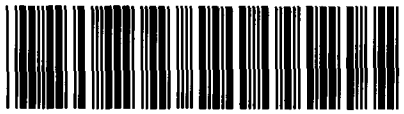

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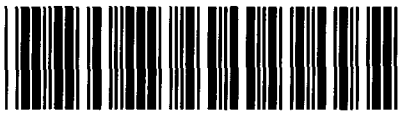

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APPLICATION OF DOUBLE DIAMOND UTILITY COMPANY, INC. FOR WATER AND SEWER RATE/TARIFF CHANGE	§ § §	**PUBLIC UTILITY COMMISSION OF TEXAS**

COMMISSION STAFF'S REPLY 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 Reply Brief on Legal or Policy Issues to respond to arguments made by Double Diamond Utility Company, Inc. (DDU) and White Bluff Ratepayers Group (WBRG). Pursuant to the Briefing Order issued May 30, 2018, the deadline for reply briefs is July 9, 2018. Therefore, Staff's Reply Brief is timely filed. In support of its Reply Brief, Staff states the following:

I. INTRODUCTION

Staff addresses two arguments raised by DDU and one argument raised by WBRG. DDU claims that the Texas Water Code's (TWC) *exceptions* to the general rule that contributions, or cost free capital, should not be allowed for ratemaking purposes should be broadly interpreted to permit recovery of depreciation for all cost free capital except those explicitly referenced by statute.[1] The rationale for excluding developer or customer contributions from recovery is embodied in the Commission's rule, which states that contributions in aid of construction and other sources of cost-free capital shall be deducted from a utility's rate base "unless otherwise determined by the [C]ommission, for good cause shown."[2] The TWC permits an exception for the recovery of depreciation on governmental or developer-contributed capital only.[3] The restrictive interpretation of the TWC that DDU employs to answer to the Commission's questions regarding 1) the difference between developer and customer contributions, 2) the factors used to determine

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[1] Double Diamond Utility Company, Inc.'s Brief Regarding Utility Asset Treatment in Water and Sewer Cases at 7-8 of 19, 12 of 19 (Jul. 2, 2018) (DDU's Brief Regarding Utility Asset Treatment).

[2] 16 Tex. Admin Code (TAC) § 24.31(c)(3).

[3] TWC § 13.185(j).

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whether a capital investment qualifies as developer or customer-contributed, and 3) the impact the Texas Supreme Court's decision in *Sunbelt Utilities v. Public Utility Commission of Texas*[4] should have on the analysis does not acknowledge the basic principal that a utility should not recover a return on, and of, a capital investment it did not make.

Staff also disagrees with DDU's argument that the Commission's decision to exclude developer or customer contributions from invested capital in the current case would imply that an acquiring utility would not be permitted to earn a return on its investment.[5] The recovery of investments made by an acquiring utility are governed by the TWC's requirement of original cost to the predecessor utility as well as the rule on acquisition adjustments.[6] The Commission's rule on acquisition adjustments makes allowances for contributions in the determination of a reasonable acquisition adjustment, but does not necessarily prohibit the recovery of an acquisition adjustment on account of any capital contribution.[7]

Staff disagrees with WBRG's assertion that a customer contribution of capital should change its character to a developer contribution if the customer contribution is made to the developer and the developer makes the contribution of assets to the utility.[8] The intervening contribution of assets from the developer to the utility does not change the fact that it is the customers that paid for the assets. And if the customers originally paid for the assets, they should not be required to pay for them again through depreciation rates. However, given WBRG's concerns regarding DDU's ability to make needed investments in repairs or replacements of assets, Staff is unopposed to a good cause exception to treat any customer contributions as developer contributions so long as the revenues associated with the depreciation of such assets are accounted for and committed to future capital improvements.

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

[5] DDU's Brief Regarding Utility Asset Treatment in Water and Sewer Cases at 16 of 19.

[6] TWC § 13.185(b); 16 TAC § 24.31(d).

[7] 16 TAC § 24.31(d).

[8] White Bluff Ratepayers Group's Brief on Contribution Issues at 3 (Jul. 2, 2018) (WBRG Brief on Contribution Issues).

II. ARGUMENT

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)?

DDU's narrow reading of TWC §§ 13.185(b) and (j) should be rejected because it ignores key words in these subsections. Under DDU's interpretation, a utility's assets cannot be classified as customer-contributed absent either an explicit agreement with customers or a surcharge approved by a regulatory authority.[9] However, DDU disregards the "or" in both subsections, which is used to distinguish "explicit customer agreements" from "customer contributions in aid of construction."[10] This word choice suggests that a customer contribution in aid of construction can take a form that does not involve an explicit agreement between the customer and the utility. Additionally, TWC § 13.185(b) uses the phrase "such as" to make it clear that a surcharge is just one example included in the broader category of customer contributions in aid of construction.[11] Moreover, reading this statute in the limited manner proposed by DDU does not negate the fact that the lot sales agreement for White Bluff is an agreement with customers that obligates the seller to provide water and sewer systems.[12]

DDU also cautions that excluding what it characterizes as "investor supplied" capital from rate base will result in a situation where a third party would have no interest in "acquiring a system for which there is no ability to earn even a modest return on investment."[13] However, this argument overlooks the fact that the acquiring utility may seek a positive acquisition adjustment for plant, property, or equipment acquired from another utility through a sale, transfer, or merger approved by the Commission.[14] While, the utility requesting the positive acquisition adjustment must show that the actual purchase price is reasonable in consideration of the amount of

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[9] DDU's Brief Regarding Utility Asset Treatment at 8 of 19.

[10] TWC § 13.185(b) and (j).

[11] *Id.* § 13.185(b).

[12] White Bluff Real Estate Sales Contract, Ex. WBRG-1G at WBRG000092.

[13] DDU's Brief Regarding Utility Asset Treatment at 16 of 19.

[14] 16 TAC § 24.31(d).

contributions in aid of construction included in the system being acquired, the rule does not prohibit the recovery of any amount of capital above the original cost to the predecessor utility. Instead, the rule appropriately strikes a balance between allowing a utility to recover its investment, while limiting that recovery to reasonable and necessary levels of investment.

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

DDU's overly restrictive interpretation of TWC §§ 13.185(b) and (j) also leads it to a set of factors for classifying an asset as customer-contributed that is too narrow. According to DDU, the only two factors that should be considered to determine whether an asset is customer-contributed are: (1) the presence of an explicit agreement between the customer and the utility for the customer to fund the construction of an asset; or (2) a Commission-approved surcharge or fee allowing the utility to recover the cost of a specific asset.[15]

DDU's reading of *Sunbelt* is also too limited to make it of any use in determining the factors relevant to classifying a contribution in aid of construction, and its reliance on *Texas Water Commission v. Lakeshore Utility Co.*[16] is misplaced. The fact that the developer in *Sunbelt* wrote off the entire cost of the utility system against lot sales addressed the amount of assets that were to be excluded from rate base—not whether they were correctly classified as a contribution in aid of construction. The foremost issue for the Court in finding that construction of the utility plant was already paid for by contributions in aid of construction was whether these construction costs had been paid for by customers via lot sales.[17] Likewise, *Lakeshore* does nothing to inform the analysis because the opinion merely stated that there "could" be a situation in which a utility demonstrates that it is entitled to earn a return on facilities that are wholly owned by another entity, but did not actually address whether ownership of facilities was necessary to treat an asset as invested capital.[18] And the Court's findings as to the evidence needed to establish the value of a

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[15] DDU's Brief Regarding Utility Asset Treatment at 12 of 19.

[16] *Tex. Water Comm'n v. Lakeshore Util. Co.*, 877 S.W.2d 814 (Tex. App.—Austin 1994, writ denied).

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

[18] *Lakeshore*, 877 S.W.2d at 822.

utility's facilities as invested capital are immaterial to determining whether an investment qualifies as developer or customer-contributed in this case because no one has disputed that assets included in rate base are valued using the original cost at the time the asset was placed into service less depreciation.

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?

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

Staff maintains that customer-contributed property should remain customer-contributed property even if it is subsequently contributed by a developer to a utility. Given WBRG's position in this case, Staff is unopposed to a good cause exception to treat any customer contributions as developer contributions so long as the revenues associated with the depreciation of such assets are accounted for and committed to future capital improvements.

In the event that the Commission agrees with WBRG that an intervening act of a developer contributing assets to a utility changes the nature of customer contribution of such assets, Staff recommends that such a scenario should not exist where the developer and the utility are the same entity.

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?

DDU's claims that the sales agreement for lots in White Bluff is not a deed, is not an executed contract, and is meaningless on its own as a matter of substantive law are moot.[19] As explained in Staff's Initial Brief on Policy or Legal Issues, *Sunbelt* does not require any independent evidence that the cost of the utility system is included in the sales price of a lot.[20] Instead, the Court adopted the reasoning from other jurisdictions that testimony regarding the items

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[19] DDU's Brief Regarding Utility Asset Treatment at 15 of 19.

[20] *Sunbelt*, 589 S.W.2d at 394.

included in the purchase price of the lots was unnecessary because it is a matter of common knowledge that the cost of constructing utility plant is often financed through lot sales.[21] Thus, the evidentiary value of the sales agreement, standing alone, only reinforces the reasonable inference that lot prices reflect the cost of constructing a utility system.[22]

III. CONCLUSION

For the reasons discussed above, Staff respectfully recommends that the Commission reject DDU's constrained interpretations of the statute and case law applicable to the classification of developer and customer-contributed investments. Staff is also unopposed to a good cause exception to treat any customer contributions as developer contributions so long as the revenues associated with the depreciation of such assets are accounted for and committed to future capital improvements.

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[21] *Sunbelt*, 589 S.W.2d at 395 (citing to *Princess Anne Util. Corp. v. Commonwealth of Va. ex rel State Corp. Comm'n*, 179 S.E.2d 714, 717 (1971) and *Fla. Cities Water Co. v. Bd. of Cty. Comm'rs of Sarasota Cty.*, 334 So.2d 622, 625 (Fla.Dist.Ct.App.2d 1976).

[22] *See id.*

Dated: July 9, 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 9, 2018, in accordance with 16 TAC § 22.74.

Eleanor D'Ambrosio