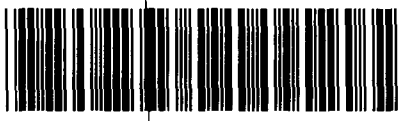

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APPLICATION OF DOUBLE DIAMOND UTILITY COMPANY, INC. FOR WATER AND SEWER RATE/TARIFF CHANGE	§ § §	**PUBLIC UTILITY COMMISSION OF TEXAS**

COMMISSION STAFF'S INITIAL BRIEF ON LEGAL OR POLICY ISSUES

COMES NOW the Staff of the Public Utility Commission of Texas (Staff), representing the public interest, and files this Initial Brief on Legal or Policy Issues and would show the following:

I. PROCEDURAL BACKGROUND

On August 1, 2016, Double Diamond Utility Company, Inc. (DDU) filed applications for a Class B rate/tariff change pursuant to Texas Water Code (TWC) § 13.1781 and 16 Texas Administrative Code (TAC) §§ 24.21-.26. Specifically, the applications sought to increase the water and sewer rates for two residential resort developments—White Bluff in Hill County and the Cliffs in Palo Pinto County.

This matter was referred to the State Office of Administrative Hearings (SOAH) on September 8, 2016, and a three-day hearing on the merits was convened on October 24, 2017. The parties represented at the hearing included DDU, the White Bluff Ratepayers Group (WBRG), the Cliffs Utility Committee, and Staff. On February 13, 2018, the SOAH Administrative Law Judge (ALJ) issued a Proposal for Decision (PFD), which included a recommendation to reduce DDU's requested rate base for White Bluff to remove developer contributions.

At the open meeting held on May 25, 2018, the Commission considered a Draft Order and requested briefing on the differences between customer contributions in aid of construction and developer contributions. The Briefing Order, issued May 30, 2018, set July 2, 2018, as the deadline for initial briefs. Therefore, Staff's Initial Brief is timely filed.

II. FACTUAL BACKGROUND

DDU is an investor-owned utility that is wholly owned by Double Diamond Delaware, Inc. (DDD).[1] DDD has two other subsidiaries relevant to this case—Double Diamond, Inc. (DDI)[2] and Double Diamond Properties Construction Co. (DDPC).[3] DDU and DDPC were both established in December 1996.[4]

DDU serves approximately 640 water[5] customers and 567 sewer[6] customers in the White Bluff subdivision. The approximate total number of lots within White Bluff is 6,314.[7] About 85 to 90 percent of the lots within White Bluff have been sold.[8]

The original water and sewer systems at White Bluff were constructed by DDI in 1990-1991.[9] For the purposes of the application, DDU treated 80% of the cost of each asset in the original water and sewer systems as developer-contributed.[10] As new sections of each subdivision were opened, additional distribution lines and collection systems were constructed; these assets were also treated as 80% developer contributed.[11] The 80-20 split is consistent with the settlement reached in DDU's 2008 rate application filed with the Texas Commission on Environmental Quality.[12] In 2008, the decision was made to begin treating all newly-constructed utility plant and facilities as 100% utility contributed.[13]

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[1] Direct Testimony and Exhibits of Randy Gracy, Ex. DDU-3 at 3 of 27 (Aug. 4, 2017).

[2] Tr. at 56:10-17 (Gracy Cross) (Oct. 24, 2017).

[3] Ex. DDU-3 at 3 of 27.

[4] Tr. at 56:2-6 (Gracy Cross) (Oct. 24, 2017).

[5] Ex. DDU-3 at 7 of 27.

[6] *Id.* at 10 of 27.

[7] *Id.* at 7 of 27.

[8] Tr. at 63:22-64:3 (Gracy Cross) (Oct. 24, 2017).

[9] Tr. at 56:15-17 (Gracy Cross) (Oct. 24, 2017); Ex. DDU-3 at 7-8 of 27, 11-12 of 27.

[10] Ex. DDU-3 at 8-10 of 27, 12 of 27.

[11] *Id.* at 8-9 of 27, 11-12 of 27.

[12] Tr. at 528:1-529:10 (Joyce Rebuttal Cross) (Oct. 26, 2017).

[13] Tr. at 67:6-20 (Gracy Cross) (Oct. 24, 2017). Staff notes that the depreciation schedules sponsored by DDU witness Jay Joyce are not consistent with this testimony and show almost all of the assets installed in 2005,

DDU's amended application requested the following rate base for each system:[14]

Table 1 – DDU's Requested Rate Base				
	White Bluff		The Cliffs	
	Water	Sewer	Water	Sewer
Net Plant	$2,188,228	$1,642,255	$785,987	$574,728
Cash Working Capital	$24,568	$24,568	$23,152	$28,823
Developer Contributions	($1,186,227)	($137,457)	($248,421)	($71,898)
Total	$1,026569	$1,527,949	$573,335	$531,652

The PFD concluded that the preponderance of the evidence showed that the utility plant, property, and equipment used to service ratepayers at White Bluff were funded in part by developer contributions.[15] However, the PFD also stated that the record was insufficient to allow for a finding as to the amount of developer contributions that were included in rate base or whether the 80-20 split accurately represented the amount of developer-contributed funds.[16] Accordingly, the ALJ recommended that White Bluff's rate base include only those assets which the evidence showed were funded by DDU.[17] Per the number running document, this amounted to 4 assets from White Bluff water with a total net book value of $68,355.48[18] and 3 assets for White Bluff sewer with a total net book value of $24,029.64.[19]

2006, and 2007 as 100% utility-contributed. White Bluff Asset Listing Applying 80% Theoretical Developer Contribution to Certain Assets, Ex. DDU-6C.

[14] Direct Testimony of Jay Joyce, Ex. DDU-6 at 13 of 89 (Aug. 4, 2017).

[15] Proposal for Decision at 48 (Feb. 13, 2018).

[16] *Id.* at 48-49.

[17] Number Running Memoranda and Workpapers at 5 (Mar. 8, 2018) ("The ALJ recommends that the Commission remove from White Bluff s invested capital all utility assets, except the net book value of those which the evidence shows were funded by DDU, as set forth in WBRG witness Nelisa Heddin's direct testimony at pages 19-20 and Tables NDH-1 and NDH-2.").

[18] Direct Testimony and Workpapers of Nelisa Heddin, Ex. WBRG-1 at WBRG000022.

[19] *Id.* at WBRG000023.

III. ARGUMENT

The dispute over the amount of contributions in aid of construction that should be deducted from DDU's rate base stems from two main issues. The first issue is whether DDU has met its burden of proof to show that the 80-20 split accurately represents the amount of developer-contributed assets included in its utility plant. The second issue is whether the Texas Supreme Court's holding in *Sunbelt Utilities v. Public Utility Commission of Texas*[20] is applicable to this case. As explained below, if the rule established in *Sunbelt*—that recovery of the cost of utility plant through the sale of lots is treated as customer contributions in aid of construction—is applicable,[21] it is the controlling issue. In addition, applying *Sunbelt* would lower DDU's revenue requirement even further because all customer-contributed assets would be excluded from its depreciation expense.

1. What is a developer contribution as that term is used in TWC § 13.183(j)? What is a customer contribution as that term is used in TWC §§ 13.183(b), 13.185(b), and 13.185(j)?

The terms "contribution in aid of construction," "customer contribution," and "developer contribution" are not explicitly defined in either the TWC or Commission rules. Nevertheless, all three constitute cost-free capital.[22] Contributions in aid of construction are cost-free capital because they are funds used to purchase plant that are not supplied by the utility.[23] Cost-free capital is deducted from rate base to prevent a utility from earning a return on plant or other capital assets its investors did not pay for.[24]

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[20] *Sunbelt Util. v. Pub. Util. Comm'n of Tex.*, 589 S.W.2d 392 (Tex. 1979).

[21] *Id.* at 394.

[22] *See* 16 TAC § 24.31(c)(3)(D)-(E).

[23] *Application of SJWTX, Inc. dba Canyon Lake Water Service Company to Change Water Rates*, TCEQ Docket No. 2010-1841 UCR, Final Order at Finding of Fact No. 59 (Jun. 27, 2013) ("Cost-free capital occurs when a utility does not use its own funds to obtain plant assets.")

[24] *Id.* at Finding of Fact No. 49 ("...Customer- and developer- CIAC is excluded from the rate base because the utility has not made an investment upon which it should earn a return.).

For the purposes of ratemaking, the difference between a customer contribution in aid of construction and a developer contribution in aid of construction lies in the calculation of the depreciation expense.

> Depreciation expense included in the cost of service includes depreciation on all currently used, depreciable utility property owned by the utility except for property provided by explicit customer agreements or funded by customer contributions in aid of construction. Depreciation on all currently used and useful developer or governmental entity contributed property shall be allowed in the cost of service.[25]

The depreciation expense may include property contributed by a developer or governmental entity,[26] even though the utility has not paid for the depreciable asset. The depreciation expense claimed by the utility may not include depreciation on property provided by explicit customer agreements or funded by customer contributions in aid of construction.[27]

There is no difference in the treatment of customer and developer contributions when determining a utility's invested capital, also called rate base, upon which a return to shareholders is calculated. The Commission is required to set rates at a level that gives a utility the opportunity to earn a reasonable return on its invested capital over and above its reasonable and necessary operating expenses.[28] The amount of a utility's invested capital is determined using the original cost of utility property that is used and useful in providing service.[29] Original cost is the actual value of the property at the time it is dedicated to public use, less depreciation.[30] It does not matter whether the utility that currently owns the property or a predecessor actually placed the property into service.[31] A utility may not include "property funded by explicit customer agreements or

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[25] TWC § 13.185(j).

[26] *Id.*; 16 TAC § 24.31(b)(1)(B).

[27] TWC § 13.185(j).

[28] *Id.* § 13.183(a)(1).

[29] *Id.* § 13.185(b).

[30] *Id.*

[31] *Id.*

customer contributions in aid of construction such as surcharges" in its rate base.[32] Additionally, "contributions in aid of construction" and "other sources of cost-free capital" are two of the items specifically identified as deductions from rate base absent a showing of good cause.[33]

a. What factors should be evaluated to determine whether an investment qualifies as developer contributed or customer contributed?

Staff notes that this question is a complex question that may be more appropriate for a rulemaking proceeding to permit the Commission to receive the input of all interested stakeholders in order to develop a policy to be applied in all future cases. In this case, Staff recommends that the factors to be considered to determine whether an investment qualifies as utility funded, developer contributed, or customer contributed is the source of the investment at the time it is dedicated to public use. Central to the analysis is whether an entity other than the utility paid for a capital asset. In cases where a utility is a wholly owned subsidiary of another company, this question could lead to an inquiry into the overall corporate structure of the parent company. If the utility has one or more affiliates, details relevant to accounting practices, such as whether a joint financial statement or tax return is filed for all affiliates, could impact the analysis.

The federal regulations regarding the treatment of contributions in aid of construction for tax purposes are also instructive.[34] Using these as a guide, the form of the funds used to purchase or construct an asset should be considered. For example, if a developer loaned a utility the funds to construct a specific facility like a well, then the developer-supplied capital would no longer be cost-free once the loan was repaid. Attention should also be given to the timing of the contribution of the funds as it relates to the date the asset purchased or constructed with the funds was placed into service. If the funds are provided to reimburse the utility for an asset that is used and useful at the time the reimbursement is made, then thought should be given to what portion of the asset's

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[32] *Id.*; *see also* TWC § 13.183(b) ("A facility constructed with surcharge funds is considered customer contributed capital or contributions in aid of construction and may not be included in invested capital, and depreciation expense is not allowed").

[33] 16 TAC § 24.31(c)(3)(D)-(E).

[34] *See generally,* 26 C.F.R. § 1.118-2 (2018).

original cost is truly cost-free. Finally, the specific terms of any written agreements that dictate the terms under which the funds are provided must be taken into account.

The Legislature made a distinction regarding the recoverability of a return *of* investment between (1) customer-contributed capital and (2) developer or government-contributed capital. The Legislature permitted the recovery of a return of investment, or depreciation, for developer or government-contributed capital despite the fact that the utility did not make any investment for which recovery is permitted. Depreciation is an operating expense, and the TWC only permits recovery of "reasonable and necessary operating expenses."[35] One factor that may weigh in favor of allowing a utility to recover a return of investment that is not made by the utility is that the depreciation expense recovered through rates increases the utility's cash flow, which may be used for reinvesting in or replacing contributed capital.

Customer-contributed capital is also not funded by the utility; however, customer-contributed capital is distinguishable from developer or government-contributed capital in that the investment has already been directly paid for by customers. Even so, developer or government contributions are, theoretically, indirectly paid for by customers.

Another factor that may be relevant to determine whether an investment qualifies as developer-contributed or customer-contributed is the typical nature of the investment. Developer-contributed capital may typically consist of the initial investment in a water system. Government contributions of capital can vary, but are often project based. Customer-contributed capital most frequently consists of individual customer interconnections. The TWC also classifies capital improvements that are not customer specific, but which are paid for through customer surcharges, to be customer-contributed capital.[36]

The question is further complicated by scenarios where the initial investment may have been paid by customers, and subsequently dedicated by the developer to the utility, or the initial investment may have been paid by customers' payments to the developer, which is also the utility.

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[35] TWC § 13.183(a).

[36] *Id.* § 13.183(b).

2. How should the fact that Double Diamond, Inc. was both the developer and the utility at White Bluff through 1996 be considered in this analysis?

The fact that DDI was both the developer and the utility from 1991 through 1996 is pertinent to determining which assets should be classified as utility investment, developer-contributed investment, or customer contributed investment. Using the White Bluff subdivision as an example, there are three important dates: (1) 1990-91, which marks the beginning of the construction of the original water system;[37] (2) December 1996, which marks the formation of DDU;[38] and (3) 2008, the year that all newly-constructed plant was treated as 100% utility-contributed.[39] Because rate base is determined using original cost, and original cost is determined by the date an asset is placed into service, an argument can be made that those assets paid for by DDI and placed into service prior to 1996 were assets paid for by the utility, but partially funded through lot sales. A review of the depreciation schedules for White Bluff shows that 15 assets in the water system[40] and 10 assets in the sewer system[41] were installed before December 1996.

The evidence illustrating how to classify the assets installed once DDU was formed and assumed the role of utility (from 1997 on) is a bit less concrete. In response to a request for information from WBRG, DDU provided the following timeline:

> Utility infrastructure has been in installed 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 DDI. DDPC and DDU were created in December 1996. In 1997, DDPC began paying for most of the infrastructure, and DDU paid for a few items...As of the 2007-2008 rate case before the Texas Commission on Environmental Quality, most of the initial utility infrastructure was completed, and DDU begin paying for all utility assets and operations. The same contractors and employees worked for each entity that paid for the infrastructure.[42]

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[37] Ex. DDU-3 at 7 of 27, 10 of 27.

[38] Tr. at 56:2-6 (Gracy Cross) (Oct. 24, 2017).

[39] *Id.* at 67:6-20.

[40] Ex. DDU-6C at 44-48 of 89.

[41] *Id.* at 49-52 of 89.

[42] Workpapers of Nelisa Heddin, Ex. WBRG-1M at WBRG000135.

This response along with the testimony of DDU witness Randy Gracy[43] supports a finding that 100% of the value of the assets dedicated to public use between January 1, 1997 and December 31, 2007, was paid for by the developer and 100% of the value of the assets dedicated to public use on or after January 1, 2008, was paid for by DDU. Because DDU was unable to produce documentation showing which entity paid for 121 of the 190 (76%) of the assets in the White Bluff water system[44] and 99 of the 125 (79%) of the assets in the White Bluff sewer system,[45] this discovery response is the most concrete evidence available. Thus, if these assets were classified as developer-contributed (and not as customer-contributed) the record supports a finding that all assets installed from 1997 through 2007 for which no proof of payment was provided were 100% developer-contributed and that all assets installed on or after January 1, 2008, for which no proof of payment was provided were 100% utility-contributed.

a. How should the Commission consider, if at all, the rationale of the court in *Sunbelt Utilities v. Public Utility Commission* in this analysis?

Sunbelt was decided prior to the enactment of the current version of the TWC, which explicitly distinguishes developer contributions and customer contributions. Although not identical to the facts in the record, the facts underlying the decision in *Sunbelt* are sufficiently similar to inform the Commission in its interpretation of the TWC as applied to the specific facts of this case. However, *Sunbelt* does not provide any insight as to the distinction between developer-contributed capital and customer-contributed capital as the distinction did not exist at the time this case was decided.

The utility in *Sunbelt* was structured as a partnership of five corporations under common ownership.[46] The utilities in each subdivision were installed by the developer, and the utility systems were deeded to the utility company for the respective subdivision.[47] Pursuant to federal

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[43] Tr. at 67:6-20 (Gracy Cross) (Oct. 24, 2017).

[44] Ex. WBRG-1M at WBRG000022, WBRG000132.

[45] *Id.*

[46] *Sunbelt*, 589 S.W.2d at 393.

[47] *Id.*

income tax laws, the developer wrote off the entire cost of the utility system against the monies acquired through lot sales.[48]

Sunbelt did not dispute the rule that customer contributions in aid of construction are excluded from rate base and agreed that any costs to construct the system that were recovered through lots sales should be carried over to the Sunbelt partnership due to the "identity of ownership" between the developer and the utilities.[49] To bridge the gap between developer contributions and customer contributions, the opinion framed the "pivotal" question in the case as follows: "[w]ere the developer's costs of constructing the utility system recovered from the rate payers as part of the purchase price of their lots?"[50] Citing to cases from other states, the Court held that a developer's costs for a utility system that are recovered through lot sales are treated as contributions in aid of construction.[51] In addition, the Court rejected Sunbelt's argument that these cases did not apply because there was no evidence of an agreement that the cost of the utility systems was included in the lot prices on the grounds that it is reasonable to infer that the cost of constructing a utility system is reflected in the price of the lots.[52]

Here, the developer (whether DDI or DDPC) and DDU have the same parent company, DDD. It is also clear from the record that first DDI and then DDPC paid for and installed the utility plant placed into service from 1991 through 1997. Furthermore, DDU has acknowledged that contributions in aid of construction are excluded from rate base through its decision to remove "hypothetical" developer contributions[53] in order to "keep the utility cost down for the customers."[54] And, DDU witness Tim Grout testified that development costs, which include the costs of preparing a lot for sale, are expensed once a lot sold.[55]

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[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.* at 394.

[52] *Id.* at 394-95.

[53] Double Diamond Utility Company, Inc.'s Initial Brief at 21 of 32 (Nov. 22, 2018).

[54] Ex. DDU-3 at 8 of 27; *see also*, Tr. at 214:5-14 (Joyce Cross) (Oct. 24, 2017).

[55] Tr. at 156:11-22 (Grout Cross) (Oct. 24, 2017).

Most importantly, the lot sales agreement for White Bluff makes an express distinction between providing and maintaining the utility system and assigns responsibility for these tasks to the Seller (DDI)[56] and the utility (DDU) respectively.[57] The terms of this agreement constitute evidence that the sales price of a lot takes into account the cost of providing the utility system; to read the contract otherwise would render the division of responsibilities between DDI and DDU moot. Because the *Sunbelt* decision does not require any specific evidence whatsoever that the cost of the utility system is included in the sales price of a lot, the existence of the sales agreement is compelling. And when added to the facts recited above, it is reasonable to conclude that the rule in *Sunbelt* applies to DDU and that the costs of constructing all utility plant, no matter what date an asset was installed, are properly classified as customer contributions in aid of construction.

Should the Commission apply *Sunbelt*, it is important to note the record developed in the instant case is unclear as to exactly what proportion of the White Bluff assets were funded by customers through lot sales. This question was not an issue the Texas Supreme Court considered in *Sunbelt* because the developer admitted to writing off the full cost of the utility systems against the revenues derived from lot sales for income tax purposes.[58] Therefore, it would be appropriate to consider the information in the record that does exist—namely the amount of assets on DDU's books for depreciation purposes—when determining how much of White Bluff's water and sewer plant was recovered through lot sales.

b. How should the Commission consider the fact that Double Diamond, Inc. contractually obligated itself through deeds to provide and complete the central water system and central sewer system at White Bluff, while the utility company as listed as the party responsible for maintaining the systems?

The answer to this question is discussed in the preceding section. Additionally, Staff does not oppose the motion to reopen the record filed by The Cliffs Utility Committee[59] in the event

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[56] White Bluff Real Estate Sales Contract, Ex. WBRG-1G at WBRG000091.

[57] *Id.* at WBRG000092.

[58] *Sunbelt,* 589 S.W.2d at 393-94.

[59] The Cliffs Utility Committee's Motion to Reopen the Record for Admission of Lot Sales Agreement (May 22, 2018).

that the Commission decides that *Sunbelt* is dispositive regarding customer contributions in aid of construction.

IV. CONCLUSION

As explained above, the legal framework to be applied to this case is as follows: (1) any assets classified as customer-contributed must be deducted from the depreciation expense; (2) any assets classified as developer-contributed may be included in the depreciation expense; (3) contributions in aid of construction and other cost-free capital must be deducted from rate base; and (4) the Commission has the discretion to include contributions in aid of construction in rate base "for good cause shown." Applying this framework, the record is clear that that DDU should not be entitled to earn a return on all of the utility plant in the White Bluff subdivision because at least a portion of those assets are developer-contributed, customer-contributed or both.

Dated: July 2, 2018

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I certify that a copy of this document will be served on all parties of record on July 2, 2018, in accordance with 16 TAC § 22.74.

Eleanor D'Ambrosio

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