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

INITIAL BRIEF OF WHITE BLUFF RATEPAYERS GROUP

Respectfully submitted,

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Dated: November 22, 2017

645

TABLE OF CONTENTS

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

APPLICATION OF DOUBLE	**§**	**BEFORE THE STATE OFFICE**
DIAMOND UTILITY COMPANY, INC.	**§**	**OF**
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INITIAL BRIEF OF WHITE BLUFF RATEPAYERS GROUP

White Bluff Ratepayers Group ("WBRG") hereby files its Initial Brief in this matter. Pursuant to Order No. 10, the deadline for initial briefs is November 22, 2017. Therefore, this brief is timely filed. In support of its Initial Brief, WBRG states the following:

I. INTRODUCTION AND SUMMARY

The record in this proceeding reveals many questions regarding Double Diamond Utility's ("Double Diamond's" or "DDU's") rate base and the appropriate level of return. These questions arise from DDU's continued[1] refusal to properly identify the level of developer-contributed capital, DDU's refusal to produce full and accurate records, and from DDU's developer-parent's continued treatment of DDU's assets as the developer's own assets.

WBRG is recommending a number of significant adjustments to DDU's requested revenue requirement, which are shown on the two tables at the end of the brief (Tables 1 and 2). The brief explains the basis for these adjustments, but also contains alternative positions regarding several issues WBRG believes that the Commission should address, but for which the record is not fully developed to allow WBRG to provide a recommended number.

[1] The issue of the appropriate level of developer-contributed assets led to DDU's 2007 rate case being denied after SOAH and the TCEQ found that DDU failed to properly account for such contributions. Excerpts from PFD, SOAH Docket No. 582-08-0698, White Bluff Ratepayers Group Ex. WBRG-1J.

II. REVENUE REQUIREMENT [PO ISSUES 3, 5, 6, 34]

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

Salaries

DDU requested the following adjustments for "known and measurable" changes in salaries at White Bluff: $415 adjustment for water and $20,472 adjustment for sewer. DDU did not provide an explanation for these known and measurable changes, and the reason for the post-test year adjustment is not clear from the record. For these reasons, the adjustment should be disallowed.

Under Commission rules, a known and measurable change is a change that is: "[v]erifiable on the record as to amount and certainty of effectuation. Reasonably certain to occur within 12 months of the end of the test year."[2] The Commission's rate change application form requires an applicant to "Provide copies of source documents . . . to verify the applicant's known and measurable changes."[3] The specific schedule for salaries, Schedule II-6, requires the applicant to "[a]ttach an explanation and calculation for K&M salary changes from test year."[4]

DDU did not provide any documentation verifying the requested known and measurable changes for salaries. DDU did not attach an explanation and calculation in the application for these requested known and measurable changes. DDU's application appears to seek salaries for seven individuals at White Bluff.[5] At hearing, DDU's witness and CEO, Mr. Gracy, testified that only four individuals work at White Bluff.[6] On cross-examination, Mr. Gracy clarified that these four individuals are all of the employees currently working at White Bluff.[7] Later in the hearing, DDU's rate consultant, Mr. Joyce, testified that the number of employees used in the application was based on "fully staffed costs," with the fully staffed assumptions coming from DDU.[8] Mr. Joyce did not personally verify these assumptions. Mr. Gracy also was unable to verify the number of employees constituting "fully staffed."

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[2] 16 Tex. Admin. Code § 24.3(32) (TAC).
[3] Rate/Tariff Application for White Bluff, Double Diamond Utility Company, Inc. Ex. DDU-2 at 10.
[4] Ex. DDU-2 at 15.
[5] *Id.*
[6] Prefiled Direct Testimony and Exhibits of Randy Gracy, Double Diamond Utility Company, Inc. Ex. DDU-3 at 15.
[7] Tr. at 104:2 (Gracy Cross) (Oct 24, 2017).
[8] Tr. at 206:13–207:4 (Joyce Cross) (Oct. 24, 2017).

DDU's request for a known and measurable adjustment for these costs should be disallowed. DDU failed to provide an adequate explanation for the adjustments, and the facts brought out at the hearing do not support Mr. Joyce's claims regarding full staffing. WBRG's recommended changes to DDU's revenue requirement are shown on Table 1.

Regulatory Fees

Schedule II-D of DDU's application contains Regulatory Expense (Other).[9] The instructions for this schedule direct the applicant to include regulatory expenses, but not regulatory assessments. The instructions also direct the applicant to identify all large items (more than 10% of total and more than $1,000). The instructions also direct the applicant, if applicable, to provide the reason why the test year amount exceeds the prior year.

For White Bluff water, DDU identified $24,476, two large water items – both "Regulatory Water Fees," and no explanation as to why the test year amount exceeded the prior year amount of $1,180.[10] In the trial balance provided by DDU in testimony, these expenses are explained in a little more detail. For White Bluff, the amounts shown are $2,429 for water tests, and $22,047 in regulatory water fees.[11]

WBRG recommends that the $22,047 amount for regulatory water fees be disallowed. On rebuttal, DDU identified these regulatory assessment fees as expenses paid to Prairieland Groundwater Conservation District.[12] DDU claims that a "rider" in the tariff currently addresses this amount. DDU did not, however, offer the current tariff into the record or proof that the "rider" will no longer apply. The Commission's rate application clearly states that these expenses do not include "regulatory assessments," which are pass-through costs.[13] Additionally, in rebuttal, DDU appears to concede that this expense should be disallowed.

WBRG recommends that the regulatory water fees be disallowed from DDU's revenue requirement. WBRG's recommended changes to DDU's revenue requirement are shown on Table 1.

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[9] Exs. DDU-1 at 27; DDU-2 at 27.
[10] Ex. DDU-2 at 74.
[11] Detail Trial Balance, Double Diamond Utility Company, Inc. Ex. DDU-4E at 148–49.
[12] Rebuttal Testimony of Jay Joyce, Double Diamond Utility Company, Inc. Ex. DDU-11 at 9–10.
[13] Ex. DDU-2 at 74.

Professional Fees

In its request for a rate change for White Bluff water, DDU included a test year expense of $2,907 for "CCN map revisions for application."[14] At the hearing, DDU's witness, Mr. Gracy, testified that White Bluff did not file a CCN application during the test year, and that this charge should not have been included in DDU's application for White Bluff.[15] Also at the hearing, DDU's witness, Mr. Joyce, stated that DDU would remove this cost from the White Bluff revenue requirement.[16] WBRG recommends that the full amount of $2,907 be disallowed. WBRG's recommended changes to DDU's revenue requirement are shown on Table 1 below.

B. Depreciation [PO Issues 12, 27]

i. Improper Known and Measurable Adjustment/Inappropriate Use of Trended Original Cost Study

Improper Use of Trended Original Cost Study

DDU's application contains $46,156[17] in "known and measurable" changes in the deprecation for the total White Bluff system, and $24,724[18] for the total The Cliffs system. As with the requested known and measurable adjustments for salaries, this request should be denied because DDU provided no explanation in its application verifying or supporting this request. Moreover, the adjustment should be disallowed because it is based on the inappropriate use of a trended original cost study that artificially inflated the original cost of some of DDU's assets beyond the cost of the assets as shown on DDU's books.

Under Commission rules, trended original cost studies can be used to establish original cost of assets only if the utility has "no historical records for verification purposes."[19] As the Commission stated at the time it adopted the rule:

> The commission recognizes that TCEQ trended studies were sometimes used because some utilities' books and records were not properly kept or were destroyed. The commission establishes a rule for trending studies and seeks to incentivize water and sewer utilities to keep proper books and records. As a general rule, the commission discourages the use of trending studies except when historical records are unavailable from any source. Trending studies are a

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[14] Ex. DDU-4E at 137.

[15] Tr. at 100:15–101:2 (Gracy Cross) (Oct. 24, 2017).

[16] Tr. at 224:5–6 (Joyce Cross) (Oct. 24, 2017).

[17] Ex. DDU-2 at 6.

[18] Ex. DDU-1 at 6.

[19] 16 TAC § 24.31(c)(2)(B)(i).

subjective estimate of depreciable utility plant, which is the single most significant cost driver in most rate cases.[20]

In its application, DDU used a trended original cost study to establish the original cost of certain assets for both White Bluff and The Cliffs.[21] Dr. Harkins performed this study. Dr. Harkins testified that such a study was necessary because she could not locate original invoices for all of the line work.[22] For installation dates, she used a "conservative" approach by selecting 1981 for The Cliffs and 1991 for White Bluff. The known and measurable adjustment to depreciation included in DDU's application is a result of the inflation of original cost of the assets shown on DDU's books resulting from the trended original cost study.[23]

The use of a known and measurable adjustment to DDU's book entries for depreciation (and for rate base) is inappropriate in this case because reliable historical records exist to establish original cost values. At the hearing, DDU's chief financial officer, Mr. Grout, testified that DDU maintained records of all construction costs and recorded these in the corporate books and that he has no reason to doubt the asset values shown on DDU's books.[24] Dr. Harkins testified that she did not look at DDU's books to see if DDU had accounted for the value of the assets, and if she had, she might have used the lower book values because that would have been more conservative.[25] The lack of invoices should result in the disallowance of the asset, not open the door to inflate the value of the asset beyond its booked value. Based on this record, DDU should not be allowed to inflate its asset values, and consequently its depreciation, using a trended original cost study.

DDU's request for a known and measurable change to depreciation, for both White Bluff and The Cliffs, should not be allowed. WBRG's recommended changes to DDU's revenue requirement are shown on Tables 1 and 2. WBRG's recommendation assumes that DDU is not allowed any return as set out below. If DDU is allowed some return, additional adjustments to invested capital, return, and income tax expense will be required.

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[20] *PUC Rulemaking Project to Amend Chapter 24 for the Implementation of Phase II of the Economic Regulation of Water and Sewer Utilities*, Project No. 43871, Order Adopting Amendments at 82 (Aug. 24, 2015).

[21] Prefiled Direct Testimony and Exhibits of Victoria Richards Harkins, Ph.D., P.E., Double Diamond Utility Company, Inc. Ex. DDU-5 at 8–9.

[22] *Id.*

[23] Tr. at 205:6–21 (Joyce Cross) (Oct. 24, 2017).

[24] Tr. at 158:10–159:3 (Grout Cross) (Oct. 24, 2017) ("[F]rom what I've seen, everything looks pretty intact.").

[25] Tr. at 187:2–189:23 (Harkins Cross) (Oct. 24, 2017).

Error in Trending Study

Moreover, even if the Commission allows the use of a trending study to establish original cost for these assets, DDU's study for the White Bluff assets contains a significant error that needs to be fixed. The problem with DDU's trending study is detailed in the testimony of WBRG's witness, Ms. Heddin. As explained by Ms. Heddin, Dr. Harkins used an installation date of January 1, 1996, rather than an installation date of January 1, 1991, which Dr. Harkins claimed she used.[26] Dr. Harkins claimed in testimony that the use of 1991 was the "conservative" approach. This error resulted in an overstating of rate base, depreciation expense, return, and income tax expense.

On rebuttal, Dr. Harkins did not directly respond to why she used an installation date of 1996 in her study. Instead she stated: "As a conservative estimate the earliest date is chosen knowing that in reality the system was installed over the next several years."[27] Yet, at the hearing Dr. Harkins confirmed that she used the 1996 date rather than the 1991 date.[28] Also at the hearing, Mr. Gracy explained that construction of collection and distribution lines in White Bluff began in 1990.[29] The testimony in the record clearly supports the use of an installation date of January 1, 1990 as the conservative date to use for the trending study. As explained by Ms. Heddin, this is the date that DDU should have used. The significance of choosing the appropriate date when applying a trended cost study—such as the Handy-Whitman Index used by Dr. Harkins—cannot be over-emphasized. The Handy-Whitman Index calculates the cost trends for different types of utility construction. Separate Indexes are published for the electric, gas, and water industries. Handy-Whitman Index values are widely used to trend earlier valuations and original cost records to estimate reproduction cost at prices prevailing at a certain date. Since construction costs and commodity prices change over time, the installation date for which these values are trended is critical. If, however, the ALJ agrees with WBRG's contention that that the use of the trending study was inappropriate to begin with, the error between Dr.

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26 Direct Testimony and Workpapers of Nelisa Heddin, White Bluff Ratepayers Group Ex. WBRG-1 at WBRG000029–000037.

27 Rebuttal Testimony of Victoria Richards Harkins, Ph.D., P.E., Double Diamond Utility Company, Inc. Ex. DDU-9 at 8.

28 Tr. at 193:20 (Harkins Cross) (Oct. 24, 2017).

29 Tr. at 65:11–15 (Gracy Cross) (Oct. 24, 2017).

Harkins's dates is not relevant to the level of DDU's revenue requirement or rates, and Ms. Heddin's adjustments do not need to be made.

WBRG's recommended changes to DDU's revenue requirement are not shown on Table 1 because they are fully subsumed by the disallowance of all known and measurable changes. If WBRG's disallowance of the known and measurable changes is not accepted, then the changes required to correct the error are shown on Table NDH-9 in Ms. Heddin's testimony.[30]

ii. Fully Depreciated Assets

In Ms. Heddin's testimony, she identified fully depreciated assets that were included in DDU's depreciation table.[31] Additional depreciation of such assets is inappropriate (because they have been fully depreciated); allowing further depreciation would be over-recovery. DDU did not respond to Ms. Heddin's testimony. The adjustments to remove this property are set out in Tables NDH-14, NDH-15, NDH-16, and NDH-17 in Ms. Heddin's testimony. WBRG's recommended changes to DDU's revenue requirement are shown on Table 1.

C. Taxes [PO Issues 28, 31]

i. Federal Income Tax Expense [PO Issue 30]

As explained in Ms. Heddin's testimony, DDU's income tax expense needs to be adjusted to reflect the decrease in the allowed return. This expense is solely a function of the return amount. Once the ALJ determines the appropriate level of return, the amount of income tax expense can be calculated.

ii. Other Assessments and Taxes [PO Issue 29]

WBRG has no position on this topic.

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

For WBRG, the most important aspect of this case is the proper determination of DDU's rate base, including the appropriate amount of developer-contributed assets. Rate base has been an issue in all of DDU's prior rate filings. Each time DDU files a new rate case, it presents a different view of the proper amount.[32] In this docket, DDU's version of its rate base changed

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[30] Ex. WBRG-1 at WBRG000036.
[31] *Id.* at WBRG000046–000048.
[32] *See* Ex. WBRG-1J.

dramatically between DDU's initial filing in August 2016 and its revised filing in April 2017. WBRG would like for the Commission to establish DDU's rate base once and for all.

i. Property Not Belonging to DDU

As explained in Ms. Heddin's testimony, DDU included in its rate base property that was previously conveyed from DDU to the White Bluffs Property Owners Association ("POA").[33] Because this property does not belong to DDU, it should not be included in invested capital. DDU did not respond in its rebuttal testimony to Ms. Heddin's testimony on this issue. At hearing, DDU's witness Mr. Gracy testified that he thought that DDU had intended to convey a different tract to the POA, but inadvertently deeded the utility property.[34] He further testified that he did not know whether this conveyance had been corrected.[35] DDU did not provide a copy of any correction deed or conveyance from the POA to DDU. Based on the evidence in the record, this property should be excluded from DDU's invested capital. The adjustments to remove this property are set out in Table NDH-13 in Ms. Heddin's testimony. Table 1 does not include the adjustments necessary to remove this property from the revenue requirement. These adjustments will depend on outcome of the developer contribution issue.

ii. Inappropriate Use of Trended Original Cost Study

As explained previously, DDU inappropriately inflated the amount of its invested capital through the use of a trended cost study, even though historic financial records existed establishing the value of the assets. Based on DDU's books, the amount of invested capital should be adjusted to remove the inflated amounts. Unfortunately, the record does not contain the book values without the trending study adjustments. If the Commission allows DDU to include these assets (recognizing that 80% of the costs were developer contributed), WBRG recommends that the Commission order DDU to provide book values for these assets.

iii. Rate Base: 100% Developer-contributed Assets

Overview

As explained in detail in Ms. Heddin's testimony, WBRG's position is that all of DDU's invested capital should be treated as developer-contributed. First, it is WBRG's position that

[33] Ex. WBRG-1 at WBRG000045–000046.
[34] Tr. at 99:8-22 (Gracy Cross) (Oct. 24, 2017).
[35] *Id.*

when the developer and the utility are essentially the same entity, the burden is placed on the developer/utility to prove that the investments were not funded out of lot sales, and that DDU failed to meet this burden. Second, it is WBRG's position that the record shows the vast majority of DDU's assets were paid for out of lot sales and that the developer continues to treat the capital invested in the utility as the developer's own capital, and because the full amount of developer contributions cannot be found in the information provided by DDU, all of the invested capital should be presumed to be developer-contributed.

Under Commission rules, all contributions in aid of construction and other sources of cost-free capital (as determined by the Commission) must be deducted from rate base.[36] Also, as stated in the instructions for *Class B Investor-owned Utilities Water and/or Sewer, Instructions for Rate/Tariff Change Application 2015*, the "utility can include plant and equipment paid for by DEVELOPER contributions in the depreciation schedule, but the utility cannot include plant and equipment paid for by CUSTOMER contributions. Furthermore, when calculating the return on net invested capital, developer and customer contributions must be removed."[37]

Developer-contributed assets are plant and facilities that were paid for in whole or in part by a developer and given to a utility at no cost. As these facilities were paid for (contributed) by the developer, and not the utility, they are excluded from the rate base when calculating the utility's return. Simply put, the utility is not permitted to earn a return on an investment it did not make. Fundamentally, this protects customers from paying the developer for the assets through their purchase of the lot, and then paying the utility a profit on the same assets.

The Commission first addressed the treatment of developer-contributed assets in 1977 when a newly formed water and sewer utility, Sunbelt Utilities, filed an application to change its water and sewer rates in Harris County.[38] The unique thing about this case was the fact that the affiliated development company installed the utility system and transferred the assets to the utility without charge. Commission staff argued that because the development company recovered the cost of the utility assets through lot sales, the ultimate purchaser of the lot, the home buyer, paid for his share of the utility assets with the purchase of the home, and that it

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[36] 16 TAC § 24.31(c)(2)(B)(v); *id.* § 24.31(c)(3).

[37] Class B Investor-owned Utilities Water and/or Sewer, Instructions for Rate/Tariff Change Application 2015 at 11 (Sept. 17, 2015) *available at* https://www.puc.texas.gov/industry/water/forms/Class_B_Rate-Tariff_Change_Application_Instructions.pdf (emphasis in original).

[38] *Petition of Sunbelt Utilities for Authority to Change Rates*, Docket No. 804, 3 P.U.C. Bull. 1167 (March 22, 1978).

would be unfair to require the home purchaser to pay for the utility assets a second time through utility rates. The examiner in that docket reviewed the provisions of PURA and case law from other states and concluded that the utility assets paid for by the development company and recovered through lot sales should be excluded from rate base.[39] The Commission agreed with the examiner, as did the District Court and the Court of Appeals.

In 1979 the case came before the Supreme Court of Texas.[40] The court specifically focused on the exclusion of developer contributions of assets related to a utility that had the same ownership as the developer of the same system. The Commission had "excluded the developer's cost of the utility system from the rate base because the rate payers had already paid for the system as a part of the purchase price of their lots."[41] The Texas Supreme Court agreed with the Commission's findings. The court evaluated the issue of developer contributions of assets and consideration of these issues by courts and regulatory bodies in other states. The court concluded: "the uniform rule followed in these cases is that when a developer has recovered all or part of the cost of the utility system through the sale of lots, the regulatory body has excluded that amount from the utility's rate base."[42]

DDU and the Developer are Essentially the Same Entity

DDU is a wholly-owned subsidiary of Double Diamond–Delaware, Inc. ("DDD"). DDD also wholly owns Double Diamond, Inc. ("DDI"), and Double Diamond Properties Construction Co. ("DDPC"). All of these companies maintain a single set of financial records and file a joint tax return.

DDU Failed to Prove the Assets Were Not Funded from Lot Sales

When the developer and the utility are the same entity, the burden is on the utility to clearly demonstrate that the utility (and not the developer) paid for the assets. This is the implicit holding of the *Sunbelt Utilities* case.[43] Additionally, the burden should be placed on the

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[39] Examiner's Report, *Petition of Sunbelt Utilities for Authority to Change Rates*, Docket No. 804, 3 P.U.C. Bull. 1167 (March 22, 1978), White Bluff Ratepayers Group Ex. WBRG-1B.

[40] *Sunbelt Utilities v. Public Utility Commission*, 589 S.W.2d 392 (Tex. 1979), White Bluff Ratepayers Group Ex. WBRG-1C.

[41] *Id.*

[42] *Id.* at 394.

[43] In *Sunbelt*, the Texas Supreme Court favorably citied the decisions of other states holding that in such situations, the cost of construction of utility facilities can be presumed to be included in the cost of the lot and that the "reasonable inference" is that the monies used to build the facilities came from the sale of lots. *Sunbelt Utilities* at 395.

developer/utility because only the developer/utility has the information necessary to make this showing. How the developer accounted for the costs of development is something only the developer knows. If the developer assigned the costs of the system to the utility entity, the utility could easily satisfy its burden by showing the entries in the developer's books that effectuated the transfer.

In this case, DDU has not satisfied its burden of showing that the cost of the utility system was not included by the developer in the cost of the lots. DDU's "demonstration" that utility assets were not paid for out of lot sales is contained in the direct testimony of Mr. Gracy. In his testimony, Mr. Gracy states that the developer "treated" the initial investment in the water and systems for both White Bluff and The Cliffs, and distribution lines in new sections, as being 80% developer contributions and 20% utility investment.[44] The problem with Mr. Gracy's claim is that DDU produced no documentation to support it.

DDU provided no accounting records supporting these conclusory statements, despite WBRG's continued requests for such records. In response to WBRG 1-15, Double Diamond states: "The basis for the 80/20 separation is discussed in Randy Gracy's prefiled testimony in [SOAH Docket 582-09-4288]. No documentation exists that corresponding entries were made in the financial records of the developer and the utility." Mr. Gracy's testimony on this issue in the prior docket is identical to his testimony here, and provides no greater insight into the developer's actions.[45] There simply is no documentary support for DDU's claims regarding the division of assets between developer contributions and utility investment.

Because DDU admits that no documentation exists to show that the developer did not recover the cost of the utility assets out of lots sales, DDU cannot meet its burden of showing that the assets were not contributed by the developer. All of the investment in DDU to serve White Bluff and The Cliffs, therefore, should be treated as developer-contributed assets.

The Record Shows the Developer Recovered the Cost of the Utility Assets Out of Lot Sales

Even without the presumption of developer contributions, as set out in the previous section, the record in this matter demonstrates that the developer contributed the assets, or at least the bulk of the assets, to the utility without cost to the utility. This is shown primarily by the

[44] Ex. DDU-3 at 7:13–12:10.
[45] Ex. WBRG-1 at WBRG000016.

agreements made between the developer and the lot purchasers and in Double Diamond's own accounting records.

Exhibit WBRG-1G is a "true and correct copy of a Real Estate Sales Contract used to sell property in the White Bluff subdivision to purchasers."[46] These contracts outline the terms and conditions related to the sale of lots within the White Bluff Resort. The contracts are between the purchaser (as identified in the contract) and the seller, Double Diamond, Inc. Item number 9 in these contracts clearly outlines that the "Seller" will be responsible for providing the "Central Water System" and the "Central Sewer System." The table further identifies "Double Diamond Utilities Co. ("Utility Co.")" as the party responsible for maintaining the Central Water and Central Sewer Systems. These provisions clearly represented to the purchasers of lots (who are ultimately going to be ratepayers), that the developer (DDI) would provide utility infrastructure that would be maintained by the utility (DDU). In other words, these contracts explained to the lot purchasers that the cost of infrastructure would be paid for out of the proceeds of lot sales and that the cost of operating the utility would be paid for out of utility rates.

This sales contract makes a commitment to the property owners that DDI, the developer of the lots, will contribute/provide/make available/supply/furnish the utility infrastructure, which the developer would recover through lot sales, and that the cost of operating the utility would be paid for the by DDU, the utility, through utility rates. The purchase agreement establishes a distinction between the "seller" (DDI) and the "Utility Co." (DDU) and clearly indicates that DDI (the developer) would provide (contribute) the utility infrastructure and DDU (the utility) would maintain the system. Based upon the terms of the purchase agreement alone, all of DDU's utility assets should be treated as developer contributions.[47] This is the agreement that DDI entered into with property owners when they sold the lots, and this agreement should be honored when it comes to assessing water and wastewater rates to these customers.

Additionally, DDD's Chief Financial Officer, Mr. Grout, testified that the cost of utility infrastructure, along with the other costs associated with preparing raw land for sale, would have been recorded on DDD's books as part of the development costs of the lots in the subdivisions, and that these costs would have been "taken down to the balance sheet and expensed" when lots

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[46] DDU's response to WBRG 3-12 admits that the document is a true and correct copy. Workpapers of Nelisa Heddin, White Bluff Ratepayers Group Ex. WBRG-1M at WBRG000137.

[47] Arguably, DDU might be allowed to include as invested capital that investment in the utility made as part of its operation of the infrastructure contributed by DDI. DDU, however, did not provide any basis to identify what investment is a repair or replacement of original infrastructure and what is original investment.

were sold.[48] This testimony matches the testimony from the utility in the *Sunbelt Utilities* case that led the hearings examiner, the Commissioners, and the Texas Supreme Court to conclude that such assets must be treated as developer contributions.[49]

The record also reveals that DDU did not exist until December 30, 1996.[50] Because DDU did not exist until December 30, 1996, the White Bluff system could not have been constructed by DDU. Moreover, DDU did not provide any documentation of how the assets were transferred from the developer to DDU. In fact, in response to WBRG 1-15, DDU admitted that no documentation exists of any accounting entries recording the transfer of property installed by the developer to DDU.[51]

The record also reveals that the vast majority of the assets were constructed by DDI or DDPC. DDU only directly paid for an insignificant amount of the utility assets. For example, DDU lists Well No. 4 as being installed on February 22, 2001, at a cost of $163,215.41.[52] The receipts and documentation provided by DDU shows that this construction was paid for by DDPC. Based on the study done by WBRG's witness, Ms. Heddin, DDU only funded $71,367.48 in White Bluff water assets and only $25,624.64 in White Bluff sewer assets.

DDU provided some tax depreciation schedules during discovery, but however, DDU did not explain in what way these schedules support DDU's position regarding invested capital. Moreover, these schedules do not reconcile with the asset lists provided by DDU. For example, Well No. 4 is shown on the tax schedules as being installed on September 1, 2001, at a cost of $222,306, but on the asset list for this matter, the well is shown as being installed on a different date: February 22, 2001, and at a different cost: $163,215.41.

The above excerpts of the record support WBRG's contention that the developer included the cost of the utility system as part of the cost of its lots. Because the utility infrastructure operated by DDU was funded out of lot sales, the infrastructure must be treated as developer-contributed assets, and thus be excluded from rate base.

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[48] Tr. at 156:11–21(Grout Cross) (Oct. 24, 2017).
[49] *Sunbelt Utilities* at 394 ("[T]he entire cost of the utility system was expensed by the developer against the sum realized from the sale of the lots.").
[50] Ex. WBRG-1 at WBRG000021.
[51] Ex. WBRG-1M at WBRG000132.
[52] Ex. WBRG-1 at WBRG000021.

Developer's Use of Utility Capital

The record also demonstrates that the developer has treated DDU's invested capital as if it were the developer's own capital. This behavior supports the conclusion that all of the DDU's assets are developer-contributed.

Double Diamond's audited financial statements for the year ending December 27, 2015 include a loan from First Financial Bank secured by "utility assets" in the amount of $3,000,000 with a maturity date of July 7, 2017. This note is also identified in Schedule III-6 of the Application, which shows that the loan was issued on March 7, 2013. As explained by Double Diamond in its response to WBRG 2-19, the assets pledged as collateral for this loan are "the water and wastewater utility assets located within White Bluff."

At the hearing on the merits, the president of DDU, Mr. Gracy, admitted that the loan was taken out to provide capital to DDD for "whatever . . . the parent company chose to do with the monies."[53] He further testified that he did not know if any of the funds were used by DDU[54] and that he did not know whether there was an agreement between DDD and DDU for DDD to repay the loan.[55] Mr. Grout, the CFO of DDD, explained that when DDD needs funds, it looks at all of DDD's assets (including DDU's) to see which assets can be used to obtain a loan for DDD.[56] Mr. Grout was similarly unable to explain the use of the funds for which the White Bluff system was leveraged: "It would be like looking for a needle in a haystack, sir."[57] He was also unaware of any written plan for the use of the funds[58] and that the only plan for paying off the note is for it to be "refinanced."[59]

The record clearly demonstrates that the developer used the invested capital in the utility system as if it was the developer's invested capital. As explained by Mr. Grout, the developer considered these utility assets to be the developer's assets, and the developer took out a loan on these assets to fund non-utility activities. This action is consistent with WBRG's position that the developer contributed all of the assets of the utility. DDU cannot claim that the investment is invested capital in the utility when Double Diamond uses the capital for non-utility purposes.

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[53] Tr. at 91:22–92:1 (Gracy Cross) (Oct. 24, 2017).
[54] Tr. at 92:7 (Gracy Cross) (Oct. 24, 2017).
[55] Tr. at 97:8 (Gracy Cross) (Oct. 24, 2017).
[56] Tr. at 150:17-21 (Grout Cross) (Oct. 24, 2017).
[57] Tr. at 151:22–25 (Grout Cross) (Oct. 24, 2017).
[58] Tr. at 152:5 (Grout Cross) (Oct. 24, 2017).
[59] Tr. at 155:1 (Grout Cross) (Oct. 24, 2017).

Conclusion

For the reasons explained in this section, WBRG asserts that all of DDU's assets should be treated as developer-contributed assets, either because DDU failed to rebut the presumption that all assets of a developer-controlled utility will be treated as developer-contributed unless the developer can show that the cost of the facilities were not included in the cost of the lots, or because the record shows that the assets were, in fact, contributed by the developer. WBRG's recommended changes to DDU's revenue requirement are shown on Tables 1 and 2.

iv. Rate Base: 80/20 Split Developer Contributions

Overview

As set out in the previous section, WBRG recommends that the Commission find that all of DDU's assets, for both The Cliffs and White Bluff, were developer-contributed. Without waiving that recommendation, WBRG offers the following arguments regarding the problems associated with DDU's position that only a portion of the assets was developer-contributed.

DDU's revised application asserts that the cost of constructing an initial set of assets was split between the developer and the utility on an 80% / 20% basis, with the remainder of the assets funded 100% by the utility. The details of which assets were split are shown on Exhibit DDU-6C (White Bluff) and DDU-6D (The Cliffs). According to Mr. Joyce, any split at all—any acknowledgement that the developer contributed any of the assets—is purely a gift from the developer to the lot owners/ratepayers, and that DDU is under no obligation to recognize these developer contributions in its rate case.

No Supporting Documentation

As explained previously, DDU admits that no documentation exists to verify that DDD, DDI, or DDU recognized this split on their books.[60] In other words, there is no contemporaneous documentation for each asset to confirm if or how the split was made. The only proof of how the division was made is contained in the testimony of Mr. Gracy.

DDU Erred in Treating Initial Wastewater Assets As 100% DDU

According to DDU's witness, Mr. Gracy, DDU treated 80% of the cost of the original wastewater system (treatment plant and collection system) as developer contributions at both

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[60] Ex. WBRG-1M at WBRG000132.

White Bluff and The Cliffs.[61] Nevertheless, the asset lists included with DDU's testimony identified the costs of the original wastewater collection system at both White Bluff and The Cliffs as being 100% assigned to the utility. For White Bluff, the list identifies: Total Pipe Installed: $1,628,405.39 as 100% DDU,[62] and Grinder Station Receiving Tank and Pump: $78,443.22 as 100% DDU.[63] For The Cliffs, the list identifies: Total Pipe Installed: $703,723.37 as 100% DDU.[64] To be in accordance with Mr. Gracy's testimony, these assets should be shown as 80% developer-contributed and 20% DDU.

At the hearing, Mr. Gracy seemed not to know the reason why these assets were shown as 100% DDU, and he admitted that the infrastructure was installed at the same time as the corresponding water infrastructure that was shown as 80% developer contributed.[65] Mr. Joyce later testified that Mr. Gracy believed this infrastructure should be split 80% developer and 20% DDU.[66]

Based on the record, WBRG recommends that the amount of developer contributions be increased for both White Bluff and The Cliffs and that associated adjustments be made to DDU's return, and income tax expense. The Tables do not include the adjustments necessary to remove this property from the revenue requirement. These adjustments will depend on outcome of the developer-contribution issue.

Not Consistent with DDU's Stated Rationale

The split between developer and utility-contributed assets shown on Exhibits DDU-6C and 6D is not consistent with the split as described by DDU in discovery. In response to a discovery request regarding who installed infrastructure at White Bluff (WBRG 3-5), DDU stated:

> Utility infrastructure has been <u>installed</u> by Double Diamond Inc. (DDI), Double Diamond Properties Construction (DDPC) or Double Diamond Utilities (DDU) at various times. Before 1996, most all of infrastructure was constructed and paid for

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[61] Ex. DDU-3 at 10–12.

[62] White Bluff Asset Listing Applying 80% Theoretical Developer Contribution to Certain Assets, Double Diamond Utility Company, Inc. Ex. DDU-6C at 49.

[63] Ex. DDU-6C at 51.

[64] The Cliffs Asset Listing Applying 80% Theoretical Developer Contribution to Certain Assets, Double Diamond Utility Company, Inc. Ex. DDU-6D at 70.

[65] Tr. at 74:20–76:4 (Gracy Cross) (Oct. 24, 2017) ("Q: And so why was that not split 80/20 as the . . . distribution system was? A: I don't know.").

[66] Tr. at 222:21–25 (Joyce Cross) (Oct. 24, 2017).

> by DDI. DDPC and DDU were created in December 1996. In 1997, DDPC began paying for most of the infrastructure, and DDU paid for a few items. Payment for utility infrastructure is identified and itemized in the invoices whose bates numbers are referenced on the asset list previously produced. As of the 2007–2008 rate case before the Texas Commission on Environmental Quality, most of the initial utility infrastructure was completed, and DDU began paying for all utility assets and operations. The same contractors and employees worked for each entity that paid for the infrastructure.[67]

This response suggests that all of assets installed before 1997 should be treated as 100% developer-contributed, that 80% of assets constructed between 1997 and 2008 should be treated as developer-contributed, and that 100% of the assets built after 2008 should be treated as 100% utility-contributed. The 80/20 split shown by DDU in Exhibits DDU-6C and 6D is not consistent with its response to WBRG RFI 3-5. Moreover, the explanation given in response to WBRG RFI 3-5 is consistent with the fact that DDU did not exist until 1997.

Conclusion

DDU has failed to support its position that only 80% of the initial investment, and 0% of later investment came from its developer parent. For this reason, all of DDU's investment should be considered to be developer-contributed. Alternatively, as demonstrated by the record, all of the investment in DDU prior to December 1996 should be considered to be developer-contributed, and that 80% of the investment between 1996 and 2008 should be considered developer-contributed. At the very least, DDU should treat at least 80% of the initial investment in wastewater collection lines at White Bluff and The Cliffs as developer-contributed.

v. Rate Base: Used and Useful/Prudence

Based on the testimony presented in this case, WBRG asserts that the ratepayers at White Bluff and The Cliffs are paying for infrastructure (mostly pipes) that are either not used and useful, or that were imprudently constructed. The impact of this concern will be minimized if the ALJ agrees that all infrastructure was contributed by the developer, and if the effects of the inflation based on the trended original cost study are removed. Nevertheless, WBRG asserts that this is an issue that should be addressed by the Commission in this matter.

At the hearing, Mr. Gracy admitted that the White Bluff system was designed and built to

[67] Ex. WBRG-1M at WBRG000135 (emphasis added).

serve 6,314 lots.[68] The Cliffs system was built to serve 2,518 lots. The White Bluff system currently serves about 640 lots. The Cliffs serves only 287. Based on Dr. Harkins's study, there are approximately 65 miles of water line and 60 miles of sewer lines at White Bluff, and 23 miles of water and sewer lines at The Cliffs.[69]

According to the record, DDU installed more than $3.8 million (125 miles) of water and sewer lines at White Bluff and more than $1.25 million (46 miles) in water and sewer lines at The Cliffs to provide service to the entire subdivisions, both of which cover a large geographic area. Lines were constructed to all lots so that the developer could sell the lots, but only about 10% of the lots at both subdivisions are actually receiving service. The owners of these 10% are being asked to pay for 100% of the lines through return and depreciation (or through 20% of return and 100% of depreciation). By transferring these lines to the utility, the developer is able to shift the risk of not selling the lots from the developer to the utility and, consequently, to the ratepayers. This is an inequitable allocation of risk. Ten percent of the lots are essentially paying for the lines to provide service to 100% of the subdivision.

Neither the Commission, nor its predecessor, addressed how water and sewer rates should be structured to recognize the shift in risk and costs from the developer to the ratepayers. If the Commission were to find that 80% of the lines at White Bluff and The Cliffs are not "used and useful," this would reduce the amount of return and depreciation that the ratepayers would have to bear. As additional lots are connected to the system, the Commission could increase the amount of the system that is used and useful. Alternatively, the Commission could find that the extension of the lines to the entire subdivision was imprudent and disallow the excess lines from ratebase.

The only evidence offered by DDU regarding used and useful is in the testimony of Dr. Harkins, which contains an unsupported conclusion that "all are used and useful to the operations of their respective utility systems."[70] On cross-examination, however, Dr. Harkins admitted that she was not familiar enough with the systems to know if they were used and useful.[71]

Based on the record, WBRG recommends that all distribution and collection lines in both White Bluff and The Cliffs be found to be no more than 20% used and useful, and the value of

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[68] Ex. DDU-3 at 7.
[69] Ex. DDU-5 at 41, 50, and 52.
[70] Ex. DDU-5 at 10.
[71] Tr. at 197:9–14 (Harkins Cross) (Oct. 24, 2017).

the lines be reduced for purposes of determining return and depreciation. These recommendations are not reflected in Table 1 or 2 because of the adjustments made for developer-contributed assets and depreciation.

vi. Conclusion: Return on Invested Capital

DDU's return on invested capital should be $0. The record in this case, including Ms. Heddin's expert testimony, demonstrates that DDU's developer parent contributed all of DDU's invested capital. The developer committed to the property owners (ratepayers) that the developer would construct the utility system using funds generated through real estate sales. The developer treated the cost of the utility infrastructure as part of the cost of the lots. The developer also treated these utility assets as the developer's own assets in obtaining a $3,000,000 loan for the non-utility purposes. DDU provided no documentation that supports any other conclusion. As a result, WBRG recommends that 100% of the system assets be treated as developer contributions. Thus, return on rate base should be set at $0, resulting in $0 for income tax expenses. WBRG's recommended changes to DDU's revenue requirement are shown on Tables 1 and 2.

III. RATE OF RETURN

1. Return on Equity [PO Issue 8]

In its direct case, WBRG recommended a return on equity of 9.49%, which was based on WBRG's position that DDU's return on equity should be reduced to reflect the utility's poor performance on water accountability.[72] WBRG did not express an opinion on what DDU's unadjusted return on equity should be, but used the return on equity recommended by DDU in its direct case: 11.49%.

WBRG continues to advocate for an adjustment to DDU's return based on the amount of unaccounted-for water associated with the two systems that are the subject of this proceeding. DDU's application identifies DDU's unaccounted-for water at 50% for White Bluff[73] and 76% for The Cliffs.[74] In responses to discovery and during cross-examination, DDU and Mr. Gracy admitted that DDU has no formal infrastructure plan for the utility.[75] This level of unaccounted-

[72] Ex. WBRG-1 at WBRG000050–WBRG000051.
[73] Ex. DDU-2 at 58.
[74] Ex. DDU-1 at 58.
[75] Tr. at 106:18–107:1 (Gracy Cross) (Oct. 24, 2017).

for water is extremely high and has significant economic consequences for the ratepayers.[76] Either DDU's operating costs are higher than they need to be because of waste, or secretly-selected customers are being subsidized by receiving more water than is being metered. This result is unfair to the ratepayers. DDU is responsible for the losing the water, but wants the ratepayers to bear the costs.

Texas Water Code 13.184(b) states that the Commission, in fixing a reasonable return on invested capital, shall consider the "efforts and achievements of the utility in the conservation of resources, and the quality of the utility's management." The Legislature did not intend for this provision to only allow for increases in returns for those utilities that outperformed other utilities. The Commission should exercise its authority to adjust a utility's return on equity to provide an incentive for underperforming utilities to perform at an appropriate standard.

As recommended by Ms. Heddin, the Commission should reduce DDU's return on equity by 2% to reflect the lack of effort to conserve water resources, and to reflect DDU's management decision to refrain from actively working to reduce the level of unaccounted-for water. Rather than applying the reduction to DDU's recommended unadjusted return on equity (now at 11.90%), WBRG asserts that the adjustment be made to Staff's recommended unadjusted return on equity of 8.79%. This recommendation is not reflected on the Tables because WBRG is recommending that all of DDU's invested capital be recognized as developer-contributed.

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

As set out in its direct case, WBRG recommends that the cost of debt be set at 4.96%, which is the weighted average cost of outstanding DDD remaining debt balances as of December 27, 2015.[77] The short-term balloon note, issued by DDU with 6% interest rate, is inappropriate to use for this purpose. As set out in the Commission's application form, only long-term debt is appropriate to use for the purpose of determining a utility's cost of debt.[78] A two or three-year note is not long-term debt.

3. Capital Structure [PO Issue 7]

In its direct case, WBRG recommended the use of the capital structure proposed by DDU: 44.16% equity and 55.84% debt. This capital structure is based on DDD's capital

[76] Ex. WBRG-1 at WBRG000050.
[77] Ex. WBRG-1 at WBRG000049.
[78] Ex. DDU-2 at 30.

structure.[79] This would be an acceptable approach given that DDU has no balance sheet separate from its related companies, which makes it difficult if not impossible to determine the appropriate capital structure just for DDU. Based on the testimony at the hearing, however, WBRG now recommends that DDU's capital structure be set at 0% equity and 100% debt.

This recommendation is based on the disclosures by DDU as to the use of the $3,000,000 proceeds from the short-term loan to DDU that was used by DDD for non-utility purposes. As explained by Mr. Scheig at the hearing on the merits, when a utility takes out a loan and provides those funds to its shareholders, that is considered a dividend, and when the utility pays a dividend, that reduces the amount of equity that the shareholders have in the utility.[80] Based on DDU's application, DDD (the shareholder) had $1,616,213 in equity capital in DDU during the test year.[81] When DDU paid a $3 million dividend to DDD, DDD took $3 million in equity out of DDU. Because $3 million is greater than $1.6 million,[82] DDD effectively removed all of its equity in DDU. DDU's capital structure needs to reflect this fact. WBRG recommends that the capital structure used to determine the overall rate of return be 0% equity and 100% debt. This recommendation is not reflected on the Tables because WBRG is recommending that all of DDU's invested capital be recognized as developer-contributed.

4. Overall Rate of Return [PO Issue 8]

To the extent that the ALJ decides that DDU has any invested capital for which a return is required, WBRG recommends that the overall rate of return be set at 4.96% reflecting DDU's imputed cost of debt. This recommendation is not reflected on the Tables because WBRG is recommending that all of DDU's invested capital be recognized as developer-contributed.

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

WBRG has no position on this topic.

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79 Ex. DDU-6 at 15.
80 Tr. at 424:20–425:21 (Scheig Cross) (Oct. 24, 2017).
81 See Ex DDU-1 at 30 (The Cliffs equity = $488,015); Ex. DDU-2 at 30 (White Bluff equity = $1,128,198).
82 And almost greater than the total capitalization of DDU.

V. RATE CASE EXPENSES [PO ISSUE 38]

WBRG recommends, for the purpose of determining whether DDU should be granted rate case expenses, that the originally-submitted revenue requirements should be utilized for both White Bluff and The Cliffs.

DDU initially submitted an erroneous application that included misrepresentations of rate base from the previous rate case as well as developer contributions on August 1, 2016. DDU later submitted a revised application making corrections for these issues, which were identified by WBRG. For the purpose of assessing whether rate case expenses should be allowed, the revenue requirements that were initially submitted should be used for measurement. These errors were made by DDU; ratepayers should not pay the price for DDU's misrepresentations and inaccuracies. These misrepresentations were material, and had the ratepayers not protested, could have resulted in customers paying higher fees that were not justified. The errors pointed out by the ratepayers prior to the hearing on the merits or submittal of testimony resulted in a reduction of the water revenue requirements by 42%, without any of the disallowances recommended by WBRG.[83]

INTERIM RATES AND EFFECTIVE DATE [PO ISSUES 39, 40, 41]

WBRG has no position on this topic at this time

VI. 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.

VII. CONCLUSION

For the reasons discussed above, White Bluff Ratepayers Group respectfully requests that the presiding officer issue a proposal for decision that adopts WBRG's recommendations. WBRG's recommended revenue requirements for White Bluff and The Cliffs are shown on the attached Tables 1 and 2.

[83] Ex. WBRG-1 at WBRG000055.

TABLE 1

WBRG'S REVENUE REQUIREMENT RECOMMENDATION
WHITE BLUFF

	Water	Wastewater
Total Operating Expense	$294,813	$277,819
Less Salaries Adjustment	(415)	(20,472)
Less Regulatory Fees	(22,047)	-
Less Prof Exp Adjustment	(2,907)	
Total Allowable Operating Expense	$269,444	$257,347
Annual Depreciation Expense	$110,077	$84,700
Less K&M Adjustment	(31,272)	(14,884)
Less Adjustment for Trending Error	(Included in K&M)	(Included in K&M)
Less Fully Depreciated Assets	(122)	(49)
Total Depreciation Expense	$78,683	$69,767
Taxes Other than Income	$64,171	$58,106
Return on Investment	$86,485	$128,724
Less 100% Developer Contributions	(86,485)	(128,724)
Total Return	$-	$-
Income Tax Expense	$18,378	$27,354
Less 100% Developer Contributions	(18,378)	(27,354)
Total Income Tax Expense	$-	$-
Total Revenue Requirement	$412,298	$385,220
Application Revenue Requirement	$573,923	$576,704
Test Year Revenues	$473,455	$390,030
Actual Revenue Over/(Under)	$61,157	$4,180

TABLE 2

WBRG'S REVENUE REQUIREMENT RECOMMENDATION
THE CLIFFS

WBRG Revenue Requirement Recommendation The Cliffs	Water	Wastewater
Total Operating Expense	$286,150	$230,581
Annual Depreciation Expense	$78,443	$29,263
Less K&M Adjustment	(32,620)	
Total Depreciation Expense	$45,823	$29,263
Taxes Other than Income	$10,545	$9,970
Return on Investment	$48,301	$44,790
Less 100% Developer Contributions	(48,301)	(44,790)
Total Return	$-	$-
Income Tax Expense	$5,576	$5,171
Less 100% Developer Contributions	(5,576)	(5,171)
Total Income Tax Expense	$-	$-
Total Revenue Requirement	$342,518	$269,814
Application Revenue Requirement	$426,113	$317,357
Test Year Revenues	$332,031	$205,300
Actual Revenue Over/(Under)	$(10,487)	$(64,514)

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CERTIFICATE OF SERVICE

I certify that a copy of the foregoing pleading was served on all parties of record in this proceeding on November 22, 2017, by hand-delivery, facsimile, electronic mail, and/or First Class Mail.

C. Joe Freeland