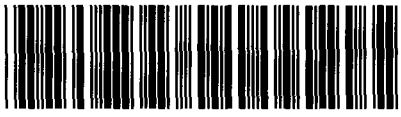

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APPLICATION OF DOUBLE DIAMOND UTILITY COMPANY, INC. FOR WATER AND SEWER RATE/TARIFF CHANGE	§ § § §	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

DOUBLE DIAMOND UTILITY COMPANY, INC.'S
REPLY BRIEF REGARDING UTILITY ASSET TREATMENT
IN WATER AND SEWER CASES

TO THE HONORABLE ADMINISTRATIVE LAW JUDGES:

COMES NOW, Double Diamond Utility Company, Inc. ("Double Diamond"), in the above styled and docketed water and wastewater rate proceeding and files the attached Reply Brief Regarding Utility Asset Treatment in Water and Sewer Cases.

Respectfully submitted,

By: _____
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CERTIFICATE OF SERVICE

I hereby certify that I have served or will serve a true and correct copy of the foregoing document via hand delivery, facsimile, electronic mail, overnight mail, U.S. mail and/or Certified Mail Return Receipt Requested to all parties on this the 9th day of July, 2018.

_____
John Carlton

INTRODUCTION

The Commission is charged with the responsibility of implementing a:

> comprehensive regulatory system that is adequate to the task of regulating retail public utilities to assure rates, operations, and services that are just and reasonable to the consumers **and to the retail public utilities.**"[1] **(emphasis added)**.

And while Chapter 13 of the TWC was "adopted to protect the public interest inherent in the rates and services of retail public utilities",[2] part of that responsibility is to protect the financial integrity of a utility and preserve its ability to maintain its credit and attract capital, as discussed in Double Diamond's Brief Regarding Utility Asset Treatment in Water and Sewer Cases ("Initial Brief").

It is clear from the initial briefs filed by the parties in response to the Commission's questions regarding the treatment of assets in water and sewer cases that this is not a simple issue.[3] Both the Commission Staff ("Staff") and the White Bluff Ratepayers Group ("WBRG") suggest rulemaking to address the issue. Double Diamond would not oppose such a rulemaking effort, which would give interested parties and experts from the industry the ability to help formulate a well thought out Commission policy on the issue, but a rulemaking project would not address the issues presented in this case in a timely manner.

Double Diamond is a wholly owned subsidiary of a private company, Double Diamond – Delaware, Inc. ("DDD").[4] DDD is also the parent corporation and sole owner of Double Diamond, Inc. ("DDI") and Double Diamond Properties Construction Co. ("DDPC").[5] Like any private business enterprise, DDD's purpose is to earn money for its owners. And all of DDD's subsidiary entities were created to be profitable for DDD and its owners. DDD files a consolidated tax return for its subsidiary entities, which includes Double Diamond.[6] As the sole owner of its subsidiary entities, DDD has the right to determine how it funds its subsidiaries and how it treats its expenditures and those of its subsidiaries. These are simply the realities of business in America.

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1 Texas Water Code ("TWC") §13.001(c).
2 TWC §13.001(a).
3 Staff's Initial Brief on Legal or Policy Issues, p. 6.
4 Exhibit WBRG-1D.
5 *Id.*
6 Tr. at 81:1-4 (Gracy Cross)(October 24, 2017).

DDD invests its funds in the entities it owns, and its investments are not cost-free or simply contributions to these entities. DDD expects to earn a return.

1. What is a developer contribution as that term is used in TWC § 13.183(j)?[7] 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)?

As discussed in Double Diamond's Initial Brief, customer contributed capital or contributions in aid of construction can only exist if there is an agreement in place or a surcharge or fee approved by the regulatory authority, and developer contributed capital under 13.185(j) would be capital, such as facilities or money, contributed by a developer to the water or sewer utility.

Staff argues that there is no difference between developer contributions and customer contributions as those contributions relate to earning a return on rate base.[8] Provided that developer contributions do not include investor supplied capital, Double Diamond generally agrees with Staff's assertion. However, Staff also asserts that any money from the utility parent is cost-free capital or developer contributions. Staff analyzes the terms developer contribution and customer contribution in aid of construction by equating both to cost-free capital. Staff's analysis fails to recognize that there is also a third category, investor supplied capital. Investor supplied capital is not cost-free.

An owner of a utility may choose to invest capital – in the form of cash or assets into the utility – and expects to earn a return for that investment. Investor supplied capital has a cost; it is not simply a gift to the utility and its customers. The owner/investor provides funds to construct, upgrade or expand the utility system in order to serve the utility's customers. The cost to the owner/investor is that they no longer have access to those funds.

So, the initial question must be: did the owner intend to invest capital in the utility? The answer can be found in the books of the utility. As discussed in Double Diamond's Initial Brief, the assets that have not been written off are investor supplied capital, which is distinguishable from developer contributed capital. Double Diamond has requested that 80% of the value of certain assets be removed from rate base because only 20% of the value of those assets was intended to

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[7] There is no 13.183(j) in the Texas Water Code. Double Diamond presumes that the Commission intended to reference 13.185(j) in this question and will answer it using that assumption.

[8] Staff Initial Brief on Legal or Policy Issues, p. 5.

remain as investor supplied capital in the utility to reduce costs to the customers.[9] The value of those utility assets that are still on its parent company's books, both for tax purposes and depreciation,[10] is the amount of investor supplied capital upon which Double Diamond is entitled to and requesting to earn a return.

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

As discussed in Double Diamond's Initial Brief, the factors that should be used to evaluate investor supplied capital, including developer contributed capital, are:

1. Determination of all assets that are used by and useful to the utility in providing service;
2. Determination of the original cost of each such asset, or the actual money cost or the actual money value of any consideration paid, other than money, for the asset at the time it was dedicated to public use, whether by the utility that is the present owner or by a predecessor;
3. Determination of the accumulated depreciation for each such asset;
4. Determine whether such asset was written off, in whole or in part, as a developer expense and the value of the asset, if any, that was not written off as such an expense; and
5. Determine whether such asset was customer contributed capital.

The factors to consider when evaluating customer contributed capital are:

1. Is there an explicit agreement between the customer and the utility for the customer to fund the construction of an asset or group of assets; or
2. Has the regulatory authority approved a surcharge or fee to allow the utility to recover the costs of a certain asset or assets from the utility's customers that the utility has used to construct that asset?

WBRG asserts that one factor to be considered is that if costs for assets are recorded as part of the costs of lots, then those assets must be developer contributions, and if assets are not so recorded, then they must be customer contributions.[11] But like Staff's cost-free capital analysis,

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[9] Exhibit DDU-3, p. 8 of 27, lines 3-5 (Testimony of Randy Gracy), admitted into the record on October 24, 2017.
[10] Exhibit WBRG-8 CONFIDENTIAL at Bates No. DDU003584, and Exhibit WBRG-8 CONFIDENTIAL at Bates No. DDU16-015470 – DDU16-015475.
[11] WBRG Brief on Contributions, p. 3.

WBRG's assertion ignores the fact that the owner of the utility may provide investor supplied capital to earn a profit or return on that investment. Assets on the utility's books that have not been written-off against the revenue from the sale of lots are investor supplied capital – not developer contributions and certainly not customer contributions in aid of construction.

WBRG also asserts that "if the payment or contribution goes directly from a customer to a developer as part of the cost of lots, and then to a utility, the payment or contribution is, unquestionably, developer-contributed."[12] Double Diamond agrees. These types of costs have been written-off against the revenue from sales of lots, and *Sunbelt Utilities v. Public Utility Commission*,[13] requires this treatment. Unlike *Sunbelt*, none of DDD's wholly owned subsidiaries have expensed the entire cost of the utility system against lot sales. In order to determine what amount has been written-off in this way, the Commission need only look to the utility's tax depreciation schedules, which show the values of all the assets that have not been written off. The assets on the tax depreciation schedules show what has not been written off and remains investor supplied capital.[14]

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 Double Diamond, Inc. ("DDI") was both the developer and the utility at White Bluff through 1996 is not relevant to this analysis.

In its response to this question, Staff asserts that (1) all assets dedicated to public use prior to 1997 were paid for by DDI, the utility, but partially funded through lot sales; (2) all assets dedicated to public use between January 1, 1997, and December 31, 2007, after DDU was created, are developer contributions; and (3) that all assets dedicated to public use after January 1, 2008, are Double Diamond supplied capital.[15] Double Diamond agrees with Staff's first and third assertions. As Mr. Gracy testified, 80% of certain assets were installed prior to 1997 were treated

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[12] WBRG's Brief on Contributions, p. 2.

[13] *Sunbelt Utilities v. Public Utility Commission*, 589 S.W.2d 392, 394 (1979). The court held that "the finding of the Commission, that the purchasers of the lots in the subdivisions had paid the developer's cost of the utility system as a part of the purchase price of their lots, is reasonably supported by substantial evidence. Sunbelt is therefore not entitled to a rate of return on this contributed property and this cost was properly excluded from its rate base." The court noted that "it is undisputed that the entire cost of the utility system was expensed by the developer against the sum realized from the sale of the lots."

[14] *See* Double Diamond's Brief Regarding Utility Asset Treatment in Water and Sewer Case, pp. 13-15 and Attachment 1.

[15] Staff's Initial Brief on Legal or Policy Issues, p. 9.

as developer contributions, and hence, Double Diamond has removed 80% of their value from its rate base. Double Diamond has also treated all of the post-2007 assets as 100% utility funded and included their full value in its rate base. Double Diamond does not agree with Staff's assertion that assets dedicated to public use from 1997 to 2007 were paid for by a developer. These assets were ultimately paid for by DDD, the parent company, and the owner chose to split their value between developer contributions and investor supplied capital as reflected in Double Diamond's application, the tax depreciation schedules, and Mr. Gracy's testimony.[16]

WBRG asserts in its response that DDI agreed to fund construction of all utility infrastructure and that all costs of utility infrastructure were written-off against lot sales.[17] Double Diamond made no such promise and did not write-off all costs of utility infrastructure against lot sales as suggested by WBRG. Both Staff and WBRG completely mischaracterize Double Diamond's witness on this point in an attempt to claim that all the utility assets were written-off against lot sales. Mr. Grout did testify that "the costs of prepping the land, getting the land ready for sale" go into the development cost.[18] But he clarified that he did not know "whether any utility infrastructure was included" in the part that is expensed when a lot is sold.[19] He further testified that "within our financials, you can go into the balance sheet and look at detail..." in order to show what is part of the utility asset inventory.[20] He did not testify that all costs of utility infrastructure were written off against lot sales.

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

As discussed in Double Diamond's Initial Brief, the *Sunbelt* holding does not require the exclusion of all developer contributed assets from rate base for purposes of earning a return, only the exclusion of those that have been fully written off by the developer.

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16 Ex. DDU-2, pp. 79 and 127, Ex. WBRG-8 CONFIDENTIAL at Bates DDU16-15470 - DDU16-15475; Ex. DDU-3, p. 8 of 27, lines 7-10 (Testimony of Randy Gracy).

17 WBRG Brief on Contributions, p. 4.

18 Tr. 156:13-19 (Cross examination of Tim Grout).

19 Tr. 157: 4-8 (Grout Cross).

20 Tr. 157: 12-15 (Grout Cross)

WBRG correctly points out that the Texas legislature addressed the *Sunbelt* case in part when it amended the law to specifically require that a utility may earn depreciation on developer contributions, while prohibiting depreciation and return on customer contributed capital.[21]

Staff admits that *Sunbelt* "does not provide any insight" regarding the distinction between developer and customer contributed assets, assumingly recognizing that *Sunbelt* is not relevant.[22] However, Staff goes on to erroneously assert that "the Sunbelt decision does require any specific evidence whatsoever that the cost of the utility system is included in the sales price of a lot."[23] The court's holding stated that:

> It is undisputed that the entire cost of the utility system was expensed by the developer against the sum realized from the sale of the lots...We conclude that the finding of the Commission, that the purchasers of the lots in the subdivisions had paid the developer's cost of the utility system as a part of the purchase price of their lots, is reasonably supported by substantial evidence. Sunbelt is therefore not entitled to a rate of return on this contributed property and this cost was properly excluded from its rate base.[24]

Strangely, Staff subsequently acknowledges that *Sunbelt* is not exactly on point because the *Sunbelt* utility admitted that it wrote off all its costs against lot sales.[25] And just as Double Diamond has suggested, the Commission should look to 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."[26]

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?

As discussed in Double Diamond's Initial Brief, DDI did not obligate itself through a deed. The document offered into evidence by the Intervenors is not a deed. It is not even an executed

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21 WBRG Brief on Contributions, p. 4; *See* Act of May 29, 1989, 71st R.S.,ch. 567 (HB 1808), General and Special Laws of Texas, §§17 and 18, secs. 13.183 and 13.185(b) and (j), 1891.

22 Staff Brief on Legal or Policy Issues, p. 9.

23 *Id.* at 11.

24 *Sunbelt* at 394.

25 Staff Brief on Legal or Policy Issues, at 11.

26 *Id.*

contract. The Commission should not consider the document as evidence supporting a claim that the customers have paid for utility assets.

Staff's assertions are discussed above. The Commission should look to 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."[27] Following this suggestion results in a rate base that is consistent with Double Diamond's request as discussed in Double Diamond's Initial Brief.

On the other hand, WBRG makes an assertion that glosses over the pertinent facts. WBRG asserts that, because some of the utility assets were written off against lot sales, all the assets funded by DDI should be considered developer contributed assets.[28] As discussed above and in Double Diamond's Initial Brief, this simply does not follow from the tenants of *Sunbelt* and the TWC provisions. Only the portion of the utility asset costs that have been written off against lot sales should be excluded from rate base for purposes of earning a return.

CONCLUSION

Double Diamond is a small water and sewer utility. The Commission has an obligation to protect the financial integrity of water and sewer utilities like Double Diamond. In order to protect Double Diamond's financial integrity, the Commission must ensure that Double Diamond can maintain its credit and attract capital.

Double Diamond has provided significant investor supplied capital for its utility systems. The capital that Double Diamond and its parent provide was not cost-free. Double Diamond chose to deduct from rate base 80% of the value of many utility system assets to save money for its customers, which was written off against the cost of lot sales. Double Diamond is entitled to earn a reasonable return on the remaining asset value that was not written off as requested in its application with the changes it agreed to on the record.

If the Commission excludes Double Diamond's investor supplied capital from its rate base, it will jeopardize Double Diamond's financial integrity. Without the ability to maintain its credit and attract capital for investment in its systems, Double Diamond will not be able to continue to serve its customers, nor will any other entity be interested in acquiring a system for which there is

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27 *Id.*

28 WBRG Brief on Contributions, at 4.

no ability to earn even a modest return on investment. Without the ability to earn a return on its investments, a utility like Double Diamond would struggle to make any investment in its utility systems. With little to no rate base upon which to earn return, utilities like Double Diamond will not have access to capital because no one will want to invest in them, and they will slowly die, leaving their customers without access to reliable, good quality water and sewer services.

PRAYER

WHEREFORE, PREMISES CONSIDERED, Double Diamond Utility Company, Inc., respectfully requests that the Commission issue a final order recognizing Double Diamond's rate base as requested in its application with the changes it agreed to on the record and reversing the relevant recommendations of the Administrative Law Judge.

Respectfully submitted,

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