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APPLICATION OF DOUBLE §  
DIAMOND UTILITY COMPANY, INC. §  
FOR WATER AND SEWER §  
RATE/TARIFF CHANGE §

PUBLIC UTILITY COMMISSION  
OF TEXAS  
PUBLIC UTILITY COMMISSION  
FILING CLERK

COMMISSION STAFF'S EXCEPTIONS TO THE PROPOSAL FOR DECISION

Respectfully submitted,

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Dated: March 28, 2018

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<b>RATE/TARIFF CHANGE</b>	<b>§</b>	

**COMMISSION STAFF’S EXCEPTIONS TO THE PROPOSAL FOR DECISION**

COMES NOW the Staff (Staff) of the Public Utility Commission of Texas (Commission), representing the public interest, and files this Commission Staff’s Exceptions to the Proposal for Decision. On February 13, 2018, the State Office of Administrative Hearings (SOAH) Administrative Law Judge (ALJ) issued a Proposal for Decision (PFD)<sup>1</sup> in this proceeding. The deadline for filing exceptions is March 28, 2018; therefore, this pleading is timely filed. In support of its Exceptions, Staff shows the following:

**I. INTRODUCTION**

Staff is grateful for the reasoned consideration of the SOAH ALJ. This proceeding has presented many novel and complex issues, and the SOAH ALJ has carefully considered each of them. However, Staff respectfully excepts to portions of the PFD. In particular, Staff’s positions on employee labor expense, allocated resort overhead, the treatment of expenses for grinder pumps as investment in utility plant, and return on equity (ROE), as well as Staff’s other miscellaneous exceptions, should be adopted.

**II. JURISDICTION, NOTICE, AND PROCEDURAL HISTORY**

No exceptions.

**III. BACKGROUND**

No exceptions.

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<sup>1</sup> Proposal for Decision (Feb. 13, 2018) (PFD).

## **IV. REVENUE REQUIREMENT [PO ISSUES 3, 5, 6, 34]**

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

#### **1. Other Revenues**

Staff recommends adding \$3,600 for monthly revenues received from Nextlink to the other revenues for White Bluff water.<sup>2</sup> DDU agrees with the recommendation,<sup>3</sup> and the PFD found that it should be adopted.<sup>4</sup> However, the PFD states that \$3,600 should be added to the O&M expenses for White Bluff water.<sup>5</sup> Therefore, Staff recommends a correction to the PFD and corresponding schedules adding the \$3,600 for Nextlink revenues to White Bluff water's other revenues.

#### **2. Other Volume-Related Expenses**

No exceptions.

#### **3. Employee Labor**

Staff recommends that the Commission disallow \$43,680 in labor expenses for the salaries paid to Jerry Whitworth, a backhoe operator, and Danny Keeton, an equipment operator, that were not reasonable and necessary for normal operations.<sup>6</sup> This is one of two discrete recommendations Staff made related to employee labor. The other recommendation was to adjust how the salaries of Clovis Wilhelm, Jody Bledsoe, and Dwayne Cota were allocated between White Bluff water and sewer.<sup>7</sup> The PFD appears to conflate these recommendations stating: "The ALJ finds that DDU has shown at least some if not all of the salaries of Messrs. Whitworth, Keeton, Wilhelm, and Bledsoe were reasonably and necessarily incurred by DDU in providing water and sewer service during the test year."<sup>8</sup> To clarify, Staff does not contest the reasonableness and necessity of the salaries paid to Wilhelm, Bledsoe, and Cota; Staff's

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<sup>2</sup> Direct Testimony of Emily Sears, Staff Ex. 2 at 8-9.

<sup>3</sup> Tr. at 512:25-513:10 (Joyce Supplemental Rebuttal) (Oct. 26, 2017).

<sup>4</sup> PFD at 5.

<sup>5</sup> *Id.*

<sup>6</sup> Commission Staff's Initial Brief at 9-11 of 41 (Nov. 22, 2017) (Staff's Initial Brief).

<sup>7</sup> *Id.* at 11 of 41.

recommendation with respect to those three operators only addresses whether allocating these salaries equally between White Bluff water and sewer is appropriate.<sup>9</sup>

However, Staff disagrees with the PFD's recommendation that DDU met its burden to show by a preponderance of the evidence that the \$43,680 in salaries paid to Whitworth and Keeton were reasonable and necessary.<sup>10</sup> Texas courts have interpreted preponderance of the evidence to mean the greater weight and degree of credible evidence.<sup>11</sup> The PFD describes the evidence in the record supporting how Keeton and Whitworth spend 99% of their time as "scant and non-specific" and details the issues related to these salaries that remain unclear and the types of evidence not offered.<sup>12</sup> The only explanation as to why the evidence DDU did offer is sufficient to support the conclusion that the entire amount of the salaries paid to Whitworth and Keeton were reasonable and necessary is "that all of the employees worked on both the water and sewer systems and responded to service calls on both systems."<sup>13</sup> Thus, the PFD seems to be addressing the allocation of employee labor expense, not the reasonableness or necessity of the expense.

The weight and degree of evidence produced by DDU does not prove that the salary expenses for Keeton and Whitworth are reasonable and necessary to provide service to DDU's ratepayers. At most, DDU has proven that Whitworth was paid \$20,880 per year as a "Utilities Back Hoe Operator," Keeton was paid \$22,880 per year as an "Equipment Operator," both men were cross-trained to work on the White Bluff water and sewer systems, and both men spent 99% of their time performing "other duties as needed" and 1% of their time installing taps.<sup>14</sup> DDU failed to provide any evidence related to the types of duties categorized as other duties as

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<sup>8</sup> PFD at 8.

<sup>9</sup> Commission Staff's Reply Brief at 5-6 of 26 (Dec. 15, 2017) (Staff's Reply Brief).

<sup>10</sup> PFD at 9.

<sup>11</sup> *Quintanilla v. West*, 534 S.W.3d 34, 43 (Tex. App.—San Antonio 2017, pet. filed); *R&R Contractors v. Torres*, 88 S.W.3d 685, fn. 12 (Tex. App.—Corpus Christi 2002, no pet.); *Upjohn Co. v. Freeman*, 847 S.W.2d 589, 591 (Tex. App.—Dallas 2002, no pet.); *Davenport v. Cabell's, Inc.*, 239 S.W.2d 833, 835 (Tex. Civ. App.—Texarkana 1951, no writ); *Tex. Farm Products Co. v. Johnson*, 190 S.W.2d 178, 180 (Tex. Civ. App.—Waco 1945, no writ).

<sup>12</sup> PFD at 8-9.

<sup>13</sup> *Id.* at 9.

<sup>14</sup> Workpapers of Emily Sears, Staff Ex. 2A at ES Workpaper 5-6; Rebuttal Testimony of Randy Gracy, Ex. DDU-8 at 4 of 155; Rebuttal Testimony of Jay Joyce, Ex. DDU-11 at 4 of 106; Workpapers for Rebuttal Testimony of Jay Joyce, Ex. DDU-11B at 91-99 of 106.

needed,<sup>15</sup> whether any of these other duties required skill operating a backhoe,<sup>16</sup> why DDU needs more than one full time backhoe operator,<sup>17</sup> the number of overtime hours worked by these employees,<sup>18</sup> the market salary rate for a backhoe/equipment operator,<sup>19</sup> and the experience and skill level of these employees.<sup>20</sup>

The evidence in the record is insufficient to support the conclusion that DDU has shown that it is more likely than not<sup>21</sup> that the entire \$20,880 paid to Mr. Whitworth and the entire \$22,880 paid to Mr. Keeton were reasonable and necessary expenses to provide service to DDU's ratepayers. To hold otherwise would set an improperly low bar a utility must meet to carry its burden of proof regarding employee salaries. Thus, Staff's deductions of \$21,840 from the employee labor expense for both White Bluff water and sewer should be adopted.

#### **4. Contract Work**

No exceptions.

#### **5. Transportation Expense**

Staff supports the PFD's adoption of Staff's recommendation to reclassify a tool box expense for White Bluff to the depreciation schedule.<sup>22</sup> However, Staff clarifies that the amount to be reclassified should be \$850,<sup>23</sup> not \$580.<sup>24</sup>

#### **6. Other Plant Maintenance**

The Commission should reject the PFD's recommendation to classify DDU's costs for purchasing grinder pumps as recurring expenses. The grinder pumps at issue are capital

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<sup>15</sup> Staff's Initial Brief at 10 of 41.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 11 of 41.

<sup>18</sup> PFD at 9.

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

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

<sup>21</sup> *See In re Lipsky*, 460 S.W.3d 579, 589 (Tex. 2015) (describing the preponderance of the evidence standard as, "a fact-finder's determination that the plaintiff's version of the events is more likely than not true").

<sup>22</sup> PFD at 12.

<sup>23</sup> Staff's Initial Brief at 13 of 41.

<sup>24</sup> PFD at 12, 82 (Finding of Fact No. 35).



investments as they have a useful life of ten years.<sup>25</sup> DDU's own capitalization policy would also require the grinder pumps to be capitalized rather than expensed.<sup>26</sup> The Texas Water Code (TWC) requires that invested capital be recovered through depreciation with a return on the utility's investment.<sup>27</sup> By categorizing the investment as an expense, DDU effectively seeks recovery of 100% of its investment in the first year of operation instead of spreading the recovery of the investment over the useful life of the asset.

DDU has presented evidence that it replaces some grinder pumps each year, and that it has historically treated costs for the repair and replacement of grinder pumps as expenses.<sup>28</sup> However, DDU has not provided any evidence demonstrating that its historical practice was authorized by TWC § 13.185 as an approved alternative methodology of calculating invested capital or any evidence as to why DDU's own capitalization policy should not apply. In fact, DDU's witness Dr. Victoria Harkins, who offered testimony in support of expensing the grinder pumps, admitted that she did not review the capitalization policy at all.<sup>29</sup> The PFD reasoned that the costs related to grinder pumps should be classified as expenses because they are typical and recurring,<sup>30</sup> but whether an investment is typical or recurring is irrelevant as to whether it should be capitalized and included in rate base or expensed in the year it is incurred. It is undisputed that grinder pumps have a service life of ten years, and it is expected that a utility would have to replace some portion of its plant on an annual basis.<sup>31</sup> Accordingly, these grinder pumps should be capitalized as plant and recovered using a service life of 10 years.<sup>32</sup>

Staff's recommended adjustment to capitalize grinder pumps and recover this investment through depreciation is based upon capitalizing the \$79,590.73 for test year grinder pumps that were expensed in the cost of service and including them in rate base instead.<sup>33</sup> Any grinder

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<sup>25</sup> Staff Ex. 2 at 18; Tr. at 344:3-4 (Sears Cross) (Oct. 25, 2017).

<sup>26</sup> DDU's Response to Commission Staff's First Request for Information, Staff Ex. 6 at 4.

<sup>27</sup> Tex. Water Code (TWC) § 13.185(b) and (j).

<sup>28</sup> See PFD at 16-17.

<sup>29</sup> Tr. at 423:2-8 (Harkins Cross) (Oct. 26, 2017).

<sup>30</sup> PFD at 17.

<sup>31</sup> See Rebuttal Testimony of Victoria Harkins, Ex. DDU-9 at 5 of 527; Tr. at 343:8-15 (Sears Cross) (Oct. 25, 2017).

<sup>32</sup> Staff's Reply Brief at 11 of 26.

<sup>33</sup> Staff Ex. 2 at 12.

pumps that were acquired prior to the test year have presumably already been expensed and recovered through customer rates.<sup>34</sup>

**7. Professional Services**

No exceptions.

**8. Insurance Expenses**

No exceptions.

**9. Salaries**

No exceptions.

**10. Regulatory Fees**

No exceptions.

**11. Miscellaneous Expenses**

Staff disagrees with the PFD's recommendation to include expenses for resort overhead and G&A in DDU's cost of service. A utility may only include expenses that are reasonable and necessary to provide service to the ratepayers in its cost of service.<sup>35</sup> The evidence in this case has clearly shown that the amount of resort overhead allocated to White Bluff and the Cliffs includes the cost of items like uniforms and commissions/bonuses for resort employees; items that are unrelated to the provision of utility service.<sup>36</sup> And, it is undisputed by the parties and the PFD that a flat three percent of all expenses incurred by the White Bluff resort, including those that are resort-specific, are being allocated to DDU.<sup>37</sup> However, the PFD chooses to overlook DDU's inappropriate allocation methodology because, had DDU set up its own office with its own employees, the three percent allocated equates to a dollar amount that is a reasonable amount for overhead.<sup>38</sup>

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<sup>34</sup> Staff's Initial Brief at 22 of 41.

<sup>35</sup> 16 Tex. Admin. Code (TAC) § 24.31(b).

<sup>36</sup> Tr. at 330:6-8 (Sears Cross) (Oct. 25, 2017); Staff Ex. 2 at 22; Tr. at 475:10 (Gracy Rebuttal Cross) (Oct. 26, 2017).

<sup>37</sup> PFD at 25.

<sup>38</sup> *Id.*

The relevant inquiry is not whether the dollar amount is reasonable, but whether the actual expense is reasonably incurred in furnishing normal utility service.<sup>39</sup> The PFD ignores this question and instead concludes that the ends justified the means. Therefore, the Commission should reject the PFD's recommendation because it is unacceptable for a utility's ratepayers to pay for three percent of any item not related to the provision of water or wastewater service.

## **B. Depreciation [PO Issues 12, 27]**

As discussed in more detail above in section IV(A)(6), Staff continues to recommend that grinder pumps are utility plant, and not expenses, which are properly capitalized and included on the White Bluff sewer depreciation schedule.

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

No exceptions.

### **2. Error in Trending Study**

No exceptions.

### **3. Fully Depreciated Assets**

No exceptions.

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

### **1. Federal Income Tax Expense [PO Issue 30]**

Staff recommends that the rates recommended by the PFD be reduced to reflect the reduction in tax expense resulting from the change in the Federal Income Tax rate. On January 12, 2018, the Commission opened Project No. 47945 to evaluate and address the effects of the federal income tax reforms enacted by the Tax Cuts and Jobs Act of 2017 (TCJA).<sup>40</sup> The Commission's accounting order in Project No. 47945 directed Staff to review each investor-owned utility in Texas, on a case-by-case basis, to determine the appropriate mechanism to

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<sup>39</sup> See 16 TAC § 24.31(b)(1)(A).

<sup>40</sup> *Proceeding to Investigate and Address the Effects of the Tax Cuts and Jobs Act of 2017 on the Rates of Texas Investor-Owned Utility Companies*, Project No. 47945 (Jan. 12, 2018).

adjust its rates to reflect the changes under the TCJA.<sup>41</sup> Because DDU's rate application is currently pending before the Commission, Staff recommends that any savings DDU will realize as a result of this change to federal income tax laws should be reflected in the rates set. Staff further recommends that the Commission order DDU: (1) to adjust the income tax rates used in the number running process and file a compliance tariff reflecting the approved rates; and (2) to record the excess Accumulated Deferred Federal Income Tax in a regulatory liability account for return to customers in DDU's next base rate case.

## **2. Other Assessments and Taxes [PO Issue 29]**

Staff continues to recommend that a flow through adjustment to payroll taxes be adopted<sup>42</sup> consistent with Staff's exceptions to employee labor expenses discussed in section IV(A)(3).

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

### **1. Original Cost of Plant in Service**

As discussed in section IV(A)(6), Staff continues to recommend that grinder pumps are utility plant, and not expenses, which are properly capitalized and included on the White Bluff sewer depreciation schedule.

### **2. Accumulated Depreciation**

As discussed in section IV(A)(6), Staff continues to recommend that grinder pumps are utility plant, and not expenses, which are properly capitalized and included on the White Bluff sewer depreciation schedule.

### **3. Cash Working Capital**

No exceptions.

### **4. Developer Contribution**

No exceptions.

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<sup>41</sup> Project No. 47945, Amended Order Related to Changes in Federal Income Tax Rates at 1 (Feb. 15, 2018).

<sup>42</sup> See Staff's Initial Brief at 25 of 41.

## **5. Property Not Belonging to DDU**

No exceptions.

## **6. Improper Use of Trending Study**

No exceptions.

## **7. Used and Useful/Prudence**

No exceptions

## **8. Accumulated Deferred Federal Income Tax (ADFIT)**

No exceptions.

# **V. RATE OF RETURN**

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

Staff excepts to the 9.84% return on equity (ROE) recommended by the PFD. The only existing Commission precedent setting a ROE for a water utility does not support a ROE this high.<sup>43</sup> Further, Staff's witness Emily Sears relied on the Discounted Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) methods, which are both widely accepted at the Commission, and her estimated ROE of 8.79% falls squarely within the requirements established by the Texas Water Code and Commission rules.<sup>44</sup>

The PFD gives undue weight to the rebuttal testimony of DDU's witness Gregory Scheig.<sup>45</sup> Specifically, the PFD concludes that Mr. Scheig's criticisms of the various inputs used and assumptions made by Ms. Sears in developing her DCF model were "convincing,"<sup>46</sup> and that Mr. Scheig's ROE is more accurate because he performed an analysis using more models than Ms. Sears.<sup>47</sup> However, the PFD does little to elaborate on these conclusions and instead notes

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<sup>43</sup> *Id.* at 34 of 41; *Application of Rio Concho Aviation, Inc. for a Rate/Tariff Change*, Docket No. 45720, Order (Jun. 29, 2017).

<sup>44</sup> See TWC § 13.184; 16 TAC § 24.31(c)(1).

<sup>45</sup> PFD at 66.

<sup>46</sup> *Id.* at 67.

<sup>47</sup> *Id.* at 68.

that Staff did not take issue with Mr. Scheig's critiques of Ms. Sears' DCF model or his position that an ROE estimated using multiple models is better.<sup>48</sup>

These comments ignore the fact that Mr. Scheig's criticisms and additional models were introduced through rebuttal testimony thereby depriving Staff of the opportunity to propound discovery and respond via its own rebuttal testimony. Staff raised this issue in a motion to strike arguing that Mr. Scheig's rebuttal constituted supplemental direct testimony because it went beyond rebutting the recommendation of Ms. Sears and presented a separate, independent analysis of ROE.<sup>49</sup> Although Staff's motion was denied,<sup>50</sup> the PFD now cites Staff's lack of response as support for its conclusions. Thus, the PFD's deference to Mr. Scheig's independent analysis of DDU's ROE is unwarranted given the way in which it was introduced, and the Commission should adopt Staff's recommended ROE of 8.79%.

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

No exceptions.

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

No exceptions.

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

For the reasons discussed in section V(A), Staff excepts to the use of a 9.84% ROE. Instead, Staff recommends that the Commission authorize an 8.79% ROE. When combined with DDU's cost of debt (4.91%), Staff's recommended ROE results in an overall return of 6.96%.<sup>51</sup>

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

No exceptions.

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<sup>48</sup> *Id.* at 67.

<sup>49</sup> Commission Staff's Objection and Motion to Strike Portions of the Rebuttal Testimony of Gregory E. Scheig at 4 (Oct. 20, 2017).

<sup>50</sup> Tr. at 24:12-14 (Judge Bell ruling on Staff's objections and motion to strike) (Oct. 25, 2017).

<sup>51</sup> Staff's Initial Brief at 31 of 41.

**VII. RATE-CASE EXPENSES [PO ISSUE 38]**

No exceptions.

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

No exceptions.

**IX. CONCLUSION**

For the foregoing reasons, Staff respectfully requests that any final order in this proceeding be revised consistent with Staff's exceptions.

**X. FINDINGS OF FACT**

Staff recommends corresponding revisions to the Findings of Fact consistent with Staff's exceptions discussed above.

**XI. CONCLUSIONS OF LAW**

Staff excepts to Conclusion of Law No. 10 consistent with Staff's exceptions set forth in section V(A).

**XII. ORDERING PARAGRAPHS**

No exceptions.

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**CERTIFICATE OF SERVICE**

I certify that a copy of this document was served on all parties of record on March 28, 2018, in accordance with 16 TAC § 22.74.

  
Eleanor D'Ambrosio  
Eleanor D'Ambrosio