

SOAH DOCKET NO. 582-09-2069  
TCEQ DOCKET NO. 2008-1811-UCR

APPLICATION OF SOUTHERN WATER  
CORPORATION FOR A WATER AND  
SEWER RATE/TARIFF CHANGE IN  
HARRIS COUNTY

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BEFORE THE STATE OFFICE

APPEAL OF SOUTHERN WATER  
COMPANY FROM A WATER AND  
SEWER RATE-MAKING DECISION OF  
THE CITY OF HOUSTON

OF

(SEWER CCN NO. 20500 WATER CCN  
NO. 11389)

ADMINISTRATIVE HEARINGS

SOAH DOCKET NO. 582-09-2069  
TCEQ DOCKET NO. 2008-1811-UCR

IN RE: APPEAL OF SOUTHERN  
WATER CORP FROM A WATER AND  
SEWER RATEMAKING DECISION OF  
THE CITY OF HOUSTON

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BEFORE THE STATE OFFICE OF

ADMINISTRATIVE HEARINGS

**SOUTHERN WATER CORPORATION'S EXCEPTIONS TO  
THE PROPOSAL FOR DECISION**

Southern Water Corp (SWC) files its Exceptions to Administrative Law Judge Thomas Walston's (ALJ) Proposal for Decision (PFD) in the above-referenced rate change application and rate appeal. For the reasons set forth below, SWC believes it has met its burden of proof under the controlling preponderance of the evidence standard and is generally entitled to the rate relief it requested of the Texas Commission on Environmental Quality (TCEQ) and City of Houston (City), with some adjustments agreed to in these exceptions.

SWC accepts all of the ALJ's proposed adjustments to its requested cost of service and rate design except for those specific items discussed below. SWC would note that its legal name on file with the Texas Secretary of State is "Southern Water Corp" and not "Southern Water Corporation."

**IV(B)(1) Rate of Return (PFD pg 39)**

The ALJ has proposed adopting the returns on equity proposed by the Executive Director's (ED) accounting witness Leila Guerrero-Gantioqui. In reaching his conclusions, the ALJ listed the portions of the Water Code and TCEQ rules which he believes control the calculation of return on equity. Judge Walston omitted the controlling law which governs all utility ratemaking in the United States. That law is found in the US Supreme Court's decisions in *Bluefield Water Works Co. v. Public Service Commission*, 262 U S 679 (1923) and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U S 591 (1944).

In those cases, the Court established a capital attraction and financial integrity standard which the Water Code and the TCEQ rules must follow. The Court said:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. *Bluefield Waterworks & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-693 (1923).

From the investor or company point of view, it is important that there be enough revenue not only for operating expenses, but also for the capital costs of the business. These include service on the

debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

As described in the PFD, the testimony of SWC's witness John Martin is directly on point with the Supreme Court's standard. Mr. Martin testified:

First, 12% is the default presumptive return on equity in the instructions of the TCEQ rate change application. **(Bluefield's comparable return test and Hope's comparable return test)**

12% is the rate of return the TCEQ is approving for other IOUs in recent years. **(Bluefield's comparable return test and Hope's comparable return test)**

Because of these two TCEQ actions, 12% has become the capital attraction rate of return for Texas water and sewer IOUs. **(Bluefield's comparable return test and Hope's comparable return and capital attraction tests)**

Finally, 12% is the return which has induced the shareholders of this utility to reinvest earnings to build up capital improvement reserves. **(Hope's comparable return and capital attraction tests)**

This has created useful financial reserves which will alleviate the need to borrow money in today's restricted capital markets if a well needs reworking or the sewer plant needs an overhaul. **(Hope's financial integrity test)**

Mr. Martin's testimony clearly meets the test of Water Code §13.184(a) – not more than a fair return – because SWC is only asking for the same return earned by other utilities in Texas. The efficiency tests of Water Code §13.184(b) were addressed through SWC's presentation on cost of service and how the utility seeks to operate efficiently. Contrary to the ALJ's assertion, SWC also presented evidence to address the standards

of Rule 291.31(c)(1). Other than the testimony of Mr. Martin quoted above, this portion of SWC's evidentiary case was not neatly compartmentalized under the return heading, but was found throughout the cost of service testimonies and exhibits.

In contrast, the Rate of Return Worksheet used by Ms. Gantioqui does not address the US Supreme Court's standards. Ms. Gantioqui showed no professional knowledge of this controlling body of law. As she quite candidly stated under cross examination, Ms. Gantioqui approaches the calculation of return on a check list basis. She is given a bond yield number by an unidentified "someone in her Section." She does not know how this bond yield is calculated or what it means. Ms. Gantioqui then checks off items on the Worksheet that she thinks might apply to the applicant utility. She admitted under oath that she made errors in her check offs.

Ms. Gantioqui did not present the Rate of Return Worksheet as a qualified risk premium analysis or any other generally accepted method of calculation equity return. She had no professional or personal knowledge of what a Baa Bond Yield is or how it relates to return on equity. No attempt was made to demonstrate that the Rate of Return Worksheet addressed any equity return criteria in the Water Code and rules as cited by the ALJ.

That form states:

### Rate of Return Worksheet

Step		<input type="checkbox"/>	%
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<b>A</b>	<b>Most current Baa Public Utility Bond average. (Call TCEQ staff at 512/239-4691 to get this number.)</b>		
<b>B</b>	<b>Add 2% - for utilities with 200 or less customers</b>		
<b>C</b>	<b>Add 1% if the utility can demonstrate that it has both:</b>		
	<b>1</b>	<b>Debt/equity ratio is greater than 60% (Table IV. D. — Box ② ÷ Box ③) AND</b>	
	<b>2</b>	<b>No affiliated companies with access to revenues or other funds to support utility operations</b>	
<b>D</b>	<b>Add 1% if the utility can demonstrate that it has at least 2 of the following 4 conditions:</b>		
	<b>1</b>	<b>unstable population - Weekender/seasonal population:</b> a. >25% of total customers; <b>OR</b> b. >10% of total customers and do not use seasonal reconnect fee;	
	<b>2</b>	<b>commercial customers account for more than 15% of revenues</b>	
	<b>3</b>	<b>low growth</b> a. less than 5% customer growth over the last three years; <b>OR</b> b. documentation of potential customer growth of less than 5% over the next three years; declining population	
	<b>4</b>	<b>aging system</b> a. more than 50% depreciated; <b>OR</b> b. low rate base (<\$500/customer)	
<b>E</b>	<b>Add 1% if the utility is a stand alone sewer system with no agreement for either billing and collection or discontinuance for nonpayment with the water supplier.</b>		
<b>F</b>	<b>Add 1% if the utility can demonstrate that it has at least 3 of the 4 following conditions:</b>		
	<b>1</b>	<b>Number of complaints</b> 2 complaints or less per year to TCEQ for less than 200 customer system	
	<b>2</b>	<b>No major deficiencies in the most recent PWS inspection report</b>	
	<b>3</b>	<b>No current or prior enforcement actions under current management within the last 3 years</b>	
	<b>4</b>	<b>Good faith efforts to solve any current problems</b>	
<b>G</b>	<b>Add 1% if the utility can demonstrate that it has at least 4 of the following 5 conditions:</b>		
	<b>1</b>	<b>well-maintained, up-to-date books and records</b>	
	<b>2</b>	<b>effective communications and good customer relations</b>	
	<b>3</b>	<b>consistently timely in meeting reporting requirements (ex. annual reports for last 3 years) and payment of fees</b>	
	<b>4</b>	<b>exhibit fiscal responsibility with respect to rate filings, including completeness, accuracy and frequency</b>	
	<b>5</b>	<b>Less than 12% unaccounted for water - (Section VIII of the Application - Page 16 of 41)</b>	

H	Add 1% if the utility can demonstrate that it has at least 4 of the following 5 conditions:		
	1	rate structure - any two of the following a. zero gallons included in minimum bill b. gallonage rate set high enough to encourage conservation (> \$2.00/1000 gal.) c. use of inclining blocks, i.e. higher use pays higher cost	
	2	drought contingency plan included in tariff and enforced (if applicable)	
	3	conservation plan including encouragement of the use of water conserving devices, efficient lawn watering, or xeriscaping	
	4	program to educate the customers about the nature of the system, its production and distribution ability, PWS standards, and the need for water conservation	
	5	unaccounted for water a. greater than or equal to 10% and or b. successful program to reduce losses (ex. leak detection & repair) (within last 3 years 25% reduction since program implemented)	
I	Total Rate of Return %		

SWC respectfully submits that the Rate of Return Worksheet is an invalid tool and cannot be used to calculate the equity return of a Texas water/sewer utility. Contrary to the ALJ's assertions, SWC has presented a preponderance of the evidence on equity return under the legal standards the TCEQ must follow. Since the utility has no debt in its capital structure, SWC should be granted a 12.0% return on its invested capital.

This change in return will also change federal income taxes. These should be recalculated using the methodology in the rate change application form with the other items in Judge Walston's proposed costs of service.

### Refunds and Surcharges

Although he does not present any discussion in the PFD on the issue of refunds or surcharges of the difference between collected rate revenues and the final approved

rate, Judge Walston does present FoF 95 in which he concludes that SWC has over collected rates during the pendency of this case. No record evidence is cited to support this finding. Judge Walston has found that "Under the Application [the errata application], the proposed rate increases were effective August 1, 2008." [FoF 8] SWC does not dispute this finding. However Judge Walston goes on to find in FoF 15 that the proposed rates were implemented on August 1, 2008. This is incorrect factually and as a matter of law. Under Water Code §13.187(a) proposed rates may not be implemented until sixty days after the noticed effective date. There is no record evidence that SWC violated this prohibition.

Judge Walston is in error and his findings on refunds must be rejected. They are based solely upon supposition. While a utility may begin charging its proposed rates sixty days after the noticed effective date under Water Code §13.187(a), nothing in that statute mandates that the rates be changed at that time. Forgetting that this was also a municipal rate appeal, Judge Walston supposed that SWC exercised the options available in the Code to bill the proposed rates. SWC did not.

The ALJ's proposed findings overlook what the City did during the pendency of this consolidated docket to the rates of almost all the customers. The City of Houston suspended SWC's in-city rate increase before the noticed August 1, 2008 effective date. The City then implemented new rates effective November 1, 2008 before the suspension expired. [Ordinance No. 2008-970 citing Ordinance No. 2008-616] SWC never implemented its proposed rates when it filed its applications with the City and the

TCEQ. [SWC presented no evidence that it charged the proposed rates and it can find nothing in the other parties' evidence that suggests the contrary.] Rates in the SWC service area were not changed until November 1, 2008 when the City's final rates went into effect. [Out of an abundance of caution now that this unexpected issue has arisen, SWC requests the TCEQ to take official notice of City of Houston Ordinance No. 2008-970 under TRE 204, a true copy of which is already in this record as part of the petition of appeal.]

This is not a refund situation. When Judge Walston's final costs of service are calculated, they will result in rates in excess of those approved by the City. Pursuant to Water Code §13.043(a), the TCEQ should authorize surcharges of the lost revenues. SWC suggests that these surcharges be made over twenty-four months, the normal period for rate case expense surcharges. SWC agrees to file periodic reports on the collection of these surcharges.

### **Revised Findings of Fact and Conclusions of Law and Order Provisions**

SWC respectfully submits that the following Findings of Fact (FoF) and Conclusions of Law (CoL) should be amended as shown below:

1. Existing FoF 2. Change to, "On May 29, 2008, Applicant submitted to the City of Houston (City) an application for a water and sewer rate/tariff change for those portions of its certificated service area inside the City.

2. New FoF 3. Add, "On May 29, 2008, Applicant submitted to the Commission an application for a water and sewer rate/tariff change for those portions of its certificated service area outside the City's corporate limits."

3. Existing FoF 8. Change finding to, "There are two effective dates in this consolidated docket. The effective date of the proposed rates in the City appeal is August 1, 2008. The effective date of the proposed rates in the environs rate case is August 1, 2008."

4. New FoF 10. Add, "The City suspended the effective date of the rate change application inside the City on July 1, 2008 in Ordinance No. 2008-616."

5. New FoF 11. Add, "The Applicant did not implement its proposed rates on August 1, 2008, inside or outside the City."

6. New FoF 12. Add, "The City issued its final order on in-city rates on October 28, 2008 in Ordinance No. 2008-970. The effective date of the City's final rates was November 1, 2008."

7. New FoF 13. Add, "The Applicant's proposed rates were never charged in the City."

8. New FoF 15. Add, "The Applicant changed its old Commission-approved in-city rates to the rates approved by the City in Ordinance No. 2008-970 effective November 1, 2008."
  
9. New FoF 14. Add, "The Applicant chose not to charge the four environs customers rates that differed from those charged in-city customers."
  
10. Existing FoF 15 Delete, "which it implemented August 1, 2008."
  
11. Existing FoF 51. Change "total office expense" to "total accounting and legal expense."
  
12. Existing FoF 88. Change "9.25%" to "12.0%."
  
13. Existing FoF 89 Change "10.25%" to "12.0%."
  
14. Existing F0F 95 Change to, "Because of the City's Ordinances Nos. 2008-616 and 2008-970, Applicant has received an under-recovery of rates (i.e., underpayment by customers) while this rate case and appeal were pending."
  
15. Existing FoF 96 Change to, "The total lost revenue surcharges due from Applicant's customers for undercharges is \$ \_\_\_\_\_ for the water system and \$ \_\_\_\_\_ for the sewer system."

16. New FoF 97. Add, "Twenty-four months is a reasonable period to collect lost revenue surcharges as it coincides with the customary period for surcharging rate case expenses."

17. Existing CoL 12. Change to, "The total lost revenue surcharge due from customers for underpayments during the pendency of these consolidated dockets is \$ \_\_\_\_\_ for the water system and \$ \_\_\_\_\_ for the sewer system."

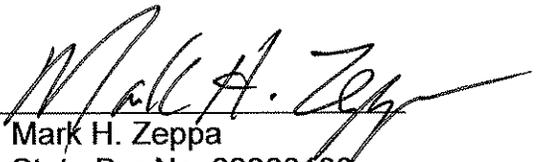
18. Existing CoL 13. Delete conclusion in its entirety.

19. Existing Order Provision 3. Make Order Provision No. 4 and pluralize "surcharge" and "balance."

20. Existing Order Provision 4. Make Order Provision No. 3 and change to, "The request of Southern Water Corporation to apply a surcharge to recover its lost revenues due to underpayments as a monthly surcharge of \$ \_\_\_\_\_ to each water and sewer customer for two years or until paid, is approved. The surcharge shall be discontinued at such time as the amount of \$ \_\_\_\_\_ is recovered."

21. Existing Order Provision No. 5. Delete in its entirety

Respectfully submitted,

By:   
Mark H. Zeppa  
State Bar No. 22260100  
Law Offices of Mark H. Zeppa, PC  
4833 Spicewood Springs Road #202  
Austin, Texas 78759-8435  
(512) 346-4011, Fax (512) 346-6847

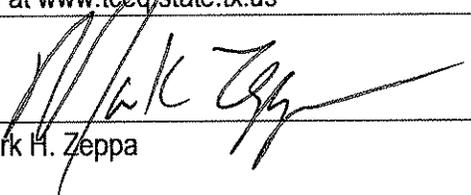
ATTORNEY FOR SOUTHERN WATER CORP

**CERTIFICATE OF SERVICE**

I hereby certify that a true and correct copy of the foregoing was served by efilng with the TCEQ Chief Clerk's Office with email notice to all attorneys of record on June 4, 2010. Judge Walston was served by fax and U. S. Mail:

**SERVICE LIST**

Scott Humphrey Office of Public Interest Counsel	Texas Commission on Environmental Quality Office of Public Interest counsel PO Box 13087, MC-103 Austin TX 78711-3087 Phone: (512) 239-6363 Fax: (512) 239-6377 shumphre@tceq.state.tx.us
Brian McLeod Executive Director Texas Commission on Environmental Quality	Texas Commission on Environmental Quality PO Box 13087, MC 175 Austin TX 78711-3087 Phone: (512) 239-0750 Fax: (512) 239-0606 bmacleod@tceq.state.tx.us
James Aldredge Executive Director Texas Commission on Environmental Quality	Texas Commission on Environmental Quality PO Box 13087, MC 173 Austin TX 78711-3087 Phone: (512) 239-0750 Fax: (512) 239-0606 jaldredge@tceq.state.tx.us
Alton J. Hall, Jr. City of Houston	Epstein Becker Green Wickliff & Hall PC 1000 Louisiana Suite 5400 Houston TX 77002 Phone: (713) 750-3100 Fax: (713) 750-3101
ALJ Thomas Walston	State Office of Administrative Hearings PO Box 13025 Austin, Texas 78711-3025 Fax: (512) 475-4994 Tom.Walston@soah.state.tx.us
TCEQ Docket Clerk	Office of the Chief Clerk PO Box 13087, MC 105 Austin, Texas 78711-3087 Fax: (512) 239-3311 Efilng at www.tceq.state.tx.us

  
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 Mark H. Zeppa