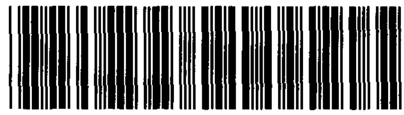

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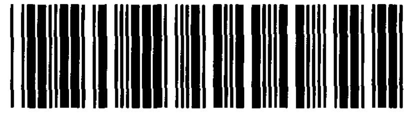

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APPLICATION OF DOUBLE DIAMOND UTILITY COMPANY, INC. FOR WATER AND SEWER RATE/TARIFF CHANGE	§ § § §	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

WHITE BLUFF RATEPAYERS GROUP'S REPLIES TO EXCEPTIONS TO THE PROPOSAL FOR DECISION

TO THE HONORABLE PUBLIC UTILITY COMMISSION OF TEXAS:

White Bluff Ratepayers Group ("WBRG") hereby files these replies to the exceptions to the Proposal for Decision ("PFD") filed by Double Diamond Utilities ("DDU"). Pursuant to letter from the Commission dated March 12, 2018, the deadline for exceptions is April 12, 2018. Therefore, this pleading is timely filed. In support of its positions, WBRG would show the following:

INTRODUCTION

DDU is a developer-owned, developer-controlled, utility. The rate base issues raised in this docket (developer contributed assets, use of trended costs studies), are typical of issues associated with developer-controlled utilities. These issues result from the developer's failure to segregate the costs of constructing the utility infrastructure from the costs of constructing the general infrastructure of the development such as streets, etc., and failure to segregate how these costs would be recovered, either through lot sales (like all other infrastructure) or utility rates. The developer's failure to segregate costs makes it difficult to determine the appropriate cost-of-service, in particular because it makes it difficult to determine if the developer "contributed" the infrastructure or if the "utility" constructed the facilities using its own capital. Also, the developer, unlike a utility, lacks the regulatory obligation to maintain original cost information, which leads to these utilities having to use trended cost methodologies to attempt to establish original cost information.

These issues significantly affect the costs borne by the ratepayers/lot owners. The risk to the ratepayers/lot owners is that the developer will claim the utility infrastructure costs as part of the cost of the lot (and thereby lower the developer's tax obligation on the lot sales), and then claim the same infrastructure as part of the utility's rate base. If this occurs, the ratepayers/lot

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owners effectively end up paying for the utility infrastructure twice – once through the purchase of their lots, and second time through water and sewer rates. This problem is less likely to occur when the developer and the utility are separate entities because the utility should show the infrastructure acquired from the developer as developer contributed assets (on which the utility earns no return) and require the developer to provide original cost documentation.

This issue has plagued regulatory agencies since the Commission last had jurisdiction over water utilities.[1] In 1979 the issue came before the Supreme Court of Texas.[2] The court specifically focused on the exclusion of developer contributions of assets related to a utility that had the same ownership as the developer of the same system. The Commission had "excluded the developer's cost of the utility system from the rate base because the rate payers had already paid for the system as a part of the purchase price of their lots."[3] The Texas Supreme Court agreed with the Commission's findings. The court evaluated the issue of developer contributions of assets and consideration of these issues by courts and regulatory bodies in other states. The court concluded: "the uniform rule followed in these cases is that when a developer has recovered all or part of the cost of the utility system through the sale of lots, the regulatory body has excluded that amount from the utility's rate base."[4]

After the jurisdiction over water utilities transferred to TCEQ, the issues surrounding rate base for developer controlled utilities became dormant. TCEQ staff did not press developer-controlled utilities to demonstrate that the utility, and not the developer, installed the assets. This was primarily because TCEQ favored settlement of rate cases without the establishment of a rate base. Also, because of its complexity, ratepayers were not aware of the issue, and given the smaller size of most of these utilities, ratepayers could not afford to challenge a utility's rate base. This lack of interest in the issue did not mean that the law or policy underlying the prior decisions of the Commission had changed. In those rare instances when ratepayers raised these issues, TCEQ confirmed that when a developer constructed the utility assets, the utility bears the burden of showing that the assets are not developer-contributed assets.[5] This is what the law and

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

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

[3] *Id.*

[4] *Id.* at 394.

[5] TCEQ last addressed the issue in *Application of SJWTX, Inc., d/b/a Canyon Lake Water Service Company to Change Rates in Comal and Blanco Counties*, TCEQ Docket No. 2010-1842-UCR, SOAH Docket No. 582-11-1468. TCEQ entered a final order in that docket on August 23, 2013.

policy should require because of a developer/utility's desire to maximize profits and ability to hide the facts.

The facts in this docket reveal that the developer constructed most, if not all, of DDU's assets. The utility did not exist until after all of the initial infrastructure was constructed, and no documentation was entered into the record to show if, or how, the assets were conveyed from the developer to the utility, or that the assets were accounted for as if they belonged to the utility, rather than the developer (such as whether asset costs were, or were not, expensed against lot sales to reduce the developer's tax obligations). The evidence in the record does indicate that the developer, through its lots sales agreements, committed to pay for the cost of the infrastructure from the lot sales rather than through utility charges. Additionally, the record reveals that the developer continues to treat the assets as if they belong to the developer (developer obtained $3 million loan secured by utility assets).

Given the facts in the record, the ALJ has done a remarkable job of sifting through DDU's attempts to obfuscate the truth and reach an acceptable outcome. DDU could have avoided the hit to its rate base by clearly documenting, in the application or in its testimony, how these assets were treated. DDU simply chose not to provide the necessary documentation (or offer a compromise position if documentation truly does not exist).[6] DDU and its developer parent are sophisticated entities that should not be allowed to plead ignorance to gain an unjust result. Most importantly, DDU's ratepayers are entitled to a final resolution of the rate base issues. They should not have to litigate historic rate base issues ever again.

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[6] WBRG was willing to accept a compromise approach if DDU could show that the approach roughly matched Double Diamond's books and matched the rationale for the approach provided by DDU in response to RFI WBRG 3-5. DDU's 80/20-split approach, as proposed by DDU, did neither.

SPECIFIC REPLIES

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]

9. Salaries

The ALJ did not err in determining that DDU failed to support its request for a post-test-year adjustment to salaries. DDU listed $20,866 as "Known & Measurable" expenses for White Bluff salaries in its application.[7] Under Commission rules, a known and measurable change is a change that is: "[v]erifiable on the record as to amount and certainty of effectuation. Reasonably certain to occur within 12 months of the end of the test year."[8] The Commission's rate change application form requires an applicant to "Provide copies of source documents . . . to verify the applicant's known and measurable changes."[9] The specific schedule for salaries, Schedule II-6, requires the applicant to "[a]ttach an explanation and calculation for K&M salary changes from test year."[10]

DDU did not provide any documentation verifying the requested known and measurable changes for salaries. DDU did not attach an explanation and calculation in the application for these requested known and measurable changes. DDU's application appears to seek salaries for seven individuals at White Bluff.[11] At the hearing, DDU's witness and CEO, Mr. Gracy, testified that only four individuals work at White Bluff.[12] On cross-examination, Mr. Gracy clarified that these four individuals are all of the employees currently working at White Bluff.[13] Later in the hearing, DDU's rate consultant, Mr. Joyce, testified that the number of employees used in the application was based on "fully staffed costs," with the fully staffed assumptions coming from DDU.[14] Mr. Joyce did not personally verify these assumptions. Mr. Gracy also was unable to verify the number of employees constituting "fully staffed."[15] DDU did not

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[7] Ex. DD-2 at 6.
[8] 16 Tex. Admin. Code § 24.3(32) (TAC).
[9] Rate/Tariff Application for White Bluff, Double Diamond Utility Company, Inc. Ex. DDU-2 at 10.
[10] Ex. DDU-2 at 15.
[11] *Id.*
[12] Prefiled Direct Testimony and Exhibits of Randy Gracy, Double Diamond Utility Company, Inc. Ex. DDU-3 at 15.
[13] Tr. at 104:2 (Gracy Cross) (Oct 24, 2017).
[14] Tr. at 206:13–207:4 (Joyce Cross) (Oct. 24, 2017).
[15] Tr. at 102 – 105 (Gracy Cross) (Oct. 24, 2017).

establish what constitutes "fully staffed" or the number of employees needed to adequately run the utility.

Based on the record, the real issue should be whether DDU's test-year salaries should be reduced, not whether they should be adjusted upward. The record shows that DDU can operate just fine with four employees, which is three fewer than worked during the test year. The Commission should confirm the ALJ's recommendation on this issue.

B. Depreciation [PO Issues 12, 27]

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

DDU's application contains $46,156[16] in "known and measurable" changes in the deprecation for the total White Bluff system, and $24,724[17] for the total The Cliffs system. As WBRG explained in its briefs, this request should be denied because DDU provided no explanation in its application verifying or supporting this request, and because it is based on the inappropriate use of a trended original cost study that artificially inflated the original cost of some of DDU's assets beyond the cost of the assets as shown on DDU's books. The ALJ properly interpreted the Commission's rule and the facts in recommending that the known and measurable adjustment to White Bluff deprecation should be disallowed.

Under Commission rules, trended original cost studies can be used to establish original cost of assets only if the utility has "no historical records for verification purposes."[18] As the Commission stated at the time it adopted the rule:

> The commission recognizes that TCEQ trended studies were sometimes used because some utilities' books and records were not properly kept or were destroyed. The commission establishes a rule for trending studies and seeks to incentivize water and sewer utilities to keep proper books and records. As a general rule, the commission discourages the use of trending studies except when historical records are unavailable from any source. Trending studies are a subjective estimate of depreciable utility plant, which is the single most significant cost driver in most rate cases.[19]

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[16] Ex. DDU-2 at 6.
[17] Ex. DDU-1 at 6.
[18] 16 TAC § 24.31(c)(2)(B)(i).
[19] *PUC Rulemaking Project to Amend Chapter 24 for the Implementation of Phase II of the Economic Regulation of Water and Sewer Utilities*, Project No. 43871, Order Adopting Amendments at 82 (Aug. 24, 2015).

In its application, DDU used a trended original cost study to establish the original cost of certain assets for both White Bluff and The Cliffs.[20] Dr. Harkins performed this study. Dr. Harkins testified that such a study was necessary because she could not locate original invoices for all of the line work.[21] The known and measurable adjustment to depreciation included in DDU's application is a result of the inflation of original cost of the assets shown on DDU's books resulting from the trended original cost study.[22]

The use of a known and measurable adjustment to DDU's book entries for depreciation (and for rate base) is inappropriate in this case because, as summarized by the ALJ, reliable historical records exist to establish original cost values. At the hearing, DDU's chief financial officer, Mr. Grout, testified that DDU maintained records of all construction costs and recorded these in the corporate books and that he has no reason to doubt the asset values shown on DDU's books.[23] Dr. Harkins testified that she did not look at DDU's books to see if DDU had accounted for the value of the assets, and if she had, she might have used the lower book values because that would have been more conservative.[24] The lack of invoices should result in the disallowance of the asset, not open the door to inflate the value of the asset beyond its booked value. Based on this record, DDU should not be allowed to inflate its asset values, and consequently its depreciation, using a trended original cost study.

DDU's exceptions show that DDU is confused as to the application of the Commission's rule. As explained in its exceptions, DDU's only basis for wanting to use a trending study is that DDU could not locate all of the invoices for its assets.[25] WBRG does not dispute that a trending study is appropriate to use to verify the accuracy of a utility's books when invoices are missing. A utility, whose books show an asset value of $1 million but with no supporting invoices, should be allowed to verify the book value by showing a trended cost value equal to or exceeding the book value. **But the trending study should not be treated as superior to the utility's own books.**

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

[21] *Id.*

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

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

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

[25] DDU Exceptions at 11.

DDU does not dispute the accuracy of its total book values; it merely states that these values are "lump-sum numbers" from which DDU cannot identify specific assets.[26] What is particularly curious is that DDU was able to include a value for depreciation without using the trended cost study.[27] How did DDU determine that number, if it only has "lump-sum numbers"? A trending study should never be used, as here, to inflate recorded book values when there is no evidence that the book values are not accurate.

Although not required, there are explanations as to why the book values differ from the trended values. The most important explanation is the fact that the vast bulk of DDU's assets were constructed before DDU existed, and the costs of those assets were included as part of the cost of the lots, and not as a cost of the utility. This is shown by the real estate contracts, which clearly state that the developer would fund the utility infrastructure,[28] and by the testimony of DDD's CFO.[29] Since the value of the assets were included as part of the cost of the lots, the values were not included in DDU's depreciation schedules.

DDU also complains about the ALJ's recommendation that rate base be adjusted to remove the inflated trended cost values. Again, DDU argues that because the invoices cannot be found, the values shown on the books should be inflated to reflect Dr. Harkins' "guess" as to what the original costs were. The lack of invoices should not be a basis for adjusting book values, particularly when there is no indication of problems with the books, and when the utility is part of a multi-million dollar development company.

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

4. Developer Contributions

WBRG agrees with DDU that Developer Contributions are the single most important aspect of this case. WBRG, however, disagrees with DDU's characterization of the ALJ's findings and conclusions on this issue. DDU's exceptions should be disregarded as just a

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[26] DDU Exceptions at 11.

[27] DDU Ex. 2 at 6. DDU's application lists Depreciation as $148,621 prior to the known and measurable adjustment of $46,156. Presumably, the $148,621 was derived from DDU's books.

[28] Ex. WBRG-1G.

[29] Mr. Grout, testified that the cost of utility infrastructure, along with the other costs associated with preparing raw land for sale, would have been recorded on DDD's books as part of the development costs of the lots in the subdivisions, and that these costs would have been "taken down to the balance sheet and expensed" when lots were sold. Tr. at 156:11-21 (Grout Cross) (Oct. 24, 2017).

continuation of DDU's long history of playing "hide the ball" with regard to developer contributions.[30]

As set out in DDU's exceptions, DDU followed the following "process" to identify developer contributions:[31] Dr. Harkins created as list of assets, with original cost and accumulated depreciation, and then Mr. Gracy went through the list and identified (based on his "recollection" of DDU's historic practices) whether each asset was funded 80% by the developer or 100% by DDU. The ALJ found that DDU has the burden to show how much of the original cost of the utility assets included in rate base were contributed by the developer, and that DDU failed to meet that burden through Mr. Gracy's "recollection."[32] Rather than including all of DDU's rate base as developer contributed (the logical end-point of the ALJ's reasoning), the ALJ dug through the record to allow those assets expressly paid for by DDU to be included as investment by DDU.

DDU does not challenge any of the factual bases supporting the ALJ's conclusion that DDU failed to meet its burden of proof. The evidence in the record demonstrates that the 80/20 split advanced by DDU is nothing more than a post-hoc position designed to avoid acknowledging the full extent of the actual developer contributions. Since no party other than DDU knows the full extent of these contributions, and since DDU refuses to divulge this information, the ALJ's recommendation is fully supported by the record.

DDU's 80/20 split is not even supported by DDU's discovery response. In response to a discovery request regarding who installed infrastructure at White Bluff (WBRG 3-5), DDU stated:

> Utility infrastructure has been <u>installed</u> by Double Diamond Inc. (DDI), Double Diamond Properties Construction (DDPC) or Double Diamond Utilities (DDU) at various times. Before 1996, most all of infrastructure was constructed and paid for by <u>DDI</u>. DDPC and DDU were created in December 1996. In 1997, DDPC began paying for most of the infrastructure, and DDU paid for a few items. Payment for utility infrastructure is identified and itemized in the invoices whose bates numbers are referenced on the asset list previously produced. As of the 2007–2008 rate case before the Texas Commission on Environmental Quality, most of the initial utility infrastructure was completed, and DDU began paying for

[30] The problem is that DDU has refused to provide sufficient information to allow the Commission to appropriately resolve the issue. DDU filed this case acknowledging only $5,684 in developer contributions. Only after WBRG produced DDU's prior sworn applications acknowledging more than $2 million in developer contributions did DDU even deign to acknowledge the real scope of the contributions.

[31] DDU's Exceptions at 16 – 17.

[32] PFD at 50.

> all utility assets and operations. The same contractors and employees worked for each entity that paid for the infrastructure.[33]

This response suggests that all of assets installed before 1997 should be treated as 100% developer-contributed, that 80% of assets constructed between 1997 and 2008 should be treated as developer-contributed, and that 100% of the assets built after 2008 should be treated as 100% utility-contributed. The 80/20 split as advocated by DDU is not consistent with its response to WBRG RFI 3-5. Moreover, the explanation given in response to WBRG RFI 3-5 is consistent with the fact that DDU did not exist until 1997, and that no documentation exists memorializing the transfer of the assets from DDI or DDPC to DDU. The ALJ did not err in concluding that DDU failed to meet its burden with regard to the 80/20 split.

DDU claims that the ALJ proposes to "wipe out" 99% of DDU's original cost of plant in service.[34] This claim is hyperbole. DDU's cost will not be wiped out because this is the developer's cost, not DDU's. DDU will still be able to recover depreciation on the assets that were given to DDU. Additionally, evidence in the record supports the conclusion that the developer paid for the installation of the infrastructure and that the developer recovered those costs through lot sales. The lot sales agreement clearly outlines that the "Seller" (the developer, DDI) will be responsible for providing the "Central Water System" and the "Central Sewer System."[35]

DDU claims that the ALJ appears to confuse the issues of customer contributions with developer contributions.[36] This claim misconstrues the PFD. Nowhere on page 46 (or any other page) does the ALJ claim to be treating any of the assets as customer contributed assets.

DDU finally claims that if the Commission accepts the ALJ's recommendation that "DDU will not be able to remain financially sound."[37] This claim is entirely unsupported by the record, and DDU offers no citation to any evidence supporting the claim. As explained previously, the evidence in the record supports a conclusion that the developer recovered the cost of its investment through lot sales, and that to allow DDU to include these assets in its rate base would cause the ratepayers to pay twice for the same facilities. Also, DDU's claim seems counter to the evidence in the record. The record shows that even with its existing rates, a bank was willing to lend DDU $3,000,000 without

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[33] Ex. WBRG-1M at WBRG000135 (emphasis added).
[34] DDU's Exceptions at 15.
[35] Ex. WBRG-1G.
[36] DDU's Exceptions at 18.
[37] DDU's Exceptions at 18.

restricting the use of the funds to utility purposes. Than indicates that the private sector views DDU as being financially sound today without a rate increase.

5. Property Not Belonging to DDU

The ALJ's summary of the evidence in the record is accurate. Mr. Gracy acknowledged that DDU conveyed a tract of land containing a number of DDU's facilities to the White Bluff Property Owners Association in December 1995. He stated that the conveyance was in error, but that he did not know whether the error had been corrected.[38] Based on this testimony, the ALJ was correct to conclude that DDU had failed to meet its burden of proof to demonstrate that it owns the property.[39]

DDU's only evidence that it owns the tract are current "tax records" that are not contained in the record.[40] The portion of the record referenced by DDU in its Exceptions is DDU's Response to WBRG RFI 3-10.[41] This response contains the following language:

> **WBRG No. 3-10** If you contend that Double Diamond owns WB4 TR2, please explain the basis for your contention.
>
> **RESPONSE: Please see the tax records previously produced as DDU16-011011-011015. DDU is the owner.**

The "previously produced" tax records were not admitted into the record. Without the records showing who paid the taxes, DDU's argument must fail.

Even if the tax records had been admitted into the record, such records cannot be used to dispute ownership of the tract. Legal ownership of property in Texas is established by deed, not by listings on county tax records. The issue of whether DDU met its burden is a question of fact, not of law. The Commission should defer to the ALJ's resolution of a disputed question of fact.

6. Improper Use of Trending Study

For the reasons stated in Section IV.A.1., the ALJ did not err in recommending that DDU's rate base be adjusted to remove the increase in rate base coming from the improper use of a trending study. As pointed out in WBRG's exceptions, this adjustment was not reflected in the Schedules and Rates attached to the PFD.

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[38] Tr. at 99 (Gracy Cross) (Oct 24, 2017).
[39] The ALJ did not make a finding regarding who actually owns the property, as this would not be a proper finding for the ALJ or the Commission.
[40] DDU's Exceptions at 18
[41] Ex. WBRG-1M at WBRG000137.

CONCLUSION

For the reasons discussed in its exceptions and herein, White Bluff Ratepayers Group respectfully requests that the Commission reject DDU's proposed changes to the PFD and amend the PFD and the final order as recommended in WBRG's exceptions.

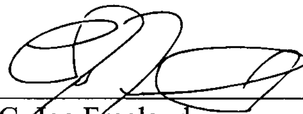
Dated: April 12, 2018

Respectfully submitted,

C. Joe Freeland
State Bar No. 07417500
Mathews & Freeland, LLP
8140 N. MoPac Expy, Suite 2-260
Austin, Texas 78759
(512) 404-7800
jfreeland@mandf.com
ATTORNEYS FOR
WHITE BLUFFS RATEPAYER GROUP

CERTIFICATE OF SERVICE

I certify that a copy of the foregoing pleading was served on all parties of record in this proceeding on April 12, 2018, by hand-delivery, facsimile, electronic mail, and/or First Class Mail.



C. Joe Freeland