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APPLICATION OF DOUBLE DIAMOND UTILITY COMPANY, INC. FOR WATER AND SEWER RATE/TARIFF CHANGE	**§ § § §**	**BEFORE THE STATE OFFICES OF ADMINISTRATIVE HEARINGS**

COMMISSION STAFF'S INITIAL BRIEF

Respectfully submitted,

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Dated: November 22, 2017

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APPLICATION OF DOUBLE	§	**BEFORE THE STATE OFFICES**
DIAMOND UTILITY COMPANY, INC.	§	**OF**
FOR WATER AND SEWER	§	**ADMINISTRATIVE HEARINGS**
RATE/TARIFF CHANGE	§	

COMMISSION STAFF'S INITIAL BRIEF

COMES NOW the Staff (Staff) of the Public Utility Commission of Texas (Commission), representing the public interest, and files this Initial Brief. The deadline for initial briefs is November 22, 2017. Therefore, Staff's Initial Brief is timely filed. In support of its Initial Brief, Staff states the following:

I. INTRODUCTION AND SUMMARY

Double Diamond Utility Company, Inc. (DDU) is a utility that owns and operates several water and sewer utility systems in North Texas. In this case, DDU is seeking a rate increase for the White Bluff water system, the White Bluff sewer system, the Cliffs water system, and the Cliffs sewer system. DDU proposes revenues in this proceeding that are excessive, as the result of several accounting maneuvers that are not consistent with public policy, Commission precedent, or the Texas Water Code. DDU proposes to require ratepayers to pay for costs not related to the provision of utility service, such as personal cell phone use, personal commuting use of utility vehicles, and the allocation of resort overhead and expenses unrelated to the utility. DDU also proposes to treat certain utility plant as expenses to be recovered annually instead of depreciating these assets over a useful life. Further, DDU proposes a return on equity that is far in excess of the 8.79% rate recommended by Staff witness Emily Sears, who uses methodologies that are reflective of market conditions and Commission precedent for water utilities. DDU's proposals on all of these issues should be denied. Finally, the Commission should disallow various operations and maintenances expenses, administrative and general expenses, and tax expenses, as discussed below. Staff recommends that the Administrative Law Judge (ALJ) cost of service model and rate design in this proceeding and require them to be used for number-running purposes.

II. REVENUE REQUIREMENT [PO ISSUES 3, 5, 6, 19]

For the White Bluff water system, Staff recommends a cost of service of $441,815 less other revenues of $8,673, resulting in a revenue requirement of **$433,052**, as summarized in the below table:[1]

Table 1
White Bluff Water Revenue Requirement

Account Name	**DDU Requested**	**Staff Adjustment**	**Staff Recommended**
Operations and Maintenance Expenses	$294,812	($87,932)	$206,880
Depreciation and Amortization Expense	$110,077	$1,078	$111,155
Taxes Other Than Income	$64,171	($2,148)	$62,023
Federal Income Taxes	$18,378	($6,011)	$12,367
Return on Invested Capital	$86,485	$37,096)	$49,390
TOTAL	$573,924	($132,109)	$441,815
(Less Other Revenues)	($5,163)	($3,600)	($8,673)
Revenue Requirement Used to Set Rates	$568,761	($135,709)	**$433,052**

For the White Bluff sewer system, Staff recommends a cost of service of $397,436 less other revenues of $4,574, resulting in a revenue requirement of **$392,862**, as summarized in the below table:[2]

Table 2
White Bluff Sewer Revenue Requirement

Account Name	**DDU Requested**	**Staff Adjustment**	**Staff Recommended**
Operations and Maintenance Expenses	$277,820	($163,864)	$113,956
Depreciation and Amortization Expense	$84,700	$12,188	$96,888
Taxes Other Than Income	$58,106	($5,025)	$53,081
Federal Income Taxes	$27,354	($618)	$26,736
Return on Invested Capital	$128,724	($21,949)	$106,775
TOTAL	$576,704	($179,268)	$397,436
(Less Other Revenues)	($4,574)	($0)	($4,574)
Revenue Requirement Used to Set Rates	$572,130	($179,268)	**$392,862**

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[1] Direct Testimony of Emily Sears, Staff Ex. 2 at Attachment ES-3, Staff Schedule I (White Bluff Water Revenue Requirement).

[2] *Id.* at Attachment ES-4, Staff Schedule I (White Bluff Sewer Revenue Requirement).

For the Cliffs water system, Staff recommends a cost of service and revenue requirement of **$391,091**, as summarized in the below table:[3]

Table 3 The Cliffs Water Revenue Requirement			
Account Name	**DDU Requested**	**Staff Adjustment**	**Staff Recommended**
Operations and Maintenance Expenses	$286,150	($21,712)	$264,438
Depreciation and Amortization Expense	$78,443	($2,538)	$75,905
Taxes Other Than Income	$10,545	($686)	$9,859
Federal Income Taxes	$5,576	($888)	$4,688
Return on Invested Capital	$48,301	($12,099)	$36,202
TOTAL	$429,015	($37,924)	$391,091
(Less Other Revenues)	($0)	($0)	($0)
Revenue Requirement Used to Set Rates	$429,015	($37,924)	**$391,091**

For the Cliffs sewer system, Staff recommends a cost of service and revenue requirement of **$288,713**, as summarized in the below table:[4]

Table 4 The Cliffs Sewer Revenue Requirement			
Account Name	**DDU Requested**	**Staff Adjustment**	**Staff Recommended**
Operations and Maintenance Expenses	$230,581	($19,907)	$210,674
Depreciation and Amortization Expense	$29,263	($1,007)	$28,256
Taxes Other Than Income	$9,970	($561)	$9,409
Federal Income Taxes	$5,171	($483)	$4,688
Return on Invested Capital	$44,790	($9,102)	$35,688
TOTAL	$319,775	($31,062)	$288,713
(Less Other Revenues)	($0)	($0)	($0)
Revenue Requirement Used to Set Rates	$319,775	($31,062)	**$288,713**

[3] Direct Testimony of Jonathan Ramirez, Staff Ex. 3 at Attachment JR-2, Staff Schedule I (The Cliffs Water Revenue Requirement).

[4] *Id.* at Attachment JR-3, Staff Schedule I (The Cliffs Sewer Revenue Requirement).

A. Operations and Maintenance Expenses [PO Issue 20, 38]/ Administrative and General Expenses [PO Issue 21, 25, 38]/ Other Expenses [PO Issue 38]

Under 16 Tex. Admin. Code § 24.31(b) (TAC), only those expenses that are reasonable and necessary to provide service to the ratepayers may be included in allowable expenses. Accordingly, Staff recommends adjustments to DDU's requested expenses as shown below.

1. White Bluff

Staff's adjustments to expenses for the White Bluff water system[5] are summarized in the below table, and discussed in further detail in the following subsections.

Table 5
White Bluff O&M Adjustments for Water

Account Name	**DDU Requested**	**Staff Adjustment**	**Staff Recommended**
Other Volume Related Expenses	$8,289	$318	$8,607
Total Employee Labor	$80,520	($3,380)	$77,140
Total Contract Work	$3,298	$651	$3,949
Total Transportation	$13,313	($10,209)	$3,104
Total Other Plant Maintenance	$41,055	($18,806)	$22,249
Total Insurance	$9,668	($4,815)	$4,853
Total Regulatory Expense	$24,476	($23,291)	$1,185
Total Miscellaneous	$29,261	($28,400)	$861
Total O&M Adjustments		**($87,932)**	

5 Staff Ex. 2 at Attachment ES-3, Staff Schedule II (White Bluff Water O&M Expense).

Staff adjustments to expenses for the White Bluff sewer system are summarized in the below table, and discussed in further detail in the following subsections.[6]

Table 6 White Bluff O&M Adjustments for Sewer			
Account Name	**DDU Requested**	**Staff Adjustment**	**Staff Recommended**
Other Volume Related Expenses	$2,409	($530)	$1,879
Employee Labor	$91,440	($40,300)	$51,140
Total Contract Work	$2,922	$578	$3,500
Total Transportation	$11,795	($6,300)	$5,495
Total Other Plant Maintenance	$100,955	($83,962)	$16,993
Professional Services	$3,937	($2,907)	$1,030
Total Insurance	$8,566	($1,500)	$7,066
Regulatory Expense	$7,049	($2,519)	$4,530
Total Miscellaneous	$26,424	($26,424)	$0
Total O&M Adjustments		**($163,864)**	

a. Other Revenues

Staff recommends adding a total of $3,600 to water for monthly revenues received from Nextlink.[7] At the hearing on the merits, DDU witness Jay Joyce testified that DDU is in agreement with this recommendation.[8] Therefore, this issue is no longer contested.

b. Other Volume Related Expenses

The rate design for a Class B Utility allows the utility to recover certain expenses through a base service charge and other expenses through a volumetric rate.[9] Only variable costs can be recovered through the volumetric rate.[10] In accordance with Commission policy, expenses categorized as other volume related expenses are considered variable costs. Accordingly, all operations and maintenance expenses included in the Other Volume Related Expenses Account are variable costs.

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[6] *Id.* at Attachment ES-4, Staff Schedule II (White Bluff Sewer O&M Expense).

[7] *Id.* at 8.

[8] Tr. at 512:25-513:10 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

[9] *See generally,* Class B Rate/Tariff Change Application, Schedule VI-1 Rate Design.

[10] *Id.* at line 14.

Staff's recommended adjustments to other volume related expenses were made to remove incorrectly categorized fixed costs and ensure an accurate rate design. Staff witness Ms. Sears recommended a net addition of $318 to water, as the result of reclassifying expenses included in the Other Volume Related Expenses Account to the Other Plant Maintenance Account and vice versa.[11] A total of $830 for fixed expenses unrelated to volumes treated was moved to the Other Plant Maintenance Account,[12] and a $1,148 expense for chlorine gas cylinders was added to the Other Volume Related Expenses Account.[13]

Staff also recommends that $530 of fixed expenses unrelated to volumes treated be removed from sewer Other Volume Related Expenses Account and added to the Other Plant Maintenance Account.[14]

c. Employee Labor

White Bluff's requested employee labor expenses include $20,800 for the salary of Jerry Whitworth, a "utilities back hoe operator" and $22,880 for the salary of Danny Keeton, an "equipment operator."[15] Each employee's salary was allocated 50-50 between the White Bluff water and sewer systems.[16] The only job description for these employees was provided in response to Staff's discovery requests, and states:

> Both employees are experienced backhoe operators. As part of the work crew, they are involved in all tap installations. Their tasks include installing water and sewer taps, excavation for installing taps, and clean up of work site after the installations. They also perform other duties as needed within the utility department.[17]

Staff recommends removing these salaries from employee labor because the tap fees charged by DDU already include the cost of labor, and the only reference in the above job description to

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11 Staff Ex. 2 at 11.

12 Workpapers of Emily Sears, Staff Ex. 2A at ES Workpaper 4.

13 Supplemental Workpapers of Emily Sears, Staff Ex. 2B at ES Workpaper 1-3.

14 Staff Ex. 2A at ES Workpaper 11.

15 White Bluff – Water and Sewer Rate Increase Applications, Ex. DDU-2 at 15 of 151.

16 *Id.*

17 Staff Ex. 2A at ES Workpaper 6.

duties not related to tap installations is too vague to allow Staff to analyze whether these positions are reasonable and necessary expenses.[18]

DDU witness Mr. Joyce agreed that the labor costs for tap installations should be removed from the requested salaries to prevent double recovery of these costs through both tap fees and the employee labor expense.[19] Based on the work orders for the four water taps and three sewer taps installed during the test year, the amounts to be removed are $272 for water and $343 for sewer.[20] Using these same work orders, Staff witness Ms. Sears added up the total number of hours each employee spent installing taps, multiplied the total number of hours by the employee's hourly rate of pay,[21] and then took that dollar amount as a percentage of the employee's total salary.[22] Her calculation verifies that these employees spend only 1% of their time installing taps leaving 99% of their time accounted for by the catch-all job descriptor "other duties as needed."[23]

Yet, DDU has not provided any supporting documentation, such as work orders or time sheets, explaining what these other duties include or whether they require operating a backhoe.[24] In fact, the only concrete evidence DDU provided on rebuttal regarding the job duties of Mr. Keeton and Mr. Whitworth were the work orders related to tap installations.[25] And as Ms. Sears testified, DDU had ample opportunity to provide a more robust description of the other duties since they comprise 99% of the work these employees perform.[26]

DDU witness Randy Gracy attempts to explain the meaning of "other duties as needed" through a blanket statement that all employees are "crosstrained on everything having to do with

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18 Staff Ex. 2 at 12; Tr. at 335:21-336:7 (Sears Cross) (Oct. 25, 2017).

19 Tr. at 513:10-13 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

20 Rebuttal Testimony of Jay Joyce, Ex. DDU-11 at 4-5 of 106.

21 *See* Workpapers for Rebuttal Testimony of Jay Joyce, Ex. DDU-11B at 90 of 106.

22 Tr. at 403:10-18 (Sears Redirect) (Oct. 25, 2017).

23 For example, Jerry Whitworth spent 14 hours installing water taps at a rate of $10/hour for a total of $140. Dividing the portion of his salary allocated to water ($10,400) by $140 yields a result of .01. Mr. Whitworth spent 11 hours installing sewer taps for a total of $110. Dividing the portion of his salary allocated to sewer ($10,400) by $110 yields a result of .01.

24 Tr. at 399:20-400:20 (Sears Cross) (Oct. 25, 2017).

25 Rebuttal Testimony of Randy Gracy, Ex. DDU-8 at 4 of 155.

26 Tr. at 338:18-24 (Sears Cross) (Oct. 25, 2017).

the utilities—water and sewer."[27] However, this statement does nothing more than suggest that the other duties performed by Mr. Keeton and Mr. Whitworth are performed on both systems; a fact that is already suggested by DDU's allocation of their salaries 50-50 between water and sewer.[28] Furthermore, neither Mr. Keeton nor Mr. Whitworth is a licensed water or wastewater operator, and unlicensed employees must be directly supervised by a licensee to work on the systems.[29] Absent any justification as to what these employees do with 99% of their time on the job, this testimony demonstrates the unreasonableness of these salaries because it shows that a quarter of DDU's workforce cannot work on either system without a minimum of one additional employee to supervise.

DDU has left important questions unanswered, such as why it needs more than one full time skilled backhoe operator or what tasks other than tap installations require the use of a backhoe. Thus, removing these salaries from DDU's cost of service is warranted because DDU has failed to show that the positions held by these employees are a reasonable and necessary expense.

Additionally, Staff recommends that the allocation of employee labor expenses between water and sewer be adjusted to reflect the type of license that each employee holds.[30] The overall effect of Staff's recommended deductions and reallocations related to employee labor expenses results in the removal of $3,380 from water and $40,300 from sewer.[31]

d. Contract Work

White Bluff's requested contract work expenses include a phone allowance for the utility manager, Todd Dilworth.[32] However, DDU is unable to account for how much of the phone use is attributable to utility business and how much is for the employee's personal use.[33] Therefore,

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27 Ex. DDU-8 at 4 of 155.

28 Staff also notes that the work orders (DDU00477-005638 produced in response to RFI 1-32 from the Whitebluff Ratepayers' Group) Mr. Gracy refers to in his prefiled rebuttal testimony to support his assertion about crosstraining were not attached to that testimony or otherwise admitted into evidence.

29 Ex. DDU-11B at 90 of 106; Tr. at 401:6-14 (Sears Redirect) (Oct. 25, 2017); *see* 30 TAC § 290.46(e).

30 Staff Ex. 2 at 12-13.

31 *Id.* at 12.

32 *Id.* at 15; Ex. DDU-8 at 6 of 155.

33 Staff Ex. 2 at 15; Staff Ex. 2A at ES Workpaper 15 (DDU Response to Staff RFI 1-13, stating that the amount of personal use of the phone is "unknown").

Staff recommends that the phone allowance be reduced by 50% ($450 for 12 months), and allocated between water ($239) and sewer ($212).[34]

Staff also recommends reclassifying the portion of resort G&A attributable to security costs from Miscellaneous Expenses to Contract Work. The expenses for security should have been recorded as an intercompany labor transfer, and properly recorded in Contract Work.[35] Therefore, Staff recommends removing these expenses from Miscellaneous Expenses and reclassifying $890 to water and $790 to sewer under this account.[36]

e. Transportation Expenses

Staff has made three adjustments to White Bluff's requested transportation expenses, which in total result in the removal of $10,209 from water and $6,300 from sewer.[37] First, Staff recommends the removal of $6,447 from water and $3,388 from sewer for certain vehicle fuel expenses.[38] As Staff witness Ms. Sears testified, the information related to fuel expenses provided in discovery and in rebuttal did not provide the information necessary for her to determine how much fuel is actually used for utility purposes.[39] White Bluff has four utility trucks.[40] One of these trucks is driven "daily to and from work" by the utility manager, Todd Dilworth, who is on call 24/7, and another truck is "used by an employee assigned to be on call and is used to drive to and from work during the assignment."[41] While Staff is not challenging the appropriateness of having on-call vehicles, only the portion of vehicle expenses incurred while the vehicle is being used for utility business and taken out on a service call is recoverable.[42] The cost of an employee's daily commute back and forth from home to work is not an expense that DDU can include in its cost of service and recover from its ratepayers.[43]

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[34] Staff Ex. 2 at 15.

[35] *Id.*

[36] *Id.*

[37] *Id.* at 16.

[38] *Id.*

[39] Tr. at 278:22-279:14 (Sears Cross) (Oct. 25, 2017).

[40] Staff Ex. 2A at ES Workpaper 17 (DDU Response to Staff RFI 1-14).

[41] *Id.*

[42] *See* Tr. at 283:22-285:1 (Sears Cross) (Oct. 25, 2017).

[43] Tr. at 283:8-10 (Sears Cross) (Oct. 25, 2017) ("Again, as I stated previously, daily to and from work is not a recoverable expense for the utility just because they are on call.").

Since White Bluff did not provide mileage logs or other documentation sufficient to determine what portion of vehicle fuel expenses were related to service calls, and what portion were related to daily employee commuting miles, this adjustment is appropriate.

Staff's second adjustment to transportation expenses is to remove $850 from water for the cost of a toolbox for a Ford F-150 service truck, including delivery and side mount.[44] In her rebuttal testimony, DDU witness Dr. Harkins stated that if the cost of the toolbox was not allowed as an expense, "the cost of the toolbox should then be capitalized and placed on the system's depreciation schedule."[45] DDU's capitalization policy provides the following guidelines for the capitalization of expenses:

1. The expense is greater than or equal to $750.00.
2. The item materially extends the useful life of the plant or equipment more than one year.
3. The repair is not a typical, reoccurring expense.[46]

The toolbox expense exceeds $750 and is therefore appropriately capitalized under DDU's capitalization policy. The toolbox was installed on a service truck, an asset that is present on the White Bluff sewer depreciation schedule.[47] Accordingly, in Staff's errata testimony, the toolbox expense was given the same useful life as the service truck, and added to the White Bluff sewer depreciation schedule.[48] Since the capitalization of the toolbox is consistent with Dr. Harkins' recommendation, it appears that the treatment of this expense is no longer contested.

Finally, Staff removed the vehicle lease expense for the Ford F-150 ($2,912 each for water and sewer) and added this vehicle to the White Bluff sewer depreciation schedule.[49] At the hearing on the merits, DDU witness Mr. Joyce testified that DDU is in agreement with Staff's

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[44] Staff Ex. 2 at 16; *see* Staff Ex. 2A at ES Workpaper 21-22.

[45] Rebuttal Testimony of Victoria Harkins, Ex. DDU-9 at 7 of 527.

[46] DDU Response to Staff RFI 1-26, Staff Ex. 6 at DDU16-015961.

[47] *See* Direct Testimony of Jolie Mathis, Staff Ex. 4 at Attachment 2 (White Bluff Sewer Depreciation Schedule).

[48] Staff Ex. 2 at 16; Staff Ex. 4 at Attachment 2 (White Bluff Sewer Depreciation Schedule, reflecting the addition of a TK Crossbed Toolbox).

[49] Staff Ex. 2 at 17; Staff Ex. 4 at Attachment 2 (White Bluff Sewer Depreciation Schedule, reflecting the addition of a 2014 Ford F-150, VIN 6893).

adjustments regarding "the elimination of the vehicle lease expense."[50] Therefore, the treatment of this expense is no longer contested.

f. Other Plant Maintenance

Staff recommends removing $18,806[51] from water for other plant maintenance expenses.[52] This adjustment is the result of reclassifying expenses that are properly treated as capital assets ($18,927), removing expenses not supported by invoices or receipts ($709), and adding the amount reclassified from other volume related expenses ($830) as previously addressed in section II(A)(1)(b).[53]

Staff also recommends removing $83,962 from sewer expenses and reclassifying that amount to the White Bluff sewer depreciation schedule.[54] Staff's recommendation to reclassify items such as booster pumps, well meters, electric panels, and grinder pumps from expenses to invested capital is in line with the guidelines set forth in DDU's capitalization policy.[55] As discussed below in section II(B), the grinder pump expenses reclassified by Staff total $79,590.73.[56] On rebuttal, DDU witness Dr. Harkins testified that an invoice for $2,252 for "machine work on pump, repair bearing, and seals" and an invoice for $1,599.33 for "service and parts for motor and repair at crimp connection" should not have been reclassified because they are for repairs.[57] However, these expenses are for amounts well in excess of $750, the repairs materially extended the useful life of the plant or equipment more than one year, and there is no evidence that these types of repairs are typical, recurring expenses.[58] Accordingly, Ms. Sears' reclassification of the amounts shown in these two invoices is appropriate.[59]

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50 Tr. at 513:13-14 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

51 This adjustment does not include the $1,148 expense for chlorine gas cylinders addressed in section II(A)(1)(b). Staff Ex. 2 at 18.

52 Staff Ex. 2 at 17.

53 *Id.*

54 *Id.*

55 *See* Staff Ex. 6.

56 Staff Ex. 4 at 6.

57 Ex. DDU-9 at 4-5 of 527.

58 Staff Ex. 2A at ES Workpaper 35, 37.

59 Dr. Harkins identified a third invoice for $534.96 to "replace two rechargeable batteries, clean contacts, and replace a weak coil on a starter," which was eliminated from the adjustment to other plant maintenance in the

g. Professional Services

Staff recommends removing $2,907 from sewer requested in White Bluff's professional services expenses.[60] White Bluff originally claimed the costs associated with a Certificate of Convenience and Necessity (CCN) map amendment and a wastewater permit renewal as professional services expenses.[61] In their prefiled rebuttal testimony, DDU witnesses Mr. Joyce and Dr. Harkins both recommend that these costs should instead be reclassified as assets on the White Bluff sewer depreciation schedule.[62]

Mr. Joyce testified that "Ms. Sears recommends amortizing the $3,090 in wastewater permitting costs," but that "Staff failed to add any amortization or include it in the invested capital schedule."[63] However, Staff has not recommended that the cost of the wastewater permit renewal be amortized. Staff has included a *normalized* amount of $1,030 per year for this expense in the cost of service because the wastewater permit is renewed every three years.[64] White Bluff's wastewater permit clearly shows that it was renewed in 2013, again in 2016, and will need to be renewed next in 2019.[65] DDU witness Dr. Harkins agrees that "in this particular situation, this permit is renewed in three years" but states that in 2019 the permit could be given a different renewal term as "other wastewater permits don't necessarily renew every three years."[66] Dr. Harkins' speculation that the White Bluff wastewater permit renewal term could change in 2019 is not dispositive, as ratemaking is not intended to capture every variable that may or may not happen in the future. Staff continues to recommend that it is appropriate to treat the wastewater permit renewal cost as an expense, and to normalize this cost over three years in order to allow DDU to recover one-third every year, and the full amount every three years.[67]

Errata to the Direct Testimony of Emily Sears and is not included in the $18,927 adjustment for reclassified expenses.

[60] Staff Ex. 2 at 18.

[61] *Id.*

[62] Ex. DDU-9 at 6 of 527; Ex. DDU-11 at 8 of 106.

[63] Ex. DDU-11 at 8 of 106.

[64] Staff Ex. 2 at 19.

[65] TPDES Permit No. WQ0013786002, Staff Ex. 8.

[66] Tr. at 499:7-13 (Harkins Rebuttal Cross) (Oct. 26, 2017).

[67] *See* Staff Ex. 2 at 19.

Staff recommends that the entire cost of the CCN amendment ($2,907) be removed from expenses, and also not included on the depreciation schedule. As Staff witness Ms. Sears testified, this is not a recurring expense.[68] White Bluff should not be permitted to recover the cost of a CCN amendment every year in its rates when it is unclear how frequently White Bluff will incur such an expense.[69] It is also not appropriate to capitalize this cost and add the CCN amendment to the depreciation schedule. Depreciation is only allowed on currently used depreciable utility property owned by the utility.[70] A CCN, or an amendment to a CCN, is not utility property;[71] thus, it is not an asset. The testimony of Dr. Harkins that a CCN amendment is "more of a professional expense" than property supports this point.[72]

Further, it is not possible to assign a useful life to the cost of a CCN amendment. Dr. Harkins recommends that a five-year life is appropriate for a CCN amendment,[73] but when asked how she calculated that useful life, she testified that "That was more of just a reasonable time for that to depreciate out. I don't believe you do amendments – a CCN amendment less than five years."[74] This underlying assumption that utilities do not file CCN amendments more frequently than every five years is flawed, as a utility may file a CCN amendment any time that it needs to add or remove service area. Accordingly, a utility may file a CCN amendment far more frequently than once every five years, or may not file an amendment for a period far longer than five years. Since a CCN amendment modifies a CCN in perpetuity, it is not possible to accurately identify a point in time at which a CCN amendment will be fully depreciated and no longer useful.

Finally, at the hearing on the merits, DDU witness Mr. Gracy testified that White Bluff did not in fact file a CCN amendment in 2015, and that the expense of this CCN amendment was

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[68] *Id.*

[69] *Id.*; *see also* Tr. at 496:19-497:4 (Harkins Rebuttal Cross) (Oct. 26, 2017) (stating that water utilities file CCN applications if they expand their service area, and that she did not know how many CCN amendment applications DDU filed in the five years preceding the test year or since the test year).

[70] *See* 16 TAC § 24.31(b)(1)(B).

[71] *City of Celina's Notice of Intent to Provide Water and Sewer Service to Area Decertified from Aqua Texas, Inc. in Denton County*, Docket No. 45848, Order on Rehearing at 16, Finding of Fact No. 11 (Jun. 29, 2017) ("A CCN is not property.").

[72] Tr. at 499:25-500:2 (Harkins Rebuttal Cross) (Oct. 26, 2017).

[73] Ex. DDU-9 at 6 of 527.

[74] Tr. at 500:8-12 (Harkins Rebuttal Cross) (Oct. 26, 2017).

actually incurred by the Cliffs.[75] Accordingly, Staff recommends that during the number-running process this expense should be re-classified to the Cliffs and then removed from the Cliffs' cost of service consistent with Staff's adjustment.

h. Insurance Expenses

Staff recommends two adjustments to White Bluff's requested insurance expenses, which result in a total removal of $4,815 from water and $1,500 from sewer.[76]

Staff removed the expense for Worker's Compensation insurance ($1,444 for water and $373 for sewer).[77] At the hearing on the merits, DDU witness Mr. Joyce testified that DDU is in agreement with "the elimination of the insurance for non-Texas workers' compensation."[78] Therefore, this issue is no longer contested.

Staff also removed the premium for an Auto, Crime, Spa & Ski umbrella insurance policy ($3,371 for water and $1,127 for sewer).[79] This umbrella policy covers multiple underlying base policies.[80] Of these base policies, coverage for Auto and Crime is a recoverable expense related to the provision of water and sewer service, but coverage for Spa & Ski is not. Because Ms. Sears was unable to determine the cost attributable to only the Spa & Ski umbrella coverage and exclude that amount, she necessarily removed the entire umbrella policy amount.[81]

As Ms. Sears testified, the insurance schedules she reviewed did not indicate how much of the umbrella premium was related to Spa & Ski, and the only way to determine that amount would be to obtain an insurance quote for an umbrella policy that did not include Spa & Ski coverage.[82] DDU witness Mr. Joyce disputed this testimony, stating that Ms. Sears' workpapers contain the information required to separate out the Spa & Ski portion of the premium.[83] However, Mr. Joyce's proposed calculation does not make sense, and does not accurately

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[75] *Id.* at 100:15-101:3 (Gracy Cross) (Oct. 24, 2017).

[76] Staff Ex. 2 at 19.

[77] *Id.* at 20.

[78] Tr. at 513:14-15 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

[79] Staff Ex. 2 at 20.

[80] *Id.*

[81] *Id.* at 30; Tr. at 318:4-10 (Sears Cross) (Oct. 25, 2017).

[82] Tr. at 325:6-21 (Sears Cross) (Oct. 25, 2017).

[83] *Id.* at 514:13-24 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

identify the portion of the umbrella premium attributable to Spa & Ski. First, Mr. Joyce adds together the total premium of the umbrella policy ($100,797) and the premium for the base Spa Omissions and Errors policy ($3,100) for a total of $103,897.[84] Mr. Joyce does not provide any rationale for his decision to add the base policy premium to the umbrella policy premium. Mr. Joyce then states "Thus, the umbrella/spa/ski insurance premium is 2.98% related to the spa/ski portion of the insurance" and concludes that the appropriate exclusion is to remove 2.98% from water and sewer.[85] If Mr. Joyce was trying to identify what portion of $100,797 is attributable to Spa & Ski, that is not accomplished by adding a base policy premium on top of the umbrella policy premium and then calculating what percentage of that new number the base policy premium represents. Further, the umbrella policy premium and the base policy premium are not correlated, which is evidenced by the fact that the total of all of the underlying base policy premiums is not equal to the total umbrella policy premium.[86] As it is not possible to separate out the portion of the umbrella policy premium attributable to Spa & Ski with the information provided, the entire umbrella policy premium should be removed.

i. Regulatory Expenses

Staff recommends removing $23,291 for water and $2,519 for sewer from White Bluff's requested regulatory expenses.[87] Staff witness Ms. Sears testified that the regulatory water fees for groundwater conservation in the amount of $22,047 are properly treated as pass-through fee and added to DDU's tariff, and should be removed from the requested revenue requirement for White Bluff.[88] At the hearing on the merits, DDU witness Mr. Joyce agreed that this expense is properly treated as a pass-through fee;[89] therefore, this issue is no longer contested.

Staff's remaining adjustments to regulatory expenses for water ($1,244) and sewer ($2,519) are the result of normalizing water test expenses for those water tests that are only

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84 Ex. DDU-11 at 9 of 106.

85 *Id.* (It appears that Mr. Joyce's testimony states this backwards. Correctly stated, $3,100 (the base Spa & Ski premium) is 2.98% of $103,897 (the base Spa & Ski premium added to the total umbrella premium).

86 *See* Ex. 2A at ES Workpaper 84-95.

87 Staff Ex. 2 at 21.

88 *Id.*

89 Tr. at 513:15-514:4 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

required every three years.[90] In his prefiled rebuttal testimony, DDU witness Mr. Joyce stated that if Staff treated these water test expenses as "non-recurring expenses" then the costs "should be capitalized as a regulatory asset and amortized over a reasonable period," which he further states Staff "failed" to do.[91] However, Staff has not excluded these expenses. DDU agrees that these water test expenses only occur once every three years,[92] therefore, Staff has normalized these amounts so that DDU recovers one third of the expenses each year, and the full amount every three years.[93]

j. Miscellaneous Expenses

Staff recommends removing a total of $28,400 for water and $26,424 for sewer from White Bluff's requested miscellaneous expenses.[94] Staff's first adjustment is to remove expenses incurred by the White Bluff resort that are allocated to the utility.[95] As Staff witness Ms. Sears testified, it would be appropriate to allocate certain office expenses from the resort to the utility, as the utility office is located in the resort's administrative building.[96] However, DDU's allocation in this case is not based on the utility's share of resort expenses that it directly uses, it is an across-the-board allocation of three percent of all overhead and G&A expenses incurred by the resort.[97] As DDU witness Mr. Gracy testified, the allocation budget was built by several department heads who went through each category of expenses and assigned percentages to each department.[98] For the utility, Mr. Gracy testified that they "picked numbers like 3 to 5 percent" and the weighted average resulted in an overall allocation of three percent for DDU.[99] This

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90 Staff Ex. 2 at 21.

91 Ex. DDU-11 at 8 of 106.

92 Tr. at 541:10-13 (Joyce Rebuttal Cross) (agreeing that these water test costs only occur once every three years).

93 Staff Ex. 2 at 21; *see* Tr. at 499:2-6 (Harkins Rebuttal Cross) (Oct. 26, 2017) (testifying that to normalize a cost "you just divide it by the number of years you want to normalize it over and you get that particular cost").

94 Staff Ex. 2 at 9-10.

95 *Id.* at 22-23.

96 Tr. at 329:25-330:6 (Sears Cross) (Oct. 25, 2017).

97 *See* Ex. DDU-8 at 8 of 155; Tr. at 474:4-475:6 (Gracy Rebuttal Cross) (Oct. 26, 2017).

98 Tr. at 474:4-5 (Gracy Rebuttal Cross) (Oct. 26, 2017).

99 *Id.* at 474:6-475:6 (Gracy Rebuttal Cross) (Oct. 26, 2017).

allocation was done several years ago, and since then it has been the resort's practice to "take 3 percent of the total budget and send it to utilities."[100]

Some of these resort expenses, such as advertising for the resort, commissions/bonuses for resort employees, or uniforms for resort employees, cannot be allocated to the utility because the utility and its ratepayers do not use or benefit from those expenses at all.[101] DDU witness Mr. Gracy confirmed that some expenses included in the three percent allocation are not used by the utility.[102] Other resort expenses, such as office supplies or computer expenses, should not be allocated to the utility as those same types of expenses have already been included in White Bluff's cost of service.[103] Another such duplicative expense is the allocation of a portion of the general manager's salary. DDU witness Mr. Gracy testified that this property general manager oversees the resort personnel for general maintenance, security, a hotel, a restaurant, golf course maintenance, and the pro shop, as well as the utility.[104] Mr. Gracy testified that it is "very fair" for DDU to be allocated three percent of this general manager's salary, as he is "the guy with the most authority on property."[105] However, Mr. Gracy admits that the utility does not use very many services from the general manager, and that the utility employs its own full time utility manager who supervises utility employees.[106] For these reasons, Staff recommends removing \$7,410 from water and \$5,366 from sewer for allocated overhead, and \$970 from water and \$702 from sewer for allocated G&A expenses.[107]

Staff also removed \$500 from sewer for a sewer tap fee expense, as the cost of sewer taps are paid for through the sewer tap fee.[108]

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[100] *Id.* at 476:7-14 (Gracy Rebuttal Cross) (Oct. 26, 2017).

[101] *Id.* at 330:6-8 (Sears Cross) (Oct. 25, 2017); Staff Ex. 2 at 22; Tr. at 475:10 (Gracy Rebuttal Cross) (Oct. 26, 2017).

[102] Tr. at 475:10 (Gracy Rebuttal Cross) (Oct. 26, 2017) ("The allocation – any uniforms purchased by the allocation department, I can sit here and tell you none of that went to a utility employee.")

[103] Tr. at 331:3-12 (Sears Cross) (Oct. 25, 2017); Staff Ex. 2 at 22; *see* Staff Ex. 2A

[104] Tr. at 477:18-478:1 (Gracy Rebuttal Cross) (Oct. 26, 2017).

[105] *Id.* at 478:3-14 (Gracy Rebuttal Cross) (Oct. 26, 2017).

[106] *Id.* at 478:11-12, 478:22-479:9 (Gracy Rebuttal Cross) (Oct. 26, 2017).

[107] Staff Ex. 2 at 23.

[108] *Id.*

Finally, Staff recommends removing $19,728 from water and $20,148 from sewer for equipment lease expenses associated with automatic meter reading and the 50,000 gallon wastewater treatment plant, for which DDU did not provide lease agreements.[109] At the hearing on the merits, DDU witness Mr. Joyce testified that DDU is in agreement with the elimination of these lease expenses.[110] Therefore, this issue is no longer contested.

2. The Cliffs

Staff's adjustments to expenses for the Cliffs water system[111] are summarized in the below table, and discussed in further detail in the following subsections.

Table 7 The Cliffs O&M Adjustments for Water			
Account Name	**DDU Requested**	**Staff Adjustment**	**Staff Recommended**
Transportation	$15,924	($1,637)	$14,287
Miscellaneous	$22,432	($20,075)	$2,357
Total O&M Adjustments		**($21,712)**	

Staff's adjustments to expenses for the Cliffs sewer system are summarized in the below table, and discussed in further detail in the following subsections.[112]

Table 8 The Cliffs O&M Adjustments for Sewer			
Account Name	**DDU Requested**	**Staff Adjustment**	**Staff Recommended**
Transportation	$13,261	($1,637)	$11,624
Miscellaneous	$18,681	($18,270)	$411
Total O&M Adjustments		**($19,907)**	

a. Transportation Expenses

The Cliffs' requested transportation expenses included several journal entries for vehicle fuel that are dated outside of the test year.[113] Only a utility's test year expenses, as adjusted for

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109 *Id.*

110 Tr. at 513:18-21 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

111 Staff Ex. 3 at Attachment JR-2, Staff Schedule II (The Cliffs Water O&M Expense).

112 *Id.* at Attachment JR-3, Staff Schedule II (The Cliffs Sewer O&M Expense).

113 Staff Ex. 3 at 10; *see* Staff Ex. 3B, Supplemental Workpapers of Jonathan Ramirez at 1-3.

known and measurable changes, may be considered in computing a utility's allowable expenses; therefore, Staff recommends removing those expenses dated outside of the test year.[114] This results in the removal of $1,637 from water and $1,637 from sewer.[115]

b. Miscellaneous Expenses

Staff recommends removing $20,075 from water and $18,720 from sewer for allocated resort overhead and allocated resort G&A,[116] for the same reasons set forth in the above section II(A)(1)(j).[117]

B. Depreciation [PO Issues 12, 27]

Staff's recommended adjustments to depreciation are the result of reclassifying certain items that were originally treated as expenses,[118] and removing items already fully depreciated.[119] One of Staff's recommended reclassifications from expenses are grinder pump replacements, which were added to the White Bluff sewer depreciation schedule with a cost of $79,590.73.[120] Grinder pumps are utility plant, with service lives of ten years, and are properly capitalized.[121]

DDU witness Dr. Harkins testified that grinder pumps should remain as annual expenses, but that if they are treated as capital assets and depreciated, that all of White Bluff's grinder pump purchases since 2006 should be added to the depreciation schedule.[122] However, it is DDU witness Mr. Gracy's testimony that during his tenure as president of DDU, from 1996 to present, it has been DDU's practice to categorize grinder pump expenses and replacement costs for the White Bluff system as expenses.[123] Since DDU has consistently treated these costs as annual expenses in the past, the utility has fully recovered the cost of its grinder pump replacements

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114 16 TAC § 24.31(b).

115 Staff Ex. 3 at 10.

116 *Id.*

117 *Id.* at 11.

118 *See* Staff Ex. 4 at 6; *see also* section A above detailing Staff's expense adjustments.

119 Staff Ex. 4 at 6.

120 *Id.*

121 *See id.* at Attachment 2 (White Bluff Sewer Depreciation Schedule).

122 Tr. at 494:1-5 (Harkins Rebuttal Cross) (Oct. 26, 2017); Ex. DDU-9 at 5-6 of 527.

123 Tr. at 473:5-16 (Gracy Rebuttal Cross) (Oct. 26, 2017).

each year as the expenses were incurred. Accordingly, White Bluff's grinder pump purchases since 2006 should not be included on the depreciation schedule, as this would allow DDU to capitalize assets that it has already fully expensed, thereby resulting in a double recovery. Therefore, only the grinder pump costs associated with the test year should be included on White Bluff's sewer depreciation schedule.

Since the hearing on the merits, it has come to Staff's attention that in the errata White Bluff sewer depreciation schedule, the "TK Crossbed Toolbox" was added with an original cost of $930.04,[124] but only $850 was removed from expenses for that item.[125] This $80 difference is due to the cost of a "Truck Bed Mat" that is also shown on the invoice for the toolbox.[126] Since that $80 expense was left in White Bluff's cost of service, it should not also be capitalized. Therefore, the original cost of the "TK Crossbed Toolbox" on the White Bluff sewer depreciation schedule should be revised to be $850.[127]

Staff's adjustments have the following effect on depreciation:

Table 9
White Bluff Depreciation Adjustments for Water

	DDU Requested[128]	Staff Adjustment	Staff Recommended[129]
Original Cost Total	$3,791,956	$16,630	$3,808,586
Annual Depreciation	$110,077	$1,078	$111,155
Accumulated Depreciation	$1,603,728	($1,709)	$1,602,019

124 Staff Ex. 4 at Attachment 2 (White Bluff Sewer Depreciation Schedule).

125 Staff Ex. 2 at 16.

126 Staff Ex. 2A at ES Workpaper 22.

127 This adjustment is not reflected in the tables below.

128 White Bluff 80/20 Asset Listing, Ex. DDU-6C at 47 of 89.

129 Staff Ex. 4 at Attachment 2 (White Bluff Water Depreciation Schedule).

Table 10 White Bluff Depreciation Adjustments for Sewer			
	DDU Requested[130]	Staff Adjustment	Staff Recommended[131]
Original Cost Total	$2,847,335	$106,487	$2,953,822
Annual Depreciation	$84,700	$12,188	$96,888
Accumulated Depreciation	$1,205,081	$1,284	$1,206,365

Table 11 The Cliffs Depreciation Adjustments for Water			
	DDU Requested[132]	Staff Adjustment	Staff Recommended[133]
Original Cost Total	$1,612,546	($22,458)	$1,590,088
Annual Depreciation	$110,077	($34,172)	$75,905
Accumulated Depreciation	$1,603,728	($807,109)	$796,619

Table 12 The Cliffs Depreciation Adjustments for Sewer			
	DDU Requested[134]	Staff Adjustment	Staff Recommended[135]
Original Cost Total	$1,017,635	($11,088)	$1,006,547
Annual Depreciation	$29,263	($1,007)	$28,256
Accumulated Depreciation	$442,907	($9,441)	$433,466

C. Taxes [PO Issues 12, 27]

1. Federal Income Tax Expense [PO Issue 30]

If Staff's recommended adjustments to DDU's cost of service are adopted, Staff recommends a corresponding adjustment to federal income taxes resulting from flow through

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130 Ex. DDU-6C at 51 of 89.

131 Staff Ex. 4 at Attachment 2 (White Bluff Sewer Depreciation Schedule).

132 The Cliffs 80/20 Asset Listing, Ex. DDU-6D at 67 of 89.

133 Staff Ex. 4 at Attachment 2 (The Cliffs Water Depreciation Schedule).

134 Ex. DDU-6D at 70 of 89.

135 Staff Ex. 4 at Attachment 2 (The Cliffs Sewer Depreciation Schedule).

calculations. These tax calculations are included in Staff Schedule V for each separate water and wastewater system.[136]

Staff further recommends treating White Bluff and the Cliffs as separate entities for tax purposes because DDU operates a total of four systems—White Bluff, the Cliffs, the Retreat, and Rock Creek Sewer.[137] Therefore, DDU's taxable income should be derived from the books for all four entities. Because DDU filed two separate applications addressing only two of its systems, it is more appropriate to treat those systems separately when calculating the expense for federal income tax.

2. Other Assessments and Taxes [PO Issue 29]

If Staff's recommended adjustments to DDU's cost of service are adopted, most notably the reclassification of the 2014 Ford F-150 truck to the White Bluff sewer depreciation schedule, Staff recommends a corresponding adjustment to other taxes.[138] Staff also recommends an adjustment to payroll taxes resulting from flow through calculations.[139] These tax calculations are included in Staff Schedules IV and VI for each separate water and sewer system.[140]

D. Return on Invested Capital [PO Issues 9, 10, 15, 16, 18, 19]

For the White Bluff water system, Staff recommends invested capital in the amount of $709,624, as shown below:

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136 Staff Ex. 2 at Attachments ES-3, Staff Schedule V (White Bluff Water Federal Income Taxes) and ES-4, Staff Schedule V (White Bluff Sewer Federal Income Taxes); Staff Ex. 3 at Attachments JR-2, Staff Schedule V (The Cliffs Water Federal Income Taxes) and JR-3, Staff Schedule V (The Cliffs Sewer Federal Income Taxes).

137 Tr. at 60:17-21 (Gracy Cross) (Oct. 24, 2017).

138 Staff Ex. 2 at 24.

139 *Id.*; Staff Ex. 3 at 12.

140 Staff Ex. 2 at Attachments ES-3, Staff Schedule IV (White Bluff Water Taxes Other Than FIT) and ES-4, Staff Schedule IV (White Bluff Sewer Taxes Other Than FIT); Staff Ex. 3 at Attachments JR-2, Staff Schedule IV (The Cliffs Water Taxes Other than FIT) and Staff Schedule VI (The Cliffs Water and Sewer Payroll Taxes) and JR-3, Staff Schedule IV (The Cliffs Sewer Taxes Other Than FIT).

Table 13 White Bluff Water Invested Capital			
	DDU Requested[141]	**Staff Adjustment**	**Staff Recommended**[142]
Plant in Service – Original Cost	$3,791,956	$16,630	$3,808,586
Accumulated Depreciation	($1,603,728)	$1,709	($1,602,019)
Cash Working Capital	$24,568	($7,328)	$17,240
Developer Contribution	($1,186,227)	$23	($1,186,204)
ADFIT	$0	($327,979)	($327,979)
Invested Capital	**$1,026,569**	**($316,945)**	**$709,624**

For the White Bluff sewer system, Staff recommends invested capital in the amount of $1,534,123, as shown below:

Table 14 White Bluff Sewer Invested Capital			
	DDU Requested[143]	**Staff Adjustment**	**Staff Recommended**[144]
Plant in Service – Original Cost	$2,847,336	$106,486	$2,953,822
Accumulated Depreciation	($1,205,081)	($1,284)	($1,206,365)
Cash Working Capital	$23,152	($13,656)	$9,496
Developer Contribution	($137,457)	($53,998)	($191,455)
ADFIT	$0	($31,375)	($31,375)
Invested Capital	**$1,527,949**	**$6,173**	**$1,534,123**

141 Direct Testimony of Jay Joyce, Ex. DDU-6 at 12 of 89.

142 Staff Ex. 2 at Attachment ES-3, Staff Schedule III (White Bluff Water Invested Capital).

143 Ex. DDU-6 at 12 of 89.

144 Staff Ex. 2 at Attachment ES-4, Staff Schedule III (White Bluff Sewer Invested Capital).

For the Cliffs water system, Staff recommends invested capital in the amount of $520,143, as shown below:

Table 15 The Cliffs Water Invested Capital			
	DDU Requested[145]	Staff Adjustment	Staff Recommended[146]
Plant in Service – Original Cost	$1,612,546	($22,458)	$1,590,088
Accumulated Depreciation	($826,559)	$29,940	($796,619)
Cash Working Capital	$35,769	($13,733)	$22,036[147]
Developer Contribution	($248,421)	($6,785)	($255,206)
ADFIT	$0	($39,857)	($39,857)
Invested Capital	**$573,335**	**($52,893)**	**$520,143**

For the Cliffs sewer system, Staff recommends invested capital in the amount of $512,752, as shown below:

Table 16 The Cliffs Sewer Invested Capital			
	DDU Requested[148]	Staff Adjustment	Staff Recommended[149]
Plant in Service – Original Cost	$1,017,635	($11,088)	$1,006,547
Accumulated Depreciation	($442,907)	$9,441	($433,466)
Cash Working Capital	$28,823	($11,267)	$17,556[150]
Developer Contribution	($71,898)	$3,819	($68,079)
ADFIT	$0	($9,495)	($9,495)
Invested Capital	**$531,652**	**($18,590)**	**$512,752**

[145] Ex. DDU-6 at 12 of 89.

[146] Staff Ex. 3 at Attachment JR-2, Staff Schedule III (The Cliffs Water Invested Capital)

[147] The Errata to the Direct Testimony of Jonathan Ramirez changed Staff's recommendation for total operations and maintenance expenses for the Cliffs water system to $264,438. The recommended total cash working capital of $21,737 was not updated to reflect this change. The correct amount of cash working capital based on operations and maintenance expenses totaling $264,438 is reflected in this table.

[148] Ex. DDU-6 at 12 of 89.

[149] Staff Ex. 3 at Attachment JR-3, Staff Schedule III (The Cliffs Sewer Invested Capital).

[150] The Errata to the Direct Testimony of Jonathan Ramirez changed Staff's recommendation for total operations and maintenance expenses for the Cliffs sewer system to $210,674. The recommended total cash working capital of $17,245 was not updated to reflect this change. The correct amount of cash working capital based on operations and maintenance expenses totaling $210,674 is reflected in this table.

1. **Plant in Service – Original Cost**

Staff's adjustments to DDU's plant in service include the reclassification of the toolbox expense and the addition of the 2014 Ford F-150 truck discussed above in section II(A)(1)(e) and the reclassification of expenses included in other plant maintenance discussed in sections II(A)(1)(f) and II(B).

Additionally, since the hearing on the merits, it has come to Staff's attention that on the Cliffs water depreciation schedule, the original cost of a "75,000 gallon gst, field erect wtth pad" and "75,000 gallon gan, field erect mth pad" were incorrectly listed as $15,565.[151] The correct original cost of each of these assets is $16,565.[152] Staff recommends that this correction be made in the number-running process.[153]

2. **Accumulated Depreciation**

Staff's adjustments to DDU's accumulated depreciation are discussed above in sections II(A)(1)(e), II(A)(1)(f), and II(B).

3. **Cash Working Capital**

Cash working capital is the money a utility uses to bridge the gap between the time it pays for an expense and the time it recovers that expense through the receipt of revenues. Staff recommends adjustments to cash working capital due to flow through calculations from changes to the operations and maintenance and administrative and general expenses requested by DDU.[154] DDU is a Class B utility that serves in excess of 500 water connections, including both the White Bluff and the Cliffs water and wastewater systems.[155] Under Commission rules, 1/12 of operations and maintenance expenses is considered a reasonable allowance for cash working capital of a Class B utility.[156] Accordingly, Staff agrees with DDU's use of a ratio of 1/12 of expenses to calculate cash working capital for the White Bluff systems,[157] but recommends that

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[151] Staff Ex. 4 at Attachment 2 (The Cliffs Water Depreciation Schedule).

[152] *See* Ex. DDU-6D at DDU16-011341.

[153] This correction is not reflected in the tables above.

[154] *See* Staff Ex. 2 at 24.

[155] Direct Testimony of Randy Gracy, Ex. DDU-3 at 6 of 27.

[156] 16 TAC § 24.31(c)(2)(C)(iii)(III).

[157] Staff Ex. 2 at 24.

the 1/12 ratio also be used for the Cliffs systems, rather than the 1/8 ratio requested by DDU.[158] Because the Cliffs is a system within DDU, it is appropriate use the 1/12 ratio applicable to DDU because the Cliffs has access to all of DDU's capital.

4. Developer Contribution

Staff agrees with DDU witness Mr. Joyce's identification of certain developer contributions on Staff's White Bluff sewer depreciation schedule which should have been shown as 0%, not 80%. Therefore, Staff adopts the amount for developer contributions included in Mr. Joyce's rebuttal testimony.[159] Staff recommends that this correction be made in the number-running process.[160]

5. Accumulated Deferred Federal Income Tax (ADFIT)

Staff recommends the following deductions from invested capital for ADFIT, using the original costs of capital assets listed in DDU's 2015 tax return and the documents related to depreciation supplied by DDU: [161]

Table 17 ADFIT Deductions from Invested Capital[162]	
White Bluff – Water	$327,979
White Bluff – Sewer	$31,375
The Cliffs – Water	$39,859
The Cliffs – Sewer	$9,495

The depreciation of a utility's capital assets is integral to setting rates in two ways. First, a utility may include its depreciation expense in its cost of service.[163] Second, a utility may take a deduction for the depreciation of capital assets from its federal income taxes.[164] The depreciation expense included in the cost of service is computed on a straight line basis over the useful life of

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158 Staff Ex. 3 at 11.

159 Joyce Corrected Staff Schedules, Ex. DDU-11A at 54-57 of 106.

160 This correction is not reflected in the tables above.

161 Tr. at 264:24-265:6 (Loockerman Cross) (Oct. 25, 2017).

162 Direct Testimony of Debi Loockerman, Staff Ex. 1 at 3.

163 16 TAC § 24.31(b)(1)(B).

164 26 U.S.C.A. § 167 (West).

the asset, while the deduction for federal income tax purposes is based on an accelerated rate of depreciation.[165]

Taking accelerated depreciation allows the utility to save money by deferring a portion of its tax liability,[166] but it also causes significant disparities in a utility's tax liability from year to year. For ratemaking purposes, federal income taxes are normalized to allow for a more stable rate.[167] Normalization allows a utility to recover an estimated amount of federal income tax over the period of time that would have elapsed had it not taken accelerated depreciation.[168] In other words, the federal income tax expense included in the cost of service is matched to the period in which it would have been paid using straight line depreciation.

As a result of normalization, the utility recovers its federal income tax expense before the taxes are actually due.[169] Therefore, the utility has collected monies from the ratepayers that it has not yet paid to the federal government.[170] The difference between the amount recovered through rates and the amount paid in taxes—referred to as ADFIT—accumulate over time and may be used by the utility for capital investment.[171] To ensure that the ratepayers are not paying a return on capital that they themselves provided, the Commission's rules state that ADFIT will be deducted from a utility's invested capital.[172]

It should be noted that DDU's parent company, Double Diamond Delaware, Inc. (DDD), is an S-corporation that files a consolidated tax return.[173] Consequently, the shareholders, and not the company itself, pay federal income taxes, so the shareholders ultimately reap the benefit of the deferred tax liability resulting from taking accumulated depreciation.[174] It also means that the normalization rules promulgated by the Internal Revenue Service do not apply because the

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165 26 U.S.C.A. § 168; 16 TAC § 24.31(b)(1)(B).

166 Staff Ex. 1 at 4.

167 16 TAC § 24.31(b)(1)(D).

168 *See* 26 U.S.C.A. § 168(i)(9)(A).

169 Staff Ex. 1 at 3.

170 *Id.* at 4.

171 *Id.*

172 16 TAC § 24.31(c)(3)(A); *see also* Class B Rate/Tariff Change Application, Schedule III-9(a).

173 Tr. at 80:1-7 (Gracy Direct Cross) (October 24, 2017).

174 Staff Ex. 1 at 4.

company will never owe federal income tax, never record an income tax payable, and never record ADFIT. Both the federal income tax expense and the related ADFIT are used solely for the regulatory purpose of ratemaking.

On rebuttal, DDU witness Mr. Joyce asserted that Staff's recommendation on ADFIT should take into account net operating losses (NOL).[175] However, DDU has not provided evidence sufficient to establish: (1) that DDU actually realized a NOL, (2) the amount of the alleged NOL, and (3) that the alleged operating loss was carried forward. Mr. Joyce rests his entire argument in support of this theory on the premise that "DDU, as a direct result of claiming bonus depreciation, will realize a NOL for current income tax purposes."[176] Yet, Mr. Joyce's revisions to Staff witness Debi Loockerman's ADFIT calculations merely "incorporate[ ] the effect of a net operating loss carryforward" based on his estimate that "the effect [of a NOL] would be to reduce the ADFIT by approximately 50 percent."[177] Staff's adjustment for ADFIT represents the historical balance of the savings generated by taking accelerated depreciation for tax purposes. Therefore, it should not be adjusted based on an undetermined amount of NOLs DDU may or may not have incurred or carried forward.

III. RATE OF RETURN

Staff recommends that DDU be permitted the 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. Staff's proposed overall rate of return is 6.96%, which is calculated as follows:[178]

Table 18
Staff Recommended Overall Rate of Return

Type of Capital	Ratios	Cost Rate	Weighted Cost Rate
Long-Term Debt	47.27%	4.91%	2.32%
Common Equity	52.73%	8.79%	4.64%
Total	**100%**		**6.76%**

[175] Ex. DDU-11 at 16 of 106.

[176] *Id.*

[177] Tr. at 538:20-25, 540:1-2 (Joyce Rebuttal Cross) (October 26, 2017).

[178] Staff Ex. 2 at 27.

As will be discussed more fully below, Staff's overall rate of return is based upon the expert recommendation of Staff witness Ms. Sears and is a reasonable rate of return given the comparable returns for regulated water utilities.

A. Return on Equity [PO Issue 8]

The appropriate rate of return on equity (ROE) for DDU is 8.79%.[179] This figure was calculated using a Discounted Cash Flow (DCF) methodology and a Capital Asset Pricing Model (CAPM) applied to a proxy group of utilities comparable to DDU in order to determine the appropriate ROE.[180] The result of the first methodology was used to determine the appropriate rate of return for DDU. The latter methodology was used as a comparison to verify the reasonableness of this rate of return.[181]

Ms. Sears, Staff's expert witness, started development of her proxy group with all of the domestic water utility companies tracked by Value Line Investment Survey (Value Line).[182] Ms. Sears then applied screens to this universe of water utilities in order to determine a proxy group of utilities that are sufficiently similar to DDU. Water utilities that met the following criteria were included in her proxy group:

1. 50% or more of the company's revenues are generated from the water utility distribution industry;
2. The company's stock is publicly traded;
3. Investment information for the company is available from more than one source; and
4. The company is not currently involved/targeted in an announced merger or acquisition.[183]

As a result, the following companies were included in Ms. Sears' proxy group: American States Water Company, American Water Works, Aqua America, California Water Service Group, Connecticut Water Service, Middlesex Water Company, SJW Corporation, and York Water.[184]

Ms. Sears applied the DCF model, employing a spot dividend yield, a 52-week dividend yield, and earnings growth forecasts.[185] The underlying theory of the DCF model is that the price

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179 *Id.* at 34.

180 *Id.*

181 *Id.*; Tr. at 348:21-22 (Sears Cross) (Oct. 25, 2017).

182 Tr. at 394:1-6 (Sears Cross) (Oct. 25, 2017).

183 Staff Ex. 2 at 29.

184 *Id.*

of any security or commodity is the discounted present value of all future cash flows.[186] The DCF model assumes that investors evaluate the value of a stock by its ability to generate future cash flows.[187] To develop a dividend yield that avoided the problems of short-term anomalies and "stale" data series, Ms. Sears placed equal emphasis on the most recent spot and 52-week-average dividend yield for the companies in her proxy group, averaging the two results for a dividend yield of 2.21%.[188] The expected growth rate of 6.58% used in Ms. Sears' analysis is the average of the expected five-year projected growth rates for the companies in her proxy group as forecasted by established entities including Value Line, Yahoo! Finance (Reuters), Zacks, and Morningstar. [189] Employing her recommended dividend yields and growth rates, Ms. Sears' DCF result is 8.79%.[190]

Ms. Sears also used CAPM as a second method to compare to the results of the DCF analysis in this case.[191] The CAPM model describes the relationship between a stock's investment risk and its market rate of return, and assumes that investors will not hold a risky asset unless they are adequately compensated for the risk.[192] In the CAPM, two types of risk as associated with a stock: (1) firm-specific risk (unsystematic risk) and (2) market risk (systemic risk), which is measured by a firm's beta.[193] The CAPM only allows for investors to receive a return for bearing systematic risk, as unsystematic risk is assumed to be diversified away.[194] Ms. Sears used the CAPM method to determine an estimated equity cost rate for each company in her proxy group.[195] In doing so, Ms. Sears used the average of the betas for the proxy group companies as provided in Value Line.[196] Ms. Sears used a risk-free rate of 4.26% for her historic

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[185] *Id.* at 33.

[186] *Id.*

[187] *Id.*

[188] *Id.* at 34-35.

[189] *Id.* at 35.

[190] *Id.*

[191] *Id.* at 36.

[192] *See id.*; *see also* Tr. at 381:3-20 (Sears Cross) (Oct. 25, 2017).

[193] Staff Ex. 2 at 36.

[194] *Id.*

[195] *Id.* at 37.

[196] *Id.*

analysis, which is the average yield of the 10-year Treasury bond over time periods matching the historic market return.[197] For the future analysis, Ms. Sears used a rate of 2.81%, which is the average of the 10-year Treasury yields over seven quarters and the five-year projection.[198] By applying the CAPM analysis to her proxy group, Ms. Sears calculated a forecasted cost of equity for DDU of 8.69% and a historic cost of equity of 8.40%.[199] Using these CAPM results as a qualitative check on the DCF analysis, Ms. Sears determined that the estimates of the cost of DDU's equity using the DCF were not too low.

The Commission has set a ROE in a contested water rate case in only one previous instance, Docket No. 45720.[200] Like DDU, the subject water utility of Docket No. 45720 (Rio Concho) filed a Class B Rate Change Application.[201] The Commission determined that a reasonable ROE for Rio Concho, based on a DCF analysis and consistent with its business and regulatory risk, is 8.48%.[202] Accordingly, Ms. Sears' recommended ROE of 8.79% for DDU is further supported by very recent Commission precedent.

B. Cost of Debt [PO Issues 8, 14]

Staff recommends using the overall weighted average cost of debt of DDD as of December 31, 2015, of 4.91%.[203] DDU requested a 6.00% cost of debt "based on the portion of DDD's debt that is collateralized with utility assets based on a 2013 loan."[204] However, as Staff witness Ms. Sears testified, it is more appropriate to use the actual cost of debt as of the end of the test year, because 1) the loan was a five-year note, which would have had a higher cost rate

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197 *Id.* at 38.

198 *Id.*

199 *Id.* at 40.

200 *Application of Rio Concho Aviation, Inc. for a Rate/Tariff Change*, Docket No. 45720, Order (Jun. 29, 2017) (45720 Order).

201 *Id.* at 11 of 20.

202 *Id.* at 16 of 20, Finding of Fact No. 38.

203 Staff Ex. 2 at 32; *see also* Direct Testimony and Workpapers of Nelisa Hedin, Ex. WBRG 1 at 46 of 54 (identifying the appropriate cost of debt as the weighted average cost of outstanding DDD remaining debt balances as of December 27, 2015).

204 Ex. DDU-6 at 16 of 89.

than longer term loans, and 2) that particular loan could not have financed the assets in this case.[205] Therefore, the appropriate cost of debt for DDU is 4.91%.

C. Capital Structure [PO Issue 7]

Staff recommends a hypothetical capital structure of 47.27% debt and 52.73% equity.[206] DDU witness Mr. Joyce testified that DDU depends completely on its parent company, DDD, for its financing needs, and is therefore requesting DDD's capital structure of 55.84% debt and 44.16% equity.[207] However, as Staff witness Ms. Sears testified, a capital structure should be representative of the industry norm, and be an efficient use of capital.[208] Staff's recommended hypothetical capital structure is the current five-year average capital structure of the proxy group, which is more representative of other capital structures among water utility distribution systems, and better minimizes the overall cost of capital.[209]

D. Overall Rate of Return [PO Issue 8]

Water utilities such as DDU are regulated monopolies. As such, the capital structure and costs of debt and equity approved by the Commission should be market based substitutes for the overall return that would be reasonably expected to accrue to shareholders in a competitive environment.[210] In a competitive environment, natural competitive forces would require DDU to reduce the level of overall return to reflect a market based capital structure and costs of debt and equity. Staff's recommended overall cost of capital provides a reasonable proxy for the overall cost of capital that would be required in order to be competitive in a non-monopolistic environment, and is consistent with the Commission's decision in Docket No. 45720.[211] Therefore, Staff's recommendations on rate of return should be adopted.

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[205] Staff Ex. 2 at 32.

[206] *Id.* at 30.

[207] Ex. DDU-6 at 14-15 of 89.

[208] Staff Ex. 2 at 30-31.

[209] *Id.* at 31.

[210] *See* Tr. at 361:8-9 (Sears Cross) (Oct. 25, 2017) ("Regulation is a substitute for the market for competition.").

[211] *See* Docket No. 45720 Order at 16.

IV. RATE DESIGN [PO ISSUES 1, 2, 4, 35, 36, 37]

The Commission is charged with ensuring that every rate "made, demanded, or received" by a utility is just and reasonable.[212] A rate must not be unreasonably preferential, prejudicial, or discriminatory and must be sufficient, equitable, and consistent as applied to each class of consumers.[213] DDU did not request any changes to its existing two-part rate design consisting of a meter charge and a volumetric charge, and Staff did not recommend any changes.[214] Therefore, the differences between the rates recommended by Staff and those requested by DDU stem from Staff's adjustments to the revenue requirement requested by DDU.

For the White Bluff water system, Staff recommends the following rates:[215]

Table 19 White Bluff Water Rates				
Meter Size	**DDU Requested**	**Staff Recommended**	**Usage (in gallons)**	**DDU/Staff Agreed[216]**
¾" or less	$39.00	$25.00	0 - 3,000	$2.10
1"	$97.50	$62.50	3,001 -10,000	$2.95
1 ½"	$195.00	$125.00	10,001 - 15,000	$3.90
2"	$213.00	$200.00	15,001 - 20,000	$5.25
			20,001+	$5.76

For the White Bluff sewer system, Staff recommends the following rates:[217]

Table 21 White Bluff Sewer Rates				
Meter Size	**DDU Requested**	**Staff Recommended**	**Usage (in gallons)**	**DDU/Staff Agreed[218]**
¾" or less	$56.65	$36.00	0 - 3,000	
1"	$144.00	$90.00	3,001 -10,000	$11.00
1 ½"	$295.00	$180.00	10,001 - 15,000	
2"	$465.00	$288.00	15,001 - 20,000	

212 Tex. Water Code § 13.182(a) (TWC).

213 TWC § 13.182(b).

214 Ex. DDU-6 at 23 of 89.

215 Staff Ex. 4 at 13.

216 Staff does not contest the volumetric rate requested by DDU.

217 Staff Ex. 4 at 16.

For the Cliffs water system, Staff recommends the following rates:[219]

Table 22 The Cliffs Water Rates				
Meter Size	**DDU Requested**	**Staff Recommended**	**Usage (in gallons)**	**DDU/Staff Agreed[220]**
¾" or less	$40.00	$37.00	0 - 3,000	$3.50
1"	$110.00	$92.50	3,001 -10,000	$4.00
1 ½"	$230.00	$185.00	10,001 - 15,000	$6.50
2"	$395.00	$296.00	15,001 - 20,000	$10.50
			20,001+	$14.45

For the Cliffs sewer system, Staff recommends the following rates:[221]

Table 23 The Cliffs Sewer Rates				
Meter Size	**DDU Requested**	**Staff Recommended**	**Usage (in gallons)**	**DDU/Staff Agreed[222]**
¾" or less	$72.00	$55.00	0 - 3,000	
1"	$126.00	$137.50	3,001 -10,000	$12.00
1 ½"	$216.00	$275.00	10,001 - 15,000	
2"	$324.00	$440.00	15,001 - 20,000	

V. RATE-CASE EXPENSES [PO ISSUE 38]

A utility may recover rate-case expenses, including attorney fees, incurred as a result of filing a rate-change application under Tex. Water Code § 13.1871, only if the expenses are just, reasonable, necessary, and in the public interest.[223] However, a utility may only recover rate-case expenses if the increase in revenue generated by the rate determined by the Commission after a contested case hearing is at least 51% of the increase in revenue that would have been generated by the utility's proposed rate.[224] As shown in the table below, DDU's increase must be at least

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218 Staff does not contest the volumetric rate requested by DDU.

219 Staff Ex. 4 at 9.

220 Staff does not contest the volumetric rate requested by DDU.

221 Staff Ex. 4 at 11.

222 Staff does not contest the volumetric rate requested by DDU.

223 16 TAC § 24.33(a).

224 16 TAC § 24.33(b); *see* Staff Ex. 3 at 12.

$122,943 for White Bluff and $81,602 for the Cliffs, for a total company increase of $204,545, in order for DDU to be eligible to recover its reasonable and necessary rate case expenses. If DDU is eligible to recover its rate-case expenses, the reasonableness and necessity of those expenses will be taken up in Docket No. 47748.[225]

Table 24
51% for Rate Case Expense Recovery

	White Bluff			The Cliffs		
	Water	**Sewer**	**Total**	**Water**	**Sewer**	**Total**
Rate Revenues at Present Rates	$465,237[226]	$412,543[227]	$877,780	$368,356[228]	$215,111[229]	$583,467
Rate Revenues at Proposed Rates	$546,714[230]	$572,130[231]	$1,118,844	$426,113[232]	$317,357[233]	$743,470
Requested Increase in Revenues	$81,477	$159,587	$241,064	$57,756	$102,246	$160,003
51% of Requested Increase	**$41,553**	**$81,389**	**$122,943**	**$29,456**	**$52,145**	**$81,602**

DDU's assertion that if the Commission determines an appropriate ROE less than DDU's requested ROE, that reduction should not count against DDU's 51% threshold is without basis, and should be rejected.[234] The Commission's substantive rule clearly sets forth the application of

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225 *Review of Rate Case Expenses Incurred by Double Diamond Utility Company, Inc. in Docket No. 46245*, PUC Docket No. 47748, SOAH Docket No. 473-18-0767.WS.

226 Ex. DDU-2 at 95 of 151.

227 *Id.* at 143 of 151.

228 Ex. DDU-1 at 95 of 151.

229 *Id.* at 143 of 151.

230 Ex. DDU-2 at 95 of 151. The figure contained in the revenue proof is $568,761, which Staff then subtracted $22,047 from to reflect the removal of the Prairieland Groundwater Conservation District fees, which DDU no longer seeks in its revenue requirement. Tr. at 513:15-514:4 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

231 *Id.* at 143 of 151.

232 Ex. DDU-1 at 95 of 151.

233 *Id.* at 143 of 151.

234 *See* Ex. DDU-11 at 13 of 106.

the 51% threshold.[235] A utility should not be permitted to request a certain increase only to later assert that, should it lose certain issues, the portion of its requested increase attributable to those issues should not count for purposes of the rule.

VI. INTERIM RATES AND EFFECTIVE DATE [PO ISSUE 39, 40, 41]

The notice issued to DDU's customers at both White Bluff and the Cliffs included an effective date for the proposed rate change of October 1, 2016.[236] On November 29, 2016, State Office of Administrative Hearings (SOAH) Order No. 5 was issued suspending the effective date until at least 35 days after the date DDU filed an amended application. DDU filed a status report on May 1, 2017, stating that it had amended its water and sewer applications with a new effective date of June 1, 2017. During the prehearing conference held on May 26, 2017, the SOAH ALJ granted Staff's motion to suspend the June 1 effective date and set a procedural schedule. On July 20, 2017, the parties filed an agreed motion to modify the procedural schedule, extend the effective date, and establish a "relate back" date, allowing for any rate change ultimately made to DDU's current rates to relate back to the date of implementation of the interim rates. In response to the motion, the ALJ issued SOAH Order No. 10 modifying the procedural schedule and extending the effective date for DDU's rate change to April 1, 2018, with a relate back date of February 21, 2018.

Consistent with the parties' agreement and the ALJ's order, Staff recommends that DDU's interim rates, which are the current rates it is charging customers, go into effect on February 21, 2018. After the Commission makes a final determination in this matter, DDU shall provide refunds or collect surcharges relating back to February 21, 2018.

VII. ISSUES NOT ADDRESSED [PO ISSUES 11, 13, 17, 22, 23, 24, 26, 32, 33]

Preliminary Order Issues 11, 13, 17, 22, 23, 24, 26, 32, and 33 are not applicable to this proceeding, and are therefore not addressed.

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[235] *See* 16 TAC § 24.33(b).

[236] The Cliffs – Affidavit of Notice of Proposed Rate Change, Ex. DDU-1A at 148 of 151; White Bluff – Affidavit of Notice of Proposed Rate Change, Ex. DDU-2A at 148 of 151

VIII. CONCLUSION

For the reasons discussed above, Staff respectfully requests that the presiding officer issue a proposal for decision that adopts Staff's above recommendations.

SOAH DOCKET NO. 473-17-0119.WS
PUC DOCKET NO. 46245

CERTIFICATE OF SERVICE

I certify that a copy of this document was served on all parties of record on November 22, 2017, in accordance with 16 TAC § 22.74.

Erika N. Garcia