

# State Office of Administrative Hearings



Cathleen Parsley  
Chief Administrative Law Judge  
May 19, 2010

Les Trobman, General Counsel  
Texas Commission on Environmental Quality  
P.O. Box 13087  
Austin Texas 78711-3087

Re: **SOAH Docket No. 582-09-2068; TCEQ Docket No. 2008-1830-UCR; In Re: Application of Southern Water Corporation for a Water and Sewer Rate/Tariff Change in Harris County**  
**SOAH Docket No. 582-09-2069; TCEQ Docket No. 2008-1811-UCR; In Re: Appeal of Southern Water Corporation from a Water and Sewer Rate-Making Decision of the City of Houston; (Sewer CCN No. 20500; Water CCN No. 11389)**

Dear Mr. Trobman:

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 documents with the Chief Clerk of the Texas Commission on Environmental Quality no later than **June 8, 2010**. Any replies to exceptions or briefs must be filed in the same manner no later than **June 18, 2010**.

This matter has been designated **TCEQ Docket Nos. 2008-1830-UCR and 2008-1811-UCR; SOAH Docket Nos. 582-09-2068 and 582-09-2069**. All documents to be filed must clearly reference these assigned docket numbers. All exceptions, briefs and replies along with certification of service to the above parties shall be filed with the Chief Clerk of the TCEQ electronically at <http://www10.tceq.state.tx.us/epic/efilings/> or by filing an original and seven copies with the Chief Clerk of the TCEQ. Failure to provide copies may be grounds for withholding consideration of the pleadings.

Sincerely,  
  
Thomas H. Walston  
Administrative Law Judge

THW:nl  
Enclosures

cc: Mailing List

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**AGENCY:** Environmental Quality, Texas Commission on (TCEQ)  
**STYLE/CASE:** SOUTHERN WATER CORP  
**SOAH DOCKET NUMBERS:** 582-09-2068 AND 582-09-2069  
**REFERRING AGENCY CASES:** 2008-1830-UCR AND 2008-1811-UCR

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**STATE OFFICE OF ADMINISTRATIVE  
HEARINGS**

**ADMINISTRATIVE LAW JUDGE**  
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Chief Clerk- Texas Commission on Environmental Quality



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This Proposal for Decision (PFD) recommends that the Commission grant Southern's request to increase rates, subject to several adjustments. It also recommends that the Commission authorize Southern to recover rate case expenses of \$51,579.36 as a billing surcharge over a two-year period. The Administrative Law Judge (ALJ) requests the ED, when he files exceptions, also to provide the Commission a calculation of the revenue requirement and rates that incorporates the adjustments recommended in this PFD.

## I. PROCEDURAL HISTORY

The relevant procedural history for this case is set forth below:

- May 29, 2008 Southern filed an application with the TCEQ to change water and sewer rates.
- August 1, 2008 Southern filed an Errata Application with the TCEQ with an updated test year. Interim rates commenced.
- November 14, 2008 Southern filed petitions with the TCEQ to appeal the water and sewer rate decisions by the City of Houston.
- November 14, 2008 Southern's petitions declared administratively complete.
- January 14, 2009 Southern's Errata Application (2008-1811-UCR) and Southern's petitions (2008-1830-UCR) referred to the State Office of Administrative Hearings (SOAH) for contested case hearings.
- April 7, 2009 Preliminary hearing held and the two cases were consolidated for one hearing and one PFD.
- January 6, 2010 Hearing on the merits held in Houston.
- February 8, 2010 Hearing on the merits resumed telephonically and concluded.
- February 25, 2010 Parties filed closing arguments.
- March 22, 2010 Parties filed replies to closing arguments and the record closed.

The following were admitted as parties, participated in the hearing, and filed post-hearing arguments:

<b>Party</b>	<b>Representative</b>
Southern Water Corporation	Mark H. Zeppa
City of Houston	Alton J. Hall, Tammy Wavle-Shea
Executive Director, TCEQ	Brian MacLeod
Office of Public Interest Counsel, TCEQ	Scott Humphrey

## **II. BACKGROUND / EVIDENCE PRESENTED**

Southern is an investor-owned utility with offices located at 5710 Airline Drive, Houston, Texas. It operates as a single utility with an integrated water and sewer system in Harris County under Water Certificate of Convenience and Necessity (CCN) No. 11389 and Sewer CCN No. 20500. Southern has approximately 1,256 customers. Only four customers – three residences and one church – are located outside the Houston city limits. Two of these three residences are sewer only customers that have private wells. All remaining customers are inside the City and are both water and sewer customers. Southern is quite solvent. Its annual report dated August 13, 2007, showed no debt and \$1.8 million cash on the company's balance sheet. The report also showed a \$28,804 annual loss from operations, although that loss was offset by \$100,016 of other income, for net income of approximately \$71,000.<sup>4</sup>

Southern's currently approved rates were set in 1986. New rates proposed in the Errata Application are based on a test year of May 1, 2007, through April 30, 2008.<sup>5</sup> The requested rates have been charged since August 1, 2008, pending the outcome of this proceeding. Southern's current and proposed rates have a base charge that includes 2,000 gallons, plus a gallonage charge for additional usage. The current and proposed rates for a typical residential customer with a 5/8th or

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<sup>4</sup> COH Ex. 2, Pous direct at 6.

<sup>5</sup> Southern's original application used a test year of May 1, 2006, thorough April 30, 2007. In response to a Notice of Deficiency, Southern filed its Errata Application on August 1, 2008, using the May 1, 2007, through April 30, 2008, test year. ED Ex. 1, Guerrero-Gantioqui direct at 5.

3/4th inch meter are:<sup>6</sup>

	<b>Base rate including 2,000 gallons (monthly)</b>	<b>Charge for each additional 1,000 gallons</b>
Current water rates	\$11.92	\$1.00
Proposed water rates	\$16.58	\$1.60
Current sewer rates	\$19.18	\$2.25
Proposed sewer rates	\$33.95	\$2.75

Under Southern’s requested rates, the total cost to typical residential customers for 10,000 gallons of water and for 30,000 gallons of water are shown on the following table:<sup>7</sup>

	<b>Water</b>	<b>Sewer</b>	<b>Total</b>	<b>Increase</b>
10,000 gallons current	\$19.92	\$37.18	\$57.10	-
10,000 gallons proposed	\$29.38	\$55.95	\$85.33	49%
30,000 gallons current	\$39.92	\$82.18	\$122.10	-
30,000 gallons proposed	\$61.38	\$110.95	\$172.33	41%

Southern introduced into evidence the original application and the Errata Application, as well as the testimony of three witnesses: Stephen Rachac, who testified concerning operating expenses, financial integrity, and rate and tariff design; John Martin, CPA, who sponsored the Errata Application and offered testimony concerning operating expenses, taxes, rate base, return, and rate design; and Mr. Zeppa, who testified concerning rate case expenses.

The City of Houston introduced testimony from two witness: David Parcell, who testified concerning capital structure, cost of debt, and return on equity; and Jacob Pous, who testified concerning rate base, operating expenses, rate design, and Southern’s rate case expenses.

<sup>6</sup> Southern Ex. 1, Errata Application at 36 and 38.

<sup>7</sup> Southern Ex. 1, Errata Application at 35-36.

The ED called two witnesses: Leila C. Guerrero-Gantioqui, a TCEQ auditor who addressed cost of service and revenue requirement; and Kamal Adhikari, a TCEQ engineering specialist who testified concerning depreciation, water consumption and line loss, and proposed water and sewer rate design.

Southern’s Errata Application and the proposed adjustments by the ED and City of Houston produce the following revenue requirements:

	<b>Cost of Service</b>	<b>Return on Net Invested Capital</b>	<b>Less Other Revenue</b>	<b>Net Revenue Requirement</b>
<b>Southern<sup>8</sup></b>				
Water	\$423,564	\$115,498	\$(66,625)	\$472,437
Sewer	\$630,458	\$194,122	\$(7,165)	\$817,415
Total	\$1,054,022	\$309,620	\$(73,790)	\$1,289,852
<b>ED<sup>9</sup></b>				
Water	\$423,657	\$74,429	\$(10,040)	\$488,046
Sewer	\$514,479	\$160,205	\$(10,040)	\$664,644
Total	\$938,136	\$234,634	\$(20,080)	\$1,152,690
<b>City<sup>10</sup></b>				
Water	\$358,151	\$69,162	\$(75,150)	\$352,163
Sewer	\$512,642	\$112,682	\$(16,997)	\$608,336
Total	\$870,793	\$181,844	\$(92,147)	\$960,490

<sup>8</sup> Southern Ex. 1, Errata Application at 15 (water) and 29 (sewer).

<sup>9</sup> These figures are derived from ED’s Closing Argument at Attachment 1 Revised (water) and Attachment 5 Revised (sewer).

<sup>10</sup> COH Ex. 2, Pous direct at 58 (water) and 59 (sewer). These figures do not reflect the City of Houston’s withdrawal of its request to reduce Southern’s rate base by \$50,508 for insurance proceeds received after the test year. *See*, City’s Initial Post-hearing Brief at 4.

### III. EXPENSE ALLOCATION BETWEEN WATER AND SEWER

**Southern's Position:** For the test year, Southern allocated to specific accounts those costs it identified as directly attributable to water or sewer. Southern then allocated overhead and other general operating expenses to either sewer or water based on the revenue received for each service as a percentage of total revenues: 37% for water and 63% for sewer.<sup>11</sup> Southern's accountant, Mr. John Martin, testified that he chose this allocation method because it was used in Southern's last rate case and because the Internal Revenue Service (IRS) used it in recent audits. In his professional judgment, this was a reasonable allocation.<sup>12</sup> Southern used this revenue allocation method for salary and wages, contract labor, overhead for repair and maintenance, office expense, accounting and legal costs, insurance expense, miscellaneous expense, ad valorem taxes, and payroll taxes. Federal income taxes were allocated based on the bottom line revenue requirement for each service.<sup>13</sup> In its closing brief, Southern states that both its allocation methodology and the ED's 50/50 method discussed below are reasonable and consistent with TCEQ practice, but it requests that Mr. Martin's 37/63 allocation methodology be approved.<sup>14</sup>

**ED's Position:** The ED proposed a different allocation methodology. Its auditor, Ms. Guerrero-Gantioqui, testified that she charged identified direct costs to the applicable account, either water or sewer. She then allocated the remaining general expenses or indirect costs 50% each to water and sewer. She based her 50/50 allocation method on the near identical number of connections: 1,286 for water and 1,285 for sewer.<sup>15</sup> The ED argues that allocation based on the number of connections is a fairer method because it more accurately reflects the probable burden of

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<sup>11</sup> The precise percentages are 36.57% for water and 63.43% for sewer.

<sup>12</sup> Southern Ex. 3, Martin direct at 3; Tr. 40-41.

<sup>13</sup> Southern Ex. 3, Martin direct at 3-8, 13-15.

<sup>14</sup> Southern Closing Argument at 11.

<sup>15</sup> ED Ex. 1, Guerrero-Gantioqui direct at 7.

cost on each area of service. The ED also states that putting a disproportionate share of expenses on sewer puts an undue burden on the few customers who do not receive water service.<sup>16</sup>

**City of Houston's Position:** Although he did not offer testimony on allocation methodology, City witness Jacob Pous allocated indirect expenses and overhead 37% for water and 63% for sewer, the same as Southern.<sup>17</sup>

**ALJ's Analysis and Recommendation:** The ALJ recommends that the Commission allocate overhead and other general expenses 37% to water service and 63% to sewer service, as proposed by Southern. Neither the ED's allocation methodology, based on the number of meters, nor Southern's methodology, based on revenues, has a particularly strong nexus to the proportion of costs actually incurred to provide each service. However, the value of the depreciable assets used for each service is one indication of relative costs, and the value of those assets used for sewer service is significantly greater than those used for water service. Even using the ED's 50/50 allocation for unassigned assets, plant net book value still totaled \$1,520,315 for sewer and only \$825,856 for water. This equals 65% sewer assets and 35% water assets.<sup>18</sup> Likewise, the allowable expenses for water and sewer, again using the ED's 50/50 allocation for general costs, equaled \$514,479, or 55%, for sewer and \$423,657, or 45%, for water. If the costs allocated under the ED's 50/50 methodology were removed from this calculation, the percentage of costs directly attributable to sewer service would be even higher. Thus, it appears clear that the ED's 50/50 allocation method underestimates the cost for sewer service and overestimates the cost for water service.

As a practical matter, the allocation method used to assign general costs and overhead will have little effect on the vast majority of customers, as nearly all have both water and sewer service.<sup>19</sup>

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<sup>16</sup> ED Closing Argument at 2-3.

<sup>17</sup> See, e.g., allocation of legal and professional fees, COH Ex. 2, Pous direct at 27.

<sup>18</sup> See p. 53 of this PFD.

<sup>19</sup> However, as discussed in this PFD, a higher rate of return is recommended for sewer service than for water, so allocating more assets to rate base for sewer service using the 37/63 method will result in slightly higher rates than the 50/50 method.

Nevertheless, based on the costs directly assignable to each service and based on the value of plant assets specifically used to provide each service, Southern's proposal to allocate overhead and general costs 37% to water and 63% to sewer is more accurate and should be approved.

#### IV. COST OF SERVICE

##### A. Allowable Expenses

Water and sewer rates are based on a utility's allowable expenses and return on invested capital. 30 TEX. ADMIN. CODE (TAC) § 291.31(a). For allowable expenses, only those expenses that are reasonable and necessary to provide service to the ratepayers may be included, based on the utility's historical test-year expenses, adjusted for known and measurable changes. 30 TAC § 291.31(b). The components of allowable expenses, to the extent they are reasonable and necessary, may include, but are not limited to: operations and maintenance; depreciation; taxes other than income taxes; federal income taxes; reasonable expenditures for ordinary advertising; contributions and donations; and funds expended in support of membership in professional or trade associations. 30 TAC § 291.31(b)(1).

##### 1. Operations and Maintenance Expense

Operations and maintenance expense (O&M) incurred in furnishing normal utility service and in maintaining utility plant used and useful in providing service is allowed. 30 TAC § 291.31(b)(1)(A). The O&M expense items that the parties contested are discussed below.

##### a. Salaries and Wages

**Southern's Request:** Southern included in its Errata Application a total of \$296,768 in salaries and wages, allocated \$108,517 for water and \$188,251 for sewer. These salaries covered six employees: Frank Rachac, President and CEO of Southern; Stephen Rachac and two fulltime

employees for operations; and two fulltime office personnel. Stephen Rachac testified that Southern asks only for historic costs actually incurred during the test year. In his opinion, Southern operates efficiently with the minimum number of necessary employees, and it pays wages sufficient to keep an experienced workforce.<sup>20</sup>

Mr. Martin allocated salary and wages 37% to water and 63% to sewer. He stated that these expenses were reasonable and necessary because the company must have employees to operate plant, service customers, and perform normal office work. The costs have been consistent year-to-year, and Mr. Martin believes they are comparable to labor costs for similar businesses in the Houston labor market.<sup>21</sup>

**ED’s Position:** Southern’s Errata Application showed \$296,798 in salaries paid during the test year. Ms. Guerrero-Gantioqui made several adjustments to this amount, which resulted in a net increase of \$8,512. Her adjustments are shown below:

Amount	Description
\$296,768	Test-year salaries listed in Southern’s Errata Application.
(32,095)	Deduction for Billy Elizondo, a laborer who was terminated 02/20/2008.
(224)	Deduction for Chavis Aldridge, who is no longer employed.
(2,670)	Deduction for Karl Tyson, who is no longer employed.
250	Addition for Janice Doyle; amount erroneously listed as office expense.
950	Addition for Douglas Doyle; amount erroneously listed as office expense.
(4,280)	Difference between the general ledger and the total of 2007 IRS W-2’s.
(21,319)	Deduction for retirement of Louis Powell in December 2008.
29,120	Addition for hiring of David Flores in June 2008.
13,820	Addition for 2008 salary increase for Michael Estes.
24,960	Addition of salary for Randal Rankin, hired 04/28/2009.
\$305,280	Ms. Guerrero-Gantioqui’s net adjusted result; an increase of \$8,512.

<sup>20</sup> Southern Ex. 5, Rachac direct at 3.

<sup>21</sup> Southern Ex. 3, Martin direct at 3.

Using her 50/50 allocation method, Ms. Guerrero-Gantioqui allocated salaries and wages of \$152,640 each to water and sewer services.<sup>22</sup>

The ED states that known and measureable changes that occur within twelve months following the test year are appropriate adjustments to make sure a utility can recover all of its costs and protect its financial integrity. The ED points out that 30 TAC § 291.25(a) and (b) requires an applicant to file and prove the information contained in the rate filing package. In turn, the Commission's application in the rate filing package allows a utility to include its known and measurable changes if they occur within twelve months after the end of the test year. Specifying the time for known and measureable changes is important, according to the ED, to allow the parties to discover and analyze the applicable data. Therefore, the ED argues that Ms. Guerrero-Gantioqui's properly made adjustments for known and measureable changes to salaries and wages that occurred during the twelve months following Southern's test year.<sup>23</sup>

The ED disagrees with the City's proposal to eliminate certain employee positions that remained unfilled by Southern for up to four months. In the ED's opinion, an open position for four months does not amount to a vacant position that should be excluded from cost of service.<sup>24</sup>

The ED acknowledges that Ms. Guerrero-Gantioqui allowed for more wages and salaries than requested by Southern. However, the ED states that it has the duty to recommend the amount supported by the evidence, so long as the total revenue increase does not exceed the amount stated in the public notice of the proposed rate increase.<sup>25</sup>

OPIC supports the ED's position on wages and salaries.<sup>26</sup>

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<sup>22</sup> Ex. ED-1, Guerrero-Gantioqui direct at 11-12; Ex. ED-1 Supp., Guerrero-Gantioqui supplemental direct at 3.

<sup>23</sup> ED Closing Argument 12-15.

<sup>24</sup> ED Closing Argument at 15.

<sup>25</sup> ED Closing Argument at 15-16; ED Reply to Closing Arguments at 5.

<sup>26</sup> OPIC Reply to Closing Arguments at 1.

**City of Houston's Position:** The City argues that Southern has excess supervisory personnel. Both Steve and Frank Rachac hold supervisory positions and receive annual salaries of \$75,000 plus benefits, which the City argues is unreasonable for a small water and sewer system with 1,250 meters. The City states that a comparable utility (Nitsch and Son) functioned with half the number of supervisory employees as Southern.<sup>27</sup> Further, Southern employs a full-time office manager who oversees administration. In the City's view, Southern failed to show the need for two highly paid supervisory personnel for a company of its size.<sup>28</sup>

The City also objects to the ED's proposed increase to salaries and wages by more than \$8,000. It notes that the ED initially recommended reducing salaries and wages by \$16,448, but then Ms. Guerrero-Gantioqui filed supplemental testimony to add the cost of a new employee hired a year after the end of the test year. The City argues that Ms. Guerrero-Gantioqui's proposed adjustment is unwarranted and untimely. It points out that Southern operated with two unfilled positions for about four months each. The City contends that operating at lower staffing levels for four months during two separate times within an approximate one-year period demonstrates that Southern could operate safely and efficiently without the number of employees it has included.<sup>29</sup> Reducing the revenue requirement for the time one position was vacant for even the lowest paid employee would nearly eliminate the ED's proposed increase, according to the City.<sup>30</sup>

**ALJ's Analysis and Recommendation:** The ALJ recommends that the Commission approve Southern's \$296,768 in proposed salaries and wages, as well as the ED's proposed downward adjustment of \$4,280 for the difference between the general ledger and the 2007 W-2's and the ED's upward adjustment of \$1,200 for the wage expenses incorrectly listed as office

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<sup>27</sup> Tr. 29-34; City Post-hearing Reply Brief at 3-4.

<sup>28</sup> City Initial Post-hearing Brief at 5-6.

<sup>29</sup> One vacancy occurred February 20 through June 3, 2008 (during the test year); the second occurred December 2, 2008, through April 28, 2009 (during the twelve months after the close of the test year). COH Ex. 4, Pous supplemental direct at 8.

<sup>30</sup> COH Ex. 4, Pous supplemental direct at 7-9; City Initial Post-hearing Brief at 7-8.

expense. This produces a net amount of salaries and wages of \$293,688, allocated \$108,665 to water and \$185,023 to sewer.

The ED proposed additions and reductions to salaries based on changes in personnel during the test year and within twelve months thereafter. These changes had the net effect of increasing the wages and salaries expense by \$11,592. However, Southern made clear in its testimony that it only requested historic salary and wage costs actually incurred during the test year. This request must be considered in conjunction with Southern's request for contract labor discussed below. Southern explained that it hired an employee after the test year to do the type of work done by contractors during the test year, but for ratemaking purposes Southern elected to seek the lesser amount incurred for contract labor during the test year.<sup>31</sup> The ED, however, has included both the expense for the employee hired after the test year and the contract labor incurred during the test year. The ED's proposal would result in an over-recovery by Southern. Therefore, the ALJ recommends calculation of wages and salaries by using only the actual test-year historic costs, as proposed by Southern.

The evidence does not support the reduced staffing proposed by the City of Houston. A general statement was made to the lower staffing level by Nitsch and Son, but the evidence also indicated that Nitsch and Son is a smaller utility with only 800 meters compared to Southern's 1,250 meters.<sup>32</sup> Further, evidence that one position was not filled during part of the test year and another position was not filled during part of the twelve months after the test year does not justify eliminating the cost an employee. Because Southern only requested historic salary and wage costs actually incurred, its request is already reduced for the period during the test year when the position was not filled. In addition, Southern was required to utilize contract labor during the test year to accomplish all of its work, so the evidence does not support a finding that Southern is overstaffed.

Therefore, the ALJ recommends that the Commission approve Southern's expenses for salaries and wages of \$293,688, allocated \$108,665 to water and \$185,023 to sewer.

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<sup>31</sup> Southern Ex. 4, Rachac direct at 4.

<sup>32</sup> Tr. 30.

**b. Contract Labor**

**Southern's Request:** Southern requested \$4,000 for contract labor, allocated \$1,463 to water and \$2,537 to sewer. This expense covered temporary labor hired during the test year from B 5 Construction to help pull a lift station and for other similar work. Southern found it less expensive to perform these services with contract labor than with its own employees. Southern has hired a new operator who can do this work in the future, but for ratemaking purposes it included the lesser amount for contract labor and did not include the cost of the new employee.<sup>33</sup> Southern rejects the City of Houston's proposed adjustment to contract labor costs. It contends that Mr. Pous averaged the costs over time simply to lower this cost component.<sup>34</sup>

**ED's Position:** The ED increased the contract labor expense by \$400, to a total of \$4,400. Ms. Guerrero-Gantioqui found that an additional \$400 was paid during November 2007 to a contract worker for meter reading. Southern charged this cost to office expense, but Ms. Guerrero-Gantioqui reclassified it as contract labor. Ms. Guerrero-Gantioqui allocated her revised contract labor expense \$2,200 to water and \$2,200 to sewer.<sup>35</sup>

**City of Houston's Position:** The City of Houston argues that contract labor expenses should be reduced because the amount incurred during the test year was abnormally high. Mr. Pous testified that during the five-year period ending April 30, 2009, Southern incurred contract labor expenses during only two years – the initial test year and the final test year. During the initial test year, contract labor expenses totaled \$1,966.50 and during the final test year they totaled \$4,000.00, but contract labor expenses were \$0.00 during the other three years of this five-year period. As a result, Mr. Pous recommended allowing only the five-year average contract labor expense of \$1,193, which is a reduction of \$2,807 from the \$4,000 requested by Southern. Mr. Pous allocated these expenses

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<sup>33</sup> Southern Ex. 4, Rachac direct at 4.

<sup>34</sup> Southern Closing Arguments at 11.

<sup>35</sup> ED Ex. 1, Guerrero-Gantioqui direct at 12.

between water and sewer using the same percentages as Southern.<sup>36</sup> The City argues that its proposed adjustment is fair and reasonable.<sup>37</sup>

**ALJ's Analysis and Recommendation:** The evidence supports contract labor expenses of \$4,400, allocated \$1,628 to water and \$2,772 to sewer. Although Southern claimed only \$4,000 for contract labor, the ED identified an additional \$400 that had been erroneously charged to office expense. The City complained that the test-year expense for contract labor was the highest of the five years ending 2009. However, Southern explained that the expense for contract labor is actually less than the cost of the employee who was hired after the test year to do the same type of work. The ALJ has recommended denial of the ED's proposal to include the higher cost of that employee in Southern's expenses; accordingly, the lower cost of the contract labor incurred during the test year to perform this work should be allowed.

**c. Purchased Water**

**Southern's Request:** Southern is located within the Harris-Galveston Subsidence District (District) and is under orders to convert from groundwater to surface water. Because no surface water is available to Southern, the District allows it to join an alternate program sponsored by the City of Houston, which is constructing infrastructure necessary to provide surface water. Until that is completed, Southern pays Houston a fee per 1,000 gallons pumped to help offset the infrastructure costs. Mr. Martin explained that these costs are required by laws governing the District and are beyond Southern's control. Specifically, Houston sets the gallonage fee, and consumption by Southern's customers dictates how much water is pumped. This expense totaled \$65,353 for the test year, and Mr. Martin allocated the entire amount to water service.<sup>38</sup>

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<sup>36</sup> COH Ex. 2 at 22-23.

<sup>37</sup> City Initial Post-hearing Brief at 8-9.

<sup>38</sup> Southern Ex. 3, Martin direct at 4-5; Southern Ex. 4, Rachac direct at 4-5.

Southern argues that these expenses are uncontested, so it put these expenses in its cost of service. It also included the revenues collected under its pass-through clause as part of “other revenues.”<sup>39</sup> In Southern’s view, it properly matched and offset these expenses and revenues. In contrast, it complains, the ED removed the entire purchased water expense but included the offsetting revenues. It argues that the ED failed to apply matching principles. In other words, Southern states, if the ED excludes the purchased water expense, it must also exclude the pass through revenues received for this expense.<sup>40</sup>

**ED’s Position:** The ED recommends reducing Southern’s request for this item to \$0.00. Staff does not consider the fee paid to the District to be an expense because the charges paid by Southern to Houston are collected from customers in the exact amount. In other words, Staff considers the fee to simply be a pass through from Southern to its customers. Therefore, Staff argues that this expense should be deleted entirely.<sup>41</sup>

The ED rejects Southern’s statement that the ED violated matching principles by removing this expense item but not removing the other revenues received for the purchased water. The ED states that it did make a downward adjustment to the other-revenue item by \$56,585 to account for the removal of this expense. This adjustment does not exactly match Southern’s purchased water expense, the ED states, because Southern’s records did not show an exact match. In other words, the ED’s adjustment reflects Southern’s records of the actual purchased water expense and the actual revenues received for that expense.<sup>42</sup>

**City of Houston’s Position:** The City of Houston did not address this issue directly. However, the City did recommend balancing Southern’s purchased-water revenue and expense by

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<sup>39</sup> “Other revenues” reduce the revenue requirement for the utility.

<sup>40</sup> Southern Closing Argument at 11-12; Southern Replies to Closing Arguments at 7-8.

<sup>41</sup> ED. Ex. 1, Guerrero-Gantioqui direct at 12.

<sup>42</sup> ED Supplemental Ex. 1, Guerrero-Gantioqui supplemental direct at Attachment 1 Revised; ED Reply to Closing Arguments at 4.

increasing Southern's other revenues by \$5,893 (*See*, part IV.A.5 below).

**ALJ's Analysis and Recommendation:** All parties agree that Southern's purchased water expense should be offset by an equal amount of other revenue. In other words, the expense and revenue for the purchased water assessment should balance and cancel each other for ratemaking purposes. The problem is that the purchased water expense and revenue amounts do not match in Southern's documents. The ED proposes to correct this imbalance by eliminating both from the rate calculations. The City of Houston proposes to leave Southern's purchased water expense unchanged but increase the other-revenue entry to completely offset the expense. The ALJ recommends adopting the City's approach because it more accurately reflects Southern's circumstances. The expense is undisputed, but the ED's approach would remove the expense and the related revenue from the rate filing package. This would show an incomplete picture of Southern's business activities. Therefore, the ALJ recommends that the Commission not adopt the ED's proposal to remove the purchased water expense. However, to balance this expense with an equal amount of revenue, the ALJ also recommends a corresponding adjustment to other revenue in part IV.A.5 of this PFD.

**d. Chemicals**

**Southern's Request:** Southern's test year included \$48,313 in expenses for chemicals for treatment of water and sewer. These expenses are allocated directly \$7,411 to water and \$40,902 to sewer. Southern has a groundwater system with good quality water that only requires disinfection. In contrast, it uses a much larger amount of chemicals to treat and process raw sewage to required levels. Southern also books to this account laboratory fees, which are primarily for sewer, and sewer sludge processing costs, which are exclusively for sewer.<sup>43</sup> Southern does not object to the adjustments to the chemical expenses proposed by the ED, provided they are allocated in the same manner as all other allocated costs.<sup>44</sup>

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<sup>43</sup> Southern Ex. 4, Rachac direct at 5.

<sup>44</sup> Southern Closing Argument at 12-13.

**ED's Position:** Ms. Guerrero-Gantioqui added \$912 to this category for laboratory fees that Southern erroneously charged to Accounting and Legal Fees, bringing the total expense to \$49,225. Ms. Guerrero-Gantioqui allocated the \$912 laboratory fee directly to water and \$28,046 in sludge expense directly to sewer and then divided the remaining chemical expense 50/50 between water and sewer. This produced a total allocation of \$11,046 for water and \$38,180 for sewer.<sup>45</sup>

**City of Houston's Position:** The City offered no evidence and took no position on this issue.

**ALJ's Analysis and Recommendation:** The ALJ agrees with the ED's proposal to add \$912 in chemical expenses for laboratory fees, allocated directly to water. However, the unassigned chemical expenses of \$20,267 should be allocated using Southern's 37/63 method.<sup>46</sup> With \$28,046 in sludge expense assigned directly to sewer, \$912 in laboratory fees allocated directly to water, and \$20,267 in unassigned expenses allocated 37/63 to water and sewer, the result is \$8,411 in chemical expense allocated to water service and \$40,854 allocated to sewer, for total chemical expenses of \$49,225.

**e. Utilities**

**Southern's Request:** Southern's Errata Application includes test-year expenses for utilities of \$42,549 for water and \$73,813 for sewer, for a total of \$116,362.<sup>47</sup> This calculation applies Southern's 37/63 allocation method.

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<sup>45</sup> ED. Ex. 1, Guerrero-Gantioqui direct at 13.

<sup>46</sup> Total expenses of \$49,225 less \$912 directly assigned to water and \$28,046 directly assigned to sewer leaves a balance of \$20,267 in general expenses for allocation.

<sup>47</sup> Southern Ex. 1, Errata Application at 15 and 29.

**ED's Position:** Ms. Guerrero-Gantioqui did not dispute the amount Southern requested for utility expenses. However, she recommended allocating these expenses 50/50, \$58,181 each to water and sewer.<sup>48</sup>

**City of Houston's Position:** Mr. Pous noted that Southern's utility expense is almost exclusively for electricity. He also pointed out that Southern purchases electricity from a retail electric provider in a deregulated electricity market. Because the price of electricity in this area is based on the price for natural gas, and because natural gas prices have fallen substantially, prices of electricity have also dropped. Mr. Pous testified that Southern changed to a new retail electric power provider after the test year, and its utility charges have dropped by more than two cents per kilowatt hour. By his calculation, Southern's annual electricity costs are now \$15,727 lower than the test year. Accordingly, he recommends a reduction in utility expenses by that amount, allocated \$5,819 to water and \$9,908 to sewer.<sup>49</sup>

**ALJ's Analysis and Recommendation:** The ALJ recommends that the Commission adopt the City of Houston's proposed adjustment. Neither Southern nor the ED disputed that Southern entered into a new contract for lower priced electricity, nor did they dispute the City's calculations for its adjustment. Likewise, at hearing, Ms. Guerrero-Gantioqui seemed to agree that a new electricity contract within twelve months of the end of the test year would be a known and measureable change.<sup>50</sup> Therefore, the ALJ recommends that the Commission lower Southern's utilities expense by \$15,727, with the reduction allocated \$5,819 to water service and \$9,908 to sewer. This results in a revised utility expense for cost of service of \$36,730 for water and \$63,905 for sewer, for a total expense of \$100,635.

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<sup>48</sup> ED Ex. 1, Guerrero-Gantioqui direct at 13.

<sup>49</sup> COH Ex. 2 at 23-24; *See* City Initial Post Hearing Brief at 9-10.

<sup>50</sup> Tr. 268.

**f. Repairs, Maintenance, and Supplies**

**Southern's Request:** Southern requested \$5,198 in expenses for repairs, maintenance, and supplies for water and \$9,017 for these expenses for sewer, for a total of \$14,215.<sup>51</sup> Mr. Martin testified that these expenses are routine costs of servicing the utility plant to insure its efficient operation. He also stated that the direct costs were allocated based on the estimated useful life of the expenditure, and the overhead portion of some of the expenses was allocated using the revenue allocation method. Mr. Martin explained that the cost merely to restore an asset to its normal working condition is a repair or maintenance expense, while a cost that extends the useful life of an asset or is non-recurring is a capital repair that is capitalized rather than included in cost of service. Also, a purchased item is capitalized or expensed depending on whether its useful life is more than one year.<sup>52</sup>

Mr. Rachac testified that Southern keeps repairs and maintenance expenses as low as possible by regularly inspecting and servicing equipment and by following accepted industry practices. The company also uses its own equipment to jet sewer blockages and to clean sewer lines. Mr. Rachac stated that he buys supplies in bulk when this is prudent, and he shops different vendors to get good market prices.<sup>53</sup>

Southern does not object to the adjustments proposed by the ED, as long as they are allocated consistently with other costs.<sup>54</sup>

**ED's Position:** The audit performed by Ms. Guerrero-Gantioqui revealed several expenses incorrectly charged to repairs and maintenance, including personal expenses for Mr. Stephen Rachac, expenses out of the test year, an expense not supported by an invoice, late charges, a fee for a TCEQ

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<sup>51</sup> Southern Ex. 1, Errata Application at 15 and 29.

<sup>52</sup> Southern Ex. 3, Martin direct at 5-6.

<sup>53</sup> Southern Ex. 4, Rachac direct at 5-6.

<sup>54</sup> Southern Closing Argument at 13.

license renewal (transferred to miscellaneous expense), and payments to three employees (transferred to salaries and wages). These adjustments resulted in a decrease of \$6,611, leaving total expenses of \$7,604 for repairs and maintenance. Ms. Guerrero-Gantioqui allocated these expenses \$3,802 each to water and sewer.<sup>55</sup>

**City of Houston's Position:** The City offered no testimony or argument on this issue.

**ALJ's Analysis and Recommendation:** The ED's adjustments to expenses for repairs, maintenance, and supplies should be adopted, but these expenses should be allocated using Southern's 37/63 methodology. Southern does not object to the ED's adjustments, and the City of Houston took no position on this item. Therefore, the ALJ recommends that the Commission reduce Southern's request for repairs, maintenance, and supplies by \$6,611. This would leave \$7,604 total expenses for this category, allocated \$2,813 to water and \$4,791 to sewer.

**g. Office Expenses**

**Southern's Request:** Office expenses are routine expenses normally incurred by Southern for clerical and administrative work. Mr. Martin stated that this category includes the costs for items such as postage, office supplies, cleaning supplies, and coffee. Southern claimed total test-year office expenses of \$26,854, allocated \$9,819 to water and \$17,035 to sewer.<sup>56</sup> Mr. Rachac added that his brother operates a small business called Revinyl in the Southern office. Southern provides electricity and air conditioning, and Revinyl pays rent to Southern.<sup>57</sup> Southern does not oppose the ED's proposed adjustments, but it suggests that the City's adjustments were "skewed by bias."<sup>58</sup>

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<sup>55</sup> ED Ex. 1, Guerrero-Gantioqui direct at 13-14.

<sup>56</sup> Southern Ex. 1, Errata Application at 15 and 29; Southern Ex. 3, Martin direct at 6.

<sup>57</sup> Southern Ex. 4, Rachac direct at 6.

<sup>58</sup> Southern Closing Argument at 13-14.

**ED's Position:** Ms. Guerrero-Gantioqui recommended a \$4,190 reduction to office expenses. This reduction included disallowing a payment to Stephen Rachac of \$2,590 due to lack of appropriate documentation; \$400 reclassified to contract labor; and \$1,200 reclassified to salaries and wages. Ms. Guerrero-Gantioqui allocated the remaining \$22,664 balance of office expenses \$11,332 each to water and sewer.<sup>59</sup>

**City of Houston's Position:** Mr. Pous recommended a total reduction to office expenses of \$7,445, leaving a net balance of \$19,409. His proposed reductions were as follows:

Amount	Description
\$26,854	Office expenses requested by Southern.
(1,262)	Non-recurring expense paid to the Houston Chronicle.
(229)	Late payment and finance charges.
(125)	Charge for flowers.
(900)	Chiropractor charges.
(1,184)	Meal payments charged to credit card, not shown to be reasonable and necessary.
(3,745)	Charges from the office manager Doyle, not supported with explanatory information.
\$19,409	Net balance of office expenses after recommended reductions.

Mr. Pous allocated the office expenses 37% to water and 63% to sewer, using Southern's revenue allocation method.<sup>60</sup> The City also agrees with the additional adjustments proposed by the ED.<sup>61</sup>

**ALJ's Analysis and Recommendation:** The ALJ recommends that office expenses be reduced by the adjustments proposed by the ED, plus the adjustments proposed by the City of Houston for flowers, and payments to office manager Doyle in the amount of \$2,545. The ALJ agrees that Southern has not produced documentation to support the payments to Mr. Doyle.

<sup>59</sup> ED Ex. 1, Guerrero-Gantioqui direct at 15.

<sup>60</sup> COH Ex. 2, Pous direct at 24-26.

<sup>61</sup> City Initial Post-hearing Brief at 10-11.

However, the ALJ reduced the City's proposed deduction for payments to Mr. Doyle by \$1,200 because the City's deduction included the \$1,200 that Ms. Guerrero-Gantioqui already transferred to salaries and wages.

The other amounts cited by the City for late payment and finance charges, chiropractor charges, and meal payments are shown on credit card receipts included in the City's exhibits. However, those amounts are not shown on the ledger entries for office expense, so the ALJ cannot determine that Southern included those items as office expense as contended by the City.<sup>62</sup> In addition, most of these charges appear to have been already deducted by Ms. Guerrero-Gantioqui's adjustment to repair and maintenance expenses.<sup>63</sup> The payment to the Houston Chronicle is included in Southern's office expense, but the ALJ does not find that this payment is an inappropriate expense.

Therefore, the ALJ recommends that the Commission adjust Southern's requested office expenses as follows:

<b>Amount</b>	<b>Description</b>
\$26,854	Office expenses requested by Southern.
(2,590)	Payment to Mr. Stephen Rachac without adequate documentation.
(400)	Reclassified to contract labor.
(1,200)	Reclassified to salaries and wages.
(125)	Flower charges.
(2,545)	Payment to office manager Doyle without adequate documentation.
\$19,994	Net balance of office expenses after recommended reductions.

This balance of office expenses should be allocated \$7,398 to water service and \$12,596 to water service.

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<sup>62</sup> COH Ex. 2, Pous direct at 92-109.

<sup>63</sup> ED Ex. 1, Guerrero-Gantioqui direct at 13-14.

#### h. Accounting and Legal expenses

**Southern's Request:** Southern included accounting and legal expenses totaling \$39,926, allocated \$14,599 to water and \$25,327 to sewer. Mr. Rachac testified that most of these expenses were for ongoing accounting and tax work. Southern also hired a local attorney to seek a reduction in property taxes. Mr. Rachac investigated comparable professional fees and believes the charges to Southern were reasonable.<sup>64</sup> Mr. Martin added that the accounting work was necessary and was performed competently and efficiently.<sup>65</sup>

Southern does not dispute the ED's removal of costs associated with a trust, or the removal by the ED and the City of rate case expenses to be recovered through a surcharge. It does, however, disagree with the City's removal of required fees paid to the TCEQ and to the City of Houston.<sup>66</sup>

**ED's Position:** Ms. Guerrero-Gantioqui recommends reducing accounting and legal expenses by \$12,788. Her adjustments were:

Amount	Description
\$39,926	Amount requested by Southern.
(912)	Reclassified to chemicals and treatment (laboratory fees).
(480)	Fees concerning federal income tax return for a trust (personal expense).
(418)	Fees to prepare an income tax return for a trust (personal expense).
(10,979)	Reclassified to rate case expenses.
\$27,137	Net amount of Accounting and Legal expenses.

Ms. Guerrero-Gantioqui allocated \$13,569 of these expenses each to water and sewer.

<sup>64</sup> Southern Ex. 4, Rachac direct at 6-7.

<sup>65</sup> Southern Ex. 3, Martin direct at 6-7.

<sup>66</sup> Southern Closing Argument at 14-15.

**City of Houston's Position:** Mr. Pous recommended reductions to accounting and legal expenses totaling \$23,795:

Amount	Description
\$39,926	Amount requested by Southern.
(17,987)	Professional fees also booked as rate case expenses.
(40)	Payment of a fine.
(100)	Payment to a church.
(1,101)	Non recurring payment to the Houston Chronicle.
(4,567)	Reduction of payments to TCEQ to equal prior year's level due to unusually high amount related to adding plant during the test year.
\$16,131	Net amount of Accounting and Legal expenses.

Mr. Pous allocated these expenses 37% to water and 63% to sewer.<sup>67</sup>

**ALJ's Analysis and Recommendation:** The only adjustment that Southern has opposed is the City's reduction for payments to the TCEQ during the test year. There is no evidence that these fees were for fines or other expenses that should not be recovered, and the ALJ agrees with Southern that they should be allowed. There was no explanation concerning why the City of Houston and the ED determined different amounts of professional fees that are also booked as rate case expenses. However, the documentary evidence supports the City's calculation.<sup>68</sup> Therefore, the ALJ recommends that the Commission adjust Southern's requested accounting and legal fees as follows:

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<sup>67</sup> COH Ex. 2, Pous direct at 26-27; See City Initial Post-hearing Brief at 11.

<sup>68</sup> COH Ex. 2, Pous direct at 111-113; Southern Ex. 3, Martin direct at Schedule B.

Amount	Description
\$39,926	Amount requested by Southern.
(17,987)	Professional fees also booked as rate case expenses.
(40)	Payment of a fine.
(100)	Payment to a church.
(1,101)	Non recurring payment to the Houston Chronicle.
(912)	Reclassified to chemicals and treatment (laboratory fees).
(480)	Fees concerning federal income tax return for a trust (personal expense).
(418)	Fees to prepare an income tax return for a trust (personal expense).
\$18,888	Net amount of Accounting and Legal expenses.

These accounting and legal expenses should be allocated \$6,989 to water service and \$11,899 to sewer.

**i. Insurance Expenses**

**Southern’s Request:** Southern requested \$136,412 of test-year insurance expense, allocated \$49,880 to water and \$86,532 to sewer. Mr. Martin testified that these expenses included casualty insurance on the physical plant, general liability insurance for the company, medical insurance for employees, workers compensation insurance, and key-man life insurance. In Mr. Martin’s opinion, all of these types of insurance were necessary to protect the company and to retain valuable employees.<sup>69</sup> The Errata Application does not break out the costs between the different types of insurance.

Southern disagrees with the City’s rejection of all health insurance expenses, pointing out that the Water Code and TCEQ rules do not disallow an expense merely because it benefits owners

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<sup>69</sup> Southern Ex. 3, Martin direct at 7-8.

in their role as employees. It argues that all the insurance expenses are reasonable and necessary and should be allowed.<sup>70</sup>

Southern also disagrees with the ED's removal of health insurance expense for family members of employees. Southern states that Ms. Guerrero-Gantioqui failed to cite any TCEQ rule or precedent that such expenditures were against public policy; consequently, Southern views Ms. Guerrero-Gantioqui's adjustment as "arbitrary and capricious."<sup>71</sup>

**ED's Position:** In her original direct testimony, Ms. Guerrero-Gantioqui recommended a reduction to insurance expenses of \$91,351 for all health related insurance, due to lack of documentation or other information from Southern to support this expense. Ms. Guerrero-Gantioqui also noted information in Southern's records concerning a \$50,508 insurance refund, but she was not able to verify the details of this item. Therefore, Ms. Guerrero-Gantioqui reserved the right to make further adjustments to insurance expenses if she obtained additional information.<sup>72</sup>

Southern did provide Ms. Guerrero-Gantioqui additional information during December 2009, so she filed supplemental testimony at the hearing to address this information. In her supplemental testimony, Ms. Guerrero-Gantioqui allowed expenses of \$54,778 for health and dental insurance for employees, but she disallowed employee life insurance premiums and any insurance expense for the spouses and children of employees. This disallowance totaled \$36,573. She also determined that no adjustment was necessary for the insurance refund noted in her direct testimony.<sup>73</sup> When the commercial insurance expenses are added to Ms. Guerrero-Gantioqui's allowed health insurance expenses, it produces a total insurance expense of \$99,839.

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<sup>70</sup> Southern Closing Argument at 15-16; Southern Replies to Closing Arguments at 9.

<sup>71</sup> Southern Replies to Closing Arguments at 8.

<sup>72</sup> ED Ex. 1, Guerrero-Gantioqui direct at 16-17.

<sup>73</sup> ED Ex. 1 Supplemental, Guerrero-Gantioqui supplemental direct at 4-6.

The ED notes that health insurance premiums can vary greatly based on various factors, including the number, age, and health of employees. Thus, the ED disagrees with the City's comparison of Southern's health insurance rates to other utilities because the City did not show that the examples were similar to Southern. The ED also rejects the City's argument that no health insurance premiums should be allowed in water/sewer utility cases.<sup>74</sup>

**City of Houston's Position:** Mr. Pous noted that the total \$136,412 requested insurance expense exceeds 10% of Southern's entire revenue requirement. In Mr. Pous' opinion, Southern did not show the health insurance cost of \$91,351 represent a reasonable and necessary expense for the company, and he complained that most of the health insurance expense was paid on behalf of the company owners and family members. According to Mr. Pous, only 49% of Texas employees are covered by employer-paid health insurance plans, and he believes it is not appropriate to require Southern's customers, many of whom may not have health insurance, to pay for the health insurance of Southern's owners, employees, and families. Therefore, Mr. Pous and the City of Houston argue that Southern's insurance expense should be reduced by the total health related insurance expense of \$91,351. Mr. Pous would apportion the remaining balance of \$45,061 for commercial insurance expense using Southern's revenue allocation methodology.<sup>75</sup>

In its brief, the City stresses that Southern failed to meet its burden of proof that the health insurance expenses were reasonable and necessary, and it complains that Southern's request equals more than \$21,000 per employee. The City states that neither Southern nor the ED provided any analysis regarding the reasonableness of these costs. If health insurance costs are to be allowed, the City requests that they be limited to a range of \$4,627 to \$5,664 per employee, which is the amount Mr. Pous showed as examples of health insurance expense for other utilities. In addition, the City notes that Mr. Rachac testified on cross examination that only three employees currently receive

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<sup>74</sup> ED Closing Argument at 9-11.

<sup>75</sup> COH Ex. 2, Pous direct at 27-29.

health insurance benefits, compared to four during the test year. The City argues that this is a known and measureable change for which a reduction should be made.<sup>76</sup>

**Public Interest Counsel's Position:** OPIC agrees with Southern and the ED on the basic premise that health insurance is a reasonable and necessary expense for a utility. OPIC also agrees with the ED that only health insurance expenses related to employees should be allowed, and the expenses for spouses and children of employees should not be allowed. In addition, OPIC is concerned about the magnitude of health insurance expenses requested by Southern. It notes that Southern had three different insurance companies and a flexible pay account involved in healthcare coverage, even though it only had four employees. In OPIC's opinion, any amount over the \$54,778 recommended by Ms. Guerrero-Gantioqui for healthcare expense would be excessive. However, OPIC also states that it cannot determine from the record what portion of the \$54,778 would be reasonable and necessary for healthcare insurance expense.<sup>77</sup>

**ALJ's Analysis and Recommendation:** The ALJ agrees with Southern, the ED, and OPIC that employee health insurance can be a reasonable and necessary expense for an investor owned water/sewer utility. The ALJ disagrees with the City of Houston that health insurance expense should not be allowed simply because some of Southern's ratepayers may not have employer-paid health insurance or because the owners of the utility benefit from the insurance. However, the ALJ does agree with the City of Houston, the ED, and OPIC that Southern's health insurance expenses are excessive.

The ED and OPIC recommend allowing expenses for health and dental insurance for employees but disallowing employee life insurance premiums and any insurance expense for employees' family members. Southern complained that Ms. Guerrero-Gantioqui failed to cite any TCEQ rule or precedent that expenditures for employee family members are against public policy. However, that is not the standard for deciding whether expenses should be included in cost of

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<sup>76</sup> City Initial Post-hearing Brief at 11-12; Tr. 65-66.

<sup>77</sup> OPIC Closing Argument at 2-4; OPIC Reply to Closing Arguments at 2-4.

service. Rather, Southern had the burden to establish that the health insurance expense for employee family members is reasonable and necessary, but it offered no such evidence.

Ms. Guerrero-Gantioqui provided the following breakdown of her proposed adjustment to remove expenses for life insurance and family member health and dental insurance:<sup>78</sup>

	<b>United Healthcare (Dental)</b>	<b>Fort Dearborn (Life)</b>	<b>Blue Cross Blue Shield (Health)</b>	<b>Payflex Systems USA (Health)</b>	<b>Totals</b>
<b>Totals</b>	\$3,604.25	\$667.39	\$83,308.42	\$3,771.20	\$91,351.26
<b>Disallowed</b>	(2,134.25)	(667.39)	(30,000.42)	(3,771.20)	(36,573.26)
<b>Allowed</b>	\$1,470.00	\$0.00	\$53,308.00	\$0.00	\$54,778.00

This results in costs of \$13,327 per employee for health insurance (four employees covered) and \$490 per employee for dental insurance (three employees covered) for a total of \$13,817 per covered employee. The ALJ agrees with the ED’s proposed adjustment with one exception – the ALJ also believes that employer-paid dental insurance should be eliminated from cost of service completely, resulting in an additional reduction of \$1,470 and a total health insurance expense of \$53,308. While employer-paid health insurance for employees is a relatively common benefit, employer-paid dental insurance is not, and Southern provided no evidence that such insurance was necessary to attract and maintain a competent workforce. Southern can continue to provide these benefits if it desires, but the cost should be paid by the company rather than by ratepayers.

The total recommended adjustment results in health insurance costs of \$13,327 per employee, which is significantly higher than costs incurred by certain utilities cited by Mr. Pous. However, those companies are much larger and are not comparable to Southern. Considering the small number of Southern employees, it is logical that the per-employee cost for health insurance would be higher.

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<sup>78</sup> ED Ex. 1-Supplemental, Guerrero-Gantioqui supplemental direct at 4-6 and Attachment 27.

Therefore, the ALJ recommends that the Commission approve insurance expenses for employee health insurance in the amount of \$53,308 plus commercial insurance expenses of \$45,061, for a total insurance expense of \$98,369, allocated \$36,397 to water service and \$61,972 to sewer service.

**j. Miscellaneous Expenses**

**Southern's Request:** Southern's Errata Application included test-year miscellaneous expenses totaling \$25,005, allocated \$9,143 to water and \$15,862 to sewer.<sup>79</sup> Mr. Martin testified that these included auto and truck expenses, dues and subscriptions, and bank charges for customers' NSF checks deposited by the company. In his opinion, all of the miscellaneous expenses were reasonable and necessary.<sup>80</sup>

Southern does not oppose the ED's removal of vehicle related expenses that were incurred outside the test year. However, it does object to the ED's removal of other expenses that were not supported by charge slips, arguing that no TCEQ rule requires this type of accounting detail. Southern contends that all expenses for fuel and truck maintenance are necessary and should be allowed. Likewise, Southern argues that the City's reduction of miscellaneous expenses based on lower gasoline prices after the test year is unsupported.<sup>81</sup>

**ED's Position:** Ms. Guerrero-Gantioqui disallowed automobile expenses totaling \$2,149 for expenses incurred before the test year. However, she also added \$111 for expenses for a TCEQ license renewal, reclassified from Repairs and Maintenance. Therefore, Ms. Guerrero-Gantioqui reduced miscellaneous expenses by a net \$2,038, leaving a balance of \$22,967, which she allocated \$11,484 each to water and sewer.<sup>82</sup> The ED disputes Southern's complaint that additional

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<sup>79</sup> Southern Ex. 1, Application at 15 and 29.

<sup>80</sup> Southern Ex. 3, Martin direct at 13.

<sup>81</sup> Southern Closing Argument at 16-17.

<sup>82</sup> ED Ex. 1, Guerrero-Gantioqui direct at 18-19.

documentation for expenses is not required, citing a recent Commission decision that required adequate supporting documentation before allowing cost-of-service expenses.<sup>83</sup>

**City of Houston's Position:** Mr. Pous testified that gasoline prices have dropped dramatically since the test year. Therefore, he reduced miscellaneous expenses by \$1,005, with the remaining balance allocated according to Southern's revenue allocation method.<sup>84</sup>

**ALJ's Analysis and Recommendation:** The City's proposed adjustment based on lower gasoline prices is unfounded. It is common knowledge that gasoline prices can be volatile. Indeed, they have risen significantly since Mr. Pous based his recommendation on a price of \$2.08 per gallon.<sup>85</sup> In short, because gasoline prices fluctuate frequently, Mr. Pous' proposed adjustment for fuel prices is not a valid known and measurable change.

Southern complained that Ms. Guerrero-Gantioqui improperly reduced miscellaneous expenses for lack of documentation. However, a review of her testimony shows that she did not make an adjustment to miscellaneous expenses for lack of documentation. Rather, her only deduction was for charges incurred before the test year, which Southern does not oppose.<sup>86</sup> Therefore, the ALJ recommends approval of the Ms. Guerrero-Gantioqui's proposed adjustments to miscellaneous expenses, with the result allocated 37% to water service and 63% to sewer. This adjustment allows total miscellaneous expenses of \$22,967, allocated \$8,498 to water and \$14,469 to sewer.

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<sup>83</sup> ED Reply to Closing Arguments at 4, *citing*, *Application of Double Diamond Utilities to Increase Rates*, TCEQ Docket No. 2007-1708-UCR; SOAH Docket No. 582-08-0698 (Order, Nov. 11, 2009).

<sup>84</sup> COH Ex. 2, Pous direct at 29-30; City Initial Post-hearing Brief at 12-13.

<sup>85</sup> COH Ex. 2, Pous direct at 30.

<sup>86</sup> ED Ex. 1, Guerrero-Gantioqui direct at 18-19.

## 2. Depreciation Expense

**Southern's Request:** For the test year, Southern claimed \$46,859 annual depreciation expense for water plant and \$64,409 for sewer plant, for a total annual depreciation expense of \$111,268.<sup>87</sup> It opposes the City's proposed adjustment for assets that will fully depreciate before the conclusion of this rate case. Southern points out that Mr. Pous made no adjustment for plant to be added during that period, and it argues that this proposed adjustment is not consistent with prior TCEQ rate cases.<sup>88</sup> Southern also states that a water well found not to be used and useful by the ED is subject to the early plant retirement requirements of Senate Bill 2306 (81st Legislature, Reg. Sess.). That bill amended TEX. WATER CODE § 13.131 to require the Commission to adopt rules to allow depreciation on retired plant in a manner consistent with accounting treatment of regulated electric and gas utilities.<sup>89</sup>

**ED's Position:** Mr. Kamal Adhikari testified for the ED and recommended a depreciation expense of \$56,581 for water plant and \$65,844 for sewer plant, for a total of \$122,425. Mr. Adhikari audited Southern's invoices and supporting documents, and he inspected both the water and sewer system to verify that the items claimed in Southern's depreciation schedules are used and useful in providing service. He found one well that has been plugged and is not used and useful, and he revised the depreciation schedule by renaming some assets, combining assets, and moving some assets from the water schedule to the sewer schedule. For common assets, Mr. Adhikari allocated the depreciation expense using Ms. Guerrero-Gantioqui's 50/50 allocation methodology. The results of all these adjustments are reflected on exhibits ED-KA-1 (water) and ED-KA-2 (revised sewer) attached to his prefiled direct testimony and supplemental direct testimony.<sup>90</sup>

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<sup>87</sup> Southern Ex. 1, Application at 15 and 29.

<sup>88</sup> Southern Closing Argument at 18.

<sup>89</sup> Senate Bill No 2306 added the following language to section 13.131(c): "Rules adopted under this subsection must require the book cost less net salvage of depreciable utility plant retired to be charged in its entirety to the accumulated depreciation account in a manner consistent with accounting treatment of regulated electric and gas utilities in this state."

<sup>90</sup> ED Ex. 2, Adhikari direct at 8-9, 10-13; ED Ex. 2 Supplemental, Adhikari supplemental direct at 2-4.

The ED disagrees with Southern's contention that the plugged well removed by Mr. Adhikari is covered by Senate Bill 2306. The ED points out that the bill was not effective until 2009, well after Southern filed its Errata Application during 2008. Also, the amendment requires the Commission to adopt rules to implement the statute, but the rulemaking process has not been completed.<sup>91</sup>

The ED also disagrees with Mr. Pous' adjustment that removes from the depreciation expense calculation those assets that will be fully depreciated by the end of this rate case proceeding. The ED complains that this proposal ignores the test year and the twelve-month post test-year window for known and measureable changes. Further, the ED states that depreciation assumes an asset will be replaced after its useful life and the annual depreciation expense allows the utility to pay for a replacement.<sup>92</sup>

OPIC supports the ED's position concerning depreciation.<sup>93</sup>

**City of Houston's Position:** Mr. Pous proposed a \$5,531 downward adjustment to the depreciation expense for six assets that would become fully depreciated before the conclusion of this proceeding. The City states that this is a known and measurable change because all six assets were fully depreciated as of November 2009. Because the assets are fully depreciated, Southern has been fully reimbursed for its initial investment, and, in the City's view, it is not reasonable to require customers to continue paying for these assets. Therefore, the City recommends reduction of Southern's revenue requirements for water and sewer of \$1,343 and \$4,188, respectively.<sup>94</sup>

**ALJ's Analysis and Recommendation:** No party cross-examined Mr. Adhikari or challenged his adjustments to the depreciation expense, except that Southern suggested the water

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<sup>91</sup> ED Reply to Closing Argument at 1-2.

<sup>92</sup> ED Closing Argument at 18-20; ED Reply to Closing Arguments at 6.

<sup>93</sup> OPIC Reply to Closing Arguments at 1.

<sup>94</sup> COH Ex. 2, Pous direct at 31; Tr. 198-201, 207-208; City Initial Post-hearing brief at 13-14.

well removed from the depreciation calculation should be included under Senate Bill 2306. But as the ED pointed out, that enactment did not become effective until after Southern filed its applications, and the Commission has not yet adopted the rules required to implement the changes approved by the bill. Further, even if the statute did apply, Southern offered no evidence concerning the well's salvage value or other necessary information.

The City's proposal to remove assets that will be fully depreciated by the end of this rate case is unfounded. Because it would include assets not fully depreciated until November 2009, this proposal would go outside the test year and the twelve-month post test-year window for known and measureable changes. Further, adopting this approach would also require adjustments for assets added during the course of a rate proceeding, which could become an unmanageable process. Consequently, the ALJ declines to recommend the City's proposed adjustment.

Therefore, the ALJ recommends that the Commission adopt the total depreciation expense of \$122,425 as calculated by Mr. Adhikari. However, the depreciation expense for common assets should be allocated 37% to water service and 63% for sewer service rather than 50/50 under the ED's method. The ALJ requests the ED to recalculate the allocation of this expense to water and sewer using the 37/63 allocation methodology.

### 3. Taxes Other Than Federal Income Taxes<sup>95</sup>

**Southern's Request:** For payroll taxes, Southern requested \$9,289 for water and \$16,114 for sewer; for property and other taxes, it requested \$14,214 for water and \$24,659 for sewer. The combined request is \$25,403 for payroll taxes and \$38,873 for property and other taxes.

**ED's Position:** Based on her recommended increase for Salaries and Wages, Ms. Guerrero-Gantioqui testified that payroll taxes would increase by \$449. She allocated these payroll taxes

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<sup>95</sup> See 30 TAC § 291.31(b)(1)(C).

50/50 to water and sewer, resulting in \$12,926 payroll taxes for each, for total payroll taxes of \$25,852. Ms. Guerrero-Gantioqui did not propose any adjustment to the other non-income taxes.<sup>96</sup>

**City of Houston's Position:** The City offered no evidence or argument on this issue.

**ALJ's Analysis and Recommendation:** Southern's request for \$38,873 in property and other non-payroll taxes was not disputed. Therefore, it should be approved and allocated \$14,214 to water service and \$24,659 to sewer service.

Southern's requested payroll taxes should be adjusted downward to reflect the \$3,080 downward adjustment to salaries and wages recommended in section IV.A.1.a. The ALJ requests the ED to recalculate the payroll taxes to reflect that adjustment, with the result allocated 37% to water and 63% to sewer.

#### 4. Federal Income Taxes<sup>97</sup>

**Southern's Request:** For water service, Southern projected income of \$115,498, based on a 12% return on total invested capital of \$962,486. Calculated at 34%, the corporate federal income tax for this income would equal \$39,210. For sewer, Southern projected income of \$194,121, based on a 12% return on total invested capital of \$1,617,679. The corporate federal income tax for this income would equal \$66,001. Thus, Southern's total projected federal income tax equals \$105,211.<sup>98</sup> It notes that adjustments to federal income taxes by the ED and the City reflect their proposed lower rates of return. Southern rejects those adjustments and submits that its proposed income tax expense should be adopted.<sup>99</sup>

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<sup>96</sup> ED Ex. 1-Supplemental, Guerrero-Gantioqui supplemental direct at 4.

<sup>97</sup> See 30 TAC § 291.31(b)(1)(D).

<sup>98</sup> Southern Ex. 1, Errata Application at 14 and 28; Southern Ex. 3, Martin direct at 14.

<sup>99</sup> Southern Closing Argument at 17.

**ED's Position:** Ms. Guerrero-Gantioqui made a different federal income tax calculation. Taking into account the adjustments she and Mr. Adhikari have recommended, Ms. Guerrero-Gantioqui determined the separate revenue requirements for sewer service and water service and then deducted the expenses attributable to each service to calculate the respective taxable income and federal income tax. Her calculations resulted in federal income tax for water of \$20,539 (a decrease of \$18,671 from Southern's calculation) and federal income tax for sewer of \$74,967 (an increase of \$8,966), for a total federal income tax of \$95,506 (a net decrease of \$9,705).<sup>100</sup>

**City of Houston's Position:** Mr. Pous noted that the level of income tax would change with each of his proposed changes to rate base and with the City's proposed change to capital structure. He also pointed out that that Southern must pay income tax on the additional revenue received for the authorized income tax expense. Therefore, even though the income tax was calculated at 34%, a mathematically proper "gross up" for income tax requires increasing the revenue by 1.5151 times the estimated income tax. This process recovers a full 34% on every dollar collected for equity related return.<sup>101</sup> Based on his other recommended adjustments and on the gross-up methodology, Mr. Pous recommended reducing the income tax revenue requirement for the water system by \$13,537 and for the sewer system by \$24,077, for a total reduction of \$37,614.<sup>102</sup>

**ALJ's Analysis and Recommendation:** Southern's estimated annual federal income tax will change based on various adjustments recommended in this PFD. The ALJ requests the ED to recalculate the federal income tax expense utilizing these adjustments. City of Houston witness Pous suggested grossing up income tax expense because Southern would be required to pay income tax on the additional revenue received for the income tax expense authorized in its rates. Such a gross up might be more mathematically accurate, but the Commission's rate filing package provides specific

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<sup>100</sup> These income tax calculations include revisions the ED made to the proposed rates of return. *See*, ED's Closing Argument at 3 n. 3 and attachments. The ED's previous calculation for federal income tax is explained at ED Ex. 1 Supplemental, Guerrero-Gantioqui supplemental direct at 7-8.

<sup>101</sup> COH Ex. 2, Pous direct at 32-33.

<sup>102</sup> *Id.* at 11; City Initial Post-hearing Brief at 14. Since the City has withdrawn its request to reduce rate base for certain insurance proceeds, this calculation would be slightly different with that adjustment.

instructions on calculating the federal income tax expense.<sup>103</sup> For consistency among the rate cases filed at the TCEQ, the ALJ recommends that the tax calculations provided in the rate filing package be utilized rather than the grossing up as suggested by Mr. Pous.

## 5. Other Revenue

**Southern's Request:** Southern's Errata Application includes other revenue of \$66,625 for water and \$7,165 for sewer, for total other revenue of \$73,790.<sup>104</sup> This other revenue reduces the revenue requirement to provide those services. Southern offered no specific testimony on these amounts, but it appears the other revenue for water includes a partial offset to the purchased water expense (See IV.A.1.c. above).

**ED's Position:** The ED calculated a total of \$20,080 in other revenue, allocated 50/50 between water and sewer. This includes \$11,600 rental income and \$8,480 tap fees, reconnections, and transfers. This is lower than Southern's other revenue estimate, in part because Ms. Guerrero-Gantioqui removed both the purchased water expense and the offsetting purchased water revenue claimed by Southern.<sup>105</sup>

**City of Houston's Position:** The City of Houston recommends an increase in Southern's other revenue of \$18,357, allocated \$8,525 to water revenues and \$9,832 to sewer revenues. Mr. Pous testified that Southern understated its revenue due to:

- the failure to recognize \$7,200 in rental payments (allocated \$2,633 to water and \$4,567 to sewer);

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<sup>103</sup> See, Southern Ex. 1, Errata Application at 14 and 28; ED Ex. 1, Guerrero-Gantioqui direct at Attachments 2, 4, 6, and 8.

<sup>104</sup> Southern Ex. 1, Errata Application at 15 and 29.

<sup>105</sup> ED Ex. 1 Supplemental, Guerrero-Gantioqui supplemental direct, Attachment 11 Revised at 3.

- for water, the failure to properly synchronize its revenue and expense related to purchased water in the amount of \$5,893;<sup>106</sup> and
- for sewer, the \$5,265 balance of all penalties, escrow interest, and reconnection and transfers not allocated to the water system.

Therefore, the City requests an adjustment to Southern's revenue requirement based on these understatements of other revenue.<sup>107</sup>

**ALJ's Analysis and Recommendation:** All parties seem to agree that Southern's purchased water expense should offset by an equal amount of other revenue. The Errata Application lists \$65,353 expense for purchased water,<sup>108</sup> but Southern offset this by only \$59,460 in other revenue, a difference of \$5,893.<sup>109</sup> In addition, Mr. Pous explained that Southern failed to include \$7,200 in rental payments and \$5,265 in penalties, escrow interest, and reconnection and transfers not allocated to the water system. Southern offered no testimony or argument to challenge the City's proposed adjustment and the ALJ finds the City's evidence credible. The ALJ recommends an increase in Southern's other revenue of \$18,357, allocated \$8,525 to water revenues and \$9,832 to sewer revenues, as described by Mr. Pous. Therefore, Southern's annual other revenues total \$92,148, allocated \$75,150 to water service and \$16,998 to sewer service.

## **B. Return on invested capital**

The return on invested capital is the rate of return times invested capital (rate base). 30 TAC § 291.31(c).

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<sup>106</sup> In contrast to the ED, the City included other revenues for purchased water because it did not eliminate the purchased water expense claimed by Southern.

<sup>107</sup> COH Ex. 2 at 33-34; City Initial Post-hearing Brief at 14.

<sup>108</sup> Southern Ex. 1, Errata Application at 15.

<sup>109</sup> COH Ex. 2, Pous direct at 144.

## 1. Rate of return

**Southern's Request:** Southern requested a 12% return on equity. Because Southern has no debt, this would also be the overall rate of return. Mr. Martin testified that company management has chosen not to borrow money. Shareholders have not asked for large cash dividends on their investment and no large capital improvement projects are planned that cannot be paid with accumulated reserves. Therefore, Mr. Martin did not foresee any significant debt for Southern in the immediate future.<sup>110</sup>

Mr. Martin testified that a 12% return is appropriate because:

- 12% is the default presumptive return on equity in the instructions to the TCEQ rate change application;
- the TCEQ has approved a 12% return for other investor owned utilities in recent years;
- because of these actions by TCEQ, 12% has become the capital attraction rate of return for investor owned water and sewer utilities in Texas; and
- a 12% return has induced Southern's shareholders to reinvest earnings to build up capital improvement reserves, which are needed to pay for major repairs in the current restricted capital markets.<sup>111</sup>

Mr. Martin noted that the cash reserves held by Southern do not earn this rate of return. Rather, the rate base to which this return applies is the actual plant in service, not capital reserves. Mr. Martin added that the cash reserve held by Southern is not a reason to deny a rate increase. These funds are retained earnings that could have been paid to shareholders as dividends, but the owners decided to keep the earnings in the company to pay for future capital improvements. To deny a rate increase because funds are held in reserve would discourage utilities from retaining earnings, which could interrupt service if a major equipment failure occurred and the utility had trouble getting financing. In Mr. Martin's opinion, companies with minimal or no debt are more stable and have

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<sup>110</sup> Southern Ex. 3, Martin direct at 17-18.

<sup>111</sup> *Id.* at 18.

fewer financial problems; thus, penalizing a utility for maintaining adequate working capital would do more harm than good.<sup>112</sup>

Mr. Rachac also testified that Southern has maintained its financial integrity by saving the profits earned since the last rate case 23 years ago. He stated that Southern has paid off all its debts except for monthly accounts payable. He also explained that Southern has no customer growth, as the subdivision it serves was built out many years ago. Mr. Rachac said that his family has funded significant plant from Southern's savings, including rebuilt storage tanks, refurbished and new pressure tanks, a new sewer treatment plant, three new lift stations, and one rebuilt lift station. He noted that Southern is entirely owned by the Rachac family, and no other potential shareholders are available to invest in it. Therefore, without the reserve, any major repair or addition to plant would require financing, which, in his opinion, might be difficult for a small built-out family owned water and sewer utility. Mr. Rachac testified that Southern is requesting a 12% return on equity. He pointed out that the Commission has allowed this rate of return for other water and sewer utilities, and he does not know of any reason to treat Southern differently.<sup>113</sup>

Southern rejects the City's proposed hypothetical capital structure of 65% equity and 35% long-term debt. It points out that 30 TAC § 291.31(c)(1)(C) requires the Commission to consider "the cost of various classes of capital *used by* the utility."<sup>114</sup> Southern argues this rule prohibits the Commission from applying anything other than its actual capital structure, which is 100% equity. Southern also complains that the other companies cited by the City's expert witness to develop a hypothetical capital structure are not comparable to Southern.<sup>115</sup>

Concerning the City's proposed rate of return, Southern argues that Mr. Parcell failed to explain why a 7.5% debt return was appropriate for Southern and failed to show that the other

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<sup>112</sup> *Id.* at 18-19.

<sup>113</sup> Southern Ex. 4, Rachac direct at 8-10.

<sup>114</sup> Emphasis added by Southern.

<sup>115</sup> Southern Closing Argument at 6-7; Southern Replies to Closing Arguments at 2-4.

companies he considered were comparable to Southern. It also disagrees with City's proposed return on equity because the mathematical models used by Mr. Parcell have not been used by the TCEQ for small water and sewer utilities. Instead, Southern contends that those models are typically used for large publicly traded companies, such as electric utilities. Therefore, Southern argues that the "presumptive" 12% rate of return it used should be approved.<sup>116</sup>

Southern also disagrees with the ED's proposed separate rates of return for water and sewer based on the Rate of Return Worksheet that accompanies the rate change application. It states that Ms. Guerrero-Gantioqui could not explain the worksheet, and it complains that the ED offered no evidence to show why the worksheet was financially appropriate for Southern or that it would preserve Southern's financial integrity.<sup>117</sup>

**ED's Position:** Ms. Guerrero-Gantioqui testified that in contested cases the ED uses the rate-of-return worksheet included in the rate application package. As part of this worksheet, Ms. Guerrero-Gantioqui used 7.45% as the most current Baa public utility bond average. Using that information and other criteria in the worksheet, Ms. Guerrero-Gantioqui calculated a 10.45% rate of return for water service and an 11.45% rate of return for sewer service.<sup>118</sup> In its closing statement, the ED acknowledged two mistakes made by Ms. Guerrero-Gantioqui on the worksheet: (1) the most current Baa public utility bond average should have been 7.25% instead of 7.45%, and (2) Southern should not have been given credit for seasonal customers, which increased the rate of return on the worksheet. With these corrections, the ED contends that the appropriate rate of return, calculated under the rate-of-return worksheet, should be 9.25% for water and 10.25% for sewer.<sup>119</sup>

The ED stresses that the Commission must set the rate of return based on the facts of each case, so a 12% rate of return is not always appropriate. The ED also notes that Southern has the

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<sup>116</sup> Southern Closing Argument at 8-10; Southern Replies to Closing Arguments at 6-7.

<sup>117</sup> Southern Closing Argument at 8; Southern Replies to Closing Arguments at 5-6.

<sup>118</sup> Tr. 228-230; ED Ex. 1, Guerrero-Gantioqui direct at Attachments 13 and 14.

<sup>119</sup> ED Closing Argument at 3 and 6-8.

burden of proof, and it argues that merely showing 12% has been allowed in other cases does not make it appropriate in this case. In the ED's view, it would be improper to allow a 12% rate of return without considering the required principles and factors contained in the Water Code and the Commission's rules. The ED believes the rate-of-return worksheet attached to the rate filing package adequately considers the applicable factors.<sup>120</sup> In response to Southern's criticism, the ED points out that each line in the worksheet is related to the statutory and regulatory considerations for setting a rate of return (TEX. WATER CODE § 13.184(b) and 30 TAC § 391.31(c)(1)).<sup>121</sup> According to the ED, the worksheets resulted in a rate of return 9.25% for water service and 10.25% sewer service.

The ED does not directly dispute the City's rate-of-return evidence, but the ED prefers to use its worksheet. The ED believes it would set bad precedent to require sophisticated expert testimony to establish an appropriate rate of return. This would increase rate case expenses that are passed on to customers. In the ED's opinion, the Commission's worksheet provides an efficient, streamlined estimate of an appropriate rate of return without the need for expensive experts.<sup>122</sup> OPIC supports the ED's position on rate of return.<sup>123</sup>

**City of Houston's Position:** The City of Houston offered extensive testimony from Mr. David C. Parcell on return on equity and capital structure. He testified that a fair and reasonable capital structure for Southern would assume 35% long-term debt and 65% equity, rather than Southern's actual 0% debt and 100% equity capital structure. Using a 7.5% cost for long-term debt and a 10.5% return on equity, Mr. Parcell calculated an overall rate of return for Southern of 9.45%. This is summarized as follows:

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<sup>120</sup> ED Closing Argument at 6-8.

<sup>121</sup> ED Reply to Closing Arguments at 1-3.

<sup>122</sup> ED Closing Argument at 9.

<sup>123</sup> OPIC Reply to Closing Arguments at 1.

	<b>Percentage</b>	<b>Cost</b>	<b>Return</b>
Long-term debt	35.00%	7.50%	2.62%
Common Equity	65.00%	10.50%	6.83%
Total	100.00%		9.45%

To determine the cost for common equity (return on equity), Mr. Parcell used the Discounted Cash Flow Model (DCF), the Capital Asset Pricing Model (CAPM), and Comparable Earnings (CE). These produced the following estimated costs for common equity:

<b>Methodology</b>	<b>Range of Results</b>
Discounted Cash Flow	9.5-10.5% (10.0% mid-point)
Capital Asset Pricing Model	8.0-9.0% (8.5% mid-point)
Comparable Earnings	9.5-10.5% (10.0% mid-point)

Mr. Parcell testified that the 7.50% cost for long-term debt was actually 100 basis points higher than recent yields on Baa-rated utility bonds, and the 10.50% return he used for cost of common equity was the upper end of the range of his results. In Mr. Parcell’s opinion, his recommendation properly considers to Southern’s relatively small size when compared to proxy companies.<sup>124</sup>

Concerning capital structure, Mr. Parcell acknowledged that Southern is financed with 100% equity, but he said this is not normal for a water utility. He examined two groups of water utilities and one group of natural gas utilities for the period 2004-2008 and observed that they were financed with about 45-50% common equity, compared to Southern’s 100%. According to Mr. Parcell, a 100% equity capital structure is not efficient because it does not recognize the lower cost of debt, compared to the cost of equity, nor does it recognize the lower risk of utilities, which justifies including debt in the capital structure. His examination of other utilities showed a typical capital structure of about 50% debt and 50% common equity, but Mr. Parcell assumed only 35% debt and

<sup>124</sup> COH Ex. 1, Parcell direct at 2-3.

allowed 65% common equity to account for Southern's small size.<sup>125</sup> Although this is not Southern's actual 100% equity capital structure, Mr. Parcell stated that ratepayers are entitled to just and reasonable rates, which he believes Southern's actual capital structure does not provide.<sup>126</sup> He also noted that a 10.50% return on equity assumes a risk factor based on the presence of debt; so if no debt is assumed, the return on equity should be lower.<sup>127</sup>

In argument, the City reiterates that 100% equity is abnormal for a water utility, and it criticizes Mr. Martin for failing to perform any analysis to compare Southern's capital structure with other utilities. The City also cites regulatory authorities in other states that have imputed debt into a capital structure for a utility in order to consider the interests of both the utility and customers when determining just and reasonable rates. In short, the City argues that it is unfair to require Southern's ratepayers to pay higher rates for a 100% equity capital structure when reasonable, lower cost debt is available to the utility.<sup>128</sup>

The City of Houston stresses that Mr. Parcell was the only witness properly qualified to evaluate rate of return and was the only expert to perform a traditional cost-of-capital analysis. It also disputes Southern's claim that a presumptive 12% rate of return exists. Because Southern's witness, Mr. Martin, lacked expertise and performed no analysis on rate of return, the City believes that his testimony should not be given any weight. The City also believes its rate-of-return analysis is superior to the worksheet used by the ED's witness, Ms. Guerrero-Gantioqui. However, if the Commission decides to rely on the worksheet instead of the traditional analysis used by Mr. Parcell, then the City requests that Ms. Guerrero-Gantioqui's original calculations be corrected for her acknowledged mistakes.<sup>129</sup>

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<sup>125</sup> *Id.* at 13.

<sup>126</sup> Tr. 88-89.

<sup>127</sup> Tr. 98.

<sup>128</sup> City Initial Post-hearing Brief at 22-24.

<sup>129</sup> City Initial Post-hearing Brief at 19-21.

**ALJ's Analysis and Recommendation:** The ALJ recommends that the Commission approve a rate of return for Southern of 9.25% for water service and 10.25% for sewer service, as proposed by the ED (with corrections to Ms. Guerrero-Gantioqui's original calculation). Concerning rate of return, TEX. WATER CODE § 13.184 provides:

(a) . . . [T]he commission may not prescribe any rate that will yield more than a fair return on the invested capital used and useful in rendering service to the public. . . .

(b) In fixing a reasonable rate of return on invested capital, the regulatory authority shall consider, in addition to other applicable factors, the efforts and achievements of the utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management.

(c) In any proceeding involving any proposed change of rates, the burden of proof shall be on the utility to show that the proposed change . . . is just and reasonable.

The applicable rule at 30 TAC § 291.31(c)(1) states:

The commission shall allow each utility a reasonable opportunity to earn a reasonable rate of return, which is expressed as a percentage of invested capital, and shall fix the rate of return in accordance with the following principles.

(A) The return should be 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 money necessary for the proper discharge of its public duties.

(B) The commission shall consider the efforts and achievements of the utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management, along with other relevant conditions and practices.

(C) The commission may, in addition, consider inflation, deflation, the growth rate of the service area, and the need for the utility to attract new capital. In each case, the commission shall consider the utility's cost of capital, which is the composite of the cost of the various classes of capital used by the utility.

(i) Debt capital. The cost of debt capital is the actual cost of debt.

(ii) Equity capital. The cost of equity capital must be based upon a fair return on its value. . . .

TEX. WATER CODE § 13.184(c) places the burden of proof on Southern to show that its proposed rates are just and reasonable. This burden includes proving a reasonable rate of return. However, Southern offered very little evidence concerning rate of return, other than to suggest that 12% is a presumptive return on equity that has been approved by the Commission in other cases and has become the expected rate for water and sewer utilities in Texas. Southern offered virtually no evidence concerning the factors described in TEX. WATER CODE § 13.184(b) or 30 TAC § 291.31(c). As the ED noted, the Commission must set the rate of return based on the statutory and regulatory criteria and on the facts of each case. A mere showing that 12% has been allowed in other cases does not satisfy Southern's burden of proof.

The City of Houston provided valuable, competent expert testimony on rate of return. But the City's evidence was limited solely to economic analysis through three rate-of-return models. The City's analysis did not consider the additional factors described in 30 TAC § 291.31(c)(1)(B), such as conservation of resources, quality of services, efficiency, and quality of management.

Although Ms. Guerrero-Gantioqui initially made two errors in calculating the rate of return using the Commission's worksheet, the ALJ agrees with the ED that, in this case, the worksheet calculation more fully considered the prescribed rate-of-return factors than the evidence presented by Southern or the City of Houston. The worksheet begins with the most current Baa public utility bond average and then provides for upward adjustments for factors such as the number of customers; capital structure; unstable customer population; high percentage commercial customers; low growth; an aging system; low number of complaints; lack of inspection deficiencies or enforcement actions; good faith efforts to solve problems; quality books and records; customer communication and relations; timely reports; fiscal responsibility; low percentage of unaccounted for water; desirable rate structure; drought contingency planning; conservation planning; and customer education. In this case, consideration of these factors increased Southern's rate of return from the Baa public utility bond average of 7.25% to 9.25% for water service and to 10.25% for sewer service. Further, these two rates of return fall within the range of results determined by the City's economic analysis.

The ALJ also recommends that the Commission not adopt the City's proposed hypothetical capital structure of 65% equity and 35% debt. The evidence clearly established that during the test year Southern had no long term debt, so its actual capital structure was 100% equity. The City raised legitimate questions about whether a 100% equity capital structure is efficient or fair to ratepayers. However, the Commission's rules make clear that a utility's actual capital structure should be used in establishing a rate of return. As noted by Southern, 30 TAC § 291.31(c)(1)(C) states: "In each case, the commission shall consider the utility's cost of capital, which is the composite of the cost of various classes of capital *used by the utility*." Further, § 291.31(c)(1)(C)(i) describes debt capital as "The cost of debt capital *is the actual cost of debt*." In this case, Southern had no long-term debt and had no "actual cost of debt." Therefore, under the Commission's rules, Southern's actual 100% equity capital structure should be used in setting the rate of return.

Therefore, the ALJ recommends that the Commission adopt the ED's calculation rate of return of 9.25% for water service and 10.25% for sewer service.

## **2. Invested Capital (Rate Base)**

As set out in 30 TAC § 291.31(c)(2), the rate of return applies to the following components in the rate base:

(A) original cost, less accumulated depreciation, of utility plant, property, and equipment used by and useful to the utility in providing service:

(i) original cost is the actual money cost, or the actual money value of any consideration paid other than money, of the property at the time it was dedicated to public use, whether by the utility that is the present owner or a predecessor;

(ii) reserve for depreciation is the accumulation of recognized allocations of original cost, representing recovery of initial investment, over the estimated useful life of the asset. Depreciation must be computed on a straight line basis over the expected useful life of the item or facility;

(B) working capital allowance to be composed of, but not limited to, the following:

- (i) reasonable inventories of materials and supplies, held specifically for purposes of permitting efficient operation of the utility in providing normal utility service;
- (ii) reasonable prepayments for operating expenses (prepayment to affiliated interests) are subject to the standards set forth in TEX. WATER CODE ANN. § 13.185(e); and
- (iii) a reasonable allowance for up to one-eighth of total annual operations and maintenance expense excluding amounts charged to operations and maintenance expense for materials, supplies, and prepayments (operations and maintenance expense does not include depreciation, other taxes, or federal income taxes).

Further, 30 TAC § 291.31(c)(3)(A) excludes any downward adjustment to rate base for accumulated deferred federal income taxes (ADFIT), without a showing of good cause:

Terms not included in rate base. Unless otherwise determined by the commission, for good cause shown, the following items will not be included in determining the overall rate base.

(A) Miscellaneous items. Certain items that include, but are not limited to, the following:

- (i) accumulated reserve for deferred federal income taxes; . . . .

**Southern's Request:** For water services, Southern's Errata Application claimed a rate base of \$962,485, comprised of \$923,244 net book value of land and plant<sup>130</sup> plus a \$39,241 working cash allowance.<sup>131</sup> For sewer, it claimed a rate base of \$1,617,679, comprised of \$1,560,270 net book value of land and plant<sup>132</sup> plus a \$57,409 working cash allowance.<sup>133</sup> Thus, Southern's total claimed rate base for sewer and water combined equals \$2,580,164.

Mr. Martin testified that he determined these amounts from Southern's accounting records and by physical inspection of some larger plant items. The rate base was set at the end of the test

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<sup>130</sup> \$1,460,577 original cost less \$537,333 accumulated depreciation.

<sup>131</sup> Southern Ex. 1, Errata application at 11 and 14.

<sup>132</sup> \$2,652,034 original cost less \$1,091,759 accumulated depreciation.

<sup>133</sup> Southern Ex. 1, Errata application at 25 and 28.

year and no post-test-year plant was added. He also noted that no developer or ratepayer contributed property is included in the rate base. In calculating depreciation, Mr. Martin used the plant service lives found in the TCEQ rate change application form and instructions. For the cash working capital component, Mr. Martin used the formula in the instructions of the rate change application (1/8th of O&M expense), which he thought was reasonable.<sup>134</sup>

Southern rejects the City's proposal to eliminate the cash working capital component of its rate base. It stresses that 30 TAC § 291.31(c)(2)(B) requires that a cash working allowance be included in rate base. Southern also argues that the 1/8th (45-day) cash allowance tracks the period that a utility must pay operating expenses before it collects revenue from customers. TCEQ prohibits billing a customer in advance of service. Therefore, Southern states, in a typical 30-day billing month, the customer is served for 30 days before billing, and 30 TAC § 281.87(b)(1) requires a utility to give a customer at least sixteen days to pay the bill, for a total lag of 46 days. Under this scenario, Southern contends that a 45-day cash working capital allowance is reasonable.<sup>135</sup>

**ED's Position:** As noted previously, Mr. Adhikari audited Southern's supporting documents and inspected the water and sewer systems to verify that the items Southern claimed as rate base are used and useful in providing service. He found one plugged well that is not used and useful, and he revised the depreciation schedule by renaming some assets, combining assets, and moving some assets from water to sewer. For common assets, Mr. Adhikari allocated the depreciation expense using Ms. Guerrero-Gantioqui's 50/50 water/sewer allocation instead of Southern's 37/63 allocation. The results of these adjustments are reflected on exhibits ED-KA-1 (water) and ED-KA-2 (sewer revised), attached to his prefiled testimony. These show that for water, Mr. Adhikari determined that net plant totaled \$826,856,<sup>136</sup> and for sewer it totaled \$1,520,315.<sup>137</sup>

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<sup>134</sup> Southern Ex. 3, Martin direct at 15-17.

<sup>135</sup> Southern Closing Argument at 4-5; Southern Replies to Closing Arguments at 1-2.

<sup>136</sup> \$1,393,249 original cost less \$566,392 accumulated depreciation. ED Ex. 2, Adhikari direct at attached Ex. ED-KA-1.

<sup>137</sup> \$2,638,865 original cost less \$1,118,550 accumulated depreciation. ED Ex. 2-Supplemental, Adhikari supplemental direct at attached Ex. ED-KA-2.

For the working cash allowance, Ms. Guerrero-Gantioqui calculated 1/8th of her adjusted operations and maintenance expense for Southern, as described in 30 TAC § 291.31(c)(2)(B)(iii). This produced a water cash working allowance of \$39,272 and a sewer cash working allowance of \$42,663.<sup>138</sup>

Ms. Guerrero-Gantioqui also reduced the water rate base by \$61,492 for customer deposits held by Southern.<sup>139</sup>

Although acknowledging that a lead/lag study might indicate that less working capital is needed than the 1/8th of O&M expense estimate, the ED contends that such a cash working capital allowance should be allowed to be certain that a water and sewer utility can provide adequate and continuous service. The ED states that its practice has been to allow 1/8th of O&M expense for cash working capital, even though the statute indicates that 1/8th is a cap. The ED quotes the American Water Works Association Manual of Water Supply Practices, which states: “For smaller utilities, the one-eighth method is frequently used.” Therefore, the ED argues that Southern should be allowed a cash working capital allowance in rate base equal to 1/8th of its O&M expenses.<sup>140</sup> OPIC supports the ED’s position on the cash working capital allowance.<sup>141</sup>

**City of Houston’s Position:** Mr. Pous pointed out that Southern erred by calculating accumulated depreciation as of April 30, 2007, rather than at the end of the correct test year, April 30, 2008. This adjustment increases accumulated depreciation and reduces rate base by \$46,859 for water and by \$64,409 for sewer, for a total rate base reduction of \$111,268.<sup>142</sup> At the hearing, Southern-witness John Martin acknowledged the error.<sup>143</sup>

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<sup>138</sup> ED Ex. 1, Guerrero-Gantioqui direct at 20; ED Ex. 1 Supplemental, Guerrero-Gantioqui supplemental direct at 8-9 and at Attachments 3 Revised and 7 Revised.

<sup>139</sup> ED Ex. 1, Guerrero-Gantioqui direct at 20.

<sup>140</sup> ED Closing Argument at 12-13.

<sup>141</sup> OPIC Reply to Closing Arguments at 1.

<sup>142</sup> COH Ex. 2, Pous direct at 7 and 15.

<sup>143</sup> Tr. 50-51.

Mr. Pous further stated that no working cash allowance should be included in the rate base. In his view, the TCEQ rule that allows “up to” a 1/8th year (45-day) cash flow lag is not appropriate in this case, because he believes Southern does not pay for services and products 45 days sooner than when customers pay for receiving water and sewer service.<sup>144</sup> Therefore, the City proposes a downward adjustment to rate base equal to the amount of working cash Southern included in rate base, \$39,241 for water and \$57,409 for sewer. The City criticizes Southern for not conducting a lead-lag study, and it argues that the Commission rule that allows “*up to 1/8th*” of current O&M expense as a working cash allowance clearly contemplates a lesser allowance. It states that Southern had the burden to establish an appropriate working cash allowance, but Southern failed to satisfy its burden.<sup>145</sup> The City agrees that a lead-lag study is not required in every case, but it complains that Southern made no effort to prove its need for cash working capital other than to cite the TCEQ rule that allows “up to 1/8th” of a utility’s O&M expense.<sup>146</sup>

Like Ms. Guerrero-Gantioqui, Mr. Pous contends that customer deposits held by Southern should be deducted from rate base, although he calculated test-year-end customer deposits at \$57,173 (\$20,582 for water and \$36,591 for sewer).<sup>147</sup> The City states that Southern can only earn a return on *investor* supplied capital, but these deposits are *customer* supplied capital on which Southern is not entitled to earn a return.<sup>148</sup>

Finally, Mr. Pous argued that Southern’s rate base should be reduced for Accumulated Deferred Federal Income Tax (ADFIT). Although the Commission’s rules do not provide for an ADFIT adjustment, Mr. Pous states that a “good cause” exception should be applied in this case. ADFIT concerns current federal income tax liabilities that are deferred to a future tax year. It arises

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<sup>144</sup> COH Ex. 2, Pous direct at 16-18.

<sup>145</sup> City Initial Brief at 2-3.

<sup>146</sup> City’s Post-hearing Reply Brief at 2.

<sup>147</sup> *Id.* at 8 and 18-19. Mr. Pous also noted that Southern received insurance proceeds of \$50,508 that he believed should be deducted from rate base. *Id.* at 8 and 19-20. However, in closing arguments, the City of Houston withdrew its request on this issue. City of Houston Post Hearing Brief at 4.

<sup>148</sup> City Initial Brief at 4.

because of timing differences permitted for actual tax payments, and the largest timing difference occurs between booked and taxed depreciation expense. In other words, because many assets can be depreciated faster as an expense for income tax purposes than for ratemaking purposes, actual current tax liabilities are reduced below the amount estimated for rate making purposes, and the utility has cost-free use of the difference. When an ADFIT adjustment is made, the utility is denied a return on this amount that is considered to be customer supplied capital. Mr. Pous calculated an ADFIT adjustment at \$101,838 for water and \$181,044 for sewer.<sup>149</sup> The City concedes that the Commission's rate filing package does not require an offset to rate base for ADFIT. However, it argues that a good cause exception should be allowed in this case due to (1) the large rate increase Southern has requested; (2) the large cash reserve Southern has accumulated; and (3) the health insurance provided to Southern's owners and employees, which the customers should not have to shoulder without receiving credit for customer supplied capital such as ADFIT.<sup>150</sup>

#### **ALJ's analysis and recommendation**

The ALJ recommends approval of Southern's requested rate base, subject to the following:

- a downward adjustment to plant net book value of \$111,268 for the error in accumulated depreciation cited by the City;
- a downward adjustment of \$25,075 to plant net book value for additional corrections to plant net book value as proposed by the ED;
- an allowance for a working cash allowance equal to 1/8th of Southern's O&M expense, as adjusted by the recommendations in this PFD;
- a downward adjustment of \$57,173 for customer deposits, as calculated by the City;  
and
- no downward adjustment for ADFIT, as proposed by the City.

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<sup>149</sup> COH Ex. 2, Pous direct at 9 and 20-22.

<sup>150</sup> City Initial Post-hearing Brief at 4-5.

A comparison of the parties' rate base positions shows the following:

	<b>Plant Net Book Value</b>	<b>Working Cash Allowance</b>	<b>Customer Deposits</b>	<b>ADFIT</b>	<b>Total</b>
<b>Southern:</b> <sup>151</sup>					
Water	\$923,244	\$39,241	--	--	\$962,485
Sewer	\$1,560,275	\$57,409	--	--	\$1,617,684
Total	\$2,483,519	\$96,650	--	--	\$2,580,169
<b>ED:</b> <sup>152</sup>					
Water	\$826,856	\$39,272	\$(61,492)	--	\$804,636
Sewer	\$1,520,315	\$42,663	--	--	\$1,562,978
Total	\$2,347,171	\$81,935	\$(61,492)	--	\$2,367,614
<b>Houston:</b> <sup>153</sup>					
Water	\$876,385	--	\$(20,582)	\$(101,838)	\$753,965
Sewer	\$1,495,861	--	\$(36,591)	\$(181,044)	\$1,278,226
Total	\$2,372,246	--	\$(57,173)	\$(282,882)	\$2,032,191

Plant net book value: The City's total reflects the reduction for the error in Southern's accumulated depreciation calculation. This error occurred because Southern calculated accumulated depreciation as of April 30, 2007, rather than at the end of the test year, April 30, 2008. Southern-witness John Martin acknowledged the error, and the ALJ agrees that this correction should be made.<sup>154</sup> The ED's calculation for total net book value is \$25,075 less than the City's calculation. Mr. Adhikari made various adjustments to the depreciation schedule as described in section IV.A.2. Because Mr. Adhikari's calculations correctly began with amounts from the end of the test year,

<sup>151</sup> Southern Ex. 1, Errata Application at 14 and 28.

<sup>152</sup> ED Closing Argument, Attachment 3 Revised and Attachment 7 Revised.

<sup>153</sup> COH Ex. 1, Pous direct at 14-22. The amounts shown for City reflect the City's withdrawal of its request for a reduction to rate base for certain insurance proceeds. See, City Initial Post-hearing brief at 4.

<sup>154</sup> Tr. 50-51.

April 30, 2008, his calculations already take into account the error pointed out by the City. Thus, the \$25,075 additional reduction to Southern's proposed net plant book value concern the additional adjustments made by Mr. Adhikari discussed previously.<sup>155</sup> No party cross examined or challenged those adjustments, and the ALJ finds they are appropriate. Therefore, the ALJ recommends that the Commission approve a total plant net book value of \$2,347,171 as proposed by the ED. However, for common assets, Mr. Adhikari allocated the net book value 50/50 between water and sewer. The ALJ requests the ED to recalculate this allocation using the 37/63 methodology recommended in this PFD and to adjust the plant net book value for water and sewer service accordingly. In other words, the total plant net book value should reflect the ED's recommendation, but the allocation between water and sewer service will change slightly using the 37/63 allocation methodology for common assets.

Working cash allowance: Southern's rate base should include a cash working allowance equal to 1/8th of Southern's annual O&M expense, as adjusted by the recommendations in this PFD. The City objected that Southern did not perform a lead/lag study to calculate an accurate working cash allowance, and it pointed out that the Commission's rule merely allows such an allowance "up to" 1/8th of annual O&M expense. Southern explained how customers are allowed up to 46 days to pay for water they have already received. This 46-day lag equals 1/8th of a year, which is the basis of the 1/8th rule. Likewise the ED noted that it is its common practice to allow a 1/8th O&M cash working allowance for water and sewer utilities, and the American Water Works Association Manual of Water Supply Practices states that the 1/8th method is frequently used for smaller utilities. The City pointed out that Southern likely receives some of its materials, supplies, and services before it has to pay for them, which delay in payment by Southern would offset the lag in its customers' payments. To determine this offset would require a formal lead/lag study, but the cost of such a study would be added to rate case expenses and might well exceed any benefit to be received by ratepayers of small utilities. A formal lead/lag study may be appropriate for a large utility to determine its working cash allowance, but for utilities such as Southern, an allowance equal to 1/8th

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<sup>155</sup> ED Ex. 2, Adhikari direct at attached Ex. ED-KA-1 (water); ED Ex. 2 Supplemental, Adhikari supplemental direct at attached Ex. ED-KA-2 (Sewer Revised).

of O&M expense is reasonable. Therefore, the ALJ recommends that the Commission approve a working cash allowance in rate base equal to 1/8th of Southern's annual O&M expense, as adjusted in this PFD. The ALJ requests that the ED recalculate the allowance using the recommended adjustments as well as the 37/63 allocation methodology for unassigned O&M expenses.

Customer deposits: Both the City and the ED recommended a downward adjustment to rate base for customer deposits held by Southern, as these represent cost-free capital on which Southern is not entitled to a return. Southern did not dispute that an adjustment for customer deposits should be made, and the ALJ finds that an adjustment is appropriate. The only issue is the amount of the adjustment and the allocation between water and sewer service. The ED recommends a \$61,492 adjustment, allocated entirely to water service, while the City recommends a \$57,173 adjustment, allocated \$20,582 to water and \$36,591 to sewer. The workpapers attached to Mr. Pous' testimony and to Ms. Guerrero-Gantioqui's testimony show \$57,173 in customer deposits on Southern's balance sheet as of April 30, 2008.<sup>156</sup> The ALJ cannot determine the source of the \$61,492 amount recommended by Ms. Guerrero-Gantioqui. Therefore, the ALJ recommends that the Commission reduce Southern's rate base for customer deposits by \$57,173, allocated \$20,582 to water and \$36,591 to sewer.

ADFIT: The ALJ recommends that the Commission deny the City of Houston's request to reduce Southern's rate base for ADFIT. As noted previously, 30 TAC § 291.31(c)(3)(A) excludes any adjustment to rate base for ADFIT without a showing of good cause. The City contends good cause exists due to the size of the rate increase Southern has requested, the large cash reserve Southern has accumulated, and because Southern provides health insurance to its employees. Neither the size of Southern's cash reserve nor the fact that it provides health insurance to its employees can credibly be considered good cause to reduce Southern's rate base. Under some circumstances the size of a rate increase may constitute good cause. However, the adjustments proposed in this PFD will reduce the size of Southern's rate increase, the resulting rates will be based upon applicable criteria and methodology, and the amount of the final rates are not excessive when

compared to other water and sewer rates in the state. Therefore, the evidence does not establish good cause to support an adjustment to Southern's rate base for ADFIT.

In summary, the ALJ recommends that the Commission approve the rate base requested by Southern with the adjustments described above. The ALJ also requests the ED to recalculate Southern's rate base to reflect these adjustments.

### V. RATE DESIGN

**Southern's Request:** Mr. Martin designed Southern's water and sewer rates based on the instructions in the TCEQ rate change application form. He included 2,000 gallons in the base monthly minimum bill because it was done in Southern's last rate case and customers are accustomed to it. Likewise, he designed residential sewer rates with winter averaging for all residential customers because that is how Southern has done it historically and the Commission requires it. In Mr. Martin's opinion, the resulting rates are reasonable because they comply with the instructions; they follow the design adopted in Southern's last rate case, which was contested, and Southern and its customers are familiar with the rate design.<sup>157</sup> Southern's proposed rates are:<sup>158</sup>

<u>Water</u>		<u>Sewer</u>	
Minimum Bill		Minimum Bill	
(including 2,000 gallons)		(including 2,000 gallons)	
5/8" x 3/4"	\$16.58	5/8" x 3/4"	\$33.95
3/4"	\$23.28	3/4"	\$33.95
1"	\$36.66	1"	\$33.95
1 1/2"	\$70.12	1 1/2"	\$33.95
2"	\$110.27	2"	\$33.95
3"	\$203.95	3"	\$33.95
<u>Gallonage Rate</u>		<u>Gallonage Rate</u>	
\$1.60 for each 1,000 gallons		\$2.75 for each 1,000 gallons	
over the 2,000 gallon minimum		over the 2,000 gallon minimum	

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<sup>156</sup> COH Ex. 2, Pous direct, workpapers at 76; Ex. ED-1, Guerrero-Gantioqui direct at attachment 17.

<sup>157</sup> Southern Ex. 3, Martin direct at 19-20.

<sup>158</sup> Southern Ex. 1, Errata Application at 18 and 32.

New residential customers are charged the system average winter water consumption. All non-residential rates are based on monthly water consumption.

Southern stresses that it and the ED followed the rate design instructions contained in the TCEQ application form. It disagrees with the City's proposed weather adjustment, suggesting that the TCEQ has not used such an adjustment in any water utility rate case. Southern further complains that the weather adjustment is arbitrary because Mr. Pous had no statistical analysis to support it. Southern also states that the City's adjustment to the reported 13.97% system losses is unsupported, and it notes that the Commission has historically accepted line losses less than 15% as reasonable.<sup>159</sup>

As noted, Southern included 2,000 gallons of water in its base charge. Southern agrees that current TCEQ practice is not to include any gallonage in the base rate, but Southern states that its customers are familiar with this billing practice and removing the gallonage would increase the rate shock. Therefore, it recommends maintaining the 2,000 gallons included in the base charge.<sup>160</sup>

**ED's Position:** To achieve its proposed revenue requirement, the ED recommended the following rate schedule, with no gallons included in the minimum bill.<sup>161</sup>

<u>Water</u>		<u>Sewer</u>	
<u>Minimum Bill</u>		<u>Minimum Bill</u>	
5/8" x 3/4"	\$17.41	5/8" x 3/4"	\$19.56
1"	\$43.52	1"	\$19.56
1 1/2"	\$87.04	1 1/2"	\$19.56
2"	\$139.27	2"	\$19.56
3"	\$261.13	3"	\$19.56
<u>Gallonage Rate</u>		<u>Gallonage Rate</u>	
\$1.60 for each 1,000 gallons		\$2.75 for each 1,000 gallons based on winter average water consumption	

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<sup>159</sup> Southern Closing Argument at 18-19; Southern Replies to Closing Arguments at 9-10.

<sup>160</sup> Southern Closing Argument at 19.

<sup>161</sup> ED Closing Argument at attached Ex. ED-KA-5 (Water Revised) and Ex. ED-KA-6 (Sewer Revised).

The ED disagrees with the City's proposed weather normalization adjustment, which is based on high rainfall during the test year. The ED questions both the underlying data and Mr. Pous' qualifications concerning meteorology. In the ED's opinion, the proposed adjustment is too speculative.<sup>162</sup>

**City of Houston's Position:** The City of Houston proposes three adjustments related to rate design. Weather Normalization: First, Mr. Pous testified that the test year had unusually high rainfall that likely depressed the amount of water Southern sold to its customers because of less need to water lawns. Fewer gallons sold during the test year requires a higher per/gallon charge to meet Southern's revenue requirement. Therefore, Mr. Pous recommended increasing the assumed water sales for the test year by 5%, or 5,514,000 gallons. In Mr. Pous' opinion, this is a conservative estimate because it relies on the average usage per customer during the initial test year (2006-2007), which was also rainier than normal. Mr. Pous made no adjustment to sewer gallonage based on weather, and he made a corresponding increase to the expense for chemicals, as his proposed adjustment assumes more gallons would be pumped, sold, and chemically treated. By his calculation (using \$1.00 per 1,000 gallons), this weather normalization would result in a \$5,514 adjustment to Southern's revenues.<sup>163</sup>

System Losses: A system loss factor establishes the level of billable gallons to customers in order to design the gallonage rate. In other words, a higher loss factor results in fewer billable gallons to customers and a higher per gallon rate. The City of Houston notes that during the initial test year, Southern had a system loss factor of 10.17%, while during the second test year, used by Southern to calculate its proposed rates, it had a system loss of 13.97%. Mr. Pous recommended averaging these two amounts and applying a system loss factor of 12.07% for determining Southern's loss factor. This adjustment would result in a \$2,504 increase in revenues for purposes of calculating rates.<sup>164</sup>

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<sup>162</sup> ED Closing Argument at 17-18.

<sup>163</sup> COH Ex. 2, Pous direct at 35-36; City Initial Post-hearing Brief at 14-15.

<sup>164</sup> COH Ex. 2, Pous direct at 36-37; City Initial Post-hearing Brief at 16.

Rate Design: The City of Houston disagrees with Southern's proposal to include 2,000 gallons in the base charges and with Southern's proposal to have the same base charge for sewer service regardless of the size of the water meter. Houston argues that good public policy requires that customers not pay for water that they may not use. Including 2,000 gallons in the base charge artificially increases the customer charge, discourages conservation, and fails to send the appropriate price signals to customers, stated Mr. Pous.<sup>165</sup> Thus, the City of Houston recommends elimination of the 2,000 gallons included in the base charge for water, and it recommends a sewer rate design that proportionately increases with the size of the meter.<sup>166</sup>

With these adjustments and with no gallons included in the minimum bill, the City's proposed rate schedule is:<sup>167</sup>

**Water****Minimum Bill**

5/8" x 3/4"	\$11.75
1"	\$30.00
1 1/2"	\$50.00
2"	\$92.00
3"	\$179.00

**Gallonge Rate**

\$1.20 for each 1,000 gallons

**Sewer****Minimum Bill**

5/8" x 3/4"	\$16.50
1"	\$34.00
1 1/2"	\$55.00
2"	\$73.00
3"	\$122.00

**Gallonge Rate**

\$2.55 for each 1,000 gallons

based on winter month average of water consumption

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<sup>165</sup> COH Ex. 2, Pous direct at 38-40.

<sup>166</sup> City Initial Post-hearing brief at 16-17.

<sup>167</sup> COH Ex. 2, Pous direct at Schedule JP-4. The City's proposed rate schedule does not include meters greater than 3" because Southern has no such customers.

**ALJ’s Analysis and Recommendation:** The ALJ recommends that the Commission approve a rate design that:

- eliminates the 2,000 gallons of water that Southern has included in the base rates;
- makes no weather adjustment as proposed by the City of Houston;
- makes no adjustment for system losses as proposed by the City of Houston; and
- includes the same sewer base charge for all meter sizes.

The ED and the City request a rate design that eliminates the 2,000 gallons of water that Southern includes in its current base rate and proposes to include in the new rates. Southern acknowledges that the Commission’s current practice is not to include any gallons in the base rate, but it states that its customers are familiar with the current base charge and continuing it will reduce rate shock. However, the mere fact that customers are accustomed to the current base charge is not sufficient reason to continue it. And as Mr. Pous testified, including 2,000 gallons in the base charge artificially increases the charge, discourages conservation, and fails to send the appropriate price signals. Southern’s argument that keeping the current format will reduce rate shock is also not supported by the evidence. Any rate shock that might occur will result from the overall rate increase approved, not from eliminating the 2,000 gallons that are included in the base charge.

The overwhelming majority of Southern’s customers have a 5/8” or 3/4” meter. A comparison of charges for such a customer under the current rates and under each party’s proposed rates for 10,000 gallons and 30,000 gallons is shown below:

	10K Water	10K Sewer	<b>10K Total</b>	30K Water	30K Sewer	<b>30K Total</b>
Current	\$19.92	\$37.18	<b>\$57.10</b>	\$39.92	\$82.18	<b>\$122.10</b>
Southern	\$29.38	\$55.95	<b>\$85.33</b>	\$61.38	\$110.95	<b>\$172.33</b>
ED	\$33.41	\$47.06	<b>\$80.47</b>	\$65.41	\$102.06	<b>\$167.47</b>
Houston	\$23.75	\$42.00	<b>\$65.75</b>	\$47.75	\$93.00	<b>\$140.75</b>

The amount of the rate increase for these customers will not change based on including or excluding 2,000 gallons in the base charge. Therefore, eliminating the 2,000 gallons from the base charge will have no impact on rate shock.

The evidence also did not support making a weather adjustment as proposed by the City. Mr. Pous presented some very basic information about rainfall for the test year and for the 30-year average. However, Mr. Pous has no significant expertise in meteorology and the underlying data he presented was not sufficient to support a weather adjustment. The ALJ agrees with the ED that the City's proposed adjustment is too speculative.

Finally, the ALJ recommends that the Commission not make an adjustment for system losses or differentiate sewer base rates based on the size of water meter. As noted by Southern, the Commission has historically accepted line losses less than 15% as reasonable, and the ED did not recommend a system-loss adjustment in this case. In addition, sewer base rates are typically the same regardless of the size of the water meter. With a larger water meter, more gallons will likely be consumed than with a smaller water meter, but this increase is accounted for by the variable sewer rate based on the total gallons of water purchased. A larger water meter may require more water infrastructure to justify a higher water base rate, but the water meter size should have little, if any, impact on the sewer infrastructure.

Therefore, the ALJ recommends that the Commission approve a water rate design as provided in the instructions to the water rate packet, without any gallons included in the base rate, without a weather or system loss adjustment, and with a flat sewer base rate. The ALJ requests the ED to recalculate the proposed rates with the adjustments proposed in this PFD.

## VI. SUMMARY OF RECOMMENDATIONS

In summary, the ALJ recommends that the Commission approve Southern's application for a water and sewer rate change with the following adjustments and recommendations discussed in this PFD:

- Allocation of unassigned expenses, assets, depreciation, and other revenues 37% to water service and 63% to sewer service;
- \$3,080 net decrease to salaries and wages;
- \$400 increase for contract labor;
- \$912 increase for chemicals;
- \$15,727 decrease for utilities;
- \$6,611 decrease for repairs, maintenance, and supplies;
- \$6,860 decrease for office expenses;
- \$21,038 decrease for accounting and legal expenses;
- \$38,043 decrease for insurance expense;
- \$2,038 net decrease for miscellaneous expenses;
- \$11,157 increase to depreciation expense;
- A downward adjustment to payroll taxes to reflect the recommended \$3,080 decrease for salary and wages;
- A downward adjustment to federal income taxes to reflect the change to income resulting from the other proposed adjustments;
- \$18,357 increase to Southern's other revenues;
- A 9.25% rate of return for water service and a 10.25% rate of return for sewer service;
- Total plant net book value in rate base of \$2,347,171 (a reduction of \$136,343) as determined by the ED, except that common assets should be allocated 37% to water and 63% to sewer;
- A cash working allowance in rate base equal to 1/8th of Southern's annual O&M expense, as adjusted by the recommendations in this PFD;
- \$57,173 decrease to rate base for customer deposits, as calculated by the City;

- A rate design that eliminates the 2,000 gallons Southern has previously included in the base rate and is determined in accordance with the rate design instructions contained in the TCEQ application form.

The ALJ requests the ED to make the appropriate recalculations based on the ALJ's recommendations and to include those along with the ED's exceptions to this PFD. Further, the Commission should order Southern to refund any over recovery of rates that occurred during the pendency of this rate proceeding, plus interest. Water Code § 13.187(2)(i) and 30 TAC § 291.21(h).<sup>168</sup>

## VII. RATE CASE EXPENSES

As set out in 30 TAC § 291.28(7), a utility may recover reasonable and necessary rate case expenses, including attorney fees, incurred as a result of a rate change application. Under 30 TAC § 291.31(b)(2)(I), any expenditure the Commission finds unreasonable, unnecessary, or not in the public interest may be disallowed.

**Southern's Request:** Southern seeks to recover \$62,558.36 in rate case expenses. It proposes to recover these through a traditional 24-month base rate surcharge, which would equal \$2.08 per customer or, if separated between sewer and water bills, \$1.04 per month per bill for each service. Southern also requests a provision in the Commission's order requiring it to stop charging the surcharge after it collects this amount of rate case expenses from customers.<sup>169</sup>

**ED's Position:** The ED recommends that the Commission reduce Southern's rate case expenses by \$10,979.00, because that amount is attributable to work done on Southern's first application that had an incorrect test year. The ED states that customers should not be required to pay for an erroneous application. The ED agrees that the rate case expenses should be recovered

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<sup>168</sup> The record contains no evidence concerning the appropriate rate of interest.

<sup>169</sup> Southern Ex. 4, Rachac direct at 7-8; Southern Ex. 5, Zeppa direct at 1-3; Southern Closing Argument at 20.

through a surcharge for water and sewer customers over 24 months or until the total amount is collected, whichever occurs first. However, the ED also requests an order requiring Southern to submit a semi-annual report to the TCEQ, Water Supply Division, showing the total surcharge collected and the remaining balance, in order to insure that the surcharge ceases when the full amount is collected.<sup>170</sup> OPIC supports the ED's position on rate case expenses.<sup>171</sup>

**City of Houston's Position:** The City of Houston agrees with the ED's proposed \$10,979 reduction to Southern's rate case expenses concerning the first erroneous application. It also complains that Southern did not participate in the hearings held by the Houston City Council on Southern's application. The City suggests that if Southern had participated and supported its application, the City Council may have awarded Southern higher rates; this appeal would not have been necessary; and significant rate case expenses could have been avoided. Therefore, City argues, the expenses of Southern's appeal were not reasonable and necessary expenses and should not be charged to Southern's customers. The City also contends that allowing Southern a recovery of these fees would not be in the public interest because it would allow utilities to ignore municipalities' original jurisdiction.<sup>172</sup>

The City of Houston is also authorized to recover its reasonable rate case expenses from the utility, pursuant to TEX. WATER CODE § 13.084. In turn, the utility can seek recovery of those costs from customers. However, the City of Houston has elected not to seek recovery of its rate case expenses in this case.

**ALJ's Analysis and Recommendation:** The ALJ recommends that the Commission reduce Southern's rate case expenses by \$10,979.00 for the amount is attributable to work done on Southern's first application that had an incorrect test year and had to be replaced by the Errata

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<sup>170</sup> ED Closing Argument at 16; ED Ex. 1 Supplemental, Guerrero-Gantioqui supplemental direct at 10-11. Ms. Guerrero-Gantioqui added that she could not give a precise amount for Southern's rate case expenses because she has not seen all invoices and documentation.

<sup>171</sup> OPIC Reply to Closing Arguments at 1.

<sup>172</sup> City Initial Post-hearing Brief at 17-19.

Application. However, no additional reduction should be made as proposed by the City. The City of Houston complained that Southern did not adequately pursue its applications that were pending before City Council. However, the evidence showed that Southern did pursue its application at the City. Southern worked with City staff and actually reached a settlement, but the settlement was rejected by the mayor and city council. The City's contention that further effort by Southern may have resulted in higher rates being approved by city council, thus avoiding this proceeding, is mere speculation. Therefore, the ALJ recommends that the Commission approve Southern's rate expense of \$51,579.36 (\$62,558.36 - \$10,979.00). The rate case expenses should be recovered through a surcharge for water and sewer customers over 24 months or until the total amount is collected, whichever occurs first. The Commission should also require Southern to submit a semi-annual report to the Water Supply Division, showing the total surcharge collected and the remaining balance, as proposed by the ED.

#### VIII. CONCLUSION

Southern's proposed rates, as reflected in the Rate/Tariff Change Errata Application filed with the TCEQ on August 1, 2008, are reasonable and necessary to provide water and sewer service to its ratepayers, with modifications as set out in this PFD. Further, Southern has proved that it should recover \$51,579.36 in rate case expenses.

The ALJ has attached a draft Proposed Order, which he will revise to reflect the calculations based on the ALJ's specific recommendations that the ED will provide in its exceptions.

**SIGNED May 19, 2010.**



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**THOMAS H. WALSTON**  
**ADMINISTRATIVE LAW JUDGE**  
**STATE OFFICE OF ADMINISTRATIVE HEARINGS**

**TEXAS COMMISSION ON ENVIRONMENTAL QUALITY**



**AN ORDER Approving the Application of  
Southern Water Corporation to Change Water and Sewer Rates  
and Granting the Appeal of Southern Water Corporation from a  
Water and Sewer Ratemaking Decision of the City of Houston  
TCEQ Docket Nos. 2008-1830-UCR and 2008-1811-UCR;  
SOAH Docket Nos. 582-09-2068 and 582-09-2069**

On \_\_\_\_\_, the Texas Commission on Environmental Quality (Commission) considered the application of Southern Water Corporation for water and sewer rate/tariff changes and for recovery of rate case expenses through imposition of a surcharge on water and sewer customers and the appeal of Southern Water Corporation from a water and sewer ratemaking decision of the City of Houston. Administrative Law Judge (ALJ) Thomas H. Walston 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. Southern Water Corporation (Applicant) holds Water Certificate of Convenience and Necessity (CCN) No. 11389 and Sewer CCN No. 20500.
2. On May 29, 2008, Applicant submitted to the Commission an application for water and sewer rate/tariff changes, CCN Nos. 11389 and 20500, for its integrated utility system

- located in Harris County, Texas. The application used a test year of May 1, 2006, through April 30, 2007.
3. After a Notice of Deficiency issued by the Commission's Executive Director (ED), Applicant submitted on August 1, 2008, an Errata Application for water and sewer rate/tariff changes for CCN Nos. 11389 and 20500. The Errata Application used a test year of May 1, 2007, through April 30, 2008, and was the application considered in this proceeding.
  4. On November 14, 2008, Applicant filed petitions with the TCEQ to appeal the water and sewer rate decisions by the City of Houston (City), which denied Applicant's rate increase requests.
  5. On January 14, 2009, Applicant's Errata Application (2008-1811-UCR) and Applicant's petitions (2008-1830-UCR) were referred to SOAH for contested case hearings.
  6. On April 7, 2009, Applicant's two proceedings were consolidated for one hearing and one PFD.
  7. Applicant seeks a total revenue requirement of \$1,289,852, including \$472,437 for water service and \$817,415 for sewer service.
  8. Under the Application, the proposed rate increases were effective August 1, 2008.
  9. Applicant timely provided notice of the proposed rate changes to its ratepayers and affected persons.
  10. The ED protested Applicant's proposed rate increases for customers living outside the City.
  11. On April 7, 2009, a preliminary hearing convened, jurisdiction was established, and the following parties were designated: Applicant; the ED; the Office of Public Interest Counsel (OPIC); and the City of Houston.
  12. A hearing on the merits of the Application was held on January 6, 2010, at the SOAH

hearing facilities in Houston, Texas. Applicant appeared through its attorney, Mark H. Zeppa; the ED appeared through Brian MacLeod, staff attorney; OPIC appeared through Scott Humphrey, staff attorney; and the City appeared through attorneys Alton J Hall and Tammy Wavle-Shea. The hearing resumed telephonically on February 8, 2010, with all parties participating.

13. The record closed on March 22, 2010, after the parties filed replies to written closing arguments.
14. During the test year, Applicant provided water and sewer service to 1,256 customers. Four customers reside outside the Houston City limits and two of these are sewer only customers. The remaining 1,252 customers are inside the City and are both water and sewer customers.
15. Applicant requested the following rates, which it implemented August 1, 2008:

<p><b><u>Water</u></b>          Minimum Bill          (including 2,000 gallons)</p> <table border="0"> <tr><td>5/8" x 3/4"</td><td>\$16.58</td></tr> <tr><td>3/4"</td><td>\$23.28</td></tr> <tr><td>1"</td><td>\$36.66</td></tr> <tr><td>1 1/2"</td><td>\$70.12</td></tr> <tr><td>2"</td><td>\$110.27</td></tr> <tr><td>3"</td><td>\$203.95</td></tr> </table> <p><b><u>Gallonage Rate</u></b>          \$1.60 for each 1,000 gallons          over the 2,000 gallon minimum</p>	5/8" x 3/4"	\$16.58	3/4"	\$23.28	1"	\$36.66	1 1/2"	\$70.12	2"	\$110.27	3"	\$203.95	<p><b><u>Sewer</u></b>          Minimum Bill          (including 2,000 gallons)</p> <table border="0"> <tr><td>5/8" x 3/4"</td><td>\$33.95</td></tr> <tr><td>3/4"</td><td>\$33.95</td></tr> <tr><td>1"</td><td>\$33.95</td></tr> <tr><td>1 1/2"</td><td>\$33.95</td></tr> <tr><td>2"</td><td>\$33.95</td></tr> <tr><td>3"</td><td>\$33.95</td></tr> </table> <p><b><u>Gallonage Rate</u></b>          \$2.75 for each 1,000 gallons          over the 2,000 gallon minimum</p>	5/8" x 3/4"	\$33.95	3/4"	\$33.95	1"	\$33.95	1 1/2"	\$33.95	2"	\$33.95	3"	\$33.95
5/8" x 3/4"	\$16.58																								
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3"	\$33.95																								

Expense Allocation Between Water and Sewer Service

16. The value of the depreciable assets used for sewer service is significantly greater than those used for water service.
17. The allowable expenses attributable directly to sewer service are significantly greater than those directly attributable to water service.

18. Allocation of overhead, general costs, and common assets 37% to water and 63% to sewer is reasonable and should be utilized in calculating Applicant's rates.

#### Salaries and Wages

19. Applicant's reasonable and necessary salary and wage expenses are \$293,688 for providing water and sewer service, allocated \$108,665 to water and \$185,023 to sewer.
20. Applicant's salaries and wages are based only on historic salary and wage costs incurred during the test year.
21. One employee position for Applicant was vacant during the test year for about four months.
22. Applicant incurred contract labor expense during the test year for meter reading and to help pull a lift station and for similar work.
23. Applicant's staffing levels were reasonable for a water and sewer utility with over 1,250 customers.

#### Contract Labor Expenses

24. During the test year, Applicant incurred \$4,400 in contract labor.
25. Applicant incurred contract labor costs of \$4,000 to help pull a lift station and for similar work.
26. Applicant incurred contract labor costs of \$400 for meter reading.
27. Applicant's contract labor expenses incurred during the test year were reasonable and necessary and should be allocated \$1,628 to water service and \$2,772 to sewer service.

#### Purchased Water Expense

28. Applicant is located within the Harris-Galveston Subsidence District (District) and is under orders to convert from groundwater to surface water.
29. Because no surface water is available to Applicant, the District allows it to join an alternate

program sponsored by the City of Houston, which is constructing infrastructure necessary to provide surface water.

30. Until the infrastructure is completed, Applicant pays the City a fee per 1,000 gallons pumped to help offset the infrastructure costs.
31. This expense totaled \$65,353 for the test year, allocated entirely to water service.
32. The purchased water expense is reasonable and necessary for Applicant to provide service.
33. The charges paid by Applicant to the City are collected from customers in the exact amount.
34. The purchased water expense is entirely offset in Applicant's rate calculations through a deduction for other revenues received from customers.

#### Chemical Expenses

35. Applicant incurred a sludge expense of \$28,046 directly assigned to sewer service.
36. Applicant incurred laboratory fees of \$912 directly assigned to water service.
37. Applicant incurred unassigned chemical expenses of \$20,267 that should be assigned 37% to water service and 63% to sewer service.
38. Applicant's total chemical expense of \$49,225 is reasonable and necessary and should be allocated \$40,854 to sewer service and \$8,411 to water service.

#### Utilities

39. Applicant's test-year expenses for utilities were \$42,549 for water and \$73,813 for sewer, for a total of \$116,362.
40. Applicant's utility expense is almost exclusively for electricity.
41. Applicant purchases electricity from a retail electric provider in a deregulated market.
42. Applicant changed to a new retail electric power provider after the test year, and its utility charges have dropped by more than two cents per kilowatt hour.

43. Under its new rates, Applicant's annual electricity costs would be \$15,727 lower than the test year.
44. Applicant's reduced electricity rates are a known and measureable change.
45. Total utility expense \$100,635, allocated \$36,730 for water service and \$63,905 for sewer service, are reasonable and necessary.

#### Repair, Maintenance, and Supply Expenses

46. Applicant's reasonable and necessary annual repair, maintenance, and supply expense total \$7,604, allocated \$2,813 to water service and \$4,791 to sewer service.

#### Office Expenses

47. Applicant claimed total test-year office expenses of \$26,854, allocated \$9,819 to water service and \$17,035 to sewer service.
48. Applicant's claimed total office expense should be reduced by the following items: a payment to Stephen Rachac of \$2,590 due to lack of appropriate documentation; \$400 reclassified to contract labor; \$1,200 reclassified to salaries and wages; \$125 for flowers; and \$2,545 for a payment to office manager Doyle without supporting explanatory information.
49. Applicant's reasonable and necessary annual office expenses total \$19,994, allocated \$7,398 to water service and \$12,596 to sewer service.

#### Accounting and Legal Expenses

50. Applicant claimed total test-year accounting and legal expenses of \$39,926, allocated \$14,599 to water service and \$25,327 to sewer service.
51. Applicant's claimed total office expense should be reduced by the following items: \$17,987 professional fees also booked as rate case expenses; \$40 payment for a fine; \$100 payment to a church; \$1,101 non-recurring payment to the Houston Chronicle; \$912 reclassified to

chemicals (laboratory fee); and \$898 in fees concerning a federal income tax return for a trust.

52. Applicant's reasonable and necessary annual accounting and legal expenses total \$18,888, allocated \$6,989 to water service and \$11,899 to sewer service.

#### Insurance Expenses

53. Applicant claimed total test-year insurance expenses of \$136,412, allocated \$49,880 to water service and \$86,532 to sewer service.
54. Applicant's total insurance expense included \$91,351 in health insurance expenses and \$45,061 in commercial insurance.
55. Applicant health insurance expense included health and dental insurance for Applicant's employees and family members and life insurance for certain employees.
56. Only \$56,308 of Applicant's health insurance expense for employees is reasonable and necessary.
57. Applicant's health insurance expense of \$33,772 for employee family members is not a reasonable and necessary expense of service.
58. Applicant's \$3,604.25 dental insurance expense for employees and for employee family members is not a reasonable and necessary expense of service.
59. Applicant's \$667.39 life insurance expense for certain employees is not a reasonable and necessary expense of service.
60. Applicant's reasonable and necessary annual insurance expenses total \$98,369, allocated \$36,397 to water service and \$61,972 to sewer service.

#### Miscellaneous Expenses

61. Applicant's reasonable and necessary annual miscellaneous expenses total \$22,967, allocated \$8,498 to water service and \$14,469 to sewer service.

Depreciation Expense

62. Applicant claimed total test-year depreciation expense of \$111,268, allocated \$46,859 to water plant and \$64,409 to sewer service.

63. After correcting Applicant's depreciation expense by removing one well that has been plugged and is not used or useful and by renaming some assets, combining assets, and moving some assets from the water schedule to the sewer schedule, Applicant's reasonable and necessary annual depreciation expense totals \$122,425, allocated \$\_\_\_\_\_ to water service and \$\_\_\_\_\_ to sewer service.

Taxes Other than Federal Income Taxes

64. Applicant's reasonable and necessary payroll taxes total \$\_\_\_\_\_, allocated \$\_\_\_\_\_ to water service and \$\_\_\_\_\_ to sewer service.

65. Applicant's reasonable and necessary annual property and other non-income taxes total \$38,873, allocated \$14,214 to water service and \$24,659 to sewer service.

Federal Income Taxes

66. Applicant's reasonable and necessary annual federal income taxes total \$\_\_\_\_\_, allocated \$\_\_\_\_\_ to water service and \$\_\_\_\_\_ to sewer service.

Other Revenues

67. Applicant's Errata Application included other revenue, which reduces the revenue requirement, of \$66,625 for water service and \$7,165 for sewer service, for total other revenue of \$73,790.

68. To completely offset Applicant's purchased water expenses, its other revenue should be increased by \$5,893.
69. Applicant's other revenue should be increased by \$7,200 in rental payments, allocated \$2,633 to water and \$4,567 to sewer.
70. Applicant's other revenue should be increased by the \$5,265 balance of all penalties, escrow interest, and reconnection and transfers not allocated to the water system. This increase should be allocated to sewer service.
71. Applicant's annual other revenues total \$92,148, allocated \$75,150 to water service and \$16,998 to sewer service.

Net Invested Capital (Rate Base)

72. In its Errata Application, Applicant requested a rate base totaling \$2,580,169, allocated \$962,485 to water service and \$1,617,684 to sewer service. Applicant's total requested rate base included \$2,483,519 in plant net book value and a \$96,650 working cash allowance.
73. Applicant's total plant net book value should be reduced by \$111,268 to reflect net book value as of April 30, 2008, rather than April 30, 2007.
74. Applicant's total net plant book value should be reduced by \$25,075 for corrections for the removal of one well that has been plugged and is not used or useful.
75. Applicant should be authorized a working cash allowance equal to 1/8th of its operations and maintenance (O&M) expense authorized by this order.
76. Applicant's should be allowed a working cash allowance of \$\_\_\_\_\_ for water service to reflect the reductions to its O&M expense approved in this order.
77. Applicant's should be allowed a working cash allowance of \$\_\_\_\_\_ for sewer service to reflect the reductions to its O&M expense approved in this order.

78. Applicant's total rate base should be reduced by \$57,173 for customer deposits.
79. Good cause was not established to reduce Applicant's rate base for Accumulated Deferred Federal Income Taxes.
80. Applicant's total reasonable net invested capital is \$\_\_\_\_\_, allocated \$\_\_\_\_\_ to water service and \$\_\_\_\_\_ to sewer service.

Rate of Return

81. Applicant has a capital structure of 100% equity and 0% long-term debt.
82. When Applicant filed its Errata Application, the then current Baa public utility bond average was 7.25%
83. Concerning water service, at the time of the Errata Application, Applicant had no major deficiencies in the most recent PWS inspection report; no then current or prior enforcement actions within the previous three years; and Applicant made good faith efforts to solve current problems.
84. Concerning its water service, at the time of the Errata Application, Applicant had a drought contingency plan; a conservation plan; a program to educate its customers about the nature of the system, its production and distribution ability, PWS standards, and the need for water conservation; and a successful program to reduce unaccounted for water losses.
85. Concerning its sewer service, at the time of its Errata Application, Applicant had a stand alone sewer system with no agreement with a water supplier for either billing and collection or for discontinuance for nonpayment.
86. Concerning its sewer service, at the time of its Errata Application, Applicant had no major deficiencies in the most recent PWS inspection report; no then current or prior enforcement

actions within the previous three years; and Applicant made good faith efforts to solve current problems.

87. Concerning its sewer service, at the time of its Errata Application, Applicant had well-maintained, up-to-date books and records; effective communications and good customer relations; and it consistently and timely met reporting requirements and payment of fees.

88. A fair rate of return for Applicant to receive on its water-service rate base is 9.25%.

89. A fair rate of return for Applicant to receive on its sewer-service rate base is 10.25%.

#### Rate Design

90. Applicant's current rate design includes 2,000 gallons in the base rate for water and sewer service.

91. Applicant's system-wide water loss was 13.97%.

92. A preponderance of the evidence did not support an adjustment to rates based on weather normalization.

#### Rate Case Expenses

93. Applicant incurred reasonable and necessary rate case expenses in this matter in the amount of \$51,579.36 for preparation of the Errata Application, including deriving the original plant and equipment costs, developing the proposed rate/tariff changes, filing fees, costs of notice, and participation by experts and counsel in the contested case hearing.

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

#### Refunds

95. Because of the adjustments adopted by the Commission in this order, Applicant has received an over-recovery of rates (*i.e.*, overpayment by customers) while this rate case was pending.

96. Accounting for interest, the total refunds due to Applicant's customers for overcharges is \$ \_\_\_\_\_ for the water system and \$ \_\_\_\_\_ for the sewer system.

Miscellaneous

97. Non-rate fees and charges, and service policies in the proposed rate/tariff are consistent with Commission rules and with tariffs approved by the Commission for other similarly-situated utilities.

**CONCLUSIONS OF LAW**

1. Applicant is a public utility as defined in TEX. WATER CODE ANN. § 13.002(23).
2. The Texas Commission on Environmental Quality has jurisdiction to consider an application for a rate increase filed by a public utility, pursuant to TEX. WATER CODE ANN. § 13.181.
3. The Texas Commission on Environmental Quality has jurisdiction to consider an appeal by a public utility of a rate decision by the governing body of a municipality, pursuant to TEX. WATER CODE ANN. § 13.043.
4. The ALJ conducted a contested case hearing and issued a proposal for decision on the Applicant's proposed water and sewer rate/tariff changes under TEX. GOV'T. CODE ANN. ch. 2003, TEX. WATER CODE ANN. ch. 13, and 30 TEX. ADMIN. CODE chs. 80 and 291.
5. Proper notice of the Application was given by the Applicant as required by TEX. WATER CODE ANN. § 13.187, 30 TEX. ADMIN. CODE §§ 291.22 and 291.28, and TEX. GOV'T. CODE ANN. §§ 2001.051 and 2001.052.
6. The invested capital amounts set forth in the Findings of Fact above are based on the original cost of property used by and useful to the Applicant in providing service, less depreciation, in accordance with TEX. WATER CODE ANN. § 13.185.

7. The revenue requirements are based on Applicant's reasonable and necessary operating expenses, within the meaning of TEX. WATER CODE ANN. §§ 13.183 and 13.185.
8. The revenue requirements are sufficient to provide Applicant 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.
9. The rates and fees to be charged by Applicant, as approved by the Commission in this Order, are just and reasonable, not unreasonably preferential, prejudicial, or discriminatory, and 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.
10. Rate case expenses in the amount of \$51,579.36 were a reasonable and necessary cost within the meaning of TEX. WATER CODE ANN. § 13.185(d) and (h), and recovery of these costs through a monthly surcharge of \$ \_\_\_\_\_ per customer for two years, or until the amount is paid, complies with 30 TEX. ADMIN. CODE § 291.21(k) for collection of revenues over and above the usual cost of service.
11. The following rates are appropriate to implement the Commission's rulings in this matter:

<u>Water</u>		<u>Sewer</u>	
<u>Minimum Bill (including 0 gallons)</u>		<u>Minimum Bill (including 0 gallons)</u>	
5/8" x 3/4"	\$ _____	5/8" x 3/4"	\$ _____
1"	\$ _____	1"	\$ _____
1-1/2"	\$ _____	1-1/2"	\$ _____
2"	\$ _____	2"	\$ _____
3"	\$ _____	3"	\$ _____
Gallorage Rate		Gallorage Rate	
\$ _____ per each 1,000 gallons		\$ _____ per each 1,000 gallons	

12. After accounting for interest, the total refunds due customers for overcharges is \$ \_\_\_\_\_ for the water system and \$ \_\_\_\_\_ for the sewer system.
13. The reasonable rate of interest on the overcharge balance until repaid is \_\_\_\_\_%.

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

1. Southern Water Corporation's Errata Application for water and sewer rate/tariff changes and its appeal from a water and sewer rate making decision of the City of Houston are granted as modified by, and to the extent set forth in, the Findings of Fact and Conclusions of Law.
2. The request of Southern Water Corporation to apply a surcharge to recover rate case expenses in the amount of \$51,579.36, to be recovered 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 \$51,579.36 is recovered.
3. Southern Water Corporation shall submit a semi-annual report to the TECQ, Water Supply Division, beginning six months after the date of this order, showing the total surcharge collected and the remaining balance.
4. Southern Water Corporation shall refund customers, for a period of \_\_\_\_\_ months, the amount of \$ \_\_\_\_\_ per water connection per month and \$ \_\_\_\_\_ per sewer connection per month for the over-recovery of rates that occurred during the pendency of this rate proceeding, plus interest. This refund shall occur in the form of a credit on customers' bills. Customers who no longer take service from Southern Water Corporation shall have the total amount of refund paid directly to them.

5. Southern Water Corporation shall file a report to the Commission's Utilities and Districts Section, Water Supply Division, demonstrating compliance with the refund requirements of this Order. This report shall be filed each quarter until such time that all overcharges and interest have been refunded.
6. Southern Water Corporation shall file a tariff reflecting the rates approved by the Commission within 10 days of the date of this Order.
7. Southern Water Corporation 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.
8. 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.
9. 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.
10. The Chief Clerk of the Texas Commission on Environmental Quality shall forward a copy of this Order and tariff to the parties.
11. 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

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Bryan W. Shaw, Ph.D., Chairman