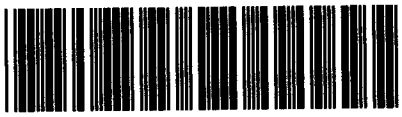

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APPLICATION OF TAPATIO SPRINGS SERVICE COMPANY, INC., TO AMEND CERTIFICATES OF CONVENIENCE AND NECESSITY NOS. 12122 AND 20698 IN KENDALL COUNTY, TEXAS	§ § § § § § §	BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

PROPOSAL FOR DECISION

I. INTRODUCTION

Tapatio Springs Service Company, Inc., (Tapatio or Applicant) has filed an application (Application) pursuant to Chapter 13 of TEX. WATER CODE ANN. (Water Code), seeking to amend its Certificates of Convenience and Necessity (CCN) Nos. 12122 and 20698, in order to extend its water and sewer utility service area within Kendall County, Texas.

The Executive Director (ED) of the Texas Commission on Environmental Quality (TCEQ or Commission) concluded that the Application satisfies the statutory criteria governing its evaluation and recommended that the Application be granted.

TCEQ's Public Interest Counsel (PIC) and the ratepayers who remain as Parties (Opposing Ratepayers) recommend denial of the Application. They claim that Applicant has not demonstrated that it is capable of providing adequate and continuous service or that it is financially stable. In addition to other criticisms, the Opposing Ratepayers maintain that Tapatio has not shown that it has access to an adequate water supply.

The Administrative Law Judge (ALJ) recommends that the Commission approve the Application.

II. PROCEDURAL HISTORY

The Applicant filed its Application with the Commission on April 20, 2005. On January 24, 2006, a preliminary hearing on the matter was conducted in Austin, Texas, by ALJ Mike Rogan of the State Office of Administrative Hearings (SOAH). The following were designated as parties: the Applicant (represented by Patrick Lindner and Maria Sanchez, Attorneys); the ED (represented by Kathy H. Brown and Jessica Luparello, Staff Attorneys); PIC (represented by Mary Alice Boehm-McKaughan and Garrett Arthur, Attorneys); and Andrew Calvert, Richard Haas, Carey McWilliams, Shel McWilliams, Carl D. Portz, Paulett Portz, David Rutherford, Thurman R. Williams, Myrna L. Williams, and Pat Wilson (Opposing Ratepayers represented by Elizabeth Martin, Attorney).

Approximately 50 other ratepayers (represented by Al Hamilton, Attorney, and including Mr. Hamilton) were provisionally designated as parties at the preliminary hearing, but they withdrew from the proceeding on February 17, 2006. The ALJ provisionally denied a request for party status by the Ranger Creek Home Owners Association (represented by Eric Sherer, Attorney), but the Association withdrew its request for party status on February 23, 2006.

The hearing on the merits was held on July 6, 2006, in Austin. After the Parties were afforded an opportunity to submit closing argument and briefing, the record closed on August 7, 2006. After the record was closed, ALJ Mike Rogan retired from SOAH. Prior to retiring, Judge Rogan prepared a draft proposal for decision (PFD) recommending that the Commission grant the Application. The case was reassigned to ALJ William G. Newchurch, who reviewed the entire record and the Parties' arguments and prepared this PFD, which also recommends that the Commission approve the Application.

III. JURISDICTION

No Party questions the sufficiency of the notice of the Application or the hearing or the SOAH ALJs' authority to conduct a hearing on the Commission's behalf or to issue this PFD. The Proposed Order contains the pertinent findings and legal conclusions concerning these uncontested points.

However, the Opposing Ratepayers dispute the Commission's authority to amend a CCN. They note that, prior to recent amendment of Chapter 13 of the Water Code,[1] no provision of that chapter gave the Commission explicit authority to amend a CCN, except under the rather limited circumstances enumerated in Water Code § 13.254, but no party argues that section applies to this case. Additionally, these recent amendments to chapter 13 apply only to an application to amend a CCN submitted to the Commission on or after January 1, 2006.[2]

While prior Water Code § 13.246 initially referred only to "an application for a certificate of public convenience and necessity" and then declared, in Subsec. (b), that the "commission may grant applications and issue certificates only if the commission finds that a certificate is necessary for the service, accommodation, convenience, or safety of the public," these provisions should be read in conjunction with the immediately preceding statute, § 13.244. That section states:

> A public utility or water supply or sewer service corporation shall submit to the commission an application to obtain a certificate of public convenience and necessity or an amendment of a certificate.

Accordingly, the authorization in § 13.246 to act upon "applications" may reasonably be interpreted as encompassing applications for CCN amendments. Indeed, interpreting the statute in any other way appears unreasonable.

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[1] Acts 2005, 79th Leg., ch. 1145, eff. Sept. 1, 2005.

[2] Acts 2005, 79th Leg., ch. 1145, § 15 (1).

Of course, the Commission has for many years granted CCN amendments, indicating that the Commission has interpreted Chapter 13 as a whole to authorize such action. That interpretation certainly appears rational. That interpretation is demonstrated by the Commission's adoption of 30 TEX. ADMINISTRATIVE CODE (TAC) § 291.102, which is entitled "Criteria for Considering and Granting Certificates or Amendments" and repeatedly refers to the granting of CCN amendments. Additionally, the Opposing Ratepayers cite no court case holding that the Commission lacks authority to approve an amendment to a previously issued CCN.

The ALJ concludes that the Commission has jurisdiction to approve Tapatio's Application to amend its CCN.

IV. BACKGROUND

The Applicant presently serves approximately 207 connections for water service and 173 connections for sewer service within its certificated service area in Kendall County. It is also extending service to about 135 additional connections within its existing service area. Development planned for the additional area sought in this case (Requested Area) would ultimately add up to about 1,700 more connections.[3] The Requested Area, which currently contains no potential customers, consists of about 5,000 acres and is located a few miles west of downtown Boerne and outside its extraterritorial jurisdiction.[4] It is generally bounded on the north by Ranger Creek Road, on the east by Johns Road, and on the west by Bear Creek.[5] The Applicant's existing service area is adjacent to the Requested Area on the south.

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[3] Ex. A-1, p. 3 and subex. 1 (Application), p. 7 and attach C.

[4] Ex. A-3, p. 3 and Ex. A-4.

[5] Ex. A-2, p. 2, subex. 1 and 2.

CDS International, Inc., (CDS or Developer) owns the land within the Requested Area and has requested the Applicant to provide the water and sewer utility service for planned development there. The Applicant and the Developer accordingly entered into a Non-Standard Service Agreement (NSS Agreement) for such services,[6] which prompted the filing of the Application in this case. The Applicant and its affiliate, Kendall County Utility Company, which are interconnected, are the only two entities providing water and sewer utility service to the immediate area.[7] Moreover, a separate application is pending to merge Tapatio and Kendall County Utility Company.[8]

Under the NSS Agreement, the Developer will be required to construct and finance all the necessary infrastructure to provide utility service in the Requested Area – including wells, storage facilities, pressure maintenance facilities, disinfection equipment, distribution system, collection system, and wastewater treatment facilities. Darrell Nichols, the Applicant's engineering consultant, stated that the Applicant will not provide service in the Requested Area until the Developer has completed the necessary infrastructure, with final inspection and testing by the Applicant and all regulatory approvals secured. According to Mr. Nichols, agreements of this type are "standard practice" within the industry and are generally encouraged by TCEQ, as they relieve utilities of initial construction costs.[9]

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[6] Ex. A-3, subex. 1.

[7] Ex. A-1, p. 3.

[8] Ex. A-1, p. 6.

[9] Ex. A-1, p. 5.

V. APPLICABLE STANDARDS AND CONSIDERATIONS

Under Water Code § 13.246(b),[10] the Commission may grant a CCN application only if it finds that the action is "necessary for the service, accommodation, convenience, or safety of the public." Water Code § 13.246(c) sets out the following criteria that the Commission must consider:

- the adequacy of service currently provided to the requested area;
- the need for additional service in the requested area;
- the effect of the granting of a certificate on the recipient of the certificate and on any retail public utility of the same kind already serving the proximate area;
- the ability of the applicant to provide adequate service;
- the feasibility of obtaining service from an adjacent retail public utility;
- the financial stability of the applicant, including, if applicable, the adequacy of the applicant's debt-equity ratio;
- environmental integrity; and
- the probable improvement of service or lowering of cost to consumers in that area resulting from the granting of the certificate.

The same criteria are also enumerated in the TCEQ Rules at 30 TAC § 291.102(d). Additionally, as the Opposing Ratepayers correctly argue and no Party disputes, Water Code §13.241 requires a CCN applicant to have certain minimum capabilities and access to an adequate water supply:

> (a) In determining whether to grant a certificate of public convenience and necessity, the commission shall ensure that the applicant possesses the financial, managerial, and technical capability to provide continuous and adequate service.
>
> (b) For water utility service, the commission shall ensure that the applicant:
>
> > (1) is capable of providing drinking water that meets the requirements of Chapter 341, Health and Safety Code, and the requirements of this code, and
> > (2) has access to an adequate supply of water.

[10] All citations and references in this PFD are to statutes and rules in effect at the time the Application was filed, unless otherwise noted. Amendments to some of these statutes and rules have become effective since that filing.

> (c) For sewer utility service, the commission shall ensure that the applicant is capable of meeting the commission's design criteria for sewer treatment plants and the requirements of [the Water Code].

What exactly does Water Code § 13.241 require? The key words are "capability" and "access," which the Water Code does not define and which have no technical meanings. There are some general guidelines that can be used to determine the meaning of any word or phrase used in any Texas code.[11] They are to be read in context and construed according to the rules of grammar and common usage. Those that have acquired a technical or particular meaning are to be construed accordingly. Otherwise, they are given their ordinary meanings.

Turning to common meanings and related statutes, it is helpful to distinguish *capability* from *ability*. They are different. "Capability" means the quality or state of being capable, which is having the attributes or *potential* to perform or accomplish a task. In contrast, "ability" is the quality or state of being able, which is having sufficient power, skill, or resources to accomplish an object.[12]

So Tapatio only needs to show that it has the attributes or potential to provide continuous and adequate service; it does not need to show that it could provide such service immediately. That does not mean, however, that Tapatio's current *ability* to serve is wholly irrelevant. One who is already able to do something certainly is capable of doing it. Accordingly, Water Code 13.246 (c) includes ability to serve as a general factor that the Commission must consider in deciding whether to grant a CCN but does not require such an ability for the application to be approved. Thus capability is determinative, but current ability is not.[13]

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[11] TEXAS GOV'T CODE §§ 311.011 (a) and (b) and 312.002 (a) and (b).

[12] Merriam-Webster's Collegiate Dictionary, http://www.m-w.com/cgi-bin/dictionary. *See Application of City of Crandall to Amend CCN No. 11295 in Kaufman County (Crandall)*, TNRCC Docket No. 2000-0393-UCR, SOAH Docket No. 582-00-1479 (Order Approving a Portion of Application)(Conclusions of Law 7 and 8)(Jan. 23, 2002).

[13] *Crandall*, Conclusion of Law 10.

Turning to the other key word, the ordinary meaning of "access" is the freedom or ability to obtain or make use of something. That sounds somewhat similar to the requirement that a CCN applicant possess certain capabilities to provide adequate service. That is no surprise, since one must exercise one's managerial, financial, and technical capabilities to obtain access to an adequate water supply. As the Commission has previously found,[14] the ALJ concludes that Tapatio must have the technical, managerial and financial capability to obtain an adequate water supply; it need not have such a supply before the CCN is granted.

VI. NEED FOR ADDITIONAL SERVICE

The ALJ recommends a finding that there is an anticipated need for additional service in the Requested Area. CDS is systematically planning an extensive residential development in the Requested Area and has requested the Applicant to provide the necessary utility services.[15] No Party disputes that there is a need for service.

VII. ADEQUACY OF CURRENT SERVICE

The Requested Area is not now receiving utility service. The ALJ finds that there is not adequate service. This issue is not in dispute.

VIII. IMPACT ON THE APPLICANT AND OTHER UTILITIES IN THE AREA

The record does not indicate that any retail public utility other than Tapatio would be directly affected by the granting the Application. Granting the requested amendments, of course, would affect Tapatio. It would increase the area in which the Applicant is obligated to provide continuous

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[14] *Crandall*, Conclusion of Law 11.

[15] Ex. A-3, subex. 1.

and adequate water and sewer service. Additionally, granting the Application would benefit the Applicant by providing funds to build a surface water pipeline that is needed to serve its existing service area as well as the additional area it requests.

To ensure sufficient water resources for the future, the Applicant and Kendall County Utility Company in 2002 secured a commitment for a supply of treated surface water from the Guadalupe-Blanco River Authority (GBRA).[16] According to Mr. Nichols, this 500 acre-feet (ac-ft.) of water per year is intended to meet normal demand within the Applicant's existing certificated area, while the existing groundwater supplies will still be required to meet peak demands there.[17] In accordance with the NSS Agreement with CDS, the Applicant later amended its water contract with GBRA to increase its reserved capacity by an additional 250 ac-ft. per year.[18] The additional increment will be used to meet normal or base demand within the Requested Area. CDS paid the initial cost of acquiring this 250 ac-ft. and will continue to pay the costs of delivering it.[19]

GBRA needed considerable time to complete regional facilities to deliver water to the Applicant's delivery point. GBRA had completed that task by the beginning of May 2006, when GBRA notified the Applicant that it could begin accepting delivery at Boerne.[20] However, the Applicant still needs to acquire an easement and construct a line from that delivery point to its system before customers in its existing service area, as well as potential customers in the Requested Area, will have access to that GBRA water.[21]

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[16] Ex. A-3, p. 5 *et seq.* and subex. 2.

[17] Ex. No. A-1, p. 4, lines 18-23.

[18] Ex. A-3, p. 6 and subex. 3.

[19] Ex. A-1, p. 5.

[20] Tr. 58.

[21] Tr. 41 *et seq.*

Granting the Application will help provide most of the capital to build that line to the GBRA delivery point. Under the NSS Agreement, CDS will contribute up to $1.5 million toward the estimated $2.2 million cost of constructing a transmission main to carry surface water from GBRA to the Applicant's water plant. Without that cash infusion, Tapatio would not have sufficient funds to build the transmission line. CDS's obligation to provide $1.5 million toward the line is contingent on the Commission's approval of the Application, as well as any other required permits and approvals, allowing Tapatio to provide service to CDS's 5,000 acres.[22] The financial arrangements between CDS and Tapatio are discussed in greater depth below where the ALJ considers the Applicant's financial stability and capability.

Based on the above, the ALJ concludes that granting the Application will positively affect Tapatio by improving its finances and its access to a more reliable water supply to serve its existing customers.

IX. APPLICANT'S ABILITY AND CAPABILITY OF PROVIDING ADEQUATE SERVICE

The ALJ finds that the Applicant has sufficient managerial and technical capability and sufficient access to water supplies, thus enabling it to provide continuous and adequate service.

A. Access to an Adequate Water Supply

John-Mark Matkin, Tapatio's civil engineering witness, testified the Applicant has access to sufficient water supplies to serve both the Requested Area and Tapatio's existing CCN area.[23] In a water supply analysis he prepared in 2005 [24] to support the Application, he calculated that Tapatio

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[22] Ex. A-3, p. 4 *et seq.* and subex. 1, p. 4.

[23] Ex. A-2, p. 4 *et seq.*

[24] Ex. A-2, subex. 1, p. 2.

will ultimately need 1,697 ac-ft. to serve estimated base demand at build-out in the combined areas, enough for 3,393 connections. That assumes, consistent with Commission Staff guidelines, that a utility needs 0.5 ac-ft. per connection per year to meet base demand. He indicated that Tapatio will have at least 1,770 ac-ft. per year available: 1,020 ac-ft. from its current wells (after conservatively assuming a 25 percent reduction in their pumping capacity) plus 750 ac-ft under the contract with GBRA.

Mr. Matkin testified that the Commission's rules require a utility to also be able to satisfy a 0.6 gallons per minute per connection peak demand.[25] He indicated that CDS anticipates drilling ten new wells within the Requested Area to provide peaking capacity for the development. The Applicant's plan to use both surface water and groundwater (conjunctive use) is consistent with the applicable 2006 Regional Water Plan, which recommends that utilities in Kendall County purchase and implement the use of surface water from GBRA prior to year 2010.[26] If regulatory authorities restrict the number of wells that CDS can install, Mr. Matkin added, the development can still go forward with a reduced number of connections and the construction of additional water storage, which would allow GBRA water to be used for both normal and peak demands.[27]

The only other expert witness on water supplies, Kamal Adhikari, a TCEQ engineering specialist, agreed that Tapatio has access to an adequate water supply.[28] However, the Opposing Ratepayers claim that Tapatio does not. They attack Mr. Matkin's analysis because it assumes that all 750 ac-ft. that the Applicant has reserved from GBRA (both the original 500-ac-ft. increment and the supplemental 250-ac-ft. increment), as well as water from the Applicant's existing wells, could be used to satisfy demand for water service in the Requested Area. They contend that the Applicant

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[25] Tr. 70 *et seq.* See 30 TAC § 290.45(b)(1)(D) and (2)(A).

[26] Ex. A-1, subex. No. 3, *South Central Texas Regional Water Planning Area; 2006 Regional Water Plan, Vol. I.*

[27] Ex. A-2, p. 5.

[28] Ex. ED-7, p. 5.

must establish annual access to 850 ac-ft. of water to satisfy the base demand and 1,649 ac-ft. to satisfy the peak demand of the anticipated 1,700 connections[29] in the Requested Area. They claim that the Applicant has only identified a definite source for 250 ac-ft., through the supplemental contract with GBRA, thus failing to show that it has access to an adequate water supply for the Requested Area.

The ALJ disagrees with the Opposing Ratepayers It is true, as they note, that the NSS Agreement states:

> Under no circumstances is [Tapatio] obligated to use any portion of the 500 acre-feet currently reserved under the GBRA contract to provide water service to the [Requested Area] or any portion of the [Requested Area]. Under no circumstances is [Tapatio] obligated to use the groundwater supply facilities that it owns and operates on the effective date of [the NSS Agreement] to supply the [Requested Area] or any portion of the [Requested Area] . . . .[30]

Additionally, Mr. Parker testified that he understood that the NSS Agreement would protect existing customers, since it stated that Tapatio would have no obligation to use its existing wells and CDS was obligated to obtain an amendment to the GBRA contract for an additional 250 ac-ft.[31] Mr. Matkin also testified that he understood that under the NSS Agreement only 250 acre-ft., the additional amount from GBRA, would be provided by Tapatio to the CDS property.[32] Despite that, the ALJ finds no fault with the assumptions that Mr. Matkin made in his water supply analysis.

Two closely related things are in play. First are the terms of the NSS Agreement, which Tapatio insisted on and CDS agreed to as a condition for obtaining service in the Requested Area.

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[29] Tr. 71.

[30] Ex. A-2, subex. 1, p. 9.

[31] Ex. A-3, p. 5.

[32] Tr. 81.

Second is the obligation that Tapatio will have in the future to serve all of its customers if its Application is granted. The NSS Agreement requires CDS to obtain all of the water needed to serve what is now its property. Tapatio could enforce that provision and deny service to further CDS development in the Requested Area, hence the addition of new customers, until CDS arranged for the additional water. That is certainly favorable to Tapatio and its current customers and will lead to a steady growing water supply if CDS proceeds with development.

However, that does not mean that the NSS Agreement would require Tapatio to reserve any portion of its water supply for its current service area. In fact, Tapatio very likely would be prohibited from doing so. Water Code § 13.189(a) prohibits a utility from granting an unreasonable preference or advantage to any person within any classification as to rates or service. Since the facilities in the Reserved Area will be interconnected with Tapatio's existing facilities,[33] reserving water supplies for one group of customers would almost certainly be unreasonable.

Thus, Mr. Matkin correctly considered whether all of Tatpatio's water supplies would be adequate to serve all of its customers, including those in the Requested Area, if the Application is granted. Confirming the distinction noted above, he noted that calculating water availability is an entirely different matter from the arrangements between utilities and developers that are contained in their contracts. While they are not in evidence, Mr. Matkin testified that Commission, presumably the Staff's, guidelines direct one to look at the entire integrated system when analyzing the adequacy of a water supply.[34]

Moreover, the Opposing Ratepayers are confusing access to an adequate supply with current rights to sufficient water to fully supply the Requested Area when it is fully developed. As the ED correctly notes, neither the Water Code nor the TCEQ's rules require an applicant to *have* an adequate water supply before it obtains a CCN, only that it *have access* to one.

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[33] Ex. A-1, p.7.

[34] Tr. 81.

In this case, build-out to a maximum of 1,700 connections in the Requested Area (if it occurs) will entail at least 15 to 23 construction phases over eight to ten years, according to Mr. Matkin.[35] As the Applicant emphasized in its closing argument, it has no absolute commitment under the NSS Agreement to serve 1,700 connections in the Requested Area. Rather, it has contracted with CDS to serve "the lesser of either 1,700 connections or the number of connections that can be served by the additional water supply . . . provided by CDS to the Applicant."[36]

The Applicant will largely rely on CDS to obtain additional supplies needed for its development. This establishes, in the Opposing Ratepayers' view, that the Applicant itself does not have access to adequate water to justify approval of its CCN amendment under the law. As the Commission has previously found and the courts have agreed, however, an applicant may rely on contractual obligations of third parties to show the capabilities required under Water Code § 13.241.[37]

Moreover, Mr. Parker testified that he has already approached GBRA for additional water and GBRA has informally, verbally agreed to provide an additional 250 ac-ft.[38] In fact, he testified that up to approximately 1,600 ac-ft is available from GBRA for private utilities in the general area.[39] That is additional evidence of access to additional water supplies.

Under the NSS Agreement, CDS must find the additional supplies. If it is unable to do so, the same contract specifies that it cannot demand additional service from the Applicant. Since CDS

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[35] Tr. 62.

[36] Under the NSS Agreement, CDS requests service "to no more than 1,700 customers," with actual demand to be determined later. Ex. No. A-1, Sub-Ex. No. 1, Attachment B.

[37] *Bexar Metropolitan Water Dist. v. T.C.E.Q. (Bexar Met)*, 185 S.W.3d 546 (Tex. App. - Austin, 2006).

[38] Tr. 24 *et seq.*

[39] Tr. 23 *et seq.*

is the only landowner in the Requested Area, the demand for and the provision of utility service there will remain in equilibrium.

Based on the above, the ALJ concludes that Applicant has access to an adequate supply of water to serve the Requested Area.

B. Technical and Managerial Capability

Testimony for both the Applicant and the ED concluded that the utility has the technical and managerial ability to provide adequate service. Witnesses reported that the Applicant's operation of existing groundwater wells, over a period of more than 15 years, has met the service demands experienced to date within its certificated area.

The Applicant also operates a TCEQ-permitted wastewater treatment facility with a capacity of 0.15 million gallons per day, which has adequately met the sewer service demands of its customers, according to Mr. Nichols.[40] All treated wastewater is irrigated on a golf course and not discharged to a watercourse (Texas Land Application Permit No. 12404-001).[41] According to a TCEQ Compliance Inspection Letter dated January 12, 2004, the utility has documented that corrective actions were taken for any alleged sewer system violations and that no other action or submittal was necessary.[42]

As to the Applicant's general adherence with applicable water- and sewer-system statutes, rules, and design criteria, the record indicates that the Applicant has satisfactorily addressed all issues raised in the latest TCEQ inspection of its facilities. According to a TCEQ Comprehensive

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[40] Ex. A-1, p. 6 *et seq.*

[41] Ex. ED-7, p. 5.

[42] Ex. A-1, subex. 1, attach. D.

Compliance Inspection Letter dated August 10, 2004, Tapatio had documented that corrective actions was taken for any alleged violations and that no other action or submittal was necessary.[43]

The Applicant and ED asserted that the record of John J. Parker–the Applicant's co-owner, vice president, secretary, treasurer, and principal manager over the past 15 years–reflects sufficient managerial capability for the proposed service-area expansion. Mr. Parker's testimony indicated that he had overseen significant expansions of the system in the past, including the interconnection of the Tapatio Springs and Ranger Creek systems and the initiation of service to new subdivisions within the existing service area.[44] The Applicant also argued that Mr. Parker's acumen was evident in his negotiating a favorable contract with CDS, which requires CDS to finance most of the cost for a water main from GBRA, as well as all of the additional water supplies and infrastructure needed for water and sewer service within the Requested Area.

Despite what seems to be a good record, PIC asserts that two specific circumstances have raised doubt that the Applicant has properly managed and can provide adequate service to an expanded service area. First, PIC criticized the utility's slowness in constructing a pipeline to deliver the 500 ac-ft. of GBRA water that the Applicant contractually reserved in 2002. Although the Applicant has an impending need for this still undeliverable water (in PIC's view) and CDS pays GBRA an annual reservation fee approaching $20,000 for it, the Applicant has not yet even acquired any of the easements needed for the pipeline's construction.

Should the Applicant be considered "slow" for not yet having built a pipeline to deliver its reserved GBRA water? Mr. Parker testified that under the GBRA contract, the Applicant had to begin paying reservation fees long before GBRA had the means to deliver water in the area, which

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[43] Ex. A-1, subex. 1, attach. D, p. 8.

[44] Ex. No. A-3, p.6, line 7, to p.7, line 24.

was not until April 2006.[45] Under the NSS Agreement, CDS is now responsible for designing the pipeline, has begun that process, and is awaiting the outcome of this proceeding to pursue the project more comprehensively. Tapatio persuasively argues that any delay in building the pipeline was largely caused by this proceeding, which has left the Applicant and CDS unable to know whether the CCN amendment would be approved so that CDS can obtain water from Tapatio. CDS would have no obligation to build or pay for a transmission line that may not benefit it.

PIC also noted that over the past two years the Applicant has lost relatively large proportions of the water pumped from its wells before delivery to its customers – 20 percent of all water pumped in 2004 and 18.6 percent in 2005.[46] There is no evidence of the reasonable range of losses by water systems comparable to the Applicant's. However, Mr. Parker acknowledged that water losses are a concern to the Applicant and that minimizing them is the object of a continuing maintenance program. He noted that the discovery and repair of a major leak about 60 days before the hearing likely addressed much of the past problem of water losses.[47]

With respect to the Applicant's proposed sewer service to the Requested Area, the Opposing Ratepayers complain that the Applicant has submitted no plans or specifications for a new sewer system in the expanded service area and that little of the existing system's capacity can realistically serve new development in the Requested Area. Testimony shows that the 173 or more current customers are utilizing 50 to 60 percent of current treatment capacity, with about an additional 135 connections coming on line soon inside the existing service area. These circumstances leave virtually no currently available treatment capacity, in the Opposing Ratepayers' view.

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[45] Tr. 44 and 58 *et seq.*

[46] Ex. No. P-4, Sec. 7, and Ex. No. P-5, Sec. 7.

[47] Tr. 39 *et seq.*

Section 9(l) of the NSS Agreement provides that the Applicant *may* use excess capacity at the facility to serve the Requested Area, but "under no circumstances" is the utility *obligated* to use such capacity to serve the area. Rather, CDS is obligated to build any wastewater facilities needed to serve its development in the Requested Area.[48] Thus, as with water facilities, additional wastewater facilities must be built by CDS for development to proceed and demand for service to increase.

The Opposing Ratepayers question the Applicant's managerial capability by alleging that customers within the existing service area have been subjected to frequent drought restrictions and by echoing PIC's criticism of the Applicant's slowness in building a pipeline to deliver surface water from GBRA – which might alleviate those drought restrictions. In September 2005 and May 2006, the Applicant did impose restrictions, limiting outside water sprinkling to once per week.[49] However, as the Commissioners know, large portions of Texas have been in an extended drought, and a Commission rule authorizes drought restrictions.[50] As of September 1, 2006, over 250 water systems have imposed watering restriction, including nine in Kendall County.[51] There is no evidence that the Applicants' customers are being subjected to drought restrictions more frequently than other utilities' or in excess of TCEQ standards.

The Opposing Ratepayers also criticized the Applicant's managerial representative at the hearing, Mr. Parker, because his knowledge of the company's organization, plans, and finances was not perfect. Mr. Parker could not answer some questions and some of his answers were odd. For example, he testified that he sometimes signs documents as president of Tapatio–though his father

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[48] Ex. A-3, subex. 1, p. 9.

[49] Ex. P-2 and P-3.

[50] 30 TAC § 291.93(2).

[51] Pursuant to Tex. Gov't Code § 2001.090(a), the ALJ takes official notice of the Commission's September 1, 2006, list of "Texas Public Water Systems Limiting Water Use to Avoid Shortages". <http://163.234.20.106/permitting/water_supply/pdw/trot/droughtw.html>. **Any objection to this taking of notice should be submitted as an exception to this PFD.**

holds that office and he is vice-president–since he has been primarily running the utility since 1991.[52] He could not say how many shares he owned[53] or whether half the total shares had been transferred yet to Michael Shalit, though that is planned.[54] He also was not as familiar as he could have been with details concerning the system's capacity and financial statements.[55] On these and other points, Mr. Parker noted that Tapatio's lawyers and engineers would know the details.[56] It would certainly be more assuring if the person primarily running the Applicant for the last 15 years had a better grasp of these details. But every utility must rely on staff or contractors to handle legal, engineering, and financial matters, and Mr. Parker did not appear alarmingly detached.

Finally, the Opposing Ratepayers assert that the Applicant has submitted no evidence of consequence to demonstrate its technical capability to serve the Requested Area. According to the Opposing Ratepayers, the Applicant failed to submit any construction plans for the anticipated new utility systems to TCEQ staff, nor any engineering report (as requested by the staff) to show adequate utility service, existing system capacity, capacity in reserve, descriptions of development phases, and distance between the existing system and the anticipated development.

If Tapatio had submitted such detailed plans, that would have been additional evidence of its technical and managerial capability, but the Opposing Ratepayers point to no rule specifically requiring them. The application form requires plans from an applicant seeking a CCN for the first time, but not of an existing system, like the Applicant's.[57] Mr. Adhikari, on behalf of the ED,

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[52] Tr. 19.

[53] Tr. 20.

[54] Tr. 55.

[55] Tr. 19 and 22.

[56] Tr. 22 and 55.

[57] Ex. A-1, subex. 1, pp. 5 and 6.

requested such plans, dropped that request when he found that they did not yet exist, and still testified that he had all the information he needed to review the Application.[58]

The ALJ would agree that Tapatio has not proven beyond a reasonable doubt that it possesses the technical and management capabilities to serve the Requested Area. The evidence is sometimes vague and sketchy. But the Applicant did not have such a heavy burden of proof. The preponderance of evidence shows that the Applicant has an acceptable track record in providing water and sewer service in its current service area over the past 15 years. When placed in context, PIC's and the Opposing Ratepayers' criticisms do not reflect serious deficiencies. The ALJ finds that the greater weight of the evidence shows that Tapatio has the managerial and technical capability to continuously and adequately serve the Requested Area.

C. Financial stability and capability

The ALJ finds that the Applicant is barely financially stable, but approving the Application will very likely increase its financial stability. He also concludes that Tapatio has the requisite financial capability to provide service to the Requested Area due mostly to its NSS Agreement with CDS and augmented by a statute allowing it to amend its tariff to require a similar arrangement from a subsequent developer.

The ED's conclusion in favor of the Applicant's finances rests on the testimony of Daniel K Smith, a program specialist with TCEQ's Water Supply Division.[59] In his pre-filed testimony, he stated that his review of available information indicated that the Applicant "has demonstrated financial and managerial capability to warrant approval of the CCN amendment."

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[58] Tr. P-9, p. 2; Tr. 137 *et seq.*

[59] Ex. ED-5.

When cross-examined, however, Mr. Smith presented a more equivocal view. He noted that, according to the most recent information available to him–Tapatio's December 31, 2004, balance sheet–the Applicant's debt-to-equity ratio was unfavorable, reflecting "a substantial amount of term debt against a small amount of equity."[60] Based on that debt-equity ratio and the rest of the Applicant's balance sheet, Mr. Smith concluded that without assistance the Applicant would not be able to fund the proposed expansion into the Requested Area, or even its $654,983 share under the NSS Agreement for construction of the pipeline to deliver GBRA water.

That 2004 balance sheet showed that the Applicant had only $244,809.22 in assets but $861,309.51 in liabilities, giving it a *negative* net worth of $616,500.29.[61] However, Mr. Smith also stated that if the Applicant satisfied one major debt–a $905,146 note payable to Clyde B. Smith for acquisition[62]–Tapatio's debt-equity ratio would show "substantial" improvement.[63] The Applicant's Mr. Parker testified that note recently had been "paid off," although he did not know what the Applicant's new debt-equity ratio was in the wake of that payment.[64] Assuming nothing else has changed on its balance sheet, that would leave Tapatio with no net liabilities and a *positive* net worth of $288,646.06.

But from where did the money come to pay the $900,000-plus debt to Clyde Smith? Both PIC and the Opposing Ratepayers criticize the lack of documentation to show payment of that debt and question whether the payment has actually changed the Applicant's debt-equity ratio. The Opposing Ratepayers speculate that the obligation under the note simply may have been replaced with new debt. There is no evidence to support that suspicion.

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[60] Tr. 91.

[61] Ex. A-1, subex. 1, attach. G, pp. 1 and 2.

[62] Tr. 33.

[63] Tr. 109 *et seq.*

[64] Tr. 20 *et seq.* and 33.

Mr. Parker testified that the Applicant's owners (he and his father) have recently or would soon convey almost 50 percent of their interest in the company to a new third owner, Michael Shalit.[65] That suggests, but only suggests, that the new investor provided the funds to pay off the old debt. There is no specific evidence showing that Mr. Shalit has put capital into the Applicant. It could be that he simply purchased the Parkers' shares without putting additional capital in the company. Nevertheless, the only specific evidence is that the $900,000-plus debt to Clyde Smith has been paid.

Once again, the evidence is not completely clear or detailed. It is, however, sufficient to show that Tapatio is financially solvent. Is Tapatio more than simply in the black? Is it financially stable?

The evidence also shows that in 2004 Tapatio had a net income of $41,773.06.[66] Assuming that all of its expenses were reasonable, that was a modest 6.6 percent return on its $635,104.75 in invested capital. The ED's Mr. Smith flagged one expense item as unusual. In 2004, the Applicant paid $55,314.14 in interest on its debts, 23.26 percent of all its expenses. Mr. Smith testified that was higher than usual for such entities. Why so much interest?

Two things stand out. In 2004, Tapatio had $905,194.95 in debt, nearly all owed to Clyde Smith, and only $635,104.75 in equity, giving it a very high 1.43 debt to equity ratio. It is also likely that 2004, when it earned only a 6.6 percent return on equity, was a relatively good year. The end-of-2004 balance sheet showed that the Applicant had $1,293,378.10 in *negative* retained earnings, better known as previous losses. That strongly suggests that in prior years its losses were substantial.[67]

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[65] Tr. 55.

[66] Ex. A-1, subex. 1, attach. G, pp. 1-3.

[67] Ex. A-1, subex. 1, attach. G, pp. 1-3.

The Opposing Ratepayers note that the largest account receivable on Tapatio's 2004 balance sheet, $357,153.05, was owed by one of the Applicant's affiliates, Tapatio Springs Golf Resort, presumably for water and sewer services that the Applicant has provided to the resort.[68] It is certainly possible that the Applicant is illegally giving its affiliate free water service,[69] but it would be quite odd for the Applicant to advertise that on its balance sheet. It is also possible that the affiliate is in financial trouble and cannot pay that bill. There is no evidence either way. In any event, the weight of the evidence is that the affiliate has not paid all that it owes the Applicant.

The Opposing Ratepayers also criticize the Applicant's apparent failure to include in its submitted 2004 income statement the annual payment of the reservation fee for GBRA water. The exact amount was not clear, though Mr. Parker testified that it was less than $20,000.[70] More likely than not, CDS paid it. The NSS Agreement specifically lists "increased reservation of GBRA water" as one of the costs CDS would pay.[71] Assuming that Tapatio, rather than CDS paid it, Tapatio's net income in 2004 would have fallen to approximately $22,000 and its return on equity would have been a stunningly low 3.15 percent.

The ED's Mr. Smith expressed several reservations about the Applicant's financial information. He stated that the Applicant had not yet provided adequate information about its expected future cash flow, annual rate of new service connections, or the overall cost of constructing utility infrastructure for the Requested Area. To be frank, Tapatio should have done a far better job of laying out its financial condition, but the evidence that its condition is not good is clear enough.

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[68] Ex. A-1, subex. 1, attach. G, p. 1.

[69] Water Code § 13.182(b) prohibits preferential rates, and receiving service without paying would certainly be preferential.

[70] Tr. 42 *et seq.*

[71] Ex. A-3, subex. 1, p. 3.

At the end of 2004, Tapatio had too much debt and not enough invested capital, which is almost certainly why its interest expense was out of proportion. Moreover, even without considering the Requested Area, Tapatio needs a larger water supply for customers in its current service area. That means it needs additional capital and revenue to pay the cost of the pipeline to bring in GBRA water. Tapatio cannot be expected to continue earning an unreasonably low 6.6 to 3.15 percent return on its investment in a good year and losing money in other years. It is entitled to an opportunity to earn a reasonable return on its investment as well as recover its reasonable and necessary operating expenses.[72]

All of that means that Tapatio needs additional invested capital and revenue and is under intense pressure to dramatically raise the rates of customers in its existing service area. Is Tapatio financially stable? Barely. Does that mean that its Application should be denied? Not necessarily.

The law requires the Commission to consider a CCN applicant's financial stability, and this would certainly be an easier case to decide if Tapatio were financially stable. But the law does not require a denial if the Applicant is not financially stable. This is the odd case in which the Applicant is, in effect, contending that granting the Application is necessary to bolster its financial stability.

Tapatio claims that allowing it to serve the Requested Area will allow it to take advantage of CDS's offer, as laid out in the NSS Agreement, to pay for the infrastructure that will be required there and share the cost of the pipeline needed to bring GBRA water to the existing as well as the requested service areas. Mr. Parker testified that the NSS Agreement requires CDS to pay all costs associated with designing and constructing the infrastructure within the Requested Area,[73] and that appears correct. The NSS Agreement refers to the entire project to serve the Requested Area as "the Extension" and states: "[CDS] shall cause the Extension to be constructed by a contractor acceptable

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[72] Water Code § 13.183(a)(1).

[73] Ex. A-1, p. 5.

to [Tapatio] in accordance with the approved plans and specifications." More specifically, the agreement states:

> [CDS] shall pay all costs associated with the Extension as a contribution in aid of construction, including without limitation the costs of the following:
>
> 1. engineering and design;
> 2. easement and right-of-way acquisition;
> 3. construction;
> 4. inspection;
> 5. engineering and attorney's fees and expenses;
> 6. governmental and regulatory approvals required to lawfully provide service;
> 7. procurement of water allotments (increased reservation of GBRA water).[74]

Additionally, CDS would also be obliged to pay up to $1.5 million for "the portion of the Extension which is not located on [CDS's] Property."[75] That would mostly be the pipeline needed to obtain water from GBRA. The contract states:

> If the costs of the Extension not located on [CDS's] property exceed $1,500,000 and [CDS] chooses not to fund the excess, [Tapatio] is under no obligation to fund any portion of [CDS's] share of the costs of the Extension and [Tapatio] is under no obligation to furnish water service to the [Requested Area] or any portion of the [Requested Area].[76]

The NSS Agreement should give Tapatio access to additional customers in the Requested area with relatively little additional investment. That would increase Tapatio's revenue while giving it significantly more customers from whom to recover its fixed costs, reducing the need for a rate increase[77] and improving its financial stability.

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[74] Ex. A-3, subex. 1, p. 3.

[75] Ex. A-3, subex. 1, p. 4.

[76] Ex. A-3, subex. 1, p. 4.

[77] Tr. 5.

While the law does not necessarily require current financial *stability*, it does require the Commission to ensure that an applicant possesses the financial *capability* to provide service in the new area. Tapatio does not have that capability based solely on its own finances. As already discussed, its finances are barely stable. However, Tapatio is claiming that its financial capability is mostly proven by its NSS Agreement with CDS, under which CDS will pay the capital costs to serve the Requested Area and dedicate that infrastructure to Tapatio, and by CDS's own financial capability to fulfill those obligations. As Mr. Smith testified, TCEQ regularly grants CCN applications on the basis that developers are contractually bound to provide necessary infrastructure.[78]

Both the Applicant and Opposing Ratepayers cite the *Bexar Met* case as supporting their arguments concerning CDS and Tapatio's financial capability. In *Bexar Met*, the City of Bulverde sought a CCN and presented, as the basis for its ability to provide service, its contract with GBRA, which provided that GBRA would design, construct, finance, operate, and maintain a water system on the City's behalf. The Commission concluded that the City's contractual relationship with GBRA imparted to it the requisite capabilities to provide service under Water Code § 13.241 and therefore granted the City's application, in preference to a competing application. The Court of Appeals ruled that the Commission's action was consistent with governing law. The Court specifically agreed with the Commission's statement, during an Agenda meeting, that system "ownership is not something legally required" to establish an applicant's ability to provide adequate service.

In the *Bexar Met* case, the Court noted that the applicant was a municipality and that its authority to contract for utility service was buttressed by additional statutes outside the Water Code. However, nothing in the record suggests that the Applicant in this case lacks authority to enter a contract such as the NSS Agreement. If a contract with a capable entity for construction, ownership, and operation of required facilities can prove an applicant's capability, then surely an arrangement

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[78] Tr.99 *et seq.*

that requires a third party to construct a system but then to convey it to the applicant–as in this case–would pass muster. That is what Tapatio argues.

However, the Opposing Ratepayers cite the *Bexar Met* case for the proposition that the Applicant must show that it exercises control over a third party if that third party's performance is to satisfy requirements under Water Code § 13.241 on the Applicant's behalf. The Opposing Ratepayers conclude that Tapatio does not have such control over CDS, since the NSS Agreement gives CDS the unilateral right to terminate the agreement for a period of 60 days after the completion of the plans and specifications for the extended utility infrastructure.[79] In the event of such termination, the Opposing Ratepayers argue, CDS would no longer fund the expansion, but the Applicant, as the CCN holder, would still have the duty to serve the area as it developed.

The ALJ is unable to find any specific statement or obvious implication in the *Bexar Met* case to support the Opposing Ratepayers' argument that the Applicant must exercise "control" over CDS beyond the Applicant's right to enforce its contract. The Court did interpret the requirements that an applicant "possess" certain capabilities as meaning "to have in one's actual control," but the Court noted that control meant "the direct or indirect power to direct the management and policies of a person or entity, whether . . . by contract, or otherwise."[80] As the ALJ reads that, an applicant possesses a capability if it has entered into a contract with another who has that capability, since the contract, which the applicant can enforce if necessary, gives the applicant indirect control over its contractor.

Even assuming that CDS's capabilities can be attributed to Tapatio due to the NSS Agreement, the Opposing Ratepayers argue that the evidence does not show that CDS has the

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[79] Ex. A-1, subex. 1, attach. B. Sec. 1(d) of the agreement states, "For a period of sixty (60) days following the date of completion of the plans and specifications of the Extension, the Developer may give notice of termination of this Agreement to the Utility Company. All costs of the preparation of those plans and specifications are to be borne by the Developer."

[80] *Bexar Met*, 185 S.W.3d 551, footnote 1.

required financial capability. Mr. Matkin estimated the ultimate cost for water and sewer infrastructure to serve the Requested Area (not counting the Applicant's share) was $13 to $14 million.[81] That includes $2,154,913 to build the line to the GBRA delivery point and, at full build out of the Requested Area, $7,000,000 to $8,000,000 for the water supply system; $1.5 million for the lift station and forced mains; and $3,000,000 for gravity mains.[82]

To show CDS's financial capability, the Applicant presented a letter from CDS's banker, Bank of America. It stated that, as of August 12, 2005, CDS had maintained a long-standing relationship with the bank, kept all accounts satisfactory, and had "unrestricted funds available in the low seven figure amount which can be provided for construction and infrastructure improvements pursuant to the certain Non-Standard Service Agreement by and between CDS and Tapatio Springs Service Co., Inc."[83]

The Opposing Ratepayers regard one unverified letter from CDS's bank as scant proof of the developer's financial strength, but they point to no evidence to the contrary. Moreover, CDS has thus far complied fully with its contractual obligations to pay the costs of acquiring the 250-ac-ft. supplemental water supply from GBRA.[84] It would be better if CDS or Bank of America had been more direct, but the ALJ can conclude from the evidence that CDS has one to five million dollars–in the low seven figures–to pay the direct and indirect costs of providing the necessary utility infrastructure in the Requested Area and obtaining water from GBRA.

Even assuming that the Bank of America letter means that CDS has access to $5 million, the upper range of a "low seven figure amount," the Opposing Ratepayers contend that would cover little

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[81] Ex. No. A-2, p. 69.

[82] Ex. A-2, p. 3; Tr. 69 and 84.

[83] Ex. No. A-1, Sub-Ex. No. 4.

[84] Ex. A-1, p. 5.

more than a third of what the Applicant will ultimately need. But they are once again confusing current ability with capability. Tapatio does not need to demonstrate its or CDS's current possession of the full amount that will ultimately be required to build infrastructure in the Requested Area. As already discussed, an applicant must have the financial capability to provide service, not the current ability, not cash in hand. As already noted, build-out to a maximum of 1,700 connections in the Requested Area (if it occurs) will entail at least 15 to 23 construction phases over eight to ten years, according to Mr. Matkin.[85]

CDS's ownership of the Requested Area and it obligation to pay all of the costs to serve that area, aside from a portion of the cost of the line to the GBRA delivery point, allows the ALJ to reasonably infer that development will not occur faster than CDS can afford to pay for the water and sewer infrastructure. He can also infer that development and property sales will give CDS cash flow allowing it to pay for the next phase of infrastructure and development, and so on.

Even though there is no need to have current funds to pay the ultimate cost of the utility infrastructure that will be needed, CDS must have at least some significant amount of capital to begin. Although he expressed reservations about some of the information, the ED's financial analyst, Mr. Smith, did not withdraw his bottom-line recommendation in favor of the Applicant. The ALJ concludes that CDS's unrestricted funds "in the low seven figures" is a reasonable amount with which to begin.

But what if CDS exercises its option to back out of the NSS Agreement after the Applicant has obtained an expansion of its service area? Mr. Smith expressed some concern about that during the hearing. He stated that such an opt-out clause typically would trigger a review of the Applicant's tariff to determine if it would require a subsequent developer to build or contribute to the cost of needed infrastructure. Although Mr. Smith explained that such a tariff provision was "fairly

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[85] Tr. 62.

standard," he was not certain that it was part of the Applicant's current tariff. No other evidence definitively addressed that point.

After the hearing and after giving the Parties an opportunity to object, the ALJ took official notice of Tapatio's water tariff.[86] It appears to be a standard-form tariff written to allow a subsection for a policy of requiring a developer to provide contribution in aid of construction for necessary water-service facilities. But in the space reserved to set out such a policy, Tapatio's tariff says, "None."[87]

Nonetheless, the Commission could amended the tariff, on Tapatio's request, to add a requirement that a developer contribute to aid construction. Water Code § 13.183 (b) provides:

> In a rate proceeding, the [Commission] may authorize collection of additional revenues from the customers to provide funds for capital improvements necessary to provide facilities capable of providing adequate and continuous utility service if an accurate accounting of the collection and use of those funds is provided to the [Commission]. A facility constructed with surcharge funds is considered customer contributed capital or contributions in aid of construction and may not be included in invested capital, and depreciation expense is not allowed.

The above statute does not require the Commission to approve such a tariff change, but it is hard to see why the Commission would not. As Mr. Smith noted, such a provision is fairly standard. It is not impossible to conjure a scenario in which CDS failed to install needed infrastructure in or develop the Requested Area, another developer acquired the property, the tariff had not been amended by Tapatio, and the new developer insisted on service without contributing to construction. However, such a sequence of events seems far fetched. The ALJ finds it much more likely that Tapatio could obtain a similar contribution in aid of construction from a subsequent developer.

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[86] Water Utility Tariff, Tapatio Springs Service Company, Inc., CCN No. 12122 (Approved by Texas Water Commission, May 31, 1988). The noticed tariff is included with the admitted exhibits.

[87] Water Utility Tariff, Tapatio Springs Service Company, Inc., CCN No. 12122, p. 9 *et seq.* (Approved by Texas Water Commission, May 31, 1988).

There is the remaining issue of Tapatio's obligation to pay the estimated $654,983 cost of building the pipeline to obtain the GBRA water that exceeds CDS obligation to pay up to $1.5 million for that purpose. While not completely separable, Tapatio's share of the pipeline cost seems more like an expense to serve its existing customers rather than those who may one day be located in the Requested Area. Tapatio needs to obtain 500 ac-ft. of water from GBRA to serve these existing customers.[88] Even if the Application were denied, Tapatio would need to build that pipeline. If the Application is approved, CDS will pay most of that cost, enhancing Tapatio's financial stability and ability to serve its existing customers.

In any event, Tapatio will need to pay the remaining $654,983 cost of the pipeline. The Opposing Ratepayers argue that Tapatio cannot pay that amount. There is no evidence that Tapatio has that amount in current assets. However, Mr. Parker testified that Tapatio has access to sufficient funds to pay that amount. He did not explain how.[89] That evidence is thin, but uncontradicted. Moreover, Tapatio likely could seek a rate increase from its existing customers to pay its share of the pipeline cost, since that cost is largely if not entirely to serve them and its current return on capital appears quite low.

Most of the above discussion concerns the Applicant's capability of financing capital costs. As to operation and maintenance once the infrastructure is in place in the Requested Area, the Applicant would be entitled to charge rates to recover those expenses, as well as a return on and eventually of its invested capital.[90]

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[88] Sec. 9(l) of the NSS Agreement states, "under no circumstances is Utility Company obligated to use any portion of the 500 acre-feet currently reserved under the GBRA contract . . . [or] the groundwater facilities that it owns and operates on the effective date of this Agreement" to serve the Requested Area. Ex. No. A-1, Sub-Ex. No. 1, Attachment B.

[89] Ex. A-3, p. 8.

[90] Water Code § 13.183(a)(1).

The evidence is not as strong as it might be, but the ALJ concludes that it is sufficient. He finds that Tapatio possesses the financial capability to provide continuous and adequate service to the Requested Area. The ALJ also concludes that granting the Application will likely improve Tapatio's financial stability.

X. FEASIBILITY OF OBTAINING SERVICE FROM AN ADJACENT UTILITY

The ALJ finds that service to the Requested Area from other public utilities would not be as feasible as extending service from the Applicant's adjacent facilities. No other utility in the area has proposed providing service to the Requested Area, though they were notified of Tapatio's Application.[91]

The City of Boerne is the only other unaffiliated utility in proximity to the Requested Area. Mr. Matkin testified that the City would be the only other possible utility provider for the CDS project. However, he said the Requested Area's distance from the City's system makes such service economically infeasible.[92] Initially, the City protested the Application but later withdrew its protest and request for hearing.[93] According to the record, the City has not expressed any intention to serve the Requested Area.

XI. IMPACT ON ENVIRONMENTAL INTEGRITY

The ALJ finds that approving the Application would have no significant effect upon environmental integrity.

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[91] Ex. A-1, subex. 1, p. 12 *et seq.*

[92] Ex. A-2, p. 2.

[93] Ex. A-1, p. 3 *et seq.*

Kamal Adhikari, an engineering specialist for the ED, testified that the environment would be temporarily disrupted, as in any development, by the construction of water and sewer lines and other facilities. However, he stated, a properly constructed and operated central sewer collection system has less long-term negative impact than individual on-site sewage facilities.[94]

Mr. Matkin also urged that granting the amendment would allow for a more proper use of water resources available to Kendall County–limiting the possible proliferation of individual residential wells in the area that could both deplete the local aquifer and subject it to greater risks of contamination.[95]

The ALJ views some of the asserted environmental benefits of granting the Application as rather speculative, *i.e.*, contingent upon events that are not wholly predictable. However, the record does not suggest that the proposed utility expansion, in itself, would discernibly undermine environmental integrity. No Party contends that it would.

XII. IMPROVEMENT IN SERVICE OR LOWERING OF CONSUMER COSTS

The ALJ finds that approving the Application would probably result in incremental improvement of service to customers within the Applicant's existing service area and help to keep their rates stable.

The statutory language refers to probable outcomes in "that area." The reference to "that area" is most logically found in a previous criterion–"the effect of the granting of a certificate on the recipient of the certificate and on any retail public utility of the same kind already serving the

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[94] Ex. Ed-7, p. 6.

[95] Ex. A-2, p. 5 *et seq.*

proximate area." Thus, the ALJ concluded that the focus is not only to the Requested Area, but also to proximate areas, which would include Tapatio's existing service area.

One probable effect of granting the Application would be accelerated access to GBRA surface water for the Applicant's existing customers, giving them a more reliable overall water supply. Under the NSS Agreement, CDS will contribute up to $1.5 million toward the estimated $2.2 million cost of constructing a transmission main to carry surface water from GBRA near Cascade Caverns to the Applicant's water plant on Johns Road. According to Mr. Nichols, if the Application is not granted, the existing customers probably will have to bear the entire cost of constructing that water main through their monthly rates.[96] In addition, as discussed above concerning Tapatio's financial stability and capability, approval would likely ease the pressure to raise the rates paid by existing customers, since Tapatio's fixed costs could be spread over a larger customer base.

XIII. SUMMARY UNDER APPLICABLE STANDARDS AND CONSIDERATIONS

The ALJ concludes that the Applicant possesses all of the capabilities to provide continuous and adequate service to the Requested Area as required by Water Code § 13.241(a), (b), and (c). Additionally, the factors that Water Code § 13.246(c) requires the Commission to consider indicate that granting the Application is necessary for the public's service, accommodation, and convenience; will not adversely impact any of the underlying concerns; and will positively impact several of them.

XIV. REGIONALIZATION

Water Code § 13.241(d) seeks to restrain the proliferation of new, stand-alone utilities by requiring an applicant seeking to establish such a utility to demonstrate that delivering the proposed

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[96] Ex. A-1, p. 8.

service would not be economically feasible through regionalization or consolidation with another existing utility. While the Applicant's existing system and the proposed utility infrastructure for the Requested Area may not be tightly integrated, the systems will be interconnected and will share the use of some facilities and equipment.[97] The ALJ concludes that Tapatio has not proposed a stand alone utility.

Additionally, the Applicant and its affiliate, Kendall County Utility Company, are the only utilities immediately adjacent to the Requested Area. They are interconnected and have an application pending to merge their companies.[98] The ALJ concludes that granting the pending Application would be consistent with the objectives of regionalization or consolidation expressed in Water Code § 13.241(d).

XV. ALLEGED APPLICATION DEFICIENCIES

The Opposing Ratepayers contended that the Applicant failed to submit adequate information for administrative and technical review of the Application by the TCEQ staff. In closing argument, the Applicant responded, "Applicant is not required to establish at the contested-case hearing that its application complied with each administrative and technical requirement because it had already done so prior to the hearing" (citing *Citizens Against Landfill Location v. T.C.E.Q.*[99]).

The *Citizens* decision involved the permitting of a landfill under Chapter 361 of the Texas Health & Safety Code. In it, the Court of Appeals declared that "the purpose of a contested-case hearing is not to verify whether the application is administratively and technically complete, but rather to determine whether the substance of the information provided in the application can fulfill the statutory purpose" of the permitting or authorizing process. The Court then concluded that the

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[97] Ex. A-1, p.7.

[98] Ex. A-1, pp. 3 and 6.

[99] 169 S.W.3d 258 (Tex. App. - Austin, 2005).

applicant "was not required to establish at the contested-case hearing that its application complied with each administrative and technical requirement because it had already done so prior to the hearing"[100]

The *Citizens* decision is not necessarily dispositive of the issue in this case, because the Health & Safety Code contains a provision (not applicable to CCN regulation) that specifically bars the re-examination of whether an application is administratively complete, once that application is referred to hearing.[101] However, the ALJ sees no reason to reach a different result in this case.

The Applicant has carried its burden of proof concerning the requirements for approving its Application. There has also been sufficient evidence to allow a meaningful review of the Application under the other criteria that the Commission must consider. The Opposing Ratepayers point to relatively small holes in that evidence. As discussed several times above, the evidence has gaps but is sufficient to carry the Applicant's burden of proof by preponderance of the evidence.[102] Nothing requires the Applicant to put on a perfect, beyond-a-reasonable-doubt case.

As to allegedly inadequate responses to questions in the Application form, they are akin to responses to written discovery requests. It is as if the Opposing Ratepayers are claiming that Tapatio's response to a discovery request by the ED was inadequate, even though the ED does not argue that, hence the Application should be denied. The Opposing Ratepayers do not point to any rule or statute mandating denial if a response was inadequate, assuming that the applicant ultimately carries its burden of proof.

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[100] *Id.*, p. 272.

[101] TEX. HEALTH & SAFETY CODE ANN. § 361.068(b)(1).

[102] 30 TAC § 80.17(a).

Addressing a similar situation, the Texas Rules of Civil Procedure provide that if there is a failure to respond to a discovery request, the judge may order sanctions that are just.[103] The ALJ concludes that denying an application based on the insufficiency of a response to a question in the application form, to which response the ED did not object when reviewing the application, would be manifestly unjust when the Applicant has proven its case in a contested hearing. The ALJ does not recommend such a denial.

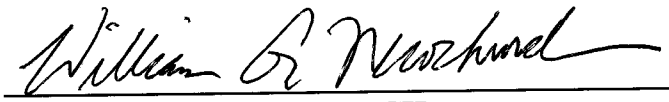
XVI. ADDITIONAL FACTS

In addition to the facts discussed above concerning contested issues, the Findings of Fact contained in the attached Proposed Order include other facts, as established during the proceeding, that are necessary to show compliance with regulatory requirements applicable to these proceedings. These additional undisputed facts are incorporated by reference into this Proposal for Decision.

XVII. CONCLUSION

After a review of the record and for the reasons given above, the ALJ recommends that the Commission adopt the attached Proposed Order approving the amendment of Applicant's certificates of convenience and necessity to add the Requested Area.

SIGNED October 6, 2006.



WILLIAM G. NEWCHURCH
ADMINISTRATIVE LAW JUDGE
STATE OFFICE OF ADMINISTRATIVE HEARINGS

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[103] Texas Rule of Civil Procedure 215.2(b).

TEXAS COMMISSION ON ENVIRONMENTAL QUALITY

AN ORDER granting the application by Tapatio Springs Service Company, Inc., for an amendment to its Certificates of Convenience and Necessity Nos. 12122 and 20698; TCEQ Docket No. 2005-1516-UCR; SOAH Docket No. 582-06-0425

On _____, 2006, the Texas Commission on Environmental Quality (TCEQ or Commission) considered the application of Tapatio Springs Service Company, Inc. (Tapatio or Applicant) for an amendment to its existing Certificates of Convenience and Necessity (CCN) Nos. 12122 and 20698, relating to the provision of water and sewer utility service within Kendall County, Texas.

Mike Rogan, an Administrative Law Judge (ALJ) with the State Office of Administrative Hearings (SOAH) conducted a preliminary hearing on the Application on January 24, 2006, and a contested case hearing on the merits of the Application on July 6, 2006. After the record was closed, ALJ Rogan retired from SOAH. The case was reassigned to ALJ William G. Newchurch, who reviewed the entire record and the Parties' arguments and prepared a proposal for decision (PFD), which recommended that the Commission approve the Application.

The following are the Parties to the proceeding: the Applicant; the Executive Director of the Commission; the Public Interest Counsel (PIC) of the Commission; and ten ratepayers (represented

by Elizabeth Martin, Attorney), including Andrew Calvert, Richard Haas, Carey McWilliams, Shel McWilliams, Carl D. Portz, Paulett Portz, David Rutherford, Thurman R. Williams, Myrna L. Williams, and Pat Wilson.

After considering the ALJ's Proposal for Decision and the evidence and arguments presented, the Commission makes the following Findings of Fact and Conclusions of Law:

FINDINGS OF FACT

Background

1. The Applicant is an investor-owned utility operating a water and sewer utility system, serving approximately 207 connections for water service and 173 connections for sewer service within its certificated service area in Kendall County, Texas.

2. The Applicant holds CCN Nos. 12122 and 20698, issued by the Commission, for water and sewer utility service within Kendall County.

3. On April 20, 2005, the Applicant filed an application with the Commission to amend its CCNs, seeking to expand its authorized service area to encompass an additional area (Requested Area).

4. The Requested Area consists of about 5,000 acres and is located a few miles west of downtown Boerne, Texas, and outside its extraterritorial jurisdiction.

5. The Requested Area is generally bounded on the north by Ranger Creek Road, on the east by Johns Road, and on the west by Bear Creek.

6. The Applicant's existing service area is adjacent to and south of the Requested Area.

7. The Requested Area currently contains no potential customers.

8. CDS International, Inc., (CDS or Developer) owns the land within the Requested Area and has requested the Applicant to provide the water and sewer utility service for planned development there.

9. The Applicant and the Developer entered into a Non-Standard Service Agreement (NSS Agreement) for such services, which prompted the filing of the Application in this case.

10. Under the NSS Agreement, CDS will be required to construct and finance all the necessary infrastructure to provide utility service in the Requested Area – including wells, storage facilities, pressure maintenance facilities, disinfection equipment, distribution system, collection system, and wastewater treatment facilities.

11. The Applicant will not provide service in the Requested Area until the Developer has completed the necessary infrastructure, with final inspection and testing by the Applicant and all regulatory approvals secured.

12. Agreements of this type are standard practice within the industry and are generally encouraged by TCEQ, as they relieve utilities of initial construction costs.

Jurisdiction

13. The Applicant mailed notice of its Application to neighboring utilities and affected parties on April 20, 2005.

14. The Applicant published notice of its Application for a CCN amendment on June 14 and 21, 2005, in the *Boerne Star*, a newspaper regularly published and generally circulated in Kendall County.

15. As a result of requests for hearing, the Application was subsequently referred to SOAH and set for hearing.

16. On December 27, 2005, the TCEQ's Chief Clerk mailed notice of a preliminary hearing on the Application to the Applicant, the ED, the PIC, and the people who had requested a hearing on the Application.

17. As indicated in the notice of hearing, a preliminary hearing on the Application was held by a SOAH ALJ in Austin, Texas, on January 24, 2006.

18. An evidentiary hearing in the proceeding was conducted by a SOAH ALJ at the same location on July 6, 2006.

Adequacy of Service

19. No water utility service currently is provided to the Requested Area

Need for Additional Service

20. There is an anticipated public need for additional service in the Requested Area.

21. CDS is systematically seeking to initiate an extensive residential development in the Request Area and requested the Applicant to provide the necessary utility services.

22. Development planned for the Requested Area could ultimately add up to about 1,700 more residential connections.

Effect of Granting Certificate on Applicant and Other Utilities

23. The Applicant and its affiliate, Kendall County Utility Company, which are interconnected, are the only two entities providing water and sewer utility service to the immediate area.

24. A separate application is pending to merge Tapatio and Kendall County Utility Company.

25. No retail public utility other than Tapatio would be directly affected by the granting of the Application.

26. Granting the requested amendments would affect Tapatio by increasing the area in which the Applicant is obligated to provide continuous and adequate water and sewer service.

27. To ensure sufficient water resources for the future, the Applicant and Kendall County Utility Company in 2002 secured a commitment for a supply of 500 acre-feet (ac-ft.) of treated surface water per year from the Guadalupe-Blanco River Authority (GBRA).

28. In accordance with the NSS Agreement with CDS, the Applicant later amended its water contract with GBRA to increase its reserved capacity by an additional 250 ac-ft. per year.

29. CDS paid the initial cost of acquiring this 250 ac-ft. and under the NSS Agreement must continue to pay the costs of delivering it.

30. CDS is obligated to pay the raw water component of the monthly reservation charges accrued by Applicant for GBRA water until at least 500 active connections (homes occupied by the end-users) exist within the Requested Area.

31. Under the NSS Agreement, CDS will contribute up to $1.5 million toward the estimated $2.2 million cost of constructing the transmission main to carry surface water from GBRA's delivery point to the Applicant's water plant.

32. Without that cash infusion, Tapatio would not have the funds to build that transmission line unless it significantly raised the rates of its existing customers.

33. CDS's obligation to provide $1.5 million toward that line is contingent on the Commission's approval of the Application, as well as any other required permits and approvals, allowing Tapatio to provide service to CDS's 5,000 acres.

34. Based on the above, granting the Application would benefit the Applicant by providing funds to build a surface water pipeline that is needed to serve its existing service area as well as the additional area it requests.

Applicant's Ability and Capability of Providing Adequate Service
Access to an Adequate Water Supply

35. Tapatio will ultimately need 1,697 ac-ft. of water per year to serve estimated base demand in its existing and Requested Areas combined, enough for 3,393 connections.

36. That assumes, consistent with Commission Staff guidelines, that a utility needs 0.5 ac-ft. per connection per year to meet base demand.

37. Tapatio will have at least 1,770 ac-ft. per year available: 1,020 ac-ft. from its current groundwater wells (after conservatively assuming a 25 percent reduction in their pumping capacity) plus 750 ac-ft under the contract with GBRA.

38. Commission rule 30 TAC § 290.45(b)(1)(D) and (2)(A) require a utility to be able to satisfy a 0.6 gallons per minute per connection peak demand.

39. CDS anticipates drilling 10 new wells within the Requested Area to provide peaking capacity for the development.

40. The Applicant's plan to use both surface water and groundwater (conjunctive use) is consistent with the applicable 2006 Regional Water Plan, which recommends that utilities in Kendall County purchase and implement the use of surface water from GBRA prior to year 2010.

41. If regulatory authorities restrict the number of wells that CDS can install, the Requested Area could still be developed with a reduced number of connections and the construction of additional water storage, which would allow GBRA water to be used for both normal and peak demands.

42. The NSS Agreement requires CDS to obtain all of the water needed to serve its property in the Requested Area, which is favorable to Tapatio and its current customers and will lead to a steadily growing water supply if CDS proceeds with development.

43. Tapatio could enforce that provision and deny service to further CDS development in the Requested Area, hence stopping the addition of new customers, until CDS arranged for the additional water.

44. Under the NSS Agreement, CDS must find the additional supplies. If it is unable to do so, the same contract specifies that it cannot demand additional service from the Applicant.

45. Since CDS is the only landowner in the Requested Area, the demand for and the provision of utility service there will remain in equilibrium.

46. The NSS Agreement would not require Tapatio to reserve any portion of its water supply for only certain of its customers, in the currently Requested Area or anywhere else.

47. Build-out to a maximum of 1,700 connections in the Requested Area (if it occurs) will entail at least 15 to 23 construction phases over eight to ten years.

48. Under the service agreement, the Applicant has contracted to serve within the Requested Area the lesser of either 1,700 connections or the number of connections that can be served by the additional water supply that is ultimately provided by CDS to the Applicant.

49. If CDS cannot obtain additional sources of water (beyond the 250 ac-ft. under the supplemental GBRA contract), in order to supply the maximum number of connections projected within the Requested Area, then the Applicant's service obligation there will be capped at the number of connections that CDS actually can supply.

50. Tapatio has approached GBRA for additional water, and GBRA has informally, verbally agreed to provide an additional 250 ac-ft., beyond the 750 ac-ft. which it has formally contracted to provide.

51. Approximately 1,600 ac-ft is available from GBRA for private utilities in the general area.

Technical and Managerial Capability

52. The Applicant's operation of existing groundwater wells, over a period of more than 15 years, has met the service demands experienced to date within its certificated area.

53. The Applicant also operates a TCEQ-permitted wastewater treatment facility with a capacity of 0.15 million gallons per day, which has adequately met the sewer service demands of its customers.

54. All treated wastewater is irrigated on a golf course and not discharged to a watercourse (Texas Land Application Permit No. 12404-001).

55. The Applicant has satisfactorily addressed all issues raised in the latest Commission inspection of its water facilities. As of August 10, 2004, the utility has documented that corrective actions were taken for any alleged water system violations and that no other action or submittal was necessary.

56. The Applicant has satisfactorily addressed all issues raised in the latest Commission inspection of its sewer facilities. As of January 12, 2004, the utility has documented that corrective actions were taken for any alleged sewer system violations and that no other action or submittal was necessary.

57. The record of John J. Parker–the Applicant's vice president, secretary, treasurer, and principal manager over the past 15 years–reflects sufficient managerial capability for the proposed service-area expansion.

58. Mr. Parker has overseen significant expansions of the system in the past, including the interconnection of the Tapatio Springs and Ranger Creek systems and the initiation of service to new subdivisions within the existing service area.

59. Mr. Parker's managerial talent is evidenced by his negotiating a favorable contract with CDS, which requires CDS to finance most of the cost for a water main from GBRA, as well as all of the additional water supplies and infrastructure needed for water and sewer service within the Requested Area.

60. Although the Applicant has an impending need for water from GBRA, and CDS pays GBRA an annual reservation fee approaching $20,000 for it, the Applicant has not yet acquired any of the easements needed for the pipeline's construction.

61. Under the GBRA contract, the Applicant was obligated to begin paying reservation fees long before GBRA had the means to deliver water in the area, and CDS has paid those fees.

62. By the beginning of May 2006, GBRA notified the Applicant that it could begin accepting delivery of water at Boerne.

63. The Applicant still needs to acquire an easement and construct a line from that delivery point to its system before customers in its existing service area, as well as potential customers in the Requested Area, will have access to that GBRA water.

64. Granting the Application will help provide most of the capital to build that line.

65. GBRA needed considerable time to complete regional facilities to deliver water to the Applicant's delivery point.

66. Under the NSS Agreement, CDS is now responsible for designing the pipeline, has begun that process, and is awaiting the outcome of this proceeding to pursue the project more comprehensively.

67. CDS would have no obligation to build or pay for a transmission line that may not benefit it.

68. Any delay in building the pipeline was largely caused by this proceeding, which has left the Applicant and CDS uncertain whether the CCN amendment would be approved so that CDS can obtain water from Tapatio.

69. Over the past two years, the Applicant has lost relatively large proportions of the water pumped from its wells before delivery to its customers – 20 percent of all water pumped in 2004 and 18.6 percent in 2005.

70. The discovery and repair of a major leak around May 2006 likely addressed much of the past problem of water losses.

71. Section 9(l) of the NSS Agreement provides that the Applicant *may* use excess capacity at the wastewater facility to serve the Requested Area, but "under no circumstances" is the utility *obligated* to use such capacity to serve the area. Rather, CDS is obligated to build any wastewater facilities it needs to serve its development in the Requested Area.

72. In September 2005 and May 2006, the Applicant imposed drought restrictions, limiting outside water sprinkling to once per week.

73. Large portions of Texas have been in an extended drought, and a Commission rule authorizes drought restrictions.

74. As of September 1, 2006, over 250 water systems have imposed watering restriction, including nine in Kendall County.

75. There is no evidence that the Applicants' customers are not being subjected to drought restrictions more frequently than other utilities' or in excess of TCEQ standards.

76. The Applicant has an acceptable record in providing water and sewer service within its certificated area over the past 15 years or more.

Financial stability and capability

77. Tapatio's end-of-2004 balance sheet showed that the Applicant had only $244,809.22 in assets but $861,309.51 in liabilities, giving it a *negative* net worth of $616,500.29.

78. In 2004, Tapatio had $905,194.95 in debt, nearly all owed to Clyde Smith, and only $635,104.75 in equity, giving it a very high 1.43 debt to equity ratio.

79. At the end of 2004, the Applicant's debt to equity ratio was unfavorable, reflecting a substantial amount of term debt against a small amount of equity.

80. If the Applicant satisfied one major debt on that end-of-2004 balance sheet, a $905,146 note payable to Clyde B. Smith for acquisition, Tapatio's debt-equity ratio would show substantial improvement.

81. Prior to July 6, 2006, the note to Clyde B. Smith was paid.

82. The Applicant's owners, John J. Parker, Sr. and Jr., have recently or will soon convey almost 50 percent of their interest in the company to a new third owner, Michael Shalit.

83. In 2004, Tapatio had a net income of $41,773.06.

84. Assuming that all of its 2004 expenses were reasonable, Tapatio earned a quite modest 6.6 percent return on its $635,104.75 in invested capital.

85. The end-of-2004 balance sheet showed that the Applicant had $1,293,378.10 in negative retained earnings, *i.e.*, previous losses.

86. Tapatio cannot be expected to continue earning an unreasonably low 6.6 percent return on its investment in a good year and losing money in other years. It is entitled to an opportunity to earn a reasonable return on its investment as well as recover its reasonable and necessary operating expenses. Water Code § 13.183(a)(1).

87. In 2004, the Applicant paid $55,314.14 in interest on its debts, an unusually high 23.26 percent of all its expenses.