

**TCEQ Docket No. 2009-1925-UCR;  
SOAH Docket No. 582-10-1944**

<b>APPEAL OF NAVARRO COUNTY</b>	§	<b>BEFORE THE STATE OFFICE</b>
<b>WHOLESALE RATEPAYERS ON</b>	§	
<b>BEHALF OF ITS MEMBERS, M.E.N.</b>	§	
<b>WATER SUPPLY CORPORATION,</b>	§	
<b>RICE WATER SUPPLY</b>	§	
<b>CORPORATION, ANGUS WATER</b>	§	
<b>SUPPLY CORPORATION, CHATFIELD</b>	§	
<b>WATER SUPPLY CORPORATION,</b>	§	
<b>CORBET WATER SUPPLY</b>	§	<b>OF</b>
<b>CORPORATION, NAVARRO MILLS</b>	§	
<b>WATER SUPPLY CORPORATION,</b>	§	
<b>CITY OF BLOOMING GROVE, CITY</b>	§	
<b>OF FROST, CITY OF KERENS, AND</b>	§	
<b>COMMUNITY WATER COMPANY, TO</b>	§	
<b>REVIEW THE WHOLESALE WATER</b>	§	
<b>RATE INCREASE OF THE CITY OF</b>	§	
<b>CORSICANA, TEXAS</b>	§	<b>ADMINISTRATIVE HEARINGS</b>

**NAVARRO COUNTY WHOLESALE RATEPAYERS' EXCEPTIONS  
TO THE PROPOSAL FOR DECISION**

The members of Navarro County Wholesale Ratepayers (“Ratepayers”) file these Exceptions to the Proposal for Decision (“PFD”) and would respectfully show:

**I. INTRODUCTION**

In 2009, the City of Corsicana faced a million dollar shortfall in its wastewater operations, and asked “how will we pay for it?” Although the question was appropriate, Corsicana’s answer was not. To make up the *wastewater* deficit, Corsicana chose to raise *water* rates. But Corsicana did not raise water rates equally for all of its customers. Instead, it devised an inclining block rate structure, based on the usage of its average residential customers, to prevent average residential customers from paying any of the rate increase, and targeted Corsicana’s 21 wholesale customers who buy as much water as Corsicana’s thousands of retail customers combined. Thus, to fix a budget shortfall for its wastewater department, the City shifted the cost to its wholesale water purchasers, while

preventing average residential water users from paying any of the increase. But that is not all — the wholesale customers *do not receive any wastewater service* from Corsicana. In short, Corsicana’s answer was, “make someone else pay for it.”

Under that new rate structure (the “2009 Rate Increase”), Corsicana’s average residential retail customer pays \$3 per thousand gallons, while its wholesale customers pay \$3.25 for over 99% of the water they buy. While the effect of the 2009 Rate Increase is apparent, the intent behind the rate is just as certain. When the Ratepayers approached Corsicana to ask why they were being yoked with most of the rate increase, the Mayor of Corsicana told them: “because y’all don’t vote.” Corsicana forced its wholesale water customers, who do not receive wastewater service, to pay for the wastewater shortfall, while simultaneously shielding the average in-city residential water customers from bearing any of that burden, and it even admitted that it was by design.

Corsicana’s blatant rate discrimination is precisely the type of abuse of monopoly power that the TCEQ has a statutory duty to police and the public interest rule 30 TEX. ADMIN. CODE § 291.133 was designed to remedy. The Proposal for Decision, however, finds that rate discrimination cannot even be considered – a decision contrary to the Water Code, contrary to the cases underlying the public interest rules, and inconsistent with the public interest rules themselves. The PFD also finds that the subsidy of wastewater service with water revenues is a “cost of service” issue and therefore it also cannot be considered, even though the cost of wastewater service is clearly not part of the cost of providing water service. The PFD also incorrectly interprets several public interest factors in § 291.133 and either determines that it cannot consider, or neglects to consider, other evidence relevant to those factors. Properly applied, the public interest rules compel the determination that the City of Corsicana abused its monopoly power, that the 2009 Rate Increase adversely affects the public interest, and that this wholesale rate appeal should proceed to a cost of service hearing.

## II. DISCUSSION

### A. **The PFD applies an incorrect legal standard by determining that evidence of discrimination may not be considered in the public interest analysis.**

The PFD applies an incorrect legal standard by determining that the public-interest inquiry under 30 TEX. ADMIN. CODE § 291.133(a)(3) is limited to the eight enumerated factors (factors A-H) under that rule.<sup>1</sup> Based on that ruling, the PFD concludes that the TCEQ (“Commission”) cannot consider the disparate or discriminatory effects of Corsicana’s 2009 Rate Increase on its wholesale customers – rate discrimination that is admitted and was intended by Corsicana. The determination that the enumerated factors under 30 TEX. ADMIN. CODE § 291.133(a)(3) are exclusive and do not encompass rate discrimination is contrary to the language of the rule itself, the applicable Water Code provisions, underlying case law, and the preamble to 30 TEX. ADMIN. CODE § 291.133.

#### I. *The Water Code makes contracts that involve rate discrimination unlawful.*

Texas Water Code § 11.036(b)<sup>2</sup> requires the TCEQ to ensure that when state-owned water is being sold pursuant to a contract, “[t]he price and terms of the contract shall be just and reasonable and without discrimination.” The public interest rules apply to wholesale rate appeals of rates set pursuant to a contract, providing a procedure for determining whether a contract is against the public interest and therefore may be set aside. Because § 11.036(b) expressly makes contracts for the sale of state-owned water at discriminatory prices illegal, and therefore against the public interest,<sup>3</sup> the analysis under the public interest rules in an appeal under Chapter 11 of the Water Code *must* encompass rate discrimination. By definition, a contract for the sale of state-owned water that is

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<sup>1</sup> See PFD at 13-15.

<sup>2</sup> The PFD correctly concludes that the Commission has jurisdiction over all of the Ratepayers’ appeals under Chapter 11 of the Water Code.

<sup>3</sup> That illegal contracts are void because they are against public policy is a longstanding rule of contract law in Texas. See, e.g., *Lewis v. Davis*, 199 S.W.2d 146, 151 (Tex. 1947).

illegal because of discriminatory pricing adversely affects the public interest. If rate discrimination exists but is not determined not to be a public interest violation under 30 TEX. ADMIN. CODE § 291.133 – or cannot even be considered in the public interest analysis – the rule would be invalid because it would contravene § 11.036(b).<sup>4</sup>

ii. *The cases underlying the public interest rules hold that rate discrimination adversely affects the public interest.*

The cases underlying the public interest rules<sup>5</sup> reinforce that conclusion because they are based on the same principle – that price discrimination adversely affects the public interest. *Texas Water Comm'n v. City of Fort Worth*<sup>6</sup> relied on *High Plains Natural Gas Co. v. Railroad Comm'n of Texas*,<sup>7</sup> which in turn relied on the United States Supreme Court decision in *Federal Power Comm'n v. Sierra Pacific Power Co.*<sup>8</sup> All three of those decisions were interpreting statutes that prohibit utilities from charging unduly or unreasonably preferential or discriminatory rates, like § 11.036(b). All three decisions required that before a rate set pursuant to a contract may be set aside, a finding be made that the contract adversely affects the public interest. All three decisions unequivocally hold that unreasonable rate discrimination adversely affects the public interest.<sup>9</sup>

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<sup>4</sup> Sound public policy also justifies the illegality of price discrimination in contracts for state-owned water, which is owned in trust for the public. TEX. WATER CODE § 11.021(a); *Lower Colorado River Authority v. Texas Dept. of Water Resources*, 689 S.W.2d 873, 875 (Tex. 1984). The State's underlying ownership of surface water provides the State with both greater authority and latitude in regulating the price of an important resource that it owns, manages and regulates.

<sup>5</sup> The underlying cases are further discussed on pages 24-27 of the Ratepayers' Closing Argument, which is incorporated by reference.

<sup>6</sup> 875 S.W.2d 332 (Tex. App.–Austin 1994, writ denied)

<sup>7</sup> 467 S.W.2d 532 (Tex. Civ. App.–Austin 1971, writ ref'd n.r.e.)

<sup>8</sup> 350 U.S. 348, 355 (1956).

<sup>9</sup> *Federal Power Comm'n*, 350 U.S. at 355; *City of Fort Worth*, 875 S.W.2d at 336; *High Plains Natural Gas Co.*, 467 S.W.2d at 537.

Specifically, *City of Fort Worth* addressed a rate appeal under Texas Water Code § 13.043, and the decision lead directly to the advent of the public interest rules. § 13.043(j) requires that water rates charged by or to retail public utilities “shall not be unreasonably preferential, prejudicial, or discriminatory” and shall be “consistent in application to each class of customers.”<sup>10</sup> The Court held that before a rate set pursuant to a contract could be set aside under § 13.043, “the Commission [must] first make a finding that the rates . . . adversely affect the public interest by being unreasonably preferential, prejudicial, or discriminatory.” 875 S.W.2d at 336. By equating an adverse effect on the public interest with unreasonably preferential or discriminatory rates, the *City of Fort Worth* decision mandates that rate discrimination be considered as part of the public interest analysis under 30 TEX. ADMIN. CODE § 291.133 – whether considered an “additional factor” or as part of the analysis under the enumerated factors. Indeed, *City of Fort Worth* definitively holds that unreasonable rate discrimination *is* a public interest violation.

In light of the holding in *City of Fort Worth* and the express declaration by § 11.036(b) that rate discrimination is unlawful, the determination in the PFD that factors A-H under 30 TEX. ADMIN. CODE § 291.133(a)(3) are exclusive and therefore preclude consideration of rate discrimination is clearly an error of law. Such a determination would lead to situations – such as the one in this case – where clear rate discrimination exists but may not be found to adversely affect the public interest, contrary to the mandatory statutory authorities discussed above.

*iii. The plain language and preamble to the public interest rules show that rate discrimination should be considered in the public interest analysis.*

The plain language of 30 TEX. ADMIN. CODE § 291.133(a) makes clear that rate discrimination may be considered in the public interest analysis, and therefore the rule does not

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<sup>10</sup> While similar, § 13.043(j) prohibits rates that are “unreasonably” preferential or discriminatory, while § 11.036(b) provides an even stricter standard by mandating that contractual rates for state owned water be “without discrimination.”

contradict the Water Code and applicable cases. Section 291.133(a) lists four “public interest criteria.” The third criteria, § 291.133(a)(3) is whether “the protested rate evidences the seller’s abuse of monopoly power in its provision of water or sewer service to the purchaser. In making this inquiry, the commission shall weigh all relevant factors. The factors may include:” the eight factors enumerated in § 291.133(a)(3)(A)-(H). By compelling the Commission to weigh “*all* relevant factors,” and by specifying that the “factors *may* include” the eight enumerated factors, the rule is clear that the relevant factors are not exclusive and may be different from case to case. In some cases, not all of the eight enumerated factors may be relevant; in others, additional factors not enumerated may be relevant. The use of the word “shall” makes the duty to consider “all relevant factors” mandatory, while use of the permissive “may” in the phrase “the factors may include” clarifies that the eight enumerated factors are neither exclusive or exhaustive, and that all eight may not apply in each case. As discussed above, an interpretation that the eight enumerated factors are exclusive is not only unsupported by the language of the rule but would be contrary to the statutes which place a mandatory duty on the Commission to ensure that sales of state-owned surface water are “without discrimination.”<sup>11</sup>

Both the ED and the Commission agree. The preamble to the public interest rule acknowledges that the eight “factors” are non-exclusive by noting that “mathematic tests” and “exact methods” for defining the public interest were rejected.<sup>12</sup> The ED simply and unequivocally states that “[t]he factors listed under the abuse of monopoly power criterion are not exclusive. Other

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<sup>11</sup> Texas Water Code § 11.036(b).

<sup>12</sup> 19 Tex. Reg. 6229 (1994)

factors can be reviewed when determining if the seller's protested rate evidences abuse of monopoly power."<sup>13</sup>

The reasoning in the PFD that additional factors such as rate discrimination and disparate treatment may not be considered may rest on language in the preamble to the public interest rules stating that the four public interest "criteria" are exclusive.<sup>14</sup> The preamble language cited in the PFD, that a "party should not be allowed to urge that some other criteria have been violated," clearly refers to the four public interest "criteria" set forth in § 291.133(a)(1)-(4) rather than the eight "factors" under criteria § 291.133(a)(3) – a crucial distinction. While the four "criteria" may be exclusive, the eight "factors" under the third criteria are clearly not exclusive. The Ratepayers allege that the third "criteria" (abuse of monopoly power) has been violated, and not "some other criteria." But the Ratepayers have also shown that Corsicana has engaged in rate discrimination. As discussed above, the language of § 291.133(a)(3) allows other "factors" to be considered, while the Water Code and applicable cases mandate that rate discrimination be considered. Rate discrimination is not only "relevant," but unreasonable rate discrimination alone constitutes a public interest violation.

The preamble also explicitly states that rate discrimination is a factor to consider under the abuse of monopoly power criterion by stating that "[t]he public interest inquiry under paragraph § 291.133(a)(3) should sufficiently cover whether any disparity in treatment between retail and wholesale customers adversely affects the public interest."<sup>15</sup> The PFD reaches the opposite interpretation of that preamble language by noting that it was in response to a comment regarding § 291.133(a)(4), and reasoning that by not explicitly including rate discrimination as a factor under

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<sup>13</sup> ED's Closing Argument at 24.

<sup>14</sup> 19 Tex. Reg. 6228 (1994)

<sup>15</sup> 19 Tex. Reg. 6229

§ 291.133(a)(3), “the Commission specifically chose to narrow the public-interest inquiry and not look into alleged discrimination favoring retail over wholesale customers.”<sup>16</sup> That reasoning misinterprets the preamble. The comment at issue was whether § 291.133(a)(4) “should concern unreasonable discrimination between customers” or “should only focus on wholesale customers.” The Commission agreed that § 291.133(a)(4) should only focus on discrimination between wholesale customers precisely because § 291.133(a)(3) already “cover[s] . . . any disparate in treatment between retail and wholesale customers.”<sup>17</sup> Thus, the Commission did not “narrow the public-interest inquiry” and preclude consideration of rate discrimination between retail and wholesale customers under § 291.133(a)(3), but precisely the opposite by affirming that § 291.133(a)(3) is the proper criteria under which to analyze rate discrimination between retail and wholesale customers.

Even Corsicana acknowledges that rate discrimination is within the public interest analysis, arguing that:

a difference or a disparity in rates in the treatment of retail versus wholesale customers may suggest discrimination, but the standard is “unreasonably discriminatory.”<sup>18</sup>

In other words, even Corsicana agrees that discrimination is a relevant consideration. The City only quibbles over how much it can discriminate before it is a violation of the public interest.

*iv. By determining that rate discrimination cannot be considered, the PFD misapplies the law to the facts and fails to consider important evidence.*

The determination that “the public-interest inquiry” does not take into account “discrimination favoring retail over wholesale customers”<sup>19</sup> or any other factors relevant to abuse of

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<sup>16</sup> PFD at 15.

<sup>17</sup> 19 Tex. Reg. 6229

<sup>18</sup> Tr. at 634:13-16.

<sup>19</sup> PFD at 15.

monopoly power that are not expressly enumerated in § 291.133(a)(3) leads to many of the other errors in the PFD. That determination fundamentally shaped the case because it prevented consideration of many pieces of evidence that proved Corsicana's discriminatory intent and the disparate impact on wholesale customers.

As a prime example, the PFD simply dismisses the Mayor of Corsicana's frank admission that the 2009 Rate Increase was designed and intended to discriminate against Corsicana's wholesale customers.<sup>20</sup> Together with the actual disparate rate increase to Corsicana's retail and wholesale customer classes, there is no better evidence of discrimination than the Mayor's admission that the 2009 Rate Increase was intentionally discriminatory.

Similarly, the PFD "assigns no evidentiary weight to the McLain study and drafts"<sup>21</sup> because it finds the study unreliable and that it contains cost of service evidence. However, the McLain study is highly relevant because the McLain study served as the fundamental basis for and was relied on by Corsicana to adopt the 2009 Rate Increase and therefore explicitly reveals Corsicana's abuse of monopoly power. Although Corsicana's abuse of monopoly power is evident from the undisputed fact that the 2009 Rate Increase targeted wholesale customers while excluding average residential customers, the McLain study presents unfiltered, unqualified proof that the 2009 Rate Increase was intentionally discriminatory.

For example, the McLain study shows that Corsicana considered three rate structures that each generated the same revenue, and that one of those rate structures was "preferred by the American Waterworks Association" ("AWWA").<sup>22</sup> The study shows that while Corsicana had the

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<sup>20</sup> PFD at 16.

<sup>21</sup> PFD at 24-25.

<sup>22</sup> NCWR-24 at 4.

knowledge and opportunity to choose the approach preferred by the AWWA, it chose a new rate structure that the AWWA considers inequitable to apply to wholesale customers. That structure benefitted Corsicana's retail customers at the expense of its wholesale customers. The study also shows *why* Corsicana chose that rate structure, candidly stating that the 2009 Rate Increase was designed to be preferential to Corsicana's residential customers at the expense of the wholesale customers: "Rate design alternative 3 incorporates conservation-block rates, modeled on our analysis of the residential consumption profile" and recommended alternative 3 because it "lowers the impact of increasing revenues on the average residential user." Thus, both the McLain study and Corsicana's Mayor explicitly admit that the 2009 Rate Increase was intentionally designed and adopted because it gave preference to one class of Corsicana's customers over another class, but the PFD does not consider those key discriminatory admissions in its public interest analysis.

The PFD also does not consider Table 1.7 of the McLain study<sup>23</sup> and similar evidence<sup>24</sup> which shows the effect of the three alternative rate increases on Corsicana's customer classes. Such evidence shows both the extent of the rate disparity of the 2009 Rate Increase and that Corsicana knew what the effects of the 2009 Rate Increase would be before adopting it. For example, Corsicana knew that the rate structure preferred by the AWWA would have lowered its wholesale customers' rates by 32%, but that the 2009 Rate Increase raised wholesale customers' rates by at least 9% while it raised rates for its average residential customers by only 2.6% – a rate disparity that is confirmed by other evidence.<sup>25</sup> Corsicana's chosen rate structure was also scheduled to multiply

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<sup>23</sup> NCWR-59 at 9.

<sup>24</sup> For example, NCWR-23 at 9 and NCWR-24 at 8 show the rate increase for Corsicana's average residential customers – the customer class expressly singled out for preferential treatment.

<sup>25</sup> For example, Corsicana-30 shows that rates for its average residential customers increased by only 2.6%, while NCWR-23 at 9, NCWR-60, and NCWR-61 show that wholesale rates increased by 9%.

that disparity by several times over the next decade.<sup>26</sup> The McLain study shows that Corsicana chose its discriminatory rate structure with full knowledge of the rate disparity it would cause.

Moreover, while the PFD states that it assigns no evidentiary weight to the McLain study, the PFD selectively considers evidence from the study. For example, the PFD concludes that Corsicana's purported need for additional operating reserves<sup>27</sup> is a "changed condition" supporting the 2009 Rate Increase. However, the purported need for additional operating reserves are supposedly proven by the McLain study. The PFD should not consider evidence from the McLain study that supports its proposed ruling but sweepingly dismiss the remainder of the study that does not, especially when it contains evidence directly relevant to abuse of monopoly power.

Due to the PFD's application of an incorrect legal standard – that the public interest factors in § 291.133(a)(3) are exclusive and evidence of rate discrimination and disparate treatment of customer classes may not be considered – the PFD does not consider the evidence outlined above and in the Ratepayers' Closing Argument. Doing so improperly ignores evidence that is not only extremely compelling, but dispositive.

**B. The PFD applies the rule excluding "cost of service" evidence too narrowly in at least one instance and too broadly in some instances.**

The PFD understandably acknowledges that § 291.133(b), which prohibits a determination that a "protested rate adversely affects the public interest based on an analysis of the seller's cost of service," is a difficult rule to apply.<sup>28</sup> As this proceeding has made clear, "the line between evidence that concerned only cost of service and that which concerned another relevant factor [is] not always

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<sup>26</sup> NCWR-24 at 40.

<sup>27</sup> Not only is the need for additional operating reserves a cost of service issue, as more fully discussed below, but the McLain study's mathematical errors and re-allocations of costs between water and wastewater actually disprove Corsicana's need for additional operating reserves.

<sup>28</sup> PFD at 19.

clear.”<sup>29</sup> The PFD correctly draws that line in some instances, but diverges at several important points and ultimately uses an interpretation of cost of service that is inconsistent and varies from the Commission’s rules.

- i. Corsicana’s alleged need for additional operating reserves is a cost of service issue and is not a “changed condition.”*

While the PFD correctly determines that most of Corsicana’s evidence of “changed conditions” under § 291.133(a)(3)(B) constitutes impermissible cost of service evidence, the PFD incorrectly finds that Corsicana’s alleged need for operating reserves for its water utility is a changed condition supporting the 2009 Rate Increase and does not constitute a cost of service issue.<sup>30</sup>

Section 291.31(b)(1)(A) broadly defines “components of allowable expenses” in a cost of service calculation to include “operations and maintenance expense incurred in furnishing normal utility service.” Moreover, § 291.129(3) defines the cash basis calculation of cost of service as “[a] calculation of the revenue requirement to which a seller is entitled to cover all cash needs.” There is simply no other way to characterize cash reserves necessary to operate a water system than as a “cash need” and an “operating expense” under those definitions.

The “expenses not allowed” by § 291.31(b)(2) are also informative. Those are:

legislative advocacy expenses . . . funds expended in support of political candidates . . . any political movement . . . in promotion of political or religious causes . . . in support of or membership in social, recreational, fraternal, or religious clubs or organizations . . . funds promoting increased consumption of water . . . additional funds expended to mail any parcel or letter containing any of the items mentioned [above] . . . costs . . . of processing a refund or credit of sums collected in excess of the rate finally ordered by the commission . . . any expenditure found by the commission to be unreasonable, unnecessary, or not in the public interest, including, but not limited to, executive salaries, advertising expenses, rate case expenses, legal expenses, penalties and interest on overdue taxes, criminal penalties or fines, and civil penalties or fines; and . . . the costs of purchasing groundwater from any source

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<sup>29</sup> *Id.*

<sup>30</sup> PFD at 48-50.

if the source of the groundwater is located in a priority groundwater management area; and a wholesale supply of surface water is available.

Thus, “expenses not allowed” are those that are clearly unrelated to the normal operations of a utility, while “allowable expenses” are normal operating expenses. The stark contrast between expenses allowed and not allowed in 30 TEX. ADMIN. CODE § 291.31(b) further confirms that operating reserves must be characterized as part of a utility’s cost of service.

The PFD alludes to the reason why operating reserves are a cost of service issue even though it reaches the opposite conclusion. The PFD acknowledges that “[i]t is certainly possible<sup>31</sup> that the deficit in the Utility Fund was caused wholly or partially by water-service rates that were too low to cover the cost of providing that service . . . or by sewer rates that were too low or by unreasonably high water or sewer services expenses” or “due to rates for certain types of customers being lower than the cost of serving them.” The PFD also concludes that “those are all cost-of-service issues,” yet, even though one or more of those cost of service issues caused the alleged shortfall in the Utility Fund and lack of sufficient operating reserves, the PFD then reaches the *opposite* conclusion — that the lack of operating reserves is *not* a cost of service issue. The apparent reasoning for this conclusion is that whatever the cause(s) of the shortfall in the Utility Fund, that shortfall actually existed and therefore is a “changed condition.”<sup>32</sup> But that reasoning is another way of saying that if in fact expenses were exceeding revenues from rates, leading to a shortfall in funds, that is a changed condition justifying Corsicana’s rate increase. That reasoning is, of course, equivalent to the conclusion that if rates were not covering Corsicana’s cost of service, that is a “changed

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<sup>31</sup> While the PFD states that it is “possible” that rates that are too low, expenses that are too high, or use of water revenues to pay for things other than water service caused the deficit, it is not “possible” but certain. There are no other possibilities.

<sup>32</sup> PFD at 50.

condition” under § 291.133(a)(3)(B) — a conclusion that is plainly impermissible under § 291.133(b).

The PFD also notes that “[t]he terms “cost of service” and “revenue requirement” are synonymous.<sup>33</sup> Here, Corsicana alleges that the need for additional operating reserves is part of its revenue requirement from its rates. Table 4.1 of the McLain study further confirms this by including operating reserves in “revenues required from rates.”<sup>34</sup> Mr. Mullins also testified that operating reserves must be included in Corsicana’s revenue requirement.<sup>35</sup>

Thus, not only do the definitions of “cost of service” and “revenue requirement” necessarily include operating reserves, but logic, Corsicana’s allegations, and the evidence all show that operating reserves are a cost of service issue. As such, the mere need for operating reserves cannot be considered, and therefore do not qualify as “changed conditions” justifying a rate increase under § 291.133(a)(3)(B).

*ii. The evidence disproves the alleged need for additional operating reserves for Corsicana’s water service as a valid “changed condition.”*

But even if the need for additional operating reserves can be considered a changed circumstance, in some cases, it certainly cannot be in this case. The PFD also asserts that “the uncontradicted evidence shows that the shortfall in the Utility Fund existed at the time that Corsicana raised its water rates.”<sup>36</sup> However, the Utility Fund *as a whole* is not the proper scope of inquiry. As more fully discussed below, because the Ratepayers are water customers but not wastewater customers, any alleged need for operating reserves must focus solely on Corsicana’s water service.

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<sup>33</sup> PFD at 51.

<sup>34</sup> NCWR-24 at 46; NCWR-69 at 2.

<sup>35</sup> Tr. at 1160:10-19 (Mullins, April 12, 2011).

<sup>36</sup> PFD at 50.

The evidence shows that Corsicana's Utility Fund required additional reserves only because water revenues were subsidizing wastewater expenses,<sup>37</sup> a subsidy that is manifestly *not* a cost of service issue. Finally, a need for additional operating reserves is not a justification for a discriminatory rate increase.

*iii. The subsidy of wastewater costs with water revenues is not a cost of service issue, and is directly relevant to abuse of monopoly power.*

While the conclusion that cost of service does not include operating reserves (which even Corsicana alleges is part of its revenue requirement) is erroneous, the conclusion that Corsicana's subsidy of wastewater costs with water revenues is a cost of service issue is more fundamentally misguided.<sup>38</sup> A donation of water revenues to cover wastewater expenses is no more a cost of water service than political and religious donations<sup>39</sup> are costs of water service. The fact that Corsicana uses an accounting system that commingles its water and wastewater revenues into one Utility Fund is immaterial – an accounting characterization or a shared bank account cannot change a wastewater expense into a water expense. If Corsicana had a City Budget Fund instead of a Utility Fund, covering all city departments including utilities, it would not transform the cost to build a new school into a cost of water service. Conversely, if Corsicana had a separate Water Fund with excess funds and Wastewater Fund with a deficit, a transfer from the former to the latter would be no different than what Corsicana does now – use of water revenues to subsidize another city service that is wholly separate from its water service.

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<sup>37</sup> NCWR-24 at 46; NCWR-69 at 2; *see also* Ratepayers' Closing Argument at 14-17.

<sup>38</sup> PFD at 20, 22.

<sup>39</sup> 30 TEX. ADMIN. CODE § 291.31(b)(2)(A)-(D).

The use of water revenues to pay wastewater costs may not matter as much to Corsicana residents who receive and are billed for both services, but the Ratepayers do not receive wastewater service from Corsicana. Therefore, it matters greatly to them – just as if Corsicana used water revenues from the Ratepayers to build a school that serves only city residents. A wastewater subsidy is not a cost of service issue for any water customer, but for the purposes of the wholesale water rate charged to the Ratepayers, it is also much more than that. At best, it is abuse of monopoly power and rate discrimination against water-only customers. At worst, it is tantamount to constructive conversion of a portion of the Ratepayers’ water payments – and a significant portion at that. The wastewater subsidy accounted for almost 10% of Corsicana’s water revenues before the 2009 Rate Increase,<sup>40</sup> and was planned to continue after the 2009 Rate Increase.<sup>41</sup> Wholesale customers buy almost half of Corsicana’s water,<sup>42</sup> and the 2009 Rate Increase raised wholesale water rates more than the combined *water and wastewater* rate increase for residential customers.<sup>43</sup>

This is a wholesale water rate appeal. Therefore, the prohibition on cost of service evidence cannot be analyzed as an issue of the cost of service of Corsicana’s utilities as a whole – it must be interpreted to bar evidence of Corsicana’s costs of wholesale water service. In a wholesale water rate appeal, costs of wastewater service would ordinarily be irrelevant as well, except to the extent that they show rate discrimination or disparate impact.

If this appeal progresses past the public interest phase to a cost of service phase, Corsicana will not be allowed to include wastewater expenses into its cost to provide wholesale water service

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<sup>40</sup> The subsidy was at least \$850,000 and Corsicana’s water revenues were \$8,926,776. NCWR-24 at 2, 8.

<sup>41</sup> Despite the \$850,000 subsidy, wastewater rate Alternative 3 in the McLain report, which was adopted by Corsicana, was projected to increase wastewater revenues by only \$409,848, from \$3,593,893 to \$4,003,741. NCWR-24 at 10.

<sup>42</sup> NCWR-24 at 15, 16.

<sup>43</sup> NCWR-23 at 9.

to the Ratepayers. Therefore, it is axiomatic that Corsicana's \$1 million dollar annual wastewater subsidy is not a cost of service to the Ratepayers – rather, it is a prime example of Corsicana's abuse of monopoly power.

*iv. The PFD characterizes many of the Ratepayers' arguments as based on cost of service issues when they are not.*

In addition to the misinterpretations of the wastewater subsidy as a cost of service issue and the alleged need for additional operating reserves as not a cost of service issue, the PFD mischaracterizes many of the Ratepayers' arguments as involving cost of service. For example, the PFD makes the general statements that:

- Throughout this case, the Ratepayers have claimed that the protested rates are not based on Corsicana's cost of service.<sup>44</sup>
- The Ratepayers contend that Corsicana's rates exceed the reasonable cost of serving them.<sup>45</sup>
- Despite its irrelevancy, the Ratepayers requested discovery concerning Corsicana's cost of service.<sup>46</sup>
- They also offered evidence purporting to show that the rates that they are required to pay Corsicana are not based on Corsicana's cost of serving them.<sup>47</sup>
- A claim that [the McLain report] . . . and other drafts of the report show that the water rates protested in this case are not based on Corsicana['s] cost of serving the Ratepayers.<sup>48</sup>
- A complaint that rates Mr. McLain suggests as possibilities in future years are not based on cost of service.<sup>49</sup>

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<sup>44</sup> PFD at 16.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 18.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 19.

<sup>49</sup> *Id.* at 20.

The Ratepayers do not claim that Corsicana's abuse of monopoly power is demonstrated Corsicana's cost of service. At this point in this rate appeal, Corsicana's cost of service is unknown. Because the Ratepayers do not claim that the 2009 Rate Increase is an abuse of monopoly power because it is not based on Corsicana's cost of service, the PFD should not generally attribute such arguments to the Ratepayers.

In addition to the general statements in the PFD as to the Ratepayers' supposed cost of service arguments, the PFD cites specific examples. But there are important distinctions that show why those arguments do not rely on impermissible cost of service issues. For example, the PFD cites the wastewater subsidy,<sup>50</sup> which has been discussed above and is simply not a cost to serve water customers, let alone wholesale water-only customers.

The PFD also notes the Ratepayers' repeated citations to Table 1.7 of the McLain study<sup>51</sup> and discussions of the alternative rate structure that McLain titled "Cost-Based Rates."<sup>52</sup> The thrust of the Ratepayers' reliance on such evidence is to highlight the extent of Corsicana's rate discrimination, which, as discussed above, must be considered as a relevant factor. That evidence shows rate discrimination quite simply and without relation to Corsicana's cost of service: Corsicana had the choice of three alternative rate structures that each generated sufficient revenue; the structure preferred by the AWWA would have lowered the Ratepayers' rates by 32%, while the structure that the AWWA considers "not equitable for wholesale customers"<sup>53</sup> would have raised wholesale rates more than rates for any other customer class. Corsicana chose the latter. That choice plainly reflects

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<sup>50</sup> PFD at 20, 22.

<sup>51</sup> NCWR-59 at 9.

<sup>52</sup> PFD at 20.

<sup>53</sup> NCWR-67 at 241.

Corsicana's discriminatory intent to shift the burden of raising revenue to wholesale customers while shielding residential customers.

The Ratepayers did not name alternative 2 "Cost-Based Rates," the City's rate consultant did. The Ratepayers do not know whether alternative 2 actually reflects Corsicana's cost of serving the Ratepayers, and have not made such an assertion. But it is important to note that alternative 2 was a rate structure available to and was expressly considered by Corsicana, and recommended by the AWWA. It is also telling that Corsicana's own rate consultant informed Corsicana that alternative 2 was "Cost-Based" but Corsicana, with that knowledge, instead chose a rate structure that gave preference to its residential customers at the expense of its wholesale customers. The effects of the scheduled future rate increases on Corsicana's customer classes future highlight Corsicana's discriminatory intent when adopting the 2009 Rate Increase.<sup>54</sup> While at first blush it may seem like fine distinction, pointing out the effects on its different customer classes of the various rate structures available to Corsicana (relevant both to a change in rate methodology under § 291.133(a)(3)(C) and to rate discrimination) says nothing about Corsicana's cost of service, and is fundamentally different than an allegation that Corsicana's cost of service is X, but Corsicana adopted a rate that exceeds X. In short, discrimination is shown through *allocation* between customer classes, not the total amount.

The remainder of the specific examples in the PFD of arguments based on cost of service were responses to evidence and arguments offered by Corsicana. But the PFD also determined that Corsicana's alleged "changed conditions" are impermissible cost of service issues, save alleged required operating reserves addressed above; accordingly, responses to irrelevant arguments need not be considered.

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<sup>54</sup> NCWR-24 at 40. Under Inclining Block Rates, Corsicana's average residential customer would continue paying \$3 per thousand gallons for the entire ten year period, while wholesale customers would pay \$3.89 beginning in the second year and eventually \$4.01 per thousand.

**C. The PFD correctly finds that Corsicana has disparate bargaining power over the Ratepayers and should also find the existence of monopoly power.**

The PFD correctly determines that “Corsicana has disparate bargaining power over the Ratepayers due to their lack of alternative sources of obtaining water service.”<sup>55</sup>

The PFD also examines the contracts between Corsicana and the Ratepayers and asserts that “[t]he Ratepayers argue that Corsicana has abused its monopoly power by developing and implementing the Standard Contract,” but does not find such abuse.<sup>56</sup> However, it should be noted that the Ratepayers do not contend that the contracts alone show *abuse* of monopoly power, but rather the existence of disparate bargaining power and monopoly power.

*i. The parties’ contracts evidence disparate bargaining power.*

For example, the fact that the contract terms have become more substantially unfavorable over time shows disparate bargaining power. Over time, the rate methodology has changed from a declining block rate, to a flat rate, to an inclining block rate. The Standard Contract introduced “sole source” language and penalties that were not present in earlier contracts. Any terms “favorable” to the Ratepayers are outweighed by the unfavorable terms, especially considering that perhaps the most material term is the rate, which has become a discriminatory inclining block rate that Corsicana argues is authorized by the contracts. While Corsicana asserts that the Ratepayers had the opportunity to “provide input” into the Standard Contract, the chance to comment at a public meeting is a far cry from bilateral contract negotiations between parties with equal bargaining power. Indeed, the Ratepayers tried to give Corsicana input on the current rate, but that input was

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<sup>55</sup> PFD at 47.

<sup>56</sup> PFD at 34. The PFD also characterizes the Ratepayers’ discussion of individual contract terms as arguments that those terms are “abusive.” PFD at 35, 41.

resoundingly rejected by Corsicana, to put it mildly.<sup>57</sup> Moreover, once the Standard Contract was developed, the Ratepayers had little choice but to agree to it because, as noted in the PFD, they have no alternatives.

Given the amount of testimony and evidence regarding the parties' contracts, the assertion that the contract terms (other than the current rate) show disparate bargaining power, but alone do not necessarily establish abuse of monopoly power, may seem unexceptional. However, § 291.133(a)(3)(A) calls for examination of the disparate bargaining power of the parties, and the history of the parties' contracts and the contract terms establish that disparity. Key to the public interest analysis is how Corsicana has brought that disparity in bargaining power to bear with respect to other relevant public interest factors: Corsicana has changed its rate methodology to a discriminatory rate that is unsupported by any changed conditions. That exercise of disparate bargaining power shows abuse of monopoly power.

*ii. The parties' contracts, as well as the lack of alternative sources, establish the existence of monopoly power.*

The contracts show disparate bargaining power, but they also establish the existence of monopoly power. The preamble to the public interest rules sets forth a standard for finding existence of monopoly power sufficient to invoke the public interest under § 291.133(a):

there are situations where a seller and purchaser have entered into a long term agreement that later is disputed. Over time the seller exercises near monopoly power over the purchaser because many agreements allow the seller the unilateral right to adjust the rate. Moreover, the purchaser substantially has no alternatives to obtain water or sewer service because it has entered into a long term agreement with the seller. The adopted criteria focus on the actual facts which will show whether the protested rate reflects this latter type of agreement so much so that it invokes the public interest.<sup>58</sup>

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<sup>57</sup> NCWR-A at 21:18-22:8 (Metcalf Prefiled); NCWR-J at 18:18-20 (Ivey Prefiled).

<sup>58</sup> 19 Tex. Reg. 6228.

The contracts between Corsicana and the Ratepayers are exactly as described in the preamble — long term contracts under which Corsicana has the unilateral right to adjust the rate and the Ratepayers have no alternatives to obtain water service because they contain “sole source” provisions and penalties. The PFD also recognizes that “an agency’s interpretation of its own rules is entitled to deference unless it is plainly erroneous or inconsistent with the clear, unambiguous language of its rules.”<sup>59</sup> The standard quoted above is the Commission’s interpretation of monopoly power under the public interest rules.

In addition to the contracts, the Ratepayers’ actual lack of viable alternative sources of water, as noted by the PFD, also establishes monopoly power separate and apart from the parties’ contracts. That conclusion is straightforward and related to the very nature of public utilities, which have long been considered natural monopolies.<sup>60</sup> Public utilities embody the classic definition of a monopoly: “[t]he market condition existing when only one economic entity produces a particular product or provides a particular service.”<sup>61</sup> A water utility very often holds a physical monopoly due to the impracticality of multiple providers building redundant infrastructure in order to compete for customers. In addition, a water utility’s monopolistic status in its service area is also often granted by law, such as through a CCN. Here, Corsicana has been designated the regional water service provider for Navarro County by the Texas Water Development Board,<sup>62</sup> which introduces regulatory

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<sup>59</sup> PFD at 17.

<sup>60</sup> *See, e.g. F.C.C. v. RCA Communications*, 346 U.S. 86, 92 (1953).

<sup>61</sup> Black’s Law Dictionary 1028 (8th ed. 1999). The definition further notes that “[t]he term is now commonly applied also to situations that approach but do not strictly meet this definition.”

<sup>62</sup> Corsicana-1 at 12:26-28 (Standridge Prefiled).

issues entrenching Corsicana as the water provider in the area.<sup>63</sup> Indeed, § 291.133(a)(3) *assumes* that the seller has monopoly power.

In light of the contracts, lack of alternative supplies of water in Navarro County, and Corsicana's designation as regional water provider, all three of the experts in this case — for the Ratepayers, the ED and even Corsicana — agree that Corsicana holds monopoly power over the Ratepayers.<sup>64</sup> Moreover, as the PFD notes, “[t]he ED agrees . . . that the existing contracts essentially give Corsicana a monopoly.”<sup>65</sup> Despite unanimity of the experts, the PFD cautiously declines to determine whether Corsicana is a monopoly, reasoning that a monopoly “is fundamentally an economic issue” and that no “expert testimony from an economist” was offered.<sup>66</sup> That caution may stem from aspects of antitrust analysis. Here, however, the lack of testimony from an economist does not prevent a determination that Corsicana is a monopoly for several reasons.

First and foremost, the resource that the Commission has a mandatory duty to regulate in the public interest is state-owned surface water.<sup>67</sup> The state's ownership of surface water in trust for the public and the Commission's duty to regulate that public resource to prevent unlawful rate discrimination places this case in a fundamentally different context than an antitrust case between two private entities. Second, the standard for finding existence of monopoly power under the public interest rules is substantially different from an antitrust case under the Sherman and Clayton acts.

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<sup>63</sup> NCWR-K at 22:11-20 (Stowe Prefiled).

<sup>64</sup> Tr. at 1037:5-15 (Mullins, April 12, 2011); Tr. at 854:8-13 (Dickey, April 1, 2011); NCWR-K at 14:20-16:16 (Stowe Prefiled).

<sup>65</sup> PFD at 34.

<sup>66</sup> PFD at 48.

<sup>67</sup> Texas Water Code §§ 11.021 and 11.036; *see also Texas Water Rights Comm'n v. City of Dallas*, 591 S.W.2d 609, 613-14 (Tex. Civ. App.—1979, writ ref'd n.r.e.) (Texas Water Rights Commission had duty to regulate rates charged by one municipality to another for state-owned surface water who “enjoys a substantial monopoly”).

A contract alone does not create a monopoly between the contracting parties in antitrust; rather, a contract must substantially lessen competition or create a “tendency to monopoly” in a relevant market.<sup>68</sup> Conversely, the Commission interprets long term contracts, in which the seller has the power to control price, as conferring on the seller “near monopoly power over the purchaser” under the public interest rules.<sup>69</sup> The public interest rules themselves, in addition to the preamble, anticipate a contractually created monopoly by the seller over the purchaser – a public interest hearing is required only where the rate being appealed “is charged pursuant to a written contract,”<sup>70</sup> and one of the criteria is whether the seller has abused its monopoly power over the purchaser.

Moreover, even in the antitrust context, the existence of a monopoly is ultimately a question of law. Of course, facts must be established as to competitors (or lack thereof), prices, and the nature of products and potential substitutes.<sup>71</sup> Expert testimony is permitted to aid in analyzing those facts to determine the relevant market.<sup>72</sup> When the relevant market and market share have been established, the question of monopolization becomes a legal issue for the Court to decide.<sup>73</sup> As noted above, an analysis of relevant market and expert economic testimony is unnecessary and unwarranted due to Corsicana’s contractual monopoly power that exists under the public interest rules. Such analysis is also unwarranted where no material fact issue exists regarding monopoly power because all experts and the ED agree on the issue. Finally, the PFD has already effectively determined that

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<sup>68</sup> See *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 326 (1961).

<sup>69</sup> 19 Tex. Reg. 6228.

<sup>70</sup> 30 TEX. ADMIN. CODE § 291.131(b).

<sup>71</sup> See, e.g., *Yoder Bros., Inc. v. California-Florida Plant Corp.*, 537 F.2d 1347, 1366-67 (5th Cir. 1976)

<sup>72</sup> *Id.* at 1367-68.

<sup>73</sup> See *id.* at 1368; see also *U.S. v. Grinnell Corp.*, 384 U.S. 563, 571 (1966) (discussing cases where monopolists had “over two-thirds” and “90% of the market” and concluding that an 87% share of the relevant market would “leave[] no doubt that the congeries of these defendants have monopoly power”)

Corsicana holds monopoly power over the Ratepayers by deciding that the Ratepayers have no viable alternative water sources, which is the equivalent of finding that Corsicana controls essentially 100% of the relevant market. Thus, the PFD should have reached the inevitable conclusion that Corsicana holds monopoly power over the Ratepayers.

*iii. All terms of the contracts should be considered.*

While the PFD analyzes many other contractual terms at length,<sup>74</sup> it declines to consider the contracts' requirement that Corsicana charge the "minimum inside city retail water rate"<sup>75</sup> to the Ratepayers, when Corsicana is, in fact, charging the *maximum rate*.<sup>76</sup> There is no reason to consider other terms in the contracts but not the requirement that Corsicana charge the minimum retail rate to its wholesale customers. In support, the PFD quotes language from the preamble to the public interest rules – language referring not to the public interest factors but to § 291.129. But the fact that § 291.129 "assumes the [rate] correctly interprets any existing agreement between" the parties does not preclude consideration of contractual provisions regarding rates, if relevant to the public interest factors.<sup>77</sup> Rather, it merely clarifies that a wholesale rate appeal does not preclude a breach of contract lawsuit. It is not intended to limit the public interest analysis.

Here, the fact that the contracts require Corsicana to charge the Ratepayers the "minimum" rate, but the Ratepayers are required to pay the maximum, is relevant for several reasons. First, it absolutely must be considered under § 291.133(a)(3)(C), because there would be no way to decide

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<sup>74</sup> PFD at 37-45.

<sup>75</sup> *See, e.g.* NCWR-22 at Section 4.03(a).

<sup>76</sup> PFD at 23-24.

<sup>77</sup> 19 Tex. Reg. 6227.

whether a change in rate methodology evidenced an abuse of monopoly power or not without considering what the parties' contracts require in terms of rate methodology.

Moreover, that conceptual term helps to explain why, with the power to unilaterally raise rates, Corsicana did not simply raise rates for wholesale but not retail customers. Corsicana has pointed to that provision since the time of the rate increase in an attempt to justify the inclining block structure, disingenuously claiming that the contracts require wholesale rates to be the "same" as retail rates.<sup>78</sup> As discussed below, the PFD concludes that the change in rate methodology does not constitute an abuse of monopoly power because at least some of Corsicana's retail customers also pay third tier rates. In the absence of the contract term requiring that the wholesale customers be charged the "minimum," which Corsicana interprets as "same," Corsicana would likely have simply raised rates for wholesale customers only, as Mayor Brown admitted Corsicana wanted to do. If Corsicana had done so, its change in rate methodology would have been an abuse of monopoly power under the PFD's reasoning. But the overall effects of the 2009 Rate Increase – a large rate increase for its wholesale customers with little increase for its residential customers and no increase whatsoever for an average residential customer — are virtually the same as if Corsicana had done so. Therefore, that contract term, and Corsicana's interpretation of it, explains why implicit rate discrimination should be viewed no differently than explicit rate discrimination.

**D. The PFD correctly determines that Corsicana changed its rate methodology and should find that the change evidences abuse of monopoly power.**

The PFD correctly determines that the change from a flat rate to an inclining block rate is a "change [in] computation of the . . . rate" within the meaning of § 291.133(a)(3)(C). However, the PFD nevertheless concludes that Corsicana's change in rate methodology does not amount to abuse

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<sup>78</sup> See, e.g., Corsicana's Closing Argument at 25.

of monopoly power.<sup>79</sup> The PFD's reasoning is that while the 2009 Rate Increase causes the Ratepayers to pay third tier rates on 99% of the water they buy, some of Corsicana's retail customers buy at least some water at third tier rates; because the 2009 Rate Increase does not affect wholesale customers *only*, the rate change does not evidence an abuse of monopoly power.<sup>80</sup>

That conclusion is incorrect for several related reasons. First, and as discussed in section A above, the PFD's determination that the public interest factors under § 291.133(a)(3) are exclusive resulted in the PFD's refusal to consider evidence of rate discrimination and Corsicana's disparate treatment of its customer classes. Thus, the PFD did not consider such evidence as the Mayor of Corsicana and the McLain study's admissions that the 2009 Rate Increase was designed to give preference to Corsicana's residential customers and to discriminate against its wholesale customers.

That interpretation is not only contrary to clear mandatory authority, but it also begs the question of the proper way to analyze § 291.133(a)(3)(C) itself. If all that is considered is the fact that a seller's rate methodology has changed, without considering the full effects of that change (for example, whether and to what extent it was disparate), how can the Commission reliably determine whether the change evidences an abuse of monopoly power?

As a result of that crabbed analysis, the PFD sweepingly dismisses the intentional large increase in rates for Corsicana's wholesale customers and comparatively miniscule increase for residential customers, and the complete exemption of all average residential customers. The evidence undisputedly demonstrates that the 2009 Rate Increase raised rates for wholesale customer by more than *three times* as much as for Corsicana's favored class of average residential customers.<sup>81</sup>

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<sup>79</sup> PFD at 56-58.

<sup>80</sup> *Id.*

<sup>81</sup> Corsicana-30 (2.6% increase for average residential customers); NCWR-23 at 9, NCWR-60, and NCWR-61 (9% increase for wholesale customers).

The 2009 Rate Increase also took away water that had been included in the base rate for customers with larger meters – as all the Ratepayers have – up to 95,600 previously included gallons for customers with 10" meters.<sup>82</sup> The evidence shows that wholesale rates increased by more than the rates for any other customer class.<sup>83</sup> Finally, Corsicana intentionally set its rate tiers so that its wholesale customers would pay the highest rate on 99% of the water they buy, while its average residential customer would always pay the lowest rate – the same rate in effect before the 2009 Rate Increase.<sup>84</sup>

The PFD does not consider any of those systematic and intended discriminatory effects, and instead merely notes that some of Corsicana's retail customers pay third tier rates. Specifically, the PFD points out that 689 of Corsicana's retail customers pay third tier rates.<sup>85</sup> But Corsicana had "12,884 active retail service connections" in June 2010.<sup>86</sup> That means that only 5% of Corsicana's customers buy any water at third tier rates. And that tally of 689 was done in July 2010,<sup>87</sup> one of the months of highest water use because of lawn watering. Moreover, of that 5%, the marginal customers that consume just enough water to fall into the third tier only pay third tier rates on a small fraction of the water they buy. For example, customers who use 26,000 gallons per month pay third tier rates on only 4% of their water. The average Corsicana retail customer buys 10,869 gallons,<sup>88</sup>

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<sup>82</sup> NCWR-24 at 7-8.

<sup>83</sup> NCWR-59 at 9. "Fire hydrant" rates increased by 17.1%, but fire hydrants account for only .03% of Corsicana's water revenues.

<sup>84</sup> Tr. 686:21-24 (Standridge, April 1, 2011); Tr. at 1007:4-9 (Mullins, April 12, 2011).

<sup>85</sup> PFD at 57.

<sup>86</sup> NCWR-62 at June 1, 2010 letter from TCEQ.

<sup>87</sup> Tr. 815:16-19 (Standridge, April 1, 2011)

<sup>88</sup> PFD at 68.

thus paying second tier rates on less than 10% of water purchased, for a blended rate of \$3.02. Meanwhile, the Ratepayers buy millions of gallons per month and pay third tier rates, or \$3.25, on 99% or more of the water they buy.

The PFD also notes that “31 out of the top 50 highest consuming customers served by Corsicana are *retail* customers.”<sup>89</sup> But since there are only 21 wholesale customers, at least 29 of the top 50 will always be retail customers, so all this figure reveals is that *only* two wholesale customers are not in the top 50. It is also the equivalent of pointing out that **12,832 out of the bottom 12,834 lowest consuming customers served by Corsicana are *retail* customers.** These figures also do not reveal how much water each customer is buying. Taking into account how much the wholesale customers purchase as a whole, however, shows that 163% of Corsicana’s customers buy half of the water it sells, paying the highest rate on almost all that is purchased. Conversely, 99.837% of Corsicana’s customers – its retail customers – buy the other half, paying the lowest rate on the overwhelming majority of water purchased.

The PFD glibly notes that a few retail customer pay third tier rates, so wholesale customers were not the only customers effected by the 2009 Rate Increase. But that analysis glosses over and ignores the actual effects of the 2009 Rate Increase on Corsicana’s customer base as a whole. Rate discrimination and abuse of monopoly power can take different forms. One form would have been to increase rates for wholesale customers only. But another is through a rate structure that nominally applies to all of Corsicana’s customers but has the effect of preferring one class at the expense of another. Corsicana knew that it could not explicitly raise rates for wholesale customers only, so it tried to conceal its true intentions – although it later admitted those intentions – by adopting a rate methodology that had the effect of raising rates for its out of city customers but shielded its

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<sup>89</sup> PFD at 58.

residential customers from the effects of the increase. In fact, Corsicana's attempt to hide its rate discrimination behind the idea that it has one rate structure, or the charade that "everyone pays the same rates," makes its discrimination all the more insidious.

**E. The 2009 Rate Increase does not encourage conservation for wholesale customers.**

While the theory behind inclining block rates generally is to promote water conservation, the PFD's conclusion that the 2009 Rate Increase does not evidence abuse of monopoly power because "incentives [were] necessary to encourage . . . water conservation" under § 291.133(a)(3)(E)<sup>90</sup> is fundamentally flawed.

First, it is undisputed that no incentives were necessary to encourage conservation; rather, the evidence shows exactly the opposite. Ms. Standridge testified that water use had been on the decline before the 2009 Rate Increase because "a lot of our customers . . . are conserving water and using less" and that a rate increase was done simply to raise revenues.<sup>91</sup> That alone is enough to conclude that this factor weighs in favor of a finding of abuse of monopoly power. No incentives were necessary to encourage conservation but Corsicana increased rates anyway.

But the nature of the 2009 Rate Increase is an even more compelling reason to find abuse of monopoly power in light of Corsicana's duplicitous assertion that it was necessary to encourage conservation. The evidence unequivocally shows that the inclining blocks in the 2009 Rate Increase do not encourage conservation by wholesale customers. For example, the inclining blocks were "modeled on . . . the residential consumption profile,"<sup>92</sup> and it is impossible for the wholesale customers to curtail their usage to take advantage of the lower tiers.<sup>93</sup> Applying such a rate structure

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<sup>90</sup> PFD at 59-60.

<sup>91</sup> Tr. at 669:10-16 (Standridge April 1, 2011)

<sup>92</sup> NCWR-24 at 13.

<sup>93</sup> Tr. at 645:5-8 (Standridge April 1, 2011).

to wholesale customers violates industry practices<sup>94</sup> and is simply a way to raise their rates while shielding city residents from the rate increase.<sup>95</sup>

Mr. Mullins even testified that if inclining block rates are used, there should be different sets of inclining blocks for each customer class.<sup>96</sup> In fact, Corsicana had the knowledge and ability to do that, and had done so before with application of its drought surcharges, which calculate usage for the purpose of inclining blocks based on the number of connections of a wholesale customer.<sup>97</sup> Therefore, if a time comes when Corsicana does need to encourage conservation, it still would not be appropriate to adopt a rate structure like the 2009 Rate Increase.

The PFD reasons that the 2009 Rate Increase encourages water conservation by giving wholesale customers the incentive to find and repair leaks.<sup>98</sup> But *any* rate increase would do that. The proper analysis under this factor should focus first on whether any incentives were necessary to encourage conservation – and there were none – and second on whether the 2009 Rate Increase properly addressed that need. Given that applying inclining block rates designed for a residential customer profile does not encourage wholesale customers to conserve but rather violates industry practices, that Corsicana had the knowledge and ability to properly apply rates that encourage wholesale customers to conserve but chose not to, and that Corsicana frankly admitted that the 2009 Rate Increase was done simply to raise revenues – and specifically to raise more revenues from its wholesale customers – this factor evidences abuse of monopoly power.

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<sup>94</sup> NCWR-K at 25:9-13 (Stowe Prefiled).

<sup>95</sup> Tr. at 1232:2-6 (Stowe, April 12, 2011).

<sup>96</sup> Tr. at 1102:7-16 (Mullins, April 12, 2011).

<sup>97</sup> NCWR-25 at 7.

<sup>98</sup> PFD at 60.

**F. The rates charged by other sellers of water does not support the 2009 Rate Increase.**

The PFD concludes, based on the fact that certain other water providers charge higher rates than Corsicana, there is no evidence of abuse of monopoly power under § 291.133(a)(3)(G).<sup>99</sup> There should not be a finding that Corsicana has not abused its monopoly power under this factor for two reasons. First, there was no evidence showing why other sellers' rates are necessary. The nature of their water systems may require higher rates, which has no bearing on Corsicana's rate. That is why the Commission does not place dispositive weight on this factor.<sup>100</sup>

Second, and more fundamentally, the only evidence differentiating between wholesale and retail rates charged by other sellers shows that other sellers charge their wholesale customers less than their retail customers.<sup>101</sup> Therefore, if any finding under this factor is warranted, the fact that Corsicana charges its wholesale customers *more* than its retail customers evidences abuse of monopoly power.

**G. The PFD incorrectly analyzes § 291.133(a)(3)(H).**

Section 291.133(a)(3)(H) requires a comparison of Corsicana's retail rates to the retail rates charged by the Ratepayers "as a result" of Corsicana's wholesale rates. The concern behind this factor is clear – it looks to ensure that outside city customers of the Ratepayers do not pay so much more for their water than Corsicana's residents that it invokes the public interest. The evidence shows that an average customer of Ratepayers pays almost twice as much or more than an average Corsicana resident for the same amount of water.<sup>102</sup>

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<sup>99</sup> PFD at 63-64.

<sup>100</sup> 19 Tex. Reg. 6229 (1994).

<sup>101</sup> Tr. 1237:12-16 (Stowe April 12, 2011).

<sup>102</sup> Corsicana-30; NCWR-K at 30:6-9 (Stowe Prefiled)

This factor also seeks to isolate the portion of the rate charged by the Ratepayers “as a result of the wholesale rate” charged by Corsicana. The PFD attempts to do so by comparing the effective rate of an average Corsicana customer to the effective rate paid by the Ratepayers. But effective rate is a blend of base rate and volumetric rate *based on the amount of water a customer consumes*. Comparing the effective rate based on usage of a 6,000 gallon customer to that of a customer buying millions of gallons is illogical and does not aid the analysis.

What is logical is to recognize that individual customers of both Corsicana and the Ratepayers both pay a base rate. Corsicana has fixed costs reflected in its base rate and variable costs reflected in its volumetric rate; the Ratepayers do too, and they also charge their customers a base rate and a volumetric rate. The PFD’s analysis takes into account the base rate paid by a Corsicana resident but not by a Ratepayer customer, which is fundamentally skewed. However, analyzing the base rate paid by a Corsicana customer compared to the base rate paid by a Ratepayer customer would likely lead to cost of service issues, because to decide whether an abuse of monopoly power had occurred would lead to an analysis of whether the fixed costs reflected in the base rate were appropriate. That leaves a comparison of the rate per 1,000 gallons purchased by all customers. Because the Ratepayers’ variable cost is primarily the cost to purchase water from Corsicana, that is what § 291.133(a)(3)(H) seeks to do by examining the Ratepayers’ rate that results from the wholesale rate demanded by Corsicana.

That comparison is simple. An average Corsicana resident pays \$3.00 per thousand gallons, while a customer of the Ratepayers, before any other costs are included, pays \$3.25 as a result of the rate demanded by Corsicana.

### **III. CONCLUSION**

The PFD concludes its analysis by pointing out that the effective rate paid by the Ratepayers is lower than the effective rate paid by an average Corsicana resident, and therefore Corsicana has not abused its monopoly power.<sup>103</sup> In other words, the PFD compares what a customer who purchases 6,000 gallons per month pays per 1,000 gallons with base rate included (\$5.43), to what customers purchasing millions or even tens of millions of gallons per month pay per 1,000 gallons with base rate included (\$3.45). As noted above, that comparison is affirmatively misleading.

It is undisputed that Corsicana has fixed costs related to each customer that it must recover through its base rate. It is also undisputed that those fixed costs will be much higher on a 1,000 gallon basis for a customer who buys 6,000 gallons per month than for customers who buy millions of gallons per month. That is not the case for variable costs reflected in the volumetric rate. Since variable costs fluctuate with the amount sold, it makes no difference to Corsicana whether a customer purchases a thousand gallons or a million; the payment for usage covers the cost. It also makes no difference whether that customer is a Corsicana resident or a wholesale customer.

That is, it should not matter. But Corsicana, through the 2009 Rate Increase, has made it matter. Because Corsicana knew that 21 out of its 12,000 customers buy enormous amounts of water, and because it knew that those 21 customers were prevented practically, contractually, and politically from doing anything about it, Corsicana chose to make the wholesale customers pay \$3.25 for their water usage, to use part of that payment to make up the city's wastewater deficit, and to ensure that its average residential customer would not pay any rate increase. There were no changed conditions justifying that rate discrimination. Corsicana made the conscious decision to force its out of city, non-voting wholesale customers to both subsidize in-city water customers and wastewater

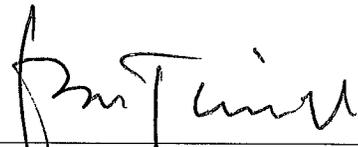
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<sup>103</sup> PFD at 70.

service that they do not receive. Corsicana clearly abused its monopoly power under the public interest rules and should be required to justify its rates in a cost of service hearing.

**Respectfully submitted,**

**THE TERRILL FIRM, P.C.**

By:  \_\_\_\_\_

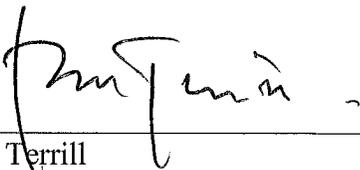
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**ATTORNEYS FOR PETITIONERS**

## CERTIFICATE OF SERVICE

I hereby certify that on September 15, 2011, a true and complete copy of the foregoing was sent to the following by facsimile, first-class mail or courier:

<b>Parties</b>	<b>Representative / Address</b>	<b>Service</b>
State Office of Administrative Hearings	Judge William Newchurch 300 West 15 <sup>th</sup> Street, Suite 502 Austin, TX 78701	<i>via e-filing</i>
State Office of Administrative Hearings	SOAH - Docket Clerk P. O. Box 13025 Austin, Texas 78711-3025	<i>via e-filing</i>
TCEQ	Docket Clerk Office of the Chief Clerk P.O. Box 13087 Austin, TX 78711	<i>via e-filing</i>
TCEQ Executive Director	Ron Olson TCEQ, MC-173 P.O. Box 13087 Austin, TX 78711-3087	<i>via fax to: (512) 239-0606</i>
Office of Public Interest Counsel	Eli Martinez TCEQ, OPIC MC-103 P.O. Box 13087 Austin, TX 78711-3087	<i>via fax to: (512) 239-6377</i>
City of Corsicana	J. Kay Trostle Smith Trostle, LLP 707 West Avenue, Suite 202 Austin, TX 78701	<i>via fax to: (512) 494-9505</i>

  
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Paul M. Terrill