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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 BRIEF ON CONTRIBUTION ISSUES

TO THE HONORABLE PUBLIC UTILITY COMMISSION OF TEXAS:

Pursuant to the Briefing Order issued on May 30, 2018, in this docket, White Bluff Ratepayers Group ("WBRG") hereby files this brief on the issues set out in the order.

BRIEF

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

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

The Texas Legislature created the concept of "customer-contributed" investment in 1987 when it added Texas Water Code ("TWC") § 13.183(i), which allowed utilities to include property acquired from a developer before September 1, 1976,[1] in ratemaking for purposes of depreciation and return, except for funds provided by "explicit customer agreements."[2] The statute neither defined "developer" nor "customer," nor did it provide guidance regarding "explicit customer agreements." No case law or administrative decisions provide any additional guidance. Given the timing of this legislation (after the transfer of regulation from the Public Utility Commission to the Texas Water Commission), the statute was probably intended to clarify *Sunbelt*[3] with regard to pre-PURA developer contributions.

Then, in 1989, the Legislature added TWC § 13.183(j) to allow utilities to recover depreciation (but not return) on all developer- and government-contributed assets, with the

[1] This is the effective date of statewide regulation of utilities under PURA.

[2] 70th Leg. R.S.ch. 539, § 10 (H.B. 1459).

[3] *Sunbelt Utils. v. Pub. Util. Comm'n*, 589 S.W.2d 392 (Tex. 1979), White Bluff Ratepayers Group Ex. WBRG-1C.

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exception of "property provided by explicit customer agreements or funded by customer contributions in aid of construction."[4] Again, the legislative history provides little insight into the reason for the changes or how to interpret "explicit customer agreements" or "customer contributions in aid of construction"— particularly with regard to the situation where the developer and the utility are indistinguishable, and where the developer's explicit customer agreements clearly state the developer will fund construction of utility infrastructure. The Commission must, therefore, provide its own interpretation of these terms, within the confines of the statutory language.

With regard to the most common fact situations, it should be straightforward for the Commission to adopt an appropriate interpretation: funds paid or assets contributed directly by rate-paying customers[5] to utilities for specific utility purposes (such as customer-funded extensions to single lots) should be viewed as customer-contributed assets. If the payment or contribution goes directly from a customer to a developer[6] as part of the cost of lots, and then to a utility, the payment or contribution is, unquestionably, developer-contributed.

When the developer and the utility are the same, are affiliates of one another, or are otherwise indistinguishable, the question becomes a little more difficult, particularly when part of the lot price is expressly intended to fund utility property. The resolution of this question probably depends on: (1) how the funds or property reach the developer utility; (2) how the developer/utility accounts for the funds or property contributed; and (3) the manner in which the assets are transferred from the developer to the utility.

The manner in which the funds reach the developer/utility will be difficult to determine when the developer and the utility are the same. The developer/utility is going to receive funds from lot purchasers and ratepayers through lot sales and through rates. Explicit customer agreements between the lot purchaser and the developer, such as the lot sales agreements in the instant case, provide a strong indication that assets purchased with the funds are developer-

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[4] 71st Leg. R.S., ch. 567, § 18 (H.B. 1808).

[5] Neither the statute nor the Commission's rules define "customer." Clearly, ratepayers who receive retail water or sewer utility service on an ongoing basis are "customers." "Developers," however, are also customers in that they too receive for services from retail public utilities (*e.g.*, extension of infrastructure), and these services are addressed by the utility's tariff. As part of its rule-making, the Commission should define the term "customer" for the purpose of determining "customer contributions."

[6] Commission rules define "developer" as "a person who subdivides land or who requests more than two water or sewer connections on a single contiguous tract of land." 16 TAC § 24.85(e)(4).

contributed, but the lack of such agreements does not clearly indicate that the funds are customer-contributed. Other factors, such as whether the contributions address specific, identifiable property that does not represent a significant portion of the utility's total assets, may provide some insight.

The other side of the accounting ledger may also provide guidance. If the developer/utility records the assets identified in the explicit customer agreement as part of the cost of the lots—the assets probably should be viewed as developer-contributed. Recording the cost of the assets in cost of lots indicates the developer intends to recover the cost of the infrastructure through lot sales. If the developer/utility records the assets in any other way, the assets should more likely be viewed as customer-contributed. This indicates the developer/utility intends for the utility to recover the cost of these assets directly from its ratepayer customers and not from its associated developer entity.

Another significant factor might be how the assets were ultimately transferred from the developer/utility to the ultimate utility entity. If the transfer reveals no exchange of funds from the utility to the developer in exchange for the utility assets, the assets probably should be classified as developer-contributed. If something of value is given to the developer in exchange for the assets, the assets (at least in part) should be classified as customer-contributed. In essence, in such situations the lot purchasers' contributions to the developer are being sold to the utility, which should be recognized in the rates the utility is allowed to charge.

A major point requiring action by the Commission remains. Given the complexities of these situations, and the fact that the developer/utility is the only entity with exclusive access to all the facts, the initial burden should be placed on the developer/utility to demonstrate that payments accruing to the developer/utility are properly recorded in the accounting books for regulatory and rate-making purposes. It is unjust and inequitable to place this burden on Commission staff or ratepayers to expend limited funds in an effort to unearth these records. The Commission should consider rulemaking as a way of developing appropriate standards and criteria and to place the utilities on notice of how the Commission intends to handle these payments/assets.

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?**

To answer this question, we need to know how Double Diamond, Inc. ("DDI") accounted for the assets constructed by the developer/utility before the 1996, and how DDI and Double Diamond Utility Company, Inc. ("DDU") accounted for the transfer of the assets from DDI to DDU. DDI entered into an agreement with lot purchasers to fund the construction of the infrastructure. DDI's CFO, at the hearing on the merits in this case, testified that the cost of utility infrastructure—along with the other costs associated with preparing raw land for sale—would have been recorded on DDI'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.[7] This evidence is sufficient to allow the Commission to conclude that the assets in this matter were developer- and not customer-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?**

The rationale of the court in the *Sunbelt* decision with regard to the treatment of developer contributions for purposes of return has been fully incorporated into the Water Code by the Legislature. The court's rationale regarding how such contributions should be treated for purposes regarding depreciation should not control. The Legislature has clarified that a utility may earn depreciation on developer-contributed assets and created the distinction between "customer" and "developer" contributions.

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 was listed as the party responsible for maintaining the systems?**

Because the customers made the payments to DDI and DDI accounted for the assets as part of the cost of lots, the assets funded by DDI and transferred to DDU should be considered to be developer-contributed assets.

[7] Tr. at 156:11–21 (Grout Cross) (Oct. 24, 2017).

OTHER ISSUES

The proper recognition of developer contributions by water and sewer utilities, and by Commission staff, is a significant problem. The Commission should consider engaging in rulemaking to clearly and comprehensively address the issues associated with developer-contributed assets. Many, if not most, utilities, like DDU, simply treat all developer contributions as invested capital, and place the burden of identifying developer contributions on Commission staff and ratepayers. The burden should not be on ratepayers, as it was in this case. Utilities, particularly utilities associated with developers, should be required to identify such assets in all rate filings. Additionally, utilities should not be able prevail simply by claiming that they do not have the records.

To resolve this issue, the Commission should institute rule-making to create a presumption: when a developer constructs a system which it later conveys to a utility, the entire system is developer-contributed. The utility may rebut this presumption upon the showing that the utility entity funded the infrastructure out of its own capital. Even with non-developer-associated utilities, the Commission should presume that all local distribution facilities are developer-contributed. Virtually all water and sewer utilities in Texas require developers to pay all of the cost of extending infrastructure to serve the development, particularly development-specific distribution facilities. The Commission needs to recognize this universal fact. The Commission should use rulemaking to create these presumptions and give utilities notice of the burden that they will have in a rate change application.

With regard to allowing utilities to recover depreciation on developer-contributed property, the Commission needs to adopt rules to assure that funds collected are properly used. During the late 1980s and the early 1990s, regulatory bodies nationwide were struggling with the issue of how to keep small utilities with mostly developer-contributed assets viable and capable of generating funds or raising capital to maintain and replace assets. Exhibit A is an excerpt from a 1993 report from the National Regulatory Research Institute (NRRI) that explains the problems associated with these types of utilities and pros and cons of allowing the utilities to recover depreciation on contributed assets.

As the NRRI paper points out, the purpose of allowing these utilities to recover depreciation on contributed assets is to provide funds to reinvest and to provide incentive to optimize performance. If utilities are allowed to recover depreciation, without any restrictions on use (which is the case now), the "depreciation" is, in reality, additional "return." The utility has no obligation to use those funds to reinvest in the system. Many ratepayers in the state might be willing to make extra payments to their utilities, if these utilities were required to use the extra revenue to improve infrastructure used to provide service. However, ratepayers do not want to simply give underperforming utilities additional funds that can be transferred to shareholders. The Commission should consider rulemaking to require affected utilities to create escrow accounts or bonding mechanisms to assure that collected funds are used for approved purpose.

Dated: July 2, 2018

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that a copy of the foregoing pleading was served on all parties of record in this proceeding on July 2, 2018, by hand-delivery, facsimile, electronic mail, and/or First Class Mail.

C. Joe Freeland

EXHIBIT A

NRRI 93-13

MEETING WATER UTILITY REVENUE REQUIREMENTS: FINANCING AND RATEMAKING ALTERNATIVES

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Depreciation Expense for Advances and Contributions

Small water utilities often are referred to as developer systems because they emerged as part of a real-estate development. Many of these systems rely heavily on customer advances or contributions-in-aid-of-construction (CIAC). Without this source of funding, some systems may not be able to provide service to new customers. A large amount of contributed capital can cause problems for an investor-owned system because it does not expand the value of the rate base on which the utility earns a return. Typically, the water utility owner-operator has few funds to reinvest and little incentive to optimize performance. Over time, the lack of depreciation expense can leave the utility without adequate cash flow or a reserve fund for emergencies, improvements, or replacements.

For many water utilities that use CIAC, alternative financing methods are not readily available. According to a report by the staff of the Florida Public Service Commission, "regulatory policies do not cause the industry to rely on CIAC," but absent CIAC, "the alternatives are for utility owners to charge the first customers exorbitant rates or absorb all investment and operating costs until a full customer base exists."[12] The 1986 Tax Reform Act made contributions taxable as income, a policy the water industry has worked hard to overturn because it undermines the use of CIAC as a financing mechanism.

Not all commissions allow depreciation on advances or contributions as an expense. The Florida staff report recommends "letting utilities bear full responsibility for obtaining financing to replace old plant" because when replacements are needed, the utility's customer base should be large enough to offset the need for CIAC cash flows.[13] In other words, the system should be financially viable and able to satisfy traditional

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[12] Florida Public Service Commission, Division of Research, *Report on Contributions-in-Aid-of-Construction* (June 1988) as reported in NRRI's *Quarterly Bulletin* 9 (October 1988): 494.

[13] Ibid., 495.

regulatory standards. If the system is not viable, structural alternatives (such as consolidation with another water system) should be considered.

As reported in table 5-5, some state commissions allow depreciation as an expense for customer advances or contributions in aid of construction. Advantages and disadvantages of this ratemaking mechanism appear in table 5-6.

TABLE 5-5
COMMISSIONS ALLOWING
DEPRECIATION AS AN EXPENSE FOR ADVANCES OR CONTRIBUTIONS

Customer Advances

Arizona	Kentucky
Arkansas	Maryland
California	Massachusetts
Connecticut	New Hampshire
Hawaii	New Jersey
Illinois	New York
Indiana	Pennsylvania
Iowa	Utah

Contributions-in-Aid-of-Construction (CIAC)

Arizona	New Jersey (c)
Arkansas	Oregon
Connecticut (a)	Tennessee (b)
Indiana	Texas
Michigan	Utah (a)
Montana	Wisconsin
New Hampshire (b)	

Source: *1992 NRRI Survey on Commission Ratemaking Practices for Water Utilities.*

(a) Sometimes.
(b) Offset by amortization.
(c) Eliminated by stipulations.

TABLE 5-6

EVALUATING DEPRECIATION EXPENSE FOR ADVANCES AND CONTRIBUTIONS

Advantages of Depreciation Expense for Advances and Contributions

- It increases cash flow to the utility, thereby enhancing financial viability.
- It can help utilities build a depreciation reserve or escrow account for improvements.
- It can bring rates closer to marginal costs.
- It can provide a temporary bridge for utilities with long-term prospects for viability.
- It can help ensure that funds will be available for needed improvements.

Disadvantages of Depreciation Expense for Advances and Contributions

- It violates traditional cost-of-service and other ratemaking standards.
- It forces ratepayers to pay twice for the same asset.
- It shifts risks from utility investors to ratepayers.
- It can result in a negative rate base.
- In the short term, it results in higher rates than justifiable on cost-of-service principles.
- It does not address further erosion of the utility's rate base.
- Without special provisions, it does not provide assurances that funds will be available for system improvements.
- It provides no incentives for expanding the rate base and taking other measures to assure long-term viability.
- It may require special accounting and oversight procedures.

Special Considerations

- It may mask or postpone attention to serious viability problems, so a viability assessment is warranted prior to approval.
- It improves the financial viability of small utilities but should not preclude consideration of structural options, such as consolidation.
- An escrow account or bonding procedure may be needed to assure that funds are used for approved purposes (somewhat like nuclear decommissioning funds).

Source: Authors' construct.