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

APPLICATION OF THE SJWTX, INC. DBA CANYON LAKE WATER SERVICE COMPANY TO CHANGE WATER RATES; CERTIFICATE OF CONVENIENCE AND NECESSITY NO. 10692; IN COMAL AND BLANCO COUNTIES	§ § § § § § § §	BEFORE THE TEXAS COMMISSION ON ENVIRONMENTAL QUALITY

THE EXECUTIVE DIRECTOR'S RESPONSE TO CLWSC'S EXCEPTIONS

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

Comes now, the Executive Director (ED) of the Texas Commission on Environmental Quality (TCEQ or Commission), and files The Executive Director's Response to CLWSC's exceptions. While the ED does not agree with all the positions taken in the Coalition for Equitable Water Rates' (CEWR's) Exceptions, the ED found no disagreement merited filing a response to CEWR's exceptions.

TABLE OF CONTENTS

I. BRIEF FACTUAL AND ISSUE BACKGROUND

There are an extraordinary amount of complicated issues and facts in the case. The PFD lays out all of the facts necessary to describe the procedural and factual history. However, in order to lend focus to the ED's position, the following is a brief cursory discussion of the key facts and issues in this case.

THE STM. The most central issues arise from Canyon Lake Water Supply Corporation's (CLWSC) purchase of a Water Supply Corporation (the former members of which are the protestants in this case). The purchase price is established by the Sales, Transfer, and Merger Application (STM), which reveals that the utility paid $26,497,000 for the assets of the WSC. The net book value of the assets purchased, which was based on audited financial statements of the WSC, was $31,221,457.[1] The 4.7 million dollar difference is a bargain price paid by the utility. Many of the assets in the transaction had insufficient documentation or no documentation to establish their original cost. After CLWSC completed the STM and before the present case was filed, CLWSC filed two other rate applications. Both were settled. In those applications, CLWSC used the figures on its books (reflected by the 31.2 million dollar number rather than the 26.5 million dollar number) for determining its annual depreciation and invested capital. Both cases settled without ever litigating the reasonableness of any of the expenses or of whether the 31.2 or 26.5 number was appropriate. After the last settled case, the ED and CLWSC agreed that CLWSC would perform a trending study to make certain of the rate base.[2] The parties had different interpretations of what that agreement meant. The ED understood the trending study was to be used to get a more accurate list of assets and to reveal whether the booked costs that the utility was using in its applications were accurate. There was some question about their accuracy because of lack of invoices and because the purchase price was much lower than the value of the assets obtained by CLWSC. Contrary to the ED's understanding, CLWSC understood that the trending study was to replace the booked costs. The result of the trending study

[1] CLWSC Ex. 3, p. 5 of 22 Bates 001031. Tr. p. 130 l. 20 – p. 131 l. 6
[2] "Trending" is a method of estimating original cost by inspection of the assets and reference to industry manuals and is used when it becomes necessary to estimate original costs.

created another increase in addition to the difference between the price paid and the net book value of what it received. Specifically it added another $3.5 million dollars to the already inflated net book value.[3] This means that CLWSC was now seeking a return and annual depreciation on assets having CLWSC's estimate of original cost at 4.7 million dollars PLUS 3.5 MILLION DOLLARS MORE -- for a total of approximately $8,200,000.00 more -- than what it actually paid for the assets it was depreciating.[4]

Capital Structure and Rate of Return. When determining a rate of return, the TCEQ rules employ a risk premium analysis, memorialized and made transparent with a worksheet that identifies each adjustment to the Baa bond rate average for public utilities. This worksheet has been accepted by the Commission in every case where the ED has argued for its use.[5] The worksheet sets the rate of return that the utility should earn on its equity, -- capital that is not financed by loans. The TCEQ realizes that a utility may need to raise some of its capital through loans. Therefore, the capital in the rate base of the utility is divided among which portions are financed and which portions are equity. The interest rate on the financed capital and the equity are then weighted and averaged. As the utility gets more and more of its capital into the equity category, it will get a larger portion of its return in the form of profit rather than in the form of servicing debt. The rate of return must be sufficient to allow the utility to attract capital. The method by which CLWSC obtains capital is not by going to banks or investors to get loans. It raises its capital by using the credit of its affiliate. As revealed by the weighted cost of capital calculations and testimony, the utility raised its capital through its affiliate at rates ranging from 2.5% to 6.5%. The utility argues that it should get a 12% rate of return on assets obtained with the 2.5% loans because they are "short term" even though the testimony revealed that the loans financed capital improvements.[6]

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[3] Tr. p. 807 l. 1-13

[4] Given the magnitude of that over-reaching, the operation of the 51% rule (explained below) became likely.

[5] The worksheet begins with the Baa bond rating and then lists factors that can adjust that rate upwards for factors that relate to the financial condition of the utility and factors laid out in TWC 13.184. Before the ED began using the worksheet, the practice involved an unwritten rule that allowed utilities to collect a 12% rate of return on equity. This is no longer the case.

[6] Tr. p. 160 l. 2-10. Jensen testifies that the low interest loans from SJW to CLWSC were "Necessary to make improvements, the capital investment. And improvements on the system." At Tr. p. 1323 l.14- 18,

Rate Case Expenses. This case cleared up an issue left hazy in past rate cases and also brings the Commission's 51% rule into consideration. In the *TLU* case[7] the PFD found that the ED's rate consultant could not give credible testimony on attorney's fees because she did not state that she relied on an attorney in making those recommendations and because she was not shown to have any experience in analyzing attorneys' fees.[8] In this case, the expert did rely on an attorney and did have twenty years of experience in which she analyzed 100s of attorney's fees invoices, participated with attorneys in all phases of contested rate cases, and gave testimony on those invoices and whether they should be included in rate case expenses that was accepted in past cases. More important, the ED's practice has always been to use rate consultants for such testimony and such testimony had been accepted by the Commission before. Additionally, there was confusion over whether attorneys' fees in a rate case should be given the same treatment as they are given in deciding whether a deceptive trade practices victim could recover attorney's fees.[9] While the difference between the culpability of a deceptive trade practices defendant and a water consumer should be obvious, this PFD pointed out that the correct cases to analyze are utility cases. The utility cases do not require attorney testimony and require instead, only that the commission articulate its policy when it decreases rate case expense and the policy must be rational. In fact, attorney testimony was not required in any of the appellate utility cases referenced in the PFD and the ED's closing arguments.

Another issue arising under rate case expenses is the 51% rule. When rule 291.28(8) was promulgated, the Commission's preamble provided that the rule was designed to respond to recurring customer complaints that utilities were overreaching in their

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Jensen testified that short term debt has to be zeroed out every one or two years. Yet he also testified that the 2.5% loans have never been repaid. P. 216 l. 13 –23. Further evidence that clarifies this point is found in ED-DL 19, CLWSC's financial statements, Bates CLWSC404691, CLWSC404684-CLWSC404685, "Intercompany notes payable" lines.

[7] Application of Texas Landing Utilities to change Water and Sewer Rates TCEQ Docket No. 2007-1867-UCR; SOAH Docket No. 582-08-1023, on remand

[8] The ED still maintains that such evidence was provided, but the PFD found otherwise in TLU. On this case, as will be shown below, it was absolutely clear that both of the TLU hurdles were cleared.

[9] CLWSC continued to cite to deceptive trade practice cases, election contest cases, contract cases, divorce cases, and the like and attempts to apply the law on the recovery of attorneys' fees in those types of cases rather than utility cases where the general public may be required to pay attorney's fees rather than a defendant in a law suit.

applications, and then using the specter of a large rate case expense surcharge to obtain a favorable settlement. Specifically, the Commission has written the following:

> "Additionally, the commission adopts the addition of 291.28(7) – (9) to establish criteria by which the commission can determine the amount of reasonable and just rate case expense recovery allowed a utility based upon concerns about rate case expenses expressed by utility customers. Utility customers have expressed concern over the possibility that utilities may have an incentive to overreach in their applications if utilities believe that the customers will ultimately bear all rate case expenses. The purpose of this rule change is to set out clearly certain instances when, as a matter of law, rate case expenses will be considered unreasonable, unnecessary, and against the public interest. In particular, two rules are adopted where rate case expenses will be disallowed as a matter of law [Sections 291.28(8), the 51% rule – and section 291.28(9), the settlement rule].... Section 291.28(7) was also added to make clear that all rate case expenses will be evaluated to see if they are reasonable, necessary, and in the public interest on a case-by-case basis. Therefore, even if the criteria outlined in the new 291.28(8) or (9) are not met, the commission may still disallow all or a portion of rate case expenses in its discretion if they are not found to be reasonable, necessary, and in the public interest."[10]

This case includes all the signposts that would indicate that the practice the rule was designed to deter may be in play.

II. <u>OVERVIEW</u>

Before addressing with particularity CLWSC's exceptions, the ED will generally discuss the posture of the entire case. There are so many issues and estimations in the case that a broad general overview of the competing theories is necessary to ensure that a just result is obtained and the legislature's declared policy that rates be "just and fair to utilities and customers" is achieved and not lost in the confusion.

The true "gold standard" for rate making, in general, was enunciated by the Legislature itself in Section 13.001 of the Texas Water Code, entitled, "Legislative Policy and Purpose." Specifically, TWC 13.001(c) provides as follows: "The purpose of this chapter is to establish a comprehensive regulatory system that is adequate to the task of regulating retail public utilities to assure rates, operations, and services that are **just**

[10] 31 Tex. Reg. 8107 (September 22, 2006)

and reasonable to the consumers and to the retail public utilities" (emphasis added). CLWSC's exceptions only focus on protecting the financial integrity of the utility and to give the utility a fair rate – CLWSC never discusses the rate result with regard to the customers. This is the most essential part of that gold standard. The legislature did not design a method of assuring that the state's residents get a continuous, adequate, and safe supply of water in order to create an opportunity for unlimited profits by out-of-state corporations. These statutes were designed to give an opportunity for a fair and equitable return to businesses investing in Texas water infrastructure while producing a fair price to consumers. Water is essential to life and demand for it largely inelastic, therefore fastidious and complete analysis should be applied to ensure that the public is paying a fair price for the water and not financing a windfall for the private enterprise.

CLWSC manipulates many numbers in its application which could create the impression that the PFD leaves the utility in a financial hardship. This is entirely untrue. The most important facts to remember and issues to remember as considering the PFD are listed below.

A. How CLWSC raises capital. The utility gets its debt funded capital at rates of 2.5 to 6.5% and it would give the utility a windfall to allow it to collect 10.88% on that same capital from its captive audience of customers residing in its CCN. If all capital funding, including the 2.5%, is not acknowledged in the weighted average rate of return, CLWSC will receive a windfall from its customers.

B. The difference between what the utility paid for the assets and what the customers will pay for in rates. The utility purchased a net book value of 31.2 million dollars' worth of assets for a 4.7 million dollar discount. The discounted purchase price was paid to the customers and CLWSC wants to charge those same customers depreciation and return for the discount. Adding insult to injury, CLWSC sought to use the trending study to increase that difference by another 3.5 million dollars.

The PFD and the ED's recommendation allow the utility to collect 31.2 million dollars in annual depreciation on assets it purchased for 26.5 million dollars -- in other words, collect depreciation expense for these assets from the customers at millions more than those assets actually cost.

The PFD went even farther and allowed the utility to collect a return on this phantom investment because it decided that no adjustments to rate base would be made for CIAC or the Acquisition Adjustment. The PFD concludes that past cases seem to provide a regulatory basis for negative acquisition adjustments applied to rate bases. Furthermore, the PFD concludes that the ED's use of the negative acquisition adjustment to remove cost free capital from rate base is reasonable, and cost free capital must be removed from rate base unless good cause is shown for NOT removing it.

C. The pragmatic effect of the various recommendations on CLWSC's financial condition. Both CLWSC's expert's testimony at trial and CLWSC's arguments and exceptions attempt to estimate what actual dollar return would be realized by the utility using various rates to illustrate that the utility would not be making money and would not be capable of raising capital. The approach is flawed because CLWSC and its expert ignore the difference between utility rate base and actual dollars invested, which is where an investor will look at return. . This approach ignores actual income and balance sheet information, and ultimately, actual flow of dollars through the utility and its bottom line profitability before taxes (which is the number any investor would be interested in rather than what theoretical rate base return could be derived). In closing arguments the ED's expert reviewed the record and analyzed the evidence to reveal what return would be generated by the utility's rate and capital structure and then compared it with what would be generated with the ED's rate and capital structure. The results were included in the ED's closing arguments. Here is a copy of that chart:

Chart 1 - Comparison of Return on Balance Sheet Equity

	A	B	C	D		E	F
1	Capitalization	Shareholder Equity	Long term Debt (6.5%)[11]	Total Capitalization		Return on Stockholder Equity per Balance Sheet)	Return on Rate Base Equity recommended
2	Per Balance Sheet[12]	$11,469,287	$15,971,401	$27,440,688			
		Return Dollars	Interest Expense	Equity Return Dollars (A-B)			
3	CLWSC Return Dollars or Interest Expense	$ 3,597,686[13]	$1,038,141[14]	$2,559,727 (B-C)		22.3%[15]	12%
4	Executive Director Return Dollars or Interest Expense	$2,161,660[16]	$1,038,141	$1,123,519 (B-C)		9.80%[17]	9.88%

The PFD recommends 10.88 percent return on equity and uses the capital structure recommended by the ED, so the return in actual dollars should be slightly higher than that in the ED's recommendation reflected in the chart. Canyon Lake's proposed rate of return and capital structure generates an actual cash return of 22.3%. A 22.3% return on equity is exorbitant and disallowed by statute and far beyond the constitutional requirements of *Hope* and *Bluefield*. If anything would be confiscatory, it would be making the customers finance a 22.3% rate of return, much of it based on financial fictions relating to capital that the customers already had paid for, but for which there were incomplete records. As shown on the chart, CLWSC would make a fine actual return on its investment under either the ED's (9.80%) or the PFD's (more than

[11] Ex CLWSC 1, Bates 00017; The ED has used the higher interest rate for long term debt cost for this calculation which actually serves to produce a lower rate of return to be conservative. The alternative would be weighting between 6.27% and 6.5%.
[12] ED DL Ex 19, CLWSC404691, CLWSC financial balance sheet
[13] Ex CLWSC Corrections Packet 1, Bates CLWSC 002088.
[14] Total long term debt of $15,971,401 times interest rate of 6.5%
[15] Chart 1 (this chart), D-3 divided by B-2
[16] Closing Arguments Attachment D, Ex ED DL 5 revised, page 1 of 3, schedule 1-Revenue Requirement
[17] Chart 1 (this chart), D-4 divided by B-2

9.80%) rates and capital structure. Rate base is used for regulatory purposes and includes adjustments that relate to policy and do not equate to a review of the balance sheet and income statement and a company's actual financial situation. One cannot ignore financial statements when reviewing overall rates. The balance sheet and income statement reflect the real flow of dollars through the utility, which is what matters when it comes to investment.

D. The Hope Case. CLWSC cites the following federal authority, which actually would support adopting the PFD. The quote is from a 1944 U.S. Supreme court case.[18] It reads 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 the theory, but the impact of the rate order that counts."[19]

The *Hope* standard is quite useful in this case. The overall effect of CLWSC's proposed rate would be unjust. Because of the history of how this CLWSC was formed and the lack of records, the rate determination required a myriad of estimations. CLWSC decided that it would estimate original cost using a trending study because there were no records to show the original cost for many assets it bought from the WSC. Interestingly, the trending study increased the difference between the price CLWSC paid and the booked costs by another 3.5 million dollars (total increase 8.2 million dollars). Furthermore CLWSC asked for annual depreciation on all of these millions in order to recover many millions of dollars more than it actually spent. Moreover, it is fundamentally unfair to approve a rate that includes inflated estimations for original cost from incomplete records (in the face of the lower price) and then to make no estimate at all for CIAC. The impact of a rate that makes the customers subsidize a windfall to the utility and gives the

[18] *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591 (1944)
[19] *Id.* at 602

utility a return on an investment it never made, and makes the customers pay a second time for assets they already paid for is not a "just and reasonable" result.

CEWR contended that there were ways to estimate the value of CIAC and furthermore that the difference between the purchase price and the net book value of the transferred assets revealed that there had to be contributed capital transferred. CEWR pointed out that the customers will be paying for the same assets a second time and giving the utility a return on assets they already paid for. The customers argued that not only would the utility be getting a return and annual depreciation on cost free capital from them, but they also would have been the involuntary donors of that the cost free capital.

While the lack of detailed records did not stop CLWSC from estimating its original costs, CLWSC made no attempt to estimate the value of CIAC, but argued that if there are insufficient records, CIAC should not be included. Under that analysis, the original costs for those assets should not be included either.

The ED submits that a negative acquisition adjustment would be one method of estimating and capturing CIAC. The ED used the value recorded in CLWSC's own books. CLWSC, in its own books, calculated what the acquisition adjustment would be in order to account or the large amount of assets added to the books without a correspondingly high price paid. This account included offsets from positive acquisition adjustments relating to other systems CLWSC purchased. The ED gave the utility the benefit of the doubt on the positive acquisition adjustments and assumed that the value in the account was the proper amount for an acquisition adjustment to be applied in this case, even though it had been decreased by the positive acquisition adjustments. These estimation methods and the lack of clarity in the records reveal that estimates and adjustments need to be made to assure that a reasonable rate is determined per *Hope*. Infinite, amorphous, and endless hairsplitting could end up calculating an unfair rate. The PFD largely derives what the ED contends is a very fair rate. The ED's rate of return and the PFD's rate of return are very close to the rate that the utility's affiliate was awarded in California.[20] The inclusion of the 2.5% loans in the weighted cost of capital in both

[20] The rate of return on equity for the affiliate of CLWSC that provides water service in California, San Jose Water (SJW), was 10.2%.[20] In a settlement, CLWSC agreed to a return on equity of 9.99%.[20] The

designs also makes the return in real dollars much closer to the return derived when using rate base than that of CLWSC which excludes the 2.5% loans.[21] Certainly a rate that gives the utility a real return of over 22% is not reasonable.

E. The Schedule of Assets. The ED exceptions include mathematical calculations that were derived from the admitted evidence in order to comply with the requests in the PFD and to give the Commission alternative methods of using the evidence to arrive at a rate. The ED offered a similar mathematical reorganization of the asset list in closing arguments. CLWSC's trending study identified with particularity all of the assets it claimed were used and useful to the utility. The ED used this list of assets to create an inventory for tracking these assets through their service lives.

The ED's list of assets attached to the closing argument offered an alternative method of distributing original cost estimates amongst the assets if the utility to that of what was offered at trial. Because the ED used booked costs for the trended assets rather than trended costs, the ED could not include in the depreciation schedule the same original cost amounts as found in the trending study offered by the applicant. The difference between the trended costs and the booked costs for the trended assets (hereinafter the "difference") had to be accounted for in the ED's schedule of assets. Therefore, at trial, the ED took the difference between the total booked costs and trended costs and applied the resulting ratio to all of the capital asset costs in the schedule that the utility made in its trending study.

At trial, an exhibit that took this approach to how math should apply to the difference was offered (KA-2). The exhibit also did remove the Startzville plant twice, as alleged by CLWSC. The effect of that over-inclusion is less than a single percent.[22] In

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ED's recommended rate of return on equity (9.88%) is quite close to those numbers. The PFD's recommended rate of 10.88% is higher than both.

[21] The chart listed above shows that the ED's rate applied to rate base gives a 9.8% return and the real dollar return would be 9.80. On the other hand, using CLWSC's capital structure and rate base ends up with the return being 12% when applied to rate base and 22.3% when applied to the real world.

[22] In ED's pre-filed testimony, staff made an adjustment to annual depreciation, accumulated depreciation, and net book value by using a 5.14% factor throughout all assets (Exhibit ED-KA-6 Revised). That 5.14% was calculated using the difference between the trended original costs ($71,911,062) claimed by CLWSC and the total original costs ($68,775,390) as per CLWSC's books. Total removal of Startzville Station wastewater treatment plant would total to $401,133. That total amount constitutes approximately 0.56% of the original claimed costs of $71,911,062 ((401133/71911062)*100%) or 0.58% ((401133/68775390)*100%) of the booked original costs.

closing argument the ED offered a schedule that deleted the double-entry and allocated the difference only to the trended assets rather than to all the assets. The ED offered the chart revealing these calculations in closing arguments and contended that these were adjustments to existing evidence and not new evidence.

CLWSC argued that the ED's chart offered in closing was new evidence in its reply to closing. The PFD agreed with the CLWSC's objection to list that included (1) the new allocation of the difference and (2) the correction of the double entry of the Startzville plant deduction. Consequently, the PFD used the list offered at trial instead.

While the ED still supports using the exhibit offered at closing, there is a policy basis to use the exhibit offered at trial as the PFD did. This is because of the *Hope* consideration that the overall effect of the rate is the guiding star to ratemaking. Because the PFD includes CIAC and cost free capital in the rate base and because the PFD and the ED's recommendation both allow the utility to collect $4.7 million more in annual depreciation than it actually spent for those assets, and because the rate base and annual depreciation figures are already based largely on estimations -- it is justifiable to spread the impact of the over-collection of depreciation and return by using the difference as a proxy to decrease all annual depreciation rather than limit it to the older assets purchased from the WSC. Therefore, the *Hope* case relied on by CLWSC actually gives good support to adopting the PFD. The uncertainties and estimations that abound in this case would make complete and total perfection in estimating every number with absolute certainty impossible. Absolute precision is impossible in this case and the case has already been extremely lengthy and expensive. Approval of the rate in the PFD would have a just and reasonable impact when viewed in its entirety. That is consistent with the reasoning of the U.S. Supreme Court.

If removal of the Startzville plant is a necessary adjustment, the ED can arrive at those figures at agenda, and provide the appropriate rate design.

III. Response to Details Raised in CLWSC's Exceptions

The PFD is sufficient to refute all the exceptions raised by CLWSC, and the ED supports nearly all of the PFD. To refute every bit of CLWSC's misanalysis and distinguish and explain the inapplicability found in many of the myriad of citations included in CLWSC's exceptions would create confusion rather than clarity. Therefore, the ED will focus on the points raised in the exceptions that are most important. Furthermore, the ED incorporates its closing arguments in this reply to exceptions and would refer the Commission to those and to the PFD and CEWR's arguments should there be concern over an issue not discussed at length herein. This discussion will generally follow the order in which CLWSC presented its exceptions.

Reply to exceptions in CLWSC's overview. CLWSC contends "customers have been receiving water at rates substantially below the utility's cost of service" and that "CLWSC's last two rate increases were voluntarily limited by CLWSC to prevent rate shock."[23] CLWSC's theme that it was charging rates that were less than its cost of service is not persuasive. The only supporting evidence is simply self-serving testimony from interested witnesses. The final orders in those last two rate increases were never adjudicated and therefore the allowable expenses and invested capital were never verified.[24] In fact, the evidence shows that the utility used the "booked costs" in both of those applications,[25] which would indicate that the utility was collecting more in annual depreciation on assets than it paid for them and that it was getting a return on a rate base calculated with an original cost that was $4.7 million more than it actually invested. So in terms of actual dollars, both those previous applications were based on costs higher than actual costs reflected in the actual $26.5 million purchase price. Furthermore, the evidence shows that CLWSC was collecting enough in revenues to

[23] CLWSC's Exceptions P.2. While this may sound magnanimous, the concern over rate shock must have been short-lived as this case asked for a very large increase in rates.
[24] Tr. p. 1345 l 24 – p. 1346 l. 9.
[25] Tr. p. 429 l. 3-6

cover all of its operating expenses, exclusive of the cost of debt.[26] Finally, CLWSC applied for a rate base determination in the earlier application using the booked costs as original costs.[27]

CLWSC also stated that "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 capital."[28] To allow the Applicant to get a return on the trended values and ignoring the acquisition adjustment would involve a two-step ballooning that results in the customers paying the utility a return on millions of dollars it never invested. CLWSC argues that at the time of the purchase of the assets from the WSC it didn't know how much it might have to invest in the future and, therefore, this means that it should get as big a rate base as it wants. This is not reasonable. The new investments of CLWSC are included in its application now and cannot go into the past and increase what they paid for the system or decrease the net book value of the system that was received at the time of sale. All the advocacy in the world cannot hide the fact that that the utility is seeking a return on an investment it never made, which violates the fundamental principle of ratemaking that rates be fair to the customers and the utilities. It also violates the theme of *Bluefield* that a regulatory authority must set the return of a utility in a way that approximates what would be needed in the private market place to attract capital. *Bluefield* does not state that a regulatory authority must allow any return requested and give a utility a windfall, as such goes beyond giving the utility a return it could expect in a similarly risky enterprise.[29]

CLWSC also argues that the "Commission must consider the long term implications that its decisions will have on attracting the capital necessary to provide safe drinking water to Texans. The Commission and the ED are aware of the need for utilities to attract capital. The PFD allows the utility to get a 10.88% rate of return on equity – more than the utility's affiliate operations agreed to in California. Additionally, the PFD allows the utility to collect 4.7 million dollars in depreciation more than it

[26] Tr. p. 414 l. 1-25
[27] Tr. p. 83 l. 15- l. 23
[28] CLWSC's exceptions p.2
[29] *Bluefield Waterworks & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-693 (1923).[29]

actually spent for the trended assets. Moreover, the PFD gives the utility a return on 4.7 million dollars more than it invested. Finally, if the ED's negative acquisition adjustment is approved in the final Commission order (it was rejected in the PFD), the utility will still be getting the benefit of positive acquisition adjustments that have offset the large negative acquisition adjustment that are reflected in CLWSC's acquisition adjustment account.

The ED contends that under the PFD the customers are paying a fair rate that will generate a healthy return for the utility and that the excess depreciation expense and rate base allowed in the PFD are sufficiently adequate to reward the utility for its efforts and investment. Ratemaking is based on the principles of being fair to the utilities and the customers, but also must be tied to empirical numbers. A vague idea that, "we did a lot for you, so now our estimation techniques are above question" is not an appropriate legal standard by which rates should be set. The original cost of those uncertain future investments is now quantified and represented in the asset list and in the loans for capital improvements in CLWSC's current application. The PFD and the ED's recommendation allow recovery of all of these previously uncertain investment amounts. CLWSC is getting recompensed for their entire investment.

CLWSC made a similar statement in its closing argument that illustrates this threat of no more investment. Specifically, it argued, "[to deny CLWSC's request] would be unjust, confiscatory, and would discourage future investment in Texas IOUs by anyone. Such a result would leave hundreds of thousands throughout the state who rely on IOUs without a safe and reliable water supply." While powerfully worded, the converse is an equally powerfully worded statement. Specifically, it would be unjust and confiscatory to make the customers pay the utility a windfall return on an investment it never made and would encourage IOUs to make those same hundreds of thousands of Texans pay for windfalls to out-of-state corporations. These large profits will not be rolled into more improvements. The improvements are all already included in the rates.

A. Reply to CLWSC's exceptions on Rate of Return and Capital Structure. CLWSC refers to the rate of return worksheet as "fundamentally flawed." Broad, argumentative characterizations do not make the generalizations true, even if they poetically alliterate. The rate of return worksheet has been approved by the

Commission numerous times, and the days of the "default 12% rate" are over (just as the days of 5% passbook savings and 10% CDs are gone). If anything is fundamentally flawed it is the idea that all utilities should get the same 12% or that a rate analysis need not consider the Texas statutory factors. If CLWSC's rate of return on equity is set at 12% and its actual cash returns come to 22.3%, there is a confiscatory rate that violates TWC 13.184(a).[30] Furthermore, it would violate the principle enunciated in both the seminal Supreme Court Cases. *Bluefield* held that the rate should only be what is necessary to attract capital and *Hope* held that the overall effect of the rate is to be considered. To approve CLWSC's suggested rate would be unlawful and confiscate the funds of the people who need to consume water in CLWSC's service area.

The rate of return worksheet is a risk premium analysis that lists the considerations to adjust the premium and the weight to be given each consideration. It specifically includes factors necessary to meet the federal standards (economic health and ability to attract capital), and the Texas Standards outlined in TWC §13.184(b).[31] CLWSC claims that the worksheet has no place where it takes into consideration the *Bluefield* requirement that it be based on rates charged in similar industries. This is patently false. The worksheet begins with the Baa bond rating average, which is the exact same place that its expert started.

CLWSC is correct when it states that *Bluefield* requires a rate of return to be high enough for a utility to attract capital on the same terms as similarly risky enterprises. However, it must also be remembered that *Bluefield* stated that the utility has no right to windfalls. There are two fundamental problems with the testimony CLWSC offered to support its return on equity request. First, neither Mr. Loy nor Mr. Scheig addressed the additional statutory factors on what needs to be considered in determining a rate of return[32] while Ms. Loockerman did through use of the rate of return worksheet. While CLWSC argues that the Supreme Court case trumps the state statute, there is nothing to

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

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

[32] Loy admitted that he did not consider the statutory factors at Tr. p. 569 l.6-12. Scheig admitted he did not consider the statutory factors at Tr. p.892 l.11 – p. 893 l.8

trump. There are no inconsistencies. All of the adjustments made by the worksheet to the rate of return were upward adjustments, giving CLWSC a higher rate of return than the Moody's Baa bond average that all parties agree is a good starting point.[33] The fact that one set of testimony addresses both the *Bluefield* factors and the statutory factors and the other set only addresses the *Bluefield* factors leads to the conclusion that one set of expert analysis (the ED's) is complete and the other incomplete (CLWSC's).

The second crucial problem with CLWSC's approach is that it used the wrong numbers when determining what dollar return would be collected by the utility if CLWSC's proposed return on equity were approved. CLWSC states on page 27 of its closing argument that "the cost of capital is the expected rate of return that market participants require in order to attract funds for a particular investment." The profit they can expect comes from the cash flows revealed by the balance sheet and income statement, not by "rate base," which is designed for determining fair rates and does not necessarily reflect cash flows. The balance sheet and income statements show the profits of the company. As outlined in the ED's original closing argument, Mr. Scheig estimated the return dollars investors could expect by using rate base. But when numbers are used from the balance sheet and income statement, it becomes clear that CLWSC's proposed rate of return would generate an excessive return which is outlawed by TWC § 13.184(b) and not part of any *Bluefield* requirement. The calculations show that CLWSC's requested rate of return would give a return on stockholder equity per balance sheet of 22.3%.[34] No doubt that would attract a lot of investment, but at a rate that is excessive and therefore disallowed under TWC § 13.184(a).

Following *Hope's* standard of looking at the overall impact of the rate decision; the worksheet is given further support. The PFD analyzed the worksheets submitted by CLWSC with Tom Hodge's testimony and the ED's worksheet and arrived at a rate of return of 10.88 percent. The utility's affiliate agreed to a rate of 9.99% in California. In the *Southern Water* rate case, the ED's expert used a worksheet that arrived at a rate very similar to one determined by an expert with similar qualification to Mr. Scheig, and without having to pay the expert tens of thousands of dollars. The fact that the worksheet analysis (which followed the risk premium method) had a checklist while

[33] Pre-filed testimony of Gregory E. Scheig p. 26 l. 1-2. Tr. p 894 l. 15-19.
[34] The Executive Director's Closing Argument page 9

CLWSC's testimony does not have a checklist on a chart does not make it less useful. It is, in fact, more useful because it transparently shows what each adjustment will be and makes the calculations easier which keeps rate case expenses down.

In *Southern Water*[35], the ED argued as follows:

> [T]he City recommends a rate of 9.45% for both water and sewer. While the testimony is exemplary in its analysis, the ED's instructions make it clear that the rate of return should be calculated based on the worksheet that is provided with the application. The ED believes it would set a bad and expensive precedent to require such a high level of expert testimony in order to establish the appropriate rate of return. To add an economics expert to those collecting rate case expenses from customers in the form of surcharge is not advisable.[36] The TCEQ has designed its rate worksheet to provide a streamlined estimate of what an appropriate rate of return should be. An economics expert is unnecessary to complete the worksheet. It is interesting to note that the City's expert and the TCEQ worksheet calculations arrived at nearly the same recommended rate of return. The fact that the result of the worksheet and the result of admirable and exhaustive research are nearly the same is a testament to the accuracy of the streamlined approach of the worksheet."

The PFD accepted this analysis and explained its position as follows on page 42:

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

The PFD explained further on p. 44:

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[35] Application of Southern Water Corporation for a Water and Sewer Rate/Tariff Change in Harris County, Texas 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 (May19, 2010), aff'd by interim order (September 5, 2010) and Final Order (April 4, 2011).

[36] Even though in this case the City is not seeking rate case expenses (which would be recoverable from the utility and then, in turn by the utility from the utility's customers), the precedent would encourage utilities to add another expert to their rate case preparation whose fees would be collectible from customers.

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

The PFD concludes as follows on pages 46-7

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

CLWSC also objects to including the 2.5% loans in the capital structure when computing the weighted cost of capital. It argues that the 2.5% loans should be characterized as equity because its affiliate does not expect repayment. However, the PFD included in the weighted cost of capital the 2.5% loans that carry the moniker of "short term" but actually were for capital improvements and were not paid off in one or two years, but have been continually carried on CLWSC's books. [37]Because these loans were used for capital improvements, this is a cost of debt used to fund rate base and should be included in the capital structure for determining return on equity.

The purpose of the weighted cost of capital is to reimburse the utility with a return that will allow it to continue to attract capital. It is not designed to center on a hypothetical measure of how much return a hypothetical utility might need to attract hypothetical investors. The weighted cost of capital takes into account how the utility is actually raising capital. Only one part of the cost of capital is based on hypothetical estimates, and that is the return on equity.[38] However, the other components are not determined hypothetically, but are based on actual experience of the utility by looking at the debts the utility has incurred for obtaining capital.

This utility does not obtain its capital by attracting outside investors, but by getting credit for capital improvements at very low rates from its large affiliate -- San Jose Water, Inc., a California Corporation. The utility raised some of its capital with loans ranging from 6.27% to 6.5% and some with a 2.5% loan. The 2.5% loan is actually a line of credit to which the utility continues to have access. These loans were used to make capital improvements according to CLWSC's witness Palle Jensen. Therefore, it is appropriate to include this in determining the reasonable amount the utility will be allowed to collect from its customers so that it will continue to be able to attract capital.

If the customers were required to pay the rate of return on equity (10.88% in the PFD) for assets the utility financed at 2.5%, the rate impact of the rate would be unfair and confiscatory. It would violate the Texas statute outlawing excessive rates of return and exceed the *Bluefield* requirements by having the customers finance a windfall to the utility if the 2.5% loans are considered equity. However, if the Commission determines that the capital structure of the utility should shift the portion of capital financed by the 2.5% loans to the equity portion of the weighted cost of capital, the ED can perform

[37] Tr. p. 160 l. 2-10. Jensen testifies that the low interest loans from SJW to CLWSC were "Necessary to make improvements, the capital investment. And improvements on the system." At Tr. p. 1323 l.14- 18, Jensen testified that short term debt has to be zeroed out every one or two years. Yet he also testified that the 2.5% loans have never been repaid. P. 216 l. 13 –23. Further evidence is clear when reviewing ED-DL 19, CLWSC's financial statements, Bates CLWSC404691, CLWSC404684-CLWSC404685, "Intercompany notes payable" lines.

[38] The method of estimating the rate of return on equity is discussed elsewhere in this response.

those calculations within an hour at Agenda.

CLWSC argues that hypothetical capital structures rather than actual capital structures are sometimes used by the PUC because it is necessary to assure that the utility have the ability to attract capital. To begin with, the details of those cases are not supplied and unknown. On top of that, in this case, the details are known; this utility does not get capital from outside investors or from selling stock. All of its stock is held by its affiliate and all of its credit for capital improvements is from that affiliate. It does not need a theoretical capital structure in order to convince a bank to lend it money or to convince a stockholder that it should buy stock if CLWSC ever sold stock publicly in either an IPO or additional issuance. To take the 2.5% rate out of the weighted cost of capital won't have any impact on how this utility raises capital, except that it might use the 2.5% loans more. Who wouldn't finance capital at 2.5% when it can charge its customers 10.88 percent for the same principle debt? The practical effect of allowing the utility to exclude the 2.5% loans is to give the utility a windfall, financed by the families who purchase water from it.

CLWSC also points to the *Weidenfield* case and argues with the underlying idea that "what is good for the goose is good for the gander." CLWSC maintains that in that case, the Commission took a 10% loan out of the weighted cost of capital because the loan was from an affiliate and including the loan in the weighted cost of capital gave the utility too high a return. Therefore, CLWSC submits, why were affiliate loans excluded in *Weidenfield* because it resulted in too high a rate of return, yet not excluded when the utility claims inclusion of the affiliate loan results in too low a rate of return? The answer is not hard. The concern of the Commission in affiliate transactions is that there could be collusion in order to obtain a higher rate. Therefore, the law requires proof that the deal was fair.[39] In this case, including the affiliate loan does not give rise to those concerns. A utility will not collude with its affiliate to get lower rates.

Finally, the use of the "actual debt structure" of the utility is consistent with how the law has been interpreted in past rate cases. In the Southern Water PFD, on page 47, the ALJ wrote the following:

> The ALJ also recommends that the Commission not adopt the City's proposed hypothetical capital structure of 65% equity and

[39] TWC 13.185(e)

> 35% debt. The evidence clearly established that during the test year Southern had no long term debt, so its actual capital structure was 100% equity. The City raised legitimate questions about whether a 100% equity capital structure is efficient or fair to ratepayers. However, the Commission's rules make clear that a utility's actual capital structure should be used in establishing a rate of return. As noted by Southern, 30 TAC § 291.3l(c)(1)(C) states: "In each case, the commission shall consider the utility's cost of capital, which is the composite of the cost of various classes of capital *used by the utility*." Further, § 291.31(c)(1)(C)(i) describes debt capital as "The cost of debt capital is the actual cost of debt." In this case, Southern had no long-term debt and had no "actual cost of debt." Therefore, under the Commission's rules, Southern's actual 100% equity capital structure should be used in setting the rate of return.
>
> Therefore, the ALJ recommends that the Commission adopt the ED's calculation rate of return of 9.25% for water service and 10.25% for sewer service.

CLWSC includes the following misleading statement in its discussion of the rate of return worksheet: "There is no statute, rule, or TCEQ application instruction requiring a utility to use the rate of return worksheet to calculate its rate of return on equity." The instructions do include this sentence: "NOTE: If your application is contested, the staff will compute your return based on the Rate of Return Worksheet." The instructions also provide a copy of the Rate of Return Worksheet in Appendix A to the instructions.[40] While there is no requirement that the utility use the worksheet, the law requires the utility to consider the statutory factors, which CLWSC's witnesses admitted they did not do. Section 13.184(b) of the Texas Water Code lists specific factors that are to be considered in setting a rate of return. Specifically, it provides as follows: "In fixing a reasonable return on invested capital, the regulatory authority shall consider, in addition to other applicable factors, the efforts and achievements of the utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management." The ED's worksheet that was used in arriving at the recommended rate takes into consideration each of these factors because the worksheet is designed to address each of these

[40] Ex. ED-4

statutory factors. The evidence presented by CLWSC's experts that did not use the worksheet did not take into consideration any of these factors.[41]

CLWSC's contention that a statute or rule is necessary for each step of calculating a revenue requirement is not workable. There is also is no statute, TCEQ rule, or TCEQ application instruction that allows trending, allocation, normalization, etc. So if the principle of law CLWSC is promoting were adopted, it would find its application in deep trouble. The ED would point out that the application does provide that if the case is referred to hearing the staff will determine the rate of return using the rate of return worksheet.[42] CLWSC is correct that this does not mandate that the utility must use the worksheet; however, the utility may ignore it at some peril because the worksheet allows for all the factors required by the statute while expert testimony from those who usually provide analysis to investors, litigants, and electric and gas utilities may not consider those factors.

The rate of return worksheet includes consideration of all factors relevant to the requirements for setting a rate of return. It begins with the public utility 12 month Baa bond rate average on line A and represents consideration of the *Bluefield* constitutional requirement that a utility should be able to get a return that is obtained by a similarly risky enterprise.

Each of the remaining lines on the worksheet[43] operate to allow consideration of the factors required to be considered by TWC section 13.184 or otherwise designed to allow a fair rate (*Bluefield*). Those additional statutory factors are:" 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." The next line (B) relates to a concern regarding *Bluefield* fairness that was expressed by Scheig; namely, a small stock premium.[44] That line provides an upward adjustment if the utility has 200 or less connections. Scheig argues that smaller companies have more difficulty raising capital and therefore need a greater rate of return. However, as the testimony revealed, the relationship with SJW allows CLWSC

[41] Loy admitted that he did not consider the statutory factors at Tr. p. 569 l.6-12. Scheig admitted he did not consider the statutory factors at Tr. p.892 l.11 – p. 893 l.8
[42] Tr. p. 1208 l. 14 – p. 1209 l. 5. CLWSC Ex. 45 p. 12 Bates 1465
[43] ED-DL- Ex. 30
[44] Pre-filed testimony of Gregory E. Scheig p. 27 l. 7 *et seq*.

easy access to cheap capital.[45] The next line allows adjustment upward if the utility has a debt/equity ratio of greater than 60% and if the utility has no affiliate with access to revenues or other funds to support utility operations. These factors cover the small stock risk premium and the fact that a utility with a high debt to equity ratio will have difficulty raising capital; in short *Bluefield* factors. The next line (C) allow the utility upward adjustments if it has an unstable population, a lot of commercial customers, low growth, and an aging system. These all would also increase the risk and be *Bluefield* factors. Line E only applies to sewer systems. Line F gives an upward adjustment if the utility can demonstrate (3 of the 4) that it has few complaints, no major deficiencies in its last PWS inspection report, no current or prior enforcement actions, and good faith efforts to solve any current problems: these factors go to the statutory standards of 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. Line G allows another upward adjustment if the utility can demonstrate (4 of the 5) well-maintained books, effective communications and good customer relations, consistent timeliness in reporting requirements, fiscal responsibility with respect to rate filings, and less than 12% unaccounted for water. Again, this line addresses the statutory factors of 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. Line H gives an upward adjustment if the utility can demonstrate 4 of the following 5 conditions: a rate structure with zero gallons in the minimum bill and inclining block rates, a drought contingency plan, a conservation plan, an education program to assist the customers in understanding the system. This line also addresses the statutory factors – primarily the utility's effort to conserve.

The ED recommended a total upward adjustment of 3 percentage points. Adding those three points to the Baa average of 6.88 percent arrives at a rate of return on equity of 9.88%. The PFD used the worksheet approach to arrive at a 10.88% rate of return. All methods of arriving at a suggested rate of return are estimates. The ED submits that the PFD's method of estimation includes all the statutory and constitutional requirements,

[45] Tr. p.160 l.5 – p. 161 l. 2

while CLWSC's does not. Additionally, the PFD's rate is very close to the rate allowed in California, reflecting the accuracy of the estimation method. The PFD's addition of one percentage point appears reasonable to the ED.

Moreover, as shown above, the actual return on equity shown on the balance sheet using the rate suggested by CLWSC results in an excessive rate of return, which is not allowed under *Bluefield*.

CLWSC also mischaracterizes the history of rate of return decision by the Commission. It recognizes that *Texas Landing* and *Southern Water* used the rate of return worksheet rather than giving a default 12% rate of return. CLWSC fails to mention that in *Southern Water* the PFD that was approved by the Commission before the case was settled on the remand issue of surcharges rejected a highly qualified economist's testimony and accepted the rate of return worksheet. The PFD stated that the reason for preferring the worksheet was that it included the statutory factors. The reason why the overall return rate in those cases was lower was because none of them had a large affiliate that could supply them with capital at a very low cost.

Additionally, in this case, the Mr. Scheig's testimony was entitled to little if any weight. To begin with he admitted that he took no consideration of the statutory factors. Additionally, he admitted that his return analysis for the purpose of determining whether the rate would encourage stockholder investment was based on applying the rate to the regulatory rate base and not to the actual flow of dollars through the utility. Therefore his analysis did not consider numbers shareholders would actually look at. Shareholders are concerned with real dollars before tax returns, while the regulatory authority is concerned with return on "rate base," which is adjusted for policy concerns that do not impact shareholders.

CLWSC also tries to get the Commission to reverse its wise course of abandoning a 12% "default" rate of return by citing many old cases or cases where the ED did not even offer the worksheet. In a barrage of cases cited in a footnote on page 17, in which CLWSC tries to convince the Commission that it should return to a default 12% rate. Several of the cases cited were from a period before the Commission took jurisdiction of rate cases, perhaps even before the Commission existed. The docket numbers in the string site reveal that the most recent case cited in the footnote was filed in 2005 -- nearly a decade ago. Recent Commission practice should trump ancient history –

especially with consideration of the recent decline of all interest rates.

The Commission has refined and improved its analysis of rate cases. In recent cases, the Commission has always adopted the rate of return worksheet results sponsored by an ED auditor/accountant over the idea that there is a "default" 12% rate of return. The Commission has approved the worksheet over the expensive testimony of an expert, who admits he considered none of the statutory factors. The *Southern Water* case was discussed above. However, the Commission has taken the same approach in other cases.

In *TLU*[46], the ED argued as follows on p. 5 of its closing:

> The Commission's instructions, which accompany the rate application, establishes three means by which the Applicant can determine the rate of return. However, regardless of the method chosen by the Applicant, the instructions expressly state that "If your application is contested, the staff will compute your rate of return based on the Rate of Return Worksheet." As noted in the instructions, Ms. Perryman used the rate of return worksheet to determine the appropriate rate of return for Texas Landing Utilities.

The PFD included the following discussion on the rate of return worksheet:

> 1. TLU's Position
>
> TLU notes that its capital structure consists of 100% equity and 0% debt. TLU Ex. D at 27. TLU is requesting a rate of return on equity of 12%, and thus an overall rate of return of 12% because it has no debt. TLU Ex. D; TLU Ex. 1 at 002062, 002077. TLU asserts that since 1997, the Commission has used the risk premium methodology to determine a standard reasonable rate of return on equity. TLU Ex. D at 27-29. TLU's expert Marvin Morgan testified that a 12% return on equity is reasonable and consistent with Commission practice and Commission precedent. TLU Ex. D at 29-30. He testified further that in all the water and wastewater utility rate applications that he has done over the past 15 years, the presumptive rate of 12% is considered a "safe harbor" rate. Tr. at 521.

[46] *Application of Texas Landing Utilities to change Water and Sewer Rates*, TCEQ Docket No. 2007-1867-UCR; SOAH Docket No. 582-08-1023, first PFD submitted by ALJ Katherine Smith before remand for rate case expense and other issue development.

Relying on the Aqua Texas decision, TLU notes that the Commission found that a 12% return on equity was reasonable in light of Aqua Texas' risk and the capital-intensive nature of water and sewer utilities. TLU Ex. 43-- Order Approving Application of Aqua Utilities, Inc. to Change Water and Sewer Rates, TCEQ Dkt. Nos. 2004-1671-UCR and 2004-1120-UCR at 15 (finding of fact no. 73) (Sept. 23, 2008). TLU asserts that the 12% return on equity is consistent with the capital-intensive nature of providing water and sewer service versus other types of utility service and reflects an appropriate risk premium for TLU's capital investment. Tr. at 516-17. Mr. Morgan testified that if a 12% rate of return on equity is acceptable for a larger utility such as Aqua Texas, it should also be acceptable for a small utility like TLU, which has a greater risk. Tr. at 184. TLU also asserts that the 12% rate of return on equity is consistent with those rates of return obtainable on alternative investments involving similar risks and to attract equity capital if needed in the future. TLU Ex. D at 29-30; tr. at 516-517.

Mr. Morgan also testified about the origin of the Commission's use of the 12% rate of return on equity as the presumptive standard, based upon a Baa utility bond priced at approximately 8% with 400 basis points added as a risk premium, when water rate cases were transferred from the Public Utility Commission of Texas to the Texas Water Commission. Tr. At 516-17. In response to the ED's and TPLOA's position that a different methodology should be used, TLU contends that such an approach runs afoul of constitutional standards, citing *Duquesne Light Co. v. Baraschi*, 488 U.S. 299 (U.S. 1989). In that decision the court stated: "[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." Tr. at 315. TLU contends that if the rate of return worksheet is used in this case, as recommended by the ED, it would constitute a new method of calculating rate of return on equity counter to Commission precedent.

TLU asserts that the Commission's rate/tariff change application form that TLU used to file its applications presents the standard 12% rate of return on equity as a valid option. In support of its position, TLU notes that the form provides three options that the applicant may choose: (1) an average equity return established by the staff each year and included with the Annual Report Instructions; (2) an interest rate that is fair that is less than the rate established by staff; or (3) use of the rate of return worksheet, which is attached to the instructions. TLU Ex. 1 at 002060 and 002075; see also ED Ex. 1 at SP-13 at 12, the application instructions document. TLU admits that Option (1) is problematic because the Annual Report Instructions do not mention an "average equity return" But TLU contends that Ms. Perryman testified that the 12% is the "average equity return" established by staff as a safe harbor rate. Tr. at 382. TLU also noted that the 12% rate of return on equity used in the application was based on advice given by Philip Gibbons, who works for Superior Water Systems or Management, a subcontractor recommended by Staff. He told Kim Comstock, who filed TLU's initial application and is TLU's office manager, that 12% was the standard rate of return that the Commission approved time and again. Tr. at 98-100.

2. ED's Position

Using the rate of return worksheet, the ED determined that a 9.48% rate of return would yield a fair return on invested capital and would assure confidence in TLU's financial integrity. The ED admits that the Commission has approved a 12% rate of return in other rate applications, but notes that the rate of return has become an increasingly debated and challenged issue and that TLU has the burden of establishing that its proposed rate of return is just and reasonable. TEX. WATER CODE ANN. § 13.184(c). The ED contends that the only factor that TLU considered in deriving the 12% rate of return was the amount of the capital expended since 1997 on its systems and how that related to regulatory and environmental risks. TLU Ex. D at 30. The ED also pointed to the testimony of Mr. Morgan in which he admitted that he did not consider the factors established in the Water Code and the Commission rules when he picked the 12% rate of return because he "used the 12 per cent rate of return forever," and dismissed the principles in the rules as penalties for bad management. Tr. at 182, 185. Staff also notes that Mr. Morgan's position was that, "If it's good enough for Aqua Texas, it's good enough for us." Tr. at 173.

The ED contends that the result in *Aqua Texas* is distinguishable from this one. In *Aqua Texas*, the utility had both debt and equity. When the weighted cost of capital methodology was used to determine the final rate of return, Aqua Texas's final rate of return was 8.44%. *Aqua Texas*, PFD at 61, 64. As previously noted, TLU has no debt. Therefore, the ED does not use the weighted cost of capital methodology, but relies solely on the principles set forth in the Water Code and the Commission’s rules. ED Ex. 1 at 10; tr. at 396. Furthermore, the ED gave the issue greater scrutiny in this case because TLU's application was contested. Applicants are warned in the rate filing instructions that "If your application is contested, the staff will compute your rate of return based on the rate of return worksheet." ED Ex. 1 at SP-13 at 12. The ED's witness Ms. Perryman used the rate of return worksheet, which takes into consideration all of the required factors that the Commission must consider when determining rate of return, to determine the appropriate rate of return for TLU. ED Ex. 1 at 8.

3. 12% Rate of Return

Despite what TLU suggests, Ms. Perryman did not testify that 12% is the "average equity return" established by staff as a safe harbor rate. Offhandly, she did not know what the average equity return rate established by staff is and only stated that the average equity return established by the staff is 12% "if there's debt and then there's the weighted cost that's applied." Tr. at 381-82. And TLU provided no support for the proposition that Mr. Gibbons' proposed rate of return is binding on the Commission.

That prior utilities have been rewarded 12% rates of return just because they asked and no one stepped forward to protest is no basis for doing so in this case, and neither is relying on the presumed rate of return of 12% on equity awarded in the *Aqua Texas* case, which was processed in a different economic time. Guaranteeing a 12% rate of return on equity forever would clearly be arbitrary. Furthermore, Finding of Fact No. 73 of the *Aqua Texas* case does not state, as TLU suggests, that investors in water and sewer utilities can generally expect to recover a 12% return on equity. It. stated that, "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." The ALJ is not aware of any evidence being presented in this case, about the returns of other investments of similar risk at this time, except for Mr. Morgan's conclusory statement. And the *Aqua Texas* case loses its relevance as time progresses.

Although use of the rate of return worksheet is optional, TLU chose the risk of not using it and relied instead on a non-existent safe harbor of 12%. Because TLU did not meet its burden of proving the need for a 12% rate of return, the ALJ relies largely on the rate of return worksheet developed by Staff. ED Ex. 1 at SP-9.

In the *Deer Creek* case, The Commission again followed the PFD and declined to entertain the idea of a "default" rate of return, and endorsed the rate of return worksheet. Judge Newchurch wrote the following clear analysis of the worksheet in the *Deer Creek* PFD on pages 61-62:

> The applicant argues that the Commission Staff has proposed a change to the method long used to determine rate of return and that change must be adopted through a rulemaking. The evidence does not show that.
>
> The worksheet is consistent with and applies rate of return principles set out in the Water Code and the current rules. It ensures access to credit and equity markets by starting with the current rate of return on publicly traded bonds. According to Mr. Rauschcuber [the utility's expert], that debt reflects debts with zero risk of return. However, the worksheet allows for upward adjustments to reflect systems with higher risk to capital, including systems with a small number of customers, low growth, instable populations, and aging facilities. Upward adjustments are also allowed when the Utility's management conserves water resources and provides high quality of service and good management.
>
> The worksheet methodology is consistent with historical practice. Given the current 7.45% Baa bond rate and the possibility of upward adjustments totaling to 8.0%, the calculation methodology set out in the worksheet allows for the possibility of a 15.45% rate of return. That would be consistent with Mr. Rauschcuber's testimony that he has seen the Commission approve rates as high as 15%.
>
> There is no evidence of a return being set lower than 10% in a prior rate case, but nothing in the rules or statutes guarantee a minimum 10% return. Moreover, the Applicant, not the ED, has the burden of proof. It has not proven facts that would lead to an upward adjustment on the Commission's worksheet. Given that, the ALJ concludes that the 7.45% rate of return on equity recommended by the ED is both reasonable and consistent with applicable law.

In all three of these cases (*Southern Water*, *TLU*, and *Deer Creek*), the Commission adopted the ALJ's analysis of the rate of return worksheet.[47]

[47] The following findings of fact are included in the *Deer Creek* Order:

187. The rate of return worksheet is consistent with and applies rate of return principles set out in the Water Code and the current rules. Water Code § 13.184 and 30 TAC § 291.3l(c)(l).
188. The rate of return worksheet ensures access to credit by starting with the current rate of return on publicly traded bonds, which reflect debt with a zero risk of return.

CLWSC used filed testimony in an un-litigated, settled case (Kendall County Utility Company) from the TCEQ's staff accountant during the period she was in private practice to provide "damning" evidence that she disliked the TCEQ rate of return worksheet. To begin with this case was settled[48] and the Commission never made a decision on any testimony in the case. Additionally, the portion of her testimony quoted on page 18, shows that the TCEQ worksheet at that time began with a flat rate of 6% rather than the Baa bond rating, which was used as a beginning for a risk premium analysis by CLWSC's witness, Mr. Scheig. Ms. Loockerman had a problem with the flat 6%, which was subsequently changed by the TCEQ to Baa bond rating for public utilities. Furthermore, there was no showing that the utility in that case was similar to this one. It was not. KCUC was a substantially smaller utility that actually had invoices for plant in service and did not use trending or booked costs to include cost-free capital in its rate base. The records in either case provide no cost-benefit analysis to determine if alternatives to the worksheet were feasible. Finally, opinions can change as conditions and corrections occur over time and Ms. Loockerman's opinion is clear from her testimony, and she supports the rate of return worksheet in this case. She has recommended a rate of return based on the worksheet. This rate is within reasonable range of what California has granted SJW recently.

B. Rate Base Exceptions; Alternative Motion to Reopen Record. This argument was discussed briefly in the overview section of this reply. As stated above, there was a large difference between the book costs that the ED recommended to use to establish rate base and the trended costs recommended by CLWSC (3.5 million dollars).

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189. The rate of return worksheet ensures access to equity markets by allowing for upward adjustments to reflect systems with higher risks to capital, including systems with small numbers of customers, low growth, unstable populations, and aging facilities.

190. Upward adjustments are also allowed when the Utility's management conserves water resources and provides high quality of service and good management.

The *TLU* order included its findings:"40. Use of the rate of return worksheet was appropriate in this case." The order then proceeded to run through each line on the sheet.

The *Southern Water* PFD came to Agenda, and an interim order was entered by the commission that remanded the PFD for consideration of several issues, but not on the discussion of the propriety of the rate of return worksheet.

[48] The case was settled after the applicant pre-filed its testimony, but before any other party filed testimony. Therefore, neither the ALJ nor the Commission ever weighed in on this testimony.

At trial the ED submitted a schedule of assets that apportioned that difference among all of the utilities assets, as prepared by the trending study. The book cost contained no detailed asset list for the purchased assets. The ED, therefore used the trending study, which was allowed as an amortizable expense, for a beginning asset list. The ED then adjusted the trended values in the detailed asset list to remove the overstated trended original cost estimates. Additionally, the ED, in the trial exhibit, removed the Startzville wastewater treatment plant from the total dollar figure at the end, which constituted a double removal because CLWSC's detailed schedule had already removed it. In closing argument the ED applied math to the same 3.5 million dollar overage by spreading the difference among only the trended assets and also removed the Startzville extra deduction. Neither of these operations are errors that require remand, a reopened record, a new hearing, new closing arguments and replies, a new PFD, and another set of exceptions and replies to exceptions. This case has already taken an extraordinary amount of time and rate case expenses. The evidence is all in the record.

The ALJs decided to use the schedule that was offered at trial rather than the schedule that applied different mathematical operations to the same facts. As discussed above, there are policy reasons that would support spreading the depreciation expense over all the assets rather than limiting the adjustment to the trended assets (the utility is already getting 4.7 million dollars in annual depreciation that it never paid and the PFD allows the utility to collect a return on that overage as well).

Finally, and most important, these adjustments are not math errors or anything that cross examination would be needed for. One need not cross examine someone to apply the rules of division or subtraction. The ED would still support using the schedule it offered in closing, but is satisfied that the ALJ's approach also leads to a just and reasonable rate. The possible exception is the removal of the Startzville plant when it already had been removed. As shown above, the adjustment is not a large portion of rate base, and the ED can calculate that adjustment at Agenda. To remand the case would only offer the parties an opportunity to get a second bite at the rate base apple and to incur additional rate case expenses.[49]

Reply to Original Cost and Use of Trending Study Exception. CLWSC argues

[49] CLWSC actually agrees that a remand is unnecessary to switch to the schedule offered in the ED's closing on page 22 of its exceptions.

that “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”. The ED agrees. However, in this case, is the original cost is unknown for the purchased assets. CLWSC established original cost when it purchased the water supply corporation assets and properly recorded them on its books and records at the WSC’s booked cost. The differences in accounting between and IOU and a WSC caused this to be an estimate (a good one, and done in accordance with generally accepted accounting principles). We have two more estimates in this case: a trending analysis and the actual price paid by CLWSC, as asserted by CEWR.

CLWSC also argues that booked costs are not estimates of original costs while a trending study is. The argument is unpersuasive. CLWSC placed the assets in service when it recorded them on their books at the WSC’s book value. CLWSC provided a trending study which ignored any CIAC paid for by customers or developers, and the actual cost paid for the assets by CLWSC. The ED believes the booked cost is the most reliable original cost estimate in this case. If one were to step back and look at the big picture one would see the following:

1. The utility paid 26.5 million dollars for 31.2 dollars’ worth of assets.
2. The ED used the original cost shown in CLWSC’s books as the original cost.
3. The utility used the trended original costs instead of the booked original costs which resulted in an additional 3.5 million dollars in original cost.

It is hard to see how CLWSC can argue that what its records show as the booked original costs are not good estimates of original cost. Furthermore, if one were to compare the two estimates and look at the fact that the value paid for the assets was lower than both, one would conclude that the estimate that was closer to what was paid would be better. The ED relied on what CLWSC’s books showed the original costs to be (even though it was much higher than what was paid for the WSC’s assets) because the trending study verified that the booked costs were not too high. It would defy common sense to argue that a study that was meant to verify that the booked costs were not overstated in the face of the sale price could be used to make the original cost even higher. The trees are confusing, but the forest is clear, the trending study is a worse estimate of original cost reflected in CLWSC's books.[50]

C. CIAC. The PFD admits that CIAC and cost free capital are included in its rate design. The ED has taken the approach that the negative acquisition adjustment is the appropriate method to remove the cost free capital that is not allowed in rate base under 291.31(c)(3)(A)(v). CEWR argues for removing the cost free capital through a consideration of CIAC. CEWR's arguments are persuasive because the customers should not have to pay return and depreciation expense on assets they already paid for. However, the ED's review of the available information led to the conclusion that the best available measure for the cost free capital was the negative acquisition amount documented in CLWSC's own books.

D. Negative Acquisition Adjustment Issue. The ED's original exceptions are sufficient to reply to this portion of CLWSC's exceptions. But some of CLWSC's misleading argument needs to be exposed. CLWSC makes the following bold statement with any support in the record or in the law: "Removal of 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."[51] This statement is glaringly incorrect. To begin with, CLWSC cagily uses the word "statute" to avoid total untruth, because a TCEQ rule does explicitly state that cost free capital is not to be included in rate base.[52] Furthermore, the *Technology Hydraulics* case held that the difference between the net book value and purchase price should not earn a full return on equity that it did not pay for. While that doesn't use the words acquisition adjustment, it is exactly what the case did. Moreover, both *Bluefield* and TWC 13.184(b) disallow excessive rates of return. That Texas statute provides thusly: "[T]he commission may not prescribe any rate that will yield more than a fair return on the invested capital used and useful in rendering service to the public". Furthermore, and as cited throughout these exceptions, the Texas Statutes require that rates be fair and

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[50] In fact the temerity to use the trending study in the face of the obvious common sense is a big part of the reason why the 51% rule may be invoked in this case.
[51] Negative Acquisition Adjustments are allowed in other jurisdictions, but the fact the Texas used one in Technology Hydraulics means that reference to those other jurisdictions is unnecessary.
[52] 30 TAC 291.31(c)(3)(A)(v)

reasonable and it is not fair and reasonable to have the customers pay the utility a return on an investment it never made, and, it is not fair and reasonable to ignore past CIAC paid by customers of a utility which causes unreasonably high return dollars to be included in the cost of service because it is too hard to figure out is by any case directly on point. Finally, if specific statutory reference were necessary before a negative acquisition adjustment could be used, then it would also be necessary before trending is used. There is no statute or rule that mentions trending.

CLWSC at trial and in its exceptions refers to the negative acquisition adjustment as an alternative ratemaking methodology and not based on original cost. A negative acquisition adjustment is not an alternative methodology any more than trending is. An alternative methodology refers to the utility method, the cash needs method, and other methods of arriving at a final rate. The consideration of negative acquisition adjustment is a regulatory choice to either take result of accounting for a purchase or sale (negative acquisition adjustment) into consideration for rate purposes (representative of cost free capital reducing rate base, in this case), or ignore it for rate purposes. The calculation that only would be used within the utility method for return purposes. The acquisition adjustment changes the value of one of the components of that methodology and is not a methodology in and of itself any more than using a trending analysis would be or taking removing CIAC from rate base would be.

Another amazing statement in CLWSC's exceptions is the following: Neither a negative or positive acquisition adjustment has anything to do with 'cost free capital,' as suggested by the ED in this case."[53] ." The statement, while bold, is not logical. To begin with, of course positive acquisition adjustments have nothing to do with "cost free capital." Positive acquisitions indicate a premium paid on a set of assets. On the other hand, a negative acquisition adjustment is by definition produced by a discounted purchase price, and in the rate arena is the removal of a cost free capital component of rate base. Just as an investor will receive a higher rate of return on a bond with a fixed stated interest rate that he buys at a discount, a utility that invests less money into purchased assets than the net book value will receive a higher return if the net book value is then used as a basis for calculating return. The higher return is produced by

[53] CLWSC's Exceptions page 33

applying the return to the phantom portion of the investment if no cost free capital is acknowledged and taken out of rate base. It is capital on which it seeks a return that cost it nothing. A negative acquisition adjustment has a lot to do with cost free capital. It is a means of removing cost free capital from rate base to ensure a reasonable return on investment. In this case, it is further justified by the fact that the customers, who previously owned the asset through the water supply corporation, provided an unknown amount of CIAC and they were willing to receive a discounted price.

The ED is satisfied with the ED's original discussion of the *Technology Hydraulics* case, but needs to address other arguments made expanding on CLWSC's contention that the TCEQ has outlawed negative acquisition adjustments -- primarily the *Quadvest* case. Before discussing *Quadvest*, the ED would draw the Commission's attention to page 24 of CLWSC's closing where CLWSC argues that RG-354 doesn't allow negative acquisition adjustments. CLWSC argued to the ALJs that this guidance document proves negative acquisition adjustments are not allowed. Actually, it proves the opposite. A copy of the RG CLWSC refers to is attached to the ED's reply to closing as attachment 1. Page 30 shows that the adjustment can be positive or NEGATIVE. It also shows the entire amount being deducted, with credit for annual depreciation. That is what the ED does in this case.

CLWSC also brought up the *Quadvest* case in order to prove that the Commission has a clear policy of disallowing negative acquisition adjustments; however, the argument is not persuasive. Attached to the ED's reply to closing as attachment 2 are the two *Quadvest* PFDs, the ALJ's Order No. 10, and the final Commission Order in *Quadvest*. CLWSC contends that a denial of a request for a certified question creates precedent for the argument that negative acquisition adjustments are not allowed. The issue was never developed in the final order of the Commission nor was it addressed at the agenda presentation. The agenda presentation can be found at http://streaming.aanet.org/ramgen/tnrcc/smil/OM081104-16.smil

The presentation reveals that no party addressed negative acquisition adjustments and should be viewed in order to clarify that the case was hardly a precedent setting "big event." No protestant filed pre-filed testimony and the case was decided on written testimony. At agenda, there was no discussion of any dispute at all and not a breath spoken about negative acquisition adjustments. The ALJ who made the presentation stated the only issues were whether the water rates were being used to subsidize the sewer service, whether the different rates set for meter sizes were appropriate, and whether the rate case expenses in the case were excessive. No protestants were present and OPIC and the ED and the ALJ and the applicant all agreed to the result on these issues. Additionally, there was no cross examination of any witnesses and the case was submitted on the pre-filed testimony.

The ED discovered an important fact after retrieving from archives the attached PFDs and the ALJ's order number 10 in the *Quadvest* case, which were attached to the ED's closing argument. That fact is that the *Quadvest* Order Number 10 relied on the same misreading of the *Technology Hydraulics* case as the one proffered by CLWSC in this case. *Technology Hydraulics* is the 1994 case referred to in Order No. 10. Again, the *Technology Hydraulics* order did not allow a negative acquisition adjustment to affect ANNUAL depreciation, but did find that an adjustment to rate base was necessary to account for the difference between the purchase price and the net book value received.[54] The key finding in *Technology Hydraulics* is this: "It is appropriate to consider the difference between the Utility's purchase price and net book value at the time of the sale in determining return on equity because pre-purchase equity was received at basically no cost and assigning a return on this portion of the Utility's equity under traditional considerations would result in an excessive and unreasonable allowance for associated risk."

Therefore, since the ALJ's ruling in *Quadvest* is based on the decision in *Technology Hydraulics*, and *Technology Hydraulics* decided that a difference between the purchase price and net book value (a negative acquisition adjustment) needs to be considered to prevent excessive return (but would not affect annual depreciation) the position taken by the ED in the present case is in concert with prior Commission reasoning and decisions.

This passing remark made in a footnote in an interlocutory order that was never addressed by the Commission regarding a request for a certified question that was denied can hardly trump the common sense that dictates that a utility should not be able to make its customers give it a return on an investment it never made. Such a principle

[54] The portion of *Technology Hydraulics* quoted in Order No. 10 in the *Quadvest* case only discusses annual depreciation, also known as depreciation expense.

is axiomatic in the entire rate setting paradigm. Rates are to be fair and equitable to both the utility and the ratepayers. There is nothing unfair to the utility when it is not allowed to make a windfall return. It is unfair to require the customers to pay a rate that gives the utility such a windfall. The agenda presentation in *Quadvest* reveals that the participation before the final hearing of the protestants was spotty at best and non-existent at the hearing and agenda. Most important, there is no indication that the Commission rule excluding cost free capital was ever even considered. Additionally, *Technology Hydraulics* specifically held that rate base needed to be adjusted for the difference between the price paid and the net book value of the utility and RG-354 specifically identifies a form which includes an entry for negative or positive acquisition adjustment. If past commission experience is the litmus test for whether a certain practice should be taken, the actual order of the Commission requiring that rate base be adjusted by subtracting the difference between the price paid and the net book value of the assets purchased will trump the passing remark relating to an interlocutory order in a case that was not fully litigated and which never considered whether such an adjustment was needed to address whether it was cost free capital. Finally, the final Commission order in the *Quadvest* case contains only one reference to negative acquisition adjustments. Specifically, finding of fact 22 states thusly: "The Utility did not apply for any negative acquisition adjustments in calculating its invested capital." That can hardly be construed as a clear Commission stance that negative acquisition adjustments are outlawed.

Furthermore, if further argument be necessary, the two rules cited in Order No. 10 in *Quadvest* as support for the proposition that negative acquisition adjustments are not allowed do not prove or support that proposition. The first, rule 291.3(d), is the definition of acquisition adjustment, which actually does define negative acquisition adjustments -- and the other, rule 291.34, is the section allowing alternative rate methodologies. The ED cannot find any language in either rule that could be construed to support the argument that negative acquisition adjustments are not allowed. On the contrary, the rule disallowing cost free capital and the general policy that ratepayers should pay fair rates and not rates that give the utility a windfall of a return on an investment it never made directly address the need to make a negative acquisition adjustment. The only policy that CLWSC puts forth that would support that there not be a negative acquisition adjustment is that it would discourage utilities from purchasing failing systems and regionalizing utility service. The ED contends that basing depreciation on the original cost even when a discounted purchase price has been paid allows the utility to recover more than its investment through depreciation, and this will still be true if cost free capital is removed from rate base by means of a negative acquisition adjustment. Indeed, CLWSC had no guarantee of its rate base when they bought the WSC assets and they bought them anyway.

E. Accumulated Deferred Federal Income Tax (ADFIT). The rates set by the Commission include enough for the utility to collect from its customers its normalized income tax expense. However, when the Commission estimates the income tax costs for ratemaking purposes it uses straight line depreciation. The utility takes advantage of the tax code's allowance of accelerated depreciation, and therefore owes less tax early in the life of its assets than it would under straight line depreciation. The utility will have to pay the tax in the future, so it sets up an account for deferred income tax. The customers rates paid now to cover income tax are accounted for in a deferred income tax category and the utility has access to the amount for investment. So the consumers, through rates, have given the utility funds to pay income tax that it does not yet have to pay. In effect, the customers have advanced the deferred income tax to the utility to earn a return on until the tax comes due. The rate base should only include items for which the utility is entitled to a return. The utility should not earn a return on money advanced to them by customers. Therefore, Deferred Income Taxes need to be subtracted from rate base. Otherwise, the utility will get a return on cost free capital.

CLWSC has an ADFIT account. It has already quantified the proper amount of ADFIT.[55] CLWSC's expert witness admitted that nearly all states allow for ADFIT to be subtracted from rate base.[56] However, he also stated that the reason why CLWSC did not subtract that amount from rate base was its belief that the Commission Rules do not allow ADFIT to be used in calculating rate base. The rule CLWSC claims supports this position is 291.31(c)(3)(a). [57] The specific portion provides as follows:

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[55] Tr. p. 593 l. 16-25
[56] Tr. p. 593 l. 12-15
[57] Tr. p.702 l. 22 – p. 703 l. 2

> (3) Terms not included in rate base. Unless otherwise determined by the commission, for good cause shown, the following items will not be included in determining the overall rate base.
> (A) Miscellaneous items. Certain items that include, but are not limited to, the following:
> (i) accumulated reserve for deferred federal income taxes;
> (ii) unamortized investment tax credit to the extent allowed by the Internal Revenue Code;
> (iii) contingency and/or property insurance reserves;
> (iv) contributions in aid of construction; and
> (v) other sources of cost-free capital, as determined by the commission.

To interpret this section as prohibiting an adjustment for ADFIT would be against the entire policy of setting rates that are fair to the customers and the utility. Furthermore, this interpretation is not supported by Texas applications in the past, nor by best practices for utility methodology ratemaking. [58] If CLWSC's interpretation were correct, then CIAC and cost free capital could not be included as a rate base adjustment either. The interpretation that makes sense in the overall regulatory scheme is that Rate Base cannot include ADFIT. In other words, ADFIT must be subtracted from rate base, as one would do with CIAC and other sources of cost free capital. CLWSC's interpretation turns the rule on its head and is the opposite of what the context of the rule would require. The ED has only recommended a portion of the ADFIT ($275,943)[59] to decrease invested capital to represent a portion of what will be collected in the next year. The actual balance of ADFIT on CLWSC's balance sheet is $1,412,406.

F. Unverified Assets. CLWSC states that Mr. Adhikari should not have excluded assets that were in the application but not present when he did his field inspection. CLWSC bases its argument on the fact that the inspection happened about a year after the application was filed. These assets must be removed from rate base. They are not being used to provide utility service and they do not appear to exist based on ED

[58] ED DL 29, pages 193, 200, 203, 209, 217 etc., Final Order issued by Florida Public Services Commission reflecting rate base adjustments for ADFIT. Furthermore, ED DL 36, page "15 of 18", question 32, reflects an old rate application used by a predecessor agency of the TCEQ which obviously did use deferred income tax as an adjustment to rate base
[59]ED DL 1, p. 18 line 15 – 19, line 5

eye witness account. Otherwise, a utility could include any number of assets in its application and say that they were there when they applied if they were not located during an inspection by TCEQ staff. The customers are paying rates that are supposed to help the utility pay for its operations. If the utility isn't using the assets to provide water, the customers should not have to pay the utility for those assets.

G. Intangible "Assets". The primary intangible assets are expenses for obtaining a CCN and a 50 year planning study. Mr. Adhikari did not remove the planning study, a large expense item, from rate calculations, but instead allowed this expense to be recovered by amortization. Nonrecurring expenses are not treated as depreciable assets on which a return is earned and on which annual depreciation is allowed as an expense. The expense for obtaining the CCN is generally legal fees paid to the transferor of the CCN, which does not increase the value the CCN. The record reflects that regulatory treatment of these expenditures should be deferred to the rate case affecting the customers within the area transferred rather than in this case, which does not cover the transferred customers. Neither the CCN nor the planning study is a recurring expense that will require replacement when the amount of the expense is recovered. This principle of ratemaking is recognized in Canyon Lake's own closing argument. On page 21, CLWSC states: "The purpose of depreciation is to provide funds for the eventual replacement of used and useful plant." Amortization is the proper treatment for these items. They are unusual, nonrecurring expenses. They do not wear out and require replacement. The ED could have removed these items totally from the cost of service because they are not assets, and they were not, for the most part, incurred in the test year. They are expenses. However, the ED allowed recovery of the cost of the planning study through amortization. The ED submits that the Commission should not encourage the utility to make expenses such as attorney's fees for obtaining a CCN to become depreciable assets and allow a utility to now get annual depreciation and return on its attorney fee expense. Such expenses are non-recurring and to allow depreciation and return on these expenses defies common sense and results in an unreasonable recovery from the customers.

H. Allowable Expenses

1- *Allocation to CLWSC's from affiliate, SJW*

The ED accepts the ALJ's proposal for reductions in allocated expenses. The ED believes that these reductions produce the amount of reasonable and necessary overhead flowed through from California to Texas to provide water service in Texas. The ED contends that the allowable expenses requested are overstated in CLWSC's application because they include an excessive and unsubstantiated amount of allocated costs that CLWSC pays its affiliate, San Jose Water C0mpany (SJW). Because SJW is an affiliate of CLWSC, there are stringent requirements that must be met before any allowable expenses paid to that affiliate can be included in the revenue requirement.[60] The evidence presented by CLWSC is insufficient to justify the amount of corporate allocations requested. CLWSC's paid witnesses testified that these amounts were reasonable and necessary and similar to charges made to other entities. The only documented evidence provided was a calculation showing how the allocation to CLWSC was done. CLWSC then indicated that this was, indeed, the "time study" supporting its allocations. No written document indicated the amount of allocations to all affiliates, only to CLWSC. There was no documentation as to how the administrative "pie" was cut to anyone but CLWSC. The ED contends that the record is sufficient to justify a portion of the allocated expenses based on the number of connections, but not sufficient to justify use of the calculations offered as "time studies" because they are not an accurate measure of the probable future expenses that would be reasonable and necessary to allocate to CLWSC, and not detailed enough to support the allocation.

The ED disagrees with CLWSC's statement that "the PFD recommendation sets the bar way too high without guiding rules provided in advance of this case for what a utility needs to show to recover these expenses." If this were true, any utility could simply introduce any new expense in any rate case and obtain the expense because it was not addressed in a rule. A balance between regulatory professional judgment and rule making is always in order. The Texas Water Code does not require a rule to determine that an expense is not reasonable and necessary in providing water service,

[60] TWC § 13.185 (e)

especially when the expense or property is in California and service is being provided in Texas.

The ED supports the PFD's disallowance of costs of being publicly traded because these costs benefit (protect) the shareholders much more than the rate payers. The ED admits that CLWSC obtained investing capital from SJW, but nothing in the record reflects that this capital would have been more or less available if SJW was NOT a publicly traded company, but a private company. Indeed, CLWSC is NOT publicly traded if viewed by itself. The record shows that many overhead expenses are driven up due to the public sale of stock to obtain capital for SJW. These expenses include executive salaries, benefits, and SEC filings. Indeed, nothing in the record reflects that the capital infused into Texas actually came from issuances of stock. Retained earnings from Texas and California operations could well have produced such capital.

CLWSC argues that "CLWSC's relationship with SJW Corp. is how it obtains capital at a low rate." The ED admits that this may be true; however, it appears that CLWSC has no desire to share these benefits with its customers and would rather have the customers pay 12% for capital, even when the affiliated cost is discounted. There is also no evidence in the record that sources of capital other than SJW would have been more expensive for CLWSC.

2- *Employee benefits*

The ED agrees with the PFD with regard to removing the free base meter fee that CLWSC is requesting to be included in calculating the customers' rates. The ED has already approved the existing salaries, and this extra benefit is inappropriate because it requires the customers to pay not only for the employees' salaries, but also for a base rate of the employees' water bill. The customers are already paying for many benefits CLWSC provides for its employees including basic and family health care, dental care, retirement, and company cars. Increasing employee benefits by paying the employees' base water rates in addition to those other benefits and salaries is excessive and not in the public interest. Ms. Loockerman testified that the benefits are excessive. Her testimony is credible evidence. She has been employed in private and public sectors in the water industry for more than 20 years and opined that the compensation/benefits package exceeded what she had seen in the Texas market dealing with many investor owned utilities and public entities. The customers are already subsidizing many benefits CLWSC provides for its employees, and having them pay the employees' base water rates in addition to those other benefits and salaries is excessive.

For the same reasons, the ED agrees with the PFD in that the Employer paid Health Savings Account Contribution be removed from the revenue requirement because the ED has already recommended that the customer rate include amounts for family health premiums (in addition to the employee) and dental insurance. The level of benefits subsidized by the customers is sufficient without including this extra benefit.

3- *Bad Debt/Uncollectible Accounts*

The ED agrees with the ALJ's adjustment to bad debts as being not known and measurable. The ED does not agree with the applicant's volume adjustments (normalization) and therefore recommends that the change proposed change in bad debts be removed as the ALJ treated the item in the PFD.

4- *Payroll and other Taxes*

The ED's agrees with the PFD that taxes should be adjusted as a flow-through item dependent on recommendations that change certain items in the cost of service necessitate adjustments in these categories.

5- *Directors Fees*

The ED agrees with the PFD which states that there is no credible evidence provided by CLWSC that any management functions directors perform benefit the customers. Indeed, the directors work for the investors. The ED has recommended removal from the cost of service $53,205 included in miscellaneous expense because the Directors of CLWSC work for SJW, Inc., and ultimately the stockholders of the publicly traded parent. These expenses are appropriately born by the stockholders and it is not in the public interest to pass them on to the customers. Loockerman testified as to the high level of salaries and staffing of CLWSC and the practices of paying directors fees in Texas[61]. Because the board members work to benefit the stockholders primarily,

[61] ED DL-1, Supplement p 2, lines 11-23.

expenses associated with the board members should be borne by the stockholders.

6- *Rate Case Expense included in Rates*

The ED agrees with the PFD which states that rate case expense should be removed from the cost of service, as has been done previously at this commission, and should not be a factor in determining the 51% threshold. Rate case expense is discussed in more detail in the following text.

7- *Normalization*

The ED agrees with the PFD concerning normalization. Two years data is not enough to determine a "normal" volume. The ED also has a concern that "normalization" is an estimate and not known and measurable, especially with the hot weather Texas is experiencing. Its use causes estimates in expense items and revenues that may or may not be accurate. Furthermore, normalization is not consistent with using an historical test year, which is defined as "the most recent 12 month period for which representative data for a retail public utility are available."

I. Regulatory Approvals.

1. Accounting Order: *Plant held for future use.* The ED recommends the following language in the Commission's final order*: "Accounting order #1: CLWSC shall place the expenses associated with acquisition of the Bexar Met/Bulverde CCN in a sub-account under Plant held for Future Use. The sub-account shall be titled* Contested Plant Held for Future Use-Bulverde CCN".

The ED believes that placing an amount in the account "Plant held for future use", which is defined by NARUC, when there is question that the amount meets the definition that has not been answered in this case will cause confusion in future cases. At this point, the ED does not believe that expenses relating to obtaining a CCN in this matter are "plant in service". While the ED accepts the PFD's decision to allow the regulatory approval for Plant Held for Future Use, the ED wants to respond to a statement made on page 52 of its exceptions. Specifically, CLWSC wrote: "these approvals will have no rate impact on this case." The reason why the ED originally objected to the inclusion of this regulatory approval was because the “assets” that CLWSC wanted to put into the PHFU account were not, in the ED’s opinion, “plant.” To put these expense items in an account entitled “Plant” could stop inquiry into whether the items placed therein were actually plant which is allowed depreciation and return. The PFD made it clear that this would have no impact on future rate cases, not just the present case. . The ED believes that the intent of the PFD is NOT to expand the definition of “Plant Held for Future Use” to include something that does not belong there, but to allow CLWSC to continue carrying a questionable asset on its books for future review. So long as that is clear, the ED does not object to this portion of the PFD. With this in mind, the ED recommends the above language be included in the TCEQ order.

2. Accounting Order: Acquisition Adjustment. The ED recommends the following language be placed into the Commission’s final order: “Accounting Order #2: CLWSC shall continue to account for the Acquisition Adjustments incurred up to March 31, 2010 as it has been doing through that date. Amortization of these amounts as reflected in the books at this time is approved. CLWSC shall keep separate, transaction descriptive subaccounts for future acquisition adjustments which have not yet been considered for rate making purposes nor accounting purposes at this Commission. Amortization of future acquisition adjustment accounts should be requested by CLWSC in future rate filings and any effect on the rates of CLWSC due to purchases or sales of utility assets after March 31, 2010 will be determined in future rate filings.

The ED notes that the PFD indicates two different acquisition adjustments. The ED would clarify that there are two different considerations for the same net acquisition adjustment account on March 31, 2010: first being the accounting consideration and second being the rate treatment with regard to cost free capital in the rate base, which is discussed elsewhere in this document and the record. The ED agrees with the ALJ and CLWSC that amortization reflected in CLWSC’s records up to March 31, 2010 should be approved and the net acquisition adjustment be carried on CLWSC’s books as they have done in the past. However, treatment and amortization of future acquisition adjustments resulting from future purchases or sales of utilities by CLWSC should be determined in future filings. The ED believes that the accounting orders above are consistent with the intent of the ALJ in the PFD, and will allow the TCEQ to regulate effects of future transfers appropriately and in accordance with the Texas Water Code and rules.

J. Rate Case Expenses. CLWSC still argues that the "public interest" is not an additional consideration in rate cases because it is too vague and that somehow not allowing it to collect its attorney's fees violates the Constitution. This is fairly farfetched as will be shown below; the public interest test has been used many times and has never even been alleged to be unconstitutional. To begin with, in American Jurisprudence the general rule is that attorney's fees are to be borne by the party incurring them. It is only in special case and where attorney's fees are allowed by statute where American practice allows the encouragement of litigation by allowing a recovery of attorney's fees.[62] There is no constitutional right to get attorney's fees.

The PFD's results in a rate that does not meet the 51% rule. Therefore, CLWSC is entitled to no rate case expenses. However, in order to have numbers available in case the final Commission order does meet the rule, the ED will explain its support for the PFD's analysis of what would be ordered in the event the rule is met.

This is one of the most important issues in this case because with no cap on rate case expenses, the utility and the attorneys representing the utility have no incentive to rein in attorney's fees. While the ED still stands by its position in closing arguments and still would urge clarification that the PFD should not be interpreted to mean that it will not question how many attorneys are at a deposition or at trial, the ED finds the PFD's decision on rate cases to be reasonable and did not file exceptions to these deductions from the ED's recommendation. Below is extensive analysis of why the PFD correctly analyzed rate case expenses.

[62] It is defined in Black's Law Dictionary thusly: "American Rule. The traditional 'American Rule' is that attorney's fees are not awardable to the winning party unless statutorily or contractually authorized...." The definition goes on to explain that there are exceptions for activities such as vexatious litigation, fraud, or civil rights violations. Black's Law Dictionary (5th Ed.) (West 1979)

1. THE PUBLIC INTEREST

The policies that underlie the recovery of rate case expenses by a utility are not remedial as they were in *Arthur Andersen*, nor are they to protect a client from an attorney overreaching in a contract as they are under the TDRPC. Instead they are to protect the utility's financial integrity in the event that the utility has an expense that it must pay in order to remain a viable financial entity. That is why a utility can collect its rate case expenses even if it loses a case. The other policy consideration relates to the overall policy of rate setting, and that is to ensure that all rates paid by a customer are fair and just and to see that the public can obtain a continuous and adequate supply of water. The very first section of Chapter 13 of the water code states: "LEGISLATIVE POLICY AND PURPOSE. (a) this chapter is adopted to protect **the public interest** inherent in the rates and services of retail public utilities."[63] (Emphasis added).

That is why the public interest is not an unnecessary add on to the two previous criteria (reasonable and necessary) but, on the contrary, is the most important focal point of determining what level of rate case expenses are appropriate. The Applicant contends that the "public interest" is merely a redundancy of "reasonable and necessary." That is not true. It is not a redundancy; it is the heart of what needs to be analyzed.

The main cases that have dealt with the public interest factor in utility rate case expense situations are *Lakeshore, West Texas Utilities*, and *Industrial Utilities Service*.[64] These cases are attached to the ED's closing argument on rate case expenses and should be the main focus of the Commission when considering the test for determining what attorneys' fees are reasonable, necessary, and in the public interest to have a utility include in the water bill sent to the customers. These cases dealt with the exact situation we have here and were not deceptive trade practice or other civil litigation in which a plaintiff seeks to recover attorney's fees from a culpable defendant.

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[63] Tex. Water Code §13.001

[64] Texas Water Commission v. Lakeshore Utility Company, 877 S.W.2d 814 (Tex. App.-Austin 1994, write denied); Industrial Utilities Service, Inc. v. Texas Natural Resources Conservation Commission, 947 S.W.2d 712, (Tex. App. Austin 1997, write denied); *West Texas Utilities v. PUC*, 896 S.W. 2d 261 (Tex. App. – Austin 1995, no writ)

Before discussing the test these utility cases set out, a short discussion of the public interest is in order. The public interest is the heart of all water utility regulation.[65] It is obvious that the utility must be able to collect all of its reasonable costs of business because it is in the public interest to protect the financial integrity of the utility. It must be a viable economic entity in order to provide continuous and adequate supply of water services which are necessary for human health and survival. Therefore, if a utility has a rate case in its normal operations it should recover its rate case expenses. However, the sky is not the limit.

To allow the utility to collect all of its attorney's fees simply on proof that it has paid them would be naïve and unfair.[66] Ordinarily, under the American Rule, a client expects to pay the fees charged by an attorney because she has a contract with the attorney. In that situation, the client has an incentive to rein in the attorneys' fees because the client doesn't want to spend more than is necessary to get adequate representation. If a utility knows that it will never pay the attorneys' fees and instead its customers will pay them, then there is a decreased incentive to put any cap on the budget for attorneys' fees – and the evidence showed that there was no budget limit put on the attorneys and consultants in this case.[67] In fact, Charles Loy testified that a budget limit "wasn't a big topic of concern at all."[68] Palle Jensen stated that any limits were placed on the attorneys' fees were in the agreements with the attorneys.[69] Those agreements are in evidence and show no budget limit.[70] That should come as no surprise because the client can spare no expense in covering every single possibility in the case because some of it might be useful and it comes for free.

The public interest requires that the attorneys' fees recoverable through rate case expenses be limited to what is reasonably necessary to pay for adequate representation. It is not in the public interest to make the customers foot the bill for boutique representation from two different firms and their entire staff when one states that it is

[65] TWC §13.001

[66] This is the same reasoning used in Arthur Andersen when it held the mere fact that a contingency contract existed did not mean that the contingency fee should be passed through to the defendant.

[67] TR p 1530 lines 24- p 1531 (Terrill); TR p 1592 lines 6-9 (Zeppa); TR p 1650 line 10 – p 1651 line 23 and p 1767 line 23 – p 1769 line 15 (Value Scope claims it had had an original budget of $7500 – however in the end it charged over $50,000); TR p. 1692 Lines 13-16 and TR p 1693 line 12 - p 1695 (GDS).

[68] TR p 1692 lines 17-24

[69] TR p 1769 lines 5-16

[70] TR p 1783 lines 10-21

the “best”[71] and the other claims to have handled the two largest utility cases in Texas history.

It is entirely ethical and allowable for a client to request an attorney to do “whatever it takes” to ensure that the utility obtains the highest possible rate, but it is against the public interest to make the customers pay for anything more than what it would cost for adequate representation. Both attorneys admitted during cross examination that a case can be overworked.[72] The shareholders benefit from the investment in superb, expensive, and expansive attorney work, and those shareholders should not fund that investment in extra fine representation with the customers’ dollars. In fact, this public interest against overreaching in rate case expenses has been an issue of public concern that the Commission has noted and acted upon. In promulgating rules specifically relating to rate case expenses the Commission has written the following:

> “Additionally, the commission adopts the addition of 291.28(7) – (9) to establish criteria by which the commission can determine the amount of reasonable and just rate case expense recovery allowed a utility based upon concerns about rate case expenses expressed by utility customers. Utility customers have expressed concern over the possibility that utilities may have an incentive to overreach in their applications if utilities believe that the customers will ultimately bear all rate case expenses. The purpose of this rule change is to set out clearly certain instances when, as a matter of law, rate case expenses will be considered unreasonable, unnecessary, and against the public interest. In particular, two rules are adopted where rate case expenses will be disallowed as a matter of law [Sections 291.28(8), the 51% rule – and section 291.28(9), the settlement rule].... Section 291.28(7) was also added to make clear that all rate case expenses will be evaluated to see if they are reasonable, necessary, and in the public interest on a case-by-case basis. Therefore, even if the criteria outlined in the new 291.28(8) or (9) are not met, the commission may still disallow all or a portion of rate case expenses in its discretion if they are not found to be reasonable, necessary, and in the public interest.”[73]

In light of the public interest in limiting attorney’s fees in utility rate case expense cases, the test that is outlined in *Lakeshore, West Texas Utilities, and Industrial Utilities Service* should be investigated. All of these cases provide that the test is whether there is a rational basis for a policy that the Commission desires to pursue. In

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[71] TR p 1627 lines 10-11
[72] Tr p 1565 l 11 – p 1566 line 1 and TR p 1638 l 16 – p 1639 line 7
[73] 31 Tex. Reg. 8107 (September 22, 2006)

other words, the policy must be stated in the proceeding and rational. Otherwise, the commission action would be arbitrary and capricious. This standard is explained by the Supreme Court as follows: “Our task is to determine whether the agency’s decision was arbitrary and capricious. Under the arbitrary and capricious standard of review, we must determine whether a rational basis exists for the agency decision.”[74]

Contrary to CLWSC’s assertion that there must be some sort of checklist or specific definition of “public interest” before it can be applied, the case law points out that the public interest is determined on a case by case basis.

In *West Texas Utilities Co. v. Office of Public Utility Counsel*, 896 S.W.2d 261 (Tex. App. – Austin, 1995, writ dism’d by agr.), the court discussed the process for making decisions based on policy. Agency decisions involving the balancing of competing interests are fundamental policy choices.[75] These decisions are agency statements that interpret, implement or prescribe agency law or policy.[76] These *ad hoc* decisions are judged by the “arbitrary and capricious” standard, not by the substantial evidence test.[77]

In order to pass the arbitrary and capricious test, there must exist a rational basis for the agency’s decision.[78] The agency’s stated policies - “to promote equity and deter duplicative efforts” - provided satisfactory justification in the *West Texas Utilities* case.[79] Therefore, the burden for meeting the rational basis test is low, and the agency must simply articulate justification for their decision to satisfy it.

The most important underlying concept to this policy is that what may be reasonable and necessary between the attorney and client is not the same as what would be reasonable, necessary, and in the public interest for the utility to charge its customers as a rate case expense. The overview of the ED’s closing argument explains the reasoning behind this policy. Furthermore, and most important, the Commission has already articulated this policy in the Texas Landing case (TLU).[80]

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[74] Bullock v. Hewlett Packard Co., 628 S.W.2d 754, 757 (Tex. 1982)
[75] *West Texas Utilities* 896 S.W.2d at 272
[76] *Id*. at 272, quoting *Texas Ass’n of Long Distance Telephone Companies (Texaltel) v. Public Utility Com’n of Texas*, 798 S.W.2d 875, 886 (Tex.App. – Austin 1990, writ. den.)
[77] *Id*.
[78] *Id*. at 273
[79] *Id*.
[80] Application of Texas Landing Utilities to change Water and Sewer Rates TCEQ Docket No. 2007-1867-UCR; SOAH Docket No. 582-08-1023

Specifically, Commissioner Rubenstein stated during the agenda that it was against the public interest to award $51,000 for drafting closing arguments and replies when the work could have been adequately completed in 80 hours.[81]

The TLU order manifested Commissioner Rubenstein's reasoning in conclusion of law number 17.[82] That conclusion of law reads as follows:

> TLU's additional rate case expenses incurred after May 22, 2009 in the amount of $70,281.79 were also reasonable and necessary within the meaning of [the Water Code sections and Administrative Code sections relating to an award of rate case expenses]. The recovery of $35,579.00 portion of TLU's requested post-hearing rate case expenses is not in the public interest."

This order of the Commission makes it crystal clear that the "public interest" is a consideration in awarding rate case expenses and may decrease an award even if it meets the "reasonable and necessary" buzz-words standard found in TDRPC. The "public interest" may authorize a reduction from what would be considered "reasonable and necessary" between attorney and client, if the work could have been adequately achieved with less time and money.

The Fifth Circuit explained the policy of not rewarding overworking a case thusly:

> Although hours claimed or spent on a case should not be the sole basis for determining a fee... they are necessary ingredient to be considered. The trial judge should weigh the hours claimed against his own knowledge, experience, and expertise of time required to complete similar activities. If more than one attorney is involved, the possibility of duplication of effort along with the proper utilization of time should be scrutinized. The time of two or three lawyers in a courtroom or conference when one would do, may obviously be discounted. It is appropriate to distinguish between legal work, in a strict sense, and investigation, clerical work, compilation of facts and statistics and other work which can often be accomplished by non-lawyers, but which a lawyer may do because he has no other help available. Such non-legal work may command a lesser rate. Its dollar value is not enhanced just because a lawyer does it.[83]

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[81] Ex. ED-6
[82] Ex. ED-7 p. 11
[83] *Georgia Highway*, 488 F. 2d at 717 (emphasis added)

While CLWSC makes a winding path through it closing argument and exceptions that would confuse the issue if it were joined in lock step, the underlying themes of its arguments are clear and without merit.

First, CLWSC claims that because Ms. Loockerman is not an economist, lawyer, or engineer, her testimony should be considered incompetent and disregarded. This argument is offered despite the fact that CLWSC offered testimony from a witness with nearly identical qualifications to testify to the same things. They base this argument on the *TLU* case because in the PFD, the ALJ found that the ED's expert's testimony was to be disregarded. However, what CLWSC fails to remember from the TLU decision is that the ALJ noted that the witness did not provide evidence that she had any experience in analyzing attorneys' fees[84] and that she had made a conscious decision not to rely on an attorney in making her attorneys' fees adjustments.[85]

In this case, the ED responded to both of those considerations by showing the witness's experience with analyzing attorneys' fees issues and by demonstrating that Ms. Loockerman made a conscious decision to rely on the advice of an attorney in all testimony relating to attorneys' fees. Additionally, CLWSC failed to mention that the actual order of the Commission in *TLU* recited that while a certain amount of attorneys' fees were reasonable and necessary, that the Commission would reduce that amount in the public interest because the work for closing arguments could have been completed in less time.[86] CLWSC also ignores that in addition to the *TLU* case both the *Aqua* case[87] and the *WaterCo* case[88] decreased the amount of attorneys' fees without any attorney testimony. Furthermore, CLWSC makes no reference to the fact that the appellate courts of Texas in *West Texas Utilities*, *Industrial Utilities*, and *Lakeshore*, made deductions to the attorneys' fees portion of rate case expenses in a utility case without any attorney testimony. CLWSC instead cited cases involving attorney fee awards with respect to

[84] CLWSC Ex. 81. Page 17 of the *TLU* PFD
[85] *Id*.
[86] ED Ex. 6 and 7
[87] APPLICATION BY AQUA DEVELOPMENT COMPANY AND AQUA UTILITIES, INC. d/b/a AQUA TEXAS, INC. TO CHANGE WATER AND SEWER TARIFFS AND RATES IN VARIOUS COUNTIES SOAH DOCKET NOS. 582-05-2770 and 582-05-277;1TCEQ DOCKET NOS. 2004-1120-UCR and 2004-1671-UCR
[88] APPLICATION OF WATERCO, INC., TO CHANGE WATER RATES IN TRINITY AND WALKER COUNTIES, TEXAS SOAH DOCKET NO. 582-04-6463; TCEQ DOCKET NO. 2004-0630-UCR

deceptive trade practices, divorce, election contests, products liability and the like – none of which include a specifically listed public interest factor.

Second, CLWSC complains that the public interest factor should never be considered because it is not defined and the only relevant factors to consider are those found in the Texas Disciplinary Rules of Professional Conduct and then cites a DTPA case to support its position. That DTPA case actually raises the bar for the proof required of someone seeking to recover attorneys' fees rather than one seeking to decrease them. Furthermore, the public interest test has been applied in several utility cases and the test is clear. It is whether the agency has a rational basis for decreasing attorneys' fees in the public interest. This test is in addition to the "reasonable and necessary" considerations. The ED identified those policy considerations in its testimony and in its original closing argument. They are: (1) that the customers should only be required to pay what would be necessary for adequate representation (the *TLU* commission order supports this policy); (2) specifically, if adequate representation could be done with less attorney time an adjustment would be in order (the *Georgia Highway* case which held that the judges themselves can determine from their experience whether there are too many lawyers at a hearing or deposition); and (3) it is not in the public interest to have the customers pay for attorneys' fees that waste resources of other parties even if there is a good strategy for the client underlying the expenditure (the *Industrial Utilities* case held that the agency properly excluded attorneys' fees from rate case expenses when those fees led to other parties wasting resources.)

While CLWSC also makes other confusing arguments, these are their main positions. The ED anticipates that CLWSC will raise the same cases and arguments as it did at trial. Therefore, the ED would refer the Commission to the ED's closing arguments and response on the rate case expense portion of this case. Because the ED will not be able to respond to the reply to his exceptions, the ED would, as an inoculation, provide the following analysis.

Most important and central to understanding the issue is that the legislature has mandated that the public interest must be considered before rate case expenses can be awarded. TWC § 13.185 (h) provides thusly: "The regulatory authority may not include for ratemaking purposes: ... (3) any expenditure found by the regulatory authority to be unreasonable, unnecessary, or not in the **public interest**, including executive salaries, advertising expenses, legal expenses, and civil penalties or fines." (Emphasis added). The public interest is not a new idea that came up in the rule only. No amount of phrase crafting can make the public interest somehow disappear from the Commission's determination of rate case expenses that the utility can charge its customers.

CLWSC goes on to imply that the lack of a definition of the terms in the rule makes the rule unenforceable, unconstitutional, and not in compliance with the statute. The statute doesn't define the term either. However, the phrase "public interest" has been subject of well-established tests and defined in utility case law both administrative and in reported appellate decisions. As was shown in the ED's original closing argument, the "public interest" is determined on a case by case basis because pinning it down to a checklist of items would be as futile as attempting to make a checklist for what is required to show "negligence" or "proximate cause." The checklist would only lead to more complaints about how the items in the checklist aren't defined. Eventually, under CLWSC's approach, the Administrative Code would be nothing but an endless list of definitions of everything from "cause" to "the." The fact is that the test for whether an agency has properly exercised its power to limit rate case expenses in the public interest is whether the agency has a rational basis for its decision that is stated in the determination. The decisions are made on an ad hoc basis, and have been made time and time again.

The "public interest" as it is codified in the statute and published in the rules today has never been disregarded for vagueness or lack of definition, but instead has been applied by both the Commission and the appellate courts of Texas. These decisions make it clear that the public interest is a separate and distinct factor and that it doesn't take an attorney to testify in order to establish a public interest deduction.

2. Administrative decisions

The administrative decisions on rate case expenses reveal that attorney testimony is not necessary in order to decrease a claim for attorneys'' fees and have made reductions based on the public interest. Three examples are the *Aqua* case, the *WaterCo* case, and the *TLU* case. In the *Aqua Texas* Case[89] the ALJ considered Charles Loy, a CPA with years of experience in rate cases, but who is not a lawyer (exactly like Ms. Loockerman) competent to give testimony on attorney's fees. In that case the ALJ also considered Elsie Pascua's testimony to be competent to decrease the amount of attorneys' fees, although she is also a non-attorney CPA with many years of rate case experience. In the *WaterCo* case,[90] the ALJ decreased the attorney's hourly rate based on Ms. Pascua's testimony. In the *TLU* case, the ALJ found Charles Loy's testimony competent as to attorneys' fees and suggested that the ED's witness could also have given testimony on attorneys' fees if she had been shown to have experience in analyzing attorneys' fees or if she had relied on the opinion of an attorney in making her recommendations.

3. Appellate Decisions

The appellate court decisions on rate case expenses also reveal that attorney testimony is not necessary in order to decrease a claim for attorneys' fees and that the public interest factor is a distinct consideration in addition to the normal "reasonable and necessary" considerations. Three examples are *Lakeshore*, *West Texas Utilities*, and *Industrial Utilities*. In the *Lakeshore* case, with regard to the applicant's request for attorneys' fees, the Commission disallowed any additional expenses on the basis that "rate case expenses should bear a reasonable relationship to the amount of the increase...."[91] There was no attorney testimony in that case. In explaining, the court wrote: "Like other determinations on whether to allow expenses, the Commission's ratemaking power includes the discretion to disallow improper legal expenses provided it does not do so arbitrarily."[92] In the *Industrial Utilities* case, again, the court upheld a reduction in the attorney's fees portion of rate case expenses without any attorney

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[89] APPLICATION BY AQUA DEVELOPMENT COMPANY AND AQUA UTILITIES, INC. d/b/a AQUA TEXAS, INC. TO CHANGE WATER AND SEWER TARIFFS AND RATES IN VARIOUS COUNTIES SOAH DOCKET NOS. 582-05-2770 and 582-05-277;1TCEQ DOCKET NOS. 2004-1120-UCR and 2004-1671-UCR

[90] APPLICATION OF WATERCO, INC., TO CHANGE WATER RATES IN TRINITY AND WALKER COUNTIES, TEXAS SOAH DOCKET NO. 582-04-6463; TCEQ DOCKET NO. 2004-0630-UCR

[91] Texas Water Commission v. Lakeshore Utility Company, 877 S.W.2d 814, 825 (Tex. App.-Austin 1994, write denied)

[92] Id. 877 S.W.2d at 825-26.

testimony. Not only was there no controverting attorney testimony offered to defeat rate case expense claims, but also the disallowance of attorney's fees was based on arguments raised after the hearing was complete. The Court explained that since the issue is one of public interest policy, it was a decision the Commission could make. Specifically, the court wrote: "Industrial Utilities contends that the lack of evidence as to the amount of its expenses means no evidence existed on their reasonableness and necessity. We disagree."[93] The court found that the testimony offered by the applicant was sufficient to explain the rational basis for the Commission disallowance. The *West Texas Utilities* case also allowed an adjustment to the attorneys' fees portion of rate case expenses without any attorney testimony. In that case, the Court held that the utility would not be required to pay the rate case expenses of two intervener cities based on the policy that it would be wasteful and could result in paying for a duplication of efforts. There was no attorney testimony offered to counter the cities' evidence showing its entitlement to the rate case expenses. In response, Chief Justice Carroll wrote: "We determine that the Commission's policy decision to impose the surcharge on the two sets of cities that generated the expenses falls within its discretion to pass ratemaking costs to the consumer."[94] The court went on to conclude that because the finding regarding disallowance of the attorneys' fees "rests in large part on a policy decision, it is unnecessary to determine whether the record contains evidence to support the Commission's decision...."[95]

The evidence is clear, and the law is clear. Neither the Commission nor the appellate courts of this state require attorney testimony to adjust rate case expenses and both consider the "public interest" factor to be a consideration independent of "reasonable and necessary." However, CLWSC cites a plethora of cases to bolster its claim that attorney testimony is necessary before a claim for attorney's fees can be entertained and that the public interest factor is just a redundancy. These cases are all inapplicable to a decision by a Commission to make water customers pay for the attorney's fees incurred by the utility in its efforts to raise those rates. While the original ED's closing explained how the customers are neither committing a deceptive trade

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[93] Industrial Utilities Service, Inc. v. Texas Natural Resources Conservation Commission, 947 S.W.2d 712,717 (Tex. App. Austin 1997, write denied)
[94] *West Texas Utilities v. PUC*, 896 S.W. 2d 261, 271 (Tex. App. – Austin 1995, no writ)
[95] Id. at 272

practice nor violating the civil rights of the applicant, but instead are a captive audience that cannot get water unless they pay the expenses, more discussion will follow here.

The *Industrial Utilities* case explains why the rate case expense issue in a utility case is a special circumstance in which the public interest is central rather than a run of the mill claim for attorneys' fees in divorces, contract claims, DTPA claims, and civil rights cases. The court explained the unique character of claims for rate case expenses as follows: "Courts have recognized that rate design is a complex problem and may be based on many factors. The Texas Supreme Court as well as this court has acknowledged the pass through of ratemaking costs to the consumer by surcharge is widely recognized as a ratemaking practice." The court went on to disallow the cities rate case expense claims based entirely on policy issues.

Even a cursory analysis reveals the inapplicability of cases cited by CLWSC in support of its claim that once they put their invoices in evidence, then they cannot be decreased unless an attorney takes the stand. To begin with, none of them are water utility cases and none of them have a public interest factor statutorily enumerated as a consideration.

CLWSC claims that "it makes no sense" to find that what is reasonable and necessary between an attorney and client is not necessarily the same as what is "reasonable necessary and in the public interest." CLWSC scoffs that "Reasonableness and necessity or the lack thereof does not fluctuate and its existence must be supported by credible evidence."[96] What is incredible about that statement is that CLWSC is arguing that Commissioner Rubenstein's statements in *TLU* and the Commission's adjustments to rate case expense in the public interest "make no sense." The ED would suggest that what "makes no sense" is to state that the attorney/relationship and the plaintiff/defendant relationship in a DTPA case is exactly the same as the relationship between a water utility and its customers. What "makes no sense" is to argue that the words "public interest" constitute a mere redundancy, and that proof of reasonableness and necessity write the words out of the statute. Moreover, the ED would also suggest that what "makes no sense" is to ignore Commissioner Rubenstein's rationale in *TLU* and to claim that *WaterCo*, *TLU*, *Aqua*, *West Texas Utilities*, *Industrial Utilities*, and

[96] CLWSC Closing Argument on Rate Case Expenses p. 3

Lakeshore were all wrongly decided and that cases dealing with divorce, contract, products' liability, guardianship, probate, election contests, and deceptive trade practices are the appropriate cases to look at rather than decisions by the TCEQ or other regulatory bodies on utility cases.

CLWSC contends that the ED's recommendation that rate case expenses be reduced based on the "public interest" is somehow arbitrary and capricious because the "public interest" doesn't have a check list of considerations in the rules. However, the authority cited for the proposition of law actually proves the opposite. Specifically, CLWSC cites the *AEP* case[97] for the proposition that lack of details regarding the "public interest" within the statute or the rule, causes any determination of the public interest when awarding rate case expense to be arbitrary and capricious.[98] If one actually reads the case, however, one finds the following language:

> The legislature did not present the Commission with any factors for the Commission to use in determining whether the transactions included capacity costs nor by which the Commission could quantify those costs. *See City of El Paso*, 883 S.W.2d at 184 (noting that an agency acts arbitrarily and capriciously by failing to follow factors the legislature mandates, following irrelevant factors, or reaching an unreasonable result). The Commission fuel rules do not contain methodology by which capacity costs may be identified and quantified. *See* 16 TEX.; ADMIN CODE § 25.236. The Commission reached a reasonable result. *See City of El Paso*, 883 S.W.2d at 184. The Commission did not act arbitrarily and capriciously.[99]

Therefore, the very case CLWSC cited to attack the Commission's power to act on the words "public interest" without specific rule or legislation detailing factors and a methodology, actually held that neither of these considerations made agency action arbitrary and capricious. The appellate courts and the Commission have made adjustments based on the public interest. This fact and the case cited by CLWSC actually confirm the legitimacy of past practice. CLWSC's contention that the public interest can't be a factor to decrease rate case expenses evaporates, and the reasonableness of rate case expense falls into further peril.

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[97] *AEP Tex. Cent. Co. v. PUC of Texas*, 286 S.W.3d 450 (Tex. App.—Corpus Christi 2008, pet. denied)
[98] CLWSC Closing Argument on Rate Case Expenses p. 5
[99] *AEP*, 286 S.W.3d at 474

4. *The ED's witness is competent to give testimony on all rate case expenses.*

CLWSC includes in its exceptions and in its closing arguments a plethora of cites in an attempt to support its proposition that attorney's fees can't be reduced without expert testimony that considers each of the *Arthur Anderson* factors and that only an attorney can contradict an attorney's testimony as to reasonableness and necessity and the public interest. Included in the list of cases is one unpublished opinion that was withdrawn,[100] but to list all the problems with the cases cited would require dozens if not hundreds of pages. The cases cited by CLWSC in its closing and exceptions include *Arthur Andersen* (a DTPA case), *Bocquet* (a real estate case involving easements), *Woolet* (a guardianship case), *Horvath* (a divorce case), *Cantu* (a contract case), *Lesikar* (a probate case), *Robinson* (a products liability suit), *Havner* (a personal injury case), *Gamill* (a products liability suit), *Ragsdale* (an election law suit), and *Collins* (an attorney contract suit following a wrongful death case).

It is hard sometimes to discern which part of the string cite applies to which principle CLWSC is proffering.[101] What can be said is this -- none of them is a water utility case that includes a public interest factor to be considered. The utility cases that consider the public interest factor (one electric and two water) are West *Texas Utilities*, *Industrial Utilities*, and *Lakeshore*. As explained in the ED's original closing, these are the cases that apply directly to this case and they all hold that the public interest is a factor that can decrease attorneys' fees and that the test is whether the agency has articulated a rational basis for its decision. Furthermore, great deference is given to the

[100] CLWSC cites *Horvath v. Hagey*, 2011 WL 590472 (Tex. App, Austin—February 15, 2011) on pages 6 and 7. On May 6, 2011, in an unpublished opinion, the Austin Court of Appeals withdrew its earlier opinion and substituted a new one. This was a divorce case.

[101] For example, CLWSC on page 7 of its closing on rate case expenses cites to a string of three cases in the body of the argument and then two administrative cases in a footnote for the proposition that the attorneys' fees cannot be assailed unless another attorney testifies against that testimony. None of the cited cases held that. In fact, in the footnote found on page seven CLWSC incorporates its exhibit A from the LCRA case. It is an out-of-context portion of the transcript of that hearing that was not entered into evidence but was referenced in CLWSC's objections to the ED's pre-filed testimony. This vague reference is extraordinarily misleading because it does not disclose that Judge Card's decision not to let Ms. Loockerman testify in that case was based on failure to disclose in response to discovery that she would offer such testimony. It was not based on her being unqualified to testify. This is explained in the ED's response to the objections to testimony. Not only does this reveal that the citation is inaccurate, but also bolsters the ED's position on disallowing rate case expense for boiler plate objections to testimony that waste resources.

agency's determination of the public interest. In none of these cases was attorney testimony necessary to decrease the rate case expense award based on the public interest.

While CLWSC has pages of string cites, the trees those pages represent should not make one lose sight of the forest in this case. That forest is this: in a utility case, the Commission may decrease an award of rate case expenses based on the public interest if the agency has a rational basis for its decision, and that attorney testimony is not necessary to make such an adjustment.

The nature of the disagreement is not on any of the *Arthur Andersen* factors. The disagreement involves policy determinations that have nothing to do with whether or not the fees sought violate the ethical rules and therefore are not reasonable and necessary. Under CLWSC's analysis, the only factors to consider are the *Arthur Andersen* factors. According to CLWSC, if those factors have testimony to support them from an attorney, then its claim is reasonable and necessary, and furthermore, because all disciplinary rules are to protect the public, they are also in the public interest. The absurd result of that logic is that the only way that attorneys' fees can be decreased in a rate case expense claim is if the attorneys violated their ethical duties to their client or if an attorney's own testimony admits to his/her fees being not in the public interest. That is not what the utility rate case expense decisions hold.

The ED does not maintain that any of the attorneys' fees sought in this case were unethically obtained, but instead, that policy considerations require that the amount billed to the customers by the utility needs to be adjusted down. The utility and their attorneys can agree to spend whatever they think is necessary to prevail in the case and to use wear down tactics such as long and convoluted objections to testimony (in an administrative case with no jury to protect) and using expensive color-coding for maximum persuasive effect. That is not unethical, nor does it show the fee charged by the attorney to the client violates any of the TDRPC. What the ED maintains is that the customers should not have to pay for a belt and suspenders when either alone would do. Furthermore, CLWSC used three attorneys for 187.25 hours to prepare closing arguments (PFD page 106) when the ED determined that 120 hours was more than sufficient.

This is the fundamental error in CLWSC's sophistry. The TDRPC rules only address what an attorney can ethically charge his client. These rules give guidance as to what rate an attorney should charge her clients, but they do not address any public interest concerns that relate to the provision of water service.

In *Arthur Andersen*, the court held that if a DTPA plaintiff wants to collect attorneys' fees from one who defrauded him, he must do more than just present a contingency contract, but instead must address factors that would reveal that what his attorney charged him was reasonable before it is passed on to the defendant. Interestingly, this case actually hurts CLWSC's position.

CLWSC takes the wrong spin out of the *Arthur Andersen* DTPA case. If anything, *Arthur Andersen* cuts against CLWSC's position. *Arthur Andersen* did not decide what is required to limit rate case expense; on the contrary, it decided what was necessary for a party attempting to prove entitlement to attorneys' fees. It decided that a DTPA plaintiff can't just throw down its contingency contract and make the other side pay that contingency under a statute meant to deter deceptive trade practices (and give full compensation to a person who had been wronged by a deceptive trade practice). Even in a case where awarding attorneys' fees is punitive and meant to deter bad behavior, one cannot argue that since one paid an amount, it can recover that amount. So *Arthur Andersen* raises the bar for proving an entitlement to attorneys' fees. CLWSC cannot just lay down its bills, say they were paid and then collect that amount from the customers. That is what would violate *Arthur Andersen's* rationale.

While the utility cases cited above are sufficient to justify the ED's position on rate case expenses, in an abundance of caution the ED will address some of the rabbit trails laid out in CLWSC's closing. CLWSC states that testimony from a party's attorney is established as a matter of law if the testimony is not contradicted by any other witness and is clear, direct, and free from contradiction. The case cited for this proposition is *Ragsdale*, which was an election contest case. What the court specifically wrote was this:

> It is the general rule that testimony from an interested witness, such as a party to a suit, though not contradicted, does no more than raise a fact issue to be determined by the jury. But there is an exception to this rule, which is that where the testimony of an interested witness is not contradicted by any other witness, or

> attendant circumstances, and the same is clear, direct, and positive, and free from contradiction, inaccuracies, and circumstances tending to cast suspicion thereon, it is taken true as a matter of law.[102]

The ED submits that even if CLWSC's position is correct, its testimony only addressed whether the attorneys charged their client an ethical amount under the rules. The ED does not dispute that. What the ED maintains is that it is not in the public interest to pass the entire amount on to the utility's customers because the customers should not have to pay for Rolex representation when a Timex would do, and it is never in the public interest to encourage waste. CLWSC offered no testimony on that issue other than to contend that the ED had two attorneys sitting at the hearing, that another TCEQ attorney came in to meet the ED staff for lunch one day and that OPIC and Mr. Freeland were also there. The ED also maintains that it is not in the public interest to encourage waste of resources by allowing a utility to collect its attorneys' fees for filing dilatory objections and discovery responses. CLWSC's only testimony countering this is that everyone else made mistakes, too. The ED has addressed both of these positions in its original closing (no other party seeks to collect its fees from the customers, and no other mistakes have been shown to result in tens of thousands of dollars in additional rate case expense). Additionally, CLWSC's testimony is not clear and direct and free from contradiction. Mr. Zeppa testified that the closing argument could be done in 80 hours,[103] yet CLWSC offered invoices showing that it had already charged for 187 hours of closing argument. Mr. Zeppa also testified that he handled many depositions all by himself and did fine at them;[104] yet CLWSC offered invoices and seeks to recover for two attorneys appearing at every deposition. Additionally, Mr. Zeppa testified that he had adequately handled large water utility cases in the past all by himself;[105] yet CLWSC offered invoices and seeks to recover for three attorneys appearing at every day of trial. Finally, Ms. Loockerman did contradict their testimony, and *Ragsdale* holds that contradiction from any witness makes the presumptive veracity of the interested testimony disappear.

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[102] *Ragsdale v. Progressive Voters League*, 801 S.W.2d 880, 882 (Tex. 1990).
[103] Tr. p 1639 line 8 – p 1640 line 17
[104] Tr. p 1638 line 16 – p 1639 line 7
[105] Tr. p 1637 line 21 – p 1638 line 3

While *West Texas Utilities*, *Industrial Utilities*, *Lakeshore*, *TLU*, *WaterCo,* and *Aqua* all show that the test for decreasing the attorneys' fees portion of rate case expense is a question of law (agency policy) and that a rate case consultant can give competent testimony to decrease an attorneys' fee claim, the ED will still respond to the claim that Ms. Loockerman's testimony was the equivalent of no testimony because she isn't an attorney.

There are so many ways to show the competency of her testimony, but the first proof should come from the mouth of CLWSC's own witness. Here is an excerpt from the ED's cross examination of Mr. Loy.

> Q. Now when you prepared your testimony in this case, you gave testimony as to rate case expenses – is that right – in your testimony?
>
> A. Yes.
>
> Q. And when you prepared your testimony, you included an attorneys' fee survey. Is that right?
>
> A. Yes. I believe I did.
>
> Q. And this survey was prepared to demonstrate the reasonableness and necessity of attorneys' fees in this case. Is that right?
>
> A. Yes.
>
> Q. And this analysis and your conclusions are based on what you as an experienced rate consultant have observed Is that correct?
>
> A. That's correct.
>
> Q. And you contend that you are qualified to direct and control this type of report and then testify as to the reasonableness and necessity of attorneys' fees based on your experience as a rate consultant. Is that correct?
>
> A. That is correct.
>
> Q. Do you also contend that you're competent to testify as to the reasonableness and necessity of attorneys'' fees in this case based on your experience of numerous rate cases and review of various legal and consulting charges by firms with similar experience?

> A. Yes.
>
> Q. And are you also are qualified to state that all the firms for which Canyon Lake seeks rate case expense, they all provided their services in a professional and timely manner?
>
> A. Yes.
>
> Q. So you are an expert on rate case expenses, aren't you?
>
> A. Yes.
>
> Q. And it's normal for rate consultants such as yourself to give testimony on rate case expenses as you have in this case?
>
> A. Yes.[106]

So CLWSC's own witness testified that non-attorney experts normally give testimony on rate case expenses including attorneys' fees. That should be enough to close the book on the issue.

However, more support for the competency of Ms. Loockerman's testimony comes from *TLU*. In the PFD after remand in that case, the ALJ stated that, "Ms. Perryman did not have the knowledge, experience, training, or background to support some of her opinions about the legal services issues in Part I."[107] The footnote reveals the basis for that statement. It reads: "Ms. Perryman testified that her duties at the TCEQ include '. . . reviewing and processing contested and uncontested water/sewer rate, Certificate of Convenience and Necessity (CCN), and Sale, Transfer and Merger (STM) applications to prepare detailed and comprehensive recommendations based on professional judgment in compliance with the Texas Water Code and TCEQ's rules and regulations.'"

The disclosures and pre-filed testimony in this case reveal that Ms. Loockerman has extensive experience in analyzing the attorneys' fees portion of rate case expense. In addition, even more predicate was laid in Ms. Loockerman's direct testimony. Consider the following excerpt.

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[106] Tr. p 1734 line 21 – p 1736 line 9
[107] CLWSC Ex. 81 p 17 of the TLU PFD

Q. Do some of these corrections deal with the reasonableness and necessary and public interest aspects of the attorneys' fees portion of the rate case and some of the consultants' rate case expenses?

A. Yes.

Q. How long have you been working in the area of determining proper water and sewer utility rates?

A. Approximately 20 years.

Q. And in that time, have you worked with attorneys representing utilities as well as for the regulatory authority?

A. Yes, Sir.

Q. Have you prepared testimony regarding the award of attorneys' fees in rate cases before?

A. Yes.

Q. Have you given testimony stating that attorneys' fees were reasonable and necessary and in the public interest in those cases?

A. Yes.

Q. Do you work closely with the attorneys and discuss the invoices for attorneys' fees when you gave that testimony?

A. Yes, sir.

Q. Have you reviewed hundreds of attorneys' fees invoices in cases similar to this one in the past?

A. Yes.

Q. Have you assisted attorneys in preparing for trial, drafting and responding to discovery, drafting closing arguments and exceptions and preparing for agenda?

A. Yes.

Q. Is it usual for rate case expenses—rate case expense experts such as you to rely on information supplied by attorneys in determining whether the rate case expense sought was appropriate?

A. It is the usual practice, yes.

Q. Do experienced rate consultants such as you often give testimony as to whether or not attorneys' fees should be awarded as rate case expenses?

A. Yes.

Q. Did Mr. Loy offer testimony as to the reasonable and necessary attorneys' fees sought in this case?

A. He did.

Q. Is Mr. Loy an attorney?

A. No.

Q. In this particular case did you consult with an attorney on all issues regarding the reasonableness, necessity and public interest aspects of the attorneys'' fees portion of the rate case?

A. Yes.

Q. And who was that attorney?

A. Mr. MacLeod. You.

Q. Were the parties informed of this reliance?

A. Yes, in my prefiled testimony.

Q. Were the details regarding that attorney disclosed to the parties?

A. Yes, in discovery.

Q. I'm handing you what has been marked as ED 5, and can you identify that?

A. ED 5 is the Executive Director's supplemental response to CLWSC's request for disclosure.

Q. And does that disclose the identity and qualifications of the attorney you relied on in making your determinations?

A. Yes.[108]

After considering this testimony and the rules of evidence dealing with expert testimony (TRE 702 et seq.) and the *TLU* PFD, the clear conclusion is exactly what the

[108] Tr. p 1778 line 1 – p 1780 line 17

ALJ stated in this case: "I think he's met the threshold that she's qualified to testify about rate case expenses."[109]

The excerpt above also addresses more issues that show the competency of Ms. Loockerman's testimony. In the *TLU* PFD the ALJ wrote that the evidentiary problem would have been solved if she consulted with and relied on an attorney, but that she had made a conscious decision "to provide this type of evidence without assistance from counsel."[110] In the excerpt above and throughout the record, Ms. Loockerman reveals that she made a conscious decision to use the assistance of counsel.

The excerpt above also counters CLWSC's tenuous contention that Ms. Loockerman's testimony should be stricken because the sixth amendment requires a criminal defendant to have the ability to cross examine anyone who a testifying witness relies on.[111] While this argument disregards TRE 703 (which provides an expert may rely on hearsay if it is the type usually relied on) and attempts to apply criminal law in a civil case, Mr. MacLeod's identity was disclosed and Ms. Loockerman was cross examined. Therefore, CLWSC's claim of unfairness by not having the attorney presented for cross examination is without merit.

Furthermore, CLWSC claims that "there is nothing in the record that indicates Mr. MacLeod has any experience as a litigator representing a party with the burden of proof in a water utility rate case."[112] That sets the bar so high that no attorney in the Water Utility Section could clear it. Under CLWSC's analysis, even if she had relied on the attorney identified in disclosure, her testimony would still be incompetent because the attorney had no experience working as an attorney representing the party with the burden of proof in a water rate case. As revealed by the response to disclosures, Mr. MacLeod does have over ten years' experience with the burden of proof when representing state agencies in tax collection cases in addition to representing the ED in several fully litigated utility cases. In fact, the attorney has more private practice and general experience than any other staff attorney in the ED's water utility section of the Environmental Law Division. Under CLWSC's approach, the ED is unable to produce

[109] Tr. p 1786 lines 11-13
[110] CLWSC Ex. 81 page 17 of the *TLU* PFD
[111] CLWSC doesn't make this argument explicitly. However, the case it cited for support of this proposition held exactly this. On cross examination, CLWSC's attorney continued to maintain that the case was applicable. Tr. p 1575 line 7 – p 1576 line 7
[112] CLWSC closing argument on rate case expenses p. 15

any witness to counter its self-serving, conclusory statements[113] and there would never be any limit on the number of attorneys or hours spent on the case. ALJs would have no alternative but to add every penny of that rate case expense to the customers' bills in every case. The customers would pay these rate case expenses or lose their water because only the utility has the resources to provide an attorney competent to give testimony.

5. The 51% rule.

As explained in the ED's exceptions, the utility will not meet the requirement of Rule 291.28(8). The revenue generated by the final approved rates in the PFD with or without the Acquisition Adjustment urged by the ED will not generate revenues which meet the 51% test with regard to the utility's proposed rates. When the Commission promulgated that rule, the regulated community was put on notice that it should avoid overreaching in its applications and then raise the specter of incurring large rate case expenses in order to coerce a favorable settlement. While this utility has been operated very well and has been cooperative with the Commission, the facts of this case reveal that this rate application was an overreaching one, and that the utility did over-litigate the case.

To begin with, rate case expenses have been a problem that consumers and legislators have consistently raised for many years. On its face, the complaint is obvious. The customers have to pay not only for their own attorney, but also for the best available (in this case two of the best available) attorneys whose ethical duties require them to get as high a rate as possible for their client. The customers are paying for better representation of their opponent than they can afford for their own attorney. Furthermore, if CLWSC's arguments stand, recoverable attorney's fees cannot be limited because only the applicant's attorneys are qualified to testify on the issue. The incentive is to use every resource possible because the customers will pay for it in the end.

[113] In fact, in footnote 53 of CLWSC's Closing on Rate Case Expenses makes this very proud and bold assertion: "this case is unique so neither Ms. Loockerman or Mr. MacLeod could possibly possess this information."

While the rule only requires the 51% threshold to be met, an inquiry into the facts of this case shows that the policy is invoked also in this case. To begin with, the utility used the trending study numbers to attempt to include 8.2 million extra dollar to estimate original cost rather than confirm the previously claimed estimate available in the financial statements and previous rate cases. The utility also wanted to collect a return on that inflated amount. The record reflects little effort by CLWSC to limit rate case expenses. CLWSC's witness Chuck Loy testified that limiting rate case expenses wasn't much of a concern at all. CLWSC's witness Jensen testified that all limits put on rate case expenses were included with the written agreements with the consultants and attorneys, and those agreements which were provided in discovery revealed no limitations. The only limit that Jensen did testify to was that Mr. Scheig was to be paid $8,000. However, CLWSC did not enforce that limit, but instead asked that it recover $55,000 from the customers to pay Mr. Scheig. The attorneys also appeared to do little to limit rate case expenses. In fact after the PFD was issued, CLWSC's attorneys continued to make filings with the ALJ, as reflected in the e-filings on this docket.

The application proposed unreasonably high rates. The utility also included other inflated numbers in its application. Even though it claimed it was an error, it initially included the $150,000 cost of filing the application both in rates and in its request for rate case expenses and the overreaching may have flowed through to the final order had CEWR not pinned down the witness in cross examination.

These examples of overreaching could be summarized in the following manner: Canyon Lake overstated its cost of service as a basis for its rate increase. The proposed rate was much higher than the just and reasonable rate.

- Overstated operating expenses: Canyon Lake has requested a 33.9% (ED recommended 13.1%) increase in operating expenses over the test year operating expenses.
- Excessive rate of return: Canyon Lake requested an excessive rate of return on equity (12% versus 10.88%) and excessive estimated rate base (trending) rather than documented receipts.
- Excessive rate base: A substantial amount of rate base was estimated using trending rather than documented receipts or audited books and records, exceeding the audited books and records of the entity from whom the assets were purchased. Rate base was either overstated by $7.4 million (21.8%) if cost free

capital is removed from rate base or $3.5 million (9%) if cost free capital is not removed.

- Excessive total return: Canyon Lake’s requested return on invested capital is 63.5% higher than the ED’s recommendation ($1.4 million more). The fact is that if the ED’s recommended return had been collected in the test year, net profit would have been about $2 million for Canyon Lake, with operating expenses totaling $6.8 million. The net income ratio would then have been 2 to 8.8, or 22.7%. The return on balance sheet equity for the requested revenue requirement is 22.3%. April 1, 2010 to the present time has shown record drought with record water usage in Central Texas, and continued customer base growth. Profit experienced in 2010/2011 would reasonably be expected to be much more.

Calculations with record citations:

Canyon Lake’s total operating expenses in the test year: (a) $6,819,139 (ED DL 19)

ED recommended operating expenses: (b) $7,712,585 (ED DL 5, Revenue requirement less return)

Recommended increase in operating expenses (b-a) $ 893,446 (13.1%)

Recommended return $2,200,128

Total ED recommended increase $3,093,574

Canyon Lake’s requested operating expenses (c) $9,129,730 (ED DL 5, Revenue requirement less return)

Requested increase in operating expenses (c-a) $2,310,591 (33.9%)

Requested return $3,597,868

Total Canyon Lake requested increase $5,908,459

The word “may” in Rule 291.28(8). On page 60 of CLWSC’s exceptions is argues that the use of the word “may” makes the disallowance of rate case expenses under the 51% rule discretionary with the Commission. CLWSC missed the important word that appears in the rule immediately after the word “may.” Rule 291.28(8) uses the phrase “a utility may **not** recover....”[114] Section 311.016 of the Texas Government Code provides that in construing law “’may not’ imposes a prohibition and is synonymous with “shall not.” Furthermore, CLWSC’s position does not comport with the preamble published in the Texas Register when the rule was promulgated. Here is an excerpt from that preamble that was quoted at more length earlier in this reply. “The purpose of this

[114] Emphasis added

rule change is to set out clearly certain instances when, as a matter of law, rate case expenses will be considered unreasonable, unnecessary, and against the public interest. In particular, two rules are adopted where rate case expenses will be disallowed as a matter of law."[115] This statement shows that the intent of the rule was to bar all rate case expenses if the 51% threshold is met as a matter of law – not to create a loophole that would allow advocacy to continue the practice that customers have been complaining of for years.

Unbilled revenues and non-metered revenues. CLWSC also argued that the ED used the wrong number for the denominator in the 51% rules calculation because it included unbilled revenues. This argument is unpersuasive. The 51% rule requires two numbers. The first number is the increase in revenue that would be generated by the utilities existing rates while the second is the increase in revenue that would be generated by the Commission's final approved rates. The ED took the numbers for what would be generated from the existing rates straight from CLWSC's application.

The ED then listed the numbers in ED Ex 9. The removal of non-metered revenues was appropriate because there was no evidence presented as to what this number is. Unbilled revenues are revenues, whether billed or not, and no evidence was presented to indicate that the rates did not, or should not have produced these revenues if they were actually billed. It is CLWSC's burden of proof to show that these revenues were produced by something other than the rates. The unexplained, unbilled revenues most likely were part of the rate structure of the utility. For instance, if the unbilled revenues were produced by CLWSC not billing its employee's water bills, then, most certainly, these revenues must be included in the calculation. If CLWSC chose not to bill revenues which should be produced by the rates, these revenues must be included in the calculation. Since CLWSC provided no explanation for the unbilled revenues, the ED recommends including them in the calculation as was previously presented. When CLWSC's witness Loy was asked what that figure represented, he answered, "I can't remember."[116]

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[115] 31 Tex. Reg. 8107 (September 22, 2006)
[116] Tr. p 1734 lines 15-20

CLWSC also maintains that its rate case expenses should also be included in determining what increase in revenues would be generated by the Commission's finally approved rates. This would undermine the entire purpose of the 51% rule.

The rule was meant to discourage filing applications with overreaching total revenue requirement requests for ratemaking purposes. The result of CLWSC's argument would be to skew the 51% calculation for the benefit of the utility. The more rate case expense awarded, the easier for the utility can meet the 51% test. To argue that the purpose of the rule can be circumvented by charging even more rate case expenses in order to increase the numerator in the calculation is puzzling. Including rate case expense in the calculation would defeat the whole purpose of the calculation in the first place. The purpose of the rule is to encourage utilities to apply for increases that are justified rather than applying for much more than they can justify, then negotiating or litigating down to a level that the utility believes is acceptable. Indeed, if the 51% could be reached by including revenues collected to cover rate case expense, it would be to the utility's advantage to rack up as much rate case expense as possible, especially if the ED has no witness that can testify as to the reasonableness, necessity, and public interest aspects of the rate case expenses--such a position and calculation borders on absurd.

Including rate case expenses in the 51% calculation meant to limit exorbitant rate case expenses is illogical. CLWSC also maintains that its rate case expenses should also be included in determining what increase in revenues would be generated by the Commission's finally approved rates. This would undermine the entire purpose of the 51% rule.

The rule was meant to discourage filing applications with overreaching total revenue requirement requests for ratemaking purposes. The result of CLWSC's argument would be to skew the 51% calculation for the benefit of the utility. The more rate case expense awarded, the easier for the utility can meet the 51% test. To argue that the purpose of the rule can be circumvented by charging even more rate case expenses in order to increase the numerator in the calculation is puzzling. Including rate case expense in the calculation would defeat the whole purpose of the calculation in the first place. The purpose of the rule is to encourage utilities to apply for increases that are justified rather than applying for much more than they can justify, then negotiating or litigating down to a level that the utility believes is acceptable. Indeed, if the 51% could be reached by including revenues collected to cover rate case expense, it would be to the utility's advantage to rack up as much rate case expense as possible, especially if the ED has no witness that can testify as to the reasonableness, necessity, and public interest aspects of the rate case expenses--such a position and calculation borders on absurd.

IV. CONCLUSION AND PRAYER

There are so many issues in this case that to address every single point in CLWSC's exceptions would require hundreds of pages. The PFD sufficiently addresses all of the issues, and therefore, an extended discussion of each corner of the exceptions is unnecessary. The ED has already filed 100s of pages of briefing in the trial court as has CEWR and CLWSC. This utility serves approximately over 9,000 connections and tens of thousands of Texans, and they should be entitled to a fair rate on their water and should not be required to pay for CLWSC's total unlimited budget for rate case expenses. As CLWSC pointed out in its citation to the *Hope* case, ratemaking is sometimes more of an art than a science. The quotation CLWSC used was cited at the top of this reply and bears repeating here.

> [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 the theory, but the impact of the rate order that counts."[117]

While the PFD did not make the negative acquisition adjustment to remove the cost free capital, nearly all of the remaining portions of the PFD arrive at a fair rate and are based rationally on the law and the evidence admitted at trial. To find a reason to remand the case would not offer an opportunity to provide perfection, but instead would elongate an already too long proceeding, offer the parties an opportunity to raise all

[117] *Id.* at 602

imaginable arguments and motions, and to charge the customers for three attorneys that charge $375, $250, and $225 per hour for appearing at the hearing, drafting new closings and exceptions, and appearing at Agenda another time.

WHERFORE, PREMISES CONSIDERED, the ED respectfully request that the Commission adopt the PFD with the exceptions urged by the ED, and incorporate the regulatory approvals spelled out in this response in the Commission's final order.

Respectfully submitted,

Texas Commission on Environmental Quality

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REPRESENTING THE
EXECUTIVE DIRECTOR OF THE
TEXAS COMMISSION ON
ENVIRONMENTAL QUALITY

CERTIFICATE OF SERVICE

I certify that on January 22, 2013, the "Executive Director's Response to CLWSC's Exceptions" for TCEQ Docket No. 2010-1841-UCR was filed with the Texas Commission on Environmental Quality's Office of Chief Clerk and served in accordance with the TCEQ rules, SOAH rules and the TRCP as appropriate.

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TCEQ DOCKET NO. 2010-1841-UCR

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