

SOAH DOCKET NO. 582-11-1468
TCEQ DOCKET NO. 2010-1841-UCR

APPLICATION OF SJWTX, INC, § BEFORE THE STATE OFFICE
DBA CANYON LAKE WATER §
SERVICE COMPANY TO § OF
CHANGE WATER RATES; CCN §
NO. 10692; IN COMAL AND §
BLANCO COUNTIES § ADMINISTRATIVE HEARINGS

CANYON LAKE WATER SERVICE COMPANY'S EXCEPTIONS TO THE
PROPOSAL FOR DECISION AND PROPOSED ORDER

Paul M. Terrill III
State Bar No. 00785094
Geoffrey P. Kirshbaum
State Bar No. 24029665
THE TERRILL FIRM, P.C.
810 W. 10th Street
Austin, Texas 78701
(512) 474-9100
(512) 474-9888 (fax)

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

ATTORNEYS FOR SJWTX, INC. D/B/A CANYON LAKE
WATER SERVICE COMPANY

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TO THE HONORABLE COMMISSIONERS OF THE TEXAS COMMISSION ON ENVIRONMENTAL QUALITY:

SJWTX, Inc. d/b/a Canyon Lake Water Service Company ("CLWSC") respectfully submits its Exceptions to the Administrative Law Judges' ("ALJs") Proposal for Decision ("PFD") and Proposed Order, and in support thereof would show the following:

I. INTRODUCTION

This rate case presents a number of complex and novel questions of law and policy with far-reaching implications for the acquisition of troubled systems by investor-owned utilities in Texas. Through the acquisition of assets from a troubled non-profit water supply corporation ("WSC"), CLWSC is one of the state's largest investor-owned utilities, providing high-quality, professional water service to more than 9,000 connections in the Canyon Lake region of Comal County and southern Blanco County. The WSC water system assets that CLWSC acquired began as a number of privately-owned, state-regulated utilities near or on Canyon Lake. Most were started by developers and were operated as small "mom and pop" water utilities. These small systems were groundwater-supplied and had limited water service capacity during droughts.

After these mom and pop IOUs were consolidated into a non-profit WSC, the WSC made some efforts to fix the myriad regulatory problems these inadequate small systems. But by 2006, the

WSC was in serious trouble. It was in violation of several TCEQ drinking water standards — drinking water contained elevated levels of trihalomethane (a disinfection by-product regulated by the TCEQ), and there was inadequate water pressure, storage and production capacity throughout the system. Yet the WSC lacked the financial wherewithal, along with the technical and managerial expertise to fix the systemic problems. Needing a large infusion of capital and expertise, the WSC — by an overwhelming vote of its members — agreed to sell its assets to CLWSC, a newly-formed affiliate of a publicly-traded water utility with the capital and technical expertise necessary to fix the WSC's problems.

With the essential backing of San Jose Water Company and SJW Corp., CLWSC began an expensive systematic upgrade of the WSC's facilities and technical expertise. CLWSC brought the system into compliance with TCEQ regulations, dramatically improved the reliability and service standards, and brought professional utility management to what had been an amalgamation of stand-alone “mom and pop” utilities. It is uncontroverted that CLWSC now provides excellent quality service. But those improvements to facilities and management came at a cost — and the need for that cost was not only known when the WSC's members chose to sell their assets to CLWSC — it was *the reason* why the WSC chose to sell its assets to an investor-owned utility. CLWSC has invested tens of millions of dollars upgrading water systems, expanding its water treatment plant capacities, reserving long-term water resources and fixing systemic problems such as excessive line loss.

For several years since CLWSC acquired the WSC's assets and began investing money into system improvements, the utility's customers have been receiving water service at rates substantially below the utility's cost of service. Two years of that subsidized service was due to a rate moratorium in the Asset Purchase Agreement, but CLWSC's last two rate increases were voluntarily limited by CLWSC to prevent rate shock. This case represents the utility's first effort to fully recover the many millions of dollars in investment made years ago and to earn a reasonable return on that investment.

Because of CLWSC's unique transactional history — from stand-alone mom and pop IOUs to a non-profit WSC to a larger, professionally run IOU — this rate case and the PFD necessarily involve a number of novel questions of ratemaking law and policy. As explained in greater detail below, CLWSC agrees with many of the conclusions reached by the ALJs in their thorough PFD. But one overarching issue with serious long-term policy implications in Texas is largely absent from consideration in the ALJs' PFD. In reaching its decision in this case, the Commission must consider the implications its decision will have on attracting capital to acquire and fix the numerous troubled systems throughout this state. Private capital has played an invaluable role — at no expense to the taxpayer — in upgrading and bringing troubled systems like the WSC's into compliance with Commission's rules for providing continuous and adequate water service. With each issue set forth below, but particularly with regard to the issues of rate of return and rate base of acquired assets, CLWSC respectfully submits that the Commission must consider the long-term implications that its decisions will have on attracting the capital necessary to provide safe drinking water for Texans.

II. CLWSC'S EXCEPTIONS

The most significant error in the PFD concerns the capital structure used to calculate overall rate of return for CLWSC incorporating a debt component for \$11,250,000 in intercompany fund transfers for which CLWSC's parent affiliate charged a below-market 2.25% interest rate. This is closely followed by the PFD's determinations for rate of return on equity and rate base. CLWSC also excepts to several of the ALJs' findings concerning allowable expenses. There are also statements of law included in the PFD which would set a bad precedent for the Commission if adopted. All these issues should be corrected before rates are finally calculated for CLWSC and a final Commission order issued.

A. Rate of Return

CLWSC requested an annual overall rate of return of 8.673%, incorporating a return on equity of 12%, debt at interest rates of 6.27% and 6.50%, and a capital structure of 42% equity/58% debt, as shown in the application.¹ While including the requested debt and associated interest rate components in CLWSC's return calculation, the PFD recommends incorporating an additional debt amount of \$11,250,000 supplied by CLWSC's parent affiliate at a below-market 2.25% interest rate.² The PFD also declines to use the return on equity determined reasonable by CLWSC's expert³ in favor of a fundamentally flawed rate of return ("ROR") worksheet to calculate return on equity at 10.88% .⁴ The PFD's application of these methods results in an unreasonably low recommended 6.46% overall rate of return which the Commission should not accept.⁵

Utilizing the additional 2.25% debt component and ROR Worksheet constitute improper and unreasonable regulatory utility rate-setting methods for calculating return. If adopted, an unlawful, confiscatory rate order that prevents CLWSC from earning a reasonable rate of return will result. CLWSC excepts to both PFD recommendations for the reasons that follow.

1. Including 2.25% Funding Results in Unreasonably Low Return

The PFD unreasonably recommends modifying CLWSC's capital structure proposed in the application to incorporate intercompany transfers of funds from CLWSC's parent affiliate at a below-market 2.25% interest rate.⁶ The record evidence shows the following. The TCEQ rate application calls for calculating a weighted average return rate for long-term debt as part of the overall return

¹ CLWSC Ex. A, p. 71:21 - 72:1; CLWSC Ex.1 at CLWSC 000017.

² PFD, at p. 82-84.

³ CLWSC Ex. E (Testimony of Gregory E. Scheig, CPA/ABV/CFF, CFA)

⁴ PFD, at p. 89-90.

⁵ PFD, at p. 82-84, 89-90.

⁶ PFD, at p. 82-84.

calculation.⁷ In the table where long-term debt is typically included, CLWSC included a note that says: “Working capital loans from the parent company have been excluded in order to normalize the cost of capital for rate making purposes.”⁸

CLWSC witness Palle Jensen testified that \$11,250,000 of these intercompany loans resulted from a *short-term* line of credit held by CLWSC’s parent affiliate (not CLWSC), which is really more of an intercompany transfer of equity capital than debt since there is no real expectation for CLWSC to repay it.⁹ CLWSC was charged a low interest rate of 2.25% by its affiliate to use these funds which, as CLWSC’s other long-term debt components plainly demonstrate, is not consistent with market interest rates for third party long-term debt.¹⁰ There is nowhere in the debt market that long-term, permanent debt can be acquired at such a low 2.25% rate. Moreover, evidence discussed in the PFD shows that, unlike typical third-party long-term debt, no set repayment schedule was enforced despite interest accruals.¹¹ This is merely temporary financing (*i.e.*, short-term) between affiliates — not long-term third party debt. CLWSC has not possessed the ability to issue bond debt or raise equity capital on its own, so it has relied on its parent.¹²

Mr. Jensen testified that CLWSC and its affiliated parent company consider what is booked as an intercompany loan to be “functionally equity.”¹³ But, if this capital infusion were treated as equity in CLWSC’s return calculation for ratemaking purposes, CLWSC would be entitled to a much

⁷ CLWSC Ex. 1, p. CLWSC 000016-17 (“Section IV - Long-term Debt and Equity Information - Water”).

⁸ *Id.*

⁹ Tr. 216:8-218:13 (Palle Jensen, March 26, 2012); Tr. 1322:6-1325:20 (Palle Jensen, April 19, 2012).

¹⁰ *Id.*

¹¹ PFD, at p. 83 (citing CLWSC’s statement of cash flows (ED-DL-22, pp. CLWSC 407049-407052) and other company records regarding intercompany notes payable to SJW Corp. (ED-DL-42, p. CLWSC 405194).

¹² Tr. 216:8-218:13 (Palle Jensen, March 26, 2012); Tr. 1322:6-1325:20 (Palle Jensen, April 19, 2012).

¹³ *Id.*

higher rate of return on these funds than 2.25% — either the 10.88% rate of return on equity the ALJs have deemed appropriate or the 12% rate of return on equity CLWSC requested.¹⁴ Instead, CLWSC left this intercompany transfer of funds and its corresponding 2.25% interest rate completely out of its capital structure for calculating return in an effort to achieve a resulting overall rate of return that was neither too high nor low, *i.e.*, “reasonable,” and considered only true long-term debt liabilities held by CLWSC with respect to non-affiliates as the TCEQ application form ostensibly requires.¹⁵

As the PFD recognizes, the impact of the PFD capital structure compared with the structure CLWSC proposed is significant.¹⁶ Assuming use of the PFD’s 10.88% rate of return on equity and \$38,096,384 rate base figures, the PFD’s modified capital structure alone reduces CLWSC’s return by approximately *9.9% per year, or \$930,884.00 annually*, from the level it would be without that modification.¹⁷ Further, any increase to rate base by the Commission in its final order would enhance the impact of this PFD recommendation if it is not rejected.

The PFD indicates the legal basis for the recommended capital structure modification is 30 TEX. ADMIN. CODE, §291.31(c).¹⁸ The PFD focuses on provisions in this rule which state the “cost of debt capital is the actual cost of debt” and the Commission “shall consider the utility’s cost of capital”.¹⁹ However, nowhere in this rule appears the PFD statement that “if [a] loan was an actual debt, it must be included in the cost of debt capital, regardless of whether it is a long-term or short-

¹⁴ *Id.*

¹⁵ CLWSC Ex. 1, p. CLWSC 000016-17 (“Section IV - Long-term Debt and Equity Information - Water”).

¹⁶ PFD, at p. 80.

¹⁷ CLWSC would be left with \$2,461,026 in return per year at the PFD’s 6.46% overall rate of return (PFD, at p. 90) instead of \$3,391,910 per year at a 8.2% overall rate of return. CLWSC’s requested 8.673% overall rate of return utilized a 12% rate of return on equity, which, if implemented, would increase the PFD’s overall return rate even further.

¹⁸ PFD, at p. 82-84.

¹⁹ *Id.*; 30 TEX. ADMIN. CODE § 291.31(c)(1)(C)(I).

term loan” in setting a utility’s return.²⁰ In fact, the cited rule actually has multiple issues to “*consider*” which are supposed to be taken into account when setting return. The entire text of the rule is as follows:

(c) Return on invested capital. The return on invested capital is the rate of return times invested capital.

(1) Rate of return. 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. For companies with ownership expressed in terms of shares of stock, equity capital commonly consists of the following classes of stock.

(I) Common stock capital. The cost of common stock capital must be based upon a fair return on its value.

(II) Preferred stock capital. The cost of preferred stock capital is its annual dividend requirement, if any, plus an adjustment for premiums, discounts, and cost of issuance.

²⁰ PFD, at p. 82.

30 TEX. ADMIN. CODE, §291.31(c). The overarching consideration which the Commission must bear in mind is the requirement to permit each “*utility a reasonable opportunity to earn a reasonable rate of return*” and “*preserve the financial integrity of the utility*” as required by the Texas Water Code, the aforementioned TCEQ rule and others, and the *Bluefield* and *Hope* United States Supreme Court cases which are all referenced in the PFD.²¹ *Hope* sets forth an end result test which is as follows:

[R]atemaking . . . involves the making of “pragmatic adjustments”. And when [a commission’s] order is challenged in the courts, the question is whether that order “viewed in its entirety” meets the requirements of [the governing statute]. Under the statutory standard of “just and reasonable” it is the *result reached* and not the method employed which is controlling. It is not theory but the impact of the rate order which counts.

Hope, 320 U.S. 591, 602 (1944) (emphasis added; citations omitted). The PFD loses sight of this overarching requirement because the result reached is not reasonable.

This Commission and other utility regulatory authorities have previously adopted modified capital structures which consider a utility’s “actual debt” per its books, but replace the actual capital structure with a modified version in an effort to achieve the end result of a reasonable return rate. These modified capital structures have included or excluded utility debt components that may or may not be structured that way on the utility’s books for varying reasons when reasonable to do so.

A “hypothetical capital structure” approach designed to allow a utility a reasonable opportunity to earn a reasonable rate of return is routinely employed by the Texas Public Utility Commission. A prime example is the PUC decision in *Pioneer Natural Resources USA, Inc. v. Public Utility Comm’n*.²² In that case, the applicant “proposed a capital structure of 60% debt and 40% equity

²¹ TEX. WATER CODE §§13.183(a)(1)-(2) and 13.184(a)-(b); 30 TEX. ADMIN. CODE §§291.31(c) and 291.32(a); *Bluefield Water Works and Improvement Co. v. Public Service Comm’n of West Virginia*, 262 U.S. 679 (1923); *Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *see also* PFD, at 77-78.

²² *Pioneer Natural Resources USA, Inc. v. Public Utility Comm’n*, 303 S.W.3d 363 (Tex. App.–Austin 2009, no pet.).

in order to strengthen its financial position and increase access to funds”.²³ The issue was whether this “hypothetical capital structure” should be used even though the utility’s actual capital structure was 83% debt and 17% equity.²⁴ The PUC ultimately adopted a 75% debt and 25% equity hypothetical capital structure which was challenged on appeal and upheld.²⁵ The court stated, “Indeed, this Court has affirmed the Commission’s use of figures other than those actually computed from a utility’s current balance sheet to determine the cost of capital.” The court cited its decision in *Public Utility Comm’n v. GTE-SW*.²⁶ The *Pioneer* decision states that, although the record in *GTE-SW* contained the actual costs of debt and equity, the Commission applied a weighted cost so as to estimate a rate that would be sufficient for the utility to attract new capital.²⁷ The hypothetical cost of capital was employed because the actual cost of capital would not obtain the “reasonable return” required by statute.²⁸ The *Pioneer* court, concurring with and reaffirming its *GTE-SW* decision on this issue, concluded that the Commission is not prohibited by statute or regulation from employing a hypothetical capital structure when the use of such a hypothetical structure is supported by substantial evidence.²⁹ This directly contradicts the proposition stated in the PFD that “actual debt” must be used in all instances to calculate a utility’s return.

In the TCEQ’s *Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc.* water utility rate decision, this Commission found that a debt structure imputed from the utility’s parent was

²³ *Id.* at 371-373.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Public Util. Comm’n v. GTE-SW*, 833 S.W.2d 153, 157-158 (Tex. App.–Austin 1992), *aff’d in part, rev’d in part on other grounds*, 901 S.W.2d 401 (Tex. 1995).

²⁷ *Pioneer*, 303 S.W.3d at 372-373.

²⁸ *Id.*

²⁹ *Id.*

reasonable.³⁰ Aqua Texas had no debt, but its parent company did.³¹ Therefore, the Commission found that “imputing” the parent company’s 50/50 debt-equity structure in the return calculation was reasonable.³² This is akin to the “hypothetical capital structure” approach used by the PUC in *Pioneer* to achieve a reasonable rate of return and is a method commonly used in utility ratemaking.

The TCEQ has also seen fit to set aside “actual debt” components when deemed reasonable. In the TCEQ water utility rate case styled *Application of Wiedenfeld Water Works, Inc.*, the ED recommended and the Commission approved removing an actual utility debt amount provided by an affiliate at a 10% interest rate from the utility’s return calculation.³³ The ED staff found that 10% was higher than the average of interest rates for three other loans the utility had obtained on the loan market and was not shown to be reasonable.³⁴ In the TCEQ’s final order, it stated, “10% is not an appropriate interest rate for a loan from an affiliated interest because a loan between affiliated interests is not an arm’s length transaction.”³⁵ Thus, the Commission removed “actual debt” between affiliates to *reduce* interest rates in a utility’s capital structure for return purposes as necessary to achieve reasonableness. But the PFD in this case indicates CLWSC’s parent affiliate could set its interest rate on intercompany loans to CLWSC at whatever rate desired (e.g., 10%) no matter how absurd and the Commission would be bound to accept that “actual debt” and corresponding interest rate when assessing CLWSC’s capital structure for rate-setting. In light of *Wiedenfeld* and other cases like it, CLWSC does not believe the Commission would accept such a rate proposal.

³⁰ *Application of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc.*, TCEQ Docket Nos. 2004-1671-UCR and 2004-1120-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771, Final Order (September 23, 2008), p. 15.

³¹ *Id.*

³² *Id.*

³³ *Application of Wiedenfeld Water Works, Inc.*, TCEQ Docket No. 2009-0372-UCR, SOAH Docket No. 582-09-3549, Final Order (September 29, 2011), p. 11-12 and Proposal for Decision (October 1, 2010), p. 41-42.

³⁴ *Id.*

³⁵ *Id.*

But reasonableness works both ways. “Debt” — in the form of an affiliate transfer — should also not be included for ratemaking purposes when it produces unreasonably low return. In a Federal Energy Regulation Commission (“FERC”) electric utility case, an intervenor customer rate committee (“Committee”) and other intervenors sought review of a FERC rate order for the New England Power Company (“NEP”).³⁶ NEP was an investor-owned electric utility.³⁷ The Committee proposed to adjust NEP’s capital structure to reflect proceeds of a \$30,000,000 debenture issued by NEP’s parent, New England Electric System (“NEES”), at an interest rate of 3.25%.³⁸ These funds were included by the utility as equity and not as debt imputed from the parent company.³⁹ The Committee argued that this portion of NEP’s equity should be treated as long-term debt.⁴⁰ The FERC rejected the proposed adjustment noting that NEES’ 3.25% interest cost was well below the 9.26% cost ascribed to NEP’s common equity and determined to only use NEP’s (not NEES’) capital structure where NEP’s structure “*would produce a reasonable end result*”⁴¹

The PFD rejects CLWSC’s contention that the intercompany transfers were actually treated as equity by CLWSC and its parent. But other jurisdictions, like the TCEQ in *Wiedenfeld*, use a substance over form approach that considers the lack of an arms-length deal together with the reasonableness of the result. Thus, while a transfer of funds from an affiliate may be booked as “debt,” it is not treated as true arms-length, long-term third party debt for the purpose of determining the true cost of debt. For example, in a Florida Public Service Commission water/sewer utility rate decision, the following statement was made: “A loan from the utility’s shareholders was excluded from

³⁶ *NEPCO Municipal Rate Committee v. Federal Energy Regulatory Comm’n*, 668 F.2d 1327, 1331 (D.C. Cir. 1981).

³⁷ *Id.*

³⁸ *Id.* at 1332, 1345-1346.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.* (emphasis added).

our determination of the cost of debt and, instead, treated as equity, since the loan is not considered to be an arm's length transaction."⁴²

The PFD's recommendation to include the intercompany "loan" (at a substantially below market rate of 2.25%) in CLWSC's capital structure results in an overall rate of return which is far out of line with return rates found reasonable by TCEQ for other Texas investor-owned utilities in recent years. In *Aqua Texas*, an overall return rate of 8.44% was approved.⁴³ In *Southern Water Corporation*, a 9.25% overall water utility rate of return was approved.⁴⁴ In *Wiedenfeld*, a 8.43% overall return rate was found reasonable.⁴⁵ In *Texas Landing Utilities*, the overall return rate approved was 9.48%.⁴⁶ In *HHJ, Inc. d/b/a Decker Utilities*, an overall water utility return rate of 8.8541% was approved.⁴⁷ While each utility's situation has unique elements, these decisions show that the 6.46% overall return rate in the PFD is egregiously out of line with past Commission practice. The net result is a loss of almost a million dollars every year.

There are other problems with the PFD's capital structure and return recommendations. For example, in recommending a 70.36% debt to 29.64% equity capital structure in place of CLWSC's

⁴² *In re Request by Beverly Beach Surfside Utility Company for Staff-Assisted Rate Case in Flagler County*, Florida Public Service Commission Docket No. 870412-WS, Order No. 18553, 87-12 FPSC 262 (December 16, 1987); 1987 Fla. PUC Lexis 64, at *10.

⁴³ *Application of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc.*, TCEQ Docket Nos. 2004-1671-UCR and 2004-1120-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771, Final Order (September 23, 2008), p. 15.

⁴⁴ *Application of Southern Water Corporation for a Water and Sewer Rate/Tariff Change in Harris County and Appeal of Southern Water Corporation from a Water and Sewer Rate-Making 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, Proposal for Decision (May 19, 2010), pp. 44-47, *aff'd* by Interim Order (September 5, 2010) and Final Order (April 4, 2011).

⁴⁵ *Application of Wiedenfeld Water Works, Inc.*, TCEQ Docket No. 2009-0372-UCR, SOAH Docket No. 582-09-3549, Final Order (September 29, 2011), p. 11-12 and Proposal for Decision (October 1, 2010), p. 41-42. The request to raise rates was denied on other grounds, but the amount reflected herein was determined to be reasonable for the utility.

⁴⁶ *Application for a Water/Sewer Rate Tariff Change of Texas Landing Utilities*, TCEQ Docket No. 2007-1867-UCR, SOAH Docket No. 582-08-1023, Final Order, p. 16 (September 12, 2011).

⁴⁷ *Application of HHJ, Inc. d/b/a Decker Utilities*; TCEQ Docket No. 2008-0164-UCR; SOAH Docket No. 582-08-1719, Final Order, p. 8 (April 19, 2011).

proposed structure, which approaches a more reasonable 60%/40% ratio, the PFD fails to offer any corresponding increase to CLWSC's return on equity to reflect the enhanced risk of investing in a more leveraged utility. Also, the 6.46% rate is so low it does not even permit CLWSC enough return to meet all its true debt obligations given that one has an interest rate of 6.50%.⁴⁸

CLWSC's proposed capital structure was designed to achieve a reasonable overall rate of return. If the intercompany transfer funds had been treated as equity, the resulting rate would have been much higher. If the funds had been treated as debt as the PFD-recommends, the resulting rate is too low. Instead, CLWSC excluded the \$11,250,000 and its 2.25% interest rate from its capital structure completely for ratemaking purposes in calculating return. As the decisions discussed above show, CLWSC's approach was both supported by sound precedent and reaches a reasonable result.

In sum, dragging down CLWSC's overall rate of return as the PFD recommends would harm CLWSC's financial integrity and result in a confiscatory rate order. By law, the Commission must use the most "reasonable" approach. CLWSC's proposed capital structure is the most reasonable approach offered in the record and should be accepted in this case without its intercompany transfers at 2.25% even if the PFD 10.88% rate of return on equity is used in place of CLWSC's requested 12%. Even with a 10.88% rate of return on equity, CLWSC's overall rate of return would still be left at a much more reasonable 8.2% compared to the 6.46% the PFD recommends if CLWSC's proposed capital structure is used as requested.

2. ROR Worksheet Should Not be Used to Set Return on Equity

The cost of capital is the expected rate of return that market participants require in order to attract funds to a particular investment.⁴⁹ The cost of equity capital is the rate of return that common

⁴⁸ PFD, p. 85.

⁴⁹ CLWSC Ex. E, p. 7:20-8:11.

stockholders expect.⁵⁰ Equity investors expect a return on their capital commensurate with the risks they take and consistent with returns that might be available from similar investments.⁵¹ The “rate of return on equity” in the context of a utility is essentially the amount of profit that utility investors can expect.

CLWSC’s application requests a 12% rate of return on equity.⁵² Rate of return calculation methods can vary according to principles accepted by qualified experts.⁵³ CLWSC offered a rate of return on equity supported by its qualified expert, Mr. Gregory E. Scheig, CPA/ABV/CFF, CFA, who employed several methods that are regularly utilized by the regulated utility industry throughout the country.⁵⁴ These methods fully consider the complexities presented by various market forces.⁵⁵ He used a capital asset pricing model (“CAPM”), discounted cash flow model (“DCF”), and a risk premium model and was able to support CLWSC’s requested 12% rate of return on equity as reasonable given the range provided by all these models.⁵⁶

In contrast, the PFD rate of return on equity recommendation uses a ROR Worksheet at the ED’s recommendation with a 1% increase based on evidence provided by Tom Hodge about CLWSC’s seasonal customer population and associated businesses in CLWSC’s recreational lake service area.⁵⁷ CEWR did not offer competing evidence on any rate of return issue in this case.⁵⁸ If

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² CLWSC Ex. 1 at CLWSC 000017.

⁵³ CLWSC Ex. E, p. 6:8–7:13.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ PFD, at p. 87, 89-90; *see also* CLWSC Ex. B, pp. 52-54.

⁵⁸ Tr. 958:24-960:4 (Nelisa Heddin, March 29, 2012).

the ROR Worksheet is used, CLWSC accepts the PFD 1% increase. However, the Commission should not adopt the PFD recommendation using the ROR Worksheet to set CLWSC's rate of return on equity in place of Mr. Scheig's method.

The PFD rejects Mr. Scheig's approach used by CLWSC while simultaneously acknowledging that it is a market-based risk analysis.⁵⁹ That is precisely how return on equity should be properly analyzed and is in line with applicable law. Despite the credible expert testimony to the contrary, the PFD says the ROR Worksheet provides "a fair and reasonable method to calculate the return on equity".⁶⁰ That is incorrect for several reasons.

The PFD focuses on one narrow set of return considerations set forth in the law while excluding consideration of others. In particular, while 30 TEX. ADMIN. CODE § 291.31(c)(1)(B) captures the language in TEX. WATER CODE §13.184(b) concerning management and conservation issue considerations, the Water Code and TCEQ rules also recognize the overarching requirement for return to support capital attraction and a utility's financial integrity. TEX. WATER CODE §13.183(a); 30 TEX. ADMIN. CODE § 291.31(c)(1)(A), (C). This is in line with the U.S. Supreme Court's overriding mandate to assure a utility's ability to earn a return that will allow capital attraction, which trumps both the Water Code and TCEQ rules. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Water Works & Improvement Co. v. West Virginia Public Service Commission*, 262 U.S. 679 (1923).⁶¹

Mr. Scheig's approach is consistent with the applicable legal requirements under case law, the Texas Water Code, and TCEQ rules discussed above, in the PFD, and in CLWSC's closing briefs. It is also consistent with methods employed in Public Utility Commission cases following very similar

⁵⁹ PFD, p. 84, 89-90.

⁶⁰ *Id.*

⁶¹ *See also* PFD, p. 78.

legal requirements under the Public Utility Regulatory Act (“PURA”). TEX. UTIL. CODE §§36.051 and 36.052; see, e.g., *In re Petition to Inquire into the Reasonableness of the Rates and Services of Cap Rock Energy Corporation*, PUC Docket No. 28813; SOAH Docket No. 473-04-3554 (August 5, 2005), *aff’d Pioneer Natural Res. USA, Inc. v. PUC*, 303 S.W.3d 363 (Tex. App.–Austin 2009, no pet.) (“Cap Rock”) PFD, at 43-49 (describing methods used to calculate 11.75% rate of return on equity affirmed in the *Cap Rock*, Final Order, at FOF No. 64 and on appeal in *Pioneer*, 303 S.W.3d at 374); *Reliant Energy, Inc., et al v. PUC et al*, 153 S.W.3d 174, 192–196 (Tex. App.–2004, pet. denied) (describing methods used to calculate a 11.25% rate of return on equity for a very large electric utility and determining that company-specific factors could be considered, but were not required under TEX. UTIL. CODE §36.052).

CLWSC does not dispute the 0.25% good management bonus recommended by the ED may be one means of comporting with the non-exclusive list of factors found in the Texas Water Code that can be considered in setting return, except that CLWSC’s expert Mr. Scheig testified that any such bonus should be applied in addition to figures derived using market and company-specific risk factor considerations.⁶² ED staff witness Debi Loockerman testified that, in her past experience, the ED used a risk premium methodology going back to the 1990s both in her work for the agency and in private practice, and in most cases she has recommended a 12% rate of return on equity without using the worksheet.⁶³ In contrast, in this case, she recommended using the staff ROR worksheet producing a rate dramatically lower than 12% even factoring in her bonus.⁶⁴ While the PFD’s 1% addition helps

⁶² TEX. WATER CODE §13.184(b); Tr. 913:21-914:10 (Greg Scheig, March 29, 2012).

⁶³ Tr. 1093:24-1100:3 (Debi Loockerman, March 29, 2012).

⁶⁴ *Id.*

mitigate the impact of her recommendation, her testimony still contradicts the statement in the PFD that the worksheet is “consistent with the historical practice”.⁶⁵

There is no statute, TCEQ rule, or TCEQ application instruction requiring a utility to use the worksheet to calculate its rate of return on equity.⁶⁶ The worksheet is found in the back of the application instruction document in an appendix, and on its face is merely suggestive.⁶⁷ There is a long line of TCEQ decisions that approved a 12% rate of return on equity for both large and small utilities over a number of years.⁶⁸ Although there have been a few recent TCEQ decisions based on staff recommendations that utilized the ROR worksheet for the rate of return on equity amount, those involved small utilities and should not be followed as precedent here.⁶⁹

Mr. Scheig pointed out a number of problems with the worksheet in his testimony.⁷⁰ But the most damning testimony against the staff ROR worksheet came from Ms. Loockerman herself. While

⁶⁵ PFD, p. 89.

⁶⁶ Tr. 1100:4–1101:20 (Debi Loockerman, March 29, 2012).

⁶⁷ *Id.*

⁶⁸ TCEQ Docket Nos. 2004-1671-UCR and 2004-1120-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771. *An Order in the Application of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc. to Change Water and Sewer Rates* at 15 (“[a] 12% return on equity is reasonable in light of Aqua Texas’ risk and the capital-intensive nature of water and sewer utilities and is consistent with the returns available from other investments of similar risk.”). TCEQ Docket No. 2003-0153-UCR; SOAH Docket No. 582-03-2283; *An Order on Appeal of Tall Timbers Utility Company, Inc., to Review the Ratemaking Actions of the City of Tyler for Sewer/Tariff Increase in Smith County Sewer CCN 20694* at 3 (“Tall Timbers rate of return on invested capital should be 10.27 percent, including a 12-percent cost of equity and an 8.66 percent return on long-term debt”); TCEQ Docket No. 2005-0875-UCR; SOAH Docket No. 582-05-7838; *An Order Setting Retail Water Rates for Don M. Bryant d/b/a Buena Vista Water System, Under CCN No. 11656* at 5 (“A return of 12 percent upon the Applicant’s invested capital is just and reasonable”); TCEQ Docket No. 2003-0597-UCR; SOAH Docket NO. 582-03-3827; *An Order Approving the Applications of North Orange Water & Sewer L.L.C., to Change Water and Sewer Rates* at 9 (“Twelve percent (12%) is a fair return on investment for Applicant to receive because it is reasonable in light of Applicant’s weighted cost of capital and is consistent with the returns available from other investment of similar risk”); TNRCC Docket No. 97-0241-UCR; SOAH Docket No. 582-97-0899; *An Order Setting Retail Sewer Rates for Tanglewood Water Company, Inc.* at 6 (Utility’s allowed equity “should earn at a return rate of 12.25%”); TCEQ Docket No. 2004-0630-UCR; SOAH Docket No. 582-04-6463; *An Order Setting Retail Water Rates for WaterCo., Inc., under CCN 10130 in Trinity and Walker Counties.* PFD at 15 (The ALJ recommends a conclusion that a 12-percent rate of return on Applicant’s invested capital is appropriate).

⁶⁹ *Application for a Water and Sewer Rate/Tariff Change of Texas Landing Utilities*; SOAH Docket No. 582-08-1023; TCEQ Docket No. 2007-1867-UCR; *Application of Southern Water Corporation for a Water and Sewer Rate/Tariff Change in Harris County*; *Appeal of Southern Water Company from a Water and Sewer Ratemaking Decision in the City of Houston*; SOAH Docket No. 582-09-2069; TCEQ Docket No. 2008-1811-UCR.

⁷⁰ CLWSC Ex. E, p. 31:20-34:19.

in private practice a few years ago, after recommending a 12% rate of return on equity in line with decisions by both TCEQ and the PUC and testifying that the worksheet is not required, she offered the following opinion about the rate of return worksheet in an IOU rate case:

Q: What is your opinion on the methodology for setting a rate of return that is included as an optional worksheet in the Application for a rate/tariff change published by the TCEQ?

A: It is my opinion that the rate of return produced by this untested methodology will not attract capital investments into any privately owned water and wastewater utility in Texas. The worksheet begins with a flat 6 percent rate that has no basis in any analysis, expert development, or realistic industry standard. The percentage changes recommended by the worksheet are extreme and the beginning rate does not track with what is allowed by utilities regulated by the PUC. It is a poor alternative methodology for setting a rate of return for water and wastewater utilities in Texas. It is my opinion that the worksheet does not follow the TCEQ statutes and rules that require return to be reasonably sufficient to assure confidence in the financial soundness of the utility, and 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.⁷¹

In that same testimony, Ms. Loockerman also made reference to use of “a discounted cash flow or other complex model” in line with Mr. Scheig’s approach.⁷² In contrast, when asked in this case for her opinion about whether the worksheet uses a “good and reasonable and fair” methodology, Ms. Loockerman stated: “Yes. I’ve used it in my prefiled testimony.”⁷³ That simply cannot be Ms. Loockerman’s true opinion of the worksheet given her prior inconsistent testimony and it certainly cannot be credibly used as the basis for the similar statement included in the PFD.

The attempted transition towards use of the worksheet by staff in recent years without any input from the regulated community through rule-making or otherwise after so many years of allowing a

⁷¹ CLWSCEx. 65, p. 29:9-35:14 (Direct Testimony and Exhibits of Debi Loockerman, CPA on Behalf of Kendall County Utility Company, Inc., *In re Application of Kendall County Utility Co., Inc. to Change its Water and Sewer Rates in Kendall County, Texas*, SOAHDocket No. 582-08-2241, TCEQ Docket No. 2008-0304-UCR, September 5, 2008); Tr., p. 1104:1 - 1113:11 (Debi Loockerman, March 29, 2012).

⁷² *Id.*

⁷³ Tr. 1102:21-1103:1 (Debi Loockerman, March 29, 2012).

presumptively reasonable 12% rate of return on equity runs afoul of constitutional standards. The Court held in *Duquesne Light Co. v. Baraschi*, 488 U.S. 299 (U.S. 1989) that “a State’s decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions.” *Duquesne Light*, 488 U.S. at 315. Moreover, it simply is not fair to Texas IOUs who are required to submit these rate/tariff change applications in the face of shifting ED staff theories whether legal or not. Neither the PUC, the Texas Railroad Commission, nor any other utility regulatory authority, uses any type of similar ROR worksheet to set return on equity.⁷⁴ The PUC and Texas Railroad Commission have language similar to that in TEX. WATER CODE §13.184(b), but do not use a ROR worksheet for this task.⁷⁵ The fact that TCEQ is the only utility regulatory authority in the country to even attempt use of this overly simplistic method should be reason enough not to use it.⁷⁶

The final reason the ROR Worksheet should not be used is because there is no record evidence that a single factor included in the ROR Worksheet considers a utility’s need to attract equity capital. The bond yield starting point of the ROR Worksheet relates solely to debt capital and the rest relate to efficiencies in operations and management. The equity market is not considered at all within the limitations of the ROR Worksheet. Not a single factor in the ROR Worksheet considers capital attraction, and there is no evidence that an investor would commit equity capital to a Texas utility if rates are set using a rate of return on equity developed using the ROR Worksheet. In contrast, Mr. Scheig specifically considered what equity returns would be expected based on market forces.⁷⁷

⁷⁴ CLWSC Ex. E, p. 31:20-34:19; *see also* CLWSC Ex. C, p. 74:13-22.

⁷⁵ TEX. UTILITIES CODE §36.052 (applicable to electric utilities) and 104.053 (applicable to gas utilities).

⁷⁶ *Id.*

⁷⁷ Tr. p. 912:14-913:8 (Greg Scheig, March 29, 2012).

The TCEQ needs to consistently evaluate rate of return on equity for IOUs in the same manner as other regulatory authorities in Texas and across the country using well-established analytical methods.⁷⁸ The rate of return worksheet does not do that.⁷⁹ Mr. Scheig's approach does.⁸⁰ CLWSC should be granted a 12% rate of return on equity in this case as requested.

B. Rate Base Exceptions; Alternative Motion to Reopen Record

Calculating the proper amount for CLWSC's rate base is extremely important because it forms the basis for CLWSC's return, depreciation and other flow-through amounts needed to set a utility's just and reasonable rates. For the purpose of calculating return, CLWSC requested a rate base amount of \$41,483,080. In contrast, the PFD recommends finding that CLWSC's rate base amount is \$38,096,384. The difference results from two items which the Commission must correct: (1) using misinformation the ED mistakenly supplied in its record exhibits during the hearing on the merits; and, (2) using the improper method for calculating rate base recommended by the ED. CLWSC excepts to both aspects of the PFD's findings with respect to CLWSC's rate base.

As CLWSC explains below, the Commission should reject the rate base valuation methodology used by the ED, and adopted in the PFD for pre-acquisition trended assets. But if the ED's methodology is adopted in this case, as the PFD recommends, CLWSC excepts to the adoption of rate base values that, although originally proposed by the ED, the ED now acknowledges are incorrect. Those mistakes cause a \$1,059,247 reduction in CLWSC's net plant amount.⁸¹ As acknowledged in the PFD, the ED attempted to change his rate base recommendation in the ED's Closing Arguments after the record closed.⁸² While the ED's use of admittedly incorrect rate base

⁷⁸ CLWSC Ex. E, p. 31:20-34:19.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ PFD, p. 29-30.

⁸² ED Closing Arguments, pp. 29-30.

values is a legitimate basis for rejecting the ED's approach altogether, the Commission cannot set just and reasonable rates for CLWSC based on admittedly erroneous exhibits proffered by the ED. This is a significant problem because the ED's errors have multiple flow-through effects on amounts recommended in the PFD used to set rates, such as rate base, depreciation expense, return, and others. An unlawful confiscatory rate order and "taking" of CLWSC's capital in violation of the Texas and U.S. Constitutions would result because rates would be set based on exhibits which do not accord with the PFD-adopted principles described by the ED's witnesses.⁸³ Resulting rates would be set in an arbitrary and capricious manner in violation of the law.⁸⁴

The ED's rate base valuation error is thoroughly explained in the ED's Closing Argument at pages 28-31. The primary correction centers on the ED's reduction of the value of rate base assets. The ED only intended to reduce the value of trended assets, not the other two categories of assets that were not trended (the pre-acquisition non-trended assets and the post-acquisition non-trended assets).⁸⁵ A reduction to those categories of assets that were not trended is not appropriate because the original cost is documented and the ED does not dispute those values. The correction also fixes

⁸³ TEX. CONST. art. I, §§ 17 and 19.

⁸⁴ An arbitrary and capricious order is one that fails to properly consider the relevant facts, fails to articulate a rational connection between the facts found and the choice made, violates due process or is based on "unfair or unreasonable conduct that shocks the conscience." *Texas State Bd. of Dental Exam'rs v. Silagi*, 766 S.W.2d 280, 285 (Tex. Civ. App.-El Paso 1989, writ denied); *Consumers Water v. Public Utility Commission*, 774 S.W.2d 719 (Tex. Civ. App.-Austin 1989, no writ); *Starr County v. Starr Industry Servs., Inc.*, 584 S.W.2d 352 (Tex. Civ. App.-Austin 1979, writ ref'd n.r.e.); *Gerst v. Nixon*, 411 S.W.2d 350 (Tex. 1966); *Bowman Transp., Inc. v. Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 95 S.Ct. 438 (1971). An agency decision may be arbitrary and capricious if the agency abused its discretion by considering irrelevant factors or excluding factors which the Legislature intended it to consider. *Gerst*, 411 S.W.2d at 360 & n.8; *Consumers*, 774 S.W.2d at 721-722. When the agency bases its decision on a factor not included in the enabling legislation, such a decision is arbitrary and capricious by violating the due process rights of the parties. *Texas Health Facilities Comm'n v. Charter Medical-Dallas, Inc.*, 665 S.W.2d 446, 453-454 (Tex. 1984); *Public Utility Comm'n v. South Plains Elec. Coop., Inc.*, 635 S.W.2d 954, 957-58 (Tex. App.-Austin 1982, writ ref'd n.r.e.); *Starr County*, 584 S.W. 352.

⁸⁵ ED Closing Arguments, pp. 29-30; see also Exhibit ED-KA-2 (original); ED-KA-2 (revised); ED-KA-6.

the problem with CLWSC's Startzville wastewater plant, which was removed from CLWSC's rate base by the ED twice when it should have only been removed once.⁸⁶

While CLWSC disagrees with the ED's reduction of trended asset values to "match" booked costs,⁸⁷ final rates in this case should not be set based on exhibits containing admitted errors. If this is done, the Commission would plainly not be fulfilling its duty to set just and reasonable rates as the Water Code requires using any party's proposed method in the manner intended. TEX. WATER CODE §13.182(a). The resulting unjust and unreasonable rates would instead be produced based on incorrect information.

Consequently, while maintaining its other objections, CLWSC consents to the Commissioners' consideration of the ED's exhibits included with his Closing Argument for the limited purpose of correcting record math errors. CLWSC respectfully requests that the PFD be amended to incorporate the corrected figures the ED presented in Closing Argument. Although CLWSC believes that it is unnecessary to re-open the record to correct math errors based on existing evidence, CLWSC alternatively moves, to re-open the record if the Commission believes such a motion is necessary to correct the record.

1. Original Cost and Use of Trending Study

There is only one original cost for assets in IOU ratemaking which is established at the time an asset is placed in service and that original cost never changes.⁸⁸ "Utility rates shall be based on the original cost of property used by and useful to the utility in providing service. . ." TEX. WATER CODE §13.185(b); *see also* PFD, p. 12. "Original cost is the actual money cost or the actual money value of

⁸⁶ CLWSC expert Chuck Loy testified about the need to take this item out of CLWSC's rate base, but the reduction should not have been doubled. CLWSC Ex. C, p. 21:4-14. This was fixed in the ED's correction exhibit. ED-KA-2 (revised).

⁸⁷ CLWSC also maintains its objection to the presentation of evidence outside the record by CEWR, neither which CLWSC waives or withdraws.

⁸⁸ Tr. 625:5-7 (Charles E. Loy, March 28, 2012).

any consideration paid, other than money, of the property *at the time it shall have been dedicated to public use*, whether by the utility that is the present owner *or by a predecessor*, less depreciation.” *Id.* (emphasis added). As the PFD discusses, the ED recommends a method for estimating original cost of certain assets CLWSC purchased from WSC using “booked costs” instead of adopting CLWSC’s trending study used in its application to estimate original cost for those assets.⁸⁹ Original cost, less depreciation, of a utility’s assets provide the starting point for a utility’s rate base and return calculations under the Water Code. Therefore, a proper estimate of original cost is very important to calculating a utility’s just and reasonable rates.

The PFD states that the “ALJs agree with the ED that [CLWSC’s] trending study provides a complete asset list that supports the booked values shown on the WSC’s audited financial statements.”⁹⁰ The PFD also states that “[o]riginal cost based on a reliable trending study is one way to determine original cost.”⁹¹ But the PFD also states the “ALJs conclude that the ED’s method is a more reliable way of estimating the original cost of the trended, pre-acquisition assets, than the methods proposed by CLWSC and CEWR.”⁹² CLWSC agrees with the PFD conclusion with respect to CEWR, but excepts to the PFD’s rejection of CLWSC’s trending study estimates for original cost and depreciation values for certain pre-acquisition assets in favor of using “booked costs.”

a. Booked Costs are Not Original Cost Estimates

Original cost must be assessed at the time the assets were first placed in service by whomever placed them in service, not their value at a later date.⁹³ There are not — and cannot — be two

⁸⁹ PFD, p. 21-23. CLWSC reiterates that this is why the ED’s exhibits must be corrected if the Commission adopts the ED’s method. The exhibits do not track the ED’s own recommended estimation method.

⁹⁰ PFD, p. 30.

⁹¹ PFD, p. 23-24.

⁹² PFD, p. 30.

⁹³ CLWSC Ex. C, p. 10:17– 12:13; Tr. 611:21– 24, 624:18– 20 (Charles E. Loy, March 28, 2012).

different types of “original cost” under §13.185(b). The position offered by the ED, now recommended in the PFD, disregards the importance of the terms used in §13.185(b) “*actual money cost . . . of the property at the time it shall have been dedicated to public use . . . by a predecessor.*” TEX. WATER CODE §13.185(b). The ED’s proxy “booked cost” method does not even attempt to figure out original cost of CLWSC’s trended assets at the time they were installed.

b. Prior CLWSC Rate Cases Do Not Justify Rejection of Trending

While the PFD points to CLWSC’s use of booked costs in prior rate applications as some indication of the ED method’s propriety,⁹⁴ the evidence shows there were extenuating circumstances that necessitated using the WSC’s values that are no longer present. CLWSC has only filed 2 rate/tariff change applications with TCEQ since CLWSC acquired the assets of the WSC.⁹⁵ In furtherance of CLWSC’s purchase agreement with the WSC and management decisions of CLWSC’s Board, those rate applications deliberately sought significantly less in rates than the utility’s full revenue requirement justified.⁹⁶ CLWSC did not incur the expense of fully developing an evidentiary case covering all customary IOU rate case issues because the utility knew its requested rates would be significantly less than what could be justified. Consideration of many rate case issues was deferred for later rate cases. Those first two rate applications were either uncontested or settled relatively quickly without litigation.⁹⁷

This rate application is different. Because CLWSC has invested over \$34 million since acquiring the WSC assets, while not fully recovering and earning a return on that invested capital, the utility has not been recovering its full cost of service or revenue requirement.⁹⁸ This is the first rate application

⁹⁴ PFD, p. 30.

⁹⁵ CLWSC Ex. A, p. 17.

⁹⁶ *Id.*

⁹⁷ CLWSC Ex. 7 and CLWSC Ex. 8.

⁹⁸ CLWSC Ex. A, p. 16-18.

CLWSC has filed that seeks rates commensurate with the utility's rate base and revenue requirement.⁹⁹ Therefore, in this case, several issues which were unresolved in CLWSC's prior rate cases are now contested. Rate base is one of the most significant of those issues.

In the last case, the TCEQ ED would not set CLWSC's rate base as part of the settlement but agreed that CLWSC should complete a trending study.¹⁰⁰ Treatment of assets acquired from the WSC for ratemaking purposes was not ruled upon by the Commission.¹⁰¹ The ED knew in the last case from the audited financial statements admitted into this record that the rate base numbers presented in the last rate case were purchase prices and fair market value estimates — not original cost. Once issued, audit reports do not change. The settlement agreement from the last case clearly directed CLWSC to perform a trended original cost study for this case, and CLWSC fulfilled that requirement.¹⁰² Given the settlement agreement from the last case and the absence of a trending study in CLWSC's last two cases, it would make no sense to reject sound trending methodology in this case based on actions in CLWSC's last two rate applications born out of necessity.

c. CLWSC's Trending Study is the Most Reliable Estimate of Original Cost

The PFD states that the ALJs "are not convinced of the reliability of the trending study used in this case,"¹⁰³ but the limited reasons provided do not support that conclusion. The PFD points to a cherry-picked example of a variation in pipe prices ascribed by two experts who looked at the issue at different times in preparation of different trending studies as a primary justification for the conclusion that "original costs estimated by a trending study can be highly variable, depending on the

⁹⁹ *Id.*

¹⁰⁰ CLWSC Ex. 7.

¹⁰¹ CLWSC Ex. 8.

¹⁰² CLWSC Ex. 7, p. CLWSC 000711.

¹⁰³ PFD, p. 30.

expert and his assumptions” and that CLWSC’s study is not reliable.¹⁰⁴ But that single example does not justify throwing out the *entire* trending study involving literally thousands of asset valuations. Some variation between assets in any particular set of studies does not render any one study unreliable in its entirety. This is just the nature of the trending process that has been routinely accepted in past TCEQ cases.¹⁰⁵

The PFD also incorrectly views failure to consider the WSC’s capitalization policy in CLWSC’s trending study as demonstrative of its unreliability.¹⁰⁶ However, this consideration is simply irrelevant in the performance of a trending study. The GDS expert that performed the study actually field-inspected the facilities and assessed what was on the ground during the test year.¹⁰⁷ What may or may not have been capitalized by the WSC previously, properly or improperly, is not relevant to the trending study process.

CLWSC’s trended original cost study estimates are reliable and should be used because they represent the best estimates available for the subset of pre-acquisition CLWSC assets that were trended. As the ED’s Staff Engineer conceded under cross-examination, trending is a scientific methodology to estimate the original cost of plant.¹⁰⁸ There is a plethora of testimony and evidence about the problems with using the “booked costs” of certain older pre-acquisition assets which came from WSC’s unreliable, non-IOU records and how this led to CLWSC’s agreement with the ED in

¹⁰⁴ PFD, pp. 24-27

¹⁰⁵ CLWSC Ex. D, p. 8:1-7 and 13:12-15:2; Tr. 1072:12-1074:9 (Debi Loockerman, March 29, 2012); Tr. 1300:3-16 (Kamal Adhikari, March 30, 2012); *see also In re Applications of Quadvest, Inc. for a Water and Sewer Rate/Tariff Change*, TCEQ Docket No. 2003-0242-UCR, SOAH Docket No. 582-03-2832 (August 16, 2004); *In re Application of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc. to Change Water and Sewer Rates*, TCEQ Docket Nos. 2004-1671-UCR and 2004-1120-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771 (September 23, 2008); *An Order Setting Retail Water Rates for WaterCo., Inc., under CCN 10130 in Trinity and Walker Counties*, TCEQ Docket No. 2004-0630-UCR; SOAH Docket No. 582-04-6463 (January 12, 2006); *In re Appeal of Tecon Water Company, LP from the Ratemaking Actions of the City of Blue Mound*, TCEQ Docket No. 2001-1080-UCR; SOAH Docket No. 582-02-0712 (June 11, 2003).

¹⁰⁶ PFD, pp. 24-27

¹⁰⁷ CLWSC Ex. D, p. 10:6-11:14.

¹⁰⁸ Tr. 1264:5-11 (Kamal Adhikari, March 30, 2012).

the last case to perform trending.¹⁰⁹ The different non-IOU accounting methodology the WSC used to value its “booked” plant costs is reason alone not to use those values to set CLWSC’s IOU rates.¹¹⁰

Both CLWSC and ED witnesses testified that trended original cost studies have been consistently accepted by the TCEQ for IOU ratemaking purposes.¹¹¹ Trending is a time-honored method for creating a documented estimate of original cost.¹¹² Trending is particularly appropriate where, as here, utility plant records of original cost at the time of installation or dedication to public service are non-existent or unreliable.¹¹³ It was this lack of supporting and corroborating documentation which prompted the Executive Director to direct Canyon Lake in the last rate case to perform a trending study. The evidence shows the use of “booked cost” estimates in the manner recommended by the ED, now recommended in the PFD, has far less reliability than CLWSC’s trended original cost estimates.

¹⁰⁹ Tr. 201:7-202:20 (Palle Jensen, March 26, 2012) (“we obviously had assets for which there were no invoices or records. And in order to be able to establish the original cost that is necessary to determine the rate base, I believe that [the ED staff] thought that it would be beneficial to go through a trending study so we could make that determination”); CLWSC Ex. 3 at CLWSC 001032 (“The creation of the CLWSC through the consolidation of acquired water systems over the past 14 years has resulted in some historical financial records being destroyed and/or may have never been created. The non-profit status did not require the maintenance of said records, if existing at time of acquisition, beyond IRS guidelines. As purchaser, SJW will employ alternative techniques such as ‘trending’ to establish a reasonable estimate of original cost less depreciation in future rate processing.”); CLWSC Ex. B, p. 18:19-19:14; CLWSC Ex. D, p. 9:14-13:10, 16:12-17:1; Tr. 1447:21-1458:15 (Thomas A. Hodge, April 19, 2012) (discussing CLWSC Ex. 70 and CLWSC Ex. 71).

¹¹⁰ *Id.*; CLWSC Ex. 56 at CLWSC 101265-101266 (stating that for WSC “Plant and equipment is recorded at cost for purchased property and fair market value at the date of acquisition for donated property”); *see also* PFD, pp. 11-13 and CLWSC Closing Arguments, pp. 14-16 (discussing differences between IOU and water supply corporation accounting and ratemaking requirements).

¹¹¹ CLWSC Ex. D, p. 8:1-7 and 13:12-15:2; Tr. 1072:12-1074:9 (Debi Loockerman, March 29, 2012); Tr. 1300:3-16 (Kamal Adhikari, March 30, 2012); *see also In re Applications of Quadvest, Inc. for a Water and Sewer Rate/Tariff Change*, TCEQ Docket No. 2003-0242-UCR, SOAH Docket No. 582-03-2832 (August 16, 2004); *In re Application of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc. to Change Water and Sewer Rates*, TCEQ Docket Nos. 2004-1671-UCR and 2004-1120-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771 (September 23, 2008); *An Order Setting Retail Water Rates for WaterCo., Inc., under CCN 10130 in Trinity and Walker Counties*; TCEQ Docket No. 2004-0630-UCR; SOAH Docket No. 582-04-6463 (January 12, 2006); *In re Appeal of Tecon Water Company, LP from the Ratemaking Actions of the City of Blue Mound*; TCEQ Docket No. 2001-1080-UCR; SOAH Docket No. 582-02-0712 (June 11, 2003).

¹¹² *Id.*

¹¹³ CLWSC Ex. D, p. 8:13-15; *see also* Tr. 1072:12-1074:9 (Debi Loockerman, March 29, 2012) (discussing past use of trending studies in cases that lacked invoices).

2. Contributions in Aid of Construction (CIAC)

CLWSC agrees with the PFD recommendation to allow CIAC amounts to remain in CLWSC's rate base to the extent they exist "for good cause shown".¹¹⁴ However, CLWSC excepts to the PFD finding that there is either developer or customer contributions in aid of construction (CIAC) related to pre-acquisition Canyon Lake Water Supply Corporation ("WSC") assets that CLWSC did not properly consider in its rate filing.¹¹⁵

There is no CIAC to take out of CLWSC's rate base related to its pre-acquisition assets acquired from the WSC. Under regulatory rules for water supply corporations, contributions from customers or other donated system property can simply be treated as income and, ultimately, transferred to the equity account on a water supply corporation's balance sheet.¹¹⁶ That is precisely the accounting treatment the WSC ascribed to such contributed or donated property here.¹¹⁷ The WSC had no need to track its CIAC and tie it to specific plant assets as required for IOUs, meaning the contributions became part of each member's equity in the member-owned and controlled WSC.¹¹⁸ The WSC never even included a separate line item for CIAC on its balance sheet.¹¹⁹

In an IOU to IOU transaction, any booked CIAC amount should follow contributed assets to the books of the purchasing IOU and be amortized over the remaining life of that asset.¹²⁰ In fact, there is a special requirement for IOU sellers to notify a buyer of the existence of any customer CIAC

¹¹⁴ PFD, p. 54; 30 TEX. ADMIN. CODE §291.31(c)(3).

¹¹⁵ PFD, p. 36-40.

¹¹⁶ Tr. 632:18-639:6 (Charles E. Loy, March 28, 2012).

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ Tr. 624:15-627:8 (Charles E. Loy, March 28, 2012).

used in facility/system construction.¹²¹ No such requirement exists in a WSC to IOU transaction. Regardless, to the extent CLWSC and WSC intended to transfer CIAC liabilities to CLWSC, CIAC liability should have been addressed in either the Asset Purchase Agreement that effected the transfer of WSC assets and specified liabilities to CLWSC, or in the Sale, Transfer, or Merger (“STM”) application that was jointly filed with the TCEQ by both parties. Carry-over of CIAC as recorded on the WSC’s books to CLWSC’s books is not mentioned — let alone required — anywhere in the Asset Purchase Agreement as part of consideration for the transaction.¹²² Moreover, CLWSC and the WSC *jointly* filed the STM application for the asset purchase transaction with TCEQ and specifically stated that the amount of CIAC for the WSC assets being transferred was “\$0.”¹²³ The STM Application — which was sworn to by both the WSC and CLWSC — thus plainly states that the parties did not intend for any CIAC liability to transfer to CLWSC when it acquired the WSC assets.

CLWSC is not required by TCEQ rules to attempt identification and reclassification of WSC assets as CIAC on CLWSC’s books.¹²⁴ It also would not be appropriate under GAAP and would be an impossible task.¹²⁵ The results would be unreliable and, if used to reduce rate base, result in an unfair confiscation of CLWSC’s invested capital.¹²⁶ It would mean unjustly taking away funds from CLWSC and giving customers who are former WSC members a second round of compensation that was never agreed upon in the TCEQ-approved CLWSC/WSC asset purchase transaction.¹²⁷ It would mean granting current customers who were not WSC members a windfall because they did not

¹²¹ TEX. WATER CODE §13.301(j).

¹²² CLWSC Ex. 3; Tr. 1321:2–1322:5 (Palle Jensen, April 19, 2012); CLWSC Ex. C, p. 27:17–28:20.

¹²³ CLWSC Ex. 3 at CLWSC 001031 (emphasis added).

¹²⁴ CLWSC Ex. C, p. 27:17– 28:20.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

contribute anything to the pre-acquisition set of assets CLWSC bought from the WSC.¹²⁸ In sum, failure to confine CIAC treatments in this case to those contributions directly received by CLWSC, rather than the WSC, would result in rates that are unjust, unreasonable, and fail to preserve the financial integrity of CLWSC in violation of the Texas Water Code. TEX. WATER CODE §§13.182(a) and §13.183(a).

Even though CLWSC disagrees with their existence, CLWSC agrees with the PFD recommendation to allow any CIAC amounts such as those described above to remain in CLWSC's rate base "for good cause shown."¹²⁹ As the PFD mentions, in line with the testimony by CLWSC's expert, it would be extremely difficult to attempt any reliable or accurate accounting of the WSC's CIAC property which the WSC did not reliably or accurately track on its books initially in the IOU-required manner.¹³⁰ In fact, CLWSC's expert testified that it would be an "impossible task."¹³¹ No adjustment should be made to CLWSC's rate base based on CIAC alleged to exist for pre-acquisition WSC assets.

3. Negative Acquisition Adjustment Issue

CLWSC agrees with the PFD rejection of the ED's proposed unprecedented adjustment which would use a negative acquisition adjustment to "remov[e]" perceived "cost-free capital" from CLWSC's rate base, but CLWSC excepts to the finding that such an adjustment "appears reasonable in the abstract" and excepts to some of the PFD's analysis of this issue.¹³² Removal of rate base amounts generically deemed to "represent cost free capital" is not authorized anywhere in the Water Code and is unsupported by any decision from any regulatory body or jurisdiction. The fact that the

¹²⁸ *Id.*

¹²⁹ PFD, p. 54; 30 TEX. ADMIN. CODE §291.31(c)(3).

¹³⁰ PFD, p. 54; CLWSC Ex. C, p. 27:17- 28:20.

¹³¹ CLWSC Ex. C, p. 27:17- 28:20.

¹³² PFD, p. 40-48.

ED recommends using a negative acquisition adjustment to “represent cost free capital” is an acknowledgment that it is not *actually* “cost free capital.” Unlike standard CIAC liability credits, the ED’s recommendation includes no explanation for what specific assets used and useful by CLWSC in providing service to the public were obtained “cost free” from a third party.

For reasons discussed in Section B.2. of these exceptions and CLWSC’s closing arguments briefs, the ED’s contention that CLWSC owes ratepayers a CIAC credit for pre-acquisition assets is not supported by the record. Further, the Water Code indicates that customer CIAC must be by explicit agreement or, at least, specifically collected through means such as a surcharge. TEX. WATER CODE §13.185(b), (j). All contentions regarding pre-acquisition customer and developer CIAC amounts in this case are pure speculation and unsupported.¹³³

Even assuming for the sake of argument only, that pre-acquisition CIAC property or cost-free capital exists within CLWSC’s rate base, incorporation of acquisition adjustment amounts in ratemaking still violates the original cost standard and should not be allowed to determine rate base or rates in this case. TEX. WATER CODE §13.183(c), §13.185(a)-(b); ED Ex. ED-DL-23, p. 12-13, 18 (*Technology Hydraulics*, Final Order, June 30, 1994); *Quadwest*, Final Order, at FOF No. 22 and COL No. 5, August 16, 2004, and PFD, p. 4-5, June 4, 2004 (rev. July 29, 2004). First, as the PFD finds, there is good cause to leave any CIAC or cost-free capital in CLWSC’ rate base.¹³⁴ Second, “Specific alternate ratemaking methodologies,” such as incorporation of an acquisition adjustment, are permitted for utilities in limited circumstances, but they must be adopted by Commission rule. TEX. WATER CODE §13.183(c), §13.185(a)-(b). Otherwise, the usual original cost formula applies. *Id.*

The TCEQ has adopted such an alternate ratemaking rule with respect to *positive* acquisition adjustments that allows a utility to recover such an acquisition adjustment if certain criteria are met.

¹³³ CLWSC Closing Arguments, p. 37-46.

¹³⁴ PFD, p. 54.

30 TEX. ADMIN. CODE §291.31(d). There is no corresponding TCEQ rule about incorporation of a *negative* acquisition adjustment in ratemaking as required by TEX. WATER CODE § 13.183(c).¹³⁵ The TCEQ could have adopted a negative acquisition rule but the agency deliberately chose not to.¹³⁶ There is not a corresponding provision for either type of acquisition adjustment in the Texas Water Code.¹³⁷

Despite the Texas Water Code silence about the term “acquisition adjustment,” the TCEQ has adopted a definition of the term in its rules. Here is how the term is described, including both negative and positive acquisition adjustments, in the TCEQ definitions section:

The following words and terms, when used in this chapter, have the following meanings, unless the context clearly indicates otherwise.

(1) Acquisition adjustment—

(A) The difference between:

- (i) the lesser of the purchase price paid by an acquiring utility or the current depreciated replacement cost of the plant, property, and equipment comparable in size, quantity, and quality to that being acquired, excluding customer contributed property; and
- (ii) the original cost of the plant, property, and equipment being acquired, excluding customer contributed property, less accumulated depreciation.

¹³⁵ Tr. 1052:4–1056:3 (Debi Loockerman, March 29, 2012); TEX. WATER CODE § 13.183(c) (stating “The regulatory authority may not approve rates under an alternative ratemaking methodology unless the regulatory authority adopts the methodology before the date a rate application was administratively complete.”); TEX. WATER CODE § 13.185(a).

¹³⁶ For example, the TCEQ chose to adopt the positive acquisition rule to promote regionalization. *See* 24 Tex. Reg. 738, 741 (1999) (adopting rule amendment now codified at 30 TEX. ADMIN CODE § 291.31(d)) (Tex. Comm’n on Envtl. Quality) (stating in response to comments regarding this rulemaking, “Senate Bill 1 granted the commission the authority to promulgate alternative ratemaking rules and the use of an acquisition adjustment is included as an *alternate ratemaking process*. The authority was permissive, not mandatory, and it is not clear that the legislature mandated that an acquisition adjustment be included in these rules . . . The commission believes that acquisition adjustments *could help create an incentive for regionalization.*”) (emphasis added). In contrast, negative acquisition adjustments would create a disincentive for regionalization and no rule for such adjustments was adopted.

¹³⁷ *Id.*

- (B) A positive acquisition adjustment results when subparagraph (A)(I) of this paragraph is greater than subparagraph (A)(ii) of this paragraph.
- (C) A negative acquisition adjustment results when subparagraph (A)(ii) of this paragraph is greater than subparagraph (A)(I) of this paragraph.

30 TEX. ADMIN. CODE §291.3(1). In his testimony, CLWSC expert Charles E. Loy, C.P.A. gave several examples for how each type of acquisition adjustment might occur.¹³⁸

Neither a negative nor a positive acquisition adjustment has anything to do with “cost free capital” as suggested by the ED in this case.¹³⁹ In contrast to CIAC, it does not represent a third party capital infusion by anyone and is just an accounting entry.¹⁴⁰ In fact, the TCEQ definition for “acquisition adjustment” specifically calls for excluding CIAC from the calculation. 30 TEX. ADMIN. CODE §291.3(1).

The *Technology Hydraulics* Commission decision stands for the proposition that, in the absence of statutory authority, negative acquisition adjustments are not to be included for ratemaking purposes.¹⁴¹ Specifically, the Commission’s Findings of Fact state:

- 15. It is inappropriate to apply a negative acquisition adjustment to reduce the Utility’s depreciation expense.
 - a. Acquisition adjustments are sometimes used to offset the differences between the purchaser’s price and the net book value of utility property used and useful in providing service shown on the seller’s books. If allowed, a negative acquisition adjustment would be amortized over the remaining useful life of the system purchase, and is netted against depreciation expense.
 - b. Section 13.185(j) of the Texas Water Code addresses the treatment of depreciation expense in a rate proceeding. The language in this statute does not provide an exception for a negative acquisition adjustment which would reduce the Utility’s depreciation expense.

¹³⁸ Tr. 620:10–623:22 (Charles E. Loy, March 28, 2012).

¹³⁹ ED-DL-1, p. 19:17-19.

¹⁴⁰ Tr. 599:4–601:23 (Charles E. Loy, March 28, 2012); Tr. 1363:23-1364:8 (Palle Jensen, April 19, 2012).

¹⁴¹ ED-DL-23 at 12-13, 18 (*Technology Hydraulics*, Final Order, June 30, 1994).

The Commission's Conclusions of Law state:

10. Pursuant to Section 13.185(j) of the Texas Water Code, a negative acquisition adjustment cannot be applied to reduce a utility's depreciation expense on the currently used, depreciable property owned by the utility.¹⁴²

The *Technology Hydraulics* Order describes the proper way to account for an acquisition adjustment in ratemaking if it were allowed, but then disallows it. Acquisition adjustments are an amortized adjustment to a plant asset's depreciation expense over its useful life.¹⁴³ CLWSC expert Charles E. Loy, C.P.A., provided testimony that aligns with this description.¹⁴⁴

Mr. Loy testified that a negative acquisition adjustment would prevent a utility from earning on original cost and he has never seen the TCEQ grant a positive acquisition adjustment despite the rule applicable to same.¹⁴⁵ Positive acquisition adjustments would have to be similarly amortized in line with the TCEQ rule. 30 TEX. ADMIN. CODE §291.31(d). But utilities are never required to incorporate a negative or positive acquisition adjustment into a rate base calculation and, in most jurisdictions, it is not allowed.¹⁴⁶

Past TCEQ rate case orders show recognized existence of utility acquisition adjustment amounts, including negative acquisition adjustments in the *Quadvest* case, but: (1) have allowed utilities to carry these amounts on their books, (2) not required their inclusion for ratemaking purposes, and (3) have ultimately found rate base utilizing such treatments compliant with TEX. WATER CODE §13.185.¹⁴⁷

¹⁴² *Id.*, at 18.

¹⁴³ ED-DL-23 at 12.

¹⁴⁴ Tr. 598:10–603:19, 623:1–22 (Charles E. Loy, March 28, 2012).

¹⁴⁵ Tr. 601:19–602:15 (Charles E. Loy, March 28, 2012).

¹⁴⁶ Tr. 662:1–14 (Charles E. Loy, March 28, 2012).

¹⁴⁷ *In re Applications of Quadvest, Inc. for a Water and Sewer Rate/Tariff Change*, TCEQ Docket No. 2003-0242-UCR, SOAH Docket No. 582-03-2832, Final Order, at FOF No. 22, and COL No. 5 (August 16, 2004), PFD, p. 4-5 (June 4, 2004 (rev. July 29, 2004)); CLWSC Ex. 48, *In re Application of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc. to Change Water and Sewer Rates*, TCEQ Docket Nos. 2004-1671-UCR and 2004-1120-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771, Final Order, at FOF Nos. 68, 69 and 70 (September 23, 2008).

Underlying such a finding in the *Quadvest* case, the PFD states as follows:

Applicant acquired a number of functioning water systems and plant items that it consolidated into its operation. A number of them were acquired at less than their actual value so are booked on Applicant's balance sheet as having a negative acquisition adjustment. App. Exh. 3, pp. 8-10. Notwithstanding that, the original value of the plant or system was computed and depreciated in developing the rate base. In doing so, Applicant used the accounting method mandated in the Water Code for computation of a utility's invested capital. TEX. WATER CODE ANN. §13.185.¹⁴⁸

In a footnote, the PFD adds this additional information:

The Homeowners Group had requested certification to the Commission of the appropriateness of Applicant using this accounting practice in light of its actual cost to acquire the assets. Certification was denied on the basis that there was no controverted or unsettled question presented. (Order No. 10, January 13, 2004).¹⁴⁹

Order No. 10, referenced in the *Quadvest* PFD, states:

The Protestants requested that questions be submitted as to whether negative acquisition adjustments can be applied to the [sic] arrive at the depreciated value of utility plant in any circumstance in a rate case, and if so, under what circumstances. Upon consideration of counsels' argument and authority the ALJ concludes the Protestants' motion should be, and is hereby, *denied*. The motion is denied on the basis that the questions presented do not meet the criteria for submission of certified questions. 30 TEX. ADMIN CODE ANN. §80.131(b). In order to trigger the certified question procedure, there must be an absence of or an ambiguity in the Commission's policy declarations. There is no such ambiguity in this case. The language of TEX. WATER CODE ANN. §13.185(j) is straightforward in setting forth the formula a utility must use in computing the depreciated value of its acquisitions. Although the Water Code has been amended since Sec. 13.185(j) was adopted this section has not been amended. Commission rules adopted in 1999 which address acquisition adjustments do not permit application of negative acquisition adjustments. 30 TEX. ADMIN. CODE ANN. §§291.3(d)[,] 291.34. Further, the Protestants were unable to point to any Commission Order, policy statement, or practice which expressed a different position. The sole Commission Decision on this subject, made in a contested case issued in 1994, denied use of a negative acquisition adjustment.¹⁵⁰

This clearly shows how acquisition adjustment amounts, including negative amounts, should be treated in this case. Despite the novel theory advanced by the ED, as shown by the *Quadvest* case,

¹⁴⁸ *Quadvest*, PFD, p.4-5.

¹⁴⁹ *Quadvest*, PFD, p. 5 n.2.

¹⁵⁰ *Quadvest*, Order No. 10 Denying Quest for Certified Question (footnote citations omitted).

the law is so clear a prior request for a certified question on the same issue was rejected for lack of “ambiguity.” CLWSC is entitled to rate base treatment consistent with past TCEQ decisions, rules and the statute.

The mere existence of acquisition adjustment amounts on a utility’s books does not require their inclusion in rate base or rates. Those are two totally different matters.¹⁵¹ Acquisition adjustment amounts may only be included for ratemaking purposes if: (1) applied for, and (2) specifically allowed by rule or statute.

CLWSC requested recognition of its acquisition adjustment amounts for accounting purposes and not for ratemaking purposes.¹⁵² As previously discussed, and as the ED’s staff accountant conceded, the TCEQ has not adopted a rule authorizing the use of negative acquisition adjustments in ratemaking as required by TEX. WATER CODE § 13.183(c).¹⁵³ In the past, TCEQ has accepted the practice of excluding all acquisition adjustment amounts, while permitting these amounts to be carried on a utility’s books.¹⁵⁴ This was done in both the *Aqua Texas* and *AquaSource* cases.¹⁵⁵ As the PFD recommends, that practice should be continued here for CLWSC.¹⁵⁶

The sole purpose for CLWSC requesting recognition of acquisition adjustment amounts was to satisfy CLWSC’s auditors that there is regulatory approval to maintain the amounts on CLWSC’s

¹⁵¹ Tr.1316:18-1317:24 (Palle Jensen, April 19, 2012).

¹⁵² CLWSC Ex. C, p. 24:1–25:15; Tr. 1316:18-1317:24 (Palle Jensen, April 19, 2012).

¹⁵³ Tr. 1052:4–1056:3 (Debi Loockerman, March 29, 2012).

¹⁵⁴ *In re Applications of Quadvest, Inc. for a Water and Sewer Rate/Tariff Change*, TCEQ Docket No. 2003-0242-UCR, SOAH Docket No. 582-03-2832, Final Order, at FOF No. 22, and COL No. 5 (August 16, 2004), PFD, p.4-5 (June 4, 2004 (rev. July 29, 2004)); CLWSC Ex. 48, *In re Application of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc. to Change Water and Sewer Rates*, TCEQ Docket Nos. 2004-1671-UCR and 2004-1120-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771, Final Order, at FOF Nos. 68, 69 and 70 (September 23, 2008). *In re Applications of AquaSource Utility, Inc. to Change its Tariffs and Rates Under Certificates of Convenience and Necessity Nos. 11157 and 20453 in 45 Counties*; TNRC Docket Nos. 2000-1074-UCR and 2000-1075-UCR; SOAH Docket No. 582-01-0416, Final Order and Ordering Provision No. 1 (September 17, 2002).

¹⁵⁵ *Id.*

¹⁵⁶ PFD, p. 93-94.

books, amortize them, and possibly recover the amounts at some point in the future to satisfy Financial Accounting Standards Board (FASB) 71 and GAAP.¹⁵⁷ For negative acquisition adjustments, such recovery in rates would require a statute or rule change. For positive acquisition adjustments, presentation of proof in line with the applicable TCEQ rule is required. 30 TEX. ADMIN. CODE §291.31(d). Neither was present in this case.

CLWSC followed the law with its application in requesting rates based on the original cost standard.¹⁵⁸ A negative acquisition adjustment does not represent “cost free” capital as claimed by the ED’ staff accountant, Ms. Loockerman.¹⁵⁹ Ms. Loockerman’s recommendation, properly rejected in the PFD, violates the law by recommending a huge \$4M subtraction from CLWSC’s rate base, in addition to an additional \$4M adjustment related to use of trending, based on a net acquisition adjustment amount that she did not even analyze or calculate.¹⁶⁰ Ms. Loockerman’s attempted justification is that CLWSC’s acquisition of WSC assets was a “bargain” purchase, but she did not consider the actual terms or dollar amounts involved in the deal, including the enormous TCEQ compliance problems and unliquidated liabilities that CLWSC faced when it acquired the WSC’s assets.¹⁶¹ Ms. Loockerman’s recommended approach is unprecedented in TCEQ decisions since its rejection in *Technology Hydraulics*, the last time Ms. Loockerman recommended the treatment.¹⁶²

¹⁵⁷ CLWSC Ex. C, p. 24:1–25:15; CLWSC Ex. 33 (FASB 71); Tr. 1316:18–1317:24 (Palle Jensen, April 19, 2012).

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*; Tr. 1029:17–1069:23 (Debi Loockerman, March 29, 2012).

¹⁶¹ ED-DL-1, p. 19:6–20:1; Tr. 1049:4–1051:11 (Debi Loockerman, March 29, 2012); Tr. 1318:9–1320:18, 1344:4–18 (Palle Jensen, April 19, 2012). See also CLWSC Ex. 3 at CLWSC 001034-001035, CLWSC 001041-001042, and CLWSC 001053-001063.

¹⁶² Tr. 1055:22–1056:3 (Debi Loockerman, March 29, 2012); Tr. 1189:12–15 (Debi Loockerman, March 30, 2012); see also *Quadvest* Final Order, PFD and Order No. 10.

Deviating from original cost by incorporating acquisition adjustments here in the manner the ED recommends would also constitute bad public policy. While allowing recovery of positive acquisition adjustments might encourage larger utilities to buy smaller, troubled utilities, incorporation of negative acquisition adjustments would have just the opposite effect in violation of the Legislature's strong policy preference to promote regionalization in Texas.¹⁶³ There is no sound factual, legal, or policy basis to establish new precedent in setting rates for CLWSC using the ED's recommended novel approach in this case. The PFD does not discuss regionalization considerations in reaching its conclusions.¹⁶⁴ However, regionalization is a very important issue for all Texas utilities, such as CLWSC, involved in acquisitions that could be impacted by any Commission policy statement in this case affecting rate treatment of acquisition adjustments. The Commission should bear this in mind when deciding this case and defer to its rulemaking process if such a statement is desired.

For all these reasons, CLWSC agrees with the PFD recommendation for the Commission to refrain from using a negative acquisition adjustment to "remove cost-free capital" from CLWSC's rate base as the ED proposes given the unprecedented nature of such an adjustment.¹⁶⁵ However, CLWSC excepts to the PFD findings that there is any sound regulatory basis for such an adjustment, that the ED's proposed adjustment "appears reasonable in the abstract," and that the *Technology Hydraulics* decision provides any basis for the ED's proposed rate base adjustment.¹⁶⁶

¹⁶³ Tr. 601:19-603:19 (Charles E. Loy, March 28, 2012); CLWSC Ex. 48, *In re Application of Aqua Utilities, Inc. and Aqua Development Company d/b/a Aqua Texas, Inc. to Change Water and Sewer Rates*, TCEQ Docket Nos. 2004-1671-UCR and 2004-1120-UCR; SOAH Docket Nos. 582-05-2770 and 582-05-2771, Final Order, at FOF Nos. 37-51 and COL Nos. 13-17 (September 23, 2008).

¹⁶⁴ PFD, p. 40-48.

¹⁶⁵ PFD, p. 46-48

¹⁶⁶ *Id.*

4. Customer Deposit Issue

CLWSC agrees with the PFD's rejection of the ED's recommendation to disallow \$116,375 in customer deposits.¹⁶⁷ TCEQ rules allow IOUs to charge a customer deposit when a customer first connects, but they also require return of deposits with interest after a certain period of time within which a customer has the opportunity to establish a solid payment history. 30 TEX. ADMIN. CODE § 291.84. This policy is also reflected in CLWSC's tariff.¹⁶⁸ These are temporarily held funds that an IOU can draw upon to obtain reimbursement for unpaid bills, not payments toward plant assets. The funds are not cost free capital, as the ED contended in this case, because IOUs are required to pay interest on them for the entire period the deposits are held at a statutorily set rate. 30 TEX. ADMIN. CODE § 291.84(d). Fairness of that interest rate should not be at issue here since it is not set through the rate application process.

5. Accumulated Deferred Federal Income Tax Issue

CLWSC excepts to the PFD recommendation to violate the TCEQ rules in favor of the ED's recommendation to disallow \$268,037 in accumulated deferred federal income taxes ("ADFIT") from CLWSC's rate base.¹⁶⁹ This PFD recommendation is directly at odds with 30 TEX. ADMIN. CODE § 291.31(c)(3)(A)(I) which expressly provides that accumulated reserve for deferred federal income taxes must be excluded from rate base calculations. The PFD cites PUC authority as support for the ED's contention that ADFIT is cost free capital which must be removed under 30 TEX. ADMIN. CODE § 291.31(c)(3)(A)(v). However, TCEQ rules and precedent must be followed with respect to this issue.

¹⁶⁷ PFD, p. 49.

¹⁶⁸ CLWSC Ex. 1 at CLWSC 000048, §§1.02 and 2.03.

¹⁶⁹ PFD, p. 50-51.

An agency acts in an arbitrary and capricious manner when it (1) fails to consider a factor the legislature required it to consider; (2) considers an irrelevant factor; or (3) considers only relevant factors, yet reaches an unreasonable result. *AEP Tex. Cent. Co. v. PUC of Tex.*, 286 S.W.3d 450, 475 (Tex. App.–Corpus Christi 2008, pet. denied). Additionally, when the agency fails to follow the clear, unambiguous language of its own regulation, it acts arbitrarily and capriciously. *Id.* Finally, an agency cannot adopt new policies in the course of a contested case hearing without giving the parties pre-hearing notice because that unconstitutionally deprives parties of procedural due process and would be fundamentally unfair. *Id.*; *Madden v. Texas Board of Chiropractic Examiners*, 663 S.W.2d 622, 626-627 (Tex. App.–Austin 1984, writ ref'd n.r.e.).

There is express language in the TCEQ rules that prohibits the type of ADFIT adjustment recommended in the PFD. This particular issue was litigated in a recent *Southern Water Corporation* TCEQ rate case where interveners argued that, despite the rule, an ADFIT adjustment to rate base for “good cause” was warranted because: (1) the rate increase was allegedly too high; (2) Southern had a large cash reserve; and (3) there was allegedly a high cost of medical insurance to employees.¹⁷⁰ The request was denied.¹⁷¹ The ADFIT rate base adjustment is plainly contrary to TCEQ’s rule on the subject and the Commission should not adopt this portion of the PFD.

6. Unverified Assets

CLWSC excepts to the PFD recommendation following the ED’s recommendation to disallow \$46,535 in assets that ED staff witness Kamal Adhikari could not verify during his inspection of CLWSC’s facilities.¹⁷² Testimony by CLWSC’s V.P./General Manager, Mr. Thomas A. Hodge, rebuts

¹⁷⁰ *In re Application of Southern Water Corporation for a Water and Sewer Rate Tariff Change*, SOAH Docket Nos. 582-09-2068 and 582-09-2069, TCEQ Docket Nos. 2008-1830-UCR and 2008-1811-UCR, Proposal for Decision, p. 51-56 (May 19, 2010), *aff’d* by Final Order (April 4, 2011).

¹⁷¹ *Id.*

¹⁷² PFD, p. 51-52.

all allegations by the ED that any plant included in CLWSC's rate base was not used and useful during the test year.¹⁷³ It is undisputed that the ED's inspection occurred 14 months after the test year.¹⁷⁴ Therefore, the ED's recommended adjustment is unreliable and should not be adopted by the Commission.

7. Intangible Assets

CLWSC agrees with the PFD conclusion that utility "property" can include tangible or intangible assets in line with *State v. Public Utility Commission*, 883 S.W.2d 190, 200 (Tex. 1994).¹⁷⁵ However, CLWSC excepts to the PFD recommendation to follow the ED's recommendation to remove \$237,219 worth of certain intangible property assets from CLWSC's rate base and amortize them as expenses.¹⁷⁶

The ED was unclear in prefiled testimony as to which specific assets he was even attempting to remove from CLWSC's rate base making it difficult to respond.¹⁷⁷ But the ED's recommendation had nothing to do with a question about CLWSC's ownership of the assets, as the PFD suggests.¹⁷⁸ The ED's stated issue was solely that the assets were "intangible" and not properly included in rate base.¹⁷⁹ Since the PFD rejects that notion, no rate base adjustment is warranted. The PFD is incorrect that these items should be removed from CLWSC's rate base and amortized as expense items.

¹⁷³ CLWSC Ex. B, p. 22:4-24:10; Tr. 1420:15-1429:17 and 1466:11-1484:11 (Thomas A. Hodge, April 19, 2012).

¹⁷⁴ Tr. 1271:4-1273:14 (Kamal Adhikari, March 30, 2012).

¹⁷⁵ PFD, p. 52-53.

¹⁷⁶ *Id.*

¹⁷⁷ ED-KA-1, p. 12-13. The PFD states the assets in question were described by Mr. Adhikari as "consulting work," "system acquisition costs," and "50 years planning." PFD, p. 53.

¹⁷⁸ *Id.*

¹⁷⁹ ED-KA-1, pp. 12-13.

8. Summary of CLWSC's Rate Base Exceptions

In sum, all the adjustments discussed above to CLWSC's rate base amounts have a substantial impact on CLWSC's return and other flow-through considerations which must be correctly calculated to produce just and reasonable rates in the Commission's final order. CLWSC respectfully requests that the Commission: (1) not use "booked" value estimates for CLWSC's original cost figures and, if this method is used, at least allow for the ED's corrected exhibits to form the basis for ratemaking; (2) accept CLWSC's trending study values and related rate base, return, and flow-through calculations; (3) reject finding that any CIAC or cost-free capital amounts exist with respect to CLWSC's pre-acquisition WSC assets or, alternatively, uphold the PFD recommendation to refrain from adjustments based on CIAC or use of a negative acquisition adjustment "to represent" cost-free capital related to same for "good cause shown"; (4) uphold the PFD recommendation regarding customer deposits; (5) reject the PFD adjustment for ADFIT because it violates the Commission's rule on treatment of ADFIT; (6) reject the PFD recommendation to adopt the ED's adjustment for unverified assets; and (7) reject the PFD recommendation to adopt the ED's adjustment for intangible assets.

C. Exceptions to Expense Recommendations

While certain proposed expense disallowances were properly rejected in the PFD, other arbitrary disallowances are manifest throughout. CLWSC excepts to certain expense recommendations as follows.

1. Corporate Allocations and Related Expenses

The PFD incorrectly recommends following the ED's recommendation to use connection-based, rather than time-based, allocations of corporate expenses to CLWSC by its affiliates.¹⁸⁰ CLWSC provided evidence through testimony and records plainly showing that all allocated expenses

¹⁸⁰ PFD, pp. 63-67.

were reasonable and necessary.¹⁸¹ For example, CLWSC witness Palle Jensen testified that salary expenses for San Jose Water Company employees are uniformly allocated to CLWSC and its affiliates using time studies, included in the record, that analyze time spent specifically on CLWSC matters.¹⁸² This allocation method has never been questioned in San Jose Water Company's California PUC cases.¹⁸³ These services do not duplicate local CLWSC employee functions, provide efficiencies that most Texas IOUs do not have the opportunity to utilize, and are provided to CLWSC at or below cost.¹⁸⁴

CLWSC fails to see how its evidence was not sufficient to establish the reasonableness of these allocated expenses or otherwise establish compliance with TEX. WATER CODE §13.185(e). A time allocation is reasonable because it makes sure each affiliate is paying at the same rate for the approximate amount of services spent specifically on that affiliate. By contrast, a connection allocation is not reasonable because not all affiliates have connections. Thus, the allocation does not add up to 100%, is not functional, and does not “ensure that no affiliate is paying any higher price for any service provided” as the PFD contends.¹⁸⁵ Instead, it ensures that other affiliates will be subsidizing CLWSC because CLWSC will not be footing its fair share of costs for corporate services that specifically benefit CLWSC and its customers. Use of connections to allocate cost between affiliates ignores the fact that only two of the affiliates have connections, while others do not.¹⁸⁶ That methodology, on its face, does not fairly and reasonably allocate costs between all of the cost centers.

¹⁸¹ CLWSC Ex. A, p. 12:1-16:14; Tr. 204-209:14, 212:7-215:4, 261:22-263:15 (Palle Jensen, March 26, 2012); CLWSC Ex. 42 and 43.

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ PFD, p. 66.

¹⁸⁶ PFD, p. 65.

The unreasonable allocation adjustments used in the PFD are solely based on the opinions and novel theories of Ms. Loockerman and should be rejected.¹⁸⁷ The arbitrary and capricious nature of the ED's expense disallowance recommendations are highlighted by another particular ED recommendation that, fortunately, the PFD rejects. The ED recommended reducing all executive salaries allocated to CLWSC by 36% using the U.S. President's salary as a guide.¹⁸⁸ The two have absolutely nothing to do with one another and the PFD properly found the recommended adjustment to be a "speculative assessment."¹⁸⁹ CLWSC requests the Commission uphold the PFD's rejection of this approach.¹⁹⁰

Unfortunately, the PFD wrongly recommends a different expense reduction formula, similarly unsupported by the record, which would eliminate allocation of any executive bonus or stock option compensation to CLWSC.¹⁹¹ These items are reasonably part of executive compensation packages designed to attract talent and benefit CLWSC customers, and, therefore, should reasonably be allocated to CLWSC.¹⁹² There is nothing in the record to suggest that unreasonable salary allocations would exist if bonus and stock option compensation were converted to cash salary equivalents. CLWSC requests the Commission reject this PFD recommendation.

CLWSC further excepts to the PFD's complete rejection of allocations for its affiliates' San Jose, CA property-related expenses.¹⁹³ The PFD recommendation sets the bar way too high without

¹⁸⁷ Tr. 1153:12-1157:3 (Debi Loockerman, March 30, 2012).

¹⁸⁸ Tr. 1153:21:1155:17 (Debi Loockerman, March 30, 2012).

¹⁸⁹ PFD, p. 65.

¹⁹⁰ PFD, p. 65.

¹⁹¹ PFD, p. 65.

¹⁹² CLWSC Ex. A, p. 12:1-16:14; Tr. 204-209:14, 212:7-215:4, 261:22-263:15 (Palle Jensen, March 26, 2012); CLWSC Ex. 42 and 43.

¹⁹³ PFD, pp. 65-66.

guiding rules provided in advance of this case for what a utility needs to show to recover these expenses. The property is used, in part, to benefit CLWSC customers and recovery of property-related allocations should be permitted.

CLWSC supports the PFD finding that \$35,981 per year in corporate and accounting expenses allocated to CLWSC by revenue is reasonable.¹⁹⁴ However, the PFD also disallows \$8,713 of that amount on other grounds, to which CLWSC excepts.¹⁹⁵ There is no competent record evidence that shows the “costs of being publicly traded” should be “borne by the stockholders rather than the CLWSC ratepayers.”¹⁹⁶ This conclusion fails to consider the benefit CLWSC receives from being part of a publicly traded company.¹⁹⁷ CLWSC’s relationship with SJW Corp. is how it obtains capital at a low rate.¹⁹⁸ Such publicly held companies must be regularly audited and comply with Sarbanes-Oxley requirements.¹⁹⁹ CLWSC’s allocated share of these expenses represent a reasonable trade off and should not be taken out of CLWSC’s revenue requirement. CLWSC ratepayers, not the stockholders, benefit from capital infusions CLWSC receives from its publicly traded affiliate. Stockholders are the ones providing that capital. There is no sound reason to disallow these expenses as recommended by the PFD.

¹⁹⁴ PFD, pp. 66-67.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ CLWSC Ex. A, p. 13:5-7, 16:10-14; Tr. 1322:6-1325:20 (Palle Jensen, April 19, 2012).

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

2. CLWSC Employee Benefits

CLWSC agrees with the PFD recommendation to allow medical and dental expenses.²⁰⁰ However, CLWSC excepts to the PFD's recommendation to remove \$63,750 in annual Health Savings Account ("HSA") contributions and \$17,626 in base water fee benefits.²⁰¹

The PFD fails to consider that the HSA contributions represent a means for CLWSC to keep its medical benefit expenses lower than they otherwise would be. There is no credible evidence that the HSA contribution benefit offered to CLWSC employees is unreasonable. Testimony by Mr. Hodge, together with information presented in several record exhibits, discusses why this benefit is necessary for CLWSC to attract and retain a competent work force.²⁰² If the HSA contribution, which helps to lower CLWSC's overall health insurance costs, is not recoverable, then CLWSC will be required to re-think its entire health care plan currently used. This is an expense that actually serves to reduce rates and should reasonably be recovered in CLWSC's rates.

There is also no credible evidence that providing a water benefit amounting to approximately \$0.20 to \$0.30 per hour in additional wages in lieu of extra direct financial compensation is unreasonable.²⁰³ Plus, Mr. Hodge testified about the benefits of encouraging CLWSC employees to be connected to the system.²⁰⁴ The Commission should reject this PFD expense disallowance.

3. Bad Debt/Uncollectible Accounts Expense

CLWSC excepts to the PFD's disallowance of its known and measurable adjustment to test year bad debt expenses which results in a \$47,736 expense reduction.²⁰⁵ The adjustment is not

²⁰⁰ PFD, pp. 68-69.

²⁰¹ *Id.*

²⁰² Tr. 1429:18-1442:14 (Thomas A. Hodge, April 19, 2012); CLWSC Ex. 69; ED-DL-13.

²⁰³ Tr. 1439:17-1442:14, 1485:2-18 (Thomas Hodge, April 19, 2012).

²⁰⁴ *Id.*

²⁰⁵ PFD, p. 69.

speculative and is based on corresponding known and measurable volume adjustments.²⁰⁶ Further, any PFD disallowance based on testimony by Ms. Nelisa Heddin in this case, as this one appears to be, is not credible because she is not qualified as an expert in utility ratemaking.²⁰⁷

4. Directors' Fees

CLWSC excepts to the PFD's disallowance of \$53,205 in directors' fees.²⁰⁸ There is no credible evidence that CLWSC director fees benefit stockholders to the exclusion of CLWSC customers who benefit from the management functions directors perform as the PFD concludes based on unsupported testimony provided by ED staff witness Debi Loockerman.²⁰⁹ Director services are not duplicative of services provided by other personnel and the expenses should be permitted.

5. Rate Case Expenses Included in Rates

While CLWSC's preference would be to leave the rate case expense amount included in its application and noticed rates intact, CLWSC will accept removal and incorporation into its recoverable rate case expense total through a surcharge as recommended in the PFD.²¹⁰ However, if this removal causes CLWSC to fail to meet the 51% threshold for overall rate case expense recovery set forth in 30 TEX. ADMIN. CODE §291.28(8) when combined with any other rate adjustments adopted per PFD recommendations, CLWSC respectfully requests that \$57,250 be left in CLWSC's operations and maintenance expenses and revenue requirement for rate-setting purposes.

²⁰⁶ CLWSC Ex. C, p. 54:6-55:5.

²⁰⁷ Ms. Heddin admits that she is not an engineer, accountant, attorney, or licensed utility operator. Tr. 953:13-998:24 (Nelisa Heddin, March 29, 2012); CEWR-2. Ms. Heddin is not employed in any other capacity which would render her qualified to offer opinions pertinent to IOU ratemaking issues. *Id.* Ms. Heddin considers herself a "management consultant", but she has primarily worked with public or non-profit water and wastewater providers. *Id.* Her background does not qualify her to offer opinions on any pertinent issue before this Commission addressed in her testimony. *Id.*

²⁰⁸ PFD, pp. 69-70.

²⁰⁹ *Id.*

²¹⁰ PFD, p. 70.

The TCEQ rate application plainly allows for some rate case expenses to be included in base rates. Removal of same should not be used to preclude overall rate case expense recovery given that CLWSC's rate case expense total is significantly more than what was incorporated into CLWSC's noticed rates.

6. Normalized Expense Adjustments

The PFD seems to agree with the "premise" of using normalized volumes for volumetric expense items, but indicates more data was necessary to make CLWSC's proposed normalization adjustments known and measurable.²¹¹ CLWSC excepts to the decision to reject normalization here in the absence of TCEQ rules or policy stating how much data should be acquired before making such recommendations which have the goal of achieving overall rate reasonableness in the face of varying weather patterns.²¹² Mr. Loy made the best recommendation on this issue possible given the limited data set CLWSC had available from its short tenure of existence and it would be less reasonable to not attempt weather normalization at all in rate-setting. In future cases, CLWSC will have more data to work with. Nevertheless, CLWSC requests the Commission accept use of normalization in this case as proposed.

7. Summary - Expense Adjustments Should be Reversed

The expense reductions recommended in the PFD are unjustified. They are arbitrary and capricious adjustments that lack evidentiary support. CLWSC's requested expense amounts should be fully allowed.

D. Exceptions to Depreciation Expense Recommendation

CLWSC excepts to the PFD's adoption of the ED's depreciation expense amount.²¹³ Depreciation expense is tied to rate base and, therefore, CLWSC's exceptions related to rate base also

²¹¹ PFD, p. 73-74.

²¹² CLWSC Ex. C, p. 32:14-38:8, 52:3-13, 54:6-22.

²¹³ PFD, p. 75.

apply to depreciation expense. CLWSC's proposed depreciation expense figures should not be adjusted.

E. Exceptions to Federal Income Tax Recommendation

The PFD does not include a calculated federal income tax figure and requests the ED to calculate the tax amount and include it in his exceptions filing.²¹⁴ Therefore, CLWSC cannot reasonably be expected to except in this filing to the ED's future calculation and reserves the right to except in CLWSC's response to the ED's exceptions filing. However, CLWSC's other exceptions to PFD recommendations are incorporated here by reference. As the PFD notes, the revised rate base, capital structure, and return figures the PFD recommends to which CLWSC excepts elsewhere herein will affect the tax calculation.²¹⁵ Therefore, CLWSC excepts to Commission incorporation of a federal income tax amount based on the PFD recommendations on the same grounds as CLWSC's other exceptions.

F. Exceptions to Other Taxes Recommendation

CLWSC excepts to the PFD's "other taxes" recommendations since they appear based on flow-through impact of other recommendations to which CLWSC excepts herein. CLWSC excepts to incorporation of "other taxes" amounts based on the PFD recommendations on the same grounds.

G. Exceptions to Rate Collection True-up Recommendation

CLWSC excepts to the PFD's recommendation for any rate collection true-up to relate back to March 15, 2011 rather than October 27, 2010.²¹⁶ CLWSC's notice identifies the effective date of its proposed increase as October 27, 2010.²¹⁷ However, it also contains a proposed phased-in rate

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ PFD, p. 91.

²¹⁷ CLWSC Ex. 1 at CLWSC 000034.

schedule, containing Phase I and Phase II rate changes.²¹⁸ Phase I rates were proposed for implementation on October 27, 2010. Phase II rates were proposed for implementation on March 15, 2011, and represent CLWSC's "true cost" rates, i.e. would result in the recovery of CLWSC's full revenue requirement under the ratemaking criteria of TEX. WATER CODE §§ 13.181-13.192.²¹⁹ Whether Phase I or Phase II rates would be charged during the pendency of the hearing was tied to CLWSC's request for Commission authorization to defer depreciating its utility plant during the pendency of this rate case.²²⁰ This was CLWSC's original plan for rate implementation.

Instead, on January 14, 2011, CEWR requested interim rates. Rather than litigate that issue, CLWSC and the other parties agreed on interim rates according to terms reflected in Order No. 2. Pursuant to that agreement, interim rates were set equivalent to the Phase I rate levels.²²¹ Those rates have been charged throughout this case.²²² That has nothing to do with CLWSC's phased-in rate proposal which was rejected by the TCEQ's Executive Director when he chose not to issue the requested accounting order on deferring depreciation. The requested rate plan was replaced with the interim rate scheme. Therefore, CLWSC is entitled to recoup any total increased revenue to which the Commission finds CLWSC entitled and for which Phase I rates were insufficiently low dating back to the noticed effective date of CLWSC's rate/tariff change: October 27, 2010.^{223, 224}

²¹⁸ *Id.* at CLWSC 000035 - 000038.

²¹⁹ CLWSC Ex. 1.

²²⁰ Tr. 41:20 - 42:3 (Palle Jensen, March 26, 2012).

²²¹ *See* Order No. 2.

²²² Tr. 41:1-15 (Palle Jensen, March 26, 2012)

²²³ The lone exception would be CLWSC's Glenwood Water System, for which the ED instructed CLWSC to use November 27, 2010 as the effective date for new rates in the ED's letter accepting CLWSC's application for filing.

²²⁴ TEX. WATER CODE § 13.187(m) ("If the regulatory authority sets a final rate that is higher than the interim rate, the utility shall be allowed to collect the difference between the interim rate and final rate unless otherwise agreed to by the parties to the rate proceeding."); *see also* 30 TEX. ADMIN. CODE § 291.29(f).

There was no interim rate agreement between the parties to the contrary that would dictate “otherwise.”²²⁵ Order No. 2 reflects the parties’ agreement and shows: (1) the interim rates were agreed effective October 27, 2010; (2) the interim rates remain in place until the effective date of a final order in this proceeding; (3) the interim rates can be adjusted at that time by the final order; and (4) a surcharge under 30 TEX. ADMIN. CODE § 291.29 may be ordered as appropriate.²²⁶ This indicates all the parties understood the potential surcharge ramifications of an interim rate order in this case and that CLWSC may be made whole by such surcharge at this case’s conclusion.

The precise amount or necessity for any rate collection true-up will not be able to be assessed until final rates are determined in this case. But CLWSC notes that the ED seemed to concur with CLWSC’s assessment of the effective date issue in his closing arguments.²²⁷ CLWSC respectfully requests that the Commission make the effective date for any rate collection true-up October 27, 2010 and not March 15, 2011 as the PFD recommends.

H. Exceptions to Rate Design Recommendation

The PFD does not include a calculated rate design and requests the ED calculate rates in line with the PFD recommendations for inclusion in his exceptions filing.²²⁸ Therefore, CLWSC cannot reasonably be expected to except in this filing to the ED’s future calculation and reserves the right to except in CLWSC’s response to the ED’s exceptions filing. However, CLWSC’s other exceptions to PFD recommendations are incorporated here by reference and CLWSC requests its noticed Phase 2 rates be implemented dating back to October 27, 2010.

²²⁵ *Id.*

²²⁶ Order No. 2.

²²⁷ ED Closing Arguments, p. 46-47.

²²⁸ PFD, p. 91.

I. Exceptions to Summary of PFD Recommendations

For reasons discussed elsewhere herein, CLWSC excepts to figures in the summary of PFD recommendations calculated in contravention to its exceptions.²²⁹ For the amounts left blank pending the ED's exceptions filing, CLWSC reserves the right to except in CLWSC's response to the ED's filing.

J. Regulatory Approvals

CLWSC concurs with the PFD recommendations with respect to its regulatory approval requests related to acquisition adjustments and plant held for future use ("PHFU").²³⁰ These approvals will have no rate impact in this case and CLWSC respectfully requests the Commission adopt the PFD recommendations on these issues.

K. Exceptions to PFD Rate Case Expense Recommendations

CLWSC requested recovery of over \$971,758.39 in rate case expenses.²³¹ The PFD recommends limiting CLWSC to recovery of \$856,742.42 in rate case expenses.²³² While CLWSC accepts a few of the disallowances as reasonable, CLWSC generally excepts to not being allowed to recover the bulk of the difference between the two rate case expense amounts. CLWSC spent two days in a hearing on this issue primarily combating arbitrary and capricious rate case expense disallowance recommendations advocated by the ED and supported by the other parties who did not present any witnesses on the subject.²³³ Several of those recommendations were reversed in the PFD, which CLWSC supports.²³⁴ However, other ED disallowances are unjustly recommended to the

²²⁹ PFD, p. 92.

²³⁰ PFD, p. 93-95.

²³¹ PFD, p. 96, 113-114. The PFD does not adequately account for estimated expenses dependent on a "favorable" PFD. There are some aspects of the PFD favorable to CLWSC, but others that are not necessitating these exceptions.

²³² PFD, p. 119.

²³³ PFD, pp. 95-96.

²³⁴ PFD, p. 119.

Commission for adoption.²³⁵ CLWSC has provided thorough briefing for the Commission to consider with respect to this issue and incorporates those briefs by reference here.²³⁶ However, CLWSC will summarize the portions of the PFD to which it takes exception.

1. The “Public Interest” and Reasonable and Necessary Attorneys’ Fees

CLWSC excepts to the PFD legal analysis concluding: (1) that a non-lawyer may competently testify as an expert on the reasonableness of legal expenses; and (2) that such testimony is allowable to further the “public interest.”²³⁷ CLWSC was the only party to put on testimony by attorney expert witnesses about legal expenses.²³⁸ The PFD should have concluded there is no controverting evidence on those ED disallowances.²³⁹ Instead, the PFD finds that ED staff may competently testify about such legal rate case expenses and considered recommended disallowances to be competent evidence.

The Commission may not use the undefined “public interest” term as a cover for arbitrary and capricious expense disallowances, including rate case expense disallowances, in a rate order.²⁴⁰ To

²³⁵ *Id.*

²³⁶ CLWSC Rate Case Expense Hearing Closing Arguments; CLWSC Response to Rate Case Expense Hearing Closing Arguments.

²³⁷ PFD, pp. 97-101.

²³⁸ *Id.* Uncontroverted attorney testimony about attorneys’ fees is taken as true. *Ragsdale v. Progressive Voters League*, 801 S.W.2d 880, 882 (Tex. 1990); *In re. A.B.P.*, 291 S.W.3d 91, 98 (Tex. App.–Dallas 2009, no pet.); *see also Horvath*, 2011 WL 590472 at *9; *Collins v. Guinn*, 102 S.W.3d 825, 836-837 (Tex. App.–Texarkana 2003, no pet.); *Lesikar v. Rappaport*, 33 S.W.3d 282, 318 (Tex. App.–Texarkana 2000, pet. denied).

²³⁹ *Id.*

²⁴⁰ PFD, p. 99 (citing *Texas Water Comm’n v. Lakeshore Util. Co., Inc.*, 877 S.W.2d 814, 825-26 (Tex. App.–Austin 1994, writ denied)); *see also R.R. Comm’n of Tex. v. Texas Citizens for a Safe Future & Clean Water*, 336 S.W.3d 619, 626-632 (Tex. 2011); *Industrial Utility Services, Inc. v. Texas Natural Resources Conservation Commission*, 947 S.W.2d 712, 714-716 (Tex. App.–Austin 1997, writ denied); *Tex. Cent. Co. v. PUC of Tex.*, 286 S.W.3d 450, 475 (Tex. App.–Corpus Christi 2008, pet. denied); *Madden v. Texas Board of Chiropractic Examiners*, 663 S.W.2d 622, 626-627 (Tex. App.–Austin 1984, writ ref’d n.r.e.). An arbitrary and capricious order is one that fails to properly consider the relevant facts, fails to articulate a rational connection between the facts found and the choice made, violates due process or is based on “unfair or unreasonable conduct that shocks the conscience.” *Texas State Bd. of Dental Exam’rs v. Silagi*, 766 S.W.2d 280, 285 (Tex. Civ. App.–El Paso 1989, writ denied); *Consumers Water v. Public Utility Commission*, 774 S.W.2d 719 (Tex. Civ. App.–Austin 1989, no writ); *Starr County v. Starr Industry Servs., Inc.*, 584 S.W.2d 352 (Tex. Civ. App.–Austin 1979, writ ref’d n.r.e.); *Gerst v. Nixon*, 411 S.W.2d 350 (Tex. 1966); *Bowman Transp., Inc. v. Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 95 S.Ct. 438 (1971). An agency decision may be arbitrary and capricious if the agency abused its discretion by considering irrelevant factors or excluding factors which the Legislature intended it to consider. *Gerst*, 411 S.W.2d at 360 & n.8; *Consumers*, 774 S.W.2d at 721-722. When the agency bases its decision on a factor not included in the enabling legislation, such a decision is arbitrary and capricious by violating

arbitrarily and capriciously deny a utility the opportunity to recover reasonable and necessary rate case expenses constitutes a “taking” of its capital in violation of the Texas Constitution.²⁴¹ The PFD concedes that arbitrary legal rate case expense disallowances are not permitted.²⁴² Texas law is clear that competent testimony about the reasonableness of attorneys’ fees can only be provided by expert attorney witnesses.²⁴³ The proper standard to apply is Texas Disciplinary Rules of Professional Conduct 1.04(b).²⁴⁴ The PFD is incorrect that the Water Code provides the TCEQ with the ability to avoid its obligation to ensure legal rate case expense disallowances are not arbitrary and capricious by basing its decision on anything other than credible attorney expert witness testimony. Therefore, CLWSC excepts to the portion of the PFD which recommends legal conclusions to the contrary.²⁴⁵

the due process rights of the parties. *Texas Health Facilities Comm’n v. Charter Medical-Dallas, Inc.*, 665 S.W.2d 446, 453-454 (Tex. 1984); *Public Utility Comm’n v. South Plains Elec. Coop., Inc.*, 635 S.W.2d 954, 957-58 (Tex. App.–Austin 1982, writ ref’d n.r.e.); *Starr County*, 584 S.W. 352.

²⁴¹ TEX. CONST. art. I, §§ 17 and 19.

²⁴² PFD, p. 99.

²⁴³ *Woollet v. Matyastik*, 23 S.W.3d 48, 52 (Tex. App.—Austin 2000, pet. denied) (application for payment of attorney’s fees was insufficient without expert testimony from an attorney); *see also Horvath v. Hagey*, No. 03-09-00056-CV, 2011 WL 590472, at *8-9 (Tex. App.—Austin, Feb. 15, 2011) (Memorandum Op.) (finding that lay testimony was insufficient to support an award of attorneys’ fees and that expert testimony is required); *Cantu v. Moore*, 90 S.W.3d 821, 825-826 (Tex. App.-San Antonio 2002, pet. denied) (holding that non-attorney’s testimony about appellate fees was no evidence and that expert testimony was required); *Lesikar v. Rappoport*, 33 S.W.3d 282, 308 (Tex. App.-Texarkana 2000, pet. denied) (determining that the issue of reasonableness and necessity of attorney’s fees requires expert testimony).

²⁴⁴ TEX. DISCIPLINARY R. PROF’L CONDUCT (“TDRPC”) 1.04(b), reprinted in TEX. GOV’T CODE ANN., tit. 2, subtit. G, app. A.); *El Apple I, Ltd. v. Olivas*, 370 S.W.3d 757, 760-61 (Tex. 2012) (applying TDRPC 1.04(b) factors in an employment discrimination/retaliation class action suit); *Barker v. Eckman*, 213 S.W.3d 306, 312-313 (Tex. 2006) (applying TDRPC 1.04(b) factors in a breach of contract/bailment agreement case); *Bocquet v. Herring*, 972 S.W.2d 19, 21 (Tex. 1998) (applying TDRPC 1.04(b) factors in declaratory judgments act case); *Horvath v. Hagey*, No. 03-09-00056-CV, 2011 Lexis 3451, at *22-25 (Tex. App.—Austin, Feb. 15, 2011) (Memorandum Op.) (applying TDRPC 1.04(b) factors in a divorce case); *Brazos Elec. Power Coop, Inc. v. Weber*, 238 S.W.3d 582 (Tex. App.—Dallas 2007, no pet.) (applying TDRPC 1.04(b) factors in an eminent domain case); *Devon SFS Operating, Inc. v. First Seismic Corp.*, 2006 Lexis 1284, at *35-41, 45-47 (Tex. App.—Houston [1st Dist.], Feb. 16, 2006) (Memorandum Opinion) (applying TDRPC 1.04(b) factors in a declaratory judgments act case); *Doncaster v. Hernaiz*, 161 S.W.3d 594, 606-608 (Tex. App.—San Antonio 2005, no pet.) (applying TDRPC 1.04(b) factors in debt action case); *C.M. Asfabl Agency v. Tensor, Inc.*, 135 S.W.3d 768 (Tex. App.—Houston[1st Dist.] 2004, no pet.) (applying TDRPC 1.04(b) factors in a breach of contract case); *see also, Walker Int’l Holdings, Ltd. v. Republic of Congo*, 415 F.3d 413, 418-419 (5th Cir. 2005) (applying TDRPC 1.04(b) factors in a garnishment action); *Flourine on Call, Ltd. v. Fluorogas Ltd.*, 380 F.3d 849, 866-867 (5th Cir. 2004) (applying TDRPC 1.04(b) factors in a breach of contract case governed by state law); *see also Quanta Serus., Inc. v. American Admin. Group, Inc.*, 384 Fed. Appx. 291, 298 (5th Cir. 2008) (applying TDRPC 1.04(b) factors in a federal breach of contract case governed by state law).

²⁴⁵ PFD, pp. 99-101.

2. Order No. 8

CLWSC excepts to the PFD recommendation to adopt certain ED expense disallowances related to Order No. 8 in the amount of \$70,867.03.²⁴⁶ While CLWSC supports the PFD recommendation to not disallow an additional \$11,215 recommended by the ED, no disallowances are warranted related to Order No. 8.²⁴⁷ There was no failure by CLWSC to meet discovery obligations as the PFD alleges and all the exhibit and application revisions that entailed the expenses in question would have been necessary no matter when they were made during the application and ensuing contested case hearing process.²⁴⁸

3. Deposition and Hearing Transcript Costs

CLWSC agrees with the PFD recommendation concerning deposition and transcription costs.²⁴⁹ The PFD properly rejects disallowance of \$11,885.68 as the ED recommended.

4. Attorneys' Fees for Closing Arguments

CLWSC excepts to the disallowance of \$16,354.69 in expense related to CLWSC legal work on closing arguments.²⁵⁰ This is an arbitrary and capricious expense disallowance which is unsupported by the record evidence. The record does not clearly show how the ED's staff witness developed the 35.9% reduction method she used to reduce closing argument legal rate case expenses for which the PFD recommends adoption.²⁵¹ CLWSC's attorney experts testified that all the legal work performed in this case was reasonable, necessary, and it is in the public interest to allow recovery through rates.²⁵²

²⁴⁶ PFD, pp. 102-105.

²⁴⁷ *Id.*

²⁴⁸ CLWSC Response to Rate Case Expense Hearing Closing Arguments, pp. 9-12.

²⁴⁹ PFD, pp. 105-106.

²⁵⁰ PFD, pp. 106-107.

²⁵¹ Tr. 1794:6-20 (Debi Loockerman, August 23, 2012).

²⁵² CLWSC Ex. G; CLWSC Ex. 25; CLWSC Ex. 72, 77 and 78; Tr. 1513:11-1530:8 (Paul Terrill, August 22, 2012); CLWSC Ex. F; CLWSC Ex. 26; CLWSC Ex. 73 and 78; Tr. 1582:7-1590:5 (Mark Zeppa, August 22, 2012); *see also* TDRPC 1.04(b).

Ms. Loockerman is not qualified to testify on the amount of legal work that should go into preparing a closing arguments brief in any rate case, let alone a complex water rate case like this one.²⁵³ There are no TCEQ rules or guidance specifically addressing these considerations and TDRPC 1.04(b) was not considered by the ED's lone staff witness.²⁵⁴ The Commission should reject this expense disallowance based on the record.

5. Consultant Expenses for Closing Arguments

CLWSC excepts to the disallowance of \$9,067.50 attributable to CLWSC consultants' work on closing arguments.²⁵⁵ This is another arbitrary and capricious expense disallowance which is unsupported by the record. There is no evidence concerning how ED staff witness Ms. Loockerman arrived at her 40-hour limit and consultant work is not necessarily apparent from the face of a pleading, as the PFD suggests it should be, to be allowable. Ms. Loockerman says the recommendation was based on other cases she's been involved with, but there's never been a case like this one in Texas before. She apparently failed to consider that the ED's own revised schedules, along with CEWR's, had to be analyzed on top of the usual type of assistance performed by consultants during the closing arguments stage of a rate case, which is invaluable to the attorneys preparing the closing arguments.²⁵⁶ But the record is not clear about what exactly Ms. Loockerman considered in coming up with this adjustment. Under the *Daubert* and *Robinson* standards established by the U.S. and

²⁵³ The record shows: (1) Ms. Loockerman has never prepared such a brief; (2) the ED staff attorneys don't track their time by case; (3) Ms. Loockerman doesn't have a clear understanding of how much time the task should have taken in this case or in any other, particularly from the perspective of an applicant with the burden of proof; and (4) this case is unique so neither Ms. Loockerman nor Mr. MacLeod could possibly possess this information. Tr. 1847:19-1848:7; 1854:3-7 (Debi Loockerman, August 23, 2012).

²⁵⁴ Tr. 1819:1-5, 1834:18-1837:21 (Debi Loockerman, August 23, 2012).

²⁵⁵ PFD, pp. 107-108.

²⁵⁶ *Id.* CLWSC also notes that the PFD determines elsewhere that the referenced schedules were improperly submitted by CEWR and the ED with their closing arguments. But that does not mean CLWSC was not forced to have its consultants review them and provide consultation during the closing arguments process. CLWSC would now like the ED's corrected exhibits considered in the final ratemaking order, but those corrections could have taken place sooner and prevented CLWSC from incurring added rate case expense for consultant work during the closing arguments phase.

Texas Supreme Courts, purported expert testimony cannot be considered if its underlying basis cannot be examined.²⁵⁷ The Commission should reject this expense disallowance.

6. Rate of Return Expert Expenses

CLWSC excepts to the disallowance of \$45,213.75 in ValueScope, Inc. consultant expenses for work by CLWSC's rate of return expert, Mr. Greg Scheig.²⁵⁸ Mr. Scheig presented invoices and explained all the work he did in this case under cross-examination.²⁵⁹ His work and the time he spent on this case was essential to responding to the attacks by the opposing parties on CLWSC's rate of return and return on equity requested in the Rate Application. Neither the ED nor PFD have adequately explained why this large rate case expense reduction is appropriate. The ED staff accountant's recommendation, adopted in the PFD, should be viewed with skepticism given that she also recommended use of a rate of return worksheet that she wholly discredited in place of Mr. Scheig's work.²⁶⁰ This expense disallowance should be rejected, or at least greatly reduced to a disallowance of \$400 that Mr. Scheig himself testified could be reasonable.²⁶¹

7. Attorneys at Depositions and the Hearing

CLWSC respectfully requests that the Commission adopt the PFD recommendation to reject expense disallowances of \$4,525 and \$11,137 recommended by the ED's staff witness.²⁶² The PFD

²⁵⁷ *Daubert v. Merrell Dow Pharms.*, 509 U.S. 579 (1993); *E.I. du Pont de Nemours & Co. v. Robinson*, 923 S.W.2d 549, 557 (Tex. 1995).

²⁵⁸ PFD, pp. 108-111.

²⁵⁹ CLWSC Ex. E; CLWSC Ex. 20; CLWSC Ex. 75 and 78; Tr. 1647:7-1651:4, 1668:2-1677:13 (Greg Scheig, August 22, 2012). The only adjustment appropriate for Mr. Scheig's time is the \$400 he testified about. Tr. 1664:12-1665:1 (Greg Scheig, August 22, 2012).

²⁶⁰ Compare CLWSC Ex. 65, p. 29:9-35:14 (Direct Testimony and Exhibits of Debi Loockerman, CPA on Behalf of Kendall County Utility Company, Inc., *In re Application of Kendall County Utility Co., Inc. to Change its Water and Sewer Rates in Kendall County, Texas*, SOAH Docket No. 582-08-2241, TCEQ Docket No. 2008-0304-UCR, September 5, 2008); Tr., p. 1104:1-1113:11 (Debi Loockerman, March 29, 2012), *with* Tr. 1102:21-1103:1 (Debi Loockerman, March 29, 2012).

²⁶¹ Tr. 1664:12-1665:1 (Greg Scheig, August 22, 2012).

²⁶² PFD, pp. 111-112.

correctly finds that attorney strategy and preparation should not be second guessed.²⁶³ CLWSC notes for reasons already discussed that this is particularly true when the second guessing is by non-lawyers.

8. Estimates for Rate Case Expense Hearing

CLWSC respectfully requests that the Commission adopt the PFD recommendation to approve \$16,375 for estimated rate case expense hearing expenses.²⁶⁴ The actual amount was more than this, but the PFD recommendation accurately reflects what was offered for the record.

9. Exceptions and Agenda

CLWSC excepts to the PFD recommendation to reject the amounts Mr. Terrill testified about contingent on various events for the remainder of this case.²⁶⁵ The \$22,500 limit is another arbitrary and capricious expense determination by the ED's non-lawyer staff witness.²⁶⁶ The PFD that has resulted in this case has many aspects to it that are unfavorable to CLWSC. Therefore, a minimum of \$50,000.00 should be permitted to approximate CLWSC's rate case expenses expected to be incurred through Agenda in this case in line with Mr. Terrill's estimation.²⁶⁷ Mr. Terrill's other estimates should be accepted also.²⁶⁸

10. Other Rate Case Expense Recommendations

CLWSC concurs with all other PFD recommendations regarding rate case expenses based on the record.²⁶⁹ There was no "abuse of process" by CLWSC with respect to its prefiled testimony objections as the ED alleges and the other expense disallowances rejected in the PFD that CEWR

²⁶³ *Id.*

²⁶⁴ PFD, p. 112-113.

²⁶⁵ PFD, p. 113-115.

²⁶⁶ *Id.*

²⁶⁷ Tr. pp. 1527:4-1529:23 (Paul Terrill, August 22, 2012).

²⁶⁸ *Id.*

²⁶⁹ PFD, pp. 115-118.

proposes are unsupported.²⁷⁰ CLWSC accepts the few remaining disallowances the PFD recommends in the amounts of \$595, \$270, and \$8.²⁷¹

11. Exceptions to Rate Case Expense Summary

CLWSC excepts to the PFD summary of recommended allowed rate case expenses because it contains some disallowances based on ED recommendations that should not be accepted for reasons discussed above. CLWSC should be allowed a minimum \$1,036,860.39 of recoverable rate case expenses, incorporating at least the \$50,000.00 estimate for exceptions work through Agenda, as reasonable, necessary, and in the public interest.²⁷²

Item	Amount
CLWSC's Claimed Rate Case Expenses	\$971,758.39
Estimate for 8/22-23/2012 Hearing Expenses	\$16,375.00
Estimate for Response to Unfavorable PFD	\$50,000.00
	\$1,038,133.39
Removal of Maria Elena Eick Travel Expense	(\$595.00)
Removal of Tom Hodge Capitol Parking	(\$8.00)
Removal of GDS incorrect billing	(\$270.00)
Removal of ValueScope incorrect billing	(\$400.00)
	\$1,036,860.39

L. CLWSC's Ability to Recovery Rate Case Expenses

CLWSC does not believe the rate case expense recovery bars in either 30 TEX. ADMIN. CODE §291.28(8) or §291.28(9) will be an issue in this case because its requested rate increase is justified based on the record evidence. However, should either rule become an issue based on finally

²⁷⁰ *Id.*

²⁷¹ *Id.*

²⁷² 30 TEX. ADMIN. CODE §291.28(7).

calculated rates, CLWSC respectfully requests that the Commission exercise its discretion to allow CLWSC to recover reasonable rate case expenses.

Both rules use the word “may” and provide the Commission with the same discretion it has with respect to all expense determinations under the Water Code.²⁷³ The record shows CLWSC has been in dire need of a rate increase at its full cost of service level since it acquired WSC, there are unique and unprecedented issues which have surfaced during the course of this case, and CLWSC’s application was filed in good faith based on existing regulatory requirements. Therefore, whether or not CLWSC meets the tests set forth in these rules based on its finally approved rates, CLWSC requests that the Commission refrain from applying these rules to completely bar rate case expense recovery in the interest of justice. Even if recommended disallowances in the PFD are accepted by the Commission, the bulk of CLWSC’s rate case expenses have been found reasonable, necessary, and in the public interest. In fairness, rate case expense recovery should be permitted regardless of the Commission’s authority to employ these rules as a bar to same.

Additionally, CLWSC excepts to the PFD recommendation to not consider the impact of removing rate case expenses from CLWSC’s approved revenue requirement in performing the 51% analysis under 30 TEX. ADMIN. CODE §291.28(8).²⁷⁴ CLWSC reiterates that this rule will likely not come into play. But, if for whatever reason it is a close call, it would be unjust and unreasonable to allow the removal of \$57,250 in rate case expenses otherwise deemed reasonable from CLWSC’s requested revenue requirement to prevent any rate case expense recovery.

CLWSC also excepts to the inclusion of \$18,000 in “unbilled revenues” in the test year revenue amount used as the starting point for the 51% increase calculation.²⁷⁵ The proper “revenues generated by previous rates” figure should be lowered to either \$6,899,943 (actual test year revenue) or, if

²⁷³ 30 TEX. ADMIN. CODE §291.28(8) and (9); *see also* TEX. WATER CODE §13.185(g) and (h).

²⁷⁴ PFD, pp. 120-121.

²⁷⁵ *Id.*

CLWSC's weather normalization and customer growth known and measurable adjustments are accepted, \$6,792,242.²⁷⁶ CLWSC expert Chuck Loy explained why this removal was appropriate in his prefiled testimony, there is no controverting evidence on this issue, and this amount represents earned but not yet billed amounts for the test year analyzed that should be excluded.²⁷⁷ Therefore, one of the adjusted lower test year revenue figures should be used in the 51% increase calculation.

With respect to the other TCEQ rule discussed in the PFD, even though it will likely not be an issue in this case, CLWSC excepts to consideration of CEWR's settlement offer in connection with 30 TEX. ADMIN. CODE §291.28(9).²⁷⁸ The offer letter relied upon in the PFD contains an offer for a 20% rate increase without stated rates and with the addition of other terms and conditions that do not relate to the rates offered.²⁷⁹ For example, if CLWSC accepted the offer, it would have been required to waive its right to file another rate application for longer than the 12-month period provided for in the Water Code and TCEQ rules regardless of cost increases.²⁸⁰ Not only is the rule inappropriate given the confidential nature of settlement negotiations, but, if it is to be used at all, a settlement offer evaluated under the rule should be required to offer rates without other strings attached. Otherwise, a utility may be forced to reject an offer it might otherwise reasonably accept and still be unfairly barred from rate case expense recovery.

Finally, CLWSC excepts to the PFD recommendation at the ED's suggestion that billing, rather than full collection, be the cut-off point for its rate case expense recovery surcharge. Full rate case expense collection is needed to make the utility whole.

²⁷⁶ CLWSC Ex. 52, line 21. Removal of \$18,000 in unbilled revenue that the ED has included is shown in CLWSC Ex. 51, p. 27b of 42, "Revenue", line 3.

²⁷⁷ CLWSC Ex. C, p. 38:20-39:18.

²⁷⁸ PFD, p. 122.

²⁷⁹ CEWR Ex. 52.

²⁸⁰ *Id.*; TEX. WATER CODE § 13.187(p); 30 TEX. ADMIN. CODE § 291.23.

M. Proposed Order, Findings of Fact, and Conclusions of Law

CLWSC has reviewed the proposed order included with the PFD containing findings of fact and conclusions of law recommended to the Commission. In line with the exceptions set forth herein, CLWSC must except to the entire proposed order as drafted. Instead, CLWSC respectfully requests that the Commission incorporate into its final order the proposed findings of fact and conclusions of law attached hereto as **Exhibit A** which were submitted to the court on September 24, 2012 with the exception of blank rate case expense and surcharge information which may now be completed in accordance with the adjusted rate case expense amount requested in these exceptions.

III. CONCLUSION AND PRAYER

After considering the foregoing, CLWSC respectfully requests that the Commission adopt a final order incorporating CLWSC's proposed findings of fact and conclusions of law attached hereto as **Exhibit A**, approve the ALJs' PFD in part and reject it in part as discussed in these exceptions, and approve Application No. 36803-R and the rate/tariff changes requested by CLWSC in this proceeding.

Respectfully submitted,
THE TERRILL FIRM, P.C.



By: _____

Paul M. Terrill III
State Bar No. 00785094
Geoffrey P. Kirshbaum
State Bar No. 24029665
810 West 10th Street
Austin, Texas 78701
Tel: (512) 474-9100
Fax: (512) 474-9888

Law Offices of Mark H. Zeppa, PC

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

**ATTORNEYS FOR APPLICANT SJWTX,
INC. d/b/a CANYON LAKE WATER
SERVICE COMPANY**

CERTIFICATE OF SERVICE

I hereby certify that on January 7, 2013, a true and complete copy of the foregoing was sent to the following by facsimile, first-class mail or courier:

Parties	Representative / Address	Service
State Office of Administrative Hearings	Judge Kerrie Qualtrough 300 West 15 th Street, Suite 502 Austin, TX 78701	<i>via e-filing</i>
State Office of Administrative Hearings	SOAH- Docket Clerk 300 West 15 th Street, Suite 502 Austin, TX 78701	<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	Brian MacLeod TCEQ, MC-173 P.O. Box 13087 Austin, TX 78711-3087	<i>via fax to: 239-0606</i>
Office of Public Interest Counsel of TCEQ	Scott Humphrey TCEQ, OPIC MC-103 P.O. Box 13087 Austin, TX 78711-3087	<i>via fax to: 239-6377</i>

Parties

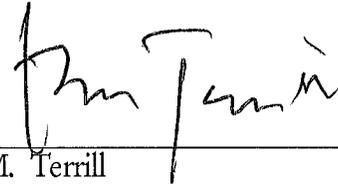
Coalition for Equitable Water Rates,
William Stephens, Paul Graf, Deena
Clausen, Nelisa Heddin, and
Geoffrey Miller

Representative / Address

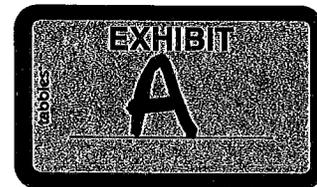
Joe Freeland
Matthews & Freeland, LLP
327 Congress Ave., Suite 300
Austin, TX 78701

Service

via fax to: 703-2785



Paul M. Terrill



SOAH DOCKET NO. 582-11-1468
TCEQ DOCKET NO. 2010-1841-UCR

APPLICATION OF SJWTX, INC, DBA § BEFORE THE STATE OFFICE
CANYON LAKE WATER SERVICE §
COMPANY TO CHANGE WATER § OF
RATES; CCN NO. 10692; IN COMAL §
AND BLANCO COUNTIES § ADMINISTRATIVE HEARINGS

CLWSC’S PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

FINDINGS OF FACT

General and Procedural Findings

1. SJWTX, Inc. d/b/a Canyon Lake Water Service Company (“CLWSC”) holds Water Certificate of Convenience and Necessity (CCN) No. 10692.
2. CLWSC is a state-regulated investor owned water utility providing service to more than 9,000 connections in the Canyon Lake region of Comal County and southern Blanco County.
3. The CLWSC water system began as a number of privately-owned, state-regulated utilities near or on Canyon Lake. Most were started by developers; some were owned by professional water utilities. These small systems were groundwater-supplied¹ and had limited water service capacity during extended droughts.
4. The Guadalupe Blanco River Authority (“GBRA”) approached the existing groundwater utilities with a proposal to construct a regional surface water plant on Canyon Lake from which GBRA would provide them with wholesale treated drinking water. This proposal started discussions that ultimately resulted in the creation of the Canyon Lake Water Supply Corporation (“WSC”), a member owned and controlled non-profit water supply corporation.
5. WSC was formed to build and operate its own means of treating and transporting GBRA raw water to area subdivisions. WSC began operations in 1994 as a member-owned non-profit water utility, consolidating 46 separate ground water systems.
6. The WSC’s founders recognized that groundwater supplies alone were inadequate to support the growth of the community and that centralized water treatment plants (“WTPs”) would

¹ One small system owned by Ivan Payton below the Canyon Lake dam was originally on surface water, but the state ordered it to be converted to groundwater when it was sold to W & W Water Company, Inc.

make it possible to distribute surface water from Canyon Lake to the residents surrounding the lake.

7. Prior to construction of the WTPs, area residents were consuming groundwater containing high levels of fluoride and other minerals. Many subdivision water systems did not have adequate water capacity during drought and frequently ran out of water.
8. The WSC found that Western Comal County was experiencing strong growth. WSC had difficulty financing and constructing the water utility facilities needed to stay in compliance with Texas Commission on Environmental Quality ("TCEQ") regulations while meeting growing demand for water service.
9. On May 31, 2006, the WSC assets were purchased by SJWTX, Inc., a subsidiary of SJW Corp.
10. SJW Corp, a California corporation, was formed as a holding company in 1985. SJW Corp. does not have any employees.
11. SJWTX, Inc., a wholly owned subsidiary of SJW Corp., was incorporated in the State of Texas in 2005. SJWTX, Inc. does business as Canyon Lake Water Service Company, its assumed business name (*i.e.*, d/b/a).
12. San Jose Water Company, a wholly owned subsidiary of SJW Corp., has employees who perform certain services for the benefit of SJWTX, Inc. d/b/a Canyon Lake Water Service Company and other companies owned by SJW Corp.
13. Other companies that are wholly owned by SJW Corp. include SJW Land Company and Texas Water Alliance Limited.
14. San Jose Water Company, SJW Corp.'s oldest subsidiary, is the largest investor-owned single district urban water system in the United States, serving approximately one million people through about 225,000 service connections, and has been providing water service in the San Jose, California area continuously since 1866.
15. CLWSC is a privately owned, retail public utility in the business of providing water service to a population of approximately 36,000 people through 9,200 service connections in a service area comprising about 237 square miles around Canyon Lake in western Comal County and southern Blanco County.
16. After SJWTX, Inc. acquired the WSC water system assets, other area utilities became interested in becoming part of CLWSC.
17. The following water systems were acquired after TCEQ review and approval: 2 PWSs from the Emerald Valley Independent Aquatic Network, Ltd, (EVIAN) and 4 PWSs from Rancho Del Lago Inc., both as asset purchase agreements. CLWSC also acquired all the assets of the North Point Homeowners WSC.

18. Bexar Metropolitan Water District, which jointly owned water utility plant with WSC and served Comal County in the Bulverde area, agreed to sell its assets in Comal County to CLWSC.
19. The City of Bulverde, which held the largest certificate of convenience and necessity ("CCN") in Western Comal County agreed to sell to CLWSC.
20. Canyon Lake is now the largest retail water supplier in Western Comal County.
21. Since acquiring the original WSC water system assets, CLWSC has invested tens of millions of dollars in acquiring and upgrading water systems, expanding its WTP capacities and acquiring long-term water resources.
22. CLWSC currently has 7 PWSs: Canyon Lake Shores (0460019); Triple Peak (0460172); Glenwood (0460246); Northpoint (0460235); North Summit (0460220); Stallion Springs (0460179); and, Rust Ranch (0160019).
23. On August 27, 2010, CLWSC filed its Application to Change its Water Tariff and Rates in Various Counties (the "Application") with the Commission.
24. CLWSC's proposed water rate/tariff changes included increased retail water rates and changes to miscellaneous non-rate fees and charges.
25. CLWSC timely and properly provided notice of the proposed rate changes to its ratepayers and affected persons.
26. On or before November 16, 2010, the Commission declared the Application administratively complete and referred the Application to SOAH.
27. The proposed rate increases in the Application became effective for the Canyon Lake Shores, North Point, Rust Ranch, Stallion Springs, Summit North and Triple Peak customers on October 27, 2010. The proposed rate increase in the Application became effective for the Glenwood customers on November 27, 2010.
28. Within 60 days of the effective date of the proposed rate changes at least ten percent of CLWSC's customers filed protests to the rate changes.
29. CLWSC's Application was referred by the Texas Commission on Environmental Quality to the State Office of Administrative Hearings (SOAH) for a contested case hearing. That proceeding was styled and numbered as follows:

TCEQ Docket No. 2010-1841-UCR; SOAH Docket No. 582-11-1468; *Application of SJWTX, Inc. dba Canyon Lake Water Service Company to Change Water Rates; CCN No. 10692; in Comal and Blanco Counties*
30. Notice of the hearing in this docket was provided to all affected persons.

31. On January 6, 2011, a preliminary hearing convened in this docket. At that preliminary hearing, the following parties were admitted and designated: CLWSC (“Applicant”); the Executive Director (“ED”) of the Commission; the Office of Public Interest Counsel (“OPIC”); the Coalition for Equitable Water Rates (“CEWR”); Thomas C. Stuebben; Thomas F. Acker; and Lawrence J. Hanson.
32. Prior to issuance of Order No. 1, Protestants Thomas C. Stuebben, Thomas F. Acker and Lawrence J. Hanson agreed to be represented by CEWR and withdrew as individual parties.
33. On March 1, 2011, Judge Qualtrough issued Order No. 2 Granting Joint Motion to Adopt Interim Rates. Pursuant to Order No. 2, CLWSC’s Phase I rates in effect as of October 27, 2010 were to remain in effect as interim rates during the pendency of this proceeding until the effective date of a final order was issued in the proceeding. All remaining portions of CLWSC’s proposed tariff; including non-water service fees and assessments, were to remain unchanged and in effect as originally proposed pending the final outcome of this proceeding.
34. On May 20, 2011, CLWSC filed its prefiled testimony. Included with CLWSC’s prefiled testimony were updates to CLWSC’s Application based on additional information received by CLWSC in the time lapsed between filing its Application and the date of filing prefiled testimony.
35. On May 31, 2011, CEWR filed a Motion to Strike CLWSC’s prefiled testimony and to Abate the proceeding. CLWSC filed a response to CEWR’s Motion on June 7, 2011.
36. On June 24, 2011, CLWSC filed a Motion to Amend its Application. On July, 14, 2011, the ED and CEWR filed Responses to CLWSC’s Motion to Amend its Application.
37. On August 2, 2011, the Court issued Order No. 8 Ruling on Motion to Strike and Motion to Amend Rate Change Application. Order No. 8 denied the motion to strike and allowed CLWSC to amend its Application.
38. The hearing on the merits was convened March 26-30, 2012 and reconvened on April 19, 2012. CLWSC appeared through its attorneys, Paul Terrill, Geoff Kirshbaum and Mark Zeppa. The ED appeared through staff attorneys Brian MacLeod and Douglas Brown. OPIC appeared through staff attorney Scott Humphrey. CEWR appeared through its attorney, Joe Freeland.
39. Except for matters judicially noticed, the record regarding the case on the merits closed at the conclusion of the hearing on the merits on April 19, 2012.
40. The hearing on the merits regarding rate case expenses was conducted on August 22 and 23, 2012. CLWSC appeared through its attorneys, Paul Terrill and Mark Zeppa. The ED appeared through staff attorneys Brian MacLeod and Douglas Brown. OPIC appeared through staff attorney Scott Humphrey. CEWR appeared through its attorney, Joe Freeland.

Rate Base, Allowable Expenses, and Revenue Requirement

41. CLWSC provides service to approximately 36,000 people through 9,200 service connections.
42. At the end of the test year, CLWSC had a total of approximately 9,068 active connections.
43. SJW Corp.'s, and therefore CLWSC's, books and records are internally audited, externally audited, and are subject to review by various state and federal agencies, following Generally Accepted Accounting Principles (GAAP) for-profit entities and subject to the regulations and oversight of the Securities and Exchange Commission (SEC). Sarbanes-Oxley Act compliance is required.
44. CLWSC follows Generally Accepted Accounting Principles (GAAP) applicable to for-profit corporations, such as investor-owned utilities. CLWSC also uses the National Association of Regulatory Utility Commissioners (NARUC) system of utility accounting, which is a utility basis accounting system.
45. WSC maintained its books and records in accordance with Generally Accepted Accounting Principles (GAAP) for nonprofit corporations, which differ from the type of accounting required for a for-profit investor-owned utility.
46. The ED's financial review staff have reviewed documentation to support the rate change calculations and found CLWSC's identified expenses to be well-supported by receipts and other acceptable documentation even though the ED recommends certain disallowances.
47. The ED's technical review staff have reviewed documentation and inspected CLWSC's physical assets and, with few exceptions, has found CLWSC's rate base well-supported by receipts, as list of trended assets, and other acceptable documentation even though the ED recommends certain disallowances.
48. The ED's recommended rate base, revenue requirement, and expense disallowances are not supported by credible evidence.
49. CEWR's recommended rate base, revenue requirement, and expense disallowances are not supported by credible evidence.
50. OPIC's recommended rate base, revenue requirement, and expense disallowances are not supported by credible evidence.
51. CLWSC considered reasonable amounts in its rate base calculations for developer and customer contributions in aid of construction (CIAC) received after the WSC acquisition, but CLWSC lacked reliable information or documentation to consider any developer or customer CIAC amounts that WSC may have received prior to the WSC acquisition in CLWSC's rate base calculations.
52. CLWSC's rate case data adequately supports its Application to change rates.

53. For its tariff, CLWSC requested the rates and miscellaneous charges set forth in **Exhibit A** and implemented the proposed rates effective October 27, 2010 for its Canyon Lake Shores, North Point, Rust Ranch, Stallion Springs, Summit North and Triple Peak customers and effective November 27, 2010 for its Glenwood customers.
54. CLWSC's proposed rates are reasonably based on a twelve month test year ending March 31, 2010 as normalized for weather and customer growth.
55. CLWSC had reasonable and necessary expenses as set forth on attached **Exhibit B** (entitled "CLWSC Proposed Rate-Setting Data").
56. The expenses set forth in **Exhibit B** are reasonable and necessary to provide service to CLWSC's ratepayers.
 - a. The expenses are based on CLWSC's test year expenses as adjusted for known and measurable changes.
 - b. The expenses are related to the provision of water service.
 - c. The amounts of costs and expenses are reasonable and necessary.
57. CLWSC's net adjusted test year rate base consists of the following elements: utility plant at original cost less accumulated depreciation less contributions in aid of construction plus cash working capital plus the deferred cost regulatory asset.
58. CLWSC's total net adjusted test year rate base broken down is set forth in **Exhibit B**.
59. It was reasonable for CLWSC to use a trending study to determine the original cost and depreciated value for certain assets dedicated to public service by CLWSC predecessor owners and include those values in CLWSC's rate base as proposed.
60. Certain assets acquired by CLWSC from WSC had zero or unreliable original cost documentation.
61. The ED and CLWSC reached a settlement agreement in CLWSC's last rate case that a trending study would be used in this rate case to determine original cost and depreciated values for certain CLWSC assets that were acquired from WSC that lacked reliable original cost documentation.
62. The depreciation rates and methodologies incorporated into CLWSC's trended original cost study used and utility plant asset schedule for the Application, as updated during the hearing, are accepted and in accordance with past TCEQ administrative practices.
63. It is reasonable to impute a 58% debt/42% equity capital structure to CLWSC based on CLWSC's debt financing.

64. A 12% rate of return on equity is reasonable in light of CLWSC's risk and the capital-intensive nature of water utilities, and is consistent with the returns available from other investments of similar risk.
65. The analysis performed for CLWSC by ValueScope, Inc. to verify that a 12% rate of return on equity is reasonable for CLWSC is reasonable and accepted.
66. The ED's determination of a rate of return on equity using the Rate of Return Worksheet attached as an Appendix to the TCEQ rate/tariff change application form instructions is not reasonable or credible and is rejected.
67. During the hearing on the merits, no party other than the ED and CLWSC presented evidence on what a reasonable rate of return on equity or overall rate of return should be for CLWSC.
68. CLWSC's debt interest rates of 6.27% and 6.50%, which result in a weighted cost of debt of 6.28%, is significantly lower than the cost of debt that a smaller utility could obtain. A debt interest rate of 2.25% does not represent a long-term debt interest rate for CLWSC and should not be used in calculating CLWSC's overall rate of return.
69. CLWSC's requested total rate of return of 8.673%, incorporating a 12% return on equity, debt interest rates of 6.27% and 6.50%, a debt return of 3.657%, and a capital structure of 42% equity and 58% debt is reasonable in light of the risk inherent in the operation of water utilities and is consistent with the returns available from other investments of similar risk.
70. CLWSC's requested total rate of return of 8.673% is also reasonable in light of CLWSC's professional management and effective conservation of resources.
71. CLWSC has satisfactory compliance levels given the condition of the facilities at the time that they were acquired and has improved compliance levels over time.
72. CLWSC has significantly improved customer service since its acquisition of WSC, and its requested rate increase is supported by this improved customer service.
73. CLWSC has demonstrated effective management by improving system compliance levels, customer service practices and by effectively managing costs.
74. CLWSC has an increased annual revenue requirement over the revenues generated by its water utility tariff rates in effect prior to the Application. The annual revenue requirement and test year revenue calculations are shown in **Exhibit B**, line 20.
75. The revenue requirement set forth in **Exhibit B** is reasonable.
 - a. These expenses are based on CLWSC's test year expenses as adjusted for known and measurable changes.
 - b. These expenses are related to the provision of water utility service.

- c. These expenses are reasonable and necessary.
 - d. The total net adjusted test year rate base figures represent CLWSC's invested capital that is used and useful in providing water service to the public.
 - e. A total return of 8.673%, applied to a rate base of \$41,083,080, is reasonable and produces a reasonable total return amount of \$3,597,865.
76. The proposed changes to miscellaneous fees and charges set forth in **Exhibit A** are reasonable and appropriate and consistent with TCEQ rules and tariffs approved for other similarly-situated investor-owned utilities.
77. The rates and fees set forth in the tariff attached as **Exhibit A** reasonably recover CLWSC's annual revenue requirement.
78. CLWSC is entitled to a surcharge to recover the difference between final rates and those charged during the pendency of this rate case dating back to October 27, 2010.

Acquisition Adjustment

79. CLWSC's audited books include acquisition adjustment amounts, both positive and negative, that result in a net acquisition adjustment amount of approximately \$4 million.
80. The ED's recommendation to subtract a \$4 million amount from CLWSC's rate base based on CLWSC's net acquisition adjustment amount is unreasonable and not supported by credible evidence.
81. CLWSC's proposal to maintain its acquisition adjustment amounts on its books, amortize the amounts over time, and omit those amounts from ratemaking calculations in this docket is reasonable.
82. This finding of fact will not prohibit consideration of treatment of CLWSC's acquisition adjustment amounts for ratemaking purposes in a future rate case if CLWSC proposes to include those amounts in future ratemaking calculations.

Plant Held for Future Use

83. CLWSC's audited books include approximately \$3.2 million in costs (at original cost) that represent an amount paid to the Bexar Metropolitan Water District to acquire a large CCN service area.
84. CLWSC's proposal to maintain this amount in its Plant Held for Future Use (PHFU) account, amortize the amount over time, and omit the amount from ratemaking calculations in this docket is reasonable.

85. This finding of fact will not prohibit consideration of treatment of CLWSC's PHFU amount for ratemaking purposes in a future rate case if CLWSC proposes to include that amount in future ratemaking calculations.

Rate Case Expenses

86. As of August 23, 2012, CLWSC incurred reasonable and necessary rate case expenses of \$971,097.39, plus estimated amounts that bring the total to 989,785.39, in preparing, filing, and litigating this rate case. CLWSC has incurred and will continue to incur rate case expenses in this case after August 23, 2012 through the date of the TCEQ Commissioners' Agenda, plus any appeals.
87. Rate case expenses in this case were not a normal, recurring expense of CLWSC's operations, but the TCEQ may treat rate case expenses incurred before filing the Application as such based on the TCEQ rate/tariff change application form.
88. CLWSC's expenses from the hearing on the merits through the conclusion of this case were generated largely in response to issues raised by CEWR, OPIC, and the ED.
89. \$114,500 in rate case expenses were included in the Application as part of the revenue requirement amortized over two years.
90. It is reasonable and appropriate for CLWSC to recover its reasonable rate case expenses as a surcharge in the amount of \$ _____ per water customer account per month, effective upon adoption of this Order and to remain in effect until CLWSC has recovered the total sum of reasonable and necessary rate case expenses of \$ _____.

CONCLUSIONS OF LAW

General and Procedural Conclusions

1. CLWSC is a "water . . . utility", "public utility", or "utility" as those terms are defined in TEX. WATER CODE § 13.002(23).
2. The WSC was not a "water . . . utility", "public utility", or "utility" as those terms are defined in TEX. WATER CODE § 13.002(23) and was not subject to Chapter 13 requirements applicable to such entities.
3. CLWSC meets, and WSC met, the definition of a "retail public utility" in TEX. WATER CODE § 13.002(19).
4. WSC was a member-owned and controlled non-profit water supply corporation duly formed under the laws of the State of Texas.
5. The TCEQ has jurisdiction to consider CLWSC's Application for a rate increase pursuant to TEX. WATER CODE §§ 13.181.

6. The ALJs conducted a contested case hearing and issued a proposal for decision on CLWSC's proposed water rate/tariff changes under TEX. GOV'T CODE ch. 2003, TEX. WATER CODE ch. 13, and 30 TEX. ADMIN. CODE chs. 80 and 291.
7. Proper notice of the Application was given by CLWSC as required by TEX. WATER CODE §§ 13.187, 30 TEX. ADMIN. CODE §§ 291.22 and 291.28 and TEX. GOV'T CODE §§ 2001.051 and 2001.052.
8. The Application, rate-filing information, and rate case data submitted by CLWSC in this case, as updated, are adequate to support its rate change Application and complies with applicable statutes and rules.

Rate Base, Allowable Expenses, and Revenue Requirement

9. 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 shall have been dedicated to public use, whether by the utility that is the present owner or by a predecessor, less depreciation. TEX. WATER CODE § 13.185(b).
10. Original cost under TEX. WATER CODE § 13.185(b) is not dependent on an acquisition price paid after property is dedicated to public use.
11. Trending is an acceptable method for estimating original cost under TEX. WATER CODE § 13.185(b) where other documentation is either unreliable or non-existent.
12. Incorporation of acquisition adjustment amounts in rate base is an alternative ratemaking methodology, per TEX. WATER CODE §§ 13.183(c), 13.184(a), and 13.185(a) that deviates from setting rate base according to original cost under TEX. WATER CODE § 13.185(b).
13. TCEQ rulemaking is required to allow incorporation of alternative ratemaking methods, such as acquisition adjustments. TEX. WATER CODE §§ 13.183(c), 13.184(a), 13.185(a)-(b).
14. There is no TCEQ rule authorizing or requiring a utility to apply a negative acquisition adjustment amount to its rate base and past TCEQ decisions have not allowed or required it.
15. Chapter 13 of the Water Code expresses a strong legislative preference for regionalization in the form of a mandate to the Commission to develop policies promoting the consolidation of systems under regional tariffs, and forced incorporation of a negative acquisition adjustment amount on a utility's rate base calculations is a disincentive to regionalization. TEX. WATER CODE §§ 13.182(d), 13.183(c), and 13.241(d).
16. The invested capital, customer contribution in aid of construction (CIAC), and developer CIAC amounts used by CLWSC to calculate cost of service and rates are based on the original cost of property used and useful by CLWSC in providing service, less depreciation, in accordance with TEX. WATER CODE § 13.185.

17. CLWSC's accumulated deferred federal income tax amount was properly excluded in determining CLWSC's rate base in accordance with 30 TEX. ADMIN. CODE 291.31(c)(3)(A)(i).
18. The revenue requirements set forth in **Exhibit B** are based on CLWSC's reasonable and necessary operating expenses within the meaning of TEX. WATER CODE §§ 13.183 and 13.185.
19. The revenue requirements set forth in **Exhibit B** are sufficient to provide CLWSC 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 §§ 13.183 and 13.184.
20. The rates and fees set forth in **Exhibit A** are just, reasonable, and adequate to allow CLWSC to recover its costs of providing water service, as required by TEX. WATER CODE §§ 13.182 and 13.183.
21. The rates and fees set forth in **Exhibit A** are just and reasonable, not unreasonably preferential, prejudicial, or discriminatory. Those rates are sufficient, equitable and consistent in application to each class of customer in accordance with TEX. WATER CODE §§ 13.182, 13.189, and 13.190.
22. The rates and fees set forth in **Exhibits A** are appropriate to implement the ALJ's rulings in this proceeding.
23. A surcharge rate amount of \$_____ per month is reasonable and necessary to permit CLWSC to recover the difference between its final rates and the interim rates charged during the pendency of this contested case hearing that were effective October 27, 2010. TEX. WATER CODE § 13.187(m).
24. CLWSC's system meets the test required for a consolidated system tariff under TEX. WATER CODE § 13.145.
25. CLWSC should be permitted to carry forward and amortize its \$4 million net Acquisition Adjustment amount and \$3.2 million Plant Held for Future Use amount on its books from this rate case to the next rate filing in which it proposes to incorporate any of those amounts in CLWSC's ratemaking calculations.

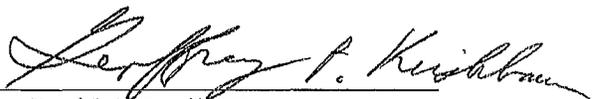
Rate Case Expenses

26. Rate case expenses in the amount of \$971,097.39 incurred by CLWSC through August 23, 2012, plus estimated amounts bring that total to at least \$989,785.39, are reasonable and necessary expenses within the meaning of TEX. WATER CODE §§ 13.183(a)(1), 13.185(d) and (h), and 30 TEX. ADMIN. CODE §§ 291.28(7) and 291.31(b) and it is in the public interest to allow CLWSC to recover those expenses.

27. CLWSC may recover its rate case expenses incurred after August 23, 2012 in an amount determined reasonable and necessary by the Commission.
28. CLWSC may recover all rate case expenses, including those incurred after August 23, 2012, through a monthly surcharge of \$_____ per water customer account per month until CLWSC has recovered the total sum of reasonable and necessary rate case expenses of \$_____. Recovery of rate case expenses through such a surcharge complies with 30 TEX. ADMIN. CODE § 291.21(k) for collection of revenues over and above the usual cost of service.

Respectfully submitted,

THE TERRILL FIRM, P.C.

By: 

Paul M. Terrill III
State Bar No. 00785094
Geoffrey P. Kirshbaum
State Bar No. 24029665
810 West 10th Street
Austin, Texas 78701
Tel: (512) 474-9100
Fax: (512) 474-9888

Law Offices of Mark H. Zeppa, PC

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

**ATTORNEYS FOR APPLICANT SJWTX, INC.
d/b/a CANYON LAKE WATER SERVICE
COMPANY**

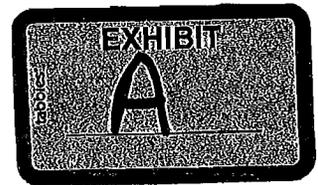
CERTIFICATE OF SERVICE

I hereby certify that on September 24, 2012, a true and complete copy of the foregoing was sent to the following via the method indicated:

Parties	Representative / Address	Service
State Office of Administrative Hearings	Judge Kerrie Qualtrough Judge Penny Wilkov 300 West 15 th Street, Suite 502 Austin, TX 78701	<i>e-filing</i>
State Office of Administrative Hearings	SOAH - Docket Clerk 300 West 15 th Street, Suite 502 Austin, TX 78701	<i>e-filing</i>
TCEQ	Docket Clerk Office of the Chief Clerk P.O. Box 13087 Austin, TX 78711	<i>e-filing</i>
TCEQ Executive Director	Brian MacLeod TCEQ MC-173 P.O. Box 13087 Austin, TX 78711-3087	<i>via e-mail</i>
Office of Public Interest Counsel of TCEQ	Scott Humphrey TCEQ, OPIC MC-103 P.O. Box 13087 Austin, TX 78711-3087	<i>via e-mail</i>
Coalition for Equitable Water Rates, William Stephens, Paul Graf, Deena Clausen, Nelisa Heddin, and Geoffrey Miller	Joe Freeland Matthews & Freeland, LLP 327 Congress Ave., Suite 300 Austin, TX 78701	<i>via e-mail</i>



Geoffrey P. Kirshbaum



CLWSC — RATE SCHEDULE

Rates

Meter Size	Monthly Base Rate
5/8" x 3/4"	\$51.60 (includes 0 gallons)
GALLONAGE CHARGE PER 1,000 GALLONS	
\$5.64	0 to 2,000 gallons
\$6.15	2,001 - 10,000 gallons
\$7.01	10,001- 25,000 gallons
\$8.88	25,001 gallons and over

Meter Size	Monthly Base Rate
3/4"	\$77.38 (includes 0 gallons)
GALLONAGE CHARGE PER 1,000 GALLONS	
\$5.64	0 to 4,000 gallons
\$6.15	4,001 - 20,000 gallons
\$7.01	20,001 - 50,000 gallons
\$8.88	50,001 gallons and over

Meter Size	Monthly Base Rate
1"	\$128.96 (includes 0 gallons)
GALLONAGE CHARGE PER 1,000 GALLONS	
\$5.64	0 to 6,000 gallons
\$6.15	6,001 - 30,000 gallons
\$7.01	30,001 - 75,000 gallons
\$8.88	75,001 gallons and over

CLWSC — RATE SCHEDULE (Continued)

Meter Size	Monthly Base Rate
1 1/2"	\$257.90 (includes 0 gallons)
2"	\$412.65 (includes 0 gallons)
3"	\$773.71 (includes 0 gallons)
4"	\$1,547.40 (includes 0 gallons)
6"	\$2,579.00 (includes 0 gallons)
Bulk Water	\$412.65 (includes 0 gallons)
GALLONAGE CHARGE PER 1000 GALLONS	
\$7.26	Per 1,000 GALLONS

SUPPLEMENTAL EMERGENCY SERVICE FEE:

APPLICABLE TO NONRESIDENTIAL WATER SERVICE CUSTOMERS THAT REQUIRE SUPPLEMENT SERVICE OVER AND ABOVE THEIR EXISTING WATER SERVICE FROM TIME TO TIME. USAGE TO BE DETERMINED BY CUSTOMER. THE MINIMUM DIAMETER FOR SUPPLEMENTAL SERVICE SHALL BE TWO INCHES

<u>Meter Size</u>	<u>Monthly Minimum Charge</u>
2"	<u>\$51.26</u>
3"	<u>\$76.88</u>
4"	<u>\$85.83</u>
6"	<u>\$145.23</u>
8"	<u>\$256.28</u>
10"	<u>\$341.71</u>
12"	<u>\$410.05</u>

FORM OF PAYMENT: The utility will accept the following forms of payment:

Cash X , Check X , Money Order X Credit Card X , Other (specify) Online

THE UTILITY MAY REQUIRE EXACT CHANGE FOR PAYMENTS AND MAY REFUSE TO ACCEPT PAYMENTS MADE USING MORE THAN \$1.00 IN SMALL COINS. A WRITTEN RECEIPT WILL BE GIVEN FOR CASH PAYMENTS

REGULATORY ASSESSMENT 1.0%

TCEQ RULES REQUIRE THE UTILITY TO COLLECT A FEE OF ONE PERCENT OF THE RETAIL MONTHLY BILL.

Miscellaneous Fees

TAP FEE - 5/8" Residential

TAP FEE COVERS THE UTILITY'S COSTS FOR MATERIALS AND LABOR TO INSTALL A STANDARD RESIDENTIAL 5/8" or 3/4" METER. AN ADDITIONAL FEE TO COVER UNIQUE COSTS IS PERMITTED IF LISTED ON THIS TARIFF. \$900.00

TAP FEE – (Large Meter) Actual Cost
TAP FEE IS THE UTILITY'S ACTUAL COST FOR MATERIALS AND LABOR FOR METER SIZE INSTALLED

METER RELOCATION FEE Actual Relocation Cost, Not to Exceed Tap Fee
THIS FEE MAY BE CHARGED IF A CUSTOMER REQUESTS THAT AN EXISTING METER BE RELOCATED.

METER TEST FEE \$25.00
THIS FEE WHICH SHOULD REFLECT THE UTILITY'S COST MAY BE CHARGED IF A CUSTOMER REQUESTS A SECOND METER TEST WITHIN A TWO-YEAR PERIOD AND THE TEST INDICATES THAT THE METER IS RECORDING ACCURATELY. THE FEE MAY NOT EXCEED \$25.

RECONNECTION FEE

THE RECONNECT FEE MUST BE PAID BEFORE SERVICE CAN BE RESTORED TO A CUSTOMER WHO HAS BEEN DISCONNECTED FOR THE FOLLOWING REASONS (OR OTHER REASONS LISTED UNDER SECTION 2.0 OF THIS TARIFF):

- a) Nonpayment of bill (Maximum \$25.00) \$25.00
- b) Customer's request that service be disconnected..... \$45.00

SEASONAL RECONNECTION FEE:

BASE RATE TIMES NUMBER OF MONTHS OFF THE SYSTEM NOT TO EXCEED SIX MONTHS WHEN LEAVE AND RETURN WITHIN A TWELVE MONTH PERIOD.

TRANSFER FEE \$5.00
THE TRANSFER FEE WILL BE CHARGED FOR CHANGING AN ACCOUNT NAME AT THE SAME SERVICE LOCATION WHEN THE SERVICE IS NOT DISCONNECTED

CUSTOMER SERVICE INSPECTION FEE \$50.00
ASSESSED TO AN APPLICANT FOR SERVICE BEFORE PERMANENT, CONTINUOUS SERVICE IS PROVIDED TO NEW CONSTRUCTION. THE CUSTOMER HAS THE OPTION TO HAVE THE INSPECTION COMPLETED BY ANOTHER PROVIDER.

LATE CHARGE 10% of the Bill
TCEQ RULES ALLOW A ONE-TIME PENALTY TO BE CHARGED ON DELINQUENT BILLS. A LATE CHARGE MAY NOT BE APPLIED TO ANY BALANCE TO WHICH THE PENALTY WAS APPLIED IN A PREVIOUS BILLING.

RETURNED CHECK CHARGE \$25.00
RETURNED CHECK CHARGES MUST BE BASED ON THE UTILITY'S DOCUMENTABLE COST.

CUSTOMER DEPOSIT RESIDENTIAL (Maximum \$50) \$50.00

COMMERCIAL & NON-RESIDENTIAL DEPOSIT 1/6th of Estimated Annual Bill

EQUIPMENT DAMAGE FEE Actual Cost

THE UTILITY MAY CHARGE FOR ALL LABOR, MATERIAL EQUIPMENT AND ALL OTHER ACTUAL COSTS NECESSARY TO REPAIR OR REPLACE ALL EQUIPMENT DAMAGED DUE TO NEGLIGENCE, METER TAMPERING OR BYPASSING, OR SERVICE DIVERSION, THE UTILITY MAY CHARGE FOR ALL ACTUAL COSTS NECESSARY TO CORRECT SERVICE DIVERSION OR UNAUTHORIZED TAPS WHERE THERE IS NO EQUIPMENT DAMAGE. INCLUDING INCIDENTS WHERE SERVICE IS RECONNECTED WITHOUT AUTHORITY, AN ITEMIZED BILL WILL BE PROVIDED TO THE CUSTOMERS.

GOVERNMENTAL TESTING, INSPECTION AND COSTS SURCHARGE:

WHEN AUTHORIZED IN WRITING BY TCEQ AND AFTER NOTICE TO CUSTOMERS, THE UTILITY MAY INCREASE RATES TO RECOVER INCREASED COSTS FOR INSPECTION FEES AND WATER TESTING, 130 TAC 291.21(K)(2)1

LINE EXTENSION AND CONSTRUCTION CHARGES:

REFER TO SECTION 3.0--EXTENSION POLICY FOR TERMS, CONDITIONS, AND CHARGES WHEN NEW CONSTRUCTION IS NECESSARY TO PROVIDE SERVICE.

TEMPORARY WATER RATE:

UNLESS OTHERWISE SUPERSEDED BY TCEQ ORDER OR RULE. IF THE UTILITY IS ORDERED BY A COURT OR GOVERNMENT BODY OF COMPLETE JURISDICTION TO REDUCE ITS PUMPAGE, PRODUCTION OR WATER SALES, THE UTILITY SHALL BE AUTHORIZED TO INCREASE ITS APPROVED GALLONAGE CHARGE ACCORDING TO THE FORMULA:

$$TGC = \frac{cgc + (pr)(cgc)(r)}{(1.0-r)}$$

Where:

TGC = temporary gallonage charge

cgc = current gallonage charge

r = water use reduction expressed as a decimal fraction (the pumping restriction)

pr = percentage of revenues to be recovered expressed as a decimal fraction, for this tariff pr shall equal 0.5.

To implement the Temporary Water Rate, the Utility must comply with all notice and other requirements of 30 TAC 291.21(1)

PURCHASED WATER AND/OR DISTRICT FEE PASS THROUGH CLAUSE:

CHANGES IN FEES IMPOSED BY ANY NON-AFFILIATED THIRD PARTY WATER SUPPLIER OR UNDERGROUND WATER DISTRICT HAVING JURISDICTION OVER THE UTILITY SHALL BE PASSED THROUGH AS AN ADJUSTMENT TO THE WATER GALLONAGE CHARGE ACCORDING TO THE FOLLOWING FORMULA:

$$AG = G + B / (1 - L)$$

Where:

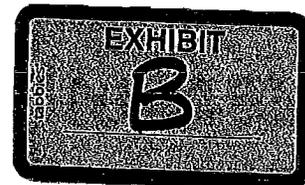
AG = adjusted gallonage charge rounded to the nearest one cent

G = approved gallonage charge (per 1,000 gallons)

B = change in purchased water/district gallonage charge (per 1,000 gallons)

L = system average line loss for the preceding 12 months not to exceed 0.15.

CANYON LAKE WATER SERVICE COMPANY
 Water Rate Increase Application
 Test Year Ended 3/31/2010



<u>REVENUE REQUIREMENT</u>				As Filed	Change	As Updated
				(a)	(b)	(c)
1	Salaries & Wages			\$1,511,547	(\$20,704)	\$1,490,844 a
2	Contract Labor			\$289,988		\$289,988
3	Purchased Water			\$1,085,728		\$1,085,728
4	Chemicals			\$87,368		\$87,368
5	Utilities			\$437,246		\$437,246
6	Repairs/Maintenance/Supplies			\$1,006,145	(\$9,442)	\$996,704 b, l
7	Office Expenses			\$283,994	\$46,808	\$330,801 c, j
8	Accounting & Legal Fees			\$84,359		\$84,359
9	Insurance			\$307,653	\$67,519	\$375,172 d
10	Rate Case Expense			\$57,250		\$57,250
11	Miscellaneous			\$265,789	\$19,840	\$284,629 l
12	Total O&M			\$5,417,068	\$103,022	\$5,520,090
13	Property & Other Taxes			\$104,259	\$43,172	\$147,431 e, j
14	Payroll Taxes			\$143,300	(\$1,442)	\$141,858 a
15	Annual Depreciation & Amortization			\$2,195,074	(\$20,274)	\$2,174,800 f, g, k
16	Income Taxes			\$1,122,163	(\$1,827)	\$1,120,336
17	Return			\$3,603,738	(\$5,874)	\$3,597,865
18	Total Revenue Requirements			\$12,585,803	\$116,777	\$12,702,380
19	Less: Total Other Revenues			\$1,017,181	\$107,001	\$1,124,163 h
20	Total Costs for Rates			\$11,568,441	\$9,776	\$11,578,217
21	Current Revenues			\$6,899,243	(\$107,001)	\$6,792,242 h
22	Revenue Increase Needed			\$4,669,198	\$116,777	\$4,785,975
23	Percent Increase			67.68%		70.46%
<u>RATE BASE</u>						
24	Gross Plant			\$68,605,895	(\$310,900)	\$68,294,995 g, k
25	Accumulated Depreciation			(\$12,312,847)	\$30,301	(\$12,282,546) g, k
26	Net Book Value			\$56,293,048	(\$280,599)	\$56,012,449
27	Working cash allowance -			\$677,134	\$12,878	\$690,011
28	Prepayments			\$4,900		\$4,900
29	Materials and supplies			\$361,235		\$361,235
30	Advances			(\$772,550)		(\$772,550)
31	Developer Contributions			(\$15,012,965)	\$200,000	(\$14,812,965) g
32	Total Rate Base			\$41,550,801	(\$67,721)	\$41,483,080
<u>INCOME TAX CALCULATION</u>						
33	Return @ 8.67%	8.67%		\$3,603,738	(\$5,874)	\$3,597,865
	Less:					
34	Interest @ 3.66%	3.66%		(\$1,519,717)	\$2,477	(\$1,517,240)
35	Taxable Income			\$2,084,021	(\$3,397)	\$2,080,624
36	FIT Rate @ 35.00%			\$729,407	(\$1,189)	\$728,219
37	Gross-Up 1.5385	1.5385		\$1,122,163	(\$1,827)	\$1,120,336 j

- a Amend payroll and related taxes to reflect charges to pipeline partners.
- b Amend fuel adjustment to reflect March 2011 average gasoline prices.
- c Remove postage expense increase adjustment due to rejection by regulators.
- d Amend for Company's HSA payment and latest employee selection count and costs.
- e Amend for actual 2010/2011 property tax charges.
- f Amend depreciation rates to reflect RG-354 recommended lives.
- g Removal of Startsville Wastewater plant related to O&M contract.
- h Move volumetric usage and customer growth revenue adjustments to service revenues.
- i Remove out of period adjustment to M&S \$52,877 total less April 2009 amount of \$855.
- j Gross-up factor calculation/ Bad Debt and Franchise Tax Expense related to revenue increase.
- k Amend original cost trending study indices.
- l Amend Corp Service Fee.