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APPLICATION OF RIO CONCHO  
AVIATION, INC. FOR A  
RATE/TARIFF CHANGE

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§

BEFORE THE STATE OFFICE  
OF  
ADMINISTRATIVE HEARINGS

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**RIO CONCHO AVIATION, INC.'S  
INITIAL BRIEF**

COMES NOW, Rio Concho Aviation, Inc. ("Rio Concho") and files this its Initial Brief.

Respectfully submitted,

By: 


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**CERTIFICATE OF SERVICE**

I hereby certify that I have served or will serve a true and correct copy of the foregoing document via hand delivery, facsimile, electronic mail, overnight mail, U.S. mail and/or Certified Mail Return Receipt Requested to all parties on this the 11<sup>th</sup> day of January, 2017.

  
John Carlton

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**RIO CONCHO AVIATION, INC.'S  
INITIAL BRIEF**

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## I. INTRODUCTION AND SUMMARY

Rio Concho is a small investor owned water utility company operating under CCN No. 12835 at the Hicks Airfield in Fort Worth, Texas, since 1995. Rio Concho serves approximately 240 customers<sup>1</sup> and is a Class C utility under Texas Water Code §13.002(4-c), which defines all public utilities that provide retail water and sewer utility service to fewer than 500 taps as Class C utilities. Rio Concho opted to file an application for a rate/tariff change on March 22, 2016, as a Class B utility in an effort to increase its rates to a level that would allow it to recover its reasonable and necessary operating expenses and earn a reasonable return on its rate base<sup>2</sup> because the Class C application only allowed a 1.57% rate increase during 2016.<sup>3</sup> Rio Concho's rates and fees, as previously approved in Commission Docket No. 43728, would have generated an annual revenue of \$118,373.58 during the test year.<sup>4</sup> Rio Concho proposes increasing its total revenue requirement to \$151,097.22, which includes \$1,793.91 in rate case expenses that Rio Concho has agreed to separately surcharge, resulting in a proposed revenue increase of \$30,929.73.<sup>5</sup> Rio Concho asserts that this increase in the revenue requirement will "(1) permit the utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service to the public over and above its reasonable and necessary operating expenses; and (2) preserve the financial integrity of the utility."<sup>6</sup>

Rio Concho initially proposed April 26, 2016, as the effective date the rate/tariff change. Notice of the application was sent to customers on March 19, 2016. On April 25, 2016, the Commission issued Order No. 1 deeming Rio Concho's application sufficient but suspending the effective date of the rate/tariff change for 265 days, until January 16, 2017, and referring the matter to the State Office of Administrative Hearings ("SOAH"). The Commission issued its Preliminary

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<sup>1</sup> Exhibit RCA-2, page 8, line 10.

<sup>2</sup> Direct Testimony of Barbie Brunson, Exhibit RCA-1, page 14, lines 7- 15.

<sup>3</sup> Commission Docket No. 45320, Order, adopted November 20, 2015.

<sup>4</sup> Direct Testimony of Debi Loockerman, Exhibit Staff-3A, p. 19, line 20.

<sup>5</sup> Staff Exhibit 13, page RCA000914, lines 32 and 20, and page RCA000915, line 6.  
(\$151,097.22 - \$1,793.91 - \$118,373.58 = \$30,929.73).

<sup>6</sup> Texas Water Code, §13.183(a).

Order setting forth the issues to be considered in this matter on May 23, 2016. The SOAH Judges conducted the hearing on the merits on December 5 and 6, 2016. During the hearing on the merits, Rio Concho moved and the other parties agreed on the record to extend the effective date to May 16, 2017, with a relate back date of January 16, 2017.<sup>7</sup> The SOAH Judges granted Rio Concho's motion as agreed to by the parties.<sup>8</sup>

## **II. REVENUE REQUIREMENT [PO Issues 3, 5, 6, 19]**

Ratemaking for retail water and sewer utilities is governed by Chapter 13, Subchapter F of the Texas Water Code.<sup>9</sup> Under this subchapter, the Commission is required to "ensure that every rate made, demanded, or received by any utility ... shall be just and reasonable."<sup>10</sup> In a ratemaking proceeding, the utility bears the burden of proof to show that the proposed rates are just and reasonable.<sup>11</sup>

A utility's rates are based upon the utility's cost of rendering service.<sup>12</sup> A utility's cost of service is comprised of two components: allowable expenses and return on invested capital.<sup>13</sup> The term "invested capital" is also referred to as the "rate base."<sup>14</sup>

Allowable expenses are characterized as expenses that are reasonable and necessary to provide service to the ratepayers, and determined by gathering expense information during a historical test year and making adjustments for known and measurable changes.<sup>15</sup> Allowable expenses may include expenses for operations and maintenance, depreciation, and taxes,<sup>16</sup> but may

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<sup>7</sup> Tr. 15:12-22 (Dec. 5, 2016)

<sup>8</sup> Tr. 15:23-16:3 (Dec. 5, 2016)

<sup>9</sup> Tex. Water Code§ 13.181.

<sup>10</sup> Tex. Water Code§ 13.182(a).

<sup>11</sup> Tex. Water Code§ 13.184(c).

<sup>12</sup> 16 TAC 24.31(a).

<sup>13</sup> *Id.*

<sup>14</sup> 16 TAC 24.31(c)(2).

<sup>15</sup> 16 TAC 24.31(b).

<sup>16</sup> 16 TAC 24.31(b)(1).

not include expenses for legislative advocacy, political activity, or other unreasonable or unnecessary expenses.<sup>17</sup> These standards do not require that the utility's expenses be the lowest possible cost. They just require that the utility's expenses be a reasonable cost and necessary to the operation of the utility.

The rate of return is expressed as a percentage of invested capital.<sup>18</sup> It allows a utility an opportunity to earn a return on its invested capital and preserve the financial integrity of the utility.<sup>19</sup> It also permits a utility to meet its credit obligations and reasonably compete in the financial markets for future capital, namely, a return on equity.<sup>20</sup> The primary task of setting a rate of return is to determine the cost of capital.

The cost of capital is the composite of the cost of the various classes of capital used by the utility: (1) "debt capital is the actual cost of debt", *i.e.* interest on debt; and (2) equity capital is based upon a fair return on its value, *i.e.* dividends or earnings.<sup>21</sup>

Before a rate of return can be fixed, the Commission must determine what percentage of the utility's cost of capital is debt and what percentage is equity capital. Once the percentage is set for each element, a weighted cost of capital is ascertained by multiplying that percentage amount by the cost of the particular element. The combined weighted values represent the overall rate of return which is then applied to the rate base.<sup>22</sup>

In addition to considering the utility's capital structure, the Commission must also consider the efforts and achievements of the utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management.<sup>23</sup> Moreover, in any proceeding involving any proposed change of rates, including

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<sup>17</sup> 16 TAC 24.31(b)(2).

<sup>18</sup> 16 TAC 24.31(c)(1).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> 16 TAC 24.31(c)(1)(B)(i) and (ii).

<sup>22</sup> Exhibit RCA- 2, page 30, line 7.

<sup>23</sup> Tex. Water Code § 13.184(a) & (b); 16 TAC §24.31(c)(1)(B).

rate of return, the burden of proof shall be on the utility to show that the proposed change is just and reasonable.<sup>24</sup>

However, the Commission must also apply the following regulatory principles in determining a fair rate of return:

... The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties....

(B) The commission may, in addition, consider inflation, deflation, the growth rate of the service area, and the need for the utility to attract new capital. In each case, the commission shall consider the utility's cost of capital, which is the composite of the cost of the various classes of capital used by the utility.<sup>25</sup>

Lastly, there are two United States Supreme Court rulings that are oft-cited as establishing the legal criteria for determining a fair rate of return for regulated industries such as utilities: *Bluefield Water Works and Improvement Co. v. Public Service Comm 'n of West Virginia*<sup>26</sup> and *Federal Power Comm 'n v. Hope Natural Gas Co.*<sup>27</sup> In *Bluefield*, the United States Supreme Court stated that:

A public utility is entitled to such rates as will permit it to earn a return on the value of property which it employs for the convenience of the public equal to that general being made ... on investments in other business undertakings which are attended by corresponding risks and uncertainties.<sup>28</sup>

In the *Hope* decision, the United States Supreme Court broadened the concept of a reasonable return to allow for increasing national competition for capital:

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<sup>24</sup> Tex. Water Code § 13.184(c).

<sup>25</sup> 16 TAC §24.31(c)(1)

<sup>26</sup> *Bluefield Water Works and Improvement Co. v. Public Service Comm 'n of West Virginia*, 262 U.S. 679 (1923).

<sup>27</sup> *Federal Power Comm 'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

<sup>28</sup> *Bluefield* at 692.

From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.<sup>29</sup>

**A. Operations and Maintenance Expenses [PO Issue 20]**

The Preliminary Order identified the issue of “What are the utility’s reasonable and necessary operation and maintenance expenses?”<sup>30</sup> The Commission’s rules define those expenses as “operations and maintenance expense incurred in furnishing normal utility service and in maintaining utility plant used by and useful to the utility in providing such service (payments to affiliated interests for costs of service, or any property, right, or thing, or for interest expense are not allowed as an expense for cost of service except as provided in TWC §13.185(e))... Within the application form, these are the expenses that are “volume related” – including purchase water, power expense-production only and other volume related expenses – and “non-volume relate exp.” – including employee labor, materials, contract work, transportation expenses and other plant maintenance.<sup>31</sup>

Rio Concho provide support for \$82,178.83 in operations and maintenance expenses.<sup>32</sup> These expenses in aggregate are all reasonable and necessary for the operation of the utility. The Commission Staff and Ratepayers questioned Rio Concho’s expenses related to the following: Mr. Brunson’s compensation of \$14,400 per year; meter reading expenses of \$3600 per year; and vehicle operating expenses of \$3,971.22 per year. All other operations and maintenance expenses were uncontested.

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<sup>29</sup> *Hope* at 603.

<sup>30</sup> Preliminary Order, May 23, 2016, Issue 20.

<sup>31</sup> Commission Staff Exhibit 13, page RCA000914, lines 1-9.

<sup>32</sup> *Id.* at lines 4 and 10.



## **1. Kevin Brunson Compensation**

Mr. Brunson receives compensation for his on-call and after-hours responses to issues at the water system and his management and strategic planning services related to the water system. He is paid \$1200 per month for these services as contract labor.<sup>33</sup> Rio Concho must have after-hours and on-call responses and the other services that Mr. Brunson provides in order to provide water services to the customers. Mr. Brunson testified, not only does he spend time responding to emergencies and after-hours calls no matter how long they take, he evaluates and implements programs to improve system operations,<sup>34</sup> such as increased system pressure and back-up power.<sup>35</sup> The question is not whether his services are necessary, but whether the cost for them is reasonable. By comparison, the cost to retain a company to be on stand-by for infrequent emergency calls would be at least \$700 per month, but that cost does not cover more than one minor call per week or the use of any equipment or parts,<sup>36</sup> which Mr. Brunson does provide as part of his compensation.<sup>37</sup> In addition, Mr. Brunson's assistance with the other aspects of operating the water system is important because Ms. Brunson already spends more than 170 hours each month working on the system.<sup>38</sup> Mr. Brunson's proposed compensation is reasonable and should be included in its entirety in the revenue requirement.

## **2. Meter Reader Compensation**

Rio Concho pays \$300 per month for meter reading services. Even though some of these payments are to individuals related to the owners of Rio Concho and could be considered affiliated transactions, they are more than reasonable. Rio Concho received a quote to provide meter reading services for \$3.50 per connection per month, which would result in a cost of \$840 per month for those services that Rio Concho only pays \$300 for. Ms. Loockerman erroneously recommends a

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<sup>33</sup> Tr. 40:20 through 41:6.

<sup>34</sup> Exhibit RCA- 7, page 3, line 9 through page 4, line 16.

<sup>35</sup> Tr. 459:3 through 461:7 (Testimony of Kevin Brunson)(December 6, 2016).

<sup>36</sup> Commission Staff Exhibit 9, pages RCA000911 and RCA000912.

<sup>37</sup> Exhibit RCA- 6, page 7, lines 11-13, and Exhibit RCA- 1, page 23, lines 13-15.

<sup>38</sup> Exhibit RCA- 1, page 9, line 21.

reduction of \$655 because she simply does not understand that the \$1470 increase in known and measurable changes shown in the application<sup>39</sup> is the difference between the meter reading expenses incurred during the test year (\$2,130)<sup>40</sup> and the proposed new cost (\$3600). The full known and measurable increase of \$1,470 should be included in the revenue requirement.

### **3. Vehicle Expenses**

Rio Concho acquired a small used sport utility vehicle (SUV) to replace an aging vehicle that was no longer usable for the utility in late 2014.<sup>41</sup> The gasoline, repairs and other operating expenses for the SUV related to the utility operations totaled \$3,971.22 during the test year.<sup>42</sup> This is 60% of the total vehicle expenses.<sup>43</sup> Ms. Brunson testified that approximately 62% of the vehicles mileage, or 19,627 miles per year, is for water system matters.<sup>44</sup> This amount is supported by Mr. Manus' calculations.<sup>45</sup>

Commission Staff recommended disallowing these expenses and replacing them with the IRS mileage rate for reimbursement. This position is entirely based upon the erroneous determination that the vehicle is only used for utility purposes 15.9% of the time.<sup>46</sup> As her rationale for excluding the vehicle expenses claimed by Rio Concho, Ms. Loockerman asserts that it is unreasonable for Rio Concho to have two offices.<sup>47</sup>

However, Rio Concho is not seeking to recover any expenses associated with its corporate office, a fact the Ms. Loockerman acknowledges.<sup>48</sup> Rio Concho has established an office at the

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<sup>39</sup> Exhibit RCA- 2, Schedule II-8.

<sup>40</sup> Commission Staff Exhibit 17A, page RCA000083.

<sup>41</sup> Exhibit RCA- 1, page 23, lines 16-21.

<sup>42</sup> Exhibit RCA- 2, page 18

<sup>43</sup> Exhibit RCA- 1, page 25, line 14 through page 26, line 3.

<sup>44</sup> Exhibit RCA- 1, page 24, lines 13-14.

<sup>45</sup> Exhibit RCA- 4, page 14, line 1 through page 15, line 17.

<sup>46</sup> Commission Staff Exhibit 3A, page 12, lines 15-20.

<sup>47</sup> *Id.*, page 10, lines 17-19.

<sup>48</sup> *Id.*, page 11, lines 2-3.

utility system simply in an effort to comply with the Commission rule on office location without seeking an exemption for the location of their corporate office. Ms. Brunson conducts work for the water system at both offices.<sup>49</sup> Had Rio Concho secured an exemption for the corporate office location, Ms. Loockerman's rationale would fail without question. Consequently, the mileage between the two offices is appropriately business mileage. The SUV operating expenses are necessary for the operation of the utility system as explained by Ms. Brunson.<sup>50</sup> Allocation of 60% of the SUV operating expenses is reasonable given that the mileage used for utility purposes exceeds that level.

#### **4. Clothing Expenses**

Rio Concho incurs clothing expenses of \$600 per year to clean and replace Ms. Brunson clothes that she wears while in the field, digging in trenches, replacing water lines and meters and completing other repairs for the utility.<sup>51</sup> This expense is reasonable and necessary to the operation of the utility system.

#### **B. Administrative and General Expenses [PO Issue 21]**

The Preliminary Order identified the issue of "What are the utility's reasonable and necessary administrative and general expenses?"<sup>52</sup> The Commission's application form for Class B utilities includes office salaries, management salaries, employee pensions & benefits, purchased power-Office only, bad debt expense, office services & rentals, office supplies & expenses, professional services, insurance, regulatory (rate case) expense, regulatory (other) expense and miscellaneous expenses.<sup>53</sup>

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<sup>49</sup> Exhibit RCA- 1, page 10, lines 3-15.

<sup>50</sup> *Id.* at page 23, line 9, through page 24, line 7.

<sup>51</sup> Exhibit RCA- 6, page 9, lines 10-15.

<sup>52</sup> Preliminary Order, May 23, 2016, Issue 20.

<sup>53</sup> Commission Staff Exhibit 13, page RCA000914, lines 11-22.

Rio Concho provided evidence to support \$40,891.28 in administrative and general expenses.<sup>54</sup> These expenses are all reasonable and necessary for the operation of the utility. The Commission Staff and Ratepayers questioned Rio Concho's expenses related to the following:

### **1. Ms. Brunson Retirement Benefits**

Rio Concho provides retirement benefits to Ms. Brunson, who has worked full-time for 21 years for the utility. It is her only full-time job.<sup>55</sup> The expense for her retirement benefits is \$4666 per year.<sup>56</sup> The benefits will provide Ms. Brunson with \$1200 per month at age 70, which is not an excessive or unreasonable amount for retirement considering her long commitment to the utility. As Mr. Manus testified, retirement benefits are commonly accepted and expected within the full-time workforce.<sup>57</sup>

### **2. Key Employee Insurance**

Rio Concho has a "key employee" life insurance policy. This policy was erroneously issued with Mr. Brunson as the beneficiary and characterized as a life insurance policy. That error has been corrected, and Rio Concho Aviation is now the beneficiary.<sup>58</sup> The policy provides insurance against the impact of the sudden loss of Ms. Brunson, who is responsible for the day-to-day operation of the utility and critical to its success. The expense of \$1,334 per year is reasonable protection for the utility to insure its continued operations. Any claims paid under the policy would be used to insure continued operation of the water system.<sup>59</sup>

### **3. On-Site Office Rent**

Rio Concho has established an office at the water system location by renting office space for \$500 per month from an affiliated entity, Barbie Land Development. This rent includes utilities.

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<sup>54</sup> *Id.* at line 23.

<sup>55</sup> Exhibit RCA- 1, page 19, lines 1-8.

<sup>56</sup> Commission Staff Exhibit 3A, page 13, line 6.

<sup>57</sup> Exhibit RCA- 4, page 16, lines 7-14.

<sup>58</sup> Exhibit RCA- 6, page 9, line 18, through page 10, line 2.

<sup>59</sup> Tr. 446:3-9 (Testimony of Barbie Brunson)(December 6, 2016)

A survey of office spaces for lease in the area shows that lesser offices space that is further away from the water system is available for \$800 per month.<sup>60</sup> Rio Concho's below market rental rate is reasonable and satisfies the affiliated transaction requirements. Rio Concho's favorable rental rate actually saves the customers \$3600 or more per year.

**C. Other Expenses [PO Issue 23]**

The Preliminary Order identified the issue of "Are any expenses, including but not limited to, executive salaries, advertising expenses, legal expenses, penalties and interest on overdue taxes, criminal penalties or fines, and civil penalties or fines, unreasonable, unnecessary, or not in the public interest?"<sup>61</sup>

Rio Concho's positions regarding whether certain expenses are reasonable, necessary or in the public interest are discussed in other sections related to each specific expense that has been challenged by the Commission Staff or Ratepayers.

**D. Affiliate Transactions [PO Issue 25]**

The Preliminary Order identified the issue of "has the utility made any payments to affiliates?" and if so, "are these transactions reasonable and necessary?" and "what are the costs to the affiliate of each item or class of items in question, and is the price for each transaction no higher than prices charged by the supplying affiliate to its other affiliates or divisions for the same item or items, or to unaffiliated persons or corporations?"<sup>62</sup>

Rio Concho's positions regarding whether certain expenses are affiliate transactions and whether those transactions are reasonable and necessary and no higher than those charged to unaffiliated persons are discussed in other sections related to each specific expense that has been challenge by the Commission Staff or Ratepayers.

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<sup>60</sup> Exhibit RCA- 4, page 17, lines 12-15; and Exhibit RCA- 10

<sup>61</sup> Preliminary Order, Issue 23, citing Texas Water Code § 13.185(h)(3) and 16 TAC §24.31(b)(2)(1).

<sup>62</sup> Preliminary Order, Issue 25, citing Texas Water Code §13.185(e).

#### **E. Depreciation [PO Issues 11, 26]**

The Preliminary Order identified the issues of “what is the original cost of the property used and useful in providing water service to the public at the time the property was dedicated to public use?” and “What is the amount, if any, of accumulated depreciation on such property?”<sup>63</sup> In addition, it identified the related issues of “what is the reasonable and necessary depreciation expense?” and “For each class of property, what are the proper and adequate depreciation rates (including service lives and salvage values) and methods of depreciation?”<sup>64</sup>

Rio Concho’s requested invested capital and proposed depreciation are shown in detail on attachment 3 to the application.<sup>65</sup> The Commission Staff and Ratepayers questioned the appropriateness of a television, DVD player, wall mount and antenna as assets that were used and useful to Rio Concho. The total cost of those assets was \$670.60, and the annual depreciation is \$135.52 per year.<sup>66</sup> However, Ms. Brunson testified on rebuttal that she uses those assets to monitor the weather and conduct video training while in the office.<sup>67</sup> Mr. Brunson testified at length about the significance of weather impacts on the operation of the system and the need to monitor it closely.<sup>68</sup>

In addition, the Commission Staff and the Ratepayers questioned the appropriateness of including invested capital and depreciation for 60% of the used 2015 SUV acquired by Ms. Brunson to operate the water system. As discussed above in Section A.3., the SUV is necessary for the operation of the water system, and the expenses incurred by the utility related to the SUV are reasonable since only 60% of the SUV’s total costs, including its net asset value and depreciation, are allocated to the utility.

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<sup>63</sup> Preliminary Order, Issues 11, citing Texas Water Code § 13.185(b) and 16 TAC §24.31(c)(2)(A)-(B).

<sup>64</sup> Preliminary Order, Issue 26, citing Texas Water Code § 13.185(j) and 16 TAC §24.31(b)(1)(B).

<sup>65</sup> Exhibit RCA- 2, page 32, row 20, column E and Commission Staff Exhibit 13, page RCA000914, line25.

<sup>66</sup> Exhibit RCA- 2, Attachment 3.

<sup>67</sup> Exhibit RCA- 6, page 4, lines 14-15.

<sup>68</sup> Tr. 461:21 – 462:9 (Testimony of Kevin Brunson) (December 6, 2016).

There were no other challenges to the proper inclusion of the Rio Concho water system assets or the depreciation of those assets as shown in the Application.<sup>69</sup>

## **F. Taxes**

### **i. Federal Income Tax Expense [PO Issue 29]**

The Preliminary Order identified the issue of “what is the reasonable and necessary amount for the utility’s federal income tax expense?”<sup>70</sup> In addition, the Commission referred the following related questions:

- a. Is the utility a member of an affiliated group that is eligible to file a consolidated income tax return?
- b. If so, have income taxes been computed as though a consolidated return had been filed and the utility realized its fair share of the savings resulting from the consolidated return?
- c. If not, has the utility demonstrated that it was reasonable not to consolidate returns?

Rio Concho’s requested federal income tax expense of \$1532.44 is shown in Rio Concho’s revised calculations.<sup>71</sup> While Rio Concho Aviation does file a return that incorporates its other business activities related to the sale of aircraft fuel, leasing of aircraft tie-down spaces, and leasing a restaurant building, the federal income taxes associated with the utility have been calculated independently of those other operations as shown in the application and revised calculations.

### **ii. Other Assessments and Taxes [PO Issue 28]**

The Preliminary Order identified the issue of “what is the reasonable and necessary amount, if any, for assessment and taxes other than federal income taxes?”<sup>72</sup>

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<sup>69</sup> Exhibit RCA- 2, Attachment 3.

<sup>70</sup> Preliminary Order, Issue 29, citing 16 TAC §24.31(b)(1)(D) and Texas Water Code §13.185(f).

<sup>71</sup> Commission Staff Exhibit 13, page RCA000924.

<sup>72</sup> Preliminary Order, Issue 28, citing 16 TAC §24.31(b)(1)(C).

Rio Concho provided evidence to support \$4,692.80 in other assessments and taxes related to local property taxes and the Hick Airfield assessments. The Ratepayers questioned Rio Concho's expenses related to the allocation of the property taxes and assessments to the utility. As Mr. Manus explained, one of the assessed and taxed parcels is solely for the well site and those taxes and assessments are 100% allocated to the utility.<sup>73</sup> The other parcel is used for the utility, the restaurant and the fuel operations. Only 25% of that parcel's taxes and assessments are allocated to the utility.<sup>74</sup> Rio Concho must pay its local property taxes and assessments. Rio Concho's allocation of those taxes and expenses is reasonable and based upon the percentage of area that is used by the utility for each assessed or taxed piece of property.

**G. Return on Invested Capital [PO Issues 9, 14]**

The Preliminary Order identified the issues of: "what are the reasonable and necessary components of the utility's invested capital?";<sup>75</sup> and the related issue of "what is the reasonable and necessary working capital allowance for the utility?"<sup>76</sup>

As discussed in Subsection E. above, Rio Concho's requested invested capital and proposed depreciation are shown in detail on attachment 3 to the application.<sup>77</sup> The Commission Staff and Ratepayers questioned the appropriateness of a television, DVD player, wall mount and antenna as assets that were used and useful to Rio Concho. The total cost of those assets was \$670.60. As discussed in Subsection E., Ms. Brunson's testimony and Mr. Brunson's testimony support the inclusion of those assets as invested capital.

In addition, the Commission Staff and the Ratepayers questioned the appropriateness of including depreciation for 60% of the 2015 vehicle acquired by Ms. Brunson to operate the water system. As discussed in Subsection A.3., Rio Concho's witnesses provided extensive testimony supporting the inclusion of the 2015 SUV's allocated cost as part of the utility's invested capital.

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<sup>73</sup> Exhibit RCA- 4, Direct Testimony of Randy Manus, page 21, lines1-6.

<sup>74</sup> *Id.*

<sup>75</sup> Preliminary Order, Issue 9, citing 16 TAC §24.31(c)(2).

<sup>76</sup> Preliminary Order, Issue 14, citing 16 TAC §24.31(c)(2)(C).

<sup>77</sup> Exhibit RCA- 2, page 32, row 20, column E and Commission Staff Exhibit 13, page RCA000914, line25.



There were no other challenges to the proper inclusion of other Rio Concho water system assets as invested capital.

### **III. RATE OF RETURN**

#### **A. Return on Equity [PO Issue 8]**

The Preliminary Order identified the issue of “what is the appropriate overall rate of return, return on equity, and cost of debt for the utility?”<sup>78</sup>

Rio Concho proposed a return on equity of 12.49% consistent with the calculations set forth in the Commission’s Class B rate application form and its instructions.<sup>79</sup> The Commission Staff’s witness, Mr. Novak, agreed that Rio Concho had prepared the 12.49% rate of return on equity correctly.<sup>80</sup> Mr. Manus calculated the 12.49% rate by adding the prescribed risk factor of 7% for Class C utilities<sup>81</sup> to the Baa Bond Ratings for Public Utilities.<sup>82</sup>

Despite acknowledging that Rio Concho correctly completed the application in calculating the rate of return on equity, Mr. Novak recommends a much lower rate of return that does not take into account the risks recognized by the Class B application form and its instructions adopted by the Commission on September 17, 2015. And despite acknowledging the increased risks for a smaller utility, like Rio Concho, on cross examination,<sup>83</sup> Mr. Novak continued to recommend a return on equity that results in an approximate 29.3% reduction in pro forma equity value for the Rio Concho water system.<sup>84</sup> The reduction in value is driven by Mr. Novak’s failure to recognize the risk, which Mr. Scheig does incorporate into his analysis.<sup>85</sup> Mr. Scheig’s report explains in

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<sup>78</sup> Preliminary Order, Issue 8.

<sup>79</sup> Exhibit RCA- 2, page 30, and Exhibit 13, pages 9 and 10

<sup>80</sup> Tr. 373:3 (Testimony of Andrew Novak) (December 6, 2016).

<sup>81</sup> Exhibit RCA- 13, page 10.

<sup>82</sup> Exhibit RCA- 2, Attachment 5.

<sup>83</sup> Tr. 381:1 through 387:15 (Testimony of Andrew Novak) (December 6, 2016).

<sup>84</sup> Exhibit RCA- 9, Rebuttal Testimony of Gregory E. Scheig, p. 4, lines 17-20, and

<sup>85</sup> Rio Concho Exhibit 9B, pages 6-7.

detail why applying a risk premium of 5.6% is appropriate for Rio Concho due to its relatively small capitalization, resulting in an appropriate cost of equity for Rio Concho of 12.3%, which is nearly the same as the 12.49% that results from following the Commission's instructions.<sup>86</sup>

Mr. Novak's reduction in value will essentially render Rio Concho unable to secure loans or equity investment for replacement or additional utility infrastructure. Mr. Novak analysis is fundamentally flawed. As he acknowledge on cross-examination, even the utilities that he used as part of his barometer group were earning a return on equity for their shareholders of 12.5% and 13.5% based upon the most pessimistic source – Value Line.<sup>87</sup> If Rio Concho is only allowed a return on equity of 8.48%, why would anyone want to invest their money in it when they could achieve a substantially higher return investing in these larger systems?

The Commission's application form and instructions support a return on equity of 12.49%, which would allow Rio Concho to remain viable and competitive in the equity markets. The Commission rules require that the rate of return allow a utility an opportunity to earn a return on its invested capital and preserve the financial integrity of the utility.<sup>88</sup> Mr. Novak's recommendation fails to do either. His approach simply results in the inability for small utility systems, like Rio Concho, to function in the Texas regulatory environment by putting them on a lower tier than the large utility systems.

#### **B. Cost of Debt [PO Issues 8, 13]**

The Preliminary Order identified the issues of “what is the appropriate overall rate of return, return on equity, and cost of debt for the utility?”;<sup>89</sup> and “does the utility have any debt? If so, what is the cost of that debt?”<sup>90</sup>

Rio Concho's only debt is a 60% allocated portion of a 3.9% loan for the vehicle acquired by Ms. Brunson, which was taken in the name of Ms. Brunson because the utility could not obtain

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<sup>86</sup> *Id.* at 7.

<sup>87</sup> Tr. 385:19-25; Tr. 391:18-22; Tr. 393:5-11 (Testimony of Andrew Novak) (December 6, 2016).

<sup>88</sup> 16 TAC 24.31(c)(1).

<sup>89</sup> Preliminary Order, Issue 8.

<sup>90</sup> *Id.*, Issue 13.

the loan.<sup>91</sup> Mr. Novak calculated a hypothetical cost of debt based upon the Baa Moody's bond rating of 5.03%.<sup>92</sup> But Ms. Brunson could secure a loan from her bank for an amount up to \$15,000 at a rate of 8.4%, but only if she personally guaranteed the loan.<sup>93</sup> Clearly, the bank recognized the risk involved with making a loan to a small company like Rio Concho. Mr. Novak failed to do so in his analysis by simply using the Baa Moody's utility bond rating, and he even acknowledged that he did not know if his barometer companies were included in the Moody's rating determinations.<sup>94</sup>

If a hypothetical debt rate is going to be used, it should be the 8.4% rate that Ms. Brunson was quoted by her bank.

### **C. Capital Structure [PO Issue 7]**

The Preliminary Order identified the issue of "what is the appropriate debt-to-equity capital structure of the utility?"<sup>95</sup>

Rio Concho's actual debt-to-equity ratio is approximately 80% equity and 20% debt, as set forth in the application.<sup>96</sup> For a small system like Rio Concho, this ratio is appropriate. As discussed above, Rio Concho's cost of debt will likely be much higher than what is typical for other larger utility systems. Commission Staff proposes the use of a hypothetical 50-50 debt-to-equity ratio because that is typical of much larger water and sewer utility systems.<sup>97</sup> Once again, Commission Staff's proposals result in financial hardship to this small utility by undermining Rio Concho's ability to attract capital for investment.

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<sup>91</sup> Tr. 68:22 through 69:1 (Testimony of Barbie Brunson) (December 5, 2016).

<sup>92</sup> Commission Staff Exhibit 2, Direct Testimony of Andrew C. Novak, page 6, lines 1-4.

<sup>93</sup> Tr. 440:10-23 (Testimony of Barbie Brunson) (December 6, 2016).

<sup>94</sup> Tr. 404:1-4 (Testimony of Andrew Novak) (December 6, 2016).

<sup>95</sup> Preliminary Order, Issue 7.

<sup>96</sup> Exhibit RCA- 2, page 30.

<sup>97</sup> Commission Staff Exhibit 2, page 7, lines 9-14.

#### **D. Overall Rate of Return [PO Issue 8]**

The Preliminary Order identified the issue of “what is the appropriate overall rate of return, return on equity, and cost of debt for the utility?”<sup>98</sup>

Rio Concho’s proposed overall rate of return is 10.78%.<sup>99</sup> This overall rate of return is calculated following the Commission’s instructions and using Rio Concho’s actual cost of debt. The Commission Staff proposes to deviate from those instructions by applying a hypothetical debt-to-equity ratio, applying a hypothetical cost of debt and a return on equity that are both based upon types of utility systems that are fundamentally different from Rio Concho, which is a small family owned business.

#### **IV. RATE DESIGN [PO Issues 1, 2]**

The Preliminary Order identified the issues of “what is the appropriate methodology to determine just and reasonable rates in this docket?”<sup>100</sup>, and “what are the just and reasonable rates for the utility that are sufficient, equitable, and consistent in application to each customer class and that are not unreasonably preferential, prejudicial, or discriminatory?”<sup>101</sup>

Rio Concho proposes an alternative rate design that will keep the base rate below \$40 per customer in order to avoid having customers who use little water disconnecting from the system because of a high base rate.<sup>102</sup> Rio Concho customers use an average of approximately 1620 gallons per month.<sup>103</sup> Because usage is so low, keeping the base rate near but not above \$40 preserves the financial integrity of the system.

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<sup>98</sup> Preliminary Order, Issue 8.

<sup>99</sup> Exhibit RCA- 2, page 30, line 7.

<sup>100</sup> Preliminary Order, Issue 1.

<sup>101</sup> Preliminary Order, Issue 2, citing Texas Water Code § 13.182.

<sup>102</sup> Tr. 516:25 through 517:16 (Testimony of Kevin Brunson) (December 6, 2016).

<sup>103</sup> Exhibit RCA- 2, page 11, column C, line 4, divided by 12 months, divided by page 8, column E, line 10 (4,662,400 gallons in test year/12 months/240 customers = 1619 gallons/customer/month).

## V. RATE CASE EXPENSES

The Preliminary Order identified the issues of “what are the utility’s expenses incurred in this rate proceeding that are just, reasonable, necessary, and in the public interest?”<sup>104</sup> and the related questions of “does that amount include any anticipated expenses to appeal this docket that are just, reasonable, necessary, and in the public interest? Should the utility be able to recover its reasonable and necessary rate-case expenses from ratepayers? If so, how should such expenses, if any, be recovered by the utility?”

### A. Recovery of Rate Case Expenses [PO Issue 35]

Rio Concho should be allowed to recover all of its rate case expenses. The Commission rules provide that:

A utility may recover rate-case expenses, including attorney fees, incurred as a result of filing a rate-change application pursuant to TWC §13.187 or TWC §13.1871, only if the expenses are just, reasonable, necessary, and in the public interest.<sup>105</sup>

And that:

A utility may not recover any rate-case expenses if the increase in revenue generated by the just and reasonable rate determined by the commission after a contested case hearing is less than 51% of the increase in revenue that would have been generated by a utility’s proposed rate.<sup>106</sup>

Rio Concho has proven its requested revenue requirement increase of \$30,929.73. The threshold for allowing recovery of rate case expense recovery in this case is 51% of that amount, or \$15,774.16. Rio Concho has exceed that amount.

### B. Amount of Rate Case Expenses that are Just, Reasonable, and Necessary, and in the Public Interest [PO Issue 35]

Rio Concho provided evidence of \$106,564.63 in rate case expenses for this matter.<sup>107</sup> Detailed invoices documenting these expenses have been produced to all parties for review. Mr.

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<sup>104</sup> Preliminary Order, Issue 35, citing 16 TAC §24.33.

<sup>105</sup> 16 TAC §24.33(a).

<sup>106</sup> 16 TAC §24.33(b).

<sup>107</sup> Exhibit RCA- 18.

Manus' fees and expenses were \$6,286.70 for his services in responding to discovery, preparing prefiled direct and rebuttal testimony, reviewing other testimony, and participating in the pre-hearing and hearing process through the end of the hearing. Mr. Scheig's fees and expenses were \$10,005.67, and were solely related to responding to Mr. Novak's deviation from the application instructions and procedures by reviewing the application, Mr. Novak's testimony and working papers, preparing rebuttal testimony and participating in the hearing. Mr. Carlton's fees and expenses were \$88,916.52 through the end of the hearing on December 6, 2016, and were related to his work in reviewing the application, participating in settlement conferences, responding to discovery requests, preparing discovery to serve on the other parties, preparation of prefiled direct and rebuttal testimony, review of other parties' testimony, preparation for and participation in the hearing and costs for copies, deliveries and other expenses. In addition, Ms. Brunson has incurred travel expenses related to participation in meetings with Commission staff, the settlement conferences, prehearing conferences, and the hearing on the merits that are not included in Exhibit RCA- 18.

This case could not have been processed by Rio Concho for any less. The Commission's process is burdensome and expensive for utility systems. A simple application for a \$30,000 increase in revenue requirement in a 240 customer system has taken over a year, required responses to over 100 questions through discovery and required hundreds of hours of work by consultants and the family owners of this small utility. Rio Concho has undergone an excruciatingly burdensome process in an effort to obtain a relatively small increase in its revenue requirement. Commission Staff has evaluated and scrutinized every single invoice and accounting entry for this small family owned business. The proposed increase in rates for customers of the Rio Concho system would have been approximately \$13.09 per month for the average user of 1620 gallons in the Rio Concho system. Even with the increase, the proposed base rates are less than the base rates for the neighboring Aqua Texas system and the costs to an average Rio Concho customer using 1600 gallons of water would be about the same.<sup>108</sup>

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<sup>108</sup> Ratepayers Exhibit 2.

**C. Surcharge [PO Issue 37]**

The Preliminary Order identified the issue of “if a refund or surcharge results from this proceeding, how and over what period of time should that be made?”<sup>109</sup>

Rio Concho proposes recovering its rate case expenses over the typical two-year period, which would result in a surcharge of \$18.50 per customer per month.

**VI. INTERIM RATES AND EFFECTIVE DATE [PO Issue 38, 39]**

The Preliminary Order identified the issue of “has the utility met the requirements for a request for interim relief in the form of interim rates? If so, what are the appropriate levels of the interim rates?”<sup>110</sup> and “what is the appropriate effective date of the rates fixed by the Commission in this proceeding?”<sup>111</sup>

Interim rates have not been set in this proceeding. As stated above, the appropriate effective date for rates in this proceeding is May 16, 2017, as ordered by the SOAH Judges during the hearing. Rate surcharges must be calculated based upon the agreed relate back date of January 16, 2017.

**VII. ISSUES NOT ADDRESSED [PO Issues 4, 10, 12, 15, 16, 17, 18, 22, 24, 27, 30, 31, 32, 33, 34, 36]**

The Preliminary Order identified the issues that were not contested by the parties or are not applicable or relevant to Rio Concho’s application. Many of these issues were simply part of a “laundry list” of issues provided to the Commission and incorporated into the preliminary order in this case.

Issue 4. Are the utility's proposed revisions to its tariffs and rate schedules, if any, appropriate?

Rio Concho’s only proposed revisions are relate to the rates themselves.

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<sup>109</sup> Preliminary Order, Issue 37, citing Texas Water Code §13.1871.

<sup>110</sup> Preliminary Order, Issue 38, citing 16 TAC §24.29.

<sup>111</sup> Preliminary Order, Issue 39, citing Texas Water Code §13.1871.

Issue 10. What is the amount for an allowance for funds used during construction, if any, that is being transferred to invested capital in this proceeding? If such amounts are being transferred, for what facilities and at what rate did the allowance for funds used during construction accrue?

Rio Concho is not seeking an allowance for funds used during construction.

Issue 12. Is the utility seeking the inclusion of construction work in progress? If so, what is the amount sought and for what facilities? Additionally, has the utility proven that the inclusion is necessary to the financial integrity of the utility and that major projects under construction have been efficiently and prudently planned and managed?

Rio Concho is not seeking the inclusion of construction work in progress.

Issue 15. Does the utility have any water property that was acquired from an affiliate or a developer before September 1, 1976? If so, has such property been included by the utility in its rate base, and has it been included in all ratemaking formulas at the actual cost of the property rather than the price set between the entities?

Rio Concho does not have any water property that was acquired from an affiliate or a developer before September 1, 1976.

Issue 16. Has the utility acquired any water property from an affiliate? If so, do the payments for that property meet the requirements of TWC § 13.185(e)?

Rio Concho has not acquired any water property from an affiliate.

Issue 17. Has the utility financed any of its plant with developer contributions? What is the amount, if any, of accumulated depreciation on that property?

Rio Concho has not financed any of its plant with developer contributions.

Issue 18. Has the utility included any customer contributions or donations in invested capital?

Rio Concho has not included any customer contributions or donations in invested capital.

Issue 22. What is the reasonable and necessary amount for the utility's advertising expense, contributions, and donations?



Rio Concho has not sought recovery of any advertising expense, contributions, and donations.

Issue 24. If the utility has a self-insurance plan approved by the Commission or other regulatory authority, what is the approved target amount for the reserve account, and is it appropriate to charge that amount? What is the amount of any shortage or surplus for the reserve account, and what actions, if any, should be taken to return the reserve account to the approved target amount?

Rio Concho is not self-insured.

Issue 27. Are any tax savings derived from liberalized depreciation and amortization, investment tax credits, or similar methods? If so, are such tax savings apportioned equitably between customers and the utility, and are the interests of present and future customers equitably balanced?

Rio Concho is not proposing liberalized depreciation and amortization, investment tax credits, or similar methods.

Issue 30. What is the reasonable and necessary amount of the utility's accumulated reserve for deferred federal income taxes, unamortized investment tax credits, contingency reserves, property insurance reserves, contributions in aid of construction, customer deposits, and other sources of cost-free capital? What other items should be deducted from the utility's rate base?

Rio Concho is not proposing an accumulated reserve for deferred federal income taxes, unamortized investment tax credits, contingency reserves, property insurance reserves, contributions in aid of construction, customer deposits, and other sources of cost-free capital.

Issue 31. What regulatory assets are appropriately included in the utility's rate base? If such assets are included in rate base, what is the appropriate treatment of such assets?

Rio Concho is not claiming any regulatory assets in its rate base.

Issue 32. Is the utility seeking rates for both water and sewer service? If so, is each component of cost of service (each allowable expense and all return on invested capital) properly allocated between water and sewer services?

Rio Concho only provides water service.

Issue 33. What is the appropriate allocation of the revenue requirement among rate classes?

Rio Concho only has one rate class.

Issue 34. What is the appropriate rate design for each rate class?

Rio Concho only has one rate class.

Issue 36. What are intervening cities' reasonable rate-case expenses?

There are no intervening cities in this case.

### **VIII. CONCLUSION**

Rio Concho requests that the SOAH Judges issue a proposal for decision recommending approval of Rio Concho's application for a rate/tariff change and a revenue requirement increase of \$30,929.73 based upon the arguments set forth above. In addition, Rio Concho requests that the SOAH Judge award Rio Concho its full rate case expenses and allow recovery of those expenses through a surcharge of \$18.50 per customer per month over a two year period.