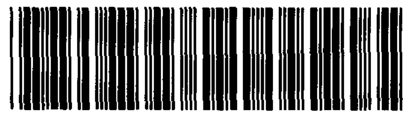

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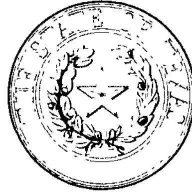

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Lesli G. Ginn
Chief Administrative Law Judge

February 13, 2018

TO: Stephen Journeay, Director **VIA EMAIL**
Commission Advising and Docket Management
William B. Travis State Office Building
1701 N. Congress, 7th Floor
Austin, TX 78701

RE: SOAH Docket No. 473-17-0119.WS
PUC Docket No. 46245

APPLICATION OF DOUBLE DIAMOND UTILITY CO. INC. FOR WATER & SEWER RATE/TARIFF CHANGE

Enclosed is the Proposal for Decision (PFD) in the above-referenced case. By copy of this letter, the parties to this proceeding are being served with the PFD.

Please place this case on an open meeting agenda for the Commissioners' consideration. The effective date of the proposed rates, as agreed to by the parties, is April 1, 2018. Please notify me and the parties of the open meeting date, as well as the deadlines for filing exceptions to the PFD, replies to the exceptions, and requests for oral argument.

Sincerely,

Casey A. Bell
Administrative Law Judge

Enclosure
xc: All Parties of Record

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

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

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

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

PROPOSAL FOR DECISION

I. INTRODUCTION

Double Diamond Utility Company, Inc. (DDU) filed Applications (Applications) with the Public Utility Commission of Texas (Commission) for a rate/tariff change under Certificate of Convenience and Necessity Nos. 12087 and 20705 for water and sewer utility service to The Cliffs and White Bluff resort/residential developments in Palo Pinto and Hill County, respectively. Pursuant to Texas Water Code § 13.1872(c)(2), DDU opted to file the Applications as a Class B utility.

The White Bluff Ratepayers Group (WBRG), an unincorporated association of DDU ratepayers located in the White Bluff development, and The Cliffs Utility Committee (TCUC) sought party status and became intervenors. WBRG and TCUC participated extensively in challenging DDU's proposed rates by attending the prehearing conference, filing testimony, responding to discovery and motions, conducting cross-examination, and submitting briefs. Commission staff (Staff) recommends a decrease in DDU's requested revenue requirement, as do WBRG and TCUC, based on numerous adjustments that Staff, WBRG, and TCUC contend should be made to DDU's proposed costs of service and rate of return.

DDU's test year revenue requirements (costs of service) for White Bluff were $465,237 for water service and $412,543 for sewer service, and for The Cliffs, were $368,356 for water service and $215,111 for sewer service. DDU proposes to increase its revenue requirements, based on test year cost data and adjustments for known and measurable changes, to $568,368 for

White Bluff water; $572,068 for White Bluff sewer; $421,488 for The Cliffs water; and $313,686 for The Cliffs sewer.

Based on the evidence and applicable statutes and Commission rules, the Administrative Law Judge (ALJ) recommends certain adjustments to the allowable expenses, the rate base, and return on invested capital set forth in the Application. These adjustments, and the resulting revisions to the revenue requirements for the White Bluff and The Cliffs systems, are more fully set forth in this Proposal for Decision and as reflected in the number-running schedules prepared by Staff and attached to this Proposal for Decision as Attachments A and B, respectively.

II. JURISDICTION, NOTICE, AND PROCEDURAL HISTORY

A. Jurisdiction and Notice

The Commission has jurisdiction in this matter pursuant to Texas Water Code §§ 13.041, 13.043(b), 13.181-.185, 13.1871, and 13.1872. The State Office of Administrative Hearings (SOAH) has jurisdiction over matters in this case relating to the conduct of the hearing and issuance of a proposal for decision, if needed, pursuant to Texas Government Code § 2003.049. Notice of the Applications was sent to DDU's customers on August 10, 2016.[1]

Jurisdiction and notice are not contested. Therefore, these issues are addressed in the findings of fact and conclusions of law without further discussion.

B. Procedural History

On August 1, 2016, DDU filed the Applications with the Commission and proposed October 1, 2016, as the effective date of the proposed rate/tariff change. Staff recommended the Applications be referred to SOAH for a contested case hearing, given that more than 10% of

[1] DDU Ex. 1, White Bluff Application, Attachment DDU-1A at 147; DDU Ex. 2, The Cliffs Application, Attachment DDU-2A at 147.

DDU's ratepayers in White Bluff and The Cliffs had filed protests to the rate/tariff changes proposed by the Applications. On September 7, 2016, a Commission ALJ found the Applications administratively complete and sufficient, and on September 8, 2016, the Commission referred this case to SOAH for assignment of a SOAH ALJ. The Commission later issued a Preliminary Order (PO) on October 7, 2016, setting forth 41 issues to be addressed in this docket.

SOAH assigned an ALJ, who convened a prehearing conference on October 18, 2016, admitted WBRG and TCUC as intervenors, and established an initial procedural schedule. On November 29, 2016, upon DDU's agreed motion, the ALJ suspended the effective date of the rate/tariff change to allow DDU to amend the Applications and the parties to discuss settlement. After DDU filed amendments to the Applications on April 26, 2017, and specified June 1, 2017, as the effective date of the proposed rate/tariff change, the ALJ conducted a second prehearing conference. At the prehearing conference, Staff moved to suspend the rate/tariff change to suspend the effective date of the proposed rate/tariff change. The ALJ granted Staff's motion and entered a new procedural schedule. DDU subsequently filed an agreed motion to modify the procedural schedule, extend the effective date of the proposed rate/tariff change, and establish a "relate back" date for purposes of determining refunds or surcharges. By order dated July 26, 2017, the ALJ granted the motion, setting April 1, 2018, as the effective date for the proposed rate/tariff change and February 21, 2018, as the "relate back" date.

The hearing on the merits was convened on October 24, 2017, before SOAH ALJ Casey A. Bell. DDU, WBRG, TCUC, and Staff all made appearances. The hearing concluded on October 26, 2017, and the record closed on December 15, 2017, after the parties filed post-hearing briefs.

III. BACKGROUND

DDU is an investor-owned water utility company servicing several communities in North Texas, including White Bluff and The Cliffs. DDU has approximately 640 water customers and 567 sewer customers in White Bluff and approximately 287 water customers and 239 sewer customers in The Cliffs.

White Bluff is a resort/residential project with amenities such as a golf course, marina, hotel, restaurant, conference center, spa, and swimming pools. The White Bluff water system obtains its water supply from four wells in the Trinity aquifer, which is regulated by the Prairielands Groundwater Conservation District.[2] The Cliffs is also a resort/residential development with amenities similar to those at White Bluff. The Cliffs water system obtains its water supply from Lake Possum Kingdom.[3]

The test year is January 1 to December 31, 2015. In this proceeding, because DDU seeks a change of rates, DDU bears the burden of proving that its proposed changes are just and reasonable.[4]

IV. REVENUE REQUIREMENT [PO Issues 3, 5, 6, 34]

As explained by Staff witness Emily Spears and DDU witness Jay Joyce, the revenue requirement for a utility in a base rate case is determined by adding together the utility's expenses (operations, maintenance, administrative, general, and depreciation), its taxes (*i.e.* payroll taxes, property taxes, and income taxes), and its return on invested capital (calculated by multiplying the utility's rate base by a rate of return).[5] In Texas, the revenue requirement is

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[2] DDU Ex. 3, direct testimony of Randy Gracy at 7.

[3] DDU Ex. 3, Gracy direct at 8-9.

[4] Tex. Water Code (Code) § 13.184(c).

[5] DDU Ex. 6, direct testimony of Jay Joyce at 5-6; Staff Ex. 2, direct testimony of Emily Sears at 6.

determined by developing a cost of service based on a historical test year.[6] Only those expenses that are reasonable and necessary to provide service to the ratepayers may be included in allowable expenses. In computing a utility's allowable expenses, only the utility's historical test year expenses, as adjusted for known and measurable changes, may be considered.[7]

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

Operations and maintenance (O&M) expenses are incurred in furnishing normal utility service and in maintaining plant used and useful to the utility when providing such service.[8] Schedule I-1 of the Applications includes volume-related expense accounts (purchased water, power expense-production only, and other volume-related expenses) and non-volume-related expense accounts (employee labor, materials, contract work, transportation, and other plant maintenance) for White Bluff and The Cliffs.[9] Staff recommends adjustments to DDU's other volume-related expenses, employee labor, contract work, transportation expenses, and other plant maintenance expenses claimed for White Bluff, and to transportation and other plant maintenance expenses claimed for The Cliffs.

1. Other Revenues

Staff recommends adding $3,600 to White Bluff water's O&M expenses for monthly revenues received from Nextlink.[10] DDU agrees with this recommendation, and the ALJ finds that it is appropriate and should be adopted.

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[6] 16 Tex. Admin. Code §§ 24.31(a), 24.3(72).

[7] 16 Tex. Admin. Code § 24.31(b).

[8] 16 Tex. Admin. Code § 24.31(b).

[9] DDU Ex. 1, White Bluff Application at 6, 53, 101; DDU Ex. 2, The Cliffs Application at 6, 53, 101.

[10] Staff Ex. 2, Sears direct at 8-9.

2. Other Volume-Related Expenses

Through Ms. Sears, Staff recommends a net addition of $318 to DDU's other volume-related expenses for the White Bluff water system and a $530 deduction from DDU's other volume-related expenses for the White Bluff sewer system.[11] These recommendations are based on Ms. Sears's determination that: (a) $830 of the water expenses were fixed expenses belonging in the other plant maintenance account; (b) a $1,148 expense for chlorine gas cylinders should be added to the other volume-related expense account for White Bluff water; and (c) $530 of the sewer expenses were fixed expenses belonging in the other plant maintenance account.[12] In its initial brief, DDU agrees with Staff's proposed reclassifications; the ALJ finds that these adjustments are appropriate and should be made.

3. Employee Labor

Staff recommends deductions and reallocation of the salaries of certain employees. Staff takes issue with and calls for the deduction of the salaries of DDU employees Jerry Whitworth ($20,800 total) and Danny Keeton ($22,880) from the employee labor accounts at White Bluff.[13] According to Staff, DDU failed to put forth sufficient evidence to show the labor these employees performed beyond their involvement in water and sewer tap installations, the charge for which is already included in the tap fees charged to DDU's customers. Moreover, Staff argues that these salaries are unreasonable because neither Mr. Whitworth nor Mr. Keeton are licensed water or wastewater operators and therefore must be directly supervised by a licensee to work on the systems.[14] Staff further contends that DDU did not show that the 50-50 allocation of these employees' salaries between White Bluff water and White Bluff sewer is warranted, and proposes to reallocate other employee labor expenses between water and sewer based on the type

[11] Staff Ex. 2, Sears direct at 11.

[12] Staff Ex. 2A, Sears workpapers at 5, 12; Staff Ex. 2B, Sears supplemental workpapers at 1-3.

[13] These salaries are split evenly ($10,400 and $11,440, respectively) between the White Bluff water and sewer systems.

[14] DDU Ex. 11-B, rebuttal workpapers of Jay Joyce at 90; Tr. at 401; 30 Tex. Admin. Code § 290.46(e).

of license held by each employee. Staff's proposed adjustments to DDU's White Bluff employee labor account are as follows[15]:

Water		Sewer
$ 80,520.00	Original Cost	**$ 91,440.00**
$ (5,460.00)	Wilhelm	$ 5,460.00
$ 13,000.00	Bledsoe	$(13,000.00)
$ 10,920.00	Cota	$(10,920.00)
$(10,400.00)	Whitworth	$(10,400.00)
$(11,440.00)	Keeton	$(11,440.00)
$ 77,140.00	Adjusted Cost	**$ 51,140.00**

Ms. Sears proposed that the salary of Clovis Wilhelm be removed from White Bluff water and added to White Bluff sewer because he holds a wastewater operator license and because his job duties only relate to the wastewater treatment plant. She also recommended that the salaries of Jody Bledsoe and Dwayne Cota be allocated 100% to water, based on their licensure, instead of 50% to water and 50% to sewer as proposed by DDU.[16]

DDU disagrees with Staff's recommendations, noting that it explained in a discovery response and through the testimony of its President, Randy Gracy, that all of these employees perform other duties as needed and assigned and answer service calls for both the water and sewer systems.[17] Mr. Gracy testified that DDU produced in discovery its 2015 work orders, totaling over 800 pages, which he claimed "demonstrate that all employees work on every call, whether water or sewer, at different times."[18] Further, Mr. Gracy testified that not all DDU employees are required to have particular licenses to work on the water and sewer systems, so

[15] Staff Ex. 2, Sears direct at 12-13, Att. ES-5 at 1 (chart taken from DDU's Initial Brief at 9).

[16] Staff Ex. 2, Sears direct at 12-13, Att. ES-5 at 1; DDU Ex. 11-B, Joyce rebuttal workpapers at 90; Staff Ex. 2A, Sears workpapers at 8.

[17] Staff Ex. 2A, Sears workpapers at 7-8; DDU Ex. 8, Gracy rebuttal at 4-5.

[18] As pointed out by Staff in its initial brief, the work orders are not in evidence.

long as they are supervised and controlled by an employee with such license.[19] According to Mr. Gracy, all DDU employees at White Bluff "are cross-trained on everything having to do with the utilities – water and sewer."[20] DDU witness Mr. Joyce determined, based on his review of the documentation concerning the tap installation work performed during the test year, that the labor cost incurred for tap installations during the test year was $615.[21]

Therefore, argues DDU, if all of Mr. Whitworth's and Mr. Keeton's salaries were deducted as recommended by Staff, 99% of their time working for DDU at White Bluff would be uncompensated through rates. DDU contends that its discovery responses and Mr. Gracy's testimony, as well as the evidence showing that DDU employees worked 1,039 hours of overtime during the test year[22], are sufficient to show that (a) the salaries of Mr. Whitworth and Mr. Keeton are necessary to provide water and sewer services to DDU's customers at White Bluff, and (b) the salaries of all these employees should be divided 50-50 between water and sewer to appropriately reflect the allocation of their work time and to prevent one system's customers from subsidizing the other.

The ALJ finds that DDU has shown that at least some if not all of the salaries of Messrs. Whitworth, Keeton, Wilhelm, Bledsoe, and Cota were costs reasonably and necessarily incurred by DDU in providing water and sewer service during the test year. The more difficult question is whether the entire amount of the salaries is reasonable and necessary. Mr. Whitworth and Mr. Keeton are identified as backhoe operators who are involved in all tap installations, and they are said to perform other duties as needed. The evidence on what those duties are is scant and non-specific. Mr. Gracy's testimony shows that these gentlemen, along with the other employees, are trained on both systems, work on both systems, and handle service calls on both

[19] DDU Ex. 8 , Gracy rebuttal at 5.

[20] DDU Ex. 8, Gracy rebuttal at 4.

[21] DDU agrees that because this $615 was already collected through tap fees, it should be deducted from the employee labor account, 50-50 between water and sewer, to prevent double recovery.

[22] Staff Ex. 2A, Sears workpapers at 9. DDU did not seek this overtime compensation as part of its revenue requirement.

systems. There is no explanation of or evidence showing what that work was, how long it took, or what any of the service calls involved. It is unclear why DDU did not offer into evidence as proof of the work performed by its employees the 800+ pages of work orders from the test year that Mr. Gracy testified were produced in discovery. Further, it is unclear how many overtime hours each of these employees worked. There was no evidence offered as to what market salary rates are for the type of work these employees performed, and evidence of their experience and skill levels was also lacking.

However, after thoroughly examining the evidence in the record, the ALJ concludes that DDU showed by a preponderance of the evidence that the salaries of these five DDU employees were reasonable and necessary for DDU to provide water and sewer services to its customers. Mr. Gracy's testimony establishes by a preponderance of the evidence that all of the employees worked on both the water and sewer systems and responded to service calls on both systems. There was no evidence to the contrary. Further, the ALJ finds that Messrs. Wilhelm, Bledsoe, and Cota were not prohibited from performing work on systems for which they were not specifically licensed. Therefore, the ALJ recommends that the Commission (a) reject Staff's proposal to allocate the salaries of Messrs. Bledsoe and Cota completely to the water system and Mr. Wilhelm's salary solely to the sewer system, and (b) reject Staff's proposal to completely remove the salary expenses for Messrs. Whitworth and Keeton.

4. Contract Work

Staff contests the phone allowance DDU seeks for its manager Todd Dilworth because DDU has not shown how much of the phone use is for business purposes and how much is for personal purposes.[23] Therefore, Staff recommends the phone allowance be reduced by 50% to $450 for 12 months and allocated $239 to water and $212 to sewer.[24] Further, Staff recommends reallocation of general and administrative (G&A) expenses attributable to security at the resort

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[23] Staff Ex. 2A, Sears workpapers at 16.

[24] Staff Ex. 2, Sears direct at 15.

property at White Bluff from miscellaneous expenses to contract work, $890 to water and $790 to sewer, arguing that these expenses are an intercompany labor transfer.[25]

DDU witness Mr. Gracy testified that Mr. Dilworth is on-call at all times and needs a cell phone to respond to issues that arise with the White Bluff systems. DDU does not account for the cost of the phone for Mr. Dilworth through his salary.[26] Therefore, contends DDU, the phone allowance is a necessary and reasonable cost incurred to provide services at White Bluff. DDU agrees with Staff's recommendation regarding reclassification of G&A expenses attributable to security at the White Bluff resort as contract work.

The ALJ finds that DDU proved that the phone allowance for Mr. Dilworth is a reasonable and necessary expense incurred to provide service at White Bluff. The evidence showed that Mr. Dilworth is on call at all times to respond to service calls at the White Bluff water and sewer systems. It is reasonable to have the utility manager on call at all times, in case issues arise that affect service, and it is a reasonable expense to allow Mr. Dilworth to have a mobile phone with cell service so that there can be effective and efficient communication regarding any such issues. The ALJ recommends the Commission reject Staff's recommendation regarding reduction of the phone allowance.

Because the ALJ finds the parties' agreement appropriate, the ALJ recommends that Staff's proposed reclassification of resort G&A security expenses from miscellaneous expenses to contract work be adopted.

5. Transportation Expense

Staff recommends $9,835 of DDU's claimed fuel expense ($6,447 in water and $6,300 in sewer) at White Bluff be excluded because two DDU employees use two on-call vehicles to

[25] Staff Ex. 2, Sears direct at 15.

[26] DDU Ex. 8, Gracy rebuttal at 6.

travel to and from their homes for work. Mr. Dilworth, DDU's manager, drives one of the trucks to and from work daily, and the other truck is used by a DDU employee assigned to be on call to drive to and from work during such assignment.[27] According to Staff, DDU was required and failed to show that the fuel costs did not include mileage for these commutes, pursuant to the Commission's order in Docket No. 45720.[28] Staff contends that DDU failed to provide evidence regarding what types of calls these employees respond to, when the calls occurred, and how many calls occurred outside normal business hours.

Ms. Sears testified that in response to a request from Staff for mileage logs, DDU provided fuel logs that showed how many gallons of fuel were purchased in the test year for the four trucks that DDU uses for its water and sewer system operations at White Bluff. Because she did not get the mileage logs as requested, Ms. Sears was unable to determine how much of the fuel was actually used for utility purposes.[29] According to Ms. Sears, the expense of DDU employees driving to and from their homes for work is not allowable "unless they actually have a service call that they had gone to."[30] Because she was not provided with information, she could not determine what portion of the fuel was for personal commuting use and what portion was for utility business.[31] Ms. Sears testified that even if the employees are on call, fuel expenses for daily commutes to and from work are not recoverable by DDU through rates.[32]

In response, DDU points out that it answered in discovery that none of the DDU vehicles are ever used for personal reasons. In further response to the request for information, Mr. Gracy explained that Mr. Dilworth and another employee have DDU vehicles they can use to respond at

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[27] Staff Ex. 2A, Sears workpapers at 18.

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

[29] Tr. at 278-79.

[30] Tr. at 280.

[31] Tr. at 280.

[32] Tr. at 283.

any time to a service call at White Bluff.[33] DDU asserts that Ms. Sears has no experience with the on-call demands of utility employees. Further, DDU argues that Ms. Sears's position that fuel expenses for on-call employees traveling to and from work are only recoverable if they were actually called out to perform service is akin to excluding the premium for an insurance policy if no claim is made on the policy.[34]

The ALJ finds that because Mr. Dilworth and the other employee are on call and expected to respond to service calls whenever they may be made, this situation and the expenses sought by DDU are distinguishable from those involved in Docket No. 45720. The evidence shows that the DDU employees do not use the truck for any personal reasons, and although they use them to drive to and from work, this is necessary so that they can respond to a service call from home if such a call is made. In Docket No. 45720, there was no evidence that the owner of the utility was on call when she made trips to and from the utility office and her home. Therefore, the fuel costs incurred by DDU for Mr. Dilworth and the other employee driving to and from work in company trucks while on-call are not purely commuter miles, and the ALJ finds them to be reasonable and necessary expenses incurred by DDU in providing service, and therefore are recoverable. The ALJ recommends the Commission reject Staff's proposed reductions of these fuel expenses.

Staff recommends reclassification of a vehicle lease expense ($2,912 for both water and sewer) and a tool box expense for White Bluff of $580 to the depreciation schedule, and DDU agrees with the proposed reclassification. The ALJ finds these adjustments appropriate and recommends they be adopted.

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

[34] DDU Initial Brief at 12.

Finally, although Staff initially recommended removing fuel expenses at The Cliffs that Staff witness Jonathan Ramirez contended were incurred outside of the test year, Staff in its reply brief indicated that it no longer recommends this adjustment.[35]

6. Other Plant Maintenance

a. Evidence and Argument

Staff proposes a deduction of $709 in water-related expenses it contends are not supported by invoices or receipts and a reclassification of $18,927 claimed by DDU as water-related expenses to capital assets and depreciation.[36] Ms. Sears reviewed the invoices submitted by DDU in support of these claimed expenses and testified that the amounts she recommends be moved to the depreciation schedule include costs for booster pumps, well meters, electric panels, grinder pumps, and the like, which she stated have lives longer than one year.[37]

DDU agrees with some of the reclassifications recommended by Staff, but disagrees with (a) the deduction of $709 in expenses it contends are shown on the detailed trial balance and related to repair and maintenance of the water system;[38] and (b) reclassification of expenses totaling $4,386.29 set forth on three invoices that it contends should not be capitalized.[39] DDU witness Victoria Harkins testified that each of the three invoices pertains to repairs and system

[35] Staff Reply Brief at 15.

[36] Staff also recommended, and DDU agreed to, reclassification of the $1,148 expense for chlorine gas cylinders to the other volume-related expense account, as discussed in Section IV.A.2., above.

[37] Staff Ex. 2, Sears direct at 17-18.

[38] DDU Ex. 4, direct testimony of Tim Grout, Att. DDU-4E at 143-144 ($500 described as "678 Bill Wallace Electrical parts" and $209.43 described as "ITC Services 16013).

[39] DDU Ex. 9, rebuttal testimony of Victoria Harkins at 4-5.

service, which should be treated as operation and maintenance expenses and not capitalized.[40] One of these invoices, from Industrial Electric Repair and Sales, references "Rewind 3 Phase," "machine work on pump," and pump repair, and reflects charges for bearings and a pump seal.[41] The other invoice, from Wallace Controls & Electric, refers to a call regarding a well not running, reflects a burned-out motor protector and service wire, and shows a motor protector replacement.[42] Dr. Harkins testified that both invoices were for repairs. She cited to criteria and standards from the American Water Works Association National Association of Regulatory Utility Commissions Accounting Policies for Plant and Equipment that she opined supported her treatment of these repair and service costs as expenses rather than capital costs.[43]

In response to Dr. Harkins's testimony, Staff argues that its recommendation regarding reclassification of the charges on these invoices to assets is "consistent with DDU's capitalization policy."[44] Specifically, Staff notes that the expenses are in excess of $750; the repairs materially extend the useful life of the plant or equipment more than one year; and that DDU did not show the repairs to be typical recurring expenses. Staff notes that Dr. Harkins did not review the DDU capitalization policy in developing her opinion that these costs should be expensed and not capitalized.[45]

More significantly, Staff also recommends reclassification of $79,590.73 in grinder pump sewer expenses as capitalized assets to be added to the White Bluff sewer depreciation schedule.[46] Ms. Sears testified that grinder pumps have a service life of longer than one year,

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[40] DDU Ex. 9, Harkins rebuttal at 4-5. Staff noted in its Initial Brief that the proposed reclassification of one of these invoices, related to a $534.96 expense to "replace two rechargeable batteries, clean contacts, and replace a weak coil on a starter," was eliminated from the proposed adjustment in the errata to Ms. Sears's direct testimony.

[41] Staff Ex. 2a, Sears workpapers at 36.

[42] Staff Ex. 2a, Sears workpapers at 38.

[43] DDU Ex. 9, Harkins rebuttal at 3. The criteria and standards were not offered into evidence.

[44] Staff Reply Brief at 10, citing Staff Ex. 6 at DDU16-015961 and DDU Ex. 9, Harkins rebuttal at 4-5.

[45] Staff Reply Brief at 10, citing Tr. at 493.

[46] Staff Ex. 4, direct testimony of Jolie Mathis at 6.

and that she believed that the service life is 10 years.[47] Staff argues that based on Ms. Sears's determination, grinder pumps are utility plant that should be capitalized.

DDU takes issue with the reclassification of grinder pump costs as capitalized assets and contends that such costs are expenses because they recur from year to year and are a constant maintenance issue in the operation of the White Bluff sewer system. DDU asserts that Dr. Harkins's opinion on the matter should be given considerably more weight than that of Ms. Sears, given Dr. Harkins's registration as a professional engineer in Texas, her 20 years of experience in the utility industry, and her knowledge of how grinder pumps work and the difficulty in dealing with grinder pumps. Dr. Harkins explained in detail how grinder pumps fit in to a wastewater system and why there is a great deal of maintenance, repair, and replacement associated with grinder pumps, especially those installed in vacation homes such as those at White Bluff.[48] She reviewed DDU invoices pertaining to grinder pump costs over a ten-year period and opined that given the amount of turnover of grinder pumps in the White Bluff wastewater system and their recurring nature, those costs should be expensed and not capitalized.[49] Dr. Harkins testified that 20 to 30 grinder pumps are replaced and approximately half of the pumps are repaired every year, and therefore the costs should remain, as DDU has historically treated them, as recurring annual expenses.[50] DDU notes that unlike Dr. Harkins, Ms. Sears admitted she has no experience with the operation or maintenance of grinder pumps and does not know how frequently they need to be repaired. Further, despite previous testimony that the service life of a grinder pump is greater than one year, Ms. Sears admitted she does not know the service life of a grinder pump.[51]

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[47] Staff Ex. 2, Sears direct at 18; Tr. at 344.

[48] Tr. at 484-485.

[49] Tr. at 485. Dr. Harkins also testified regarding reclassification of grinder pump costs incurred by DDU since 2006 as depreciation assets. DDU Ex. 9, Harkins rebuttal at 5-6.

[50] Tr. at 489, 491, 494.

[51] Tr. at 343-344.

DDU witness Jay Joyce concurred with Dr. Harkins, testifying that the costs Ms. Sears proposes to reclassify from expenses to invested capital recur from year to year. He stated that if the Commission adopts Ms. Sears's recommendation, the costs should be so reclassified for each of the last ten years. According to Mr. Joyce, the grinder pump replacement costs are the same over time, and he explained that it is more cost-effective for ratepayers if DDU expenses those costs on a yearly basis than to capitalize them and depreciate them every year.[52]

b. ALJ's Analysis and Recommendation

The evidence shows that the $709 included in the trial balance reflects costs incurred in the operation and maintenance of the water system at White Bluff, and was therefore properly included as expenses by DDU. Regarding the costs for the two invoices for work that Dr. Harkins testified were repairs, the expenses were greater than $750, and there was no specific evidence admitted regarding whether the repairs and replaced items materially extended the life of the plant or equipment for more than one year or whether the repair expense was typical or recurring. However, Dr. Harkins testified that it is industry standard to classify ordinary maintenance and repair costs as expenses rather than capital costs. Staff does not challenge this point in briefing or by reference to contradictory evidence. Therefore, the preponderance of the evidence shows that these invoices reflect repair costs that should be treated as plant maintenance. The ALJ recommends that the Commission reject Staff's proposal to remove the costs reflected in these two invoices from the other plant maintenance account and reclassify them as capitalized assets on the depreciation schedule.

As to the grinder pumps, the preponderance of the evidence shows that the grinder pump costs at issue are expenses incurred on an annual basis by DDU in order to repair and replace the pumps in the White Bluff sewer system. Dr. Harkins credibly testified as to the similar types of repair and maintenance costs pertaining to grinder pumps in the White Bluff wastewater system. Specifically, she stated that 20 to 30 pumps are replaced every year and up to 50 percent of the

[52] DDU Ex. 11, rebuttal testimony of Jay Joyce at 7.

pumps require repairs every year. Staff's primary argument is that the costs exceed $750 and the repairs extend the useful life of the plant or equipment more than a year, and therefore pursuant to DDU's own capitalization policy, these costs should be depreciated. The ALJ finds that from an accounting standpoint, because it is undisputed that the grinder pump expenses are typical and recurring, they are more appropriately categorized as operation and maintenance expenses, as has been DDU's practice. Therefore, the ALJ recommends the Commission reject Staff's recommendation that these costs be capitalized.

7. Professional Services

Citing to Staff witness Ms. Sears's direct testimony, DDU states its agreement with Staff's proposed three-year amortization of its wastewater permit renewal costs as a recurring expense for the White Bluff sewer system. Staff asserts that Ms. Sears's proposal is not amortization but rather normalization of this expense over a three-year period. Specifically, Ms. Sears testified that because the permit is renewed every three years, the $3090 cost of renewal, as proposed by Consulting Environmental Engineers, Inc., should be allowed as $1,030 per year.[53] DDU witness Dr. Harkins testified that while the wastewater permit for the White Bluff sewer system has been renewed every three years since 2013, and is currently set to expire in 2019, there is "no guarantee" it will renew in three years again after 2019.[54] According to Dr. Harkins, the term of a wastewater permit can be anywhere from three to ten years.[55]

Staff also recommends removing $2,907 incurred for a Certificate of Convenience and Necessity (CCN) amendment as a professional services expense for the White Bluff sewer system. The parties agree that the expense should be removed from White Bluff's expense account because the amendment related to the CCN for The Cliffs. However, Staff asserts that this cost cannot be recovered by DDU in its rates every year because it will not seek CCN

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[53] Staff Ex. 2, Sears direct at 19; Staff Ex. 8, TPDES Permit No. WQ0013786002.

[54] Tr. at 499.

[55] DDU Ex. 9, Harkins rebuttal at 6.

amendments every year, and therefore it is not a recurring expense.[56] Staff makes the point that a utility will file for a CCN amendment whenever it adds or removes service area, and that it is not possible to determine a useful life for the cost of such amendments.[57] DDU takes the position that this cost was necessary to provide service at The Cliffs and therefore should be recovered over time through amortization.[58] WBRG notes that Mr. Gracy testified that DDU did not file an application for a CCN amendment for White Bluff during the test year and that any cost for such an application should not have been included in DDU's White Bluff Application.[59]

Although DDU refers to Staff's recommendation regarding the wastewater permit renewal costs as an amortization, Staff's witness clearly calls for a normalization of the cost over three years. Because DDU did not take issue with this position, and given the evidence that the utility has renewed the permit on a three-year basis in the past, the ALJ recommends the Commission adopt Staff's position and allow DDU to recover one-third of the permit renewal cost every year through its rates.

With respect to the CCN amendment cost, the ALJ agrees with Staff that it is not a typical or recurring cost, and that it is difficult if not impossible to determine when or how often such a cost will be incurred. However, the cost was reasonable and necessary to provide sewer service to customers at The Cliffs and should therefore be recovered by DDU. To ensure that only the cost of the CCN amendment is recovered, and no more, the ALJ recommends the Commission include as part of DDU's tariff for The Cliffs a rider that covers the cost and expires once it is collected by DDU. This cost should be completely removed from the White Bluff

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[56] Staff Ex. 2, Sears direct at 19.

[57] Staff Initial Brief at 16. DDU witness Dr. Harkins also testified that CCN amendments are necessary when a utility expands service area, but that she thought five years was a reasonable useful life for a CCN amendment because she did not believe you would apply for a CCN amendment in less than five years. Tr. at 497, 500.

[58] DDU Reply Brief at 9. DDU witness Dr. Harkins actually testified that the cost should be reclassified as an asset and depreciated over a five-year period. DDU Ex. 9, Harkins rebuttal at 6. However, DDU appears to have abandoned this position and instead argues for amortization of the cost.

[59] Tr. at 100-101.

Application as the evidence shows no CCN amendment application was filed for White Bluff during the test year.

8. Insurance Expenses

Staff recommends that the Commission remove from White Bluff's requested insurance expenses the premium for worker's compensation insurance ($1,444 for water and $373 for sewer) and a portion of the premium for an Auto, Crime, Spa & Ski umbrella insurance policy ($3,371 for water and $1,127 for sewer). DDU agrees with the adjustment to remove the worker's compensation premium but contends that the premium for the umbrella policy was reasonable and necessary and should be recovered through rates.

The parties appear to agree that insurance coverage for spa and ski is not a recoverable expense related to DDU's provision of water and sewer service at White Bluff and The Cliffs. The dispute arises from whether, and how, the portion of the umbrella policy premium attributable to spa and ski coverage can be determined. Staff witness Ms. Sears testified that the cost of the umbrella spa and ski coverage cannot be separated out from the total umbrella policy premium, and therefore she recommends the entire premium for the umbrella policy be removed from the cost of service.[60] Ms. Sears testified that her knowledge of umbrella policies gained from working for an insurance company served as her basis for determining that the spa and ski umbrella coverage cost could not be separated out from the total umbrella policy premium.[61] She admitted that her recommendation for removing the total premium for the umbrella policy results in excluding from DDU's White Bluff revenue requirement "its ability to pay for its portion of the umbrella policy related to its operations."[62] Ms. Sears did not take the position that an umbrella policy for DDU would be unreasonable or unnecessary. However, she asserted that the particular umbrella policy at issue covers not only primary policies that are necessary for

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[60] Staff Ex. 2, Sears direct at 20.

[61] Tr. at 318-319.

[62] Tr. at 324.

the provision of services (i.e. auto, crime), but also the spa and ski policies, which are not necessary to provide service.[63]

In response, DDU witness Mr. Joyce testified on rebuttal that the insurance policy summaries included in Ms. Sears's workpapers provide a basis to separate out the spa and ski portions of the umbrella policy premium. He stated that the summaries show the total premium for the umbrella policy is $100,797, and the premium for the underlying spa and ski policy is $3,100.[64] According to Mr. Joyce, the appropriate exclusion should be based on the proportion of the primary spa and ski policy premium to the umbrella policy premium, which he calculated as 2.98%. He claimed that the amounts proposed by Ms. Sears to be deducted should be reduced to $100 for water ($3,371 x 2.98%) and $34 for sewer ($1,127 x 2.98%).[65] Staff counters that Mr. Joyce's calculation is flawed and thus DDU's argument is invalid, noting that Mr. Joyce does not explain the basis for adding the total umbrella policy premium to the premium for the base spa omissions and errors policy. Staff argues that the umbrella premium and the base premium do not correlate, pointing to the fact that the total of all of the base premiums is not the same as the umbrella premium.[66]

DDU has failed to meet its burden to prove the amount of expense that is reasonable and necessary for an umbrella insurance policy for the provision of service to its water and sewer customers at White Bluff and The Cliffs. Mr. Joyce's methodology for determining the portion of the umbrella policy premium attributable to umbrella coverage for such service is unsound and not supported by the evidence. He does so by calculating a cost for umbrella spa and coverage based on the ratio of the premium for the underlying spa and ski and the total umbrella premium, and then subtracting that cost from the total umbrella premium. The ALJ agrees with Staff that the correlation used by Mr. Joyce for his calculation is not supported by the base

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[63] Tr. at 323.

[64] DDU Ex. 11, Joyce rebuttal at 8-9; Staff Ex. 2a, Sears workpapers at 88-89.

[65] DDU Ex. 11, Joyce rebuttal at 9.

[66] Staff Initial Brief at 17-18; Reply Brief at 12-13; Staff Ex. 2a, Sears workpapers at 85-96.

premium costs for the specific coverages under the umbrella policy. The evidence shows that some portion of the umbrella policy premium is attributable to insurance coverage that is incurred as part of providing service and maintaining plant, and Staff does not argue that umbrella policy is inappropriate for a utility such as DDU. However, because DDU offered no competent evidence as to the cost of this umbrella coverage that relates to DDU's provision of service, the ALJ recommends the Commission adopt Staff's proposal to remove the umbrella policy premium cost from DDU's White Bluff expenses.

9. Salaries

DDU and WBRG dispute the nature of the employee costs sought by DDU in its Application for White Bluff. DDU contends that it is not requesting known and measurable changes in employee labor costs, but that the employee labor costs it seeks to recover are adjusted to reflect full staffing. According to Mr. Gracy, there were four employees working for the White Bluff utility systems at the time he prepared his direct testimony and at the time of the hearing.[67] However, the White Bluff Application reflects that there were seven employees on the payroll at White Bluff for the test year.[68] Mr. Gracy explained that there was some employee turnover during the year and not all of the seven employees listed in the Application worked the entire test year.[69] Mr. Joyce explained that the total employee labor cost set forth in the revenue requirement summary in the White Bluff Application is the same as the total yearly salaries of the seven employees listed in the Application. He testified that the amount that was actually paid in salaries was less than the total salaries of the seven employees because not all seven employees worked the entire test year and therefore did not earn their total yearly salaries.[70]

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[67] DDU Ex. 3, Gracy direct at 15; Tr. at 103-104.

[68] DDU Ex. 2, White Bluff Application at 15.

[69] Tr. at 104.

[70] Tr. at 206.

WBRG argues that the difference between the total yearly salaries for the seven employees and the salaries that were actually paid to the seven employees during the test year is not recoverable in DDU's rates because DDU did not provide an explanation for the change and the reason for the adjustment is not clear from the record. According to WBRG, DDU offered no evidence to show why it should recover the entirety of the annual salaries when (a) that amount was not paid in salaries during the test year and (b) DDU did not prove that it needed seven employees paid at the total yearly salaries listed in the Application to provide service at White Bluff.

DDU failed to show that the known and measurable change amount of $20,886 for employee labor sought by its White Bluff Application (the difference between the yearly salaries offered and the actual salaries paid to White Bluff employees during the test year) is reasonably certain to occur and should therefore be recoverable. Although there were seven salaried employees working for the White Bluff utility systems at some point during the test year, it is undisputed that not all seven of these employees worked the entire test year. They earned and were paid $151,074 in salary during the test year; they did not earn and were not paid their full yearly salaries. Mr. Joyce adjusted the test year employee labor amount to assume that the White Bluff utility was "fully staffed," and was told by DDU what full staffing would be. Mr. Gracy did not testify what "fully staffed" meant for the White Bluff systems, and confirmed that at the time he prepared his direct testimony (August 4, 2017) and at the time of the hearing (October 24, 2017) that there were only four employees working for the White Bluff systems. There is no evidence that White Bluff cannot provide service with only the four current employees, and there was no explanation offered as to why seven employees at the full yearly salaries set forth in the White Bluff Application were reasonable and necessary or would be incurred in DDU's provision of water and sewer service at White Bluff. Therefore, the ALJ recommends that DDU's employee labor expenses be reduced to $151,074, the amount of salaries actually paid to White Bluff employees during the test year.

10. Regulatory Fees

All parties agree to an adjustment regarding the handling of the Prairieland Groundwater District fees paid by DDU for White Bluff; specifically, that those fees be removed from DDU's revenue requirement and a pass-through provision be included in DDU's tariff. Further, all parties agree to Staff's recommendation to normalize DDU's expenses related to water tests that occur every three years, such that DDU recovers one-third of the expenses every year. The ALJ finds these adjustments are appropriate and should be made.

11. Miscellaneous Expenses

DDU agrees with Staff's recommendation to remove equipment lease and sewer tap fee expenses but takes issue with Staff's recommendation that allocated overhead expenses ($7,410 for White Bluff water, $5,366 for White Bluff sewer) and G&A expenses ($970 for White Bluff water and $702 for White Bluff sewer) related to the White Bluff resort property be removed from DDU's revenue requirement. Staff also recommends removing $20,075 from The Cliffs water and $18,720 from The Cliffs sewer for allocated resort overhead and G&A expenses.

Ms. Sears testified that DDU allocates resort expenses, such as those related to the general manager and office manager, commissions and bonuses, employee compensation, payroll burden, electricity, water and sewer, uniforms, small tools, and the like. DDU explained that the water and sewer plants are located within the resort properties at White Bluff and The Cliffs, and that it uses some of the resort's resources and allocates for those resort resources used.[71] Mr. Sears stated that those resort expenses DDU allocated in the White Bluff Application were otherwise already included in DDU's own cost of service, such that DDU is allocating resort expenses to the utility that the utility does not use.[72] Specifically, Staff points out that Mr. Gracy testified that there were expenses included within this allocation for uniforms

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[71] Staff Ex. 2a, Sears workpapers at 107.

[72] Staff Ex. 2, Sears direct at 22-23.

that did not go to the utility workers.[73] Further, Ms. Sears testified that there were overhead expenses allocated for cleaning and office supplies already included in the cost of service.[74] Staff witness Mr. Ramirez concurred with Ms. Spears' review and analysis and based the proposed reductions to The Cliffs's miscellaneous expenses on the same basis.[75]

DDU takes the position that the allocated overhead expenses are not already being recovered by DDU. DDU witness Mr. Gracy testified that some of the allocated expenses are similar to expenses within the utility department, but that they are separate and not the same.[76] He stated that the overhead expenses at White Bluff include portions of the salaries of the resort's general manager, receptionist, human resources employee, and accounts payable employee; rent for office space; and copier costs. According to Mr. Gracy, it would cost more than the combined expense of $12,000 for White Bluff water and sewer to hire those persons and rent space solely for DDU's use. DDU's White Bluff office is located in the resort's administration building, and there is no direct charge to DDU for rent, computers, phones, the receptionist, or the copiers. DDU, along with other departments within the resort, shares the expenses related to the administration building. There was an allocation budget developed, and the portion allocated to DDU was $12,000 for a year for these expenses. Mr. Gracy testified that the $1000/month charge to DDU for these expenses is reasonable.[77] Moreover, Mr. Gracy stated that the G&A expenses are not duplicated, relate to security for DDU facilities both at the administration building and at plant sites and facilities, and are reasonable.[78]

WBRG argues that the allocated costs are affiliate transactions in which DDU pays its developer affiliate for services provided by the developer, and that pursuant to Texas Water Code § 13.185(e), such payments are not allowed in the cost of service unless the Commission

[73] Staff Reply Brief at 14; Tr. at 475.

[74] Tr. at 328-329.

[75] Staff Ex. 3, direct testimony of Jonathan Ramirez at 10-11.

[76] Tr. at 464.

[77] DDU Ex. 8, Gracy rebuttal at 8; Tr. at 465-467.

[78] DDU Ex. 8, Gracy rebuttal at 8-9.

finds they are reasonable and necessary. Further, WBRG points out that this statute requires the Commission to include specific statements setting forth the cost to the affiliate of each item or class of items and a finding that the price to DDU is no higher than prices charged by the supplying affiliate to other affiliates or divisions for the same item or items. According to WBRG, because of the "deficiencies" noted by Staff in its initial brief, the Commission cannot make the findings required by the statute.

The ALJ finds that the resort overhead and G&A expenses allocated to DDU's water and sewer utilities at White Bluff and The Cliffs are reasonable and necessary to furnish service to DDU's customers and therefore should not be removed from the revenue requirement as recommended by Staff. There are some categories of costs that appear in DDU's cost of service that also appear in the resort allocation budget,[79] but Mr. Gracy explained that these are separate expenses. Further, there do appear to be certain expenses that do not pertain to DDU's provision of services, such as resort employee uniforms and advertising. However, the ALJ finds DDU's decision to allocate approximately 3% of the resorts' total overhead and G&A expenses, based on an average of DDU's portion of those costs, to be reasonable. Even Staff concedes that some portion of the resort expenses could be reasonable and necessary for the utility. While Staff finds DDU's methodology of allocating a flat percentage of all resort overhead and G&A expenses objectionable because it includes certain expenses which are unnecessary for DDU's provision of service, the evidence is undisputed that the allocated costs shared with the resort for the expenses that DDU does need, including office space, office supplies, and certain employees, were lower than if DDU had rented its own space, set up its own office, and hired its own employees. Given that fact, DDU is saving money by allocating these resort costs, and averaging out its share of those costs to 3% of the total is reasonable. Therefore, the allocated overhead and G&A costs for White Bluff and The Cliffs are reasonable and necessary operation expenses incurred by DDU to provide service to its ratepayers, and the ALJ recommends the Commission reject Staff's proposal to remove those expenses from the Applications.

[79] *See* Staff Ex. 2a, Sears workpapers at 2, 108.

As to WBRG's argument that these costs involve payments to an affiliate, and that the evidence in the record prevents the Commission from complying with the provisions of Texas Water Code § 13.185(e), it is unclear to the ALJ that DDU actually makes any payments to the resort for these costs. It appears from the evidence that these are costs incurred by the resort, 3% of which are then expensed to DDU, and the ALJ finds no support in the statute for an argument that this allocation would constitute a payment for such costs. Further, WBRG's contention assumes that the alleged payments are made to an "affiliated interest" as defined by Texas Water Code § 13.002(2), but WBRG cites to no evidence proving that payments were made to a corporation meeting the statutory definition. Therefore, the ALJ recommends the Commission reject WBRG's argument that DDU's allocated resort overhead and G&A expenses are subject to the requirements of Texas Water Code § 13.185(e).

Finally, based on a reasonable agreement between the parties, the ALJ recommends the Commission adopt Staff's proposal to remove $19,728 from White Bluff water and $20,148 from White Bluff sewer in equipment lease fees associated with automatic meter reading and the 50,000 gallon wastewater treatment plant, and $500 in sewer tap fee expenses from White Bluff sewer.

B. Depreciation (PO Issues 12, 27)

With regard to the issues set forth in the Preliminary Order concerning used and useful property costs and the depreciation rates, methods, and expenses pertaining to such assets, this Proposal for Decision previously discussed and analyzed Staff's recommended reclassification of certain costs as capital assets instead of expenses. The only remaining costs in dispute on this issue as between DDU and Staff are those related to the grinder pumps, and that discussion and analysis is set forth above.

Staff in its briefing argued that White Bluff's sewer depreciation schedule included an $80 expense for a "Truck Bed Mat" that was also included in White Bluff's cost of service.

Therefore, Staff recommends this $80 expense be removed from the depreciation schedule. DDU did not respond to Staff's proposal in this regard, and the ALJ recommends that it be adopted.

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

According to WBRG, the adjustments for known and measurable changes in depreciation for the White Bluff systems and The Cliffs systems should be disallowed because (a) DDU provided no explanation to verify or support such adjustment and (b) it is based on a trended original cost study that artificially inflated the original costs of certain assets beyond the costs shown on DDU's books. WBRG argues that because DDU possessed reliable accounting records to establish depreciation, Commission rules do not allow for a trended cost study to establish the original costs of the assets.[80]

Through a trended original cost study performed by Dr. Harkins, DDU established the original cost for certain of White Bluff's and The Cliffs's assets. Dr. Harkins explained that the study was required because original invoices for the entirety of the line work for the systems were unavailable.[81] However, WBRG notes that DDU's chief financial officer, Tim Grout, testified that the actual costs of the collection line system at White Bluff are on the balance sheet, based on invoices, and that to his knowledge, there is no reason to doubt DDU's book values for those assets because "everything looks pretty intact."[82] WBRG takes issue with Dr. Harkins's failure to review DDU's balance sheets to determine whether DDU had accounted for the construction costs for which she did not have invoices.[83] Dr. Harkins testified that her work for this case was based on invoices, and that it was her "task" to "simply . . . look at invoices to do

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[80] *See* 16 Tex. Admin. Code § 24.31(c)(2)(B)(i) ("For original cost . . ., cost of plant and equipment allowed in the cost of service that has been estimated by trending studies . . , which has no historical records for verification purposes, may receive an adjustment to rate base . . .").

[81] DDU Ex. 5, Harkins direct at 8; Tr. at 186.

[82] Tr. at 158-159.

[83] Tr. at 187.

an inventory asset and put original cost to them."[84] In doing so, she found "that the entirety of the pipe work for the two systems was not represented."[85] Dr. Harkins stated that she did not review balance sheets or general ledgers, but that if she had, and the cost set forth on the balance sheet was less than the cost she developed from her trended study, she would have used the book number.[86]

DDU counters that Mr. Grout testified regarding DDU's balance sheet and that the detail in the balance sheets is "one-line, lump-sum numbers."[87] This lack of detail, claims DDU, supports Dr. Harkins's determination that a trended cost study was appropriate for those assets for which she had no supporting invoices. DDU takes the position that by Commission rule, the use of Dr. Harkins's trended cost study under these circumstances was proper.

It is not entirely clear whether historical records exist (or existed at the time the Applications were prepared) showing the original construction costs for the collection and distribution lines at White Bluff and The Cliffs. While it was established that the available invoices did not cover all of the line work costs, Dr. Harkins did not review DDU's balance sheets to determine if those asset costs were recorded there. No witness testified that a review of the account balances indicated that not all of the original line work costs were recorded in the utility's books. While Mr. Grout testified generally that "a lot" of the details in the balance sheet entries in DDU's books were "one-line, lump-sum numbers," this statement was not explored further as to whether the original costs of line work assets were recorded as such in the balance sheets. However, DDU relies solely on this statement by Mr. Grout as support for the "idea" that the original costs of the line work cannot be determined from the balance sheets.[88]

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[84] Tr. at 187-188.

[85] Tr. at 188.

[86] Tr. at 189.

[87] Tr. at 157.

[88] DDU Reply Brief at 19.

However, Mr. Grout also stated that he believed the actual costs of the line work were on the depreciation list and therefore the balance sheet as well.[89] Mr. Joyce also conceded that the entry on DDU's depreciation schedules for known and measurable changes reflects the difference between the cost shown in DDU's accounts and the cost developed by Dr. Harkins through her trended cost study.[90] Taken as a whole, the evidence tends to support a finding that there were some historical records available to verify those costs. The Commission has taken the position that trending studies are discouraged "except when historical records are unavailable from any source."[91]

The ALJ interprets 16 Texas Administrative Code § 24.31(c)(2)(B)(i) to put the burden on DDU to show that its account balances do not reflect the original costs of the line work assets before estimating those costs by a trending study for purposes of determining rate base. The ALJ finds that DDU failed to meet that burden and therefore recommends the Commission disallow DDU's request for a known and measureable change to depreciation for both White Bluff and The Cliffs.

If the Commission determines that DDU's use of a trending study was acceptable, the ALJ notes that 16 Texas Administrative Code § 24.31(c)(2)(B)(i) provides the Commission with discretion to adjust DDU's rate base to account for the use of a trending study to estimate its level of invested capital. Based on the record evidence, the ALJ finds that DDU's rate base should be lowered to account for the trending study. DDU offered no evidence or argument to explain why it has no records of the original cost of the assets Dr. Harkins trended in her study. The ALJ recommends the Commission make such adjustment for purposes of determining the known and measurable change in depreciation.[92]

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[89] Tr. at 158.

[90] Tr. at 205.

[91] *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 (Project No. 43871 Order) at 82 (August 24, 2015).

[92] *See* Project No. 43871 Order at 82-83.

2. Error in Trending Study

Besides its argument that the use of a trended cost study was improper, WBRG also contends that Dr. Harkins made a significant error in carrying out the study, such that the results are unreliable. Specifically, WBRG contends that Dr. Harkins should have used an installation date of January 1, 1991, for her study instead of the January 1, 1996, date she used.[93] According to WBRG, Dr. Harkins's use of the incorrect installation date resulted in an overestimation of rate base, depreciation expense, return, and income tax expense.[94]

Dr. Harkins testified that she had to make a "best guess" for the installation dates in her trending study, and that she used January 1, 1996, as an installation date for the piping in the White Bluff systems.[95] Mr. Gracy testified that construction of the collection and distribution lines at White Bluff began in around 1990.[96] Although she admitted that had she used an installation date of sometime in 1991 the estimate of the original cost of the line would have been lower, Dr. Harkins explained that 1996 was a conservative installation date to use for her study because from 1991 up through 2007 and 2008, when she did the original study, construction was ongoing. Therefore, she chose a date somewhere in the middle, around the time the second well was made.[97] Dr. Harkins testified that any loss or gain in the estimated original cost caused by the installation date chosen "is considered to equilibrate" because the system actually took years to install.[98]

The ALJ finds that if the Commission is inclined to allow the use of a trending study to estimate the original costs of the collection and distribution systems at White Bluff, Dr. Harkins's use of January 1, 1996, as an installation date for the pipe work was reasonable

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[93] WBRG Ex. 1, direct testimony of Nelisa D. Heddin at 36.

[94] WBRG Initial Brief at 8; WBRG Ex. 1, Heddin direct at 228-33.

[95] Tr. at 193; DDU Ex. 5, Harkins direct at 38.

[96] Tr. at 65.

[97] Tr. at 194.

[98] DDU Ex. 9, Harkins rebuttal at 8.

and appropriate. While construction actually started in 1990, the evidence showed that construction continued into 2008, such that any gain in cost from using 1996 as the installation date will be corrected by installation done up to ten years after that date and beyond, at which time the cost would be even greater. Therefore, if the Commission determines that a trending analysis is appropriate, the ALJ recommends that it reject WBRG's recommendation to change the installation date in Dr. Harkins's study for the piping at White Bluff.

3. Fully Depreciated Assets

WBRG witness Ms. Heddin identified certain DDU assets that have fully depreciated but were still included in DDU's White Bluff depreciation tables.[99] Allowing additional depreciation for fully depreciated assets would result in over-recovery by DDU, according to WBRG. In reply, DDU indicated its agreement that annual depreciation amounts included in the test year depreciation expense for assets that fully depreciated prior to the test year should be removed.

The ALJ recommends that Ms. Heddin's proposed adjustments in this regard included in Tables NDH-14, NDH-15, NDH-16, and NDH-17 be adopted by the Commission.

C. Taxes [PO Issues 28, 29, 30 31]

1. Federal Income Tax Expense [PO Issue 30]

Although DDU asserts that no party disputes its methodology for calculating its federal income tax expense, Staff contends that its calculations use the actual tax rate based on DDU's total taxable income and then adjust for the surtax exemption, while DDU's calculations apply the effective tax rate.[100] However, according to Staff, the adjustment to DDU's federal income

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[99] WBRG Ex. 1, Heddin direct at 43-44.

[100] Staff Ex. 2, Sears direct at Att. ES-3, Schedule V.

tax expense it proposes is primarily based on the cost of service it recommends for DDU, which pertains to flow-through calculations.[101]

DDU contends in its reply brief that Staff's recommendation to treat White Bluff and The Cliffs as separate entities when calculating federal income tax expense is inappropriate. Specifically, DDU witness Mr. Joyce testified that because Staff's recommendations regarding cash working capital, capital structure, and return on debt are based on a "combined utility" for White Bluff and The Cliffs, the federal income tax calculation should be done on the same basis.[102] Because Staff cites to no evidence in support of its position, the ALJ recommends that Staff's recommendation be rejected.

WBRG asserts that DDU's federal income tax expense should be adjusted to reflect the final determination on DDU's authorized return because such expense is solely a function of the return amount. DDU agrees with WBRG's assertion, and Staff takes no position. The ALJ finds the adjustment appropriate and recommends that it be adopted.

2. Other Assessments and Taxes [PO Issue 29]

Staff proposes reductions of $2,148 for water and $5,025 for sewer for DDU's other tax expenses.[103] DDU contends that these adjustments were related to payroll taxes, which flow through from Staff's proposed adjustments to DDU's employee labor costs discussed previously. Based on the ALJ's determination that DDU met its burden to prove the reasonable and necessary employee labor expenses, the ALJ finds that Staff's proposed reductions to DDU's payroll tax expense should not be made.

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[101] Staff Initial Brief at 24-25; Staff Reply Brief at 16.

[102] DDU Ex. 11, Joyce rebuttal at 14.

[103] Staff Ex. 2, Sears direct at 24.

Staff also adjusted DDU's other tax expense by removing the sales and title taxes for the 2014 Ford because it is included in the asset depreciation schedule.[104] DDU agrees with Staff's proposed adjustment, and the ALJ recommends that the adjustment be made.

D. Return On Invested Capital [PO Issues 9, 10, 15, 16, 18, 19, 28, 31]

DDU's return on its invested capital is a component of its cost of service at White Bluff and The Cliffs.[105] DDU's invested capital, or rate base, at White Bluff and The Cliffs was a hotly-disputed issue between DDU and White Bluff in prefiled testimony and at the hearing. WBRG contends that 100% of DDU's assets at White Bluff should be treated as developer-contributed assets, such that DDU has no invested capital.[106] DDU takes the position that all of its investment in the White Bluff water and sewer systems is used and useful, and therefore the appropriate amount of developer contributions is zero.[107] WBRG also contends that there is certain property included in DDU's requested rate base that does not belong to DDU, while DDU argues that the property and utility facilities on that land are part of the utility infrastructure and should be included in rate base. Additionally, WBRG maintains that because Dr. Harkins's trending study was improperly used and erroneous, DDU's rate base should be adjusted to remove Dr. Harkins's estimates for the original costs of the assets and to instead include the book values of the assets. Finally, WBRG argues that some of the infrastructure at White Bluff and The Cliffs is not used or useful or was imprudently constructed. Specifically, WBRG contends that it is inappropriate for the customers of the utilities to pay return and depreciation for water and sewer lines that are not serving the customers.

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[104] Staff Ex. 2, Sears direct at 24.

[105] 16 Tex. Admin. Code § 24.31(a).

[106] WBRG Initial Brief at 10; *see* 16 Tex. Admin. Code § 24.31(c)(2)(B)(v) (prohibiting utility from including assets funded by customer contributions in aid of construction in invested capital or original cost), (c)(3)(D)-(E) (requiring contributions in aid of construction and other sources of cost-free capital to be deducted from rate base); 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, last accessed February 9, 2018.

[107] DDU Initial Brief at 21.

1. Original Cost of Plant in Service

a. Staff's Recommended Adjustments and ALJ's Recommendations

Staff's proposed adjustments to DDU's plant in service involve the reclassification of the tool box and the lease expense for the 2014 Ford F-150 previously discussed in Section IV.A.5. of this PFD. These adjustments were agreed to by DDU, and the ALJ recommends that these costs be added to DDU's plant in service.

Further, Staff determined after the hearing on the merits that the correct original cost of a "75,000 gallon gst, field erect with pad" and "75,000 gallon gan, field erect mth pad" is $16,565, and that the water depreciation schedule for The Cliffs system should be revised accordingly. DDU agrees with this revision, and the ALJ recommends that it be adopted.

Staff also recommends that original cost of plant in service be adjusted to reflect its position that certain other plant maintenance expenses should be capitalized as assets. As explained in Section IV.A.6.b. of this PFD, the ALJ recommends that Staff's position be rejected, such that there would be no change to the original cost of plant in service based on this recommendation by Staff.

Finally, as previously explained in Section IV.B. of this PFD, the original cost of the "TK Crossbed Toolbox" set forth on the White Bluff sewer depreciation schedule should be revised to $850 to remove an $80 expense for a "Truck Bed Mat" that was also included in White Bluff's cost of service.

b. TCUC's Argument, DDU's Response, and ALJ's Analysis

TCUC argues that for purposes of calculating DDU's invested capital in The Cliffs systems, and based on Texas Water Code § 13.185(b), the original cost is what TCUC contends

was the purchase price paid for The Cliffs property. According to TCUC, Double Diamond, Inc. paid $1.8 million for the entire resort at The Cliffs.[108] TCUC makes that assertion based on a document it presented to the ALJ with its Initial Brief that purports to be a Special Warranty Deed executed on October 29, 1993, and conveying certain property from Franklin Federal Bancorp to Double Diamond, Inc.[109] Therefore, TCUC contends, the original cost of utility plant at The Cliffs set forth in The Cliffs Application ($2,630,180)[110] is not possible.

TCUC also maintains that the net book value of The Cliffs assets at the end of the test year was $129,377.40. According to TCUC, this value should be used as original costs based on the unreliability of DDU's trending analysis, the discrepancy as to how DDU accounted for developer contributions, and the fact that DDU paid far less than book value for the assets.[111] TCUC also asserts that DDU represented in a 2007 rate case filed at the Texas Commission on Environmental Quality (TCEQ) that the original cost of The Cliffs assets was $898,290.[112]

As an initial matter, DDU notes that TCUC's original cost of utility plant argument depends on documents that were attached to TCUC's Initial Brief but that were not offered into evidence by TCUC or admitted into the record. DDU also contend that none of these documents summarize evidence that was admitted.[113] DDU further explains that TCUC Exhibit 15 inaccurately reflects the totality of the assets of The Cliffs's systems, inappropriately excludes assets that have fully depreciated, and ignores additional capital invested since 1993.[114]

The ALJ agrees with DDU that TCUC Exhibits 15 and 19, upon which TCUC relies in making its arguments regarding original cost, are not part of the record in this case and therefore

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[108] Double Diamond, Inc. is a "sister" company of DDU, as more fully discussed later in Section IV.D.4.

[109] *See* TCUC Initial Brief at 6, citing to a document attached to the brief and marked Exhibit 15.

[110] DDU Ex. 2, The Cliffs Application at 31.

[111] TCUC Initial Brief at 7, citing to a document attached to the brief and marked Exhibit 15.

[112] TCUC Initial Brief at 8, citing to a document attached to the brief and marked as Exhibit 21.

[113] DDU Reply Brief at 30, 32.

[114] DDU Reply Brief at 32.

are not evidence either of the purchase price for The Cliffs resort property or of the book value of DDU's assets.

2. Accumulated Depreciation

Staff's proposed adjustments to DDU's accumulated depreciation involve the same issues set forth in the section above, and the ALJ recommends that all revisions to the original cost of plant in service be reflected in the accumulated depreciation calculation.

3. Cash Working Capital

Pursuant to 16 Texas Administrative Code § 24.31(c)(2)(C)(iii)(III), for Class B utilities like DDU, 1/12 of its O&M expenses, with certain exclusions, will be considered a reasonable allowance for cash working capital, or the money DDU will use to bridge the gap between the time it pays for an expense and the time it recovers the cost of that expense through revenue. Staff and DDU agree that the White Bluff cash working capital allowance should be 1/12 of O&M expenses.

DDU argues that the cash working capital allowance for The Cliffs should be 1/8 of O&M expenses, which is considered a reasonable allowance for a Class C utility under 16 Texas Administrative Code § 24.31(c)(2)(C)(iii)(II).[115] However, Staff witness Mr. Ramirez testified that the 1/12 ratio should also apply to The Cliffs because The Cliffs is part of DDU and therefore should use the same ration in the cash working capital calculation as White Bluff. Mr. Ramirez explained that DDU maintains cash balances for both systems under one CCN, filed one annual report for both developments, and filed a single rate case for both developments.[116] DDU takes the position that Staff is inconsistent in its treatment of White Bluff and The Cliffs as combined or separate entities in an effort to reduce DDU's revenue requirement.

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[115] *See* DDU Ex. 6, Joyce direct at 12.

[116] Staff Ex. 3, Ramirez direct at 11.

The ALJ recommends that the Commission adopt Staff's position that 1/12 of O&M expenses is the reasonable cash working capital allowance for both the White Bluff and The Cliffs systems. While the systems are geographically separated, the same company, DDU, operates and maintains both systems, and there is no evidence disputing Mr. Ramirez's contention that DDU maintains cash balances for both systems under one CCN. Therefore, the ALJ agrees with Staff that both systems have access to the same capital, and that for purposes of the cash working capital allowance, the systems are one and the same.

4. Developer Contributions

Despite arguing that it could include 100% of the cost of all utility assets in its rate base, DDU agreed to reclassify portions of some White Bluff utility assets as developer contributions; for example, 80% of the costs of assets that were part of what Mr. Gracy termed the "original [water] system," which included Well #1, a 58,000-gallon storage tank, a pump station, the land where these facilities are located, and the initial distribution lines.[117] In determining the original cost of used and useful utility plant, property, and equipment for purposes of calculating its rate base, DDU used an asset list prepared jointly by Mr. Gracy and DDU witness Dr. Harkins, which identifies certain assets that were considered 80% developer-contributed.[118] That 80% portion of the cost of those assets was removed from DDU's rate base calculation. According to DDU witness Mr. Joyce, the Application reflects the same amounts of developer contributions claimed by DDU in previous Applications for rate changes filed with the TCEQ and in sworn testimony in previous dockets concerning those Applications.[119]

DDU witness Mr. Gracy testified that the decision of how the costs of the utility assets were split, either 80% to the developer and 20% to the utility or 100% to the utility, was initially made in 1990 and 1991. He admitted that he could not find any documentation reflecting this

[117] DDU Initial Brief at 21; DDU Ex. 3, Gracy direct at 8.

[118] DDU Ex. 6, Joyce direct at 12-13; DDU Ex. 6-C, White Bluff asset list; Tr. at 70.

[119] DDU Ex. 11, Joyce rebuttal at 22-23.

decision.[120] Until December 1996, Double Diamond, Inc., a wholly-owned subsidiary of Double Diamond-Delaware, Inc. (Double Diamond-Delaware), was the developer and the utility company at White Bluff and contracted for the construction of the original infrastructure of the utility systems; according to Mr. Gracy, Double Diamond, Inc. separated out the developer and utility costs within its own accounts.[121] Mr. Gracy stated that payments made by Double Diamond, Inc. to contractors to build the collection and distribution lines at White Bluff would have been recorded in Double Diamond, Inc.'s books as 80% developer and 20% utility.[122] However, DDU concedes that there is no documentation showing that corresponding entries for these costs were made in the financial records of the developer and the utility.[123]

After DDU was created in December 1996, also as a wholly-owned subsidiary of Double Diamond-Delaware, the original utility infrastructure and other assets existing at that time were "transferred in some form or fashion from Double Diamond, Inc. to DDU."[124] According to WBRG witness Nelisa Heddin, DDU stated in discovery that before December 1996, most of the utility infrastructure was paid for by Double Diamond, Inc., and that in 1997, Double Diamond Properties Construction Co., also created in December 1996, began paying for most of the utility infrastructure. Sometime around 2007 or 2008, most of the utility infrastructure was completed and DDU began paying for all utility assets and operations.[125]

Mr. Gracy stated that in addition to the costs of the "original" water system, the "development side of the company" funded 80% of the cost of additional distribution lines that were installed to serve new sections of the White Bluff development that opened over time, while DDU contributed 20% of that cost.[126] Mr. Gracy also testified that the costs of the original

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[120] Tr. at 67.

[121] Tr. at 55-56, 68-69.

[122] Tr. at 69.

[123] WBRG Ex. 1M, Workpapers of Nelisa D. Heddin at 132, DDU's Response to WBRG RFI No. 1-15.

[124] Tr. at 57.

[125] WBRG Ex. 1, Heddin direct at 38-39, citing DDU Response to WBRG RFI 3-5.

[126] DDU Ex. 3, Gracy direct at 8.

sewer system at White Bluff and those of additional collection lines added to that system to serve new sections of development were funded in the same manner, 80% by the development side and 20% by DDU.[127] However, in the White Bluff Application, the cost of installing the collection lines for the sewer system, which were installed at the same time as the distribution lines for the water system, was claimed as an asset wholly contributed by DDU.[128] When questioned as to why the cost of the collection line installation at White Bluff was not split 80% developer-contributed and 20% DDU-contributed, Mr. Gracy said he believed that cost was intended to be so booked, but deferred to DDU witness Dr. Harkins as to why the asset list showed it booked 100% to DDU.[129]

According to Mr. Gracy, as potential for additional connections to the White Bluff utility systems increased, facilities were expanded or added to comply with TCEQ regulations and to ensure reliability. The costs of those expansions and additions, which Mr. Gracy testified were made based on growth and demand, were booked as DDU projects with no developer contributions.[130] Mr. Gracy testified that the 80% developer/20% utility split continued until 2008, at which time the primary infrastructure for the White Bluff utility systems was completed. At that point, it was decided that all future infrastructure would be 100% utility.[131]

i. WBRG's Arguments[132]

Because DDU and the White Bluff developer are essentially the same entity, WBRG argues DDU had the burden to show the utility investments were not funded out of lot sales, and

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[127] DDU Ex. 3, Gracy direct at 10-11.

[128] Tr. at 74; DDU Ex. 6-C, White Bluff asset list at 49.

[129] Tr. at 74-75.

[130] DDU Ex. 3, Gracy direct at 8, 11; Tr. at 71, 73.

[131] Tr. at 67.

[132] TCUC generally asserts that DDU offered contradicting testimony and documentation regarding developer contributions. *See* TCUC Initial Brief at 8-9.

that DDU did not meet this burden.[133] Further, WBRG maintains that lot sales paid for the majority of DDU's assets, and that the developer continues to treat the capital invested in DDU as its own capital. Finally, WBRG claims that because DDU failed to provide documentation of the amount of developer-contributed assets at White Bluff, all capital invested in the White Bluff water and sewer systems should be considered developer-contributed.[134] WBRG contends that prohibiting DDU from earning a return on an investment made by the developer, not DDU, will prevents ratepayers from paying both (a) the developer for the assets through the sale of the lots and (b) a profit to DDU on those same assets.

Relying upon Texas Supreme Court precedent, WBRG asserts that because DDU, Double Diamond Inc., and Double Diamond Properties Construction Co. are all wholly-owned subsidiaries of Double Diamond-Delaware, Inc., and all four companies keep a single set of financial records and file a joint tax return, DDU must clearly demonstrate that it, and not one of the other companies, paid for the assets it seeks to include in its rate base.[135] According to WBRG, assigning this burden to DDU is logical, given that the developer and utility should have the information necessary to show how the utility costs were accounted for as between the developer and the utility. WBRG takes the position that Mr. Gracy's testimony that the initial investment in the systems were treated as 80% developer contributions and 20% utility investment is insufficient to meet the burden because there is no corroborating evidence to support this division of assets.[136]

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[133] There is varying evidence in the record as to the identity of the White Bluff developer. DDU witness Mr. Gracy testified that Double Diamond-Delaware, Inc. acquired and began development of the White Bluff project in 1990," but a purchase agreement for a lot in White Bluff cites Double Diamond Inc. as the seller. WBRG Ex. 1, Heddin direct, citing DDU Ex. 3, Gracy direct at 5; WBRG Ex. 1G, White Bluff Real Estate Contract. Mr. Gracy testified at the hearing that when White Bluff's distribution and collection lines were built "beginning in around 1990[,]" the contractors who built them worked for "Double Diamond, Inc. in the beginning." Tr. at 65.

[134] WBRG Initial Brief at 11.

[135] WBRG Initial Brief at 12, citing *Sunbelt Utilities v. Public Utility Commission*, 589 S.W.2d 392, 395 (Tex. 1979); *see* WBRG Ex. 1, Heddin direct at 10-11.

[136] *See* WBRG Ex. 1M, Workpapers of Nelisa D. Heddin at 132.

Moreover, argues WBRG, the record shows that the developer contributed the assets that DDU seeks to include in its rate base to DDU without cost to the utility. In support of this position, WBRG refers to the sales contracts used to convey properties in White Bluff from Double Diamond, Inc. to purchasers.[137] The contracts state that the seller is responsible for providing water and sewer service to the properties, and that the utility will be responsible for the maintenance of the systems. WBRG contends that these contract provisions mean the cost of the utility infrastructure was paid out of the sales proceeds while the operation and maintenance of the utility systems would be paid through utility rates.[138] Therefore, argues WBRG, all of DDU's utility assets are developer-contributed unless DDU can show it made investment as part of its operation of the utility infrastructure provided by Double Diamond, Inc., which it did not do.[139]

As additional support for its position, WBRG cites to testimony from Double Diamond-Delaware's Chief Financial Officer Mr. Grout, who testified that development costs, including those incurred to prepare the land for sale, would be an asset that, once a lot was sold, is taken to the balance sheet and expensed.[140] Mr. Grout stated that he did not know if the utility infrastructure costs were expensed once a lot was sold, but that they "theoretically" should have been.[141]

a. Testimony of Nelisa Heddin

WBRG witness Ms. Heddin testified that the assets trended by Dr. Harkins in her study, as listed in DDU Exhibits 5B, 5D, 5F, and 5H, were constructed or installed before

[137] *See* WBRG Ex. 1G.

[138] WBRG Initial Brief at 14.

[139] WBRG Ex. 1, Heddin direct at 16-17.

[140] Tr. at 156.

[141] Tr. at 157. Preceding this testimony, Mr. Grout conceded that he was "not quite" familiar with the way development projects are accounted for "at Double Diamond." He also testified that he is not sure how a developer determines how much profit comes in based on the sale of lots. Tr. at 155.

December 30, 1996, which is the date DDU was incorporated. By Ms. Heddin's calculation, these assets constituted 61% of the water system assets and 60% of the sewer system assets included in DDU's requested rate base for White Bluff.[142] Therefore, Ms. Heddin stated, these assets could not have been installed by DDU, and DDU produced no documentation showing that these assets were transferred to DDU and, if they were, in what manner.[143] As to assets installed after December 30, 1996, Ms. Heddin testified that most of them were paid for by Double Diamond Properties Construction Co., according to receipts and payment documentation provided by DDU in discovery.[144] Ms. Heddin testified that DDU provided proof of payment for 69 of the 190 assets claimed as part of the rate base for White Bluff water; such proof showed that of those 69 assets, only four were funded by DDU, with the vast majority being funded by Double Diamond Properties Construction Co. As for White Bluff sewer, DDU supplied proof of payment for 26 of the 125 assets claimed as part of the rate base, with such proof showing that only three assets were funded by DDU with the remaining assets primarily funded by Double Diamond Properties Construction Co.[145]

Ms. Heddin also discussed the differing amounts of developer contributions reflected in prior rate change applications filed by DDU and, in some cases, in evidence admitted in contested case hearings concerning those applications. In December 1997, DDU filed an application to change rates at White Bluff, The Cliffs, and Oakwood, another development that it serves. In that filing, there were no contributions in aid of construction identified.[146] In August 2007, DDU filed an application to change water rates at White Bluff, The Cliffs, and the Retreat, another development that it serves. This application was contested and ultimately

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[142] WBRG Ex. 1, Heddin direct at 39-40.

[143] WBRG Ex. 1, Heddin direct at 17-18; WBRG Ex. 1E.

[144] WBRG Ex. 1, Heddin direct at 18-19.

[145] WBRG Ex. 1, Heddin direct at 19-20.

[146] WBRG Ex. 1, Heddin direct at 22; WBRG Ex. 1I, Excerpt from DDU Rate Change Application (December 8, 1997).

referred to SOAH for a contested case, which was heard in February 2009.[147] The application was amended in December 2007, but neither the August 2007 nor the December 2007 amendment indicated that a portion of DDU's assets included in rate base was a developer contributions. DDU witnesses testified at hearing that there were assets contributed by the developer, and Mr. Gracy testified that DDU pays for 20% of the distribution and collection lines and the developer contributes the remainder.[148] In October 2008, DDU filed another rate change application for the same three water systems which identified the amount of developer contributions as approximately $1.9 million.[149] That application was also contested and referred to SOAH for a hearing.[150] In direct testimony, DDU's expert witness testified that based on the asset evaluation performed by Dr. Harkins for that case and the identification by Mr. Gracy of the assets on Dr. Harkins's list that were subject to the 80% developer contribution, the developer contributions were actually $2,551,674.[151] In February 2009, DDU filed another rate change application for the same three water systems, and the application indicated a total of $1,119,399 in developer contributions for the three systems.[152]

Concerning the tax depreciation schedules produced by DDU, Ms. Heddin testified that those schedules cannot be reconciled with the asset list included in the White Bluff Application. She explained that some assets are shown on both the list and the schedules, but they show different costs and installation dates on the different documents.[153] Specifically, WBRG notes that Well No. 4 is shown on the tax schedules as installed in September 2001 at a cost of $222,306, but that the asset list shows the same asset installed in February 2001 at a cost of

[147] SOAH Docket No. 582-08-0698; *Application of Double Diamond Utilities, Inc. to Change Its Water Rates and Tariff in Hill, Palo Pinto, and Johnson Counties, Texas*, Proposal for Decision (PFD) (June 15, 2009).

[148] *See* WBRG Ex. 1J, PFD in SOAH Docket No. 582-08-0698, at 117.

[149] WBRG Ex. 1, Heddin direct at 22.

[150] SOAH Docket No. 582-09-4288; *Application of Double Diamond Utilities Company, Inc. to Change Water Rate Tariff for Service in Hill, Palo Pinto, and Johnson Counties.*

[151] WBRG Ex. 1-K, Excerpt of Prefiled Testimony of DDU Witness Chris Ekrut in SOAH Docket No. 582-09-4288 (March 1, 2010), at 125-126.

[152] WBRG Ex. 1, Heddin direct at 23.

[153] WBRG Ex. 1, Heddin direct at 21.

$163,215.[154] Also, Ms. Heddin testified that an asset identified as "Ashbrook Sutton Hartley wwtp," is shown on the asset list as installed in August 2008 at a cost of $436,650, but appears to be described in the tax schedules as installed in July 2008 at a cost of $214,567.[155] WBRG argues that DDU must reconcile the tax depreciation schedules to the asset lists before it can argue that the schedules satisfy its burden to show that the assets were depreciated.[156]

WBRG further contends that DDU's purported reconciliation of the asset amounts it contends are contained within the White Bluff Application, the tax depreciation schedules, the consolidated financial statement, and the asset list is unsupported by the record and does not show the amount of developer-contributed assets or the original costs of the assets. WBRG points out that several line items are not found in the source documents cited by DDU, but that the numbers still do not reconcile. According to WBRG, the Applications indicate that the original cost of DDU's assets at White Bluff and The Cliffs was $6,217,675, net of developer contributions, while DDU's financial statements show that the cost of those assets was approximately $4.9 million, net of developer contributions. WBRG claims that this is an unexplained discrepancy that underscores DDU's failure to prove what portion of the original assets were developer contributed.[157]

Finally, Ms. Heddin opined that because Double Diamond-Delaware took out a loan in March 2013 secured by the water and wastewater utility assets at White Bluff, all of DDU's assets are developer-contributed.[158] WBRG notes that neither Mr. Gracy nor Mr. Grout knew how the funds were used or whether Double Diamond-Delaware or DDU would repay the loan.[159]

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[154] WBRG Initial Brief at 15; see WBRG Ex. 1, Heddin direct at 21.

[155] WBRG Ex. 1, Heddin direct at 21.

[156] WBRG Reply Brief at 9.

[157] WBRG Reply Brief at 8-9.

[158] WBRG Ex. 1, Heddin direct at 24-25.

[159] WBRG Reply Brief at 16.

b. DDU's 80/20 Split

WBRG identifies approximately $2.4 million total in costs associated with the original sewer systems at White Bluff and The Cliffs (approximately $1.7 million for White Bluff and approximately $700,000 for The Cliffs) that were treated as 100% DDU-contributed. Citing testimony from Mr. Gracy and Mr. Joyce, WBRG argues that 80% of those costs were developer contributions that should be removed from rate base.[160]

Staff did not offer any evidence on the issue but took the position that the amounts of the developer contributions set forth in Mr. Joyce's rebuttal should be adopted.[161] WBRG points out that the evidence shows that the initial infrastructure costs for the White Bluff and The Cliffs sewer systems were allocated 100% to DDU and not allocated as 80% developer-contributed and 20% utility-contributed, even though Mr. Gracy testified that they were "intended" to be as they were constructed at the same time. DDU did not respond in briefing to WBRG's argument that these costs should also be subject to the 80% developer/20% utility split.

ii. DDU's Position

DDU claims that WBRG's assertions regarding the Double Diamond companies maintaining a single set for financial records and filing a joint tax return are not supported by the evidence in the record. Further, according to DDU, the *Sunbelt* case does not control under the facts in this record, primarily because Double Diamond, Inc. did not write off the utility assets as the developer in *Sunbelt* did. Those assets remain on Double Diamond-Delaware's books as depreciable, according to DDU. Further, DDU witness Mr. Joyce opined that the original cost of the utility assets set forth in Double Diamond-Delaware's consolidated financial statement ($4.8 million) and the original cost set forth in DDU's depreciation schedule from its tax return

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[160] DDU Ex. 3, Gracy direct at 10-12; Tr. at 74-76; Tr. at 222. TCUC makes the same argument. *See* TCUC Initial Brief at 9.

[161] Staff Initial Brief at 29.

($4.6 million) reconcile within 5%. DDU maintains that the minor discrepancies between the documents results from differing depreciable lives reflected in each.[162] Because these assets are still shown on the consolidated financials, tax depreciation schedules, and the original costs requested as part of rate base for White Bluff, DDU argues, the assets were not funded from lot sales.[163] DDU discounts Ms. Heddin's testimony because she could not reconcile the internal depreciation schedule and the tax return depreciation schedule and did not use department codes provided by DDU.[164]

According to DDU, the developer contributions that are set forth in the White Bluff Application are "hypothetical"[165] and reflect a management decision to treat a portion of the cost of certain assets as developer contributions in an effort to keep utility costs down for DDU customers.[166] DDU argues that the lack of documentation to support Mr. Gracy's testimony regarding the 80% developer/20% utility split of the costs of White Bluff utility assets is irrelevant because Mr. Gracy has been with the utility for over 30 years and because "[h]is testimony regarding the 80/20 allocation has been consistent from case to case, . . ."[167] Regarding the allocation of the initial White Bluff sewer infrastructure that was allocated 100% to the utility instead of 80% developer/20% utility, DDU claims that the 80/20 ratio was a "general principal" pertaining to assets built before and after the 2007-2008 time period, and that the "primary decision point" was whether the asset was part of the "original system" or necessary to keep up with demand and "aging of the system."[168] DDU notes that some assets whose original costs were incurred prior to 2007-2008 were "more appropriately" allocated 100% to DDU based on this factor.

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[162] DDU Initial Brief at 24.

[163] DDU Reply Brief at 23.

[164] DDU Initial Brief at 22, *citing* WBRG Ex. 1, Heddin direct at 21, Tr. at 258.

[165] DDU Initial Brief at 21-22.

[166] DDU Ex. 3, Gracy direct at 8; Tr. at 79, 214

[167] DDU Reply Brief at 25.

[168] DDU Reply Brief at 25, citing Tr. at 67.

iii. ALJ's Analysis and Recommendation

The evidence in the record regarding to what extent DDU's customers funded any of DDU's White Bluff utility plant and to what extent DDU's White Bluff Application includes contributions in aid of construction in its rate base is muddled and unclear.

It is undisputed that DDU, the party seeking the rate change in this case, did not exist at the time the original infrastructure for the water and sewer systems at White Bluff was constructed. The investment made in that infrastructure came from Double Diamond, Inc., which apparently served as both the developer and the utility until DDU was created in December 1996. The evidence also shows that Double Diamond, Inc. paid for the utility assets included in DDU's requested rate base that were installed prior to December 1996, and that Double Diamond Properties Construction Co. paid for the vast majority of utility assets included in rate base that were installed after December 1996. According to Mr. Gracy, the costs of most of the pre-December 1996 assets were separated out in Double Diamond, Inc.'s accounting books as 80% developer contributed and 20% utility funded, pursuant to management decision; however, there is no independent or contemporaneous corroborating evidence in the record to support this assertion. Further, Mr. Gracy's testimony regarding the funding of specific assets was inconsistent with the management decision he described. Likewise, Mr. Gracy testified that the pre-December 1996 assets were transferred to DDU, but there is no independent corroborating evidence in the record to support this assertion.

According to WBRG, the *Sunbelt* case stands for the proposition that DDU bears the burden to prove that the cost of the utility assets were not included in the price paid by its customers for their White Bluff lots. The ALJ disagrees with WBRG's reading of the *Sunbelt* case and its holding. The primary basis for the Commission's determination (found by the Texas Supreme Court to be supported by substantial evidence) that the cost of the Sunbelt utility system should be removed from rate base was that the cost had been expensed by the Sunbelt developer against the amount it realized from the sale of the lots served by the utility system. The utility in the *Sunbelt* case did not dispute that the developer had taken such a write-off,

which was permitted under federal tax laws. Therefore, the separate finding by the Commission in *Sunbelt* that the lot purchasers had paid the developer's cost of the utility system as part of the purchase price of the lots was not dispositive.

The DDU asset lists and depreciation schedules in evidence offer some support for its argument that the White Bluff utility assets included in its requested rate base were not written off against lot sale revenues but remain on the books and have been depreciated.[169] The ALJ agrees with WBRG, however, that the lists and schedules contain contradictory and inconsistent information and create confusion as to the original cost of certain assets and where and how they were booked. Moreover, although Mr. Grout's testimony and the sample lot purchase contract in evidence suggest that some portion of the cost of the White Bluff utility assets may have been expensed against amounts received from White Bluff lot sales, the evidence is inconclusive and offers no insight as to the amount of lot sale funds that went towards utility infrastructure.

The preponderance of the evidence shows that there were some contributions made by the White Bluff developer to the investment made in utility plant, property, and equipment used to service ratepayers at White Bluff. However, it cannot be determined from the evidence the amount of such contributions. It is undisputed that Commission rules prohibit such contributions from being included in DDU's invested capital for purposes of determining its cost of service at White Bluff and ultimately in setting just and reasonable rates for the White Bluff systems.

The ALJ agrees with WBRG that the reconciliation between DDU's accounts as explained by DDU witness Mr. Joyce and in DDU's post-hearing briefing, which DDU argues is proof that the utility assets have been depreciated and not written off, was suspect and included information that was not included in the record.[170] The financial statements and depreciation

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[169] WBRG concedes in briefing that there is "some evidence that DDU may have depreciated some of the assets. . ." WBRG Reply Brief at 7.

[170] Specifically, the information without supporting evidence includes: the fact that the book value of water and wastewater systems included in Double Diamond-Delaware's consolidated financial statement was net of developer contributions; the original costs of all DDU's fixed assets (including Rock Creek assets and The Retreat assets); and the separate original costs of the Rock Creek assets and The Retreat assets.

schedules seem to contradict the White Bluff Application with respect to the treatment of the assets in terms of whether their costs have been written off against lot sale proceeds or depreciated. There is a major disconnect between the original costs of the totality of DDU's utility assets as set forth in the financial statements and depreciation schedule (approximately $4.6 to $4.8 million, net of developer contributions[171]) as compared to the original cost of DDU's White Bluff and The Cliffs utility assets included in DDU's requested rate base (approximately $6.2 million, net of developer contributions[172]). While the original cost set forth in the tax depreciation schedule and the book value in Double Diamond-Delaware's financial statement differ by less than 5%, both include the costs of all of DDU's assets, not just those used and useful assets at White Bluff and The Cliffs.[173] Further, Double Diamond-Delaware's Chief Financial Officer Mr. Grout, despite his just having joined DDU in February and not being completely attuned to the accounting specifics, testified that there were utility infrastructure costs included in White Bluff's inventory against which lot sales proceeds were expensed.[174]

Taken as a whole, the evidence is such that the ALJ cannot make a finding as to whether, in fact, the 80% developer-contributed/20% utility-contributed split testified to by Mr. Gracy accurately, or even approximately, depicts the amount of contributions in aid of construction made by the developer for the White Bluff systems. Therefore, it is certainly possible that the rate base requested in the White Bluff Application includes contributions in aid of construction and, as such, is greater than allowed by Commission rules. DDU is in the best position to access and discover the evidence necessary to differentiate between plant, equipment, and property contributed by the developer and that invested by DDU. The ALJ finds that given: (a) DDU's interest in earning as much of a return on the greatest amount of invested capital as allowable under the rules; (b) the importance of the determination of the amount of invested capital allowable under the rules in setting just and reasonable rates; and (c) that DDU has the burden to

[171] DDU Ex. 12, DDU internal tax depreciation schedule at DDU16-015231; WBRG Ex. 8, DDU 2015 Depreciation and Amortization Report at DDU16-015475.

[172] DDU Ex. 1, White Bluff Application at 31, 38; DDU Ex. 2, The Cliffs Application at 31, 38.

[173] Tr. at 166, 518.

[174] Tr. at 162.

prove that the rates it seeks are just and reasonable, the ALJ finds that DDU had the burden to show how much of the original cost of the utility assets included in its proposed rate base for White Bluff were contributed by the developer.[175] The ALJ further finds that DDU failed to meet that burden. However, the record does show that certain utility assets claimed as part of DDU's rate base were paid for by DDU, and the net book value of these assets should remain in DDU's rate base as invested capital.[176]

5. Property Not Belonging to DDU

Based on a warranty deed produced by DDU in response to discovery, WBRG contends that the cost of the tract of land conveyed by Double Diamond, Inc. to the White Bluff Property Owners Association (WBPOA) in December 1995, as well as certain facilities included on such tract, should not be included in DDU's White Bluff rate base.[177] DDU claims that based on Dr. Harkins's asset study, this tract and the associated facilities are DDU property, and that the 1995 deed is insufficient to show that DDU is not the current owner of the land and facilities in question.[178] DDU contends that there are tax records that show DDU as the owner of the tract.

DDU witness Mr. Gracy was questioned about the deed. He stated that he was familiar with it, and that it conveyed a tract inside White Bluff (Tract 2) from Double Diamond, Inc. to WBPOA. Mr. Gracy testified that there is a water well on Tract 2. According to Mr. Gracy, Tract 2 may possibly have been conveyed back to DDU. He stated that the deed was an error, explaining that the intention was for DDU to convey the portion of Tract 2 that included a boat storage area, but not the portion that included the water well, the water plant, and the water

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[175] 1 Tex. Admin. Code § 155.427; Tex. Water Code (Code) § 13.184(c).

[176] *See* WBRG Ex. 1, Heddin direct at 19-20, Tables NDH-1 (White Bluff water) and NDH-2 (White Bluff sewer).

[177] WBRG Ex. 1, Heddin direct at 42.

[178] WBRG Ex. 1-M at 137; DDU Ex. 5, Harkins direct at 7; DDU Reply Brief at 21.

storage tank. Mr. Gracy testified that he does not know whether the error has been corrected since 1995.[179]

The preponderance of the evidence shows that Tract 2 at White Bluff and the utility assets on such property are not owned by DDU. The warranty deed in evidence shows that the property was conveyed to WBPOA in 1995, and DDU does not appear to contest that such conveyance was made. While Mr. Gracy contends it was an error, he clearly had no knowledge whether such alleged error was ever corrected, and DDU failed to produce any documentation showing that the tract or any of the utility assets were ever conveyed to DDU from WBPOA. The tax records that DDU contends show that it is the owner of the tract are not in evidence. Therefore, DDU's request for net book value of this property of $88,565 and annual depreciation of $2,060 to be included in its rate base should be denied.[180]

6. Improper Use of Trending Study

Based on the discussion and analysis above, the ALJ recommends that DDU's rate base be adjusted to remove the known and measurable change to depreciation, which was included based on Dr. Harkins's trending study.

7. Used and Useful/Prudence

WBRG contends that because the White Bluff and The Cliffs utility systems were designed and built to serve many more lots than are actually served, a large percentage of the water and sewer lines are not used and useful and therefore should not be included in rate base. DDU witness Mr. Gracy testified that the White Bluff systems "serve" 6,314 lots and that The Cliffs systems "serve" 2,518 lots, but that at the end of the test year, White Bluff water had

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[179] Tr. at 99.

[180] *See* WBRG Ex. 1, Heddin direct at 43, Table NDH-13.

640 customers and The Cliffs water had 287 customers.[181] Dr. Harkins agreed that her trending study showed that there are approximately 65 miles of water lines and 60 miles of sewer lines at White Bluff, and 23 miles of water and sewer lines at The Cliffs.[182] According to WBRG, more than $3.8 million in water and sewer lines at White Bluff and more than $1.25 million in water and sewer lines at The Cliffs were installed to provide service to all lots within the developments, but only approximately 10% of the lots at each development are actually receiving service; therefore, 10% of the lots are paying for lines to serve 100% of the lots.[183] WBRG offers no evidence of its own on the issue of used and useful, but argues that by building out the utility infrastructure to serve the entire development before the lots are sold, and then transferring the lines to the utility, the developer inequitably shifts the risk of not selling the lots to the ratepayers. Based on these facts and argument, WBRG requests the Commission find that only 20% of the distribution and collection lines at White Bluff and The Cliffs are used and useful, or that the extension of the lines to the entire development was imprudent. In either case, WBRG maintains that the value of the lines be reduced in accordance with the recommendation for purposes of determining return on invested capital and depreciation.

In response, DDU argues that Dr. Harkins found that all of the distribution and collection lines at White Bluff and The Cliffs are used and useful, and that the systems are fully interconnected and looped.[184] According to Dr. Harkins, if the systems are "looped and they're part of a system that provides water further down, . . .", they are used and useful.[185] Therefore, DDU contends that Dr. Harkins' testimony supports a finding that the entire systems at White Bluff and The Cliffs are used and useful.[186] DDU also points out that Mr. Gracy

[181] DDU Ex. 3, Gracy direct at 7. Mr. Gracy also testified that White Bluff sewer has 567 customers and The Cliffs sewer had 239 at the end of the test year. The record is unclear as to whether any of the sewer customers are not also customers at the respective water systems.

[182] Tr. at 196-197; DDU Ex. 5E, Harkins trending study for The Cliffs water; DDU Ex. 5H, Harkins trending study for White Bluff sewer; DDU Ex. 5I, Harkins trending study for The Cliffs sewer.

[183] WBRG Initial Brief at 20.

[184] DDU Ex. 5, Harkins direct at 7, 10; Tr. at 196-198; DDU Ex. 3 at 7, Att. 3B, 3C, 3D.

[185] Tr. at 197.

[186] DDU Reply Brief at 26.

estimated that 85 to 90 percent of the lots at White Bluff have been sold.[187] Ms. Heddin confirmed that in White Bluff, Double Diamond, Inc. is still the owner, according to county tax records, of approximately 664 of the 6,314 lots. Therefore, DDU must be prepared to provide water and/or sewer service from any of those lots owners when requested, pursuant to its CCN. DDU contends that it is reasonable to have the utility systems built and in place ready to extend service, especially given how much of the infrastructure had been treated as developer contributed.[188]

DDU's rate base includes the original cost, less accumulated depreciation, of its plant, property and equipment used by and useful to DDU in providing service.[189] Dr. Harkins testified that in reviewing DDU's assets, including the entirety of the distribution and collection lines, she determined they are all used and useful to the operation of the utility systems. However, Dr. Harkins's testimony regarding whether distribution and collection lines along streets with no customers are used and useful reveals that she does not have the knowledge of how the systems work necessary to take a position. She did opine that if the lines were built out to serve customers on the edges of the developments, the entirety of the lines would be used and useful. However, she offered this opinion as a hypothetical, and followed it by testifying that she is not familiar enough with DDU's systems to say whether it is equitable to have 600-plus customers paying a return on the cost of the infrastructure built for 6,000 lots.[190]

Based on the ALJ's finding that DDU failed to meet its burden of proof regarding the amount of developer contributed assets that were included in its rate base, and specifically that almost all of the cost of the distribution and collection lines at White Bluff should be removed from rate base as contributions in aid of construction, the ALJ finds the question of whether the entirety of the lines are used and useful to be moot. However, if the Commission approves the 80% developer/20% utility split for utility asset contributions, the ALJ finds that given the sales

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[187] Tr. at 63-64.

[188] DDU Reply Brief at 27.

[189] 16 Tex. Admin. Code § 24.31(c)(2)(A).

[190] Tr. at 197-198.

of lots in White Bluff and the intentions of the developer to sell the remaining lots, the entirety of the distribution and collection systems at the two utilities are used and useful. The ALJ agrees with DDU that it was reasonable to build out the distribution and collection systems such that if any lot within either development was sold and the new owner requested service, it could be provided. Therefore, the ALJ recommends the Commission reject WBRG's proposal to find only 20% of the White Bluff system to be used and useful.

8. Accumulated Deferred Federal Income Tax (ADFIT)

DDU's accumulated reserve for deferred federal income taxes must also be deducted from DDU's overall rate base.[191] Based on the testimony of Staff witness Debi Loockerman, Staff recommends ADFIT deductions from the invested capital totals found in the Applications. Staff's recommendations are based on the original costs of the capital assets of the two systems as set forth in DDU's 2015 tax return and the depreciation documentation supplied by DDU.[192] Ms. Loockerman calculated her proposed ADFIT amounts based on Staff witness Ms. Sears's determination of total invested capital.[193] These proposed ADFIT deductions are as follows:

ADFIT Deductions from Invested Capital[194]	
White Bluff – Water	$327,979
White Bluff – Sewer	$31,375
The Cliffs – Water	$39,859
The Cliffs – Sewer	$9,495

Ms. Loockerman explained that while utility rates are set using straight-line depreciation of capital assets based on the useful lives of the assets and normalized federal income tax expenses based on payment of such taxes over those same depreciable lives, DDU takes federal

[191] 16 Tex. Admin. Code § 24.31(c)(3)(A).

[192] Staff Initial Brief at 29.

[193] Staff Ex. 1, direct testimony of Debi Loockerman at 4.

[194] Staff Ex. 1, Loockerman direct at 3, Table 1.

income tax deductions for capital asset depreciation based on an accelerated rate. Therefore, DDU recovers federal income tax expense from its ratepayers before the taxes are due to be paid.[195] As Ms. Loockerman testified, the difference in what DDU pays in federal income taxes and what it collects from ratepayers for normalized federal income taxes builds up over time and constitutes ADFIT. DDU witness Mr. Joyce compared ADFIT to an interest-free loan from the government on which ratepayers should not pay a rate of return.[196] Ms. Loockerman pointed out that because DDU is an S-corporation, its shareholders pay the taxes, so ADFIT is not shown on DDU's books.[197]

DDU witness Mr. Joyce testified that Ms. Loockerman's calculation should not have included depreciation on assets identified as developer contributed and not included in rate base. According to Mr. Joyce, these assets generate no taxable income for DDU to offset timing differences in depreciation for ratemaking purposes and depreciation for tax purposes because they are not included in rate base.[198] He also stated that Ms. Loockerman made mathematical errors in her calculations and violated normalization rule by failing to offset ADFIT with net operating loss (NOL).[199]

Mr. Joyce opined that Ms. Loockerman erred by subtracting all of the ADFIT balance related to bonus depreciation on the first day facilities are placed in service even though the ADFIT benefit is not realized at that time. For current income tax purposes, according to Mr. Joyce, DDU realizes a NOL resulting from the claimed bonus depreciation. He testified that the NOL carries forward to future years to offset taxable income. Mr. Joyce stated that in the case of such a deferred tax benefit, the government has not loaned the utility any capital, so the rationale behind the ADFIT deduction does not apply.[200] Only when the depreciation deduction

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[195] Staff Ex. 1, Loockerman direct at 5; 26 U.S.C. § 168; 16 Tex. Admin. Code § 24.31(b)(1)(B), (D).

[196] DDU Ex. 11, Joyce rebuttal at 16.

[197] Staff Ex. 1, Loockerman direct at 5-6.

[198] DDU Ex. 11, Joyce rebuttal at 15.

[199] DDU Ex. 11, Joyce rebuttal at 15.

[200] DDU Ex. 11, Joyce rebuttal at 17.

results in actual cash tax savings should ADFIT come into effect. Therefore, according to Mr. Joyce, the rate base should only be reduced to the extent ADFIT related to bonus depreciation is more than the deferred tax asset related to the NOL. Once the NOL is utilized, Mr. Joyce stated that DDU will reduce its rate base for any remaining ADFIT related to bonus depreciation.[201]

Mr. Joyce testified that because the NOL reduces the amount of cost-free capital, excluding the NOL ADFIT asset in determining rate base would violate normalization rules, which require consistency in determining tax expense, depreciation expense, reserve for deferred taxes, and rate base.[202] According to Mr. Joyce, when a utility has a NOL carrying forward resulting from its use of accelerated depreciation, the Internal Revenue Service offsets the deferred tax liability caused by accelerated depreciation with the related deferred tax asset caused by the NOL. If DDU violates normalization rules, Mr. Joyce stated that it would not be able to use accelerated tax depreciation, and therefore ratepayers would not realize the benefits of the ADFIT deduction from rate base. He estimated that the NOLs would reduce ADFIT liabilities by at least half and probably eliminate them, but recommended that the liabilities be reduced by half to avoid a normalization violation.[203] DDU in briefing contends that Commission precedent has rejected Staff's proposed exclusion of NOL from the ADFIT calculation, and that considering the NOL position in calculating ADFIT is reasonable and appropriate.[204]

Staff takes the position that DDU failed to put on any proof that it in fact realized an NOL, the amount of any such NOL, or that the alleged NOL was carried forward. While Mr. Joyce testified that DDU will realize a NOL for current tax purposes, his recommendations

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[201] DDU Ex. 11, Joyce rebuttal at 17.

[202] DDU Ex. 11, Joyce rebuttal at 18.

[203] DDU Ex. 11, Joyce rebuttal at 18-19.

[204] *Application of Lone Star Transmission, LLC, for Authority to Establish Interim and Final Rates and Tariff*, Docket No. 40020 (Docket No. 40020), Order on Rehearing at Findings of Fact 65, 66; Conclusions of Law 15, 16 (February 12, 2013).

are based on revisions to Ms. Loockerman's calculations made by "incorporat[ing] the effect of a net operating loss carry forward, . . ."[205] Mr. Joyce estimated that effect would be to reduce the ADFIT by approximately 50%, but Staff contends that he offers no explanation of how he reached this estimate. According to Staff, the ADFIT balance should not be adjusted based on an undetermined NOL that the evidence does not show DDU has incurred or carried forward.[206] Staff also notes that while DDU argues that Ms. Loockerman made mathematical errors in her calculations, there is no evidence or explanation of the substance of any such errors.[207] Further, regarding developer contributions, Ms. Loockerman testified that depreciation on such assets is still included in the cost of service, and the ADFIT deduction does apply to the depreciation on those assets.[208] Finally, Staff claims that normalization rules do not apply because Double Diamond-Delaware is an S-corporation that does not and will not pay federal income taxes. As explained by Ms. Loockerman, Double Diamond-Delaware's shareholders would incur the tax consequences of a NOL,[209] and Staff contends there is no evidence in the record that any shareholder incurred a NOL for tax purposes.

With regard to DDU's argument that depreciation on developer contributed assets should not be included in the ADFIT calculations, the applicable rule clearly provides that "[d]epreciation on all currently used and useful developer or governmental entity contributed property is allowed in the cost of service."[210] Therefore, DDU recognizes income from rates that are set to include the cost of that depreciation, such that inclusion of that expense in the ADFIT calculation was proper. The ALJ also agrees with Staff that DDU failed to support its assertion that Ms. Loockerman made mathematical errors in her calculations with any evidence beyond Mr. Joyce's conclusory statement that such errors were made. Moreover, the specific errors were never identified. Finally, the ALJ finds that DDU failed to prove by a preponderance of the

[205] DDU Ex. 11, Joyce rebuttal at 16; Tr. at 538.

[206] Staff Initial Brief at 31.

[207] Staff Reply Brief at 17-18.

[208] *See* Tr. at 265-266.

[209] Staff Ex. 1, Loockerman direct at 4.

[210] 16 Tex. Admin. Code § 24.31(b)(1)(B).

evidence that it has realized or will realize a NOL for current income tax purposes or that such NOL has been or will be carried forward. DDU offers no accounting evidence of a NOL or documentary proof that taxes were not actually deferred because of a NOL. Mr. Joyce merely offers an estimate, unsupported by calculations or any methodology whatsoever, that the alleged NOL carryover will reduce the ADFIT calculated by Ms. Loockerman by 50%. This situation differs from the Commission precedent cited by DDU, where there was no dispute that the utility would not have income to offset that depreciation, thereby resulting in a NOL, and that the utility recorded a NOL ADFIT asset in its books.[211] The ALJ finds Mr. Joyce's opinion testimony on this issue lacking in foundation and therefore accorded it very little weight. The ALJ recommends the Commission adopt Staff's proposed ADFIT deductions from DDU's invested capital.

V. RATE OF RETURN

DDU is entitled to a reasonable opportunity to earn a reasonable rate of return on its invested capital. Commission rules set forth various factors for the Commission to consider in fixing the rate of return, which should be sufficient to assure confidence in DDU's financial soundness and adequate to maintain and support its credit and enable it to raise necessary capital.[212] Specifically in this case, the Commission will determine DDU's appropriate overall rate of return, return on equity, cost of debt, and debt-to-equity capital structure.[213]

A. Return on Equity [PO Issue 8]

1. Parties' Proposals

DDU proposes a return on equity (ROE) of 11.49%, which it argues is consistent with calculations and instructions set out in the Class B rate Application form promulgated by the

[211] Docket No. 40020, Proposal for Decision at 55 (September 6, 2012).

[212] 16 Tex. Admin. Code § 24.31(c)(1)(A)-(B).

[213] Preliminary Order Issue Nos. 7, 8, 14.

Commission. DDU also offered rebuttal testimony from Gregory Scheig regarding his opinion that, based on various analyses he performed and current market and utility industry conditions, a 11.50% ROE is a "reasonable estimate of DDU's fair cost of equity."[214]

Staff witness Ms. Sears calculated an appropriate ROE for DDU of 8.79%, primarily using the Discounted Cash Flow (DCF) method and then employing the Capital Asset Pricing Model (CAPM) as a comparison to her DCF results. Her DCF analysis used a spot dividend yield, a 52-week dividend yield, and earnings growth forecasts.[215] The CAPM describes the relationship between a stock's investment risk and its market rate of return and identifies the rate of return expected by investors so it is comparable with returns of other stocks of similar risk. In this case Ms. Sears applied the CAPM to a proxy or barometer group of water utility companies. These companies were used as a benchmark for determining a ROE because they share common characteristics of regulated water distribution utilities but are publicly traded and therefore provide specific market data. Ms. Sears chose the companies to include in her barometer group based on their percentage of revenue generated from distribution, their availability for public trading, the availability of their investment information from multiple sources, and their lack of involvement in a potential merger or acquisition.[216]

WBRG witness Ms. Heddin opined that DDU's requested ROE of 11.49% is unreasonable and testified that she believed that return should be reduced by 2% to reflect DDU's "poor achievements" related to water accountability.[217] She stated that the amount of unaccounted-for water reported by DDU in its Applications (50%) is "extremely high" and has adverse economic consequences for its ratepayers. Ms. Heddin opined that a reduction of the ROE to 9.49% will incentivize DDU to better account for its water use.[218]

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[214] DDU Ex. 10, rebuttal testimony of Gregory E. Scheig at 32.

[215] Staff Ex. 2, Sears direct at 33.

[216] Staff Ex. 2, Sears direct at 28-29, 34; Tr. at 394.

[217] WBRG Ex. 1, Heddin direct at 47. In briefing, WBRG took the position that the 2% reduction recommended by Ms. Heddin should apply to Staff's recommended ROE of 8.79%. WBRG Initial Brief at 22.

[218] WBRG Ex. 1, Heddin direct at 47.

2. DDU's Argument and Rebuttal to Staff

DDU contends that the lower ROE recommended by Staff does not account for risks associated with smaller utilities as required by United States Supreme Court precedent and recognized by the instructions adopted by the Commission for the Class B rate application form.[219] Specifically, DDU contends that Ms. Sears's calculation did not ensure that DDU will earn a return equal to what is generally made on investments with "corresponding risks and uncertainties."[220] According to DDU, the methodology employed by Ms. Sears treats DDU as a large utility company, while Mr. Scheig adjusted the analyses he performed to account for DDU's relatively small capitalization.[221] DDU contrasts Mr. Scheig's opinion as one supported by multiple analyses considering ROE from various perspectives, against Ms. Sears's opinion, which is based on only the DFC method and the CAPM. DDU stresses that Mr. Scheig's opinion regarding an appropriate ROE coincides with the ROE resulting from the calculations and instructions set forth in the Commission's Application form. According to DDU, Ms. Sears's proposed ROE fails to allow DDU to earn a reasonable return on its invested capital and preserve its financial integrity.[222] Specifically, DDU contends that Ms. Sears's calculation did not ensure that DDU will earn a return equal to what is generally made on investments with "corresponding risks and uncertainties."[223]

Mr. Scheig opined regarding the problems he found with Ms. Sears's use of the constant growth DCF model. He testified that while it "is a recognized model used to estimate required ROEs, it is based upon very simplistic assumptions which limit its reliability."[224] Such assumptions include a single and constant growth rate into perpetuity, which clashes with the

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[219] DDU Initial Brief at 24-25, citing *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679 (1923).

[220] See *Bluefield Waterworks*, 262 U.S. at 692-693.

[221] DDU Initial Brief at 25; DDU Ex. 10, Scheig rebuttal at 32.

[222] DDU Initial Brief 25.

[223] See *Bluefield Waterworks*, 262 U.S. at 692-693.

[224] DDU Ex. 10, Scheig rebuttal at 7.

price history reflected in Vanguard's Utilities Exchange Traded Fund, which shows "constantly changing investor expectation and risk considerations[.]"[225] Another problem with the DCF identified by Mr. Scheig is its assumption that investors depend solely on dividends for cash flow. He explained that "growth companies" rarely pay dividends, instead reinvesting capital to earn a higher rate of return. Moreover, Mr. Scheig testified that many investors trade on shorter-term expectations and market movements. This behavior, according to Mr. Scheig, contradicts the DCF assumption that equity investors expect a return based on dividends growing at an assumed constant rate.[226] Mr. Scheig was critical of Ms. Sears calculating growth rates by mechanical averaging analyst estimates without using additional research or analysis. He showed that for one of the companies in the barometer group used by Ms. Sears, the range of share prices indicated by the growth rate she calculated was negative $18 to over $320, when the stock was currently trading at approximately $55.[227]

Mr. Scheig also detailed his concerns with Ms. Sears's use of risk-free rate inputs and equity risk premiums and her failure to consider a small stock risk premium. According to Mr. Scheig, Ms. Sears's use of a 10-year US Treasury bond yield fails to adequately compensate DDU investors for their equity investment risk. Mr. Scheig stated that Ms. Sears should not have weighted her forecasted bond yield for 2018-2022 the same as a single quarter of a year's forecast rate.[228] As for the equity risk premiums calculated by Ms. Sears for her ROE estimate, Mr. Scheig testified that Ms. Sears should have used the forward-looking equity risk premium for the CAPM instead of the historic one she developed.[229] Finally, Mr. Scheig stated that Ms. Sears should have made an adjustment for small stock risk and lack of liquidity for the CAPM to result in reasonable conclusions. Due to these inputs and failure to include a small

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225 DDU Ex. 10, Scheig rebuttal at 7-8.

226 DDU Ex. 10, Scheig rebuttal at 8-9.

227 DDU Ex. 10, Scheig rebuttal at 10-11.

228 DDU Ex. 10, Scheig rebuttal at 11-12.

229 DDU Ex. 10, Scheig rebuttal at 12-13.

stock risk premium (SSRP), Mr. Scheig opined that Ms. Sears's calculated ROE was too low and the CAPM's reliability was reduced.[230]

In response to Ms. Sears's DCF and CAPM analyses, Mr. Scheig developed a proposed ROE using the CAPM, DCF, and Expected Earnings models using a comparable group of water utilities followed by Value Line. He also employed a Risk Premium analysis using Moody's utility industry interest rates, US Treasury Bond yields, and authorized rates of return approved for electric and gas utilities by various utility regulatory authorities. Finally, he adjusted his proposed ROE based on DDU's small capital size, lack of liquidity, and private ownership, all factors by which DDU differed from the group of comparable utilities. His analysis determined that a fair and reasonable ROE for DDU is 11.50%.[231]

As to WBRG witness Ms. Heddin's recommendation that the ROE should be reduced by 2% for water accountability issues, DDU takes the position that WBRG's argument is based on TCEQ guidance prior to water and sewer regulation being transferred to the Commission. According to DDU, the rules of the Commission prescribe different procedures for determining an ROE.[232]

3. Staff's Argument

Staff takes the position that the ROE requested by DDU is much higher than any ROE set by the Commission for any other electric or water utility.[233] According to Staff, the methods relied upon by Ms. Sears in calculating her proposed ROE are "widely accepted" by the regulatory industry and the Commission, pointing out that the Commission adopted the ROE calculated by Staff using the DCF method in Docket 45720.[234] Staff contends that one of the

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230 DDU Ex. 10, Scheig rebuttal at 13.

231 DDU Ex. 10, Scheig rebuttal at 13-14.

232 DDU Reply Brief at 27; *see* Staff Ex. 7.

233 Staff Reply Brief at 19.

234 Docket No. 45720 Order at 16, Finding of Fact 38.

methods used by Mr. Scheig in his calculations is less widely used, noting that Mr. Scheig could cite to no example of Staff having used such method.[235] Further, Staff points out that in reaching his conclusions, Mr. Scheig gave greater weight to the methods employed by Ms. Sears (DCF and CAPM) than the others he used.[236]

Staff also takes issue with Mr. Scheig's incorporation of a SSRP into his results to account for certain factors applicable to DDU, *i.e.* its small size, its lack of liquidity, and the fact it is a private company.[237] According to Staff, a size premium should not be used for determining DDU's ROE. Staff asserts that the nature of a utility's business does not change based on the scale of its operations, because the business model and required functions are the same regardless of the utility's size, and because each utility operates as a regulated monopoly with a set customer base.[238] Ms. Sears testified that SSRPs apply in unregulated markets where smaller companies are more volatile.[239] She also stated that the liquidity risk for DDU, which she defined as its ability to pay off its short-term obligations, would be similar to those companies in her barometer group because they all operate in regulated markets which set costs of service to ensure that short-term obligations will be met.[240] According to Ms. Sears, DDU does not get a risk adjustment based on an investor's need to exit the market quickly in order to meet or pay the investor's obligations.[241]

As to DDU's contention that Staff's proposed ROE does not consider returns on investments made in business undertakings with similar risk and uncertainties, Staff notes that Mr. Scheig testified that investment in the utility in Docket No. 45720 is riskier than investment in DDU. Therefore, argues Staff, because the Commission set the ROE at 8.48% for the utility

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[235] Staff Reply Brief at 19.

[236] DDU Ex. 10, Scheig rebuttal at 52, Schedule A.1.

[237] See DDU Ex. 10, Scheig rebuttal at 28-32.

[238] Staff Reply Brief at 20.

[239] Tr. at 370.

[240] Tr. at 370-371.

[241] Tr. at 371.

in Docket No. 45720, DDU's ROE, because it is less risky, should be lower than 8.48%.[242] Staff also refers to DDU's own exhibit to show that, even though Ms. Sears testified that investor risk in electric utilities is not comparable to investor risk in water utilities, the ROEs approved by the Commission for investor-owned electric utilities over the last few years are all 9.8% or lower.[243]

Finally, Staff recommends the Commission deny WBRG's proposal to reduce Staff's proposed ROE by 2%. Staff argues that Ms. Heddin based her opinion on the TCEQ Rate of Return Worksheet, which she stated would have reduced the recommended return by 2% for line losses in excess of 15%.[244] Therefore, contends Staff, she used an unacceptable methodology for determining an ROE based on a worksheet from another agency not used by the Commission and not in the evidentiary record in this case.[245]

4. WBRG's Argument

WBRG points out that DDU's Applications indicate that 50% of the total water pumped at White Bluff and 76% of the total water pumped at The Cliffs during the test year is unaccounted for.[246] Further, DDU's discovery responses and Mr. Gracy's testimony revealed that DDU has no formal plans for future capital improvement, master plans or financial plans identifying future infrastructure and planning needs.[247] According to WBRG, either DDU's operating costs are too high because it is wasting water, or certain customers are receiving more water than is being metered. Either way, argues WBRG, the ratepayers are unfairly being asked to bear the cost of this lost water. WBRG contends that Texas Water Code § 13.184(b) allows the Commission to reduce a utility's ROE to ensure the utility is making efforts to conserve

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[242] Staff Reply Brief at 20.

[243] DDU Ex. 16, *Open Meeting Memo From Rate Regulation to Commissioners, Year-end 2016 PUC Earnings Reports for Electric Utilities*, Project No. 46910, at 2, n. 3 (October 19, 2017).

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

[245] Staff Reply Brief at 21.

[246] DDU Ex. 1, White Bluff Application at 58; DDU Ex. 2, The Cliffs Application at 58.

[247] WBRG Ex. 10, DDU's Response to WBRG RFI 1-34; Tr. at 106-107.

resources and based on the quality of the utility's management and services and the efficiency of its operations.

5. TCUC's Argument and DDU's Rebuttal to Same

TCUC takes the position that the evidence regarding the amount of water (a) taken from Possum Kingdom Lake; (b) processed by the water plant; (c) sold to DDU's customers; (d) used for maintenance of the processing facility and distribution lines; and (e) unaccounted for is "problematic at best."[248] TCUC notes that DDU's Application for The Cliffs showed water pumped and produced as 104,060,000 gallons in the test year, 24,724,000 gallons (approximately 23.76%) of which were sold, and the remainder of which is listed as "unaccounted for water."[249] TCUC claims that Mr. Gracy testified that 40% of the unaccounted water set forth in the Application would be used for backwashing and flushing of the system, leaving what TCUC argues is still be 31,738,000 gallons of unaccounted for water if Mr. Gracy was correct.[250] Staff witness Ms. Mathis testified that typically Staff allows up to a 15% line loss on water mains due to flushing or maintenance, and that 40% of unaccounted for water used for flushing and maintenance "sounds high."[251]

TCUC further argues that DDU's water audit reports for 2015 submitted to the Texas Water Development Board for The Cliffs and White Bluff indicate different amounts of total water pumped and processed. However, the report is not in evidence, nor is any testimony regarding what amounts of water pumped and processed were included in the report. TCUC contends that the utility infrastructure at The Cliffs has been in decline for years, that multiple line breaks occur every year causing extreme labor, material, and equipment costs funded by the ratepayers, and that DDU has no plans to improve the system. Finally, TCUC contends that line

[248] TCUC Initial Brief at 10.

[249] DDU Ex. 2, The Cliffs Application at 58.

[250] Tr. at 142-143.

[251] Tr. at 296-297.

breaks and leaks account for the majority of the unaccounted for water set forth in The Cliffs Application, and that ratepayers at The Cliffs should not be forced to pay for these expenses.[252]

Mr. Gracy explained in his rebuttal testimony and at the hearing that the production and usage numbers in The Cliffs Application do not account for loss attributable to line flushing and backwashing and discharge of brine from the lines.[253] He also stated that at The Cliffs, rocky soil, expansion and contraction of soil, and terrain and elevation changes can cause water loss, and that DDU uses routine security patrols, walks along the distribution system and in canyons and low-lying areas, and boat patrols on the inlets to "constantly chase unnecessary, uncontrolled water loss."[254]

6. ALJ's Analysis and Recommendation

The ALJ recommends that the Commission approve a 9.84% ROE and finds that such return is reasonably sufficient to assure confidence in DDU's financial soundness and will be adequate to maintain and support its credit and allow it to raise necessary capital. The ALJ finds that this ROE will not yield more than a fair return on DDU's invested capital.

DDU does not dispute that the DCF methodology used by Staff witness Ms. Sears in calculating her proposed ROE of 8.79% has been previously accepted by the Commission as valid in determining a reasonable rate of return for a water utility, and that it is widely used in the utility industry for calculated ROEs. However, DDU witness Mr. Scheig testified credibly that all methodologies used to estimate ROEs for investors have flaws, such that the use of multiple models provides a more supportable ROE determination than one devised from a single model.[255] Staff offered little evidence that the additional models employed by Mr. Scheig are

[252] TCUC Initial Brief at 11-12.

[253] DDU Ex. 8, Gracy rebuttal at 10; Tr. at 142-143.

[254] DDU Ex. 8, Gracy rebuttal at 12.

[255] DDU Ex. 10, Scheig rebuttal at 6-7.

unreliable or were improperly developed. Nor did Staff take issue with Mr. Scheig's position that an estimated ROE based on multiple models is better than an estimated ROE based on fewer models. In addition, Mr. Scheig's criticisms of Ms. Sears's use of the DCF model, and specifically various inputs and calculations she used and assumptions she made in developing the model, were convincing. Significantly, Staff did not take exception to Mr. Scheig's critique of Ms. Sears's analysis and the faults he noted.

With respect to the SSRP factored in by Mr. Scheig in calculating the ROE, Staff makes the argument that such premium should not be used based on the basic nature of the utility business being the same regardless of scale and because the utilities operate as monopolies and have rates set by regulatory agencies. It is unclear from Mr. Scheig's testimony how he determined that the ROE for DDU should include a small stock risk premium. He makes conclusory statements that it is a small privately-owned company with illiquid common stock investments. However, Mr. Scheig could not articulate how he determined DDU's market capitalization for purposes of deciding that DDU is a small company, and he stated that he based his size premium on the capital balances found in DDU's Applications, without considering that DDU is a wholly-owned subsidiary of Double Diamond-Delaware. Further, Mr. Scheig acknowledged that the regulated nature of the water utility industry in Texas reduces risk in DDU investment and should offset the SSRP, but he fails to reveal how he calculated what that offset should be, and why it would not offset the risk altogether, as indicated by Ms. Sears.

Staff put significant emphasis on the Commission's adoption in Docket No. 45720 of Staff's recommended ROE calculated using the DCF model. However, in contrast with this case, where DDU offered a challenge to Staff's development of the DCF model in the form of Mr. Scheig's analysis and testimony, the ALJs explicitly noted in Docket No. 45720 that there were no challenges to the results of Staff's DCF analysis.[256]

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[256] *Application of Rio Concho Aviation, Inc. for a Rate/Tariff Change*, PUC Docket No. 45720, Proposal for Decision at 58 (March 23, 2017).

Considering all of the evidence together, the ALJ finds that the more thorough analysis employed by Mr. Scheig, which used multiple models (including those used by Ms. Sears to which he gave the most weight) to reach an opinion regarding a fair ROE, is more accurate in determining a reasonable ROE for DDU. However, the ALJ recommends that the Commission decline to add a SSRP on top of the ROE calculated by Mr. Scheig. DDU failed to show by a preponderance of the evidence that such a premium is warranted under the circumstances. Therefore, the ALJ finds that a reasonable ROE for DDU is 9.84%.

Further, the ALJ determines that such ROE would give appropriate consideration of the efficiency and quality of DDU's operations and DDU's conservation efforts. Because DDU bears the burden to prove its proposed rates are just and reasonable, it is tasked with providing evidence that its operations are efficient and that it provides quality services. The evidence in the record regarding that efficiency and quality is circumspect; the amount of unaccounted for water reported in DDU's Applications is unusually high, and Mr. Gracy discussed claims made by TCUC's representative Byrom J. Smith in testimony regarding extensive water leaks and required repairs at The Cliffs.[257] Mr. Gracy explained that 40% of the unaccounted for water noted in the Applications is water loss due to brine discharge after water from the lake goes through a reverse osmosis plant, and that thousands of gallons a day are used to backwash sand filters.[258] Further, he testified that the unaccounted for water includes water used to regularly flush out the lines.[259] As for leaks in the systems, Mr. Gracy testified that DDU employs various methods at The Cliffs to track down leaks, and he detailed the repairs on specific leaks mentioned by Mr. Smith, which were supported by DDU work orders.[260] Mr. Gracy stated that the utility crew is instructed to respond to reports of leaks as quickly as possible and make the

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[257] DDU Ex. 8, Gracy rebuttal at 12-13. See TCUC Ex. 13, TCUC's direct testimony and statement of position at 3-5, 9.

[258] Tr. at 142-143.

[259] Tr. at 143.

[260] DDU Ex. 8, Gracy rebuttal at 12; DDU Ex. 8C, DDU Work Orders for The Cliffs at 151-155.

necessary repairs. He also testified that some leaks can be fixed in a few hours, and that most leaks are repaired the same day or the day after they are reported.[261]

The ALJ does not feel the evidence of water loss at White Bluff and The Cliffs rises to a level such that a reduction in ROE is warranted due to inefficient or poor quality service. Mr. Gracy's explanation regarding the unaccounted for water is reasonable, although it does not completely justify the amounts indicated in the Application. DDU certainly could improve their accounting for the water pumped and produced at White Bluff and The Cliffs, and should future Applications not indicate that improvements have been made in that regard, the Commission should consider a possible reduction in ROE to reflect consideration of that factor.

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

DDU contends that the evidence in the record supports that it had debt secured by utility assets at an interest rate of 6.00%. Staff, through its witness Ms. Sears, recommends a 4.91% cost of debt, which she testified is Double Diamond-Delaware's overall weighted average cost of debt as of December 31, 2015.[262] WBRG witness Ms. Heddin agreed with Staff that the cost of debt should be based on the weighted average cost of Double Diamond-Delaware's outstanding debt as of December 31, 2015, but she calculated that cost to be 4.96%.[263] However, WBRG has now agreed to Staff's proposed cost of debt.[264] DDU agrees to Staff's cost of debt recommendation, so long as the Commission also approves Staff's recommended capital structure and not the capital structure proposed by WBRG. Given the ALJ's analysis and recommendation concerning the appropriate capital structure for DDU, the ALJ recommends a cost of debt of 4.91%.

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[261] Tr. at 135-137.

[262] Staff Ex. 2, Sears direct at 32.

[263] WBRG Ex. 1, Heddin direct at 46.

[264] WBRG Reply Brief at 12.

C. Capital Structure [PO Issue 7]

Staff witness Ms. Sears testified that a utility's capital structure should be within the normal bounds of other utilities in the industry and should be an efficient use of capital. DDU bases its proposed structure of 55.84% debt and 44.16% equity on the capital structure of its parent company, Double Diamond-Delaware, because DDU is completely dependent on Double Diamond-Delaware for financing. According to Ms. Sears, such a structure is not an efficient use of capital and is outside the norm for the water and sewer utility industry.[265] Ms. Sears testified that a hypothetical capital structure of 47.27% debt and 52.73% equity, which is the current five-year average capital structure of her barometer group, is more appropriate because it is representative of capital structure in the water utility industry and better minimizes the overall cost of capital.[266] In briefing, DDU agreed with Staff's proposed capital structure.

WBRG recommends the Commission set DDU's capital structure at 0% equity and 100% debt, based on its contention that Double Diamond-Delaware effectively removed all equity in DDU when it used the proceeds of a $3 million loan taken out by DDU for non-utility purposes. WBRG points to testimony by DDU witness Mr. Scheig that a dividend paid by utility is a payment made to common equity holders to share profits made by the utility, and that payment of the dividend reduces the book value of the equity left in the utility.[267] When asked if a utility took out a loan and paid the proceeds of the loan to its investor whether that payment would be a dividend, Mr. Scheig responded, "That is not typically what we see. I guess – I guess, a utility could do that. However, in my opinion, that would probably damage the value of the remaining equity."[268] Taking that testimony along with the evidence that DDU had taken out a $3 million dollar loan secured by White Bluff utility assets, the proceeds of which Double Diamond-Delaware would use to make capital improvements or whatever else it chose to use

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[265] Staff Ex. 2, Sears direct at 30-31.

[266] Staff Ex. 2, Sears direct at 31.

[267] Tr. at 424-425.

[268] Tr. at 425.

them for, WBRG contends that DDU paid Double Diamond-Delaware a $3 million dividend. Because that dividend exceeded the amount of equity capital that DDU's White Bluff Application indicates was held by Double Diamond-Delaware, WBRG claims that all equity has been removed from DDU.

According to DDU, WBRG manipulated Mr. Scheig's testimony to suit its argument, and that in fact DDU did not distribute the proceeds of the $3 million loan to its shareholders. DDU argues that Mr. Scheig testified that a utility could do so, but did not testify that DDU had done so. Staff also opposes WBRG's recommendation, noting that the only capital to be considered in determining capital structure is the capital DDU used to finance its rate base. Therefore, the debt incurred by Double Diamond-Delaware using DDU's assets as collateral does not represent any DDU debt associated with its White Bluff rate base. Thus, the loan should not factor in to the determination of DDU's appropriate capital structure.

The ALJ agrees with Staff and DDU that the appropriate capital structure for DDU is 47.27% debt and 52.73% equity. The undisputed evidence shows that this structure is representative of the capital structure of other companies in the water utility industry and reflects an efficient use of capital. The evidence does not show that DDU took out a loan and then paid the proceeds to Double Diamond-Delaware to return equity to Double Diamond-Delaware; there is no evidence in the record regarding how the loan was accounted for. The testimony and evidence reveals that the loan proceeds were used by Double Diamond-Delaware to make capital improvements, and that Double Diamond, Inc. made payments on the loan and Double Diamond-Delaware guaranteed repayment of the debt.[269] Specifically, DDU witness Mr. Grout said finding the records to show where the $3 million proceeds of the loan at issue had gone "would be like looking for a needle in a haystack[.]"[270] He further testified that if Double Diamond, Inc. did not make payments and there was a default, the bank would look to Double

[269] Tr. at 91-92; WBRG Ex. 6, Renewal, Modification, and Extension Agreement.

[270] Tr. at 151.

Diamond-Delaware as guarantor, and not DDU, for payment.[271] The ALJ finds that the evidence supports Staff's contention that the $3 million loan is not related to DDU's debt financing and therefore cannot serve as the basis for the capital structure recommended by WBRG.

D. Overall Rate of Return

DDU and Staff agree on the mathematics of calculating the overall rate of return, using the capital structure to determine a weighted average of the overall rate of return. As set forth previously, while the capital structure is agreed to, Staff, DDU, and WBRG all have different views on the appropriate ROE to be applied to the formula. For the reasons set forth above, the ALJ recommends a 9.84% ROE and a 4.91% cost of debt, which when applied to the recommended capital structure of 47.27% debt and 52.73% equity results in a 7.51% weighted cost average.

VI. RATE DESIGN [PO Issues 1, 2, 4, 35, 36, 37]

DDU employed the utility-basis methodology set forth in the application forms for calculating its proposed rates.[272] No party takes issue with DDU's use of this methodology, and Staff witnesses Ms. Sears and Mr. Ramirez also use this methodology in their rate calculations. DDU also made the following proposals for purposes of rate design, which no party opposed:

- Maintaining the existing rate structure which classifies all ratepayers into one customer class;
- Keeping the current water rate structure that includes a monthly charge based on meter size and an inverted block volumetric charge;
- Maintaining the current wastewater rate structure using (i) a monthly minimum charge for the first 3,000 gallons, and (ii) basing charges for usage above 3,000 gallons on meter size plus a fixed charge per gallon, which is set using the average of water consumption during December, January, and February; and

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[271] Tr. at 152.

[272] DDU Ex. 1, White Bluff Application; DDU Ex. 2, The Cliffs Application.

- Using the test-year-end connections.[273]

As DDU notes, the differences in the rates it proposes and the rates recommended by Staff arise from the differences in the revenue requirement calculated by DDU and Staff. WBRG and TCUC do not take a position on the issue of rate design.

Therefore, the ALJ recommends that the Commission design the rates for the White Bluff and The Cliffs customers using the utility-basis methodology set forth in the application forms and agreed to by DDU and Staff and based on the revenue requirement resulting from the recommended revisions to the Applications set forth previously in this PFD.

VII. RATE CASE EXPENSES [PO Issue 38]

As noted by DDU, in an order dated November 1, 2017, the ALJ severed all issues related to expenses incurred in this rate case into a separate Commission and SOAH docket. However, DDU, Staff, and WBRG all briefed the threshold issue of DDU's entitlement to recover such expenses. The applicable rule provides that:

- a utility may recover rate case expenses incurred as a result of filing a rate-change application if the expenses are just, reasonable, necessary, and in the public interest; and that
- a utility may not recover any rate-case expenses if the increase in revenue generated by the just and reasonable rate determined by the Commission after a contested case hearing is less than 51% of the increase in revenue that would have been generated by a utility's proposed rate.

[273] DDU Ex. 1, White Bluff Application; DDU Ex. 2, The Cliffs Application.

A. Staff's and DDU's Evidence and Argument

According to Staff and DDU, the rule requires that the Commission determine the increase in revenue generated by the rates proposed in DDU's April 26, 2017 amendments to the Applications. Staff agrees with DDU witness Mr. Joyce's calculation in his rebuttal testimony that 51% of the increase in revenue that would be generated by the rates proposed in the amended White Bluff Application is $122,711, and 51% of the increase in revenue that would be generated by the rates proposed in the amended The Cliffs Application is $77,371.[274]

DDU, through its witness Mr. Joyce, argues that because DDU calculated its proposed ROE using the formula set forth in the instructions for the rate application form, a reduction in that calculated ROE in the Commission's final order in this case should not count against DDU's 51% measurement for purposes of determining its eligibility to recover rate case expenses.[275] Staff disagrees, claiming that the rule clearly sets the 51% threshold and that any loss on an issue affecting revenue generated by DDU's proposed rates must be included in the calculation.

B. WBRG's Position

WBRG argues that the rates proposed by DDU in the original Applications filed on August 1, 2016, should be the rates uses to calculate the 51% threshold.[276] According to WBRG, DDU made material misrepresentations in the original Applications regarding its rate base from previous cases and its developer contributions. WBRG identified these misrepresentations and filed a motion to dismiss the White Bluff Application on that basis, and DDU revised its Applications to address these matters. Had ratepayers not protested these misrepresentations, argues WBRG, they could have resulted in customers paying utility rates that were higher than allowable under the applicable law. WBRG contends that the ratepayers should not have to pay

[274] Staff Reply Brief at 23; DDU Ex. 11, Joyce rebuttal at 13.

[275] DDU Ex. 11, Joyce rebuttal at 13.

[276] WBRG Initial Brief at 24.

the price for DDU's misrepresentations in the original Applications. Furthermore, WBRG contends that by not using the proposed rates from DDU's original Applications in the 51% calculation, the Commission would encourage utilities to request rates that are not supported by the law, if there were no penalty for having done so after ratepayers protest and discover what the utility has done. According to WBRG, this is an unjust approach that violates the plain language of the applicable rule and the policy reasons behind it.

In addition, WBRG contends that Staff and DDU improperly used DDU's proposed revenue requirements, not the "rate revenues at proposed rates," in determining the revenues that would have been generated by DDU's proposed rates. Specifically, DDU's revenue requirement removes certain pass-through costs, which WBRG argues are still part of the revenue produced by the proposed rates. WBRG contends that the rule does not reference revenue requirement but the rate proposed, and that there is no evidence of proposed rates based on a revenue requirement that excludes the pass-through costs, such that there is no evidence of that those proposed rates would be.[277]

C. Staff's and DDU's Response to WBRG Argument

Staff counters WBRG's position with a policy argument of its own. According to Staff, a utility should be encouraged to amend its rate change application to correct error or to agree with protesting parties' recommendations. If the original application's proposed rates are used in the calculation of the 51% threshold, a utility would be discouraged from making appropriate and reasonable revisions to its application. Moreover, Staff maintains that the proposed rates in the amendments to the Applications replace the proposed rates from the original Applications filed by DDU and constitute the "proposed rates" that will result in an increase in revenue for DDU as envisioned by the applicable rule. Staff, in concurrence with DDU Mr. Joyce, removed the $22,047 identified by WBRG as pass-through costs from its calculation of the revenue that

[277] White Bluff Reply Brief at 14.

would be recovered through proposed rates because DDU eliminated that amount, which represents Prairieland Groundwater Conservation District fees, from its revenue requirement.[278]

D. ALJ's Analysis and Recommendation

The ALJ finds that for purposes of 16 Texas Administrative Code § 24.33(b), the increase in revenue that would have been generated by DDU's proposed rates should be calculated using the proposed rates from the amended Applications, which were those upon which a contested hearing was held. Amendments to rate change applications are permitted under Commission rule, and the ALJ finds Staff's policy argument more persuasive than that of WBRG. It is unclear that any rate case expenses would have been saved had DDU simply gone to hearing under its original Applications without making any amendments. It is part of the contested case process for protesting parties to conduct discovery and point out what they perceive as errors in an application. Ideally, those errors can be addressed and eventually an agreed resolution can be reached to avoid the necessity and cost of a contested case hearing. Unfortunately in this case no settlement could be reached, but adopting WBRG's reading of the applicable rule could dampen a utility's willingness to reach any compromises or to fix errors that could then result in a penalty in the form of its inability to recover rate-case expenses. Such a situation would lead to more costly litigation, less compromise, and ultimately higher costs to the ratepayers.

The ALJ also agrees with DDU and Staff that the pass-through costs in the form of fees DDU pays to the Prairieland Groundwater Conservation District are not part of the revenue that it will generate from its proposed fees, such that those expenses should be removed from the calculation of the 51% threshold.

Finally, the ALJ agrees with Staff that any reduction that might result in the Commission setting an ROE lower than what DDU calculated using the formula from the rate application form is part of the determination of the increase in revenue generated by the just and reasonable

[278] Staff Reply Brief at 24, *citing* Tr. 513-514; DDU Ex. 2, White Bluff Application at 95.

rate determined by the Commission for purposes of 16 Texas Administrative Code § 24.33(b). The application form clearly states that the ROE calculation method is presumed reasonable only if no other party provides opposing testimony, and that there is no presumed reasonable rate of return if the parties do not reach a settlement agreement. Here, Staff and WBRG presented testimony challenging the ROE calculated using the application form methodology, so DDU was on notice that its calculation could not be presumed reasonable. DDU clearly recognized this, in light of its decision to employ Mr. Scheig to conduct an independent analysis and determine a reasonable ROE.

Therefore, the ALJ recommends that the Commission adopt Staff's and DDU's position that 51% of the increase in revenue that would have been generated from DDU's proposed rates is $41,353 for White Bluff water and $81,358 for White Bluff sewer ($122,711 total), and $27,097 for The Cliffs water and $50,274 for The Cliffs sewer ($77,371 total).

VIII. INTERIM RATES AND EFFECTIVE DATE [PO Issues 29, 40 41]

Interim rates were not set or requested. The ALJ has previously ordered that, by agreement between the parties, the appropriate effective date for the rates set in this docket is the "relate-back" date of February 21, 2018. DDU argues that any rate surcharges should be calculated based on the relate-back date and requests that all surcharges (except any surcharge for rate case expenses) be recovered over a two-month period to help mitigate impact on its customers.[279] Staff agrees with the proposed two-month recovery period, so long as it applies to any surcharge or refund that may be warranted based on the Commission's final order.[280] WBRG and TCUC took no position on this issue.

The ALJ finds DDU's proposal to be reasonable and recommends that it be adopted by the Commission, and that it apply to any surcharge or refund ordered by the Commission.

[279] DDU Initial Brief at 29-30.

[280] Staff Reply Brief at 25.

IX. CONCLUSION

The ALJ proposes the Commission make the recommendations to DDU's requested operation and maintenance expenses, invested capital, and rate of return as set forth above in order to ensure that DDU revenue is set such that DDU earns no more than a reasonable return on its invested capital. In support of such recommendations, the ALJ makes the following findings of fact and conclusions of law.

X. FINDINGS OF FACT

General and Procedural Findings

1. Double Diamond Utility Company, Inc. (DDU) is an investor-owned water utility company that provides water and sewer utility service to several communities in North Texas.

2. DDU provides water and sewer utility service to The Cliffs development in Palo Pinto County and White Bluff development in Hill County under water Certificate of Convenience and Necessity (CCN) No. 12087 and sewer CCN No. 20705.

3. DDU has approximately 640 water customers and 567 sewer customers in White Bluff and approximately 287 water customers and 239 sewer customers in The Cliffs.

4. White Bluff is a resort/residential development with amenities such as a golf course, marina, hotel, restaurant, conference center, spa, and swimming pools.

5. The White Bluff water system obtains its water supply from four wells in the Trinity aquifer, which is regulated by the Prairielands Groundwater Conservation District.

6. The Cliffs is a resort/residential development with amenities similar to those at White Bluff. The Cliffs water system obtains its water supply from Lake Possum Kingdom.

7. DDU is a wholly-owned subsidiary of Double Diamond–Delaware, Inc. (Double Diamond-Delaware).

8. On August 1, 2016, DDU filed Applications (Applications) with the Public Utility Commission of Texas (Commission) for Class B rate/tariff changes for water and sewer utility service at White Bluff and The Cliffs.

9. The Applications use a test year of January 1, 2015, through December 31, 2015.

10. DDU mailed notice of the proposed rate change to all of its customers in White Bluff and The Cliffs on or about August 10, 2016.

11. Between August 10, 2016, and September 1, 2016, over 220 of DDU's 927 ratepayers in White Bluff and The Cliffs (more than 10 percent of such ratepayers) filed timely protests to the rate/tariff changes proposed by the Applications.

12. The Applications were found to be administratively complete on September 7, 2016.

13. On September 8, 2016, the Commission referred this docket to the State Office of Administrative Hearings (SOAH) for a contested case hearing.

14. On October 7, 2016, the Commission issued its Preliminary Order identifying 41 issues to be addressed in this proceeding.

15. On October 18, 2016, a SOAH Administrative Law Judge (ALJ) convened a prehearing conference in Austin, Texas. The following appeared and were admitted as the parties in this case: DDU; White Bluff Ratepayers Group (WBRG); The Cliffs Utility Committee (TCUC) and Commission staff (Staff).

16. By agreement between the parties, a SOAH order set the effective date for the proposed rate/tariff changes as April 1, 2018, and set February 21, 2018, as the "relate-back" date for purposes of determining refunds or surcharges.

17. The hearing on the merits convened on October 24, 2017, and concluded on October 26, 2017. The parties filed initial briefs on November 22, 2017, and reply briefs on December 15, 2017, which is when the record closed.

Revenue Requirement

Operation and Maintenance (O&M) Expenses

Other Revenues

18. DDU received $3,600 in revenue from Nextlink that should be added to White Bluff water's operation and maintenance expenses.

Other Volume-Related Expenses

19. DDU included $830 of White Bluff water expenses in the other volume-related expense account that were actually fixed expenses belonging in the other plant maintenance account.

20. A $1,148 expense for chlorine gas cylinders should be added to the other volume-related expense account for White Bluff water.

21. DDU included $530 of White Bluff sewer expenses in the other volume-related expenses account that were actually fixed expenses belonging in the other plant maintenance account.

Employee Labor

22. All DDU employees at White Bluff are cross-trained on both the water and sewer utility systems.

23. DDU employees Jerry Whitworth and Danny Keeton performed water and sewer tap installations, performed other duties as needed, and answered service calls for both the White Bluff water and sewer systems during the test year.

24. DDU employees Clovis Wilhelm, Jody Bledsoe, and Dwayne Cota worked on both the water and sewer systems and responded to service calls on both systems during the test year.

25. Messrs. Wilhelm, Bledsoe, and Cota were not prohibited from performing work on systems for which they were not specifically licensed.

26. The salaries of Mr. Whitworth, Mr. Keeton, Clovis Wilhelm, Jody Bledsoe, and Dwayne Cota were reasonable and necessary for DDU to provide water and sewer services to its customers, and DDU appropriately apportioned those salaries between the two utility systems in the White Bluff Application.

Contract Work

27. Todd Dilworth, the White Bluff utility manager for DDU, is on call at all times to respond to service calls at the White Bluff water and sewer systems.

28. It is reasonable to have Mr. Dilworth on call at all times in case issues arise that affect service, and it is a reasonable expense to allow Mr. Dilworth to have a mobile phone with cell service so that there can be effective and efficient communication regarding any such issues.

29. DDU's phone allowance of $900 for 12 months for Mr. Dilworth is a reasonable and necessary expense incurred to provide water and sewer services at White Bluff.

30. A total of $890 for White Bluff water and $790 for White Bluff sewer in general and administrative (G&A) expenses attributable to security at the White Bluff resort should

be reallocated from miscellaneous expenses to contract work as intercompany labor transfers.

Transportation

31. Mr. Dilworth and another employee have DDU vehicles that they can use to respond at any time to a service call at White Bluff.

32. Mr. Dilworth drives one of the trucks to and from work daily, and the other truck is used by the DDU employee assigned to be on call to drive to and from work during such assignment.

33. Mr. Dilworth and the on-call DDU employee do not use the trucks for any personal reasons; although they use the trucks to drive to and from work, this use is reasonable and necessary so that they can respond to a service call from home if such a call is made.

34. The fuel costs incurred by DDU for Mr. Dilworth and the other employee driving to and from work in company trucks while on-call are not purely commuter miles and are reasonable and necessary expenses incurred by DDU in providing service at White Bluff.

35. A vehicle lease expense ($2,912 for both water and sewer) and a tool box expense for White Bluff of $580 should be removed from transportation expenses and added to the depreciation schedule.

Other Plant Maintenance

36. Grinder pumps are part of the White Bluff wastewater system and installed at each service location in the White Bluff system.

37. There is significant, typical, and recurring maintenance, repair, and replacement expenses associated with the grinder pumps in the White Bluff sewer system.

38. Approximately 20 to 30 grinder pumps are replaced and approximately half of the pumps are repaired every year in the White Bluff sewer system.

39. The grinder pump costs included in DDU's other plant maintenance account for White Bluff sewer are incurred on an annual basis by DDU in order to repair and replace the pumps, and therefore are more appropriately categorized as operation and maintenance expenses than as capital assets.

40. The $709 included in the trial balance for the White Bluff water system reflects costs incurred in the operation and maintenance of the water system at White Bluff and is appropriately included as other plant maintenance expense.

41. It is standard in the water and sewer utility industry to classify ordinary maintenance and repair costs as expenses rather than capital costs.

42. The invoice from Industrial Electric Repair and Sales referencing "Rewind 3 Phase," "machine work on pump," and pump repair, and reflecting charges for bearings and a pump seal pertains to repairs, and the costs reflected in this invoice are appropriately designated as other plant maintenance expenses.

43. The invoice from Wallace Controls & Electric referring to a call regarding a well not running and reflecting a burned-out motor protector and service wire and a motor protector replacement pertains to repairs, and the costs reflected in this invoice are appropriately designated as other plant maintenance expenses.

Professional Services

44. The cost of renewing DDU's wastewater permit for White Bluff, which DDU has historically incurred approximately every three years, should be allowed to be recovered in equal parts in DDU's rates over three years.

45. The cost incurred by DDU to obtain a CCN amendment for The Cliffs during the test year was not a typical or recurring cost, and it is difficult if not impossible to determine when or how often such a cost will be incurred.

46. The cost of obtaining the CCN amendment for The Cliffs was reasonable and necessary to provide sewer service to customers at The Cliffs.

47. DDU did not incur any cost to obtain a CCN amendment for White Bluff during the test year, and the costs of such amendment reflected in the White Bluff professional services account should be removed.

Insurance

48. The premiums paid by DDU for worker's compensation insurance ($1,444 for water and $373 for sewer) are not recoverable insurance expenses.

49. Some portion of the premium paid by DDU for an umbrella insurance policy is attributable to insurance coverage that is incurred as part of providing service and maintaining plant.

50. The amount of the umbrella premium attributable to coverage for providing utility service and maintaining plant does not correlate to the base premium for such coverage.

51. DDU failed to prove the cost of the umbrella coverage that relates to DDU's provision of water and sewer utility service.

Salaries

52. There were seven salaried employees working for the White Bluff utility systems at some point during the test year; not all seven of these employees worked the entire test year.

53. The seven employees who worked for the White Bluff utility systems during the test year earned and were paid $151,074 in salary during the test year; they did not earn and were not paid their full yearly salaries.

54. As of August 4, 2017, and October 24, 2017, there were only four employees working for the White Bluff systems.

55. Employee salaries totaling $151,074 are reasonable and necessary expenses for DDU to provide services through the White Bluff systems.

Regulatory Fees

56. The Prairieland Groundwater District fees paid by DDU for White Bluff should not be included in DDU's revenue requirement but should be included as a pass-through provision in DDU's tariff.

57. DDU's expenses related to water tests that occur every three years should be normalized such that DDU recovers one-third of the expenses every year.

Miscellaneous Expenses

58. Equipment lease fees of $19,728 for White Bluff water and $20,148 for White Bluff sewer associated with automatic meter reading and the 50,000 gallon wastewater treatment plant should be removed from the miscellaneous expense accounts.

59. Sewer tap fee expenses of $500 should be removed from the White Bluff sewer miscellaneous expense account.

60. The water and sewer plants are located within the resort properties at White Bluff and The Cliffs, and DDU uses some of the resort's resources and allocates for those resort resources used.

61. Resort expenses that DDU allocates to miscellaneous expenses include those related to the general manager and office manager, commissions and bonuses, employee compensation, payroll burden, electricity, water and sewer, uniforms, small tools, and the like.

62. Overhead expenses at White Bluff include portions of the salaries of the resort's general manager, receptionist, human resources employee, and accounts payable employee; rent for office space; and copier costs.

63. DDU's White Bluff office is located in the resort's administration building, and there is no direct charge to DDU for rent, computers, phones, the receptionist, or the copiers. DDU, along with other departments within the resort, shares the expenses related to the administration building.

64. The allocated costs shared with the resort for the expenses that DDU needs, including office space, office supplies, and certain employees, were lower than if DDU had rented its own space, set up its own office, and hired its own employees.

65. DDU's allocation of approximately 3% of the resorts' total overhead and G&A expenses to be reasonable, based on an average of DDU's portion of those costs, is reasonable.

66. The resorts incur and pay costs for overhead and G&A expenses, and 3% of those costs are then expensed to DDU.

67. The allocated overhead and G&A costs for White Bluff and The Cliffs are reasonable and necessary operational expenses incurred by DDU to provide service to its ratepayers.

Depreciation

68. The $80 expense for a "Truck Bed Mat" should be removed from the White Bluff sewer depreciation schedule.

Use of Trending Study to Determine Original Cost

69. DDU retained Dr. Victoria Harkins to perform an analysis of the utility assets at White Bluff and The Cliffs and determine the original cost of such assets.

70. To perform her analysis, Dr. Harkins looked only at invoices provided to her by DDU for the utility assets and did not review any balance sheets or general ledgers.

71. The invoices reviewed by Dr. Harkins for purposes of determining the original cost of utility assets did not reflect the entirety of the pipe work for the White Bluff and The Cliffs systems.

72. Dr. Harkins performed a trended original cost study to establish the original cost for certain of White Bluff's and The Cliffs's assets for which no invoice was available.

73. DDU's Chief Financial Officer understood that the costs of DDU's utility infrastructure would have been recorded in a balance sheet based on invoices for such expenses.

74. It is unclear whether historical records exist (or existed at the time the Applications were prepared) showing the original construction costs for the collection and distribution lines at White Bluff and The Cliffs.

75. Construction of the collection and distribution lines at the White Bluff development began in around 1990. Construction was ongoing through 2007 or 2008.

76. Dr. Harkins's use in her trending study of January 1, 1996, as an installation date for the pipe work was reasonable and appropriate.

77. Any gain in original cost from using 1996 as the installation date was corrected by installation performed up to ten years after that date and beyond, at which time the cost would have been even greater.

Fully Depreciated Assets

78. All assets that have fully depreciated should be removed from DDU's White Bluff depreciation schedules, as set forth in Tables NDH-14, NDH-15, NDH-16, and NDH-17 of the direct testimony of WBRG witness Nelisa Heddin.

Taxes

Federal Income Tax Expense

79. Treating White Bluff and The Cliffs as separate entities when calculating federal income tax expense is not appropriate.

Other Assessments and Taxes

80. The sales and title taxes for the 2014 Ford truck are included in the asset depreciation schedule and therefore should be removed from taxes.

Return on Invested Capital

Original Cost of Plant In Service

81. The correct original cost of a "75,000 gallon gst, field erect with pad" and "75,000 gallon gan, field erect mth pad" is $16,565, and the water depreciation schedule for The Cliffs system should be revised accordingly.

82. The original cost of the "TK Crossbed Toolbox" set forth on the White Bluff sewer depreciation schedule should be revised to $850 to remove an $80 expense for a "Truck Bed Mat" that was also included in White Bluff's cost of service.

Cash Working Capital

83. A reasonable cash working capital allowance for the White Bluff utility system is 1/12 of the system's O&M expenses.

84. DDU maintains cash balances for both White Bluff and The Cliffs systems under one CCN, filed one annual report for both developments, and filed a single rate case for both developments.

85. Both the White Bluff and The Cliffs systems are operated and maintained by DDU and have access to the same capital.

86. A reasonable cash working capital allowance for The Cliffs utility system is 1/12 of the system's O&M expenses.

Developer Contributions

87. In determining the original cost of used and useful utility plant, property, and equipment for purposes of calculating its rate base, DDU used an asset list prepared jointly by DDU's President Randy Gracy and DDU witness Dr. Harkins, which identifies certain assets that were considered 80% developer-contributed. That 80% portion of the cost of those assets was removed from DDU's rate base calculation.

88. There is no contemporaneous accounting or other documentation showing that the assets on the asset list prepared by Mr. Gracy and Dr. Harkins were 80% developer-contributed.

89. Until December 1996, when DDU was created, Double Diamond, Inc., another wholly-owned subsidiary of Double Diamond-Delaware, was the developer and the utility company at White Bluff and contracted for the construction of the original infrastructure of the White Bluff utility systems.

90. Before December 1996, most of the utility infrastructure was paid for by Double Diamond, Inc.

91. In 1997, Double Diamond Properties Construction Co., also created in December 1996 as a wholly-owned subsidiary of Double Diamond-Delaware, began paying for most of the utility infrastructure.

92. Approximately 61% of the water system assets and 60% of the sewer system assets included in DDU's requested rate base for White Bluff were constructed before December 1996.

93. Most of the White Bluff assets included in DDU's requested rate base for White Bluff that were constructed after December 1996 were paid for by Double Diamond Properties Construction Co.

94. In December 1997, DDU filed an application to change rates at White Bluff, The Cliffs, and Oakwood, another development that it serves. In that filing, there were no contributions in aid of construction identified.

95. In August 2007, DDU filed an application to change water rates at White Bluff, The Cliffs, and the Retreat, another development that it serves. The application was amended in December 2007, but neither the August 2007 nor the December 2007 amendment indicated that a portion of DDU's assets included in rate base was developer contributions.

96. In October 2008, DDU filed another rate change application for the water systems at White Bluff, The Cliffs, and the Retreat which identified the amount of developer contributions as approximately $1.9 million.

97. In February 2009, Double Diamond filed another rate change application for the water systems at White Bluff, The Cliffs, and the Retreat, and the application indicated a total of $1,119,399 in developer contributions for the three systems.

98. There were some contributions made by the White Bluff developer to the investment made in utility plant, property, and equipment used to service ratepayers of the White Bluff water and sewer utility systems. It cannot be determined from the evidence the amount of such contributions.

99. DDU is in the best position to access and discover the evidence necessary to differentiate between plant, equipment, and property contributed by the developer and that invested by DDU.

100. The net book value of the utility assets claimed as part of DDU's rate base and paid for by DDU are properly included in DDU's invested capital.

Property Not Belonging to DDU

101. Tract 2 in White Bluff was conveyed by Double Diamond, Inc. to the White Bluff Property Owners Association (WBPOA) in December 1995, as well as certain facilities included on such tract, including a water well, the water plant, and the water storage tank.

102. DDU's request for net book value of Tract 2 and the facilities on Tract 2 of $88,565 and annual depreciation of $2,060 to be included in its rate base should be denied.

Used and Useful/Prudence

103. The White Bluff systems "serve" 6,314 lots and that The Cliffs systems "serve" 2,518 lots.

104. There are approximately 65 miles of water lines and 60 miles of sewer lines at White Bluff, and 23 miles of water and sewer lines at The Cliffs.

105. Only approximately 10% of the lots at White Bluff and The Cliffs developments are actually receiving service from DDU.

106. Approximately 85 to 90 percent of the lots at White Bluff have been sold.

107. It was reasonable to build out the distribution and collection systems such that if any lot within either White Bluff or The Cliffs was sold and the new owner requested service, it could be provided.

Accumulated Deferred Federal Income Tax (ADFIT)

108. There is no accounting evidence that DDU incurred a net operating loss (NOL) or documentary proof in the record that DDU did not defer payment of federal income taxes because of a NOL.

109. The estimate of the effect of the alleged NOL carryover on the ADFIT calculated by Staff witness Debi Loockerman was unsupported.

Rate of Return

Return on Equity

110. A reasonable return on equity (ROE) for DDU, based on a discounted cash flow (DCF) analysis employed with the Capital Asset Pricing Model (CAPM) and the Expected Earnings model and including a Risk Premium analysis, is 9.84%.

111. A ROE of 9.84% is reasonably sufficient to assure confidence in DDU's financial soundness and will be adequate to maintain and support its credit and allow it to raise necessary capital.

112. A ROE of 9.84% will not yield more than a fair return on DDU's invested capital.

113. The more thorough analysis employed by DDU witness Gregory Scheig, which used the DCF and Risk Premium analysis and employed the CAPM and Expected Earnings model and gave the most weight to the DCF and CAPM, was more accurate in determining a

reasonable ROE for DDU than the analysis of Staff witness Ms. Sears, who used only the DCF analysis and compared it to the CAPM.

114. A small stock risk premium on top of the 9.84% ROE is not warranted.

115. Approximately 40% of the unaccounted for water noted in the Applications is water loss due to brine discharge after water from the lake goes through a reverse osmosis plant, and thousands of gallons a day used to backwash sand filters.

116. Additional water is used to regularly flush out the lines at White Bluff and The Cliffs and is therefore unaccounted for.

117. DDU employs various methods at The Cliffs to track down leaks, and DDU has responded to and repaired discovered and reported leaks in a reasonable manner.

118. The utility crew at The Cliffs is instructed to respond to reports of leaks as quickly as possible and make the necessary repairs. Some leaks can be fixed in a few hours, and most leaks are repaired the same day or the day after they are reported.

119. A reduction in ROE due to the quality and efficiency of service at White Bluff and The Cliffs is not warranted.

Cost of Debt

120. A 4.91% cost of debt, which is Double Diamond-Delaware's overall weighted average cost of debt as of December 31, 2015, is an appropriate cost of DDU's debt.

Capital Structure

121. DDU took out a $3 million loan secured by White Bluff utility assets, the proceeds of which Double Diamond-Delaware used to make capital improvements and for other purposes. Double Diamond-Delaware guaranteed repayment of the debt.

122. It is unclear exactly how the $3 million proceeds of the loan were accounted for.

123. Double Diamond, Inc. has been making the payments on the loan; if Double Diamond, Inc. did not make those payments and there was a default, the bank would look to Double Diamond-Delaware as guarantor, and not DDU, for payment.

124. The $3 million loan is not related to DDU's debt financing and therefore cannot serve as the basis for the capital structure recommended by WBRG.

125. The appropriate capital structure for DDU is 47.27% debt and 52.73% equity, which is representative of the capital structure of other companies in the water utility industry and reflects an efficient use of capital.

Overall Rate of Return

126. DDU's overall rate of return should be set as follows:

Component	Ratio	Cost Rate	Weighted Cost Rate
Debt	47.27%	4.91%	2.32%
Equity	52.73%	9.84%	5.19%
Overall			7.51%

Rate Design

127. The rate structures set forth in Attachment C to this Proposal for Decision will recover DDU's revenue requirements for White Bluff water and White Bluff sewer.

128. The rate structures set forth in Attachment D to this Proposal for Decision will recover DDU's revenue requirement for The Cliffs water and The Cliffs sewer.

XI. CONCLUSIONS OF LAW

1. DDU is a retail public utility as defined in Texas Water Code § 13.002(19) and a utility as defined by Texas Water Code § 13.002(23).

2. The Commission has jurisdiction over the Applications pursuant to Texas Water Code §§ 13.041, 13.043(b), 13.181-.185, 13.1871, and 13.1872.

3. All required notices of the Applications and the contested case hearing were given as required by law. Tex. Water Code § 13.1871; Tex. Gov't Code §§ 2001.051, .052.

4. The ALJ conducted a contested case hearing and proposed a decision on the Applications under the authority of chapter 2003 of the Texas Government Code and chapter 13 of the Texas Water Code.

5. DDU bears the burden of proof that its proposed rates are just and reasonable. Tex. Water Code § 13.184(c).

6. The resort overhead and G&A expenses allocated to DDU's water and sewer utilities at White Bluff and The Cliffs are not payments to an affiliated interest. Texas Water Code §§ 13.002(2), .185(e).

7. DDU failed to meet its burden to show that its account balances do not reflect the original costs of the line work assets before estimating those costs by a trending study for purposes of determining rate base. 16 Tex. Admin. Code § 24.31(c)(2)(B)(i).

8. DDU failed to meet its burden to show how much of the original cost of the utility assets included in its proposed rate base for White Bluff were contributed by the developer. Tex. Water Code § 13.184(c).

9. In compliance with Texas Water Code § 13.183, and based on the findings of fact and conclusions of law, DDU's overall revenues approved in this case permit DDU a reasonable opportunity to earn a reasonable return on its invested capital used and useful in providing service to the public over and above its reasonable and necessary operating expenses.

10. Based on the findings of fact and conclusions of law, an overall rate of return of 7.51% will permit DDU a reasonable opportunity to earn a reasonable return on its invested capital. Tex. Water Code § 13.184.

11. Consistent with Texas Water Code § 13.185, the rates approved in this case are based on original cost, less depreciation, of property used and useful to DDU's provision of service.

12. The rates approved in this case are just and reasonable, comply with the ratemaking provisions in Texas Water Code chapter 13, and are not unreasonably discriminatory, preferential, or prejudicial.

13. The increase in revenue that would have been generated by DDU's proposed rates should be calculated using the proposed rates from the amended Applications, which were those upon which a contested hearing was held. 16 Tex. Admin. Code § 24.33(b) .

XII. ORDERING PARAGRAPHS

1. As amended in this order, DDU's applications for a rate increase at White Bluff and The Cliffs are granted.

2. The Commission is setting just and reasonable rates consistent with the findings of fact and conclusions of law.

3. Within 10 days of the issuance of this Order, DDU shall file with the Commission's Docket Clerk a copy of its tariff with the approved rates.

4. All other motions, requests of entry of specific findings of fact and conclusions of law, and any other requests for general or specific relief, if not expressly granted, are denied.

SIGNED February 13, 2018.

CASEY A. BELL
ADMINISTRATIVE LAW JUDGE
STATE OFFICE OF ADMINISTRATIVE HEARINGS

ATTACHMENT A

SOAH DOCKET NO. 473-17-0117.WS
PUC DOCKET NO. 46245
COMPANY NAME Double Diamond Utility Company, Inc. - White Bluff Subdivision - Water
TEST YEAR END 31-Dec-15

Schedule I
Revenue Requirement

REVENUE REQUIREMENT	Test Year Total (a)	Company Adjustments To Test Year (b)	Company Requested Test Year Total (c)=(a)+(b)	Adjustments To Company Request (d)	Adjusted Total (e)=(c)+(d)
Operations and Maintenance	$ 551,745	$ 20,887	$ 572,632	$ (101,364)	$ 471,268
Depreciation and Amortization Expense	$ 148,621	$ 46,156	$ 194,777	$ (47,953)	$ 146,824
Taxes Other Than Income	$ 132,290	$ (10,013)	$ 122,277	$ (3,675)	$ 118,602
Federal Income Taxes	$ -	$ 45,732	$ 45,732	$ (45,732)	$ -
Return on Invested Capital	$ 30,827	$ 184,382	$ 215,209	$ (214,342)	$ 867
TOTAL	$ 863,483	$ 287,144	$ 1,150,628	$ (413,066)	$ 737,561
Other Revenues - Taps, Recon, late fee, Etc.	$ -	$ -	$ (9,737)	$ (3,600)	$ (13,337)
Revenue Requirement Used to Set Rates	$ 863,483	$ -	$ 1,140,891	$ (416,666)	$ 724,224

SOAH DOCKET NO. 473-17-0117.WS
PUC DOCKET NO. 46245
COMPANY NAME Double Diamond Utility Company, Inc. - White Bluff Subdivision - Water
TEST YEAR END 31-Dec-15

Schedule I
Revenue Requirement

REVENUE REQUIREMENT	Test Year Total (a)	Company Adjustments To Test Year (b)	Company Requested Test Year Total (c)=(a)+(b)	Adjustments To Company Request (d)	Adjusted Total (e)=(c)+(d)
Operations and Maintenance	$ 294,397	$ 415	$ 294,812	$ (50,249)	$ 244,563
Depreciation and Amortization Expense	$ 78,805	$ 31,272	$ 110,077	$ (34,750)	$ 75,327
Taxes Other Than Income	$ 70,146	$ (5,975)	$ 64,171	$ (147)	$ 64,024
Federal Income Taxes	$ -	$ 18,378	$ 18,378	$ (18,378)	$ -
Return on Invested Capital	$ 30,106	$ 56,379	$ 86,485	$ (86,485)	$ -
TOTAL	$ 473,454	$ 100,469	$ 573,924	$ (190,010)	$ 383,913
Other Revenues - Taps, Recon, late fee, Etc.			$ (5,163)	$ (3,600)	$ (8,763)
Revenue Requirement Used to Set Rates	$ 473,454	$ -	$ 568,761	$ (193,610)	$ 375,150