations of ED if the application was not denied outright.

DDU believes that the analysis of ED and the ALJ is flawed and applies an unreasonable standard of documentary proof in a number of instances, each of which will be addressed in turn.

The Retreat:

Wells - There are two wells at the Retreat. ED allowed one well installed in March 2005 in the amount of $58,942, but did not recognize the well installed in December 2003 with an original cost of $98,363.[67] However, the depreciation schedule submitted as DDU Exhibit 12 contains a matching entry for this well and DDU Exhibit 26 lists matching entries for this well under Job # 6021 and 6036 (first 2 entries). In addition, DDU Exhibit 23, a job cost usage detail, represents the installation of this well.[68] The December 2003 well was not recognized because DDU could not locate invoices dating to 2003 for this job, however DDU believes it is reasonable to include this asset based on the other documentation submitted as part of the exhibits referenced above and the fact that its existence and use was verified by ED staff on a site visit in November 2008.

Well Pumps - Each well discussed above also has a well pump associated with it which were schedule in the amounts of $26,280 and $24,525 respectively.[69] Neither of these items are recognized by ED for lack of an invoice. At a minimum, DDU believes it is reasonable to recognize the associated well pump for the well which ED accepted.

White Bluff:

[66] DDU Exh. 12.
[67] ED Exh. 2, pg. 7, ln. 16, Att. C.
[68] Total cost $368,793; water utility share of $98,363.
[69] ED Exh. 2, Att. C.

Wells - There are 4 wells at White Bluff. Well #4 was installed in September 2001 at an original cost of $222,306.[70] Of this original cost an amount totaling $102,306 was scheduled by DDU and accepted by ED staff. Charles Gillespie used a deflationary scale to calculate a reasonable value for wells #1 through #3, as original invoices dating back to the period ranging from 1990-1999 could not be located. Based on the original cost of well #4, deflationary values were calculated as follows:

Item	Deflation Factor	Adjusted Total Cost	Diameter Factor*	Amount Scheduled
Well #3	7%	$206,460	0.5	$98,660
Well #2	10%	$200,000	0.5	$88,750
Well #1	15%	$188,700	0.5	$73,700

*Wells 1,2,and 3 are smaller diameter wells than well #4 and cost was reduced accordingly. The full amount of the deflated original cost was not claimed by DDU.

DDU believes that absent original invoice documents which were unable to be located, the deflationary method of attaching value to the original cost of these assets is a reasonable substitute for original invoices from 1990-1999.

Water Tank - DDU also included a water tank in its application in the amount of $96,240. The particular water storage tank was scheduled on DDU's internal depreciation schedule in the amount of $98,182.00.[71] In testimony at hearing, ED stated that the asset was disallowed because "there was not a ground storage tank in the application in the amount of $98,182.00."[72] ED acknowledged performing a site visit and visually inspecting storage tanks.[73] Also, a job cost usage detail and supporting invoices for the water storage tank were provided to ED in support of its application.[74] DDU believes the ALJ incorrectly concurred with ED's conclusion regarding this storage tank.

There is a discrepancy of $1,942.00 between the job cost usage detail and the amount scheduled in the application. Also, the internal depreciation schedule which was used to

[70] DDU Exh. 12 "White Bluff Water Well #4".
[71] App. Ex. 12, pg. 1.
[72] Tr. Pg. 231, Ln. 11-12.
[73] Tr. Pg. 230, ln.1-10.
[74] Generally DDU Exh. 16.

prepare the application lists the date of acquisition as 1999, while the supporting invoices are dated in 2000. These two minor discrepancies were sufficient justification in ED's view to completely disallow the entire amount, despite the supporting invoices clearly demonstrating costs for a water storage tank. No water storage tanks have been installed at White Bluff since that time. DDU believes it is reasonable to conclude that sufficient documentation was provided and entered into evidence for a minimum of $96,142.00 to be included in its application depreciation schedule.

Structures - Under the entry "Structures" on the ED form depreciation schedule, DDU included water system improvements in the amount of $8,882. This corresponds to DDU's internal depreciation schedule.[75] Additionally DDU entered into evidence a job cost usage detail with supporting documentation in the form of a check copy and accounts payable coding form in the amount of $8,882.68.[76] This exhibit clearly has notations of "water system improvements" and references to White Bluff. ED disallowed this asset because in its opinion this supporting documentation was insufficient.[77]

The ALJ incorrectly concurs with ED's conclusion regarding this asset. The ALJ asserts that the supporting documentation entered into evidence does not provide sufficient support because there is no reference to "Structures" in either the job cost usage detail, the check made in payment, or the accounts payable coding form.[78] The ALJ also references the words "Engineering – Water System improvements at WB" and "Engineering Wtr system" contained in DDU's exhibits as an example of inconsistency on the part of DDU's accounting documents and lack of support for the asset scheduled under the heading "Structures."[79]

What the ALJ ignores is the fact that "Structures" is a pre-printed term on the TCEQ mandated form for a depreciation schedule. In real estate, a structure constructed on a piece of real estate is referred to universally as an "improvement." The ALJ is improperly

[75] DDU Exh. 12, Pg. 1, "water system improvements"
[76] DDU Exh. 14.
[77] Hearing on Merits, Tr. Pg. 223, Ln. 9-21
[78] DDU Exh. 14.
[79] Proposal for Decision, pg. 39-40.

penalizing DDU for not using the word "structures" in its accounting system and forms. It cannot be denied that the following items match on the DDU depreciation schedule, the DDU job cost usage detail, and the application regarding this asset: (1) amount, (2) date, and (3) location. By any measure of what is reasonable, one would conclude that this asset is supported by a preponderance of the evidence.

To summarize, DDU believes that it has shown by its exceptions above that ED and ALJ applied an improper standard when analyzing the assets listed on DDU's depreciation schedule. This practice resulted in improper reductions in DDU's invested capital and results in an unreasonable rate of return for the utility.

L. Financial Integrity

The ALJ stated that DDU offered evidence that the company as a whole had been operating at a loss for the last several years, however concludes that DDU did not distinguish between losses attributable to the water systems and the wastewater systems.[80] However, this analysis does not face the reality that one cannot distinguish between wastewater and water systems in such a situation. The fact is, the wastewater system is losing money as well and a rate increase application that is not part of the record in this case has been filed. DDU finds it ironic that in virtually all categories of expense, the ALJ concurred with recommendations put forth by ED that applied some method of allocation based on either a 60/40 or 50/50 split, however the ALJ elects not to apply such standard to the income (or loss) side of the ledger. This action further represents the unreasonable standard applied to DDU in this case and illustrates the complete disregard for the Utility's financial well-being.

Regardless, denying DDU's application and proceeding as the ALJ recommends will force the applicant to return more money than it has collected through the rates in the application, continuing a cycle of loss for the utility. I would remind the Commission that the Water Code allows a utility only a return that is *reasonably* "sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the

[80] Proposal for Decision, pg. 92.

money necessary for the proper discharge of its public duties."[81] It is DDU's position that the ALJ's recommendation does not permit it to raise the money necessary to fulfill its public duties, and could threaten the utility with financial collapse.

By its exceptions herein, DDU has demonstrated how the ALJ's analysis is incorrect with regards to (i) the inclusion of developer contributions in invested capital, (ii) consolidation of multiple systems under one tariff and rate design, and (iii) methodology for calculating rate of return/return on invested capital. DDU has further shown that its operation and maintenance expenses are reasonable by demonstrating how the ALJ has ignored the preponderance of the evidence in many instances and applied an improper standard when disallowing expenses of DDU.

Consequently, having demonstrated that developer contributions are not included in this application, having proved the cost of capital, and having shown that its operation and maintenance expenses are reasonable, DDU contends that the Commission must consequently conclude that the rates requested in its Application for a Rate/Tariff Change are reasonable and are necessary to maintain the financial integrity of the utility in accordance with the standards in the Water Code.

M. Refund

The ALJ recommends that the application be denied and that DDU be ordered to refund any amounts collected that exceed the rates ordered, plus 6.00 percent interest, citing Texas Water Code §13.187(i) as authority. However, this section of the Texas Water Code also permits the Commission to order that any sums collected during the pendency of the rate proceeding in excess of the rate finally ordered be credited against future bills.[82]

If the Commission orders a rate different than that applied for, DDU believes that crediting amounts against future bills is the most equitable method to account for excess

[81] TEX. ADMIN. CODE §291.31(c)(1)(A).
[82] TEX. WATER CODE §13.187(i).

sums collected. Such credits should be applied over an equal fifteen month period over which they were collected to avoid a potentially catastrophic financial impact on the utility. Any order to credit excess amounts collected over a shorter period could effectively halt all revenue flow to the company for a period of time and would adversely effect the daily operations of DDU.

Further DDU believes that any order that includes a credit of interest to ratepayers would unjustly punish the applicant. As argued above in regards to financial integrity, there is already evidence in the record showing that DDU has consistently suffered net losses for several years.[83] Any order to credit excess amounts collected plus interest would force applicant credit more than it has collected and constitute an unjust risk to the financial integrity of the utility.

V. CONCLUSION

In conclusion, it is abundantly evident that the ALJ's proposal that the Commission approve the ED's methodology in calculating invested capital, rate of return, and return on invested capital will not allow the utility the opportunity to earn a reasaonble rate of return or one that will assure the financial soundness of the utility. The ED incorrectly calculates individual rates of return for each system instead of an overall rate of return for DDU. The cost of debt recommended by the ED is significantly lower than that requested by DDU without any type of analysis or justification. The return on equity recommended by the ED is in direct contradiction to prior Commission precedent. Finally, the ED's methodology does not allow the utility to even recover its cost of debt and unfairly penalizes the Utility for having negative equity, a result that would only further perpetuate the Utility's financial position. If the ALJ's recommendation is adopted by the Commission, the financial integrity of DDU will be challenged, potentially creating a situation where the Utility will be unable to meet its obligation to provide continuous and adequate service to its customers.

Further, DDU has demonstrated how ED applied an unreasonable, arbitrary, and varying standard to it analysis of DDU's operation and maintenance expenses and cost of invested

[83] DDU Exh. 34

capital. In a number of examples, ED and the ALJ disregard the documentary support provided by DDU that supported expenses and cost of capital by a preponderance of the evidence or a "reasonableness" standard.

VI. PRAYER

WHEREFORE, PREMISES CONSIDERED, Applicant respectfully prays that the Commissioners of the TCEQ accept Applicant's Application for Rate/Tariff Change.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I certify that a true and correct copy of Double Diamond Utilities, Co.'s Exceptions to the ALJ's Proposal for Decision was forwarded to the parties listed below in the manner indicated on July 3, 2009 to:

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