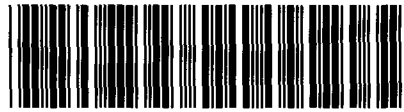

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APPLICATION OF DOUBLE DIAMOND UTILITY COMPANY, INC. FOR WATER AND SEWER RATE/TARIFF CHANGE	§ § § §	**BEFORE THE STATE OFFICES OF ADMINISTRATIVE HEARINGS**

COMMISSION STAFF'S REPLY BRIEF

Respectfully submitted,

PUBLIC UTILITY COMMISSION OF TEXAS
LEGAL DIVISION

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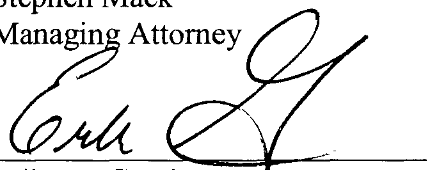

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Dated: December 15, 2017

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COMES NOW the Staff (Staff) of the Public Utility Commission of Texas (Commission), representing the public interest, and files this Reply Brief. Pursuant to State Office of Administrative Hearings (SOAH) Order No. 10, issued July 27, 2017, the deadline for reply briefs is December 15, 2017. Therefore, Staff's Reply Brief is timely filed. In support of its Reply Brief, Staff states the following:

I. INTRODUCTION AND SUMMARY

The initial brief filed by Double Diamond Utility Company, Inc. (DDU)[1] largely fails to rebut the revenue adjustments, depreciation, and return on equity established by Staff through prefiled testimony and at the hearing on the merits.[2] In particular, DDU's arguments regarding the recovery of non-utility costs as allowable expenses and its proposal to treat certain utility plant capital costs as expenses rather than assets should be denied, as they are inconsistent with public policy, Commission precedent, and the Texas Water Code. Staff addresses these, and other adjustments to DDU's operating expenses below.

Staff also commends the pro se representative for The Cliffs Utility Company (TCUC) on a well-organized and thoughtful initial brief.[3] Staff notes, however, that the documents attached to TCUC's initial brief and labeled as Exhibits 16, 17, 18, 19, 20, and 22[4] were not entered as exhibits at the hearing on the merits, contain potentially objectionable information, and are not part of the record in this case.

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[1] Double Diamond Utility Company, Inc.'s Initial Brief (Nov. 22, 2017) (DDU's Initial Brief).

[2] Commission Staff's Initial Brief (Nov. 22, 2017) (Staff's Initial Brief).

[3] TCUC's Initial Brief /Closing Arguments (Nov. 22, 2017).

[4] Staff expresses no objection to the attachment and consideration of Exhibit 15, which appears to be a demonstrative of information compiled from items in the record, and Exhibit 21 which is a Texas Commission on Environmental Quality Order.

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

Staff continues to recommend adjustments to DDU's revenue requirement as set forth in its initial brief, and in the below sections.

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

No reply.

1. White Bluff

a. Other Revenues

No reply.

b. Other Volume Related Expenses

No reply.

c. Employee Labor

DDU's argument that Staff's recommended reallocation of employee labor expenses between White Bluff water and sewer "results in the water customers subsidizing the employee labor expense for the sewer system"[5] overlooks the rationale supporting the reallocation, which is based on the Commission's rule regarding allowable expenses. The rule limits the types of expenses that may be included in a utility's cost of service to expenses that are "reasonable and necessary *to provide service to the ratepayers*."[6] In addition, Staff witness Emily Sears testified that determining whether an employee salary is reasonable and necessary requires the consideration of factors like job duties related to the utility and time spent performing each duty.[7] Clearly, the goal is to ensure that the amount of time an employee spends working on a system (aka providing service to the ratepayers) is reflected in the amount of that employee's salary allocated to the system.

With one exception, the salaries of all DDU employees are allocated 50-50 between water and sewer,[8] but DDU has not provided any evidence to support how much time each

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[5] DDU's Initial Brief at 10 of 32.

[6] 16 Tex. Admin. Code § 24.31(b) (TAC) (emphasis added).

[7] Tr. at 400:21-401:1 (Sears Redirect) (Oct. 25, 2017).

[8] Workpapers of Emily Sears, Staff Ex. 2A at ES Workpaper 5.

employee spends working on each system.[9] Instead, DDU repeatedly points to the general statement of DDU witness Randy Gracy that all employees are cross-trained to work on both utilities.[10] Absent more detailed information, Ms. Sears based her recommendation on the evidence contained in the record. For example, DDU allocated the salary of Clovis Wilhelm 25-75 in favor of sewer.[11] Ms. Sears recommended allocating 100% of Mr. Wilhelm's salary to sewer,[12] which is appropriate because Mr. Wilhelm's job title is "Waste Water Treatment Operator," he holds only a wastewater operator's license, and all of his job duties are related to the sewer system.[13] Ms. Sears also recommended allocating 100% of the salaries of Jody Bledsoe and Dwayne Cota to water based on the type of license held by each employee.[14]

DDU also mischaracterizes Ms. Sears' testimony stating that she, "insists that the full employee labor cost for [Jerry Whitworth and Danny Keeton] should be excluded and recovered through tap fees."[15] Ms. Sears did recommend removing the salaries for these two employees from the employee labor expenses requested by DDU,[16] and she argued that the tap fees include labor costs, which was corroborated by DDU witness Jay Joyce.[17] However, when directly asked if the $615 in labor costs DDU collected for the seven tap fee installations performed during the test year was, "enough money to employ two people to work on the utility for an entire year," she answered as follows:

> It is my belief, based on the information provided by Double Diamond Utilities, that the only job that they have is to install taps, minus the other duties as assigned. If 99 percent of their job duties are other job duties as assigned, then there should have been an

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[9] As Staff noted in its initial brief, the work orders (DDU00477-005638 produced in response to RFI 1-32 from the Whitebluff Ratepayers' Group) cited to by Mr. Gracy in support of his statement about cross-training were not attached to his rebuttal testimony or offered as an exhibit during the hearing. *See* Rebuttal Testimony of Randy Gracy, Ex. DDU-8 at 4 of 155.

[10] Ex. DDU-8 at 4 of 155; DDU's Initial Brief at 9 of 32.

[11] Staff Ex. 2A at ES Workpaper 5, 7.

[12] Direct Testimony of Emily Sears, Staff Ex. 2 at 12-13.

[13] Staff Ex. 2A at ES Workpaper 5.

[14] Staff Ex. 2 at 13; *see also* Tr. at 401:6-14 (Sears Redirect) (Oct. 25, 2017).

[15] DDU's Initial Brief at 10 of 32.

[16] Staff Ex. 2 at 12.

[17] *Id.*; Rebuttal Testimony of Jay Joyce, Ex. DDU-11 at 4-5 of 106.

> explanation in response to Staff RFI 1-1 detailing those job duties.[18]

Her testimony clearly conveys that DDU did not meet its burden to establish what duties these employees spend 99% of their time on;[19] Ms. Sears' testimony is silent as to whether their salaries should be recovered through tap fees.

DDU argues that "the record does not reflect the facts to be consistent with [Ms. Sears'] belief," that installing taps and other duties as assigned are the only jobs performed by Mr. Whitworth and Mr. Keeton."[20] Yet, that is exactly what the record reflects. First, the job description provided by DDU only mentions two categories of tasks: those related to tap installations and "other duties as needed."[21] Second, the only additional information DDU provided on rebuttal regarding the job duties of Mr. Keeton and Mr. Whitworth were seven work orders related to tap installations.[22] Third, Mr. Gracy's blanket statement that all employees are crosstrained to work on both systems[23] does not provide any explanation as to what specific tasks comprise the "other duties as needed" and whether these tasks require the operation of a backhoe. Finally, the record does not contain any work orders, time sheets, or other evidence that would explain how these employees spend 99% of their time.[24]

DDU has not carried its burden to show that the salaries for the positions held by Mr. Whitworth and Mr. Keeton are a reasonable and necessary expense because, aside from tap installations, it has not shown how they contribute to providing water and sewer service to its customers. DDU has also failed to carry its burden to show that the 50-50 allocation of employee salaries reflects the actual time each employee spends working on each system. Therefore,

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[18] Tr. at 338:15-24 (Sears Cross) (Oct. 25, 2017).

[19] *Id.* at 402:8-16, 403:1-4 (Sears Re-Cross) (Oct. 25, 2017); *see also* Tr. at 462:15-463:19 (Judge Bell ruling on objection by Staff) (Oct. 26, 2017) ("As I recall, what she testified was that the taps were only 1 percent of what those people did and 99 percent of what they did was something else, other duties as assigned, but that in response—her position was, in response to discovery requests and in Mr. Gracy's rebuttal testimony, there wasn't any additional information given to her about what those other duties were.").

[20] DDU's Initial Brief at 10 of 32.

[21] Staff Ex. 2A at ES Workpaper 6.

[22] Ex. DDU-8 at 4 of 155.

[23] *Id.*

[24] Tr. at 400:7-13 (Sears Redirect) (Oct. 25, 2017).

Staff's recommended reallocations and deductions from the employee labor expense should be adopted.

d. Contract Work

As Staff demonstrated in its initial brief, DDU is unable to account for what portion of cell phone usage by the utility manager is attributable to utility business, and what portion is personal use.[25] DDU does not dispute that it cannot account for personal use, but argues that the total cost of the cell phone is properly included as an expense because the utility manager is always on-call and must have a cell phone at all times in order to respond to potential issues.[26] Some portion of the cell phone is a reasonable and necessary expense; however, since DDU is unable to provide information on how that cell phone is used,[27] it is appropriate to reduce the phone allowance by 50% to account for personal use that should not be paid for by DDU's ratepayers.[28]

e. Transportation Expenses

DDU's initial brief fails to show that the requested transportation expenses do not include personal commuting miles and ignores the Commission's decision in Docket No. 45720; therefore, its argument should be rejected. DDU challenges Ms. Sears' position that "it is not an allowable expense to have an on-call vehicle at home if there is not a call that is responded to."[29] DDU argues that Ms. Sears has no experience with the on-call demands of utility employees.[30] However, DDU has provided no evidence in this proceeding as to what types of calls on-call employees responded to, the frequency of such calls, or how many of those calls occurred after normal utility business hours during the test year. The on-call demands of DDU employees is not at issue in this case; only whether transportation expenses related to personal use of a utility vehicle are recoverable from ratepayers.

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[25] Staff's Initial Brief at 11-12 of 41.

[26] *See* DDU's Initial Brief at 11 of 32.

[27] *See* 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").

[28] Staff's Initial Brief at 12 of 41; Staff Ex. 2 at 15.

[29] DDU's Initial Brief at 12 of 32.

[30] *Id.*

DDU further claims that "the Commission has never taken such a position, and should not take the position asserted by Ms. Sears on this issue."[31] However, in Docket No. 45720,[32] the only fully litigated water rate case to be considered by this Commission, the utility included in its requested transportation expenses those vehicle costs associated with a utility employee's commute from her home to the utility office.[33] The Commission held that such expenses were unreasonable and unnecessary,[34] as "the recovery of commuter miles is generally not permitted as a utility expense."[35] Therefore, Ms. Sears' position that the transportation 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 is in fact consistent with a prior Commission decision.

DDU also argues that its response to Staff RFI 1-14 demonstrates that "there is no personal use of DDU vehicles, and that the vehicles are used 100% for utility purposes."[36] However, DDU's response of "0" to the question asking what amount of time utility vehicles are used for personal use does not negate the fact that the response also states that one truck is driven by the utility manager "***daily to and from work.***"[37] Another truck is used by an employee designated to be on call, and during the time that the employee is on call it is "used to drive to and from work."[38] Unless the utility manager is responding to a call, his daily drive back and forth from home to work represents personal commuting miles, which the Commission has held are not to be included in a utility's cost of service. Similarly, if the employee on call uses the truck for his commute while on call, those expenses also must be excluded. As stated in Staff's initial brief, the portion of the vehicle expenses incurred while the vehicle is being used for utility business and taken out on a service call would be recoverable; however, no sufficient documentation has been provided in this proceeding to enable Staff to separate out what portion

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[31] *Id.*

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

[33] *Id.* at 5 of 20.

[34] *Id.* at Finding of Fact No. 21, 13 of 20 ("Rio Concho's requested transportation expenses included commuting costs, which are unreasonable and unnecessary.").

[35] *Id.* at 5 of 20 (Jun. 29, 2017)..

[36] DDU's Initial Brief at 12 of 32.

[37] DDU Response to Staff RFI 1-14, DDU Ex. 15.

[38] *Id.*

of the requested expenses are related to service calls, and what portion are related to daily employee commuting miles.[39]

f. Other Plant Maintenance

DDU argument that the $709 Staff removed from the expenses for other plant maintenance were "shown on the detailed trial balance as having occurred during the test year and being related to repair and maintenance of the water system"[40] fails to address the fact that these expenses were not supported by receipts or invoices.[41] DDU had the opportunity to provide supporting documentation on rebuttal and failed to do so. Accordingly, these expenses should be removed.

Relying on the testimony of Victoria Harkins, DDU also asserts that three invoices totaling $4,386.29 should not be reclassified to the depreciation schedule for the White Bluff sewer system.[42] Staff's recommendation that two of these expenses—$2,252 for "machine work on pump, repair bearing, and seals" and $1,599.33 for "service and parts for motor and repair at crimp connection"—should be capitalized is consistent with DDU's capitalization policy.[43] The invoices 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.[44] Furthermore, Dr. Harkins admitted that she did not review the capitalization policy.[45] Thus, the $3,851.33 reclassification of two of these invoices as recommended by Staff is appropriate and should be adopted.

DDU asserts that the grinder pump expenses incurred by DDU at White Bluff should be classified as recurring expenses.[46] DDU attempts to discredit Ms. Sears' recommendation to reclassify test year grinder pumps costs to the White Bluff sewer depreciation schedule by arguing that she "doesn't know how to operate or maintain grinder pumps or know about the

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[39] Staff's Initial Brief at 12-13 of 41.

[40] DDU's Initial Brief at 13 of 32.

[41] Staff Ex. 2 at 17.

[42] DDU's Initial Brief at 13 of 32.

[43] DDU Response to Staff RFI 1-26, Staff Ex. 6 at DDU16-015961; Rebuttal Testimony of Victoria Harkins, Ex. DDU-9 at 4-5 of 527.

[44] *See* Staff Ex. 6 at DDU16-015961.

[45] Tr. at 4923:2-8 (Harkins Cross) (Oct. 26, 2017).

[46] DDU's Initial Brief at 14 of 32.

operational problems or service life of those grinder pump [*sic*], and she has never designed a system with grinder pumps."[47] Ms. Sears' role in this case was to review the information provided in this proceeding, and present a recommendation as to the appropriate revenue requirement for DDU.[48] Whether or not Ms. Sears knows how to operate or maintain a grinder pump, or has designed a sewer system with grinder pumps, has absolutely no relevance to her role in this case. Further, it is somewhat misleading to assert that Ms. Sears does not know about the service life of grinder pumps. In her direct testimony, Ms. Sears stated that grinder pumps have a service life of longer than one year.[49] And on cross-examination, while she stated that she did not "know" the service life of a grinder pump, she correctly stated that service life when she answered "I believe it's 10 years."[50] DDU makes a similar argument as to Staff witness Jolie Mathis,[51] which again is not relevant to her role here. Ms. Sears reviewed expense items in this case, and when she identified an item that in her expert opinion was properly reclassified as an asset on the depreciation schedule, she provided that recommendation to Ms. Mathis.[52] If Ms. Mathis concurred, that item was then added to the depreciation schedules prepared by Ms. Mathis.[53]

While focusing on whether Staff's witnesses have ever operated, maintained, or designed grinder pump systems, DDU fails to provide a convincing basis for why grinder pumps, as utility plant with service lives of longer than one year, are not assets. Even though DDU has treated grinder pump costs as expenses in the past,[54] it is appropriate to begin treating them as assets to be included in rate base for DDU in this case. Accordingly, Staff recommends that grinder pumps are utility plant, with service lives of ten years, and are properly capitalized.[55]

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[47] *Id.*

[48] *See* Staff Ex. 2 at 4.

[49] Staff Ex. 2 at 18.

[50] Tr. at 344:3-7 (Sears Cross) (Oct. 25, 2017).

[51] *See* DDU's Initial Brief at 14 of 32.

[52] Tr. at 343:8-15 (Sears Cross) (Oct. 25, 2017).

[53] *See id.* at 313:4-10, 314:1-6 (Mathis Cross) (Oct. 25, 2017).

[54] *Id.* at 473:5-16 (Gracy Rebuttal Cross) (Oct. 26, 2017).

[55] Staff's Initial Brief at 22 of 41.

g. Professional Services

DDU indicates in its initial brief that it agrees with Staff's proposed "three-year amortization of the wastewater permit renewal costs as a recurring expense related to White Bluff Sewer."[56] Staff again clarifies that it has not recommended that the cost of the wastewater permit renewal be amortized, but has recommended that it is appropriate to treat the cost as an expense and to **normalize** this expense amount over three years.[57]

In rebuttal, DDU witnesses Mr. Joyce and Dr. Harkins both recommended that the cost of the Certificate of Convenience and Necessity (CCN) amendment should be treated as an asset and included on the depreciation schedule.[58] However, in its initial brief, DDU now recommends that the cost of the CCN amendment should be treated as an expense and included in the Cliff's revenue requirement.[59] Staff agrees that the cost of a CCN amendment is an expense, and not a depreciable asset.[60] However, as Staff witness Ms. Sears testified, this cost is not a recurring expense.[61] Therefore, DDU should not be permitted to recover this expense in its rates every year when it is unclear how often it will file a CCN amendment and incur such a cost.[62]

h. Insurance Expenses

For the reasons set forth in Staff's initial brief, Staff continues to recommend that the entire umbrella policy premium be removed.[63] DDU's initial brief provides no further argument on the issue of the umbrella policy premium beyond that contained in Mr. Joyce's rebuttal, and additionally provides no clarification for Mr. Joyce's flawed calculation which purports to separate out the Spa & Ski portion of the umbrella policy premium.[64] Staff also notes that DDU asserts that the amount of the Spa & Ski premium is $3,100.[65] This amount is in fact the base

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[56] DDU's Initial Brief at 16 of 32.

[57] Staff's Initial Brief at 15 of 41.

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

[59] DDU's Initial Brief at 16 of 32.

[60] Staff's Initial Brief at 16 of 41.

[61] Staff Ex. 2 at 19.

[62] Staff's Initial Brief at 16 of 41.

[63] *Id.* at 17-18 of 41.

[64] DDU's Initial Brief at 15-16 of 32.

[65] *Id.* at 16 of 32.

policy premium associated with "Spa Errors & Omissions" and does not include Ski coverage at all;[66] further detracting from the accuracy of Mr. Joyce's proposed calculation.

i. Regulatory Expenses

DDU's initial brief addresses Staff's adjustments to costs related to a CCN amendment and a wastewater permit renewal in its "Regulatory Expense" section.[67] Staff's replies to these issues are contained the above section II(A)(1)(g).

DDU's initial brief does not address Staff's recommendation to normalize water test expenses for those water tests that are only required every three years. Staff continues to recommend the normalization of these expenses.[68]

Staff and DDU agree that the regulatory fee paid to Prairieland Groundwater Conservation District is properly treated as a pass-through and added to DDU's tariff, and that the amount of $22,047 should be removed from DDU's requested revenue requirement.[69] White Bluff Ratepayer's Group (WBRG) recommends that the regulatory fees should be disallowed from DDU's revenue requirement.[70] To the extent that WBRG's recommendation is consistent with Staff and DDU's proposed treatment of the regulatory fee, it appears that this issue is not contested. However, if WBRG's recommendation is to disallow the recovery of the $22,047 entirely, even as a pass through fee, this recommendation should be rejected. WBRG notes that DDU did not offer its current tariff into the record, or any proof that any currently existing "rider" to recover this regulatory fee will no longer apply.[71] DDU will be required to prepare a revised tariff at the conclusion of this case, and Staff recommends that at that time DDU include a pass-through provision for Prairieland Groundwater Conservation District fees.

j. Miscellaneous Expenses

Staff continues to recommend its adjustments to allocated overhead and allocated G&A expenses.[72] In its initial brief, DDU makes a general claim that the "allocated overhead expenses

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[66] Staff Ex. 2A at ES Workpaper 88.

[67] DDU's Initial Brief at 16 of 32.

[68] Staff's Initial Brief at 18-19 of 41.

[69] Staff Ex. 2 at 21; Tr. at 513:15-514:4 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

[70] Initial Brief of White Bluff Ratepayer's Group at 5 (Nov. 22, 2017) (WBRG's Initial Brief).

[71] *Id.* at 5.

[72] Staff's Initial Brief at 19 of 41; Staff Ex. 2 at 23.

are *reasonable* and *required* for the local operation of the White Bluff utility systems."[73] However, DDU's own witness, and the president of utility, admitted that there are expenses in the allocation that are not related to the operation of the utility.[74] It is clear that expenses such as advertising for the resort, uniforms for resort employees, and commissions/bonuses for resort employees, expenses which no party disputes are included in this three percent of total resort expenses allocated to DDU,[75] are not at all "reasonable" or "required" for the operation of the White Bluff systems. Mr. Gracy's testimony that "there's going to be costs in there and certain categories that are going to be less than they should be . . . and then inadvertently you're going to see these other expenses that we don't need to carry over" acknowledges that the method by which the resort allocates costs to DDU does not match the actual expenses incurred by the utility.[76] However, DDU believes that this allocation of non-utility expenses is permissible because the "average ends up being 3 percent [of the resort's $400,000 budget]"[77] and because it asserts that $12,000 is a "fair share"[78] for just the office space that the utility occupies in the resort. However, the resort is not charging the utility $12,000 in office rent. Instead, it is allocating a flat percentage of all expenses incurred by the resort to the utility, regardless of whether the utility uses or benefits from those expenses. 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; therefore, it is only appropriate to allocate those resort expenses to the utility and its ratepayers which are actually reasonable and necessary to White Bluff's provision of service.

Other resort expenses, such as office supplies and computer expenses, are items that could be reasonable and necessary expenses for the utility. However, these expenses should not be allocated to the utility in this case, as those same type of expenses have already been included separately in White Bluff's cost of service.[79] Similarly, it is not appropriate to allocate a portion

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[73] DDU's Initial Brief at 17 of 32 (emphasis added).

[74] Tr. at 475:10 (Gracy Rebuttal Cross) (Oct. 26, 2017).

[75] *Id.* at 330:6-8 (Sears Cross) (Oct. 25, 2017); Staff Ex. 2 at 22.

[76] *Id.* at 476:23-477:2 (Gracy Rebuttal Cross) (Oct. 26, 2017).

[77] *Id.* at 477:1-2 (Gracy Rebuttal Cross) (Oct. 26, 2017).

[78] *Id.* at 466:11-12 (Gracy Live Supplemental Rebuttal) (Oct. 26, 2017).

[79] Staff's Initial Brief at 20 of 41; *see* Staff Ex. 2 at 22 ("DDU further allocated resources such as commission/bonuses, employee compensation, payroll burden, electricity, water and sewer, uniforms, small tools,

of the resort's general manager's salary to White Bluff, as the utility employs its own full time utility manager who supervises utility employees.[80] For these reasons, Staff's recommended adjustments to allocated resort overhead and G&A expenses should be adopted.

2. The Cliffs

a. Transportation Expenses

Staff no longer recommends this adjustment.

b. Miscellaneous Expenses

Staff's reply is the same as that set forth in the above section II(A)(1)(j).

B. Depreciation [PO Issues 12, 27]

As discussed in more detail above in section II(A)(1)(f), Staff continues to recommend that grinder pumps are utility plant, and not expenses, which are properly capitalized and included on the White Bluff sewer depreciation schedule.[81]

C. Taxes [PO Issues 12, 27]

1. Federal Income Tax Expense [PO Issue 30]

DDU incorrectly asserts that, "no party dispute [*sic*] the methodology for calculating federal income tax used by DDU."[82] The schedules attached to the direct testimony of Staff witnesses Ms. Sears and Jonathan Ramirez show a side-by-side comparison of the federal income tax calculations performed by Staff and DDU.[83] All of Staff's calculations use the actual tax rate based on DDU's total taxable income and then adjust for the surtax exemption, while

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cleaning supplies, etc. DDU, however, has already included these exact expenses in its own cost of service."); *see also* Tr. at 330:24-331:9.

[80] Staff's Initial Brief at 20 of 41.

[81] *Id.* at 22 of 41.

[82] DDU's Initial Brief at 19 of 32.

[83] Staff Ex. 2 at Attachment ES-3, Staff Schedule V (White Bluff Water Federal Income Taxes) and Attachment ES-4, Staff Schedule V (White Bluff Sewer Federal Income Taxes); Direct Testimony of Jonathan Ramirez, Staff Ex. 3 at Attachment JR-2, Staff Schedule V (The Cliffs Water Federal Income Taxes) and Attachment JR-3, Staff Schedule V (The Cliffs Sewer Federal Income Taxes).

DDU's calculations apply the effective tax rate.[84] However, as explained in Staff's initial brief, Staff's recommended adjustment to DDU's federal income tax expense is mainly attributable to the differences between the cost of service requested by DDU and the adjusted cost of service recommended by Staff.[85]

2. Other Assessments and Taxes [PO Issue 29]

No reply.

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

No reply.

1. Plant in Service – Original Cost

No reply.

2. Accumulated Depreciation

Staff's replies regarding accumulated depreciation related to grinder pumps are contained above in sections II(A)(1)(f) and II(B).

3. Cash Working Capital

As demonstrated in Staff's initial brief, the proper cash working capital for both White Bluff and the Cliffs is 1/12th of each system's operations and maintenance expenses.[86] In its initial brief, DDU states that it has proposed a cash working capital allowance of "1/12th of annual revenues."[87] However, this assertion contradicts DDU's request for a cash working capital allowance of 1/8th of operations and maintenance expenses for the Cliffs as contained in DDU witness Mr. Joyce's direct testimony.[88] If DDU has conceded that 1/12th is the correct ratio for calculating the Cliffs' cash working capital allowance, then this issue is no longer contested.

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[84] *See, e.g.* Staff Ex. 2 at Attachment ES-3, Staff Schedule V (White Bluff Water Federal Income Taxes) (showing DDU applying a 26% tax rate and Staff applying a 39% tax rate and deducting $27,459 for the surtax exemption).

[85] Staff's Initial Brief at 24-25 of 41.

[86] *Id.* at 28 of 41.

[87] DDU's Initial Brief at 21 of 32.

[88] Direct Testimony of Jay Joyce, Ex. DDU-6 at 12 of 89.

If it has not, then Staff continues to recommend a $1/12^{th}$ ratio for the Cliffs for the reasons set forth in its initial brief.[89]

4. Developer Contribution

No reply.

5. Accumulated Deferred Federal Income Tax (ADFIT)

DDU makes three assertions in its initial brief about Staff witness Debi Loockerman's recommended deductions from invested capital for ADFIT—all of which are either inaccurate or unsupported. First, it argues that depreciation on developer-contributed assets should not be included when calculating ADFIT.[90] Staff agrees that developer-contributed assets do not generate a return on investment because they are paid for by the developer, not the utility. Nevertheless, DDU's ratepayers are still paying for these assets because Commission rules allow for their inclusion in the cost of service as part of the depreciation expense.[91] Accordingly, the ratepayers should get the related benefit of the ADFIT deduction, which is directly attributable to depreciation expense.

Second, DDU's initial brief claims that Ms. Loockerman makes "substantive mathematical errors."[92] This statement is taken verbatim from the rebuttal testimony of Mr. Joyce.[93] Yet, neither the brief nor Mr. Joyce's rebuttal testimony provides an explanation of what these alleged errors are. On cross, the questions DDU asked Ms. Loockerman about her calculations were related to her treatment of developer-contributed assets and the tax rate she applied.[94] The issues related to developer contributions are addressed above, and the tax rate cannot be the source of the alleged errors because Mr. Joyce applied the same tax rate in his

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[89] Staff's Initial Brief at 28 of 40.

[90] DDU's Initial Brief at 20 of 32.

[91] Tr. at 266:7-13 (Loockerman Cross) (Oct. 25, 2017); 16 TAC § 24.31(b)(1)(B) (excluding only property provided by explicit customer agreements or funded by customer contributions in aid of construction from the depreciation expense).

[92] DDU's Initial Brief at 20 of 32.

[93] *Compare* DDU's Initial Brief at 20 of 32, *with*, Ex. DDU-11 at 15 of 106.

[94] Tr. at 264:7-9, 265:7-266:20 (Loockerman Cross) (Oct. 25, 2017).

"corrected" Staff schedules.[95] Therefore, DDU has failed to show that any errors exist in Ms. Loockerman's calculations, and this assertion should be disregarded.

Third, DDU argues that Ms. Loockerman's calculation fails to take into account net operating losses (NOLs).[96] As demonstrated in Staff's initial brief, the normalization rules do not apply because DDU's parent company is an S-corporation that will never pay federal income taxes.[97] Moreover, it is the shareholders who incur the tax consequences of a NOL because they ultimately pay the federal income taxes due,[98] and the record does not contain any evidence showing that any shareholder experienced a net NOL for tax purposes. Furthermore, Mr. Joyce's testimony only provides his *estimate* of the effect of a NOL would have on Ms. Loockerman's recommendation without any explanation as to the basis for his estimate.[99]

DDU's conclusion that the combined result of the three issues it identified should be to cut Ms. Loockerman's recommended deduction for ADFIT in half should be disregarded.[100] First, as detailed above, DDU's identified issues with Ms. Loockerman's calculation are without merit. Furthermore, DDU witness Mr. Joyce made it clear at the hearing on the merits that his recommended 50% reduction to Ms. Loockerman's recommendation was intended only to address his observations regarding NOLs.[101] For example, when asked if his rebuttal testimony included a specific amount for NOLs he stated that he took his recommended ADFIT deduction for White Bluff Water ($118,945.89) and "divide[d] that in two."[102] DDU's attempt to expand this recommendation as necessary on other grounds is without merit because it directly contradicts the testimony of its own witness.

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[95] Ex. DDU-11 at 66, 68, 71-72 of 106.

[96] DDU's Initial Brief at 20 of 32.

[97] Tr. at 80:1-7 (Gracy Direct Cross) (Oct. 24, 2017).

[98] Direct Testimony of Debi Loockerman, Staff Ex. 1 at 4.

[99] Tr. at 539:24–540:2 (Joyce Rebuttal Cross) (Oct. 26, 2017).

[100] DDU's Initial Brief at 20 of 32.

[101] Tr. at 539:6-8 (Joyce Rebuttal Cross) (Oct. 26, 2017).

[102] *Id.* at 539:1-12 (Joyce Rebuttal Cross) (Oct. 26, 2017).

III. RATE OF RETURN

A. Return on Equity [PO Issue 8]

As demonstrated in Staff's initial brief, the appropriate rate of return on equity (ROE) for DDU is 8.79%, which was calculated by Staff witness Ms. Sears using a Discounted Cash Flow (DCF) methodology and a Capital Asset Pricing Model (CAPM) methodology, applied to a proxy group of utilities comparable to DDU.[103] DDU's proposed ROE of 11.49% was calculated using a simplified formula provided as one of two methods for determining ROE contained in the Class B Rate Change Application Instructions.[104] In rebuttal, DDU sought to bolster its request by then utilizing the second method permitted in the Class B Rate Change Application Instructions, and filing the written testimony of Gregory Scheig, who conducted various more complex analyses for estimating the cost of equity.[105] The ROE proposed by DDU is significantly higher than any ROE that has been set by the Commission for an electric or water utility, and should be rejected.

DDU asserts that Mr. Scheig's opinion is supported by "multiple supporting analyses, which consider the appropriate [ROE] from various perspectives," while the basis for Ms. Sears' opinion is more limited and only includes the DCF and CAPM.[106] While Mr. Scheig does employ additional methods in estimating the appropriate cost of equity for DDU, the methods relied on by Ms. Sears are widely accepted by both the regulatory industry and the Commission. The DCF was the sole methodology used by Staff to calculate its proposed ROE in Docket No. 45720, which was then adopted by the Commission.[107] Conversely, one of the additional methods used by Mr. Scheig, the Expected Earnings Method, is less widely used, and as Mr. Scheig testified, he has not reviewed any Staff testimony that used the Expected Earnings Method.[108] Finally, in weighting the importance given to each method, Mr. Scheig gave the most

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[103] Staff's Initial Brief at 32 of 41.

[104] Class B Investor-Owned Utilities Water and/or Sewer Instructions for Rate/Tariff Change Application 2015, Staff Ex. 7 at 2.

[105] *See id.*; Rebuttal Testimony of Gregory Scheig, Ex. DDU-10.

[106] DDU's Initial Brief at 25 of 32.

[107] Docket No. 45720 Order at 16 of 20, Finding of Fact No. 38 (adopting an ROE of 8.48%, which was shown in the Direct Testimony of Staff witness Andrew Novak, to have been calculated using a DCF calculation).

[108] *See* Tr. at 434:18- 435:25 (Scheig Cross) (Oct. 25, 2017) (testifying that he has not been involved in a utility case where Staff has used the Expected Earnings Method in calculating ROE).

weight to the methods also employed by Ms. Sears – weighting the CAPM at 30% and the constant growth DCF at 20%, while weighting his additional methods at 10% or 15%.[109]

Mr. Scheig also asserts that it is necessary to incorporate a small stock risk premium of 167 basis points (+1.67%) into the results of each of his methods to properly account for "size, liquidity, capital structures, or other DDU-specific factors."[110] However, a size premium should not be used for determining an ROE for regulated monopolies such as DDU. Although the scale of operations for water and sewer systems can vary, the basic nature of a utility's business does not change with respect to scale. The business model and required functions of a utility, such as constructing and maintaining its distribution system, providing administrative functions, etc., remains essentially the same for any size utility. Such utilities, regardless of their size, operate as monopolies with a set customer base in their service area. Further, water and sewer utilities are subject to regulatory oversight, and the utility's earnings are set by the ratemaking process.

DDU additionally asserts that Ms. Sears' ROE does not take into the account "the business undertakings which are attended by corresponding risks and uncertainties."[111] However, it is DDU's recommendation that is problematic, as Mr. Scheig is asserting that a less risky water utility should be given a higher ROE than another water utility that is, in his opinion, less risky. Mr. Scheig, who was also a witness in Docket No. 45720 (Rio Concho), testified at this hearing that Rio Concho has more business risk than DDU, because it is a utility located on a for profit airfield with a very focused group of customers purchasing utility services.[112] In Docket No. 45720, however, the Commission set an ROE of 8.48% for Rio Concho.[113] If Rio Concho does have more business risk, as Mr. Scheig claims, it follows that it would be appropriate for Rio Concho to have a higher ROE than DDU. Therefore, Mr. Scheig's opinion that DDU's ROE is appropriately set at 11.5% is inconsistent with his view that DDU is less risky than a utility that has a Commission set ROE of 8.48%.

Staff would note that the capital structure for electric utilities is different than for water utilities. Ms. Sears also testified that based on her expert opinion, the risk to investors in electric

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[109] Schedule A.1 to the Rebuttal Testimony of Gregory Scheig, Ex. DDU-10B at 52 of 123.

[110] Ex. DDU-10 at 32 of 123.

[111] DDU's Initial Brief at 25 of 32.

[112] Tr. at 447:24-448:17 (Scheig Redirect) (Oct. 25, 2017).

[113] Docket No. 45720 Order at 16 of 20.

utilities is not comparable to the risk in water utilities.[114] As such, electric ROEs should not be used to benchmark water ROEs. Even so, Ex. DDU-16 shows that the ROE levels of electric IOUs approved by the Commission in orders over the past four years are not comparable to DDU's requested ROE of 11.5%.[115] The highest approved ROE shown is 9.8%,[116] which is significantly closer to Ms. Sears' recommendation in this case than to DDU's proposed ROE. For the above reasons, Staff's recommended ROE should be adopted.

Staff further recommends that WBRG's proposal to reduce Staff's recommended ROE by 2%[117] be rejected. While Tex. Water Code § 13.184(b) allows consideration of the efforts and achievements of a utility in the conservation of resources, WBRG witness Nelisa Heddin states that her recommended reduction for lack of water conservation efforts is based on the "TCEQ Rate of Return Worksheet."[118] Ms. Heddin states that this worksheet allows for reduction of a recommended return by 2% for line losses in excess of 15%.[119] Therefore, the basis and calculation of Ms. Heddin's reduction is not any accepted methodology for determining an appropriate ROE, but rather comes from a worksheet from another agency, which is not utilized at the Commission, and is further not included in the record of this proceeding.

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

DDU agrees with Staff's recommended cost of debt of 4.91%, which is the overall weighted average cost of debt of its parent company, Double Diamond Delaware (DDD), as of December 31, 2015.[120] Since the filing of initial briefs, Staff has discussed this issue with WBRG and understands that WBRG also agrees to a cost of debt of 4.91%.

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[114] *Id.* at 376:20-23, 390:19-391:8 (Sears Cross) (Oct. 25, 2017).

[115] Open Meeting Memo from Rate Regulation to Commissioners, *Year-end 2016 PUC Earnings Reports for Electric Utilities*, Project No. 46910, Ex. DDU-16 at 2, footnote 3.

[116] *Id.*

[117] WBRG's Initial Brief at 22.

[118] WBRG's Response to DDU RFI 2-8, Staff Ex. 5.

[119] *Id.*

[120] DDU's Initial Brief at 26 of 32; *see* Staff's Initial Brief at 34 of 41.

C. Capital Structure [PO Issue 7]

DDU agrees with Staff's recommended hypothetical capital structure of 47.27% debt and 52.73% equity.[121]

Staff opposes WRBG's proposed capital structure. WBRG initially recommended the use of the capital structure proposed by DDU of 44.16% equity and 55.84% debt.[122] However, in its initial brief, WBRG stated that based on the testimony at hearing it now recommends that DDU's capital structure be set at 0% equity and 100% debt.[123] WBRG argues that the $3 million loan taken out by DDD using DDU's assets as collateral[124] "effectively removed" all of DDU's equity.[125] However, WBRG's argument does not consider that in determining an appropriate capital structure, the only capital that should be considered is the capital DDU used to finance its rate base. Any return that DDU earns will be on its capital;[126] therefore, the relevant portions of equity and debt are DDU's. The $3 million loan is debt that DDU's parent company incurred using DDU's assets as collateral, but does not represent any DDU debt associated with its rate base. Therefore, the loan is not a factor that should be considered in determining the appropriate capital structure for DDU.

D. Overall Rate of Return [PO Issue 8]

Staff continues to recommend that its proposed overall rate of return of 6.96% represents a reasonable return on DDU's invested capital used and useful in rendering service to the public over and above its necessary operating expenses, and should be adopted.[127] As shown in Staff's initial brief, Staff's overall cost of capital provides a reasonable proxy for the overall cost of capital that would be required in order for DDU to be competitive in a competitive environment, and is consistent with the Commission's decision in Docket No. 45720.[128]

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[121] DDU's Initial Brief at 26 of 32; *see* Staff's Initial Brief at 35 of 41.

[122] WBRG's Initial Brief at 22.

[123] *Id.* at 23.

[124] *See* Tr. at 150:17-22 (testifying that DDD utilized DDU's assets to obtain a loan), 153:1-154:2 (testifying that DDD is obligated to repay the loan) (Grout Cross) (Oct. 24, 2017).

[125] WBRG's Initial Brief at 23.

[126] 16 TAC § 24.31(c)(2).

[127] Staff's Initial Brief at 31 of 41 (Due to a typographical error, Table 18 shows an overall Staff recommended rate of return of 6.76% - this number should be 6.96%).

[128] *Id.* at 35 of 41.

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

No reply.

V. RATE-CASE EXPENSES [PO ISSUE 38]

The calculation for rate-case expense recovery shown in Table 24 of Staff's initial brief[129] utilized the revenue requirement of each system used to set rates for the "Rate Revenues at Present Rates" row. However, DDU's rate design as proposed in this case will not fully recover these target revenue requirements. For example, for the White Bluff water system, DDU's requested revenue requirement used to set rates is $568,761.[130] DDU's proposed rates for White Bluff water, however, will only generate a total of $568,368 in revenues, which is $392 less than the requested revenue requirement used to set rates.[131] Since 16 TAC § 24.33(b) states that the 51% threshold is based on the "increase in revenue that would have been generated by the utility's proposed rate," Staff agrees that it is appropriate to use the revenues generated by DDU's proposed rates. Therefore, Staff provides the following revised table, which is consistent with the table contained in DDU witness Mr. Joyce's rebuttal testimony.[132] In order to recover rate-case expenses, DDU's increase must be at least $122,711 for White Bluff and $77,371 for the Cliffs, for a total company increase of $200,081.

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[129] *Id.* at 38 of 41.

[130] *See* White Bluff – Water and Sewer Rate Increase Applications, Ex. DDU-2 at 95 of 151 (showing that the revenue requirement for White Bluff water used to set rates is $568,761 but that the revenues generated under the proposed rates will only generate $568,368, resulting in an under-recovery of $392 of the White Bluff water revenue requirement used to set rates).

[131] *Id.*

[132] *See* Ex. DDU-11 at 13 of 106.

Table 1 51% for Rate Case Expense Recovery						
	White Bluff			The Cliffs		
	Water	Sewer	Total	Water	Sewer	Total
Rate Revenues at Present Rates	$465,237[133]	$412,543[134]	$877,780	$368,356[135]	$215,111[136]	$583,467
Rate Revenues at Proposed Rates	$546,321[137]	$572,068[138]	$1,118,389	$421,488[139]	$317,686[140]	$735,174
Requested Increase in Revenues	$81,084	$159,525	$240,609	$53,131	$98,576	$151,707
51% of Requested Increase	**$41,353**	**$81,358**	**$122,711**	**$27,097**	**$50,274**	**$77,371**

As stated in Staff's initial brief, DDU's assertion that if the Commission sets an ROE that is lower than DDU's request, the reduction should not count against the 51% threshold is inconsistent with 16 TAC § 24.33(b) and should be rejected.[141]

WBRG asserts that DDU's requested revenue requirements from its original August 1, 2016 application, instead of the revenue requirements from its amended April 26, 2017 application, should be used for purposes of determining the 51% threshold for recovery of rate-case expenses.[142] However, this interpretation is also inconsistent with the Commission's rule, which requires that this threshold is determined by the difference in the increase in revenue generated by the rates set by the Commission and the increase in revenue that would have been

[133] Ex. DDU-2 at 95 of 151.

[134] *Id.* at 143 of 151.

[135] The Cliffs – Water and Sewer Rate Increase Applications, Ex. DDU-1 at 95 of 151.

[136] *Id.* at 143 of 151.

[137] Ex. DDU-2 at 95 of 151. The figure contained in the revenue proof is $568,368, 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).

[138] *Id.* at 143 of 151.

[139] Ex. DDU-1 at 95 of 151.

[140] *Id.* at 143 of 151.

[141] Staff's Initial Brief at 38-39 of 41.

[142] WBRG's Initial Brief at 24.

generated by the utility's proposed rate.[143] DDU's proposed rates in its amended application replace the proposed rates in its original application, and therefore are the rates that would produce the increase in revenue that DDU is requesting in this case.

Further, as a policy matter, utilities should be encouraged to amend rate applications to correct errors or agree with other parties' recommendations, and should not be penalized for doing so. Considering only a utility's originally filed application for purposes of determining the 51% threshold, and not accounting for subsequent amendment, would be a disincentive to making what may be reasonable and appropriate revisions. Therefore, Staff recommends that WBRG's recommendation be rejected, and the 51% threshold be calculated consistent with revised Table 1 above.

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

DDU has requested a recovery period of two months for any rate surcharge, exclusive of a surcharge for rate-case expenses.[144] Staff agrees with the two month recovery period, but further recommends that it apply to any surcharge, or refund, depending on the outcome of the case.

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

No reply.

VIII. CONCLUSION

Staff respectfully requests that the presiding officer issue a proposal for decision that adopts Staff's recommendations as discussed above and in Staff's initial brief.

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[143] *See* 16 TAC § 24.33(b).

[144] DDU's Initial Brief at 30 of 32.

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CERTIFICATE OF SERVICE

I certify that a copy of this document was served on all parties of record on December 15, 2017, in accordance with 16 TAC § 22.74.

Erika N. Garcia