

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 CONSOLIDATED REPLY TO
EXCEPTIONS TO THE PROPOSAL FOR DECISION AND PROPOSED ORDER

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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 Consolidated Reply to Exceptions to the Administrative Law Judges' ("ALJs") Proposal for Decision ("PFD") and Proposed Order filed by the TCEQ Executive Director ("ED") and the Coalition for Equitable Water Rates ("CEWR").¹ In support thereof, CLWSC would show the following:

I. INTRODUCTION

CLWSC's opponents' rate base contentions, among others presented throughout this case and manifest in the PFD, are presented in an effort to artificially drive down CLWSC's rates without consideration for CLWSC's true cost of service or reasonably expected return. But those contentions are not based in fact or law. The ED, CEWR, and the PFD all recognize the distinctions that exist between regulations and practices applicable in ratemaking and accounting for IOUs versus those applicable to non-profit member-owned and controlled water supply corporations such as the former Canyon Lake Water Supply Corporation ("WSC"). There should be a corresponding recognition that a water supply corporation cannot possibly have CIAC and that no cost-free capital exists within CLWSC assets acquired from WSC.

¹ The TCEQ Office of Public Interest Counsel did not file PFD exceptions.

Short of correcting these findings in the PFD, the Commission should at least be willing to sustain the PFD's "good cause" exception conclusions based on the facts of this case and the aforementioned IOU v. water supply corporation differences outlined in the PFD. The Commission should also sustain the PFD's rejection of the ED's unprecedented and improper negative acquisition adjustment theories. But because the PFD only partially rejects the parties' concerted attempts to have this Commission take CLWSC's property through a confiscatory rate order, the ED and CEWR seek more from the Commission and except to the PFD's "good cause" findings for reasons that lack merit.

The rate base exceptions filed by ED and CEWR, among other aspects of the exceptions filings that will be discussed herein, must be rejected. The Commission should: (1) reverse the PFD recommendations as CLWSC outlined in its exceptions with respect to rate base, but sustain the PFD's "good cause" exception if PFD rate base findings concerning CIAC and cost-free capital are not corrected; (2) sustain the PFD's rejection of the ED's negative acquisition adjustment theories; (3) reject the ED's flawed legal analysis with respect to rate case expenses; and (4) ensure that CLWSC is allowed to recover its reasonably incurred rate case expenses in this case whether or not the Commission's 51% rule applies. The Commission also needs to ensure that, if the PFD/ED rate base method for original cost estimation is adopted over CLWSC's objections, that the proper rate base exhibits offered by the ED in his closing arguments are utilized to ensure a just and reasonable revenue requirement and rate design.

II. CLWSC'S REPLY TO ED'S EXCEPTIONS RELATED TO RATE BASE

The ED claims that "cost free capital" is embedded within CLWSC's rate base and that an unprecedented negative acquisition adjustment must be applied to reduce CLWSC's rate base.² Although, the PFD found that "cost free capital" exists within CLWSC's rate base, the PFD held that

² ED Exceptions to PFD, p. 1-15.

there is “good cause” for it to remain for ratemaking purposes.³ Further, the PFD rejected the ED’s unprecedented recommended negative acquisition adjustment methodology. The ED excepts to these PFD findings.

CLWSC replies that: (1) there is no “cost free capital” in CLWSC’s rate base, but even if one assumes that it exists, there is good cause for allowing it to remain as determined in the PFD; and (2) the concern expressed by the ED throughout this case about “windfall[s]”, “cost free capital,” and the need to further deflate CLWSC’s rate base by applying a negative acquisition adjustment are misplaced, unprecedented, and the PFD properly rejects this ED recommendation.

A. Good Cause Exists to Reject the ED’s Unprecedented Negative Acquisition Adjustment.

There is no solid basis expressed in the ED’s exceptions to refute the PFD finding that good cause exists to allow “cost free capital” — which CLWSC maintains does not exist — to remain in CLWSC’s rate base. Instead, the ED reiterates arguments as to why “cost free capital” exists and must be reduced through his unprecedented negative acquisition adjustment.

The portion of the PFD to which the ED excepts states that, pursuant to 30 TEX. ADMIN. CODE §291.31(c)(3), “there is good cause to include CIAC and cost-free capital in the rate base. As argued by CLWSC, there are no records to correlate the amount of CIAC shown on the WSC’s financial statements with specific assets. Further, non-IOUs use a different accounting system than IOUs and do not track CIAC in the same manner as an IOU. . . . The records are simply not available to reliably remove individual, contributed assets from CLWSC’s rate base.”⁴

The ED’s exceptions indicates he does not think tying CIAC or cost-free capital figures to specific assets is important.⁵ But to accurately remove CIAC or cost free capital assets, one must

³ PFD, p. 54.

⁴ *Id.*

⁵ ED Exceptions to PFD, p. 5-6.

know what those assets are, their proper values, and whether they've been fully depreciated. An IOU would have valued those assets at their proper original cost amounts at installation, less depreciation, and reported those values to CLWSC with any CIAC amounts during the acquisition transaction.⁶ However, the WSC was not legally required to do that.⁷ To retroactively accomplish that task is "impossible."⁸

In contrast, the ED discounts the importance of that information, contending that an aggregate amount can be used instead. The ED contends his adjustment can even be applied in a limited fashion to rate base for return purposes only (without applying it for depreciation purposes). But the ED has provided no support for either of these contentions.

The ED states his recommendation is meant to "represent cost free capital" using the negative acquisition adjustment amount "due to the CIAC issues, original cost issues, cost free capital issues, and the issue of the sale between a non-utility, customer-owned WSC and a utility" in this case." But the ED has never stated: (1) which assets make up this universe; (2) whether the assets still exist or are fully depreciated; or (3) what the difference is between those assets' original cost values (less depreciation) and what CLWSC might have paid for them during the acquisition (whether more or less). That information simply cannot be determined based on the circumstances of this case for reasons related to the issues stated in the PFD.⁹ Consequently, there is good cause to leave these amounts in CLWSC's rate base if they constitute "cost free capital" or "CIAC" as the PFD and other parties contend.¹⁰

⁶ Tr. 624:15–627:8 (Charles E. Loy, March 28, 2012); TEX. WATER CODE §13.301(j).

⁷ The WSC reported those values as current value estimates and purchase prices.

⁸ CLWSC Ex. C, p. 27:17– 28:20.

⁹ PFD, p. 54.

¹⁰ Although not urged by CLWSC, if the Commission follows the "unspecified possibility" for "good cause" suggested by the ED that a utility should be rewarded for upgrading systems it purchased as incentive for upgrades, CLWSC thinks that would also be appropriate. ED Exceptions, p. 10-11. However, the better reason along those lines, as will be explained later, is that the Commission is mandated to promote regionalization of utility systems, and the issues that have

B. There is No Windfall or Cost Free Capital to Remove

Not content with the PFD's incorrect acceptance of his "booked cost" method to estimate "original cost" for CLWSC rate base assets, the ED continues asserting that a negative acquisition adjustment must be applied because of "cost free capital" in CLWSC's rate base and to prevent a "windfall."¹¹ There is nothing in the Water Code, TCEQ rules, or applicable case law to support the notion that the difference between a purchase price and original cost-based asset values constitutes "cost free capital" or a "windfall" to a utility requiring the type of adjustment the ED requests.¹² The evidence shows the ED's proposed negative acquisition adjustment, correctly rejected in the PFD, has never been used by the Commission to reduce an IOUs rate base and was specifically rejected in *Technology Hydraulics*.¹³

In support of its contention about "windfalls," the ED presents a strained interpretation of the U.S. Supreme Court's decision in *Bluefield*.¹⁴ The term "windfall" is not mentioned in *Bluefield* as the ED suggests. Here is the complete language from *Bluefield* containing return considerations stated in response to a utility's contention that the rate of return set by a regulatory authority was too low and confiscatory:

plagued this case could resurface in other acquisition transactions contemplated to save troubled systems like WSC. The ED's suggested adjustments would discourage those transactions.

¹¹ ED Exceptions to PFD, p. 1-15.

¹² Tr. 599:4-601:23 (Charles E. Loy, March 28, 2012); Tr. 1363:23-1364:8 (Palle Jensen, April 19, 2012).

¹³ 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. The ED is incorrect when he states the Commission has had "few opportunities to directly address how and when to apply a negative acquisition adjustment." ED Exceptions to PFD, p. 10. There have been rate cases which directly presented such an opportunity in contested proceedings. *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). But, more importantly, the Commission's rulemaking procedures have been available the entirety of the nearly 20 years that have passed since *Technology Hydraulics*.

¹⁴ ED Exceptions to PFD, p. 3.

What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgement, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. 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. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679, 692-693 (1923).

Throughout this case, the ED has seemed intent on ignoring the requirements of *Bluefield*, reflected in the Water Code, with respect to its return recommendations.¹⁵ While CLWSC is pleased to see the ED recognize the *Bluefield* principles, the ED's exceptions statement based on *Bluefield* is misleading.

All *Bluefield* says in the language referenced by the ED is a utility can't expect the same type of profits as other types of enterprises or ventures which might be more risky.¹⁶ However, utilities should be able to expect returns similar to businesses with the same type of risks and uncertainties.¹⁷ Prevention of alleged "windfalls" in setting return because of whatever deal may have transpired between private parties is simply not a proper consideration under *Bluefield*.

The "windfall" concept the ED continues to push does not come from *Bluefield*. It comes from the 1984 *Alexa* PUC report discussed in the ED's exceptions.¹⁸ In fact, *Alexa* appears to be the source of all the ED's statements about "bargain deals" and "windfalls." The *Alexa* report cannot be considered precedential or even persuasive in conjunction with the case at bar. It is completely

¹⁵ See CLWSC Exceptions to PFD, p. 4-20. For example, the staff-created ROR Worksheet oversimplifies and does not adequately consider "market and business conditions" or capital attraction needs as discussed in *Bluefield*.

¹⁶ *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692-693 (1923).

¹⁷ *Id.*

¹⁸ ED Exceptions to PFD, p. 8-9.

outdated¹⁹ and does not even support the ED's recommended methodology for incorporating a negative acquisition adjustment as a wholesale rate base deduction, which the ED attempts to unfairly reserve for only "some cases" at his discretion.²⁰

CLWSC notes that nothing in *Bluefield* says there has to be a dollar for dollar purchase or investment in utility property by a utility in order to earn a return on it. Rather, it says, "*A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public*" to prevent unconstitutional confiscation of its property.²¹ Calculating the "value of the property" at original cost to a utility's "predecessor" less depreciation when analyzing return, not at the value of a later purchase price which may or may not be asset-specific or at its true value, is where the Water Code's original cost valuation method comes into play.²² The property employed in the public service has an inherent value which ties back to when it was first placed in service. The price paid for that used property later can be different, but its original cost does not change.

¹⁹ The *Alexa* Examiner's Report cited by the ED is from 1984, predates the 1994 *Technology Hydraulics* decision by 10 years, pre-dates the 1997 amendments to the Water Code to promote regionalization by 13 years, pre-dates the 1999 TCEQ rule amendments allowing positive acquisition adjustments in response to the alternative ratemaking method statutory change by 15 years, pre-dates the 2004 *Quadvest* decision by 20 years, and pre-dates the most recent *Aqua Texas* decision by nearly 25 years.

²⁰ ED Exceptions to PFD, p. 8-9. Unlike the ED approach, the *Alexa* approach was to incorporate a negative acquisition adjustment for depreciation purposes. *Technology Hydraulics* said that is improper. But even *Alexa* includes the following language omitted by the ED in his Closing Arguments and Exceptions:

The examiner hesitates to set down any specific rule or test for negative acquisition adjustments. At first [sic] glance it is appealing to say that a negative acquisition adjustment should always be made, but some type of balancing test may be needed, taking into account net book price, annual depreciation expense on that amount, return, and perhaps other factors. Development of a test should be reserved for a later day, preferably a contested case in which both detailed arguments and information are presented.

Alexa Enterprises Inc. d/ b/ a Engel Utility Company for a Rate Increase, 1984 Tex. P.U.C. Lexis 139; 10 Texas P.U.C. Bulletin 119, 138-139 (August 3, 1984). After *Technology Hydraulics*, *Quadvest*, and other authorities, this is not possible without rulemaking.

²¹ *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692-693 (1923) (emphasis added).

²² TEX. WATER CODE §13.185(b).

C. ED Approach Fails to Consider Regionalization

The PFD does not discuss regionalization considerations in reaching its conclusions.²³ Similarly, the ED does not mention regionalization in his exceptions.²⁴ 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. Effects on regionalization must weigh into the Commission's consideration of the issues raised in this case.

Chapter 13 of the Texas 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.²⁵ Regionalization is the Legislature's and the Commission's response to the problem of small, underfinanced, water and sewer systems that lack the resources to meet regulatory requirements.²⁶ The record shows that WSC was a troubled system before CLWSC acquired it.²⁷

Regionalization was a consideration when the positive acquisition adjustment rule was adopted by the Commission. "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.²⁸ Otherwise, the usual original cost formula applies.²⁹ The TCEQ adopted such

²³ PFD, p. 40-48.

²⁴ ED Exceptions to PFD, p. 1-15.

²⁵ See, e.g., TEX. WATER CODE §§ 13.182(d), 13.183(c), and 13.241(d).

²⁶ *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, Proposal for Decision, pp. 14-15 (July 5, 2007) (included in this record as CLWSC Ex. 47); *Id.*, Final Order, pp. 9-10 and 18 (September 23, 2008) (included in this record as CLWSC Ex. 48).

²⁷ PFD, p. 4.

²⁸ TEX. WATER CODE §13.183(c), §13.185(a)-(b).

²⁹ *Id.*

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.³⁰ There is no corresponding TCEQ rule about incorporation of a *negative* acquisition adjustment in ratemaking as required by TEX. WATER CODE § 13.183(c).³¹ There is not a corresponding provision for either type of acquisition adjustment in the Texas Water Code.³² The TCEQ could have adopted a negative acquisition adjustment rule, but the agency deliberately chose not to.

The Texas Register shows that regionalization issues were at the forefront of the Commission's decision to adopt the positive acquisition adjustment rule. Language in the response to comments accompanying that rule adoption states:

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*.³³

Conversely, negative acquisition adjustments would by their nature create a disincentive for regionalization and no rule for such adjustments was adopted. Instead, the original cost formula was allowed to stand in the absence of such a rule.

If an IOU is going to have its return on its rate base deflated post-acquisition because the ED determines it received a "good deal" or trended original cost studies are not accepted despite lacking records,³⁴ the result is that a prospective IOU purchaser will be hesitant to proceed in a transaction

³⁰ 30 TEX. ADMIN. CODE §291.31(d).

³¹ 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).

³² *Id.*

³³ See 24 Tex. Reg. 738, 741 (1999) (adopting rule amendment now codified at 30 TEX. ADMIN CODE § 291.31(d)) (Tex. Comm'n on Env'tl. Quality) (emphasis added).

³⁴ CLWSC previously excepted to the PFD's recommended rejection of its trending original cost study values to set its rate base.

to acquire a troubled system like WSC. Commonly, such systems, both IOUs and water supply corporations, have record-keeping and accounting issues, on top of technical issues, that a buyer must deal with. The Commission must have policies in place that encourage these transactions to take place despite these challenges.

Allowing return on property in the ground without a negative acquisition adjustment and accepting trended asset values are just two ways to promote regionalization in a post-acquisition IOU rate case. This has been the TCEQ's practice in the past. This was the treatment CLWSC expected in this case and when it bought WSC. This is why the ED's negative acquisition adjustment theories are more appropriately addressed in rulemaking, if at all, and should be rejected in this case whether for "good cause" or otherwise.

The fact is that there is an absence of specific Commission-established rules on this subject and the rate base rule the ED relies upon concerning "other sources of cost-free capital, as determined by the commission" does not count.³⁵ The ED seeks to take advantage of this void to deflate CLWSC's rate base and unconstitutionally confiscate CLWSC's utility property employed in the public service.³⁶ The Commission should not permit this to occur and should adopt the PFD's "good cause" recommendation, if it determines the ED and PFD are correct about the existence of cost-free capital in CLWSC's rate base resulting from acquired WSC assets. However, CLWSC urges the Commission to go further and reject the PFD recommendation to find that cost-free capital tied to those assets exists.

D. ED Omits Key Provisions of the WSC-CLWSC Transaction.

The ED's assertion that cost-free capital exists is based on an incomplete and inaccurate representation of the WSC-CLWSC transaction. The ED focuses on only one part of the transaction

³⁵ 30 TEX. ADMIN. CODE §291.31(c)(3)(A)(v). The ED offers no examples of cases where unspecified "cost free capital" amounts have been excluded from rate base under this rule, and certainly none where a negative acquisition adjustment was applied for this purpose. Therefore, the ED's statement that "Cost free capital is normally excluded from rate base" pursuant to this rule is misleading.

³⁶ *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692-693 (1923).
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— the \$26.5 million purchase price — to the exclusion of other critical components of the transaction.³⁷ The ED states that if CLWSC is allowed to earn return on anything more than \$26.5 million for these assets, the customers are paying the utility a return on dollars it never invested.³⁸ The ED indicates that its \$26.5 million amount comes from the STM application that was filed ahead of CLWSC's acquisition of WSC.³⁹ The ED also justifies its recommendation based on a representation that “the current customers are the same people who already paid for the assets once.”⁴⁰ All these statements constitute misrepresentations about the true nature of the deal between CLWSC and WSC.

First, assets paid for by developers are not ever paid for by customers. Second, for reasons already expressed herein and in prior CLWSC briefing, the Commission should be looking at “original cost” — the value of the property on the date of installation by CLWSC's predecessor, less depreciation, per the Water Code and *Bluefield* — instead of purchase price figures to calculate return.⁴¹ But, third, the ED's statements disregard the complete scope of consideration exchanged in the WSC to CLWSC transaction.

The Asset Purchase Agreement between WSC and CLWSC, included with the joint STM application, identifies the deal terms as follows:

1. \$3.2M, plus transaction costs and “reimbursable seller income tax” as defined in the agreement.⁴²
2. The two-year rate moratorium preventing rate increases during that time period.⁴³

³⁷ ED Exceptions to PFD, pp. 3, 7, and 10-11.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ TEX. WATER CODE §13.185(a)-(b); *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692-693 (1923).

⁴² CLWSC Ex. 3 at CLWSC 001352, § 3.1.

⁴³ *Id.* at CLWSC 001377, §10.2.

3. “Assumed liabilities” as that term was defined in the agreement.⁴⁴ Some of these liabilities were liquidated, such as the TWDB debt in the amount of about \$20,605,000, and some liabilities were unliquidated and subsumed in the definition of the term “liability” per the agreement.⁴⁵

During the hearing, Mr. Jensen testified about the WSC/CLWSC deal points and the unliquidated liabilities assumed by CLWSC that the WSC was incapable of addressing.⁴⁶ The WSC was a “troubled” system with serious TCEQ compliance problems and had exhausted its ability to incur debt for needed improvements.⁴⁷ The importance of the uncertainty and risk associated with the acquisition of a troubled system with serious compliance issues cannot be overstated. Among the unliquidated liabilities was risk posed by the lack of good records for all WSC assets CLWSC was acquiring coupled with the unknown cost that it would take to make all improvements necessary to bring the system up to TCEQ public drinking water quality standards.⁴⁸ This risk was in addition to the cost necessary to operate and maintain the system during the two-year rate moratorium without any increase to rates the WSC set for itself.⁴⁹ CLWSC spent about \$25 million on improvements between the acquisition and the test period for this rate case.⁵⁰ Much of that was spent in the first years post-acquisition during the rate moratorium.⁵¹ This provides the more complete picture of the price paid for the WSC acquisition than the limited \$26.5 million amount the ED considers to conclude CLWSC received a “good deal”.⁵²

More egregiously, the ED’s statements show selective consideration of the STM application by considering the stated purchase price and nothing else. The ED continues to contend his novel

⁴⁴ *Id.* at CLWSC 001349-001351, §10.2 and CLWSC 001352, §3.1.

⁴⁵ *Id.* at CLWSC 001343, §1.1.

⁴⁶ Tr. 187:2– 192:17 (Palle Jensen, March 26, 2012) and Tr. 1318:9–1319:18, 1344:4-18 (Palle Jensen, April 19, 2012).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² ED Exceptions to PFD, p. 10.

negative acquisition adjustment is necessary, in part, due to “CIAC issues.”⁵³ 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 that consideration.⁵⁴ The absence of a CIAC transfer for pre-acquisition assets is clearly demonstrated by both the deal terms and the associated TCEQ STM application filed by both parties declaring *\$0* CIAC.⁵⁵ In other words, both parties to the transaction plainly declared that there is *no* CIAC. Yet the ED continues to insist CIAC assets were transferred to CLWSC by WSC despite this sworn joint STM application statement. If the STM is good enough to establish the purchase price for the ED’s conclusions, the ED should similarly accept the lack of CIAC based on that document also.

The STM application also supported using trended original cost valuations in this case, particularly when combined with the ED’s directive to use trending at the conclusion of CLWSC’s last rate case.⁵⁶ The STM application explained why trending would be needed in a future rate case:

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.⁵⁷

But the ED determined that trending was not good enough to establish original cost and rate base in this case. The PFD erroneously concurred.

Finally, the evidence does not support the ED statement that “the current customers are the same people who already paid for the assets once” which were transferred in the WSC acquisition

⁵³ ED Exceptions to PFD, p. 9.

⁵⁴ CLWSC Ex. 3; Tr. 1321:2–1322:5 (Palle Jensen, April 19, 2012); CLWSC Ex. C, p. 27:17–28:20.

⁵⁵ CLWSC Ex. 3; Tr. 1321:2–1322:5 (Palle Jensen, April 19, 2012).

⁵⁶ CLWSC Ex. 7, at CLWSC 000711.

⁵⁷ CLWSC Ex. 3, at CLWSC 001032.

deal.⁵⁸ First, no ratepayers testified in this proceeding so the ED cannot automatically presume that any current customer was a member/customer of the WSC or its IOU predecessors. Second, any developer funded assets were not customer funded. Third, there is no evidence that customers of predecessor IOUs contributed anything to the WSC when their systems were acquired and converted to the WSC. Fourth, if this issue is relevant at all, WSC members were themselves paid twice for pre-acquisition assets, once with WSC's deflated rates that were not set using IOU ratemaking methods properly accounting for original cost and again with consideration provided by CLWSC in the WSC acquisition deal. Now requiring CLWSC to provide customers a third round of payment for assets by using a CIAC or cost-free capital credit by negative acquisition adjustment or otherwise to set rates below CLWSC's cost of service would be neither just nor reasonable. But CLWSC reiterates that there is no legally recognized IOU CIAC within the WSC universe.

E. Other ED Rate Base Issues

The ED's Exceptions include a chart that supposedly shows CLWSC's "real world returns."⁵⁹ This chart was presented for the first time in the ED's closing arguments, CLWSC was not permitted the opportunity to cross-examine the ED's experts about it; it is outside the record; and, it is completely inaccurate. Although CLWSC does not object to Commission consideration of the ED's correction exhibits filed with his closing arguments, CLWSC maintains its objection to this chart. Its information does not appear in the PFD, and the Commission should disregard it as well. CLWSC is pleased to see the ED's acceptance of the 10.88% rate of return on equity recommended in the PFD if the ROR Worksheet is used.⁶⁰

⁵⁸ *Id.*

⁵⁹ ED Exceptions to PFD, p. 13.

⁶⁰ *Id.*

CLWSC disagrees with the ED's insistence on its requested accounting order for future CLWSC treatment of acquisitions.⁶¹ That is outside the scope of this case and should be reserved for rulemaking along with other acquisition adjustment issues. Moreover, this is another issue the ED raised for the first time in his closing arguments.⁶²

III. CLWSC'S REPLY TO CEWR'S EXCEPTIONS RELATED TO RATE BASE

Like the ED, CEWR excepts to the PFD recommendation to include CIAC amounts in CLWSC's rate base for good cause.⁶³ Generally speaking, CLWSC has already addressed the "good cause" and CIAC issues raised by CEWR in reply to the ED's exceptions, but several additional issues merit a response. CEWR does not present a single argument that would cut against the PFD's "good cause" conclusion. Several fallacies included in CEWR's exceptions are as follows.

CEWR repeatedly makes the conclusory claim that contributed funds paid for pre-acquisition assets remain in CLWSC's rate base.⁶⁴ However, CEWR can point to no record evidence that shows which assets those were or whether those assets are still in service.

CEWR states the evidence "shows that no one bothered to research" whether "records to correlate CIAC to specific assets" existed.⁶⁵ That claim is incorrect for several reasons. First, it incorrectly assumes that any WSC can have CIAC, when it cannot. Second, it ignores the undisputed fact that the WSC plainly stated in its STM Application it had no CIAC.⁶⁶ Third, the evidence actually shows that the WSC records needed to make a retroactive assessment of "CIAC" were non-existent.⁶⁷

⁶¹ ED Exceptions to PFD, p. 13-15.

⁶² ED Closing Arguments, p. 47-48.

⁶³ CEWR Exceptions to PFD, p. 1.

⁶⁴ *See, e.g.*, CEWR Exceptions to PFD, p. 2.

⁶⁵ CEWR Exceptions to PFD, p. 7-9.

⁶⁶ CLWSC Ex. 3 at CLWSC 0001031.

⁶⁷ CLWSC Ex. B, p. 20:4-7 and 20:14-22:2; Tr. 322:17-18, Tr. 440:23-441:8 (Thomas A. Hodge, March 27, 2012); CLWSC Ex. C, p. 27:17- 28:20.

Moreover, many, if not most, of the WSC's older assets were fully depreciated based on their age.⁶⁸ CLWSC is not required by TCEQ rules to attempt identification and reclassification of WSC assets as "CIAC" on CLWSC's books.⁶⁹ It also would not be appropriate under GAAP and would be an impossible task.⁷⁰

Although CEWR chides Dr. Gebhard for not retroactively reconstructing an estimate of CIAC, CLWSC notes that Dr. Gebhard's responsibility in this rate case was preparation of CLWSC's trended original cost study.⁷¹ If there were reliable cost records for the installation of CLWSC's trended assets, those assets would not need trending. When the letter attached to CEWR's exceptions was written by Dr. Gebhard, he was advising the WSC Board on a completely separate matter unrelated to trending.⁷² The letter also makes it clear that Dr. Gebhard's letter was not to be construed as "a formal appraisal, a 'due diligence' study, nor a legal opinion."⁷³ Therefore, while water supply corporation to IOU accounting issues were highlighted, the letter was not conclusive on those issues.

Despite these facts, CEWR states that Dr. Gebhard's letter to WSC and testimony by CLWSC expert Palle Jensen shows "CLWSC knew about the possible accounting issues [regarding IOU v. water supply corporation differences and CIAC] and discounted its offer price to the WSC accordingly."⁷⁴ That is an unfair mis-characterization of evidence which actually indicates, as discussed previously in this reply, that there were a number of uncertainties and risks posed by WSC's

⁶⁸ Tr. 1458:1-15 (Thomas A. Hodge, April 19, 2012).

⁶⁹ CLWSC Ex. C, p. 27:17- 28:20.

⁷⁰ *Id.*

⁷¹ CLWSC Ex. D; CLWSC Ex. 7, at CLWSC000711. CLWSC reiterates that it and WSC jointly informed the TCEQ well in advance of this case that trending would be used in future CLWSC rate cases. CLWSC Ex. 3, at CLWSC 001032.

⁷² CLWSC Ex. 39.

⁷³ CLWSC Ex. 39, at CLWSC 000625.

⁷⁴ CEWR Exceptions, p. 8.

assets that led to the offered purchase price.⁷⁵ Unreliability of WSC records, which CEWR has no problem relying on for the \$13.78 million dollar CIAC figure repeated throughout its exceptions, represented part of those uncertainties and risk.⁷⁶ This also shows why purchase price, especially in a complicated purchase of a troubled water system, cannot be used as a substitute for asset valuation using the Water Code-prescribed original cost method. Market value of a system can vary from its assets' original cost, less depreciation, values for a variety of reasons.

CEWR also states that application of the good cause exception in this case would be arbitrary and that the "ALJs are arbitrarily using the good cause exception to avoid reaching a hard decision."⁷⁷ This desperate allegation directed at the ALJs is preposterous given the clear evidence presented by CLWSC, recognized in the PFD, as supporting the good cause exception: (1) inadequate records; (2) variations between WSC and IOU accounting and regulation; and (3) failure by the WSC, not CLWSC, to track specific assets as CIAC.⁷⁸ Without specific TCEQ rules on this issue governing WSC to IOU transactions, the PFD's case-specific recommendation should be adopted. In fact, making the type of rate base adjustments recommended by the ED and CEWR would be arbitrary in the absence of such rules.

All the options CEWR recommends the Commission consider to deal with this issue in opposition to the PFD recommendation are self-serving and lack merit.⁷⁹ For example, CLWSC has clearly met its burden of proof to show that it is entitled to a rate increase in this case and has put on reams of documentary evidence, in addition to testimony by qualified experts, toward that end. Yet one of CEWR's suggestions is to "find that CLWSC did not meet its burden of proof in justifying its

⁷⁵ Tr. 187:2– 192:17 (Palle Jensen, March 26, 2012) and Tr. 1318:9–1319:18, 1344:4–18 (Palle Jensen, April 19, 2012).

⁷⁶ *Id.*; see also CLWSC Ex. 3, at CLWSC 001032.

⁷⁷ CEWR Exceptions to PFD, p. 5.

⁷⁸ PFD, p. 54.

⁷⁹ CEWR Exceptions to PFD, p. 9-12.
CLWSC's Consolidated Reply to Exceptions to the Proposal for Decision and Proposed Order

rate application and deny the application completely.”⁸⁰ This would ostensibly be completely because of the CIAC issue which CLWSC inherited and attempted to deal with under existing regulations and regulatory practices which the other parties seek to reverse. There could not be a more unjust result if the Commission were to follow CEWR’s suggestion.⁸¹

In sum, CLWSC reiterates that no CIAC amounts exist within the pre-acquisition WSC assets now in CLWSC’s rate base. If the Commission determines there are such CIAC amounts, there is good cause to refrain from any adjustment CEWR suggests in its exceptions related to same.

IV. CLWSC’S REPLY TO ED ATTORNEY FEE ISSUE

The ED asserts that “[r]ate case expenses in a utility case should be treated differently than how attorneys’ fees are awarded” in every other legal proceeding in Texas in which attorneys’ fees are adjudicated. There is no basis for disregarding the settled rules of proof for determining attorneys’ fees.⁸² The TCEQ rules for contested case hearings state that the “Texas Rules of Civil Evidence, as applied in nonjury civil cases in the district courts of this state, shall be followed.”⁸³ All the cases cited by CLWSC in its exceptions and closing argument briefs show how all Texas courts deal with the issue of attorney’s fees and what constitutes credible and reliable evidence on that topic: testimony by an attorney expert. Why TCEQ rate case hearings are the sole exception to this settled rule has not been explained and has no legal basis. The ED’s avoidance of all Texas cases, together with his selective

⁸⁰ *Id.* at 12.

⁸¹ CEWR witness Nelisa Heddin was not qualified to testify in this case the first time around, so there is no need for a remand to allow her a second opportunity. 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.*

⁸² ED Exceptions to PFD, p. 15; PFD, p. 99-101.

⁸³ 30 TEX. ADMIN. CODE §80.127(a)(1).

reliance on an inapposite federal *Georgia Highway* case underscores how far out of step with Texas law the ED is on this issue.⁸⁴

The ED's sole exception to the PFD with respect to attorney fee issues relates to the ALJs' rejection of the ED proposed reduction for CLWSC having more than one attorney present at depositions and the hearing itself.⁸⁵ Sidestepping the fact that the ED practically always had more than one attorney at depositions and the hearing, the ED nevertheless requested an \$11,137 rate case expense disallowance based on such occurrences.⁸⁶ The ED does not seem to take issue with the PFD's rejection of his recommended disallowance, but requests a statement that the finding is "limited to the specific complicating facts of this case".⁸⁷ In fact, there should be a finding that there was no credible record evidence to support the disallowance and the ED's requested statement is unnecessary. However, CLWSC leaves this issue at the Commission's discretion so long as the ED's requested disallowance is rejected as the PFD recommends.

V. CLWSC'S REPLY TO ED'S FEDERAL INCOME TAX CALCULATION

If PFD figures are applied with the bad debt known and measurable adjustment reversal on PFD, p. 74, discussed by the ED in his exceptions, CLWSC concurs with the ED's tax calculation in Attachment B, p. 4 of his exceptions which results in \$709,845. CLWSC requests the Commission disregard the ED's tax calculation in Attachment C, p. 4 of his exceptions because it incorporates his negative acquisition adjustment the PFD correctly rejects.

CLWSC notes that the tax expense amount will require recalculation if other changes to PFD figures are adopted as CLWSC requests. Such recalculation might be agreed upon by the parties, but absent agreement, may require further legal proceedings.

⁸⁴ ED Exceptions to PFD, p. 16 (citing *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714, 717 (5th Cir. 1974)); PFD, p. 111-112.

⁸⁵ ED Exceptions to PFD, p. 15-17; PFD, p. 111-112.

⁸⁶ *Id.*

⁸⁷ *Id.*

VI. CLWSC'S REPLY TO ED'S RATE DESIGN CALCULATIONS

If PFD figures are applied, CLWSC generally concurs with the ED's rate design set forth in Attachment B, p. 2 of his exceptions using CLWSC's multi-tiered rate design structure proposed in its application for standard residential 5/8" x 3/4" meter-size connections. CLWSC requests the Commission disregard the ED's rate designs presented in his exception Attachment B, p. 1 incorporating a single block rate design and Attachment C, pp. 1 and 2 incorporating his negative acquisition adjustment the PFD correctly rejects. CLWSC concurs with the ED's statement that a multi-tiered rate design will encourage conservation.

CLWSC notes that the ED's rate design requires recalculation both to fix the rate base issue posed by the ED's correction exhibits, which still need to be factored into the equation, and to factor in other changes to PFD figures that should be adopted at CLWSC request as discussed in its exceptions. To recap the rate base error issue, in an effort to "match" the pre-acquisition trended assets to the book value, the ED's witness reduced *all* of the rate base assets — not just the pre-acquisition trended assets — with resulting errors in the rate base amount and flow through effects to return and depreciation, among others. While CLWSC still objects to the matching approach taken by the ED (and has filed Exceptions to that effect), CLWSC acknowledges that the ALJs have used the ED's approach for determining the value of pre-acquisition trended assets. Given that approach, CLWSC seeks to correct what the ED and the PFD acknowledge is an error in CLWSC's rate base.⁸⁸ The ED used a percentage reduction to facilitate "matching" the pre-acquisition trended assets to the book value, but mistakenly reduced *all* asset values, even on assets for which there is no arguable basis for reduction. In other words, there is no basis for reducing the value of CLWSC's assets that were *not trended* because their values are well documented and undisputed.⁸⁹ Nevertheless, that is what the

⁸⁸ ED Closing Arguments, at 29; PFD, p. 29-30.

⁸⁹ ED Closing Arguments, at 29.

ED mistakenly did. The aggregate effect of that error (and mistakenly removing the Startzville wastewater plant twice) is *\$1,059,247.00*.

In CLWSC's exceptions, CLWSC moved for Commission consideration of the ED's corrected exhibits before a final decision is made in this case.⁹⁰ CLWSC re-asserts the need to correct these ED exhibits. CLWSC also suggested that a limited reopening of the record to consider these exhibits might be appropriate, if the Commission deems necessary, given that the ED admits their record exhibits are wrong and the PFD bases recommendations on them anyway.⁹¹

CLWSC hopes the Commission will allow the parties the opportunity to confer on any rate design recalculations in line with the Commission's determinations before a final rate-setting order is issued. In the absence of agreement on the resulting calculations, further proceedings may be needed to accurately calculate the resulting rates.

CLWSC further requests that any adjustments be reflected in the monthly minimum charge (base rate) instead of CLWSC's multi-tiered gallonage charges. This will retain the conservation incentive created by those rates and simplify calculations for any necessary refunds or surcharges that may result in this case.

Despite CLWSC's general concurrence with the ED's Attachment B, p. 2 approach, there are a few problems that must be corrected before a final rate order is entered in this matter. As reflected in ED's Attachment B, p. 1, CLWSC's application rates noticed at the start of this process included rates at meter sizes larger than the standard residential 5/8" x 3/4" size up to 6", factoring in AWWA meter equivalency factors as multipliers.⁹² CLWSC also proposed and implemented, as part of both its noticed and agreed interim rates, multi-tier volume rates using consumption blocks at larger meter sizes that are different than the ones proposed for 5/8" x 3/4" meters in terms of the gallons included

⁹⁰ See CLWSC Exceptions to PFD, at 20-22.

⁹¹ The PFD does not accept CEWR's rate base methodology and, consequently no consideration or re-opener should apply for CEWR's post-hearing exhibits.

⁹² CLWSC Ex. 1, at CLWSC 000035-000039.

within each block.⁹³ The ED's Attachment B, p. 2 provides a multi-tier rate design that only sets forth a base rate for 5/8" x 3/4" meters and only uses the 5/8" x 3/4" meter Phase I volumetric rate tiers. As with any recalculations, to simplify the refund/surcharge process and effectively promote conservation, CLWSC would like the same multi-tiered rate structure applied as it proposed in its application.⁹⁴ CLWSC would also like the Commission to set base rates for CLWSC's larger meter size customers as appropriate.

Finally, there are other miscellaneous service fees and tariff provisions which were not challenged in this proceeding that must be incorporated into CLWSC's final set of rates and resulting tariff. Neither the ED nor the PFD address these issues, but the final Commission order must. CLWSC expected the ED to submit a complete set of rates with its exceptions filing, as CLWSC did in Exhibit A to its proposed findings of fact and conclusions of law, but the ED did not completely do so in line with the application as appropriate.

VII. CLWSC'S REPLY TO EFFECTIVE DATE AND SURCHARGE/REFUND ISSUES

CLWSC takes no further position on the effective date issue beyond its prior briefing. CLWSC expects that a surcharge, not a refund, will result in this case. CLWSC does not believe a follow-up filing regarding either should be required, as CEWR suggests. Clear direction in the Commission's final order as to how to calculate the differences would be appreciated.

The Commission's finally approved rate design can facilitate these calculations by keeping final gallonage charges based on volume static when compared to CLWSC's agreed interim rates, which are the same as its proposed Phase I rates. Differences between the proposed and finally approved monthly minimum charges, which are not based on volume, are much easier to determine.

⁹³ *Id.* There were also higher volumetric rates proposed as Phase II rates, but the Phase I structure is what has been in place as part of CLWSC's interim rates.

⁹⁴ The rate structure proposed in CLWSC's application was negotiated and agreed upon with its customers during its last rate case filed in 2008. *See* CLWSC Ex. 7.

CLWSC also notes that this case has been pending for several years, and its TCEQ-required regulatory assessment fee for its retail water service based on 1% of CLWSC's charges for that service (excluding certain miscellaneous fees) has come due three times.⁹⁵ CLWSC collects the 1% from its customers monthly per this TCEQ requirement and its tariff provisions. If the Commission requires surcharges or refunds, CLWSC requests clarification of whether an adjustment for the 1% regulatory assessment fee will be required. If CLWSC is required to repay any part of the 1% fee it has collected, CLWSC respectfully requests an off-setting reimbursement from TCEQ.

Finally, the ED comments on the possibility that customers may have left the CLWSC system during the pendency of this case, but it is unclear how the ED proposes CLWSC handle refunds in such instances.⁹⁶ If refunds/credits are ultimately required, CLWSC should only be required to provide same to current customers due to the cost and burden of tracking down prior customers. The final Commission order should clearly state what is expected under these circumstances.

VIII. CLWSC'S REPLY TO ED'S DISCUSSION OF SETTLEMENT AND 51% RULES

CLWSC's application did not "overreach" on its rates as the ED suggests in his exceptions. CLWSC followed the law and established TCEQ practices in proposing rates for a unique situation involving a WSC to IOU transfer. 30 TEX. ADMIN. CODE §291.28(8) states as follows: "A utility may not recover any rate case expenses if the increase in revenue generated by the just and reasonable rate determined by the commission after a contested case hearing is less than 51% of the increase in revenue that would have been generated by a utility's proposed rate." If CLWSC's revenue is properly calculated, the 51% rule does not bar recovery of rate case expenses.

To properly calculate CLWSC's revenue requirement for the 51% rule, the following corrections should be made: (1) CLWSC's 2.25% inter-company transfer should not be treated as debt

⁹⁵ 30 TEX. ADMIN. CODE §291.76 (describing regulatory assessment fees). Specifically, the regulatory assessment fee for years 2010, 2011, and 2012 have come due. The rule requires utilities to pay the 1% collected throughout the year by the end of January following each calendar year.

⁹⁶ ED Exceptions to PFD, p. 21-23.

in its capital structure; (2) rate of return using market-based data and capital attraction considerations should be used to set rate of return on equity; (3) original cost rather than booked cost should be used to set rate base; and (4) arbitrary expense disallowances which do not comport with Commission rules and the record evidence should be reversed. In some instances, correcting just one of these items would put CLWSC over the 51% threshold even using the ED's calculation. But even the ED's calculation is unfairly skewed against CLWSC in several important ways.

The Commission must use the proper starting point for the 51% comparison and properly apply the "matching principle," which is a basic accounting principle.⁹⁷ Under that principle, expenses are to be reported in the same period as revenues earned that are related to the expenses if there is a "cause-and-effect" relationship.⁹⁸ The "matching principle" is one of the cornerstones of the accrual basis of accounting and serves to determine the accounting period in which revenues and expenses are recognized.⁹⁹ For TCEQ IOU ratemaking, the accounting period used is the test year.¹⁰⁰

Here, the ED has ignored the matching principle in determining the starting point for the 51% calculation. The starting point should be CLWSC's test year revenues incurred in the same period as CLWSC's test year expenses which form the basis for CLWSC's revenue requirement. The ED adds \$18,000 in accrued, but unbilled revenues, to CLWSC's test year revenue amount even though those revenues were not collected until the following year.¹⁰¹ Yet, the ED makes no reduction for revenues accrued in the year immediately preceding the test year, collected during the test year, which are properly included in CLWSC's test year revenue amount of \$6,899,243.¹⁰² Consequently, this

⁹⁷ See "Accounting Tool" web site article on "Matching Principle": <http://www.accountingtools.com/matching-principle> (viewed January 21, 2013).

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ TEX. WATER CODE §13.002(22); 30 TEX. ADMIN. CODE. §§291.3(50) and 291.31.

¹⁰¹ ED Exhibit 9; CLWSC Ex. 52, line 21; CLWSC Ex. 51, p. 27b of 42, "Revenue", line 3; *see also* CLWSC Ex. C, p. 38:20-39:18.

¹⁰² *Id.*

disregard for the matching of revenues to CLWSC's expense period creates an over-inflated test year revenue number of \$6,917,243 as the starting point for the 51% calculation in the ED's exhibit.¹⁰³ The 51% calculation must use CLWSC's correct test year revenue of \$6,899,243 to properly apply the matching principle.

Another example of disregard for the matching principle relates to rate case expenses which affects the number used for the end point of the comparison. CLWSC's proposed rates were designed based on a revenue requirement figure of \$11,568,442, which is correctly noted in the ED's exhibit.¹⁰⁴ However, that figure incorporates \$57,250, which represents one-half of CLWSC's rate case expenses incurred in preparing and filing the application as test year expenses in line with the TCEQ application form.¹⁰⁵ The PFD follows the ED's recommendation to *remove* that amount from CLWSC's revenue requirement figure and include it in the rate case expense amount to be surcharged.¹⁰⁶ This improperly deflates CLWSC's revenue requirement for determining the difference between the approved revenue requirement and test year revenues, and further decreases CLWSC's opportunity to meet the 51% threshold. A matching methodology must be used to determine test year expenses. The first option would be to remove the \$57,250 of rate case expenses included in CLWSC's revenues generated by its proposed rates for a total of \$11,511,192 (\$11,568,442 - \$57,250) as the \$57,250 in rate case expenses is removed from the revenues generated by the PFD-based new rates. The second option would be to include ½ of all CLWSC rate case expenses in CLWSC's revenues generated by the PFD-based new rates as test year expenses for a total of \$9,609,050 (\$9,180,679 + (\$856,742/2)) while maintaining the CLWSC's revenues generated by its proposed rates of \$11,568,442.¹⁰⁷

¹⁰³ *Id.*

¹⁰⁴ ED Exhibit 9.

¹⁰⁵ CLWSC Ex. 1, Attachment 2, p. 36 of 42 (CLWSC 000110).

¹⁰⁶ PFD, p. 74.

¹⁰⁷ ED Exhibit 9.

Otherwise, the matching principle has not been followed and the calculation is skewed against CLWSC.

Another issue the Commission should consider is that the PFD improperly rounds down CLWSC's overall return figure. The ED's Exceptions to PFD Attachment B, p. 5 shows that the PFD recommends CLWSC's overall rate of return at 6.46%, but that this figure is rounded down from a properly calculated 6.47% overall rate of return if the PFD-recommended 10.88% rate of return on equity is applied.¹⁰⁸ The ED incorporated a 0.01% reduction solely to match the PFD.¹⁰⁹ If the PFD rate of return recommendations stand in other respects, this error must be corrected.¹¹⁰ Uncorrected, the error impacts the 51% calculation by lowering CLWSC's return amount and, consequently, its end revenue requirement amount.

In addition to these corrections, there is the other basic correction necessitated by the over \$1 million rate base error in the ED's uncorrected record exhibits discussed previously in this reply. The aggregate effect of that error (and mistakenly removing the Startzville wastewater plant twice) on CLWSC's rate base is **\$1,059,247.00**. Correcting the exhibits will increase CLWSC's return amount, among others, and will serve to eliminate this 51% rule issue completely.¹¹¹ Therefore, the ED's error is really a \$2 million dollar issue, rather than \$1 million, if the impact on both CLWSC's net plant and rate case expense recovery are considered. Removal of the 2.25% inter-company transfer funds from CLWSC's capital structure, among other PFD recommendation reversals, would also increase CLWSC's return and have a significant impact on the 51% rule calculation.

¹⁰⁸ Compare ED Exceptions, Attachment B, p. 5, with PFD, p. 79.

¹⁰⁹ *Id.*

¹¹⁰ CLWSC reiterates its request to recalculate its overall rate of return without using the 2.25% debt the PFD and ED include. Further, CLWSC reiterates its request to use a 12% rate of return on equity, but 10.88% should continue to be used if CLWSC's request is denied.

¹¹¹ See Exhibits A and B.
CLWSC's Consolidated Reply to Exceptions to the Proposal for Decision and Proposed Order

CLWSC has prepared its own calculations to show how the 51% rule calculation should be correctly applied with just the test year revenue, rate case expense, rounded rate of return, and ED rate base issues described above corrected, both with and without inclusion of ½ CLWSC's total rate case expenses factored into the exercise. *See* CLWSC's 51% Calculations attached as **Exhibits A and B**. Including ½ the rate case expenses, CLWSC receives 60.3% of the increase that would have been produced by its proposed rates.¹¹² Taking out the \$57,250 from the calculation, brings the recovery to 51.8%, and thus exceeds the 51% threshold.¹¹³ This shows how imperative it is that a correct and precise 51% calculation be performed by the Commission, if the 51% rule is applied. The ED's calculation is incorrect and cannot be relied upon in its current state.

In sum, the 51% rule calculation needs to be correctly and fairly applied, if at all, and the ED's corrected rate base exhibits need to be accepted and the increased return amount factored into CLWSC's revenue requirement for both rate design purposes and the 51% rule calculation. But CLWSC respectfully requests the Commission permit recovery of CLWSC's reasonable and necessary rate case expenses regardless of whether the correct 51% rule calculation cuts against CLWSC. If neither occur, an unlawful confiscatory rate order will result in this case.

IX. CLWSC'S REPLY TO ED'S PROPOSED ORDER REVISIONS

In the ED's exceptions, he presents suggested revisions to provisions of the ALJs' proposed order, including findings of fact and conclusions of law. CLWSC disagrees with all of them and requests that its proposed findings of fact and conclusions of law presented with its exceptions be used instead as previously requested.

There is one exception. CLWSC concurs with a change the ED suggests to finding of fact # 110, with a slight modification, as follows: "CLWSC's audited books include approximately \$3.2

¹¹² Exhibit B.

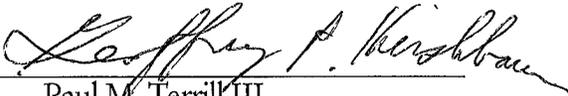
¹¹³ Exhibit A.

million in costs that represent an amount paid in a transaction to acquire a large CCN area from Bulverde.”¹¹⁴ The reference to Bexar Met should be excluded.

X. 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 to its exceptions as Exhibit A with the correction noted herein, 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,
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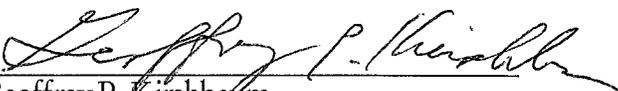
**ATTORNEYS FOR APPLICANT SJWTX,
INC. d/b/a CANYON LAKE WATER
SERVICE COMPANY**

¹¹⁴ CLWSC Ex. 51, p. 2a of 42.

CERTIFICATE OF SERVICE

I hereby certify that on January 22, 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 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

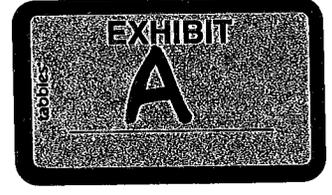
CLWSC's 51% Calculations

Corrected Rate Base and Corrected Rate of Return

Per PFD	
Revenues Generated by PFD Rates with corrected rate base and corrected rate of return calculations	\$9,286,976 ¹
Revenues Generated by Current Rates	\$6,899,243
Difference or Increase Recommended	\$2,387,733
As Requested	
Revenues Generated by Proposed Rates Adjusted for Rate Case Costs	\$11,511,192 ²
Revenues Generated by Current Rates	\$6,899,243
Difference of Increase Proposed	\$4,611,949
Percent Difference	51.8%

1 Includes \$100,450 (additional revenue earned with the inclusion of the \$1,059,247 in rate base) and \$5,847 (additional revenue from the corrected rate of return of 6.47%)

2 Removes the \$57,250 in expenses from the revenues generated by the rates proposed as they are removed from the revenues generated by the PFD rates



CLWSC's 51% Calculations

Include Approved Rate Case Expenses per the Matching Principle and Apply Corrected Rate Base and Rate of Return

Per PFD	
Revenues Generated by New Rates	\$9,715,347
Revenues Generated by Current Rates	\$6,899,243
Difference or Increase Recommended	\$2,816,104
 As Requested	
Revenues Generated by Proposed Rates Adjusted for Rate Case Costs	\$11,568,442
Revenues Generated by Current Rates	\$6,899,243
Difference of Increase Proposed	\$4,669,199
Percent Difference	60.3%

1 Includes \$100,450 (additional revenue earned with the inclusion of the \$1,059,247 in rate base), \$5,847 (additional revenue from the corrected rate of return of 6.47%), and \$428,371 (one-half of the approved rate case expenses for CLWSC)

