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APPLICATION OF DOUGLAS UTILITY COMPANY TO CHANGE WATER AND SEWER RATE/TARIFF IN HARRIS COUNTY, TEXAS	§ § § § §	BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

PREFILED TESTIMONY

DOUGLAS UTILITY COMPANY

Ronald Payne

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PREFILED TESTIMONY OF RONALD PAYNE

Q. Please state your name and business address for the record.

A. My name is Ronald Payne. My business address is 12284 FM 3803, Conroe, TX 77301.

Q. By whom are you employed and in what capacity?

A. I am the president of T & W Water Service Company, an investor-owned water utility headquartered in Conroe. I also engage in a private consulting practice involving utility accounting, ratemaking, and certification applications.

Q. What is your relationship to Douglas Utility Company ("DUC"), the applicant in this rate change docket?

A. I am appearing as a private utility consultant. I prepared and will sponsor the rate change application and proposed tariffs.[1]

Q. Do you or T & W have any affiliate interests in DUC?

A. No.

WITNESS' BACKGROUND

Q. What is your educational and professional background that makes you qualified to testify in this case?

[1] DUC Exhibit 1

A. I studied accounting at the University of Houston. From 1978 to 1986 I worked for the Houston accounting firm of Degeyter and Associates where I worked with our water and sewer utility clients. From 1986 to 1998, I was controller of H & J Water Company and B & B Sewer Company, affiliate utilities that are the predecessors of T & W Water Service Company ("T & W"). From 1988 to 1999, I owned and operated Payne Utilities, an investor-owned utility ("IOU") providing water utility service in Montgomery County and counties to the north. From 1993 to 2007, I was a principal in Water Services, Inc. and Diamond Water Company, IOU water utilities serving Bexar, Comal and Guadalupe Counties. In 2009 I returned to T & W as General Manager. I was recently made President of T & W.

Q. Have you had other training and experience in IOU operations and ratemaking?

A. Yes. I have attended many TCEQ-sponsored or certified training courses. I held a Class C water operator license. I have participated in a number of regulatory stakeholder groups at both the state and federal level. I have been an officer and a director of the Independent Water and Sewer Companies of Texas ("IWSCOT"), the trade association of Texas privately-owned water and sewer companies.

PREPARATION OF RATE CHANGE APPLICATION

Q. Where did you obtain the data you used to prepare the water and sewer rate change applications?

A. Data for different elements of the rate case came from different sources. Generally financial records and information about expenses came from Carol Zieben, owner and President of DUC, and her assistant Olga Schnur.

Q. How does DUC maintaining its accounting records?

A. Mrs. Zieben and Ms. Schnur maintain the utility's accounting records using an Intuit QuickBooks program.

Q. Is this a reliable form of accounting records?

A. Yes. It is quite common for smaller businesses, including utilities, to use QuickBooks. The program is easy to understand and use, and it can easily be converted by CPAs and tax consultants for more detailed purposes.

Q. Did DUC have historic accounting records or invoices going back to the original installation of the utility systems?

A. No. This is not uncommon for a small IOU this old.

Q. Where did you get operation and repair cost data?

A. I got it from DUC and its contract operators, TNG Utility Corp. ("TNG").

Q. Where did you get the billing determinants used in designing the proposed service rates?

A. TNG.

Q. Where did you get the data used to calculate DUC's rate bases?

A. This will be discussed in the next section of my testimony.

CALCULATING RATE BASE

Q. Where did you obtain the information on invested capital ("rate base") shown in the rate change application?

A. DUC and TNG had records of capital construction since Mrs. Zieben assumed the management of the utility following her husband's death, so I used it. I researched prior rate cases to see what reliable information might be found there. I made detailed inventories of the water and sewer plants. I determined there were a number of assets in service that were not reflected in the records I had developed. As I have done in many prior cases, I contacted GDS and Associates, a national engineering and consulting firm with offices in Austin, and asked them to perform a trending study to determine the best estimation of what it cost to construct these assets and put them into public service. I have worked on and with trending studies in the past, so I was very familiar with them. I reviewed the GDS work product and satisfied myself that it was accurate and reliable. I formulated my opinions on rate base in the application using this data in conjunction with the other data I described. The reported water and sewer rate bases are found in Sections III(B) water and sewer of the application.

Q. Is the information in Sections III(B) water and sewer of the application reliable and consistent with the TCEQ's rules on record keeping?

A. Yes to both questions. The utility no longer has original accounting data on its rate bases backed up with original cost invoices from the time of construction. IOU's are required by TCEQ Rule 291.72 to follow the NARUC Uniform System of Accounts. The NARUC accounts provide that when original accounting information is not available, rate base is to be estimated using a reliable method. Trending studies have been accepted in Texas as reliable estimations for 20 years. Two of Texas' largest IOUs, AquaSource and Monarch, had their multi-million dollar rate bases set by the Commission entirely on the basis of trend studies. I have used trending studies in the much smaller rate cases I have worked on.

Q. Were other adjustments made to these rate bases to determine the invested capital that would generate DUC's return? If so, explain.

A. Yes. TCEQ Rule 291.31(c) lists various adjustments to plant in service that may or must be made when calculating invested capital. I followed these rules and made the appropriate adjustments.

CALCULATING RETURN

Q. How did you calculate the return on investment applied to these rate bases in the application?

A. DUC had no debt in the test year. I calculated a return on DUC's equity using the Return Worksheet found in the instructions of the rate change application.

Q. Where did you get the average bond yield that is the starting point in the Work Sheet?

A. The application instructions provide a telephone number at the TCEQ to obtain that information. This is what I did.

Q. Why did you use the Return Worksheet?

A. I felt that using the Work Sheet would remove controversial elements from the rate case which we were fairly certain would be contested. I thought that the Work Sheet would generate a return at the low end of the range more traditional methodologies would generate. Since a major consideration of this rate case was going to be the financing of the wastewater treatment plant ("WWTP") rehabilitation through a capital improvement surcharge, the under-calculation of return through the use of the Work Sheet should be somewhat mitigated.

CALCULATING COST OF SERVICE

Q. You have said that Carol Zieben provided you with financial records of expenses. Looking at Section VI(A) – water and sewer of the rate change application, was DUC the source of the information you used in calculating the utility's costs of service?

A. Yes, for the most part. If you look at the top half of each schedule through Line L, the information shown came from the utility's books except for my calculation of rate case expenses. The information below Line L is a mix of historic booked data and calculated data that I will discuss separately.

Q. Did you evaluate and form an opinion on the reasonableness and necessity of the expenses shown above Line L? If so, what was it?

A. Having owned and managed a number of utilities I recognized these to be costs that a prudently managed water or sewer utility would incur in the ordinary course of business. I found them to be both reasonable in amount and necessarily incurred.

Q. Looking below Line L, how did you determine the test year payroll taxes?

A. This was a combination of booked numbers verified by my independent calculation. This is a necessary expense required by law.

Q. How did you determine other taxes?

A. This information came from DUC's books. Again, since they are taxes they are necessary expenses.

Q. How did you determine depreciation expense?

A. This is a calculated number taken from the previously discussed rate bases and applying the standard TCEQ suggested service lives to each plant account. This is shown on Section III(B) of the rate application.

Q. How did you determine income taxes? Did you use the schedule included in the application form?

A. I calculated federal income taxes in the manner required by the Internal Revenue Code for a corporation with the return calculated in the application form. I did not rely on

the schedule in the application form because I thought calculation would be more accurate. These calculations are shown in Section V – water and sewer of the rate change application.

Q. How did you calculate return?

A. Return was calculated by multiplying the calculated invested capital by the proposed rate of return. This is shown in Table IV(E) – water and sewer of the application. The Water Code provides an IOU is entitled to a reasonable return on invested capital, so this is a necessary element in a cost of service.

Q. How did you allocate the water and sewer costs of service for ratemaking purposes?

A. I followed the traditional allocation of costs between fixed expenses to be recovered through monthly base rates and variable costs to be recovered through gallonage charges. For the most part, I followed the suggested allocations in the TCEQ application form Section VI(A) – water and sewer. I did modify the allocation of water labor expenses based upon my discussions with TNG and my personal experiences. I did not make similar adjustments to sewer because this service is not as volatile as water. I believe the allocations I used better match how this Houston area IOU operates than do the suggested allocations in the TCEQ form.

RATE DESIGN -- WATER

Q. How did you design the proposed water rates?

A. I followed the traditional fixed/variable method suggested in the TCEQ application form. This rate design is based upon using a standard 5/8 x ¾-inch water meter as the base unit in designing the fixed monthly base rate. The monthly base rates for larger meters, which put a greater demand on the system, were calculated by multiplying this base rate by a meter equivalency factor provided by the TCEQ. I understand that these meter equivalency factors are taken from the AWWA standards followed nationwide. I did this for all customer classes (defined by meter size); the apartments were no longer given a flat rate for all water consumed.

Variable costs were divided by the test year billing determinants provided by TNG.

Q. Did you modify the fixed/variable rates you calculated? If so, why?

A. Yes. The TCEQ application allows an alternative rate design. I shifted some of the fixed costs to the variable costs. I did this for two reasons. I wanted to keep the base rates for the existing residential customers close to what they were paying. I also wanted a rate that promoted conservation given state policies and the drought we have experienced in recent years.

RATE DESIGN – SEWER

Q. Were the proposed sewer rates calculated in the same manner?

A. Yes. However, I recognize that you cannot achieve much in the way of water conservation through sewer rate design.

Q. Please explain the sewer capital improvement surcharge DUC is proposing.

A. The wastewater treatment plant ("WWTP") is very old and deteriorated. I have seen it during my plant inventory, and it looks bad. Carol Zieben has acquired a loan to pay for refurbishing or replacing the WWTP. The amount of this loan will vary depending on the total final construction, engineering and permitting costs. It is a ten year loan which is only 40% of the expected service life of a new WWTP. If DUC's full requested rate increase is approved without material change, Mrs. Zieben believes she can service this loan with internally generated cash. If the cash flow from the proposed service rates is cut, DUC will need other cash with which to service the loan. The Water Code authorizes the TCEQ to approve capital construction surcharges over and above ordinary service rates for this purpose.

Q. How was the surcharge calculated?

A. After discussing the matter with Mr. Zeppa, I got Rick Clark at Integrity Bank to give me the monthly debt service for the full loan. I calculated as shown in the following excerpt taken from the customer notice of the surcharge:

> Loan: $1,000,000.00 CDC loan with Integrity Bank. The interest rate is 3.75% for the 10 year term. The loan will be interest only the first year. The loan will be taken out only as WWTP upgrade costs are incurred. If the full loan is not needed, it will not be taken out. The sewer surcharge will cease as soon as Douglas has recovered the debt service for the drawn down loan funds.

Monthly debt service year 1 assuming full take down = $3,229.17
Sewer customer equivalents by AWWA water meter size = 432
Monthly surcharge per customer equivalent = $7.47

Monthly debt service years 2-10 assuming full take down = $10,006.12
Sewer customer equivalents by AWWA water meter size = 432
Monthly surcharge per customer equivalent = $23.16

TARIFFS

Q. Why is DUC proposing new tariffs?

A. The existing tariffs are out dated and do not allow DUC to take advantage of current laws and regulations. For example, DUC is allocated in the Harris-Galveston Counties Subsidence District and incurs pumpage fees imposed by law. The utility does not have mechanism to timely recover those costs, even though the TCEQ rules allow pass through clauses to do this. DUC's service rules no longer track current TCEQ customer service rules.

Q. What did you do to address this problem?

A. Mark Zeppa has long maintained sets of model tariffs that are used by IOUs across the state. I have used them for the utilities I have owned and managed and am very familiar with them. After I calculated the proposed rates, with Mrs. Zieben's consent, I gave the rate to Mr. Zeppa and asked him to prepare new water and sewer tariffs using my rates. He did this. Mrs. Zieben and I reviewed and approved them so they were included in the application.

RATE CASE EXPENSES

Q. How have you proposed to recover DUC's cost of preparing and prosecuting this rate change application?

A. It has been my experience in a number of prior rate cases the TCEQ usually allows an IOU to recover rate case expenses as a surcharge over two years. This is what is proposed for this case.

Q. Please explain Section VI(B) of the application.

A. The instructions for the rate application direct the applicant to calculate the costs it incurs in preparing and filing the application. These costs are then amortized and a portion included in the proposed cost of service so the utility can recover these costs, at a minimum, if the case settles or is uncontested.

Q. How does an IOU recover its rate case expenses if the application is contested and set for trial?

A. The costs are calculated. Then, one of two things happens. A surcharge can be calculated using these costs alone. In the alternative, the rate case expenses embedded in the cost of service are removed, added to the post-filing expenses and a surcharge calculated from the combined amount. In either case, the final order directs the IOU to stop the surcharge when a pre-set level of expenses are recovered.

Q. Which alternative does DUC want to follow?

A. It makes little difference to the utility.

Q. How have you proposed to allocate rate case expenses between water and sewer customers?

A. I proposed an allocation based on number of customers. This is 51% water versus 49% sewer.

Q. What rate case expenses have you generated.

A. As shown in the known and measurable changes notes in the application, my cost to prepare the application was $6,600. My estimated costs to conclude the case are:

Pre filed testimony	$ 500
Hearing Prep	$ 500
2 days hearing	$2,000
Travel	$ 600
Total	$3,600

CONCLUSION

Q. Does this conclude your testimony?

A. Yes, it does.