Control Number: 46662

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State Office of Administrative Hearings

Lesli G. Ginn
Chief Administrative Law Judge

March 15, 2019

TO: **Stephen Journeay, Director** **VIA EMAIL**
Commission Advising and Docket Management
William B. Travis State Office Building
1701 N. Congress, 7th Floor
Austin, TX 78701

RE: **SOAH Docket No.473-17-4964.WS**
PUC Docket No. 46662

PETITION OF THE CITIES OF GARLAND, MESQUITE, PLANO AND RICHARDSON APPEALING THE DECISION BY NORTH TEXAS MUNICIPAL WATER DISTRICT AFFECTING WHOLESALE WATER RATES

Enclosed is the Proposal for Decision-Public Interest Phase (PFD) in the above-referenced case. By copy of this letter, the parties to this proceeding are being served with the PFD.

Please place this case on an open meeting agenda for the Commissioners' consideration. There is no deadline in this case. Please notify us and the parties of the open meeting date, as well as the deadlines for filing exceptions to the PFD, replies to the exceptions, and requests for oral argument.

Sincerely,

Pratibha J. Shenoy
Administrative Law Judge

Holly Vandrovec
Administrative Law Judge

Enclosure
xc: All Parties of Record

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SOAH DOCKET NO. 473-17-4964.WS
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PETITION OF THE CITIES OF GARLAND, MESQUITE, PLANO AND RICHARDSON APPEALING THE DECISION BY NORTH TEXAS MUNICIPAL WATER DISTRICT AFFECTING WHOLESALE WATER RATES	§	BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

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Frequently Used Abbreviations, Acronyms, and Terms

Abbreviation/Acronym/Term	Definition
Board	District's Board of Directors
Bois d'Arc Reservoir	Reservoir on Lower Bois d'Arc Creek, under construction by the District
Code	Texas Water Code
Contract	August 1, 1988 Regional Water Supply Facilities Amendatory Contract between the District and the Member Cities
Customer Cities	non-Member Cities purchasing wholesale water pursuant to bilateral contracts with the District
District or NTMWD	North Texas Municipal Water District
District's Enabling Act	State laws that set out the District's governance
Effective Rate	Actual cost to a wholesale customer of the District per 1,000 gallons of water delivered by the District (*i.e.*, a purchaser's total bill, including excess charges and rebates, if any, divided by that purchaser's actual consumption of water)
Frisco & Forney	Cities of Frisco and Forney
FY	Fiscal Year (October 1 to September 30 of a given year)
Intervenors	Cities of Allen, Farmersville, Forney, Frisco, McKinney, Princeton, Rockwall, and Wylie
Member Cities	Petitioners and the Cities of Allen, Farmersville, Forney, Frisco, McKinney, Princeton, Rockwall, Royse City, and Wylie
MGD	Million gallons per day
Non-Petitioning Member Cities	Cities of Allen, Farmersville, Forney, Frisco, McKinney, Princeton, Rockwall, Royse City, and Wylie
Petition	Petitioners' petition, filed December 14, 2016
Petitioners	Cities of Garland, Mesquite, Plano, Richardson
Policy No. 8	A financing mechanism allowing Member Cities to utilize District funds to finance capital improvements
Public Interest Rule	16 Texas Administrative Code § 24.311
PUC or Commission	Public Utility Commission
Rebate Policy	Policy adopted by the Board pursuant to which the District has the discretion to refund variable costs avoided by the District due to water not used by a Member City (below its Annual Minimum); $0.41 per 1,000 gallons for FY 2017
SOAH	State Office of Administrative Hearings
Staff	Commission staff
Stipulations	Agreed Motion Regarding Entry of Stipulations, filed October 16, 2018
TAC	Texas Administrative Code
TCEQ	Texas Commission on Environmental Quality
TWC	Texas Water Commission, a predecessor agency of the TNRCC (and thereby of the TCEQ)
TNRCC	Texas Natural Resource Conservation Commission, a predecessor agency of the TCEQ
TWDB	Texas Water Development Board

Abbreviation/Acronym/Term	Definition
Undelivered water	Water that a Member City pays for, but does not take from the District
Water Year	August 1 to July 31 of a given year

August 1, 1988 Regional Water Supply Facilities Amendatory Contract (Contract) Terms

Contract Term	Definition
Annual Minimum (of a Member City)	Highest historical annual use of District water
Annual Requirement (of the District)	Total budgeted expenditures including operation and maintenance costs, bond service, and capital investment costs for repair, replacement, maintenance, or expansion of facilities
Excess Charge	Cost per 1,000 gallons of water taken in excess of a Member City's Annual Minimum; $0.41 per 1,000 gallons for FY 2017
Member City Rate	Revenue Requirement divided by total Annual Minimums of all Member Cities; $2.53 per 1,000 gallons for FY 2017
Nickel Premium	Premium charged to Customer Cities above the Member City Rate and Excess Charge; $2.58 per 1,000 gallons base rate and $0.46 per 1,000 gallons excess charge
Revenue Requirement (of the District)	Annual Requirement less other revenues received

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PETITION OF THE CITIES OF GARLAND, MESQUITE, PLANO AND RICHARDSON APPEALING THE DECISION BY NORTH TEXAS MUNICIPAL WATER DISTRICT AFFECTING WHOLESALE WATER RATES	§	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

PROPOSAL FOR DECISION—PUBLIC INTEREST PHASE

I. INTRODUCTION

On December 14, 2016, the Cities of Garland, Mesquite, Plano, and Richardson (Petitioners)[1] filed a petition (Petition) with the Public Utility Commission of Texas (PUC or Commission) to appeal the rates charged by the North Texas Municipal Water District (District or NTMWD) for wholesale water service. Petitioners are municipalities that provide retail water service to their citizens. The District is a conservation and reclamation district created under Article XVI, section 59 of the Texas Constitution, and appropriates, treats, and stores public water pursuant to water rights permits issued by the Texas Commission on Environmental Quality (TCEQ) under chapter 11 of the Texas Water Code (Code). Petitioners and nine other cities (collectively, the Member Cities) constitute the District.

Petitioners assert that the 2016-17 wholesale water rates charged by the District are adverse to the public interest as defined in 16 Texas Administrative Code (TAC) § 24.311 (Public Interest Rule).[2] The District and all but one of the other Member Cities contend that the District's rates for the last 30 years have been set pursuant to a contract intended to provide reliable and long-term

[1] In this Proposal for Decision (PFD), "City/Cities of" will be omitted after the first reference to a city or cities.

[2] At the time the Petition was filed, 16 Texas Administrative Code (TAC) § 24.133 contained the rule referenced in this PFD as the Public Interest Rule. The Public Utility Commission of Texas (PUC or Commission) renumbered this rule to 16 TAC § 24.311 and also renumbered other rules related to wholesale water cases, effective October 17, 2018. To relieve the parties of the task of revising and conforming pre-filed testimony and exhibits, the Administrative Law Judges (ALJs) directed the parties to use the prior references as necessary. Current references for all rules are used in this PFD.

regional water supplies, and that such contractually-set rates are entitled to deference. The Administrative Law Judges (ALJs) agree that the Public Interest Rule sets a high threshold to find a contract adverse to the public interest, and that the PUC gives deference to contracts negotiated among sophisticated parties. Under the specific facts of this case, however, the ALJs find that Petitioners met their burden of proof to show, under the Public Interest Rule, that the protested rate[3] is adverse to the public interest. The ALJs recommend that the Commission (1) find the rates charged by the District to be adverse to the public interest and (2) order that this case proceed to a cost-of-service inquiry that will assist the Commission in subsequently setting rates.

This is a case of first impression.[4] While the ALJs have set out the facts, law, parties' positions, and analysis at great length below, they provide a brief overview here to summarize the context and scope of this proceeding.

The District uses a non-resetting annual minimum methodology to allocate its revenue requirement among the Member Cities. A Member City's annual minimum is that city's highest historical water consumption. Each Member City is required to pay the District its annual minimum multiplied by the base rate for that year (which, broadly speaking, is derived by dividing the revenue requirement by the sum of all annual minimums for all Member Cities), whether or not that Member City takes water up to its annual minimum. Water used above the annual minimum is subject to an excess charge, and a new annual minimum is set. The District has the discretion at the end of a fiscal year to issue a rebate to Member Cities that use less than their annual minimums. The rebate is designed to refund only variable costs avoided by the District due to lower water use, and is thus relatively small compared to the base rate.

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[3] As discussed herein, the parties dispute what constitutes the protested rate(s). Because the ALJs find that the Commission's rules define "rate" broadly, the terms "rate(s)" and "protested rate(s)" both refer to the total compensation paid by Petitioners to the District for wholesale water.

[4] NTMWD Ex. 8 (Rubinstein Direct) at 13 ("However, neither the TCEQ [Texas Commission on Environmental Quality] nor the Commission has ever found a protested contractual wholesale water or sewer service rate to adversely affect the public interest . . . [and] there has never been a cost-of-service wholesale water hearing.").

Petitioners are cities that set their annual minimums between 2001 and 2008. After they set their annual minimums, due to slowing growth and the increasing importance of conservation as a statewide priority, Petitioners have consistently used considerably less than their annual minimums. At the same time, the other Member Cities have experienced faster growth and have set annual minimums in more recent years (one city in 2006, three in 2011, and five in 2016). The effective rate (a city's total bill, including excess charges and rebates, if any, divided by that city's actual consumption of water) paid by Petitioners has exceeded the effective rate paid by the other Member Cities for every year since 2001, and the gap has widened significantly since 2010. The amount of water that Petitioners have paid for, but have not taken from the District (undelivered water) has resulted in a total cost of $208 million, depicted in the table below.

Total Cost and Amount of Undelivered Water Since Each Petitioner Met Annual Minimum

Petitioner	Year Annual Minimum Established	Cost of Undelivered Water Since Annual Minimum Established
Richardson[5]	2001	$43,000,000
Mesquite[6]	2001/2008	$41,472,799
Plano[7]	2001	$88,488,763
Garland[8]	2006	$35,500,000
Total:		**$208,461,562**

The District also sells water to non-member wholesale customers, who collectively are the second-largest users of District water. Since 1970, the District has charged a premium of $0.05 over its base rate and excess charge rate to non-Member Cities. Funds the District obtains from outside wholesale customers directly reduce the revenue requirement the District demands from Member Cities. However, the $0.05 premium has remained static, effectively decreasing from a 21% premium in 1970 to 2% in 2017. Over the same time period, the District's base rate has increased by nearly 1,000%. The District recently embarked on the financing and construction of

[5] Pet. Ex. 3 (Johnson Direct) at 7.

[6] Pet. Ex. 4 (Dittman Direct) at 13. As discussed below, Mesquite's annual minimum was increased pursuant to a financing agreement with the District.

[7] Pet. Ex. 7 (Glasscock Direct) at 25.

[8] Pet. Ex. 6 (Baker Direct) at 7.

a $1.2 billion reservoir necessary to meet future regional water needs. Continued base rate increases—and thus continued effective rate disparities—are expected.

As discussed below, the ALJs find that the Public Interest Rule is triggered and Commission review of the protested rate is appropriate because Petitioners lack effective bargaining power vis-à-vis the District. Due to their disparate impact on Petitioners, the District's rates: have affected Petitioners' ability to provide retail service; evidence abuse of monopoly power by the District; and are unreasonably preferential, prejudicial, or discriminatory compared to the wholesale rates the District charges to Petitioners versus other Member Cities and non-member wholesale customers. For these reasons, the ALJs find the protested rate to be adverse to the public interest.

II. JURISDICTION, NOTICE, AND PROCEDURAL HISTORY

In its Preliminary Order issued June 29, 2017, the Commission found that it had authority over the Petition under Code §§ 12.013 and 13.043(f). However, the Preliminary Order charged the ALJs with confirming whether the facts established in this proceeding demonstrate that the requirements of the cited Code provisions have been satisfied in this case. The District and certain Member Cities (discussed below) argue that the Commission lacks jurisdiction under the facts presented. The parties do not contest whether they received adequate and timely notice of the hearing on the merits, but the District and some Member Cities assert that notice of the Petition itself was defective, preventing the Commission from exercising its jurisdiction.

As explained below, the ALJs agree with Petitioners and Commission staff (Staff) that the Commission has jurisdiction under either Code § 12.013 or § 13.043(f) to review the rates at issue. The State Office of Administrative Hearings (SOAH) has jurisdiction over matters related to the conduct of the hearing in this proceeding pursuant to Texas Government Code § 2003.049.

All of the Member Cities purchase wholesale water service from the District pursuant to an August 1, 1988 Regional Water Supply Facilities Amendatory Contract (Contract). The

Member Cities other than Petitioners are the Cities of Allen, Farmersville, Forney, Frisco, McKinney, Princeton, Rockwall, Royse City, and Wylie.

In a series of orders, the PUC ALJ granted motions to intervene in this proceeding filed by Rockwall, Princeton, and Wylie (January 4, 2017); McKinney and Royse City (January 23, 2017); Forney, Frisco and Allen (February 2, 2017); and Farmersville (February 7, 2017). Except for Royse City, which aligned its interests with Petitioners at the hearing on the merits, the remaining Member Cities (Intervenors)[9] opposed the Petition and were aligned with the District. Staff took a position generally in agreement with Petitioners.

On June 29, 2017, the Commission adopted Staff's recommendation regarding the sufficiency of the Petition and deemed the Petition administratively complete. On the same date, the Commission issued its Preliminary Order and referred the Petition to SOAH for an evidentiary hearing on the public interest. A prehearing conference was convened on August 16, 2017, and a procedural schedule was established in SOAH Order No. 4, issued August 28, 2017. Another prehearing conference was held March 27, 2018, after which the procedural schedule was extended and the hearing on the merits reset to October 2018.[10] The parties to this case are also parties to PUC Docket No. 47863, involving Petitioners' protest of the District's 2018 wholesale rates, which is abated pending resolution of the instant case.[11]

A final prehearing conference was held on October 12, 2018, at which the parties discussed procedures for the hearing. The hearing on the merits convened October 14-18, 2018.

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[9] "Intervenors" is used to refer to all Member Cities other than Petitioners and Royse City. Even though Royse City intervened in this case, its interests were not aligned with the Intervenors and it is not included in that group.

[10] The hearing on the merits was initially scheduled to convene May 14-18, 2018. Due to the sudden and unexpected death of Judd Sanderson, a key witness for the District, the proceeding was abated from March 9 to May 4, 2018, and the hearing was reset to October 2018. *See* SOAH Order Nos. 11-13. Mr. Sanderson's pre-filed testimony was adopted by District witness Rodney Rhoades, although the testimony and related exhibits continue to bear Mr. Sanderson's name.

[11] *Petition of the Cities of Garland, Mesquite, Plano, and Richardson Appealing the Decision by North Texas Municipal Water District Affecting 2018 Wholesale Water Rates*, Docket No. 47863, SOAH Docket No. 473-18-1905 (referred to SOAH on March 8, 2018). At the request of the parties and pursuant to 16 TAC § 24.319 (Commission Order to Discourage Succession of Rate Disputes), the cases were not consolidated. *See* SOAH Order No. 13.

Post-hearing initial briefs were filed by Petitioners, the District, Staff, Frisco and Forney (Frisco & Forney), McKinney, and Royse City. Allen, Farmersville, Princeton, and Wylie did not file an initial brief but reserved the right to file a reply brief. All of the parties that filed initial briefs also filed reply briefs. Farmersville, Princeton, and Wylie filed a reply brief stating that they supported the initial briefs filed by the District, McKinney, and Frisco & Forney.[12] After proposed findings of fact and conclusions of law were filed, the record closed January 18, 2019.[13]

III. FACTUAL BACKGROUND

Certain facts are undisputed.[14] The District was created by the Texas Legislature in 1951 with 10 original Member Cities (all of the current Member Cities except Allen, Frisco, and Richardson) in accordance with state laws that set out its governance (collectively, the District's Enabling Act).[15] Richardson became a Member City in 1965.[16] In 1988, the 11 then-existing Member Cities entered into the Contract. Allen became a Member City in 1998, and Frisco in 2001.[17] The contracts entered into by Allen and Frisco are substantively identical to the Contract, and all 13 current Member Cities as well as the District are considered parties to a single Contract.[18]

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[12] Allen was not named as joining in this filing. The ALJs are unaware of any reason for the omission.

[13] In addition to the briefing submitted by the parties, the ALJs received a *Brief of Amicus Curiae in Support of NTMWD's Public Interest Standard Defense*, filed on the due date for reply briefs, by the Lower Neches Valley Authority, the Sabine River Authority of Texas, Tarrant Regional Water District, and the Trinity River Authority (Amicus Brief). Amicus briefs are not commonly filed in SOAH proceedings. However, no party filed a response to the Amicus Brief or a motion opposing its consideration. The ALJs have reviewed and considered the Amicus Brief but do not discuss it directly in this PFD.

[14] Some of these facts are drawn from an October 16, 2018 Agreed Motion Regarding Entry of Stipulations (Stipulations), which the parties submitted with the proviso that the Stipulations apply solely to this public-interest phase and do not bind any party if this matter proceeds to a cost-of-service hearing.

[15] The District is a political subdivision of the State of Texas, created pursuant to Art. XVI, § 59 of the Texas Constitution by legislative Act of April 4, 1951, 52nd Leg., R.S., ch. 62, § 14, 1951 Tex. Gen. Laws 96, 103-04; Act of April 24, 1969, 61st Leg., R.S., ch. 122, 1969 Tex. Gen. Laws 334, 334-337; Act of April 23, 1975, 64th Leg., R.S. ch. 90, 1975 Tex. Gen. Laws 238, 238-242; Act of April 28, 2009, 81st Leg., R.S., ch. 20, 2009 Tex. Gen. Laws 37, 37-40 (West) (collectively, the District's Enabling Act); NTMWD Ex. 5 (Sanderson Direct) at JRS-1.

[16] Transcript of the Hearing on the Merits (Tr.) at 91; NTMWD Ex. 5 (Sanderson Direct) at JRS-1 at 3.

[17] NTMWD Ex. 1 (Kula Direct) at TK-1 at 7.

[18] NTMWD Ex. 1 (Kula Direct) at TK-1 at 7. Because no party alleged that the District's contracts with Allen and/or Frisco have any substantive variations from the Contract, no references are made in this PFD to individual contracts.

Pursuant to the District's Enabling Act, the District's Board of Directors (Board) is composed of 25 members, with each Member City (through its respective city council) being entitled to appoint two directors for staggered two-year terms (Farmersville appoints only one director based on its size).[19] The Board adopts the District's budget, approves capital improvements, sets rates, establishes policies, oversees the work of the District's Executive Director, and approves specific projects and contracts.[20]

Any change to the Contract requires unanimous consent of the 13 Member Cities and the District. The Contract states that "[n]o change or modification of the Contract shall be made without the written consent of all parties hereto."[21] The term of the Contract is based on the outstanding debt of the District and the useful life of the District's system. Specifically, the Contract provides that it "shall continue in force and effect until all Bonds and all interest thereon shall have been paid or provided for, and thereafter shall continue in force and effect during the entire useful life of the [District's water supply] System."[22]

The Contract was executed on the basis that the District's then-existing sources of water were "inadequate to provide known future treated water requirements" of the Member Cities.[23] The Contract recognized that the District had "assumed the responsibility for supplying all treated water needs" of the Member Cities, and contemplated that the District would "acquire, construct, and complete additional surface water supply and treatment facilities" at Lake Texoma on the Red River, Cooper Dam and Reservoir in Hopkins and Delta Counties, and a proposed new dam and reservoir in Fannin County.[24]

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[19] NTMWD Ex. 1 (Kula Direct) at 17.

[20] NTMWD Ex. 1 (Kula Direct) at 16.

[21] NTMWD Ex. 5 (Sanderson Direct) at JRS-1 at 41.

[22] NTMWD Ex. 5 (Sanderson Direct) at JRS-1 at 38.

[23] NTMWD Ex. 5 (Sanderson Direct) at JRS-1 at 2.

[24] NTMWD Ex. 5 (Sanderson Direct) at JRS-1 at 3.

The first two projects described in the Contract are operational: the District currently has water supplies at Lake Texoma and Cooper Dam (Chapman Lake). Permitting, financing, and construction has begun on the Lower Bois d'Arc Creek Reservoir (Bois d'Arc Reservoir) in Fannin County, which is expected to make available 108 million gallons per day (MGD) of water at an estimated project cost of $1.2 billion.[25] As of the date of the hearing, the District provided wholesale water to meet the needs of nearly 1.7 million people (retail customers of the Member Cities and other District customers) in a 10-county region encompassing a 2,200 square mile service area.[26]

The District's fiscal year (FY) is the 12-month period from October 1 to September 30, and is consistent with the fiscal years of the Member Cities.[27] The District's "water year," which is used to calculate amounts due for each new fiscal year, is the 12-month period from August 1 to July 31.[28] Each year, the District calculates its Annual Requirement, which consists of total budgeted expenditures including operation and maintenance costs, bond service, and capital investment costs for repair, replacement, maintenance, or expansion of facilities.[29] For FY 2017, the Annual Requirement was $294,086,144.[30] The District's Revenue Requirement is the Annual Requirement less other revenues received, such as revenue from wholesale water sales to non-Member Cities. For FY 2017, the Revenue Requirement was $240,426,209.[31]

Each Member City has an Annual Minimum equal to its highest historical annual use of the District's water system,[32] expressed in gallons. The District calculates a Member City Rate

[25] NTMWD Ex. 1 (Kula Direct) at 15. The project cost is expressed in 2016 dollars. *Id.*

[26] NTMWD Ex. 2 (Rickman Direct) at 6.

[27] NTMWD Ex. 5 (Sanderson Direct) at 11.

[28] NTMWD Ex. 1 (Kula Direct) at TK-1 at 1.

[29] NTMWD Ex. 5 (Sanderson Direct) at 14.

[30] NTMWD Ex. 5 (Sanderson Direct) at 16.

[31] NTMWD Ex. 5 (Sanderson Direct) at 16.

[32] NTMWD Ex. 5 (Sanderson Direct) at 11 and JRS-1 at 24-27. In some cases, the Annual Minimum may be greater than the highest historical use if agreed to by the District and the Member City. One such instance (Mesquite) is at issue in this case and is discussed below under Issue 5.c.i. of this PFD.

for each fiscal year by dividing the Revenue Requirement by the total Annual Minimums for all Member Cities. In FY 2017, the total Annual Minimums of all Member Cities equaled 95,030,122,000 gallons, and therefore the Member City Rate was $2.53 per 1,000 gallons of water. Under the Contract, every Member City is "unconditionally liable, without offset or deduction," for its Annual Minimum and is "deemed to have taken and used the minimum annual average daily amount" of water, "regardless of whether or not such amount is or was actually taken or used[.]"[33] In FY 2017, the Annual Minimums and amounts due based on the Member City Rate of $2.53 per 1,000 gallons for the Member Cities were as follows:[34]

Member City	Annual Minimum (Gallons) FY 2017	Year Established (Water Year)	Obligation (at $2.53 per 1,000 gallons) FY 2017	Percentage FY 2017
Richardson	11,019,311,000	2001	$34,716,546.15	14.4%
Mesquite	8,297,666,000	2001/2008[35]	$20,993,094.98	8.7%
Plano	26,719,809,000	2001	$67,601,116.77	28.1%
Garland	13,721,955,000	2006	$27,878,856.83	11.6%
Allen	6,011,208,000	2011	$15,208,356.24	6.3%
Farmersville	280,467,000	2006	$709,581.51	0.3%
Forney	1,849,256,000	2016	$4,678,617.68	1.9%
Frisco	10,225,090,000	2016	$25,869,477.70	10.8%
McKinney	485,886,000	2016	$1,229,291.58	0.5%
Princeton	10,762,780,000	2011	$27,229,833.40	11.3%
Rockwall	3,330,881,000	2011	$8,427,128.93	3.5%
Royse City	448,255,000	2016	$1,134,085.15	0.5%
Wylie	1,877,558,000	2016	$4,750,221.74	2.0%
TOTALS	**95,030,122,000**		**$240,426,208.66**	**100%**

The District also calculates an Excess Charge per 1,000 gallons of water used by a Member City in excess of its Annual Minimum. Pursuant to the Contract, the Excess Charge is

[33] NTMWD Ex. 5 (Sanderson Direct) at 20 and JRS-1 at 24.

[34] The ALJs generated this chart by combining two charts from the parties' Stipulations. *See* Stipulations at 7-8.

[35] The parties stipulated that the Annual Minimum for Mesquite was "established by 2001 Water Year consumption of 7,798,284,000 gallons plus an additional Annual Minimum of 499,382,000 gallons per the June 17, 2002 Agreement for Additional Water under [the District's] Policy Number 8." Stipulations at 7. The dispute between the District and Mesquite over interpretation and application of Policy No. 8 is discussed below under Issue 5.c.i.

equal to "that part of the Operation and Maintenance Expenses (electrical power, chemicals, and other similar costs) directly attributable to supplying such excess treated water" to the Member City.[36] In FY 2017, the Excess Charge was $0.41 per 1,000 gallons.[37] The Excess Charge is intended to "cover[] the District's additional, unbudgeted costs to provide water service in excess of the budgeted . . . Annual Minimum volumes."[38]

In 1993, the Board adopted Policy 19, known as the Rebate Policy. If a Member City consumes less than its Annual Minimum "and the District doesn't need all of the money it budgeted to cover certain variable costs," the Rebate Policy allows the District to "refund funds back to Member Cities . . . to recognize the District's cost savings."[39] The Rebate Policy is not mandatory, but rebates have been issued in all but two years since the policy was adopted.[40]

The District enters into wholesale water contracts with non-Member Cities (Customer Cities) and had 34 such contracts in FY 2017. Customer Cities pay the Member City Rate (and, when applicable, the Excess Charge) plus a premium of $0.05 per 1,000 gallons, frequently referred to by the parties as the Nickel Premium.[41] Thus, a Customer City in FY 2017 paid $2.58 per 1,000 gallons for the annual minimum specified in that Customer City's contract with the District. Water used by a Customer City in excess of that city's annual minimum was charged at $0.46 per 1,000 gallons.[42] The Nickel Premium has been constant since 1970, prior to the 1988 execution of the Contract, and is a subject of dispute in this case.

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[36] NTMWD Ex. 5 (Sanderson Direct) at 10-11 and JRS-1 at 33-34.

[37] NTMWD Ex. 5 (Sanderson Direct) at 11.

[38] NTMWD Ex. 5 (Sanderson Direct) at 38.

[39] NTMWD Ex. 5 (Sanderson Direct) at 45.

[40] NTMWD Ex. 5 (Sanderson Direct) at 47. Rebates were not issued in 1996 because the total rebate for all Member Cities was small ($217.68), and in 1998 because all Member Cities exceeded their Annual Minimums. *Id.* at 47-48.

[41] NTMWD Ex. 5 (Sanderson Direct) at 35. One Customer City, the City of Bonham, has a different arrangement with the District that is immaterial for purposes of this case. *Id.* at 11, 69.

[42] NTMWD Ex. 5 (Sanderson Direct) at 69-70. Some "more recent contracts" with Customer Cities specify that instead of the Excess Charge plus the Nickel Premium, the Customer City shall pay "the full Member City Rate" (*i.e.*, in 2017, $2.53 per 1,000 gallons) for volumes of water in excess of the Customer City's specified annual minimum. *Id.* at 70.

IV. LEGAL FRAMEWORK

This Proposal for Decision (PFD) addresses various legal questions in the same sequence as set forth by the Commission in the list of issues contained in the Preliminary Order. Therefore, this section provides an overview of the relevant legal provisions without extensive discussion.

Code §§ 12.013 and 13.043(f) are the primary provisions invoked with respect to the PUC's jurisdiction. Code § 12.013(a) states that the Commission shall "fix reasonable rates for the furnishing of raw or treated water for any purpose mentioned in Chapter 11 or 12 of this [C]ode." Jurisdiction under this provision encompasses "political subdivision[s]" such as water districts.[43] The Commission, in "reviewing and fixing reasonable rates for furnishing water" may use "any reasonable basis for fixing rates as may be determined" by the Commission to be "appropriate under the circumstances of the case" provided that the rate may not be "less than the amount required to meet the debt service and bond coverage requirements" of a political subdivision's outstanding debt.[44]

Code § 13.043(f) relates to appellate jurisdiction and allows a retail public utility that receives water or sewer service from a political subdivision of the state to "appeal to the [Commission] a decision of the provider of water or sewer service affecting the amount paid for water or sewer service." Appeals must be initiated by the retail public utility's filing of a petition with the PUC "within 90 days after the date of notice of the decision is received" from the provider.[45] In an appeal under Code § 13.043, the Commission is directed to "ensure that every rate made, demanded, or received by any retail public utility [is] just and reasonable."[46] The rates may not be "unreasonably preferential, prejudicial, or discriminatory" and "shall be sufficient,

[43] Texas Water Code (Code) § 12.013(b).

[44] Code § 12.013(c).

[45] Code § 13.043(f).

[46] Code § 13.043(j).

equitable, and consistent in application to each class of customers."[47] As with Code § 12.013(c), the Commission must set rates using a methodology "that preserves the financial integrity of the retail public utility."[48]

The Issues in the Preliminary Order track the subsections of the Public Interest Rule (16 TAC § 24.311). For reference, subsection (a) of that rule reads as follows:

> (a) The commission shall determine the protested rate adversely affects the public interest if after the evidentiary hearing on public interest the commission concludes at least one of the following public interest criteria have been violated:
>
> (1) the protested rate impairs the seller's ability to continue to provide service, based on the seller's financial integrity and operational capability;
>
> (2) the protested rate impairs the purchaser's ability to continue to provide service to its retail customers, based on the purchaser's financial integrity and operational capability;
>
> (3) the protested rate evidences the seller's abuse of monopoly power in its provision of water or sewer service to the purchaser. In making this inquiry, the commission shall weigh all relevant factors. The factors may include:
>
> (A) the disparate bargaining power of the parties, including the purchaser's alternative means, alternative costs, environmental impact, regulatory issues, and problems of obtaining alternative water or sewer service;
>
> (B) the seller's failure to reasonably demonstrate the changed conditions that are the basis for a change in rates;

[47] Code § 13.043(j).

[48] Code § 13.043(j).

(C) the seller changed the computation of the revenue requirement or rate from one methodology to another;

(D) where the seller demands the protested rate pursuant to a contract, other valuable consideration received by a party incident to the contract;

(E) incentives necessary to encourage regional projects or water conservation measures;

(F) the seller's obligation to meet federal and state wastewater discharge and drinking water standards;

(G) the rates charged in Texas by other sellers of water or sewer service for resale; or

(H) the seller's rates for water or sewer service charged to its retail customers, compared to the retail rates the purchaser charges its retail customers as a result of the wholesale rate the seller demands from the purchaser; or

(4) the protested rate is unreasonably preferential, prejudicial, or discriminatory, compared to the wholesale rates the seller charges other wholesale customers.

The Commission has directed that this proceeding will be conducted in two distinct phases. Because this case involves review of a wholesale rate, the first phase is an evidentiary hearing in which Petitioners have the burden of proof to show that the "protested rate is adverse to the public interest."[49] If, and only if, the Commission finds the rate to be adverse to the public interest, this matter will be remanded to SOAH[50] for a second phase in which the District would "have the burden of proof in evidentiary proceedings on determination of cost of service."[51]

[49] 16 TAC §§ 24.307(b), .317.

[50] 16 TAC § 24.313(b).

[51] 16 TAC § 24.317.

V. PRELIMINARY ORDER ISSUES

The Preliminary Order identifies 21 Issues, including subparts, for the ALJs to address. The principal arguments in this proceeding center on the first five Issues. Most of the remaining issues were settled by stipulation and are so noted. For Issues 6 through 21, the Preliminary Order states that the applicable time period is "that period that determined the rates being challenged" by Petitioners.[52]

A. Issue 1: Do the Facts Demonstrate that the Commission has Authority under Code § 12.013 to Hear this Appeal?

The ALJs find that the Commission has jurisdiction under Code § 12.013 to consider the Petition because of the plain statutory language. Whether the Commission may set rates under Code § 12.013 is dependent on the answers to Issues 4-5, *i.e.*, on the existence of facts showing the rate charged is contrary to the public interest.

1. Arguments of Petitioners and Staff

Petitioners assert that the Commission has jurisdiction under the plain language of Code § 12.013 because the provision is broad in its scope, referring to "reasonable rates for the furnishing of raw or treated water *for any purpose* mentioned in Chapter 11 or 12" of the Code.[53] Petitioners note that one purpose mentioned in Code chapter 11 for which water may be appropriated, stored, or diverted is "municipal uses, including water for sustaining human life and the life of domestic animals."[54] Staff concurs that the PUC has jurisdiction under Code § 12.013.[55]

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[52] Preliminary Order at 23.

[53] Code § 12.013(a) (emphasis added).

[54] Code § 11.023(a)(1).

[55] Staff's Initial Brief at 5-6.

2. Arguments of the District and Frisco & Forney

The District acknowledges the "Commission has the expertise to address wholesale water rate matters when a rate adversely affects the public interest," but contends that, for either Code § 12.013 or § 13.043(f), the Public Interest Rule operates as a "*prima facie* test . . . before jurisdiction may attach."[56] Thus, the District concludes that the Commission "does not have the authority under [Code] § 12.013 to hear this appeal" because Petitioners failed to show that the rates set pursuant to the Contract meet the criteria listed in the Public Interest Rule.[57]

After recognizing that Code § 12.013 is "a broad grant of authority to the Commission," Frisco & Forney argue that laches bars Petitioners from obtaining relief under that section.[58] Laches "is a defense intended to protect parties from prejudice to their position by preventing a complainant from obtaining its requested relief when the complainant delays unreasonably in pursuing its rights."[59] Assertion of laches requires a showing that a party having legal or equitable rights delayed unreasonably in pursuing its rights, and that another party made a good-faith change of position and is detrimentally affected by the delay.[60]

Frisco & Forney point out that the Contract was executed in 1988 and, "as early as 1992," the "then-city manager [of Plano] wrote to the District asking for rebates 'when wet weather conditions cause reductions in water consumption beyond our control.'"[61] Based on this letter, Frisco & Forney assert that Petitioners engaged in unreasonable delay because they are challenging the Contract rate "at least 25 years after perceiving the method [to be] inequitable[.]"[62]

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[56] District's Reply Brief at 3.

[57] District's Initial Brief at 8.

[58] Frisco & Forney's Reply Brief at 1; Frisco & Forney's Initial Brief at 12.

[59] Frisco & Forney's Initial Brief at 11.

[60] Frisco & Forney's Initial Brief at 11, citing *City of Fort Worth v. Johnson*, 388 S.W.2d 400, 403 (Tex. 1964).

[61] Frisco & Forney's Initial Brief at 12 (citing Pet. Ex. 7 (Glasscock Direct) at 23).

[62] Frisco & Forney's Initial Brief at 12.

Further, according to Frisco & Forney, Frisco had other sources of water from which to choose when it became a Member City in 2001. It made the decision to join the District because the Contract's "annual minimum take-or-pay provision was a clear, rational, and fair method of allocating costs."[63] Some alternative cost allocation scenarios discussed during this hearing would increase Frisco's costs under the contract by "up to 11% or approximately $4,000,000 per year."[64] In Frisco & Forney's view, Frisco relied in good faith on the Contract as written, and will be unfairly prejudiced if the rate is adjusted.

Frisco & Forney also challenge Staff's alleged change in position, based on briefing Staff submitted to the PUC prior to this case being referred to SOAH.[65] As noted in the Preliminary Order, Staff initially stated that the PUC's authority under Code § 12.013 was limited to "retail public utilities selling state waters (meaning surface water)."[66] The Commission rejected that argument and found that the type of entity furnishing water was not mentioned in the section and that case law established the Commission's jurisdiction was not limited to cases in which a water supplier appropriated state water.[67]

3. ALJs' Analysis

The ALJs concur with the Commission's finding in the Preliminary Order that the "express language of section 12.013 of the Water Code authorizes the Commission to hear and decide this rate appeal and complaint."[68] The scope of the section is sweeping and refers to fixing the rates to be charged for furnishing raw or treated water "for any purpose" mentioned in chapters 11 or 12 of the Code. Water districts are specifically cited in the statute as "political subdivision[s]" over

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[63] Frisco & Forney's Initial Brief at 12.

[64] Frisco & Forney's Reply Brief at 1-2 (citing testimony of Petitioners' expert witness Dr. Bente Villadsen).

[65] Frisco & Forney's Reply Brief at 1. Frisco & Forney state that both Petitioners and Staff initially contested the Commission's jurisdiction under Code § 12.013, citing the Preliminary Order. However, on the pages cited by Frisco & Forney, the Preliminary Order refers to arguments made by Staff and by Royse City, not Petitioners.

[66] Preliminary Order at 6.

[67] Preliminary Order at 7 (citations omitted).

[68] Preliminary Order at 8.

which the Commission may exercise jurisdiction under Code § 12.013. The water furnished by the District is for municipal use, a purpose mentioned in Code § 11.023(a)(1).

Frisco & Forney's argument that laches bars Petitioners from seeking relief in this proceeding is unavailing. The only evidence of unreasonable delay cited by Frisco & Forney is a 1992 letter requesting rebates. That letter, written by one city manager for one of the Petitioners, is meager proof to show that Petitioners recognized their legal and equitable rights and then engaged in unreasonable delay in asserting such rights. Moreover, the ALJs find no significance in the asserted change in position by Staff. Staff made the argument cited by Frisco & Forney at a time when the Commission was considering the District's motion to dismiss.[69] Frisco & Forney cite no basis on which Staff must be required to adhere to that argument. Also, once this case was docketed at SOAH, Staff's position has been consistent.

As for the District's treatment of the Public Interest Rule as a threshold test before jurisdiction attaches under Code § 12.013, the ALJs find that the District is conflating the Commission's authority to hold a public interest hearing under Code § 12.013, and its authority to set rates under Code § 12.013, into a single question. These are distinct issues. The Commission is empowered to inquire into the public interest effects of the Member City Rate, the Excess Charge, and rate-related issues because the grant of authority under Code § 12.013 is broad. Then, the Commission will remand this case to SOAH for a cost-of-service hearing only if the public interest inquiry demonstrates that the rates are adverse to the public interest. As Staff notes, "[b]ecause no decision has been made as to whether the [rate] adversely affects the public interest, there currently is no bar to the Commission's rate-fixing power as set forth" in Code § 12.013.[70] Thus, the District is mistaken in stating that the "facts demonstrate that the Commission does not have authority under [Code] § 12.013 to hear this appeal."[71] The Commission may hear this appeal, and at its conclusion will decide whether a cost-of-service study should be ordered.

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[69] Preliminary Order at 3.

[70] Staff's Reply Brief at 4.

[71] District's Initial Brief at 8.

B. Issue 2: Do the Facts Demonstrate that the Commission has Authority under Code § 13.043(f) to Hear this Appeal?

It is undisputed that: the District is a political subdivision of the State of Texas; Petitioners are retail public utilities; on September 23, 2016, the District notified all Member Cities of the FY 2017 Member City Rate and Excess Charge; and the Petition was filed on December 14, 2016, within 90 days of receipt of the District's notification regarding FY 2017 rates.[72] Petitioners, Staff, and Royse City take the position that the jurisdictional prerequisites of Code § 13.043(f) are satisfied, and further, that the Commission may consider the "total compensation" paid to the District in FY 2017, including in that review the application of the Annual Minimums, Rebate Policy, and other issues as they bear on the public interest inquiry.

The District repeats its argument that the Public Interest Rule (16 TAC § 24.311) is a "*prima facie* test required . . . before jurisdiction may attach."[73] The District and Frisco & Forney go on to assert that, even if Petitioners had properly invoked jurisdiction under Code § 13.043(f), only the Member City Rate and the Excess Charge were included in the rate "decision" that the District made for FY 2017, and other matters—such as the Annual Minimums (set in prior years) and the FY 2017 rebate (determined after the 90-day appeals window closed)—were not timely challenged by Petitioners and may not be considered by the PUC.

The parties also dispute whether the Commission's jurisdiction is limited because the contested rates are set pursuant to a contract, which the ALJs address under Issue 4, below.

1. Arguments of Petitioners, Staff, and Royse City

Petitioners and Staff argue that Code § 13.043(f) is broad in scope and permits the PUC to review the total compensation paid by Petitioners, including "application of the contractual

[72] The parties dispute whether the Petition met certain filing requirements, discussed under Issue 3. However, the parties agree that the Petition was filed within 90 days of receipt of the District's notification regarding FY 2017 rates.

[73] District's Reply Brief at 3.

take-or-pay minimums."[74] This is because the Commission's rules define "protested rate" to mean the "rate demanded by the seller,"[75] and in turn, "rate" is defined to include:

> [E]very compensation, tariff, charge, fare, toll, rental, and classification or any of them demanded, observed, charged, or collected, whether directly or indirectly, by any retail public utility, or water or sewer service supplier, for any service, product, or commodity described in [Code] § 13.002(23), and any rules, regulations, practices, or contracts affecting any such compensation, tariff, charge, fare, toll, rental, or classification.[76]

Petitioners also cite the statement in the Preliminary Order that the public interest is a "fact intensive concept that can be brought into focus only by a complete understanding of all the relevant facts."[77] Thus, Petitioners, Staff, and Royse City point out, the relevant facts such as the Rebate Policy, the rates charged to Customer Cities, and the Nickel Premium are all matters that bear on the factors in the Public Interest Rule and should be considered in reviewing the District's FY 2017 "rate(s)."[78] Furthermore, the Annual Minimums are "an inextricable part of the decision affecting the amount paid for water service," per Staff.

As with Code § 12.013, Petitioners and Staff reject the District's application of the Public Interest Rule as a *prima facie* test that must be met before the PUC takes jurisdiction under Code § 13.043(f). Rather, as Staff explains, a finding that a rate is adverse to the public interest "only impacts the procedural trajectory of a case filed under [Code] § 13.043 *after* the Commission has exercised its jurisdiction over the public interest phase of the proceeding."[79]

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[74] Petitioners' Reply Brief at 7.

[75] 16 TAC § 24.303(2).

[76] 16 TAC § 24.3(54).

[77] Petitioners' Reply Brief at 9 (citing Preliminary Order at 21).

[78] Petitioners' Reply Brief at 8-9; Staff's Reply Brief at 5; Royse City's Reply Brief at 6-7.

[79] Staff's Reply Brief at 4 (emphasis added).

2. Arguments of the District and Frisco & Forney

The District deems the Public Interest Rule to be a "necessary jurisdictional prerequisite, not a pro forma requirement."[80] Because, according to the District, Petitioners did not establish adverse impact sufficient to meet the factors described under the Public Interest Rule, the "facts demonstrate that the Commission does not have authority under [Code] § 13.043(f) to hear this appeal."[81]

The District argues that the purpose of the 90-day deadline in Code § 13.043(f) is to ensure that decisions made by a water supplier are appealed in a timely manner; failure to meet the deadline strips the Commission of jurisdiction over matters untimely pleaded. Joined by Frisco & Forney, the District reasons that Petitioners may not challenge any decision other than the FY 2017 Member City Rate and the Excess Charge because those other decisions "occurred well before the Fiscal Year 2017 rates were approved or well after the 90-day period."[82]

Specifically, the "allocation methodology that relies on Annual Minimums" was approved when the Contract was executed in 1988; the Nickel Premium is a continuation of a premium set in 1970;[83] the Rebate Policy was adopted in 1993; Plano, Richardson, and Mesquite established their Annual Minimums in 2001; Mesquite increased its Annual Minimum in 2002 by agreement with the District; and Garland set its Annual Minimum in 2006.[84] All of those "decisions" took place long before the Petition was filed. The District adds that the FY 2017 rebate amount was a decision made in September 2018, well outside the 90-day window after the District notified all Member Cities of the FY 2017 Member City Rate and Excess Charge.[85]

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[80] District's Reply Brief at 3.

[81] District's Initial Brief at 8.

[82] District's Initial Brief at 9; Frisco & Forney's Initial Brief at 14.

[83] The Nickel Premium's history and its impact on Member Cities versus Customer Cities is discussed under Issue 5.d. below.

[84] District's Initial Brief at 9.

[85] District's Initial Brief at 9.

According to Frisco & Forney, the only "decision" made by the Board that affects the cost of water is "the setting of the District's annual budget."[86] Once the budget is determined, the amounts due from each Member City are determined by "a mathematical calculation that is not a discretionary act or decision by the Board."[87] Therefore, the Commission has jurisdiction only over the District's "decision to approve its Fiscal Year 2017 budget."[88]

3. ALJs' Analysis

As with Code § 12.013, the District blurs the distinction between the Commission's right to hold a public interest inquiry under Code § 13.043(f) and its authority under that provision to examine the District's cost of service and set rates. The only threshold requirements stated in Code § 13.043(f) are that the appellant must be a retail public utility receiving water from another retail public utility or a political subdivision of the state; the appeal must be of a "decision of the provider of water . . . affecting the amount paid for water"; and, the appeal must be filed within 90 days after notice of the rate decision is received by the appellant. These requirements are met, and therefore the Commission's appellate jurisdiction is invoked and the Commission has authority to review whether the public interest is adversely affected by the District's FY 2017 rates. Staff explains, and the ALJs concur, that a finding that the District's rate "is adverse to the public interest is not among [the] jurisdictional requirements" of Code § 13.043(f).[89]

As to the question of what "rate" is subject to review, the ALJs find that the broad definition used by Petitioners and Staff is supported by the statutory language, PUC rules, and common sense. The statute refers to the "amount paid for water" by the retail public utility. Code § 13.043(j) states that for an appeal under Code § 13.043, the Commission "shall ensure that *every rate* made, demanded or received . . ." meets the criteria of being just and reasonable, not

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[86] Frisco & Forney's Initial Brief at 14 (citing Tr. at 753).

[87] Frisco & Forney's Initial Brief at 14 (citing Tr. at 752).

[88] Frisco & Forney's Initial Brief at 14.

[89] Staff's Reply Brief at 4.

unreasonably preferential, prejudicial, or discriminatory, and sufficient, equitable, and consistent in application to each class of customers.[90]

Similarly, the definition of "rate" in PUC rules (16 TAC § 24.3(54)) is written very broadly and specifically includes "any rules, regulations, practices, or contracts affecting any such [rate]." This language encompasses the Contract's rate-setting mechanism as well as practices such as the Rebate Policy and the Nickel Premium.

The constricted definition of the 90-day window espoused by the District and Intervenors would render the Commission's jurisdiction under Code § 13.043(f) effectively meaningless and contradicts the position expressed in the preamble to the Public Interest Rule. Under the District's narrow reading, Petitioners would have had only 90 days after the Contract was executed in August 1988 to protest the impact of the Annual Minimums. The Commission would then have had very little evidence to consider, given that the Contract would have been in effect for at most three months, well before Petitioners actually set the Annual Minimums at issue in this case. And, the preamble to the Public Interest Rule specifically refers to situations where "[o]ver time" the seller exercises near monopoly power, negating the narrow reading of Code § 13.043(f) proposed by the District and Frisco & Forney.[91]

Notably, the District implicitly adopts a broader definition of "rate" when considering whether the protested rate has an effect on incentives necessary to promote water conservation (discussed below). In that discussion, the District suggests that the Rebate Policy and the Contract's use of Annual Minimums promotes conservation, using a broader concept of "rate" that is more in line with what Petitioners support.

The ALJs determine that the "rates" Petitioners appealed under Code § 13.043(f) are the Member City Rate and the Excess Charge, and that the appeal of those rates requires consideration

[90] Code § 13.043(j) (emphasis added).

[91] 19 Tex. Reg. 6228 (Aug. 9, 1994).

of related "rules, regulations, practices, and contracts" such as the Annual Minimums, the Rebate Policy, and the Nickel Premium. Therefore, the protested rate encompasses the total compensation paid to the District.

C. Issue 3: Was the Petition Filed in Accordance with Code § 13.043(f) and 16 TAC § 24.305?[92]

The parties' contentions regarding the 90-day filing requirement of Code § 13.043(f) are addressed above. Petitioners assert that the Petition also met all filing requirements of 16 TAC § 24.305.[93] The District and Frisco & Forney find the Petition deficient because they deem the Customer Cities and the District's bondholders to be "appropriate parties" within the scope of 16 TAC § 24.305, and they were not given notice of the Petition. The District also complains that copies of some necessary contracts were not attached to the Petition. As discussed herein, the ALJs find the filing requirements of 16 TAC § 24.305 were met.

1. Arguments of Petitioners and Staff

Petitioners and Staff identify five requirements within 16 TAC § 24.305 and state that all were satisfied: the Petition was filed in writing; the Petition was served on the party against whom Petitioners seek relief (the District) and "other appropriate parties" (the other Member Cities); the Petition stated the statutory authority for the appeal (Code § 13.043(f)), alleged facts supporting Petitioners' assertion that the District's rates adversely affected the public interest, and listed the relief being sought; a copy of the Contract, by which the District charges the contested rates, was attached to the Petition; and the 90-day filing requirement of Code § 13.043(f) was met.[94]

Petitioners also observe that, prior to this matter being docketed at SOAH, the District raised the same arguments it makes now, namely that not all "appropriate parties" were notified

[92] The Preliminary Order references 16 TAC § 24.130, which was renumbered (effective October 17, 2018) to 16 TAC § 24.305.

[93] Petitioners' Initial Brief at 15.

[94] Petitioners' Initial Brief at 7-8; Staff's Initial Brief at 6-7.

and not all "applicable contracts" were attached to the Petition. Petitioners[95] and Staff directly addressed those arguments, and Staff stood by its recommendation that the Petition was administratively complete.[96] The Commission agreed and found the Petition administratively complete by order dated June 29, 2017.[97]

2. Arguments of the District and Frisco & Forney

The District and Frisco & Forney see Customer Cities as "appropriate parties" because (as discussed below under Issue 5) any increase in revenues obtained from Customer Cities directly reduces amounts due from Member Cities, and one of Petitioners' arguments is that the Nickel Premium is too low.[98] Thus, if the Commission finds in Petitioners' favor, Customer Cities will "unquestionably be affected"[99] and should have had an opportunity to respond to the Petition. The District also finds that bondholders are appropriate parties based on the wording of the Petition, the terms of the Contract, and "several statutes establishing the legality and validity of the [Contract,] which specifically recognize [bondholders'] rights and interests."[100]

The District maintains that in addition to the Contract, the Petition should have included a copy of Policy No. 8 (as discussed under Issue 5.c.i., this is a financing mechanism through which Mesquite's Annual Minimum was increased), and a copy of one or more of the District's contracts with Customer Cities.[101]

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[95] Petitioners' Reply to District's Response to Commission Staff's Recommendation (January 27, 2017).

[96] Commission Staff's Reply to District's Response on Sufficiency (January 30, 2017).

[97] Commission's Order No. 8 Deeming Petition Administratively Complete (June 29, 2017).

[98] District's Initial Brief at 10; Frisco & Forney's Initial Brief at 15.

[99] Frisco & Forney's Initial Brief at 15.

[100] District's Initial Brief at 10.

[101] District's Initial Brief at 10.

3. ALJs' Analysis

The ALJs are unpersuaded by the claim that Customer Cities are "appropriate parties" for purposes of notice under 16 TAC § 24.305(a). The Contract is between the Member Cities and the District. Member Cities are not in the same position vis-à-vis the District as are Customer Cities. Specifically, as elaborated under Issue 5, the Member Cities are entitled to appoint Board members, have superior rights to the District's water, and bear joint and several liability for the District's debts.[102] Customer Cities have individual contracts with the District and are not obligated to pay anything other than their contracted charges, plus any fees for excess water use. Customer City contracts have a set term, allowing for periodic renegotiation by both the customer and the District.[103] The District does not consult the Member Cities or require their approval before entering into contracts with Customer Cities.[104]

The District's bondholders are not appropriate parties requiring notice of the Petition because—as discussed under Issue 4 below—Commission rate-setting under Code § 13.043(f) must use a methodology that "preserves the financial integrity of the retail public utility."[105] Rates set pursuant to Code § 12.013 may not be "less than the amount required to meet the debt service and bond coverage requirements" of a political subdivision's outstanding debt.[106] Therefore, if adjustments to the District's rates are made after a cost-of-service study, the District will still be able to meet its debts and bondholders will remain whole. In addition, the District's relationships with its bondholders are governed by the relevant bond indentures, not the Contract. The statutes that bestow incontestability on the District's bonds do not thereby make the Contract incontestable. The Commission addressed this issue at length in the Preliminary Order and the ALJs do not repeat it here.[107]

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[102] NTMWD Ex. 5 (Sanderson Direct) at 69.

[103] Pet. Ex. 3 (Johnson Direct) at 14.

[104] Pet. Ex. 17 (Totten Rebuttal) at 13.

[105] Code § 13.043(j).

[106] Code § 12.013(c).

[107] Preliminary Order at 11-16.

Because Customer Cities are not appropriate parties under 16 TAC § 24.305(a), the ALJs find Petitioners were not required to attach a copy of any or all Customer City contracts to the Petition. As for Policy No. 8, it is considered in this proceeding (under Issue 5.c.i. below) because it is a practice that affects the Annual Minimums of Member Cities that seek financing pursuant to its terms and therefore is a practice that affects the rates set under the Contract. However, Policy No. 8 is not part of the Contract *per se*; it was independently adopted by the Board. Attaching the Contract itself was sufficient to notify the District and other Member Cities that the Petition challenged practices and policies related to the rates set under the Contract.

Accordingly, the ALJs find that Petitioners met the filing requirements of both Code § 13.043(f) and 16 TAC § 24.305.

D. Issue 4: Do the Rates the District Charges Petitioners for Water Service Adversely Affect the Public Interest under the Code? [Code § 13.043(j), *Texas Water Commission v. City of Fort Worth*, 875 S.W.2d 332, 336 (Tex. App.—Austin 1994, writ denied)]

Issue 4.a: Are the rates the District charges Petitioners for water service just and reasonable? [Code § 13.043(j)]

Issue 4.b: Are the rates unreasonably preferential, prejudicial, or discriminatory? [Code § 13.043(j)]

Issue 4.c: Are the rates sufficient, equitable, and consistent in application to each class of customers? [Code § 13.043(j)]

The ALJs find that the FY 2017 rates charged under the Contract are not just and reasonable; are unreasonably preferential, prejudicial, or discriminatory; and are not sufficient, equitable and consistent in application to each class of customers. Therefore, the ALJs find that the rates are adverse to the public interest. That finding is based on the specific facts established pertaining to the factors listed in the Public Interest Rule, which are discussed under Issue 5.

In this section, the ALJs address foundational questions raised by the parties that pertain to the scope of the Commission's review and authority under pursuant to Code § 13.043(j) and *Texas*

Water Commission v. City of Fort Worth (*Fort Worth*).[108] The parties disputed (a) the level of deference due to a rate set under a contract, and (b) whether oversight by other regulatory agencies provides necessary safeguards without requiring Commission intervention. Additionally, the parties disagree (c) as to whether this case could involve the Commission "upending the Contract" (in the District's words)[109] or is merely an instance of the Commission reviewing rates without impairing contractual obligations or the District's bonds (in Petitioners' view).[110]

The *Fort Worth* case concerned the City of Arlington's appeal of an increase in the rates charged to Arlington by the City of Fort Worth for treatment of Arlington's wastewater.[111] The Texas Water Commission (TWC)[112] found it had jurisdiction over Arlington's appeal under Code § 13.043(f) and set new rates.[113] Fort Worth sought judicial review. The district court confirmed that the TWC had jurisdiction over the appeal but found the agency failed to make any finding regarding the reasonableness of Fort Worth's rates before deciding to set new rates. Based on that failure, the district court reversed and remanded the matter to the TWC.[114] The TWC and Arlington appealed, and Fort Worth cross-appealed.

The Third Court of Appeals affirmed the district court. For present purposes, the Commission's Preliminary Order specifically referred to page 336 of the Third Court's decision, which states in relevant part:

> The wording of [Code §] 13.043(j) . . . expressly requires the [TWC] to make a finding that the provider city's rates are unreasonably

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[108] *Texas Water Com'n v. City of Fort Worth*, 875 S.W.2d 332, 333-34 (Tex. App.—Austin 1994, writ denied).

[109] District's Initial Brief at 12.

[110] Petitioners' Initial Brief at 5.

[111] *Fort Worth*, 875 S.W.2d at 333-34.

[112] The TWC was absorbed into the Texas Natural Resource Conservation Commission (TNRCC), which in turn is the predecessor agency to the Texas Commission on Environmental Quality (TCEQ). Jurisdiction over water utility rates was transferred from the TCEQ to the PUC in 2014. The PUC adopted the then-existing TCEQ rules for wholesale water rates without material changes.

[113] *Fort Worth*, 875 S.W.2d at 334.

[114] *Fort Worth*, 875 S.W.2d at 334.

> preferential, prejudicial, or discriminatory before modifying these rates so that they are just and reasonable.
>
> . . .
>
> The district court correctly concluded that the appropriate scope of appellate review under [Code §] 13.043(f) . . . requires that the [TWC] first make a finding that the rates affected by a "decision of the provider" adversely affect the public interest by being unreasonably preferential, prejudicial, or discriminatory.[115]

In making its decision, the Third Court rejected Fort Worth's contention that, if Code §13.043(f) authorized review by the TWC, "then this review unconstitutionally interferes with its contractual obligations."[116] Rather, the Court held that because Code § 13.043(j) required a public interest finding before the TWC addressed rates set pursuant to a contract, Fort Worth's contractual obligations would not be unconstitutionally impaired if such a finding was properly made.[117]

Subsequent to the *Fort Worth* decision, the Texas Natural Resource Conservation Commission (TNRCC), the successor agency to the TWC, began a rule-making process, noting that "[f]or several years, participants in . . . wholesale rate cases [under the Code] have urged the need for rules governing these proceedings."[118] In 1994, the TNRCC adopted what is now 16 TAC § 24.311, the Public Interest Rule, and related regulations.

1. Argument of Petitioners, Royse City, and Staff

Petitioners argue that they are in precisely the situation mentioned in the preamble to the Public Interest Rule, where unreasonable inequities develop over the course of a long-term contract between a wholesale seller and purchaser. In adopting the rule, the TNRCC noted that "both sellers and purchasers generally agree[] that most agreements for the sale of wholesale services are

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[115] *Fort Worth*, 875 S.W.2d at 334.

[116] *Fort Worth*, 875 S.W.2d at 335.

[117] *Fort Worth*, 875 S.W.2d at 335-36.

[118] 19 Tex. Reg. 6227 (Aug. 9, 1994).

reasonable and are the product of arms[']length negotiations."[119] However, Petitioners stress, the TNRCC also recognized that some contracts become inequitable over time, stating:

> [T]here are situations where a seller and purchaser have entered into a long term agreement that later is disputed. Over time the seller exercises near monopoly power over the purchaser because many agreements allow the seller the unilateral right to adjust the rate. Moreover, the purchaser substantially has no alternatives to obtain water or sewer service because it has entered into a long term agreement with the seller. The adopted criteria focus on the actual facts which will show whether the protested rate reflects this latter type of agreement so much that it invokes the public interest.[120]

Petitioners contend that they are "captive customers of the District under a 30-year-old water supply contract" wherein the District is the sole and exclusive supplier of water, and the District can "unilaterally establish its annual requirement and adjust its rates."[121] In Petitioners' view, the "fact that adherence to a contract produces unjust and unreasonably discriminatory rates is precisely why Commission intervention is critically needed."[122]

In addition, Petitioners note that the Contract itself contemplates review by regulatory bodies. Section 15 of the Contract states:

> This Contract is subject to all applicable Federal and State laws and any applicable permits, ordinances, rules, orders, and regulations of any local, state, or federal governmental authority having or asserting jurisdiction, but nothing contained herein shall be construed as a waiver of any right to question or contest any such law, ordinance, order, rule, or regulation in any forum having jurisdiction.[123]

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[119] 19 Tex. Reg. 6228 (Aug. 9, 1994).

[120] 19 Tex. Reg. 6228 (Aug. 9, 1994).

[121] Petitioners' Initial Brief at 2.

[122] Petitioners' Reply Brief at 8.

[123] NTMWD Ex. 5 (Sanderson Direct) at JRS-1 at 41.

Royse City joins Petitioners in citing section 15 of the Contract to argue for Commission review.[124] Royse City acknowledges that it is experiencing a greater rate of growth relative to Petitioners, and thus a rate revision by the Commission could result in Royse City paying more under the Contract than it does presently. That outcome is acceptable to Royse City because "the District's monopoly power abuses trigger the need for Commission oversight" and having "some check on the District's power, such as the Commission's exercise of its rate review authority, outweighs any short-term financial benefits that might exist under the current rates."[125]

Petitioners and Royse City reject the suggestion that regulatory agencies other than the Commission can provide adequate supervision over the District's rate-setting or protections for Member Cities. Petitioners, Royse City, and Staff also deny that a public interest finding would amount to "upending" the Contract or endangering the District's ability to pay its debts.[126] Royse City urges the Commission not to be distracted by the District's "red herring argument" that the Commission's review of Contract rates would cause any impairment to the interests of bondholders.[127] Because the ALJs concur with the analysis presented by Petitioners, Royse City, and Staff, it is addressed under the ALJs' Analysis section below rather than being discussed here.

2. Arguments of the District, Frisco & Forney, and McKinney

The District argues that the constitutional deference due to a contractually-set rate under Code § 13.043(j) and the *Fort Worth* case is so great as to preclude Commission review except in the most extreme of situations, stating that "[Code] § 13.043(f) and the Commission's authority under the statute *do not apply* to reasonable and legally valid contractual rates."[128] Rather, the

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[124] Royse City's Initial Brief at 13.

[125] Royse City's Initial Brief at 13-14. As previously stated, the details of the monopoly power abuse arguments presented by Petitioners and Royse City are discussed in detail under Issue 5, along with the counterarguments.

[126] Petitioners' Reply Brief at 5; Royse City's Reply Brief at 4; Staff's Initial Brief at 8.

[127] Royse City's Initial Brief at 13.

[128] District's Initial Brief at 11 (emphasis added).

Commission "only has authority to adjust wholesale contractual rates" when the rates "*so offend the public interest* as to essentially render the underlying contract *invalid*."[129]

The District exhorts the Commission to consider the "regulatory and statutory safeguards" that already ensure the District's rate-setting is reasonable before the Commission makes a decision that "fundamentally alters the agreement" in the Contract.[130] Among other things, the District is "subject to the Texas Open Meetings Act and the Public Information Act."[131] Pursuant to the Contract, the Member Cities appoint the Board, which governs all of the District's operations. The District is also regulated by the Texas Water Development Board (TWDB) because the District "actively participates in regional and state water supply planning efforts administered by the TWDB" such as the Bois d'Arc Reservoir.[132] To obtain authority necessary for constructing the reservoir, the District underwent a "rigorous permit application process with the Army Corps of Engineers and the [federal] Environmental Protection Agency [(EPA)]," and then successfully obtained "hundreds of millions of dollars of funding for the reservoir from the State of Texas itself through the TWDB."[133] The most recent bond issuances by the District have been approved by the Attorney General of Texas.

Frisco & Forney and McKinney join the District in stressing that the District was created "for the benefit of the whole," and that the public interest encompasses the interests of the District and *all* Member Cities, not just Petitioners.[134] These parties cite the TNRCC's recognition, in the preamble to the Public Interest Rule, that wholesale contracts are distinguished from retail contracts because the former involve sophisticated parties who have the capacity to negotiate shrewdly. Specifically, the TNRCC stated:

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[129] District's Initial Brief at 11 (emphasis added).

[130] District's Initial Brief at 3, 5.

[131] District's Initial Brief at 4 (referencing Tex. Gov't Code chs. 551, 552).

[132] District's Initial Brief at 4.

[133] District's Initial Brief at 5.

[134] Frisco & Forney's Initial Brief at 13; McKinney's Initial Brief at 3; District's Reply Brief at 3.

> The courts continue to recognize the [C]ommission's jurisdiction in these matters and have reconciled that jurisdiction with the argument that [C]ommission review interferes with a constitutional right of contract. The [C]ommission believes a review process with an *inherent deference to contracts will encourage careful planning by sellers and purchasers*, foster regionalization and generate an efficiency factor absent from the current process.[135]

Frisco & Forney and the District chronicle negotiations that occurred prior to the 1988 execution of the Contract, including changes made to the Contract to address concerns raised by the Member Cities and their legal counsel (discussed further under Issue 5).[136] Having vetted the Contract and entered into it without duress, Petitioners, they argue, should be held to its terms.

The District raises the concern that "[u]pending the [C]ontract may have far-reaching effects on the ability of the District to continue borrowing at favorable rates.[137] Frisco & Forney add that the revenue bond financing the District has successfully relied upon is linked to the "stability of the contractual agreement between the District and the Member Cities[.]"[138] McKinney agrees that the District's "creditworthiness is in part directly linked to the take-or-pay nature" of the Contract as well as District "management's willingness to raise rates to cover the District's rising costs and to maintain its financial position relative to its associated bond covenants."[139] If the District cannot "increase rates consistent with its increasing costs," credit-rating agencies may change their positions, "especially if the nature of the [Contract] is altered" or if the District is "no longer able to comply with its commitments under the various bonds."[140]

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[135] 19 Tex. Reg. 6227 (Aug. 9, 1994) (emphasis added).

[136] Frisco & Forney's Initial Brief at 3-8; District's Initial Brief at 2.

[137] District's Initial Brief at 12.

[138] Frisco & Forney's Reply Brief at 11.

[139] McKinney's Initial Brief at 6.

[140] McKinney's Initial Brief at 6.

3. ALJs' Analysis

The ALJs agree with Petitioners that the Public Interest Rule incorporates a deferential approach to rates set by contract and no additional deference to the Contract is required beyond what is included in the Public Interest Rule itself. The ALJs also find that other regulatory schemes do not compensate for the absence of Commission review, and that the Commission can make an adverse public interest finding without affecting the validity of the Contract or the District's bonds.

a. The Public Interest Rule provides sufficient deference to contracts

The ALJs recognize the bedrock principle enshrined in the Texas Constitution that no "law impairing the obligation of contracts" shall be made.[141] In the *Fort Worth* case, the Third Court found that Code § 13.043(f) did not violate the constitutional limitation on laws affecting contracts because Code § 13.043(j) explicitly requires a public interest finding before contract rates may be reset pursuant to Code § 13.043(f).

The District applies the *Fort Worth* case and Code § 13.043(j) to require a finding of facts so adverse to the public interest as to "essentially render the underlying contract invalid." The ALJs disagree because Code § 13.043(j) explicitly requires a public interest finding that the rates are "*unreasonably* preferential, prejudicial or discriminatory." "Unreasonable" does not imply a situation so dire that the parties' contract itself is invalid.

Notably, the Public Interest Rule does not articulate a standard as stringent as the District advocates. The TNRCC, in adopting the Public Interest Rule and related rules, declared that it was making "a substantial move towards giving due consideration to contracts."[142] The "adoption of these rules" marked the "end of past policy where the [TNRCC] essentially automatically cancelled the rate set by contract and set a rate based on cost of service."[143] Instead, the TNRCC

[141] Tex. Const. art. I, § 16.

[142] 19 Tex. Reg. 6229 (Aug. 9, 1994).

[143] 19 Tex. Reg. 6229 (Aug. 9, 1994).

going forward would take "a conservative approach when evaluating whether to cancel a rate which was set pursuant to a private agreement between utilities."[144]

The TNRCC's conservative approach resulted in a Public Interest Rule that features both certainty and flexibility. From the outset, the rule gives deference to a contract between private parties because "the rule assumes the seller's 'protested rate' correctly interprets any existing agreement between the seller and purchaser."[145] Then, to provide certainty, the TNRCC explicitly listed rate-setting "based on cost of service" as the remedy in a public interest case, stating:

> The [C]ommission has found it difficult indeed to anticipate all the possible disputes which could arise and to give guidance, to the extent possible, concerning how the [C]ommission will determine the public interest. The [C]ommission believes that if the public interest criteria cannot be explained in more definite form, then at least the [C]ommission should show in clear terms the remedy the [C]ommission will use whenever it finds the public interest has been adversely affected.[146]

Certainty is also provided because the criteria in the Public Interest Rule are "sufficiently broad" that "[a] party should not be allowed to urge that some other criteria have been violated."[147]

At the same time, the Public Interest Rule builds in a measure of flexibility. The rule states that the public interest is adversely affected if "at least one" of the listed criteria has been violated, meaning that a purchaser does not have to prove every item in the rule.[148] With respect to the criterion addressing abuse of monopoly power, the rule requires the Commission to weigh "all relevant factors," which "may include" those listed.[149] That gives the Commission some leeway to examine the different ways in which monopoly power may operate under different sets of facts.

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[144] 19 Tex. Reg. 6228 (Aug. 9, 1994).

[145] 19 Tex. Reg. 6227 (Aug. 9, 1994).

[146] 19 Tex. Reg. 6229 (Aug. 9, 1994).

[147] 19 Tex. Reg. 6228 (Aug. 9, 1994).

[148] 16 TAC § 24.311(a).

[149] 16 TAC § 24.311(a)(3).

This balance between certainty and flexibility demonstrates that the Public Interest Rule is crafted to give deference to private contract interests while recognizing that there is a public interest in remedying inequitable rates. No additional layer of deference is required such that a contract between private parties must be virtually invalid before the Commission steps in. Similarly, no stricter burden of proof is imposed. The TNRCC received a suggestion that the burden of proof should be "heightened" and a "clear and satisfactory evidence" showing should be required.[150] The TNRCC declined to amend the proposed rule on this basis.

For these reasons, the ALJs agree with Petitioners that no greater, undefined level of deference to the Contract—apart from application of the Public Interest Rule itself—is required in this case before the Commission evaluates the protested rates. The balance between private contract interests and the public interest has already been established in the rule.

b. Other regulatory schemes and agencies do not substitute for Commission review

The District asks the Commission to take into consideration that the Texas Open Meetings Act, the Public Information Act, and regulation by the TWDB provide safeguards to the Member Cities that the District's rate-setting is reasonable.

The ALJs acknowledge that compliance with the Texas Open Meetings Act and Public Information Act promotes transparency. These statutes are helpful, for example, in assuring voters who have elected a city council that the council transacts its business openly. However, transparency cannot give the voters control over the council members' votes. Dissatisfied voters have the remedy of voting for different candidates in the next election cycle.

Unlike these hypothetical voters, and as discussed further under Issue 5, the Member Cities do not have a meaningful ability to change the direction of District decisions by changing their Board appointments, because those appointees have a fiduciary duty to the District rather than to

[150] 19 Tex. Reg. 6230 (Aug. 9, 1994).

their respective Member Cities. Thus, the Texas Open Meetings Act and Public Information Act provide transparency, but do not provide an adequate rate-setting regulatory safeguard in this case.

Similarly, the District's participation in the TWDB's regional water supply planning efforts is positive in that it provides assurance that the District is pursuing goals and projects supported by other agencies with expertise. It is to the District's credit that it met federal standards imposed by the Army Corps of Engineers and EPA in the permitting process for the new reservoir, and secured funding from the TWDB (including bond approval by the Attorney General for some recent issuances). Yet, none of these state or federal agencies can review or remedy the disparities caused by a rate that is adverse to the public interest. Only the Commission has the authority to investigate and make a public interest finding if appropriate.

c. Commission review can be achieved without invalidating the Contract or affecting the District's bonds

The Commission can address any inequities caused by the Contract's rate-setting mechanism without "upending" the Contract or impairing the District's bonds. There is no law or fact presented in this proceeding to support the notion that Commission review and rate-setting (if this case proceeds to a second phase) would invalidate the Contract. Nor is there evidence that Petitioners and their aligned parties are seeking to dissolve or exit the Contract. The District, as discussed below, is the sole source of water for Petitioners and will continue to be so for the indefinite future. Petitioners, along with the other Member Cities, will continue to be jointly and severally liable for the District's debts.

Petitioners' request that the Commission examine whether the rates charged are adverse to the public interest *may* ultimately result in a realignment of costs among parties who take water from the District. However, the Commission is fully capable of setting rates while protecting the interests of District bondholders. As stated in the Preliminary Order, the Commission "has neither

the power nor motivation to set rates in a manner that impairs utilities' debt obligations."[151] If the Commission were to "ultimately revise the rates the district charges for water service, the bonds and [C]ontracts would nevertheless be valid, enforceable, and binding."[152]

E. Issue 5: Do the Rates the District Charges Petitioners for Water Service Adversely Affect the Public Interest under Commission Rules? [16 TAC § 24.311]

After analyzing each factor in Issue 5 presented below, the ALJs conclude that the rates charged Petitioners adversely affect the public interest under the Commission's Public Interest Rule.

1. Issue 5.a: Do the protested rates impair the District's ability to continue to provide service, based on the District's financial integrity and operational capability?

Although the parties did not stipulate to this issue, the parties agree that the protested rates do not impair the District's ability to continue to provide service.[153] Additionally, no evidence of impairment was presented. Therefore, the ALJs conclude that the protested rates do not impair the District's ability to continue to provide service, based on the District's financial integrity and operational capability.

2. Issue 5.b: Do the protested rates impair the Petitioners' ability to continue to provide service to their retail customers, based on each Petitioner's financial integrity and operational capability?

a. Arguments of Petitioners

Petitioners argue that the District's rates impair their ability to continue to provide service to their individual retail customers. Petitioners contend that the District's rates cause impairment

[151] Preliminary Order at 20.

[152] Preliminary Order at 15.

[153] Petitioners' Initial Brief at 9; District's Initial Brief at 13; District's Reply Brief at 4; Frisco & Forney's Reply Brief at 4; McKinney's Initial Brief at 6. The remaining parties did not address this issue in their briefs.

based on Petitioners' financial integrity because Mesquite's and Garland's bond ratings were downgraded because of the District's rates. Petitioners' witness Jerome Dittman, Mesquite's former Deputy City Manager, testified that Mesquite's ratings were downgraded for two years in a row as a result of the obligations under the Contract with the District.[154] Petitioners also point to the 2015 Fitch Rating downgrade for Garland's water and sewer system bonds.[155] The 2015 Fitch Rating noted that the District "creates cost pressure outside of [Garland's] direct control."[156] The report also indicates that "[s]ystem operations have been pressured by increasing debt service and purchased water costs, and financial metrics are now below Fitch's 'AA' median category medians."[157] Petitioners point to similar language in the 2017 Fitch Ratings for Garland.[158]

Petitioners also maintain that the District's rates impair their abilities to provide retail service based on operational capabilities. Petitioners argue that as a result of the wholesale rate increases, which include paying for millions of gallons of water never consumed by the Petitioners, Plano, Mesquite, and Richardson have curtailed retail system maintenance and capital projects that would otherwise improve each city's retail systems in an effort to avoid dramatic increases in retail rates.[159]

b. Arguments of District, McKinney, and Frisco & Forney

The District argues that each Petitioner is in an excellent financial position such that its ability to provide retail service is not impaired—either due to financial integrity or operational capability.[160] As evidence for this argument, the District points to numerous credit ratings for

[154] Petitioners' Initial Brief at 10, citing Tr. at 260-61.

[155] Petitioners' Initial Brief at 11; Pet. Ex. 6 (Baker Direct) at JB-13.

[156] Pet. Ex. 6 (Baker Direct) at JB-13 at 96.

[157] Pet. Ex. 6 (Baker Direct) at JB-13 at 96.

[158] Petitioners' Initial Brief at 11; Pet. Ex. 21.

[159] Petitioners' Initial Brief at 12-14.

[160] NTMWD's Initial Brief at 14-16.

Petitioners, which range from AA- to AAA, indicating high credit quality ratings. The District maintains that such ratings "show no indication of financial weakness."[161] The District cites to bond ratings for Garland and Mesquite that specifically refer to the District's role as wholesale supplier to the two cities, which "greatly reduc[es] operational and financial risk to [Garland],"[162] and "greatly reduces operational risk to [Mesquite]."[163]

The District also contends that significant transfers of funds from Petitioners' retail water utility budgets to the cities' respective general funds evidence a lack of impairment because the water utility budget is able to subsidize non-utility related city services.[164] Bond ratings cited by Petitioners also recognize these "large" and "above-average" transfers from the utility fund to the general fund for Garland.[165] As a result of these transfers out of the utility budgets, the District argues that Petitioners are responsible for shortfalls in their own utility funding, and that Petitioners may only prevail on this factor if the District rate is the *sole* cause of Petitioners' financial losses in utility funding.

Finally, the District argues that Petitioners have control over their own budgets, their own retail rates, and how to utilize funds for providing retail service and funding capital improvements. The District contends that Petitioners have introduced no evidence showing any specific capital improvement project that has been delayed as a result of the District's rates. Rather, Petitioners continue to fund substantial improvements to their systems each year. Additionally, the District points to a lack of evidence of interruptions in service, service requests that have been denied, or any other actual evidence that retail service has been impaired.[166]

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[161] NTMWD's Initial Brief at 14-15.

[162] NTMWD Ex. 7 (Ekrut Direct) at CE-6 at 2.

[163] NTMWD Ex. 7 (Ekrut Direct) at CE-7 at 2.

[164] NTMWD's Initial Brief at 15-16; NTMWD's Reply Brief at 5.

[165] Pet. Ex. 6 (Baker Direct) at JB-13; Pet. Ex. 21.

[166] NTMWD's Initial Brief at 16, Reply Brief at 6-7.

Frisco & Forney adopt the District's arguments on this factor, and McKinney makes the same arguments as the District, which will not be repeated here.[167]

c. ALJs' Analysis

The District argues that Petitioners are in sound financial positions and there is no evidence of "actual" impairment of retail service such as an interruption of service, deferment of necessary repairs, or service requests that have been denied or interrupted.[168] Although Petitioners enjoy high credit ratings, indicating general financial stability, the Commission's Issue 5.b. asks whether the District's rates have resulted in impairment to Petitioners' abilities to provide retail service based on financial integrity or operational capability. Notably, the issue is whether impairment of *ability* to provide service exists, not impairment of the service itself. Black's Law Dictionary defines "impairment" in relevant part as "the quality, state, or condition of being damaged, weakened, or diminished."[169] Therefore, if the District's rates weaken or diminish Petitioners' abilities to provide retail service, the answer to the Commission's question is "yes."

Applying this reasoning, the ALJs conclude that Petitioners do not have to be in financial ruin or show interruptions in service to prevail on this issue—they need only show that their financial ability or operational capability to provide service has been weakened or diminished as a result of the District's rates. Similarly, the ALJs are not persuaded by the District's argument the District must be the *sole* cause of any impairment—the Public Interest Rule contains no such limitation.

The ALJs agree that the District's rates impaired Mesquite's and Garland's abilities to provide retail service based on their financial integrity resulting from downgraded bond ratings. Mr. Dittman testified that Mesquite's water/sewer bond ratings were downgraded to AA- for two

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[167] Frisco & Forney's Reply Brief at 4; McKinney's Initial Brief at 6-8 and Reply Brief at 3-4.

[168] NTMWD's Reply Brief at 7.

[169] Impairment, *Black's Law Dictionary* (10th ed. 2014), *available at* Westlaw.

years because Mesquite did not have a sufficient "all-in" debt service coverage to cover payment of the District's rates.[170] The 2017 Standard & Poor's (S&P) Report later upgrading the rating to AA Stable explains in the "financial risk profile" section that, "all-in coverage" is an adjusted debt service coverage metric that treats certain costs—including take-or-pay minimums—as if they were debt, even if they are legally treated as operating expenses.[171] The 2017 S&P Report also references "barely sufficient all-in coverage" for previous years, consistent with Mr. Dittman's testimony.[172] Mr. Dittman explained that Mesquite had to increase cash reserves to push its all-in ratio up, resulting in the AA Stable rating in the 2017 report.

Garland's rating was also downgraded by Fitch Ratings in the year preceding the rate appeal.[173] Under the heading "Weakened Financial Performance," the 2015 Fitch Report indicates that increasing purchased water costs have pressured systems operations[174] and added to off-balance sheet debt "pushing system debt levels well above the category 'AA' rating median."[175] The 2017 Fitch Report also notes that the 2015 downgrading of Garland's rating was a result of the "increasing debt service and purchased water costs."[176] District witness Chris Ekrut conceded that Garland's system operations were pressured by the cost of water from the District and that there has been some financial impairment to Garland due to the District rates.[177] The ALJs agree with Petitioners that Garland's ability to provide retail service was impaired as a result of financial pressures from District's rates, which influenced the downgrade of Garland's bond rating in 2015.

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[170] Tr. at 252-53.

[171] NTMWD Ex. 7 (Ekrut Direct) at CE-7 at 3.

[172] NTMWD Ex. 7 (Ekrut Direct) at CE-7 at 3.

[173] Pet. Ex. 6 (Baker Direct) at JB-13.

[174] Pet. Ex. 6 (Baker Direct) at JB-13 at 1.

[175] Pet. Ex. 6 (Baker Direct) at JB-13 at 2.

[176] Pet. Ex. 21 at 2.

[177] Pet. Ex. 13 (Baker Rebuttal) at JB-R1 at 19 (indicating that Garland's system operations were pressured by purchased water), 23 (agreeing that District rates have caused some financial impairment to Garland).

The ALJs are not persuaded by the District's and McKinney's arguments that transfers from the Petitioners' utility funds to general funds somehow negate any financial impairment caused by the District's rates. Petitioners presented testimony from each petitioning city that it is a standard accounting procedure to transfer money from a city's utility fund to the general fund for franchise fees and reimbursement for overhead expenses provided by the city such as human resources, legal, and finance fees.[178] District expert Mr. Ekrut also testified that transfers from a city's utility fund to the general fund are standard practice.[179]

The ALJs concur with Petitioners that Richardson's and Mesquite's abilities to provide retail service are impaired by the District's rates based on operational capability. Dan Johnson, Richardson's City Manager, testified that Richardson has had to reduce the amount of debt issued for bond-funded capital improvements for FYs 2011, 2013, 2015, 2016, and 2017, and elected not to issue debt for FYs 2012 and 2014, due to the cost of the District's rates. As a result, Richardson deferred nearly $20 million in capital improvement projects, including replacement of faulty and outdated water lines, valves, and other distribution assets.[180] Similarly, the District's rates caused Mesquite to curtail investment in its retail water distribution system by delaying or foregoing capital projects, such as water lines and an emergency pump station generator.[181] The deferral of capital improvement projects to Richardson's and Mesquite's water systems impaired their abilities to provide retail service from an operational standpoint.

The ALJs do not find sufficient evidence to conclude that Plano's retail system has suffered from an operational standpoint. Unlike the evidence presented for Richardson and Mesquite, which included specific capital projects and dollar figures, Petitioners present only conclusory statements that the District's rates have reduced the amount of capital Plano has on hand for system improvements that could otherwise be made.

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[178] Pet. Exs. 15 (Glasscock Rebuttal) at 20; 11 (Johnson Rebuttal) at 11-12; 13 (Baker Rebuttal) at 13-14; 12 (Dittman Rebuttal) at 19.

[179] Pet. Ex. 13 (Baker Rebuttal) at JB-R1 at 24-25.

[180] Pet. Ex. 11 (Johnson Rebuttal) at 11.

[181] Pet. Ex. 12 (Dittman Rebuttal) at 17-18.

Finally, the ALJs are cognizant of the District's argument that any minute level of impairment of Petitioners' abilities to provide retail service should not suffice to draw a conclusion that the District's rates adversely affect the public interest in this case. The ALJs note that the Public Interest Rule specifically states that the Commission must find "at least one" violation of the public interest factors. As noted below, the ALJs have found several violations of the public interest factors; therefore, weighing the particular degree to which the District's rates cause the impairment discussed in this section as opposed to other factors is not necessary. The Commission is ultimately tasked with weighing all relevant factors and giving due weight to each.

3. Issue 5.c: Do the protested rates evidence the District's abuse of monopoly power in its provision of water to the Petitioners? In answering this issue, please address the following factors:

As a threshold issue, the District argues that the failure of Petitioners to present evidence on all eight factors concerning abuse of monopoly power demonstrates that the District has not abused its monopoly power.[182] The ALJs find this interpretation of the Public Interest Rule contrary to the language of the rule and unsupported by case law.[183] Although 16 TAC § 24.311(a)(3) requires the Commission to weigh "all relevant factors," not all factors may be relevant in every case. Further, the rule goes on to say that the factors "may include" the eight factors listed, reinforcing the idea that some factors may not be relevant.

a. Issue 5.c.i: The disparate bargaining power of the parties, including [Petitioners'] alternative means, alternative costs, environmental impact,[184] regulatory issues, and problems of obtaining alternative water service;

[182] NTMWD Initial Brief at 16.

[183] *Navarro Cnty. Wholesale Ratepayers v. Tex. Comm'n. on Envtl. Quality*, 2015 WL 3916249 at *5 (Tex. App.—Houston [1st Dist.] June 25, 2015, pet. denied) ("[T]he [TCEQ] is not required to consider all of the factors listed, only those that are relevant.").

[184] The ALJs address environmental impacts in the discussion of Issue 5.c.v. below regarding incentives for water conservation measures.

i. Arguments of Petitioners and Royse City[185]

Petitioners identify several arguments for the proposition that the District abused its monopoly power by using its disparate bargaining power over Petitioners. Petitioners argue that the disparate bargaining power existed in 1988 when the Contract was signed and that it continues today. Specifically, Petitioners cite an October 14, 1988 letter from the District to Garland stating that an alternate source of supply "does not really appear to be available either now or in the long term future due to the lack of developable natural resources within the state."[186] Petitioners also cite a more recent document, the District's February 2014 Administrative Memorandum No. 4129, which states that "[l]ocal and less expensive sources of water supply are largely developed," and "[a]dditional supplies to meet higher demands will be expensive and difficult to secure."[187]

According to Petitioners, the District's former executive director issued a question and answer document (Q&A Memo) dated May 6, 1988, that led Petitioners to believe that the risk of signing a potentially perpetual contract would be minimal because the cities could appoint directors to the Board who could "make determinations as to the useful life of the system in accordance with the desires of the cities."[188] Garland was further reassured by a letter from the District stating that the "main safeguard a city has is its Director who can provide leadership to the Board in its deliberations and decisions."[189] The characterization of the city-appointed directors on the Board as advocates for the desires of the cities turned out not to be true, however.

Petitioners cite two Texas Attorney General Opinions which both conclude that cities have no authority to remove or replace a director on the Board, with or without cause, because the Board

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[185] Royse City's arguments generally parallel Petitioners' arguments on this issue and will not be separately discussed. Royse City's Initial Brief at 2-7.

[186] Pet. Ex. 6 (Baker Direct) at JB-12 at 3.

[187] Pet. Ex. 9 (Totten Direct) at JT-4.

[188] Pet. Ex. 9 (Totten Direct) at 14, *citing* Pet. Ex. 4 (Dittman Direct) at JD-24 at 56.

[189] Pet. Ex. 6 (Baker Direct) at JB-3 at 37.

member is an "officer of the *[D]istrict*, who happens merely to be *appointed* by the city council."[190] The first Attorney General Opinion resulted from the District advocating for the position that, apart from appointing directors, the "cities have no control over the actions and composition of the governing [B]oard for the [D]istrict."[191] Petitioners argue that the District's about-face on the loyalties of city-appointed directors approximately two years after the Contract was signed is evidence of abuse of the District's monopoly power.

According to Petitioners, after making this about-face, the District has held firm to its position that directors' duties are to the District rather than the Member Cities. The second Attorney General opinion was sought by the District in 2016, about a year before Petitioners initiated this case by filing the Petition. Plano's City Manager, Bruce Glasscock, testified that several Member Cities in 2015 passed resolutions through their respective city councils asking the District to "acknowledge that District [B]oard members serve at the will of their appointing city."[192] A majority of participants at a joint meeting of Member City managers and elected officials in 2015 agreed that the District should either adopt a Board policy recognizing the power of Member Cities to appoint and remove Board members at will, or work with Member Cities to pass legislation to achieve that result.[193]

Mr. Glasscock explained that the participants at this meeting specifically requested that the District *not* seek another Attorney General opinion because such opinions are not binding. Yet, "the District sought another Attorney General opinion [and, not] surprisingly, the Attorney General affirmed the prior opinion [in 2016]."[194] Although the District later adopted a resolution authorizing the Executive Director to seek legislation amending the District's Enabling Act to allow for a Member City to remove a Board member it appointed, the District did not support the

[190] Atty. Gen. Op. JM-1239 (1990) at 3; Atty. Gen. Op. KP-0117 (2016) at 4.

[191] Pet. Ex. 9 (Totten Direct) at JT-11 at 9 of 107 (October 26, 1990 letter on behalf of the District to the Chairman of the Texas Attorney General's Opinion Committee).

[192] Pet. Ex. 7 (Glasscock Direct) at 12.

[193] Pet. Ex. 7 (Glasscock Direct) at 12-13.

[194] Pet. Ex. 7 (Glasscock Direct) at 13; Atty. Gen. Op. KP-0117 (2016).

legislation in the 2017 legislative session. Instead, the Board "tabled action on the governance legislation" the day after Petitioners filed the Petition, and then voted not to move forward.[195]

The end result is that Petitioners have no effective representation on the District's governing Board.[196] The Board has the power to set rates, approve capital improvement projects, and issue bonds, which further extends the life of the Contract, among other powers. As a recent example of their lack of bargaining power, Petitioners note that the District settled a third-party dispute that threatened to block permits for the new reservoir, in part by committing that Petitioners would reduce their water demands.[197] This commitment was made without the District first asking Petitioners for approval.

Petitioners also contend that the Contract terms themselves are indicative of the disparate bargaining power in several ways. For example, the Contract provides that Petitioners must buy water exclusively from the District; Petitioners cannot resell water without the District's permission; the Contract cannot be amended as a practical matter because amendment requires unanimous consent by the contracting parties; the District can unilaterally increase rates; and the District can unilaterally increase the term of the Contract so that it is essentially perpetual. These terms, taken together, make Petitioners captive customers of the District. Even if there were other water providers in the region—which Petitioners contend there are not—Petitioners argue it would be cost-prohibitive to purchase water from another provider because they would continue to be contractually obligated to pay the District millions of dollars for their minimum volumes of water—which Petitioners have not fully utilized in over 10 years.[198]

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[195] Petitioners' Reply Brief at 16; Pet. Ex. 24 at 7; Pet. Ex. 23 at 9.

[196] Pet. Ex. 9 (Totten Direct) at 14-15.

[197] Petitioners' Reply Brief at 22.

[198] Pet. Ex. 9 (Totten Direct) at 13-16, 20-25. *See also* Pet. Ex. 4 (Dittman Direct) at JD-2 (the Contract) at Section 3(a) (requiring Petitioners to buy water exclusively from the District and requiring District approval to resell water); Section 3(b) (obtaining water from another source does not relieve a Member City from making all payments due under the Contract to the District); Section 13(a) (the Contract shall remain in full force until all bonds and interest thereon are paid); Section 14 (no modification of the Contract can be made without the written consent of all parties to the Contract).

Petitioners argue that the District's rates themselves are evidence of the District's abuse of its monopoly power.[199] The District has raised the rate to Petitioners by 10% or greater for the five years leading up to this rate appeal. The resulting FY 2017 rate is over 100% greater than the rate charged in 2010.[200] Additionally, Petitioners' rates are based on their highest historical annual demand—Annual Minimums—which cannot be decreased, were all established over 10 years ago, and have not been met since.[201] From the year their Annual Minimums were set, Petitioners have engaged in proactive water conservation efforts. As such, despite modest population increases, Petitioners' total water usage has steadily decreased.[202] The District's rates have not been adjusted to account for decreasing usage resulting from conservation efforts. The following chart shows the amount of undelivered water (the difference between the Annual Minimum and the amount actually used) for FY 2017 and the cost of that undelivered water for each member city.

Member City	Cost of Undelivered Water in FY 2017	Gallons of Undelivered Water in FY 2017
Richardson[203]	$6,198,759	2,923,943,000
Mesquite[204]	$5,669,832	2,674,449,000
Plano[205]	$10,015740	4,724,406,000
Garland[206]	$7,591,330	3,580,816,000
Totals:	**$29,475,661**	**13,903,614,000**

Petitioners also point to two instances of over-collection from ratepayers as evidence of the District's abuse of its bargaining power in setting rates. First, the District's bond covenants require

[199] Petitioners' Initial Brief at 17-23. The District's charges to Non-Member Cities pursuant to the Nickel Premium are addressed in Issue 5.d. below.

[200] Pet. Ex. 9 (Totten Direct) at JT-12.

[201] Mesquite's Annual Minimum, which was increased by contract in 2008, is discussed later in this section.

[202] Pet. Ex. 4 (Dittman Direct) at 10-14; Pet. Ex. 7 (Glasscock Direct) at 17-20; Pet. Ex. 3 (Johnson Direct) at 15-22; Pet. Ex. 6 (Baker Direct) at 12-17.

[203] Pet. Ex. 3 (Johnson Direct) at 22.

[204] Pet. Ex. 4 (Dittman Direct) at 22.

[205] Pet. Ex. 7 (Glasscock Direct) at 21.

[206] Pet. Ex. 6 (Baker Direct) at 17.

a 1.0x debt service coverage.[207] However, the District's actual debt service coverage is 1.73x, meaning that the District is collecting so much revenue that its debt is covered 1.73 times.[208] Petitioners argue this excess coverage results in an unnecessary over-collection from ratepayers.[209]

Second, Petitioners point to the District's application of Policy No. 8[210]—which is ostensibly a project financing tool—to artificially increase Mesquite's Annual Minimum by nearly half-a-billion gallons of water per year.[211] Policy No. 8 allows Member Cities to utilize District funds to finance capital improvements. Mesquite used this program to fund a parallel 36-inch water transmission line and an additional point of delivery in 2002. At that time, Policy No. 8 stated that the Member City would accept a new, increased Annual Minimum that would be in effect "as long as any bonds are outstanding in the bond issue applicable to the construction."[212] Policy No. 8 was later amended to remove this language such that the increased minimum would essentially be permanent. Additionally, Mesquite later discovered that the District did not use bonds to finance Mesquite's transmission line, but instead used cash. Nevertheless, Mesquite's Annual Minimum remains at a level that includes the nearly half-a-billion added gallons per year as a result of utilizing Policy No. 8 to fund the transmission line and additional point of delivery. Mesquite calculates that the additional cost to it based on the artificially inflated Annual Minimum has been over $8 million since 2003.[213]

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[207] Pet. Ex. 34 at 33.

[208] Tr. at 704-06.

[209] Petitioners' Initial Brief at 22.

[210] Pet. Ex. 12 (Dittman Rebuttal) at JD-R2.

[211] Petitioners' Initial Brief at 18-19.

[212] Pet. Ex. 12 (Dittman Rebuttal) at JD-R2 at 3.

[213] Pet. Ex. 4 (Dittman Direct) at 16.

ii. Arguments of District, Frisco & Forney, and McKinney

The District denies that it has abused its monopoly power through any disparate bargaining power.[214] Further, the District states that none of the Petitioners was under an obligation to enter into the Contract in 1988, but that they could have proceeded under the existing agreement between the parties, which would not have expired for several years and could have been extended. The District argues that this was one viable alternative and that other alternatives have become available since that time, such as the Upper Trinity Regional Water District (UTRWD).[215] Frisco & Forney assert that the only timeframe to evaluate disparate bargaining power is when the parties were negotiating the 1988 Contract because that is when the formula the District uses to calculate the rates was established.[216] Frisco & Forney and McKinney also argue that the District cannot be abusing its monopoly power if it is charging rates according to the Contract's terms.

While the Contract was being negotiated in 1988, the District cites several drafts that were exchanged by the parties and meaningful changes[217] that were made after the District issued its Q&A Memo on May 6, 1988, but before most of the Member Cities had approved the Contract by September 28, 1988. The District also notes that Petitioners benefitted from the fixed annual minimum plus excess charge arrangement in the agreement that was in place before the 1988 Contract was executed. During those years, Petitioners were growing and exceeded minimums for 15 to 22 out of the previous 30 years.[218] Petitioners paid a low excess charge rate for the water that exceeded their minimums. In other words, Petitioners benefitted from the rate structure when they were growing and now begrudge Intervenors for benefitting from the structure as those cities grow.

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[214] District's Initial Brief at 17-26.

[215] District's Initial Brief at 20-21.

[216] Frisco & Forney's Reply Brief at 4.

[217] NTMWD Ex. 72 at 21 (suggesting a reasonableness requirement for operation and maintenance expenses); NTMWD Ex. 5 (Sanderson Direct) at JRS-1 at 8 (incorporating the reasonableness requirement).

[218] NTMWD Ex. 14 at 5, 7-8, 10.

The District also argues that Mesquite's decision to utilize Policy No. 8's District funding for its transmission line and additional point of delivery is not evidence of abuse of monopoly power. The District clarifies that District funding of the project is not governed by Policy No. 8, but by the parties' 2002 contract for the funding.[219] The 2002 contract includes a formula for calculating a new Annual Minimum that includes an increasing minimum for the new point of delivery for a period of 6 years.[220] That is why the "artificial" Annual Minimum was established in 2008—it was the sixth year after the contract was entered into, which meant that the Annual Minimum would increase by approximately half-a-billion gallons per year at that point pursuant to the contract. The 2002 contract does not contain the language included in Policy No. 8 that the increased Annual Minimum shall be in effect until the bonds covering the project have been paid. Rather, the 2002 contract states that the increased Annual Minimum shall continue "until such consumption is in excess of the sixth year total [A]nnual [M]inimum," at which time a new minimum would be set.[221] Finally, the District argues that the total project cost was $3.4 million and that Mesquite's share of that cost was only about $300,000 based on its average 9% pro rata share of the District's revenue requirement at the time the project was funded.[222]

The District also contends that its increasing base rates are due to rising costs of capital infrastructure and the formula provided by the Contract, not disparate bargaining power.[223] Recent higher rate increases are due to the fact that the District did not raise rates at all for some period of time, such that the District has been "playing catch-up" in recent years.[224] Additionally, maintaining bond coverage amounts greater than 1.0x results in lower interest rates for District bonds, resulting in a cost savings to all District customers, including Petitioners.[225]

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[219] NTMWD Ex. 5 (Sanderson Direct) at JRS-10.

[220] NTMWD Ex. 5 (Sanderson Direct) at JRS-10 at 2.

[221] NTMWD Ex. 5 (Sanderson Direct) at JRS-10 at 2.

[222] NTMWD Ex. 5 (Sanderson Direct) at 34.

[223] District's Reply Brief at 13-14.

[224] Tr. at 731.

[225] District's Reply Brief at 14.

With respect to Petitioners' complaints that they do not have meaningful representation on the Board, the District argues that many Member Cities continue to appoint the same people to the Board year after year and that Petitioners' appointed members are free to communicate Petitioners' concerns regarding any rate increase, infrastructure project, etc. to the Board as a whole.

iii. ALJs' Analysis

The ALJs agree with Petitioners that the evidence shows the District has abused its monopoly power in the use of its disparate bargaining power over Petitioners. As a preliminary matter, the ALJs do not agree with Intervenors or with District witness Jack Stowe that the only point in time at which the Commission should evaluate the effects of disparate bargaining power is at the inception of the Contract. This position conflicts with the preamble for the Public Interest Rule, which makes clear that an agreement may *become* adverse to the public interest *over time*.[226]

Petitioners had no practical alternative for water service at the time the Contract was entered into, evidencing the District's disparate bargaining power at that time.[227] The District acknowledged this fact at the time in a letter stating that an alternate supply "does not really appear to be available either now or in the long term future due to the lack of developable natural resources within the state."[228] Although the District and Frisco & Forney argue that UTRWD was an alternative source, Frisco witness George Purefoy testified that UTRWD was not created until the year after the Contract was signed.[229] Additionally, because the Contract prohibits Petitioners from obtaining water from any other source and requires payment for the Annual Minimums whether or not any water is actually delivered to Petitioners, obtaining water from an alternative source is both contractually prohibited and cost-prohibitive.

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[226] 19 Tex. Reg. 6228 (Aug. 9, 1994).

[227] "[W]hen one provider maintains the only means of rendering an essential service to a customer, the provider will have disparate bargaining power." Pet. Ex. 53 (prior testimony of District expert Jack Stowe) at 7 (emphasis removed).

[228] Pet. Ex. 6 (Baker Direct) at JB-12 at 3.

[229] Frisco Ex. 1 at 6.

The Contract in this case is also, practically speaking, perpetual in time and contains substantial limits on the power of Petitioners to effect any change. The Contract term lasts until all bonds and interest thereon have been paid and for the life of the water system thereafter.[230] Because the water system includes an existing reservoir and the District has already issued bonds for the planning of the Bois d'Arc Reservoir, it is likely that bonds will be outstanding and the system will be in existence for generations to come. The contractual limitations on Petitioners to effect any changes include: a provision requiring Petitioners to buy water exclusively from the District,[231] District approval to resell any water,[232] and unanimous written consent by all contracting parties to modify the Contract in any way.[233] Modification of the Contract is extremely unlikely given the fact that some parties have expressed an unwillingness to agree to any change that would increase *any* costs to parties.[234]

Another limit on Petitioners' ability to effect any change is the fact that Petitioners may not remove Board members that they have appointed, with or without cause.[235] That is because, once appointed, the Board members become officers of the District, not the appointing city.[236] Although the ALJs are aware that Attorney General opinions do not carry the same weight as case law and statutes, the ALJs find no evidence that a court would come to a different conclusion. Further, the District's Enabling Act supports that conclusion. It prescribes the number of Board members that may be appointed by each Member City, and their term, and specifies that "[n]o member of a governing body of a [Member] [C]ity, and no employees of a [Member] [C]ity, shall be appointed as a director."[237] This language indicates an intent that directors should not have dual allegiances.

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[230] Pet. Ex. 4 (Dittman Direct) at JD-2 at Section 13(a).

[231] Pet. Ex. 4 (Dittman Direct) at JD-2 at Section 3(a).

[232] Pet. Ex. 4 (Dittman Direct) at JD-2 at Section 3(a).

[233] Pet. Ex. 4 (Dittman Direct) at JD-2 at Section 14.

[234] Tr. at 382-83.

[235] Atty. Gen. Op. JM-1239 (1990); Atty. Gen Op. KP-0117 (2016).

[236] Atty. Gen. Op. JM-1239 (1990) at 3.

[237] Act of April 4, 1951, 52nd Leg., R.S., ch. 62, § 3(a), 1951 Tex. Gen. Laws 96, 97, 99.

The ALJs also find it significant that the District's position on this issue changed from an interpretation that city-appointed directors would act "in accordance with the desires of the cities,"[238] in the months prior to execution of the Contract, to requesting an Attorney General opinion wherein the "cities have no control over the actions and composition of the governing [B]oard for the [D]istrict," approximately two years later.[239] Although the District argues that negotiations among the parties occurred and several drafts of the Contract were exchanged after the District's initial characterization of the role of directors, the ALJs see no changes to the Contract provisions that would affect the role of the directors that resulted from those negotiations, or that would have changed Petitioners' understanding of directors' role at the time the Contract was executed.

As Petitioners point out, the District has not changed its position regarding directors' allegiances, evidenced in its decision to seek a second Attorney General opinion and to eschew legislative amendment to its Enabling Act. The ALJs agree with Petitioners that the District's ability to settle a third-party dispute by imposing limits on Petitioners' water use—without their permission—is indicative of the imbalance in bargaining power. The Board approved the settlement of the lawsuit;[240] theoretically, Petitioners (as well as any other Member Cities) had a say in the settlement through the Board's votes. However, because Petitioners lack the right to remove or demand fiduciary loyalty from the directors they appoint, they have no remedy when those directors take actions adverse to Petitioners' interests.

The ALJs do not find that the District's financing of Mesquite's 36-inch water transmission line and additional delivery point evidence an abuse of monopoly power in the manner that Petitioners allege. The financing was undertaken by an agreement between the District and Mesquite that did *not* include a term specifying that the increased Annual Minimum would only be in effect so long as any outstanding bonds for the construction were unpaid. Pursuant to the financing agreement, the increased Annual Minimum would be permanent, similar to how the

[238] Pet. Ex. 4 (Dittman Direct) at JD-24 at 56.

[239] Pet. Ex. 9 (Totten Direct) at JT-11 at 9.

[240] District's Reply Brief at 16 (citations omitted).

Contract treats increasing Annual Minimums. The agreement between the parties, as well as District Policy No. 8 which is referenced in the agreement, use the increased Annual Minimum as consideration for the District financing of the project.

The District notes that the total project cost was $3.4 million and contends that Mesquite only paid $300,000—representing Mesquite's 9% pro rata share of the revenue requirement during the development of the project.[241] The District's explanation that Mesquite paid only $300,000 for the construction is disingenuous. The pro rata share of the revenue requirement is not the consideration set out in the parties' agreement—the increased Annual Minimum is the consideration. The ALJs find it troubling, however, that the increase became permanent at a level Mesquite is unlikely ever to reach, and that the District has collected over $8 million[242] from Mesquite through FY 2017 for a $3.4 million project and continues to collect more money each year for this project.

The ALJs conclude that the District has abused its monopoly power as a result of its disparate bargaining power as evidenced by the following factors:

- environmental impacts resulting from Petitioners' conservation measures (detailed in the discussion of Issue 5.c.v. below);
- the District's unreasonably preferential, prejudicial, and discriminatory rates charged Petitioners when compared to the wholesale rates the District charges to Customer Cities (detailed in the discussion of Issue 5.d. below);
- the lack of alternative sources of water;
- the contractual and financial obstacles to obtaining water from alternative sources, if such alternative sources existed;
- the District's unilateral right to adjust Petitioners' rate and continuing increases of the rate;

[241] District's Reply Brief at 10.

[242] Pet. Ex. 4 (Dittman Direct) at 15-16.

- the perpetual nature of the Contract, which term can be unilaterally extended by the District;
- the inability of Petitioners to modify the Contract;
- Petitioners' lack of control over the directors they appoint to the Board;
- the District's change in its characterization of the role of city-appointed directors from carrying out the desires of the cities to the cities having no control over the actions of the District; and
- the District's overcharging of Mesquite for the financing of a 36-inch water transmission line and additional delivery point.

The ALJs note that if just one or two of the above factors were present in this case, there likely would not be enough evidence to conclude that the District abused its monopoly power through its disparate bargaining power over Petitioners. For example, as the District and Intervenors have pointed out, there is nothing inherently wrong with an agreement for the provision of wholesale water that is essentially perpetual in nature—in fact, similar terms are specifically authorized by statute.

Section 552.020(d) of the Texas Local Government Code states that a municipality may enter into a contract with a water district "for any duration" including for so long as any bonds (including refunding bonds) remain unpaid. Section 552.020(c) of the Texas Local Government Code also allows such a contract to prohibit a municipality from obtaining water from any other source—as is the case with Petitioners and the District. However, the ALJs conclude that over time, the combination of the factors stated in the bullet list above results in the type of agreement the TNRCC anticipated when it promulgated the Public Interest Rule. This is a situation "where a seller and purchaser have entered into a long term agreement" where "[o]ver time the seller exercises near monopoly power over the purchaser," the seller has the "unilateral right to adjust the rate," and the "purchaser substantially has no alternatives to obtain water."[243]

[243] 19 Tex. Reg. 6228 (Aug. 9, 1994).

The ALJs do not agree with Petitioners that the District's debt service coverage of 1.73x, as opposed to the 1.0x required by the bond covenants, evidences the District's abuse of monopoly power. The District is free to increase the level of debt service coverage from the required minimum such that it may enjoy a higher bond rating and borrow at lower interest rates.

b. Issue 5.c.ii: The [D]istrict's failure to reasonably demonstrate the changed conditions that are the basis for a change in rates;

i. Arguments of Petitioners and Royse City[244]

Petitioners argue that the District failed to demonstrate changed conditions that were the basis of its FY 2017 rate increase. Petitioners maintain that the rates were based on an inflated budget designed for the delivery of an unrealistically high volume of water. The District budgeted for delivery of the total volume necessary to meet the Annual Minimum of every customer—a volume of water that has never been delivered in a single year. To wit, the District budgeted for delivery of approximately 114 billion gallons of water in FY 2017, but delivered only 95 billion gallons representing 83% of the budgeted volume.[245] Petitioners claim that the District recognized its over-budgeting practice and has since altered the calculation to account for variable costs based on 90% of Annual Minimums, rather than 100%.[246] Petitioners argue that the inflated FY 2017 budget and the District's changes to the volume of water budgeted for since this rate proceeding was filed evidence the District's abuse of monopoly power due to a failure to demonstrate changed conditions.[247]

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[244] The ALJs note that Royse City's arguments refer to changed conditions, but not the changed conditions that would have justified the rate increase by the District. Royse City's arguments are addressed in other sections of this PFD: (1) 1990 change in status of the Petitioners' appointees to the Board as representatives of the District's interests rather than the appointing Petitioner's interests—addressed in Issue 5.c.i. regarding disparate bargaining power; (2) the use of conservation measures beginning in the mid-1990s—addressed in Issue 5.c.v. regarding incentives to encourage water conservation measures; and (3) the growth of the District's Customer Cities—addressed in Issue 5.d.

[245] Pet. Ex. 9 (Totten Direct) at JT-6.

[246] Royse City's Ex. RC-6.

[247] Petitioners' Initial Brief at 25-26.

ii. Arguments of District and Frisco & Forney

The District claims no party disputes that increases in costs to the District form the basis of the protested rate. The District and Frisco & Forney argue that the rates were properly set pursuant to the mathematical calculations set out in the Contract and are thus valid.[248]

iii. ALJs' Analysis

The ALJs are persuaded by Petitioners' argument that the District based its FY 2017 budget on delivery of an unreasonably high volume of water. The ALJs agree that using each Member City's Annual Minimum as the basis for budgeting variable costs is not reasonable. Frisco & Forney admit that the budget "is the only discretionary decision the District makes in setting the rates."[249] Overstating the budget for variable costs can result in artificially inflated rates. The District apparently now recognizes that fact because, beginning in FY 2019, it changed its budgeting methodology to plan for the delivery of only 90% of Annual Minimums, as opposed to 100%.[250] The ALJs agree that the practice through FY 2017 of setting budgets based on each Member City's highest historical use (that is very unlikely to be repeated) evidences an abuse of monopoly power because the District failed to reasonably demonstrate the changed conditions that are the basis of its yearly rate changes.

c. Issue 5.c.iii: Whether the [D]istrict changed the computation of the revenue requirement or rate from one methodology to another;

The ALJs find no evidence that the District changed the computation of the revenue requirement or rate from one methodology to another. The arguments posed by Petitioners in their

[248] District's Reply Brief at 15; Frisco & Forney's Initial Brief at 23.

[249] Frisco & Forney's Initial Brief at 23.

[250] Royse City's Ex. RC-6.

initial brief go beyond this factor referred by the Commission (arguing that the District's rate methodology is inherently unjust).[251]

d. Issue 5.c.iv: Other valuable consideration received by a party incident to the contract;

i. Arguments of Petitioners and Royse City

Petitioners and Royse City argue that the District receives other valuable consideration incident to the Contract in at least two ways. First, Petitioners and other Member Cities are jointly and severally liable for all expenses of the District whereas Customer Cities are not.[252] Member Cities' obligations to fully fund the District gives the District the financial security to "separately contract with [Customer Cities] under relatively friendlier terms."[253] Second, the District has unilaterally pledged to reduce Petitioners' water demands as part of a settlement agreement.[254] Petitioners and Royse City argue this is evidence of abuse of monopoly power because the District has the power to enter into third-party contracts that constrain Petitioners' water use without first obtaining Petitioners' consent. And, reductions in Petitioners' water use would reduce the District's variable costs but would have no effect on Petitioners' Annual Minimums, thus ensuring Petitioners "will continue paying more for less."[255]

ii. Arguments of District

The District includes in its briefing a lengthy list of major benefits to Petitioners resulting from the Contract, including a secure and reliable source of treated water; the fact that Petitioners do not have to build their own water systems; the benefits of economies of scale and cost-sharing,

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[251] Petitioners' Initial Brief at 27.

[252] Petitioners' Initial Brief at 28-29; Royse City's Initial Brief at 9-10.

[253] Petitioners' Initial Brief at 27 (citations omitted).

[254] Petitioners' Initial Brief at 28-29; Royse City's Initial Brief at 9-10.

[255] Petitioners' Initial Brief at 28.

along with lower debt costs; and benefits of regionalization, among others.[256] The District rejects the concept that it receives any special consideration incident to the Contract because "*all* of the 'valuable consideration' enjoyed by the District flows directly to the Member Cities."[257] The District also notes that the settlement of the third-party dispute referenced by Petitioners was "a governance issue related to the powers of the [Board, and not] a contract issue."[258]

iii. ALJs' Analysis

The preamble to the Public Interest Rule does not clarify what is meant by this factor, and the ALJs find that the arguments made by both parties address matters that are part-and-parcel of the Contract, rather than incident to it. For example, joint and several liability is an embedded component of the Contract, not incidental consideration. The Nickel Premium *does* reflect an abuse of monopoly power, but that is more squarely discussed under Issue 5.d. (comparing rates the District charges to Petitioners versus to other Member Cities and to Customer Cities). Similarly, lower debt costs and economies of scale as a result of banding together, along with the other benefits cited by the District, are fundamental to the goal of the Contract, not incident to it.

The ALJs do agree with Petitioners that the District's ability to settle a third-party dispute by imposing limits on Petitioners' water use—without their permission—is indicative of an imbalance in power. However, that imbalance does not stem from a source outside the Contract. Rather, that imbalance traces back to Petitioners' inability to meaningfully affect decisions of the District through its Board, a matter that is discussed above under Issue 5.c.i. Therefore, the ALJs do not find evidence of abuse of monopoly power based on consideration received by any party incident to the Contract.

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[256] District's Initial Brief at 27-28.

[257] District's Initial Brief at 28 (emphasis in original).

[258] District's Reply Brief at 16.

e. Issue 5.c.v: Incentives necessary to encourage regional projects or water conservation measures;

i. Arguments of Petitioners and Royse City

Petitioners argue that the rate structure improperly encourages water use and disincentivizes conservation on both a marginal-price basis and an effective-rate basis, and that the rates lack incentives necessary to encourage conservation, which constitutes an abuse of monopoly power. Petitioners do not allege and did not present evidence regarding whether the District abused its monopoly power by failing to incentivize regional projects.[259]

Petitioners characterize the District's rate to its Member Cities as a decreasing block rate—meaning that the volumetric charge of the first consumption unit ($2.53 per 1,000 gallons up to the Annual Minimum) is greater than the volumetric charge for the next consumption unit ($0.41 per 1,000 gallons Excess Charge). Petitioners argue that decreasing block rates provide poor conservation incentives.[260]

The District's rates as applied to Petitioners consist of a large fixed payment, a zero charge thereafter until the Annual Minimum is met, and $0.41 per 1,000 gallons Excess Charge for consumption above the minimum. In this scenario, the marginal cost to a Petitioner of consuming surplus water up to the Annual Minimum is $0. Because for many Petitioners the delta between water consumed and the Annual Minimum can be billions of gallons, Petitioners argue that the incentive to conserve is poor. This disincentive to conserve is not likely to change for Petitioners, who are unlikely to approach their Annual Minimum in the foreseeable future.[261]

Petitioners maintain that the District's rates disincentivize conservation when viewed on an effective rate basis as well. Petitioners describe the effective rate as the price per 1,000 gallons

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[259] Petitioners' Initial Brief at 28-34.

[260] Petitioners' Initial Brief at 29-30.

[261] Petitioners' Initial Brief at 29-30.

of water actually delivered.[262] For customers like Petitioners that are not likely to consume water in volumes close to their Annual Minimums, the effective rate for water decreases as consumption increases.

Petitioners argue these conservation disincentives evidence an abuse of monopoly power by the District because Petitioners pay more for consuming less water. Further, Petitioners argue that the District has taken steps to prevent changes to the arrangement. Petitioners point to a settlement between the District and environmental groups in which the District agreed to require Petitioners to adopt increasing block water rates for their retail customers in an effort to encourage conservation.[263]

ii. Arguments of District, Frisco & Forney, and McKinney

The District argues that it encourages regional projects because it was created to provide water to the North Texas region. Essentially, the District argues that it *is* a regional project. In creating the District, the original member cities aspired to use economies of scale to obtain a cost-effective and cost-efficient water supply for the region.[264]

The District also asserts that it incentivizes water conservation. Notably, District expert Jack Stowe argues that Petitioners' interpretation of this factor is backwards. The purpose of this factor is not to examine the impacts of the protested rate itself on water conservation,[265] but what "impact incentives necessary to encourage water conservation measures have on a protested rate

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[262] Petitioners' Initial Brief at 32; *see also* discussion of effective rates presented in connection with Issue 5.d. below.

[263] Petitioners' Initial Brief at 33-34; *see also* discussion of the settlement presented in connection with Issue 5.d. below.

[264] District's Initial Brief at 28-30.

[265] NTMWD Ex. 6 (Stowe Direct) at 77-78.

from the seller's perspective."[266] In this way, argues Mr. Stowe, this factor "functions as a defense for regional water suppliers who, by law, must implement water conservation measures."[267]

The District also contends that its rates incentivize conservation by encouraging Member Cities to limit their highest annual water use, or peak demand, and that the rebates for undelivered water (amounting to approximately $87 million since 1993) recognize and encourage conservation efforts.[268] Frisco & Forney and McKinney agree that cities are sensitive to increasing their Annual Minimums because they realize it has long-term cost implications.[269] Frisco & Forney and McKinney also fault Petitioners for not implementing effective conservation measures prior to setting their Annual Minimums.[270]

District witness Mr. Ekrut also testified that a retail rate designed to encourage conservation will not be structured the same way as a wholesale rate designed to encourage conservation.[271] Mr. Ekrut also argues that the District's wholesale rate design has no effect on a retail end-user's conservation efforts—the rate that effects a retail user's conservation efforts is Petitioners' retail rates.[272]

iii. ALJs' Analysis

The ALJs agree with the District that the existence of the District promotes regionalization because it was created to utilize economies of scale to provide wholesale water service to a specific region in North Texas. Whether the District does so in a cost-effective or cost-efficient manner, as the District alleges, however, is not before the ALJs.

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[266] NTMWD Ex. 6 (Stowe Direct) at 78.

[267] NTMWD Ex. 6 (Stowe Direct) at 78.

[268] District's Initial Brief at 31.

[269] Frisco & Forney's Initial Brief at 24; McKinney's Initial Brief at 13-14.

[270] Frisco & Forney's Initial Brief at 25; McKinney's Initial Brief at 14; *see* discussion under Issue 5.d. below.

[271] NTMWD Ex. 7 (Ekrut Direct) at 53.

[272] NTMWD Ex. 7 (Ekrut Direct) at 53-55.

The ALJs concur with Petitioners that the District's rates evidence an abuse of monopoly power because they fail to incentivize conservation measures. The TWDB's Water Conservation Best Management Practices Guide includes a section on suppliers of wholesale water, which provides in relevant part:

> Wholesale agencies should work in cooperation with their wholesale customers to identify and remove potential disincentives to conservation that are created by water management policies including, to the extent possible, when considering the nature of wholesale water service, its water rate structure. Wholesale rate structures should be designed upon the basic princip[le] of increased cost for increased usage. Incentives to conserve can be built into the base rate/volumetric rate ratio ... .[273]

The District's rates for Petitioners do not follow the principle of increased costs for increased usage. Although the District argues that the rates encourage cities to avoid using water in excess of their "peak demand" Annual Minimums, there is no meaningful pressure on cities such as Petitioners to conserve water when they are unlikely to consume their Annual Minimum in the foreseeable future. On that point, the District disputes the allegation that Petitioners are unlikely to consume their individual Annual Minimums again, but the ALJs find that Petitioners have shown consumption at that level to be unlikely. For example, the following chart includes information regarding Mesquite's and Plano's population growth and water consumption from water year 2001 to 2017:[274]

Water Year	Mesquite's Population	Mesquite's Consumption	Plano's Population	Plano's Consumption
2001	126,570	7,798,284,000	227,200	26,719,809,000
2002	127,800	6,550,839,000	234,100	22,459,418,000
2003	129,650	6,745,818,000	240,300	22,745,013,000
2004	131,582	6,411,590,000	244,300	22,149,517,000
2005	133,605	6,236,694,000	248,700	22,432,203,000

[273] Texas Water Development Board Report 362, Water Conservation Implementation Task Force, Water Conservation Best Management Practices Guide, p. 78 (November 2004), available at: http://www.twdb.texas.gov/publications/reports/numbered_reports/doc/R362_BMPGuide.pdf; *see also* Pet. Ex. 16 (Villadsen Rebuttal) at 36.

[274] This chart uses information from Pet. Ex. 4 (Dittman Direct) at 19-20 and Ex. 7 (Glasscock Direct) at 18-19.

Water Year	Mesquite's Population	Mesquite's Consumption	Plano's Population	Plano's Consumption
2006	135,894	7,115,204,000	252,600	26,265,050,000
2007	136,750	5,709,463,000	255,700	19,010,709,000
2008	137,593	6,497,748,000	257,100	22,200,580,000
2009	137,850	6,640,023,000	258,500	22,838,135,000
2010	139,550	6,035,389,000	259,841	21,408,304,000
2011	139,870	6,706,795,000	260,500	23,608,556,000
2012	139,950	6,477,455,000	261,900	21,171,393,000
2013	140,240	5,436,854,000	266,950	21,128,533,000
2014	142,210	5,143,618,000	269,330	18,020,713,000
2015	142,230	5,361,935,000	271,140	17,937,467,000
2016	142,950	6,045,214,000	274,960	21,460,479,000
2017	143,060	5,623,217,000	277,720	21,995,403,000

The chart shows a trend of decreasing water consumption despite modest population growth over the years.

The ALJs are unconvinced by the District's argument that the excess rate charged for water consumed over the Annual Minimum acts as an incentive for conservation. The excess rate for FY 2017 was only $0.41 per 1,000 gallons. This is far below the base rate of $2.53 per 1,000 gallons and results in inexpensive excess water. Even the City of Allen—an Intervenor in this case—referred to the excess rate as an "effective 'rate subsidy' given to water customers that exceed their take or pay quantity of water."[275] The same arguments apply to the District's Rebate Policy of refunding $0.41 per 1,000 gallons for water not consumed below the Annual Minimum. Additionally, there is no guarantee that the District will pay rebates in any given year because the rebates are discretionary District policy, not guaranteed by the Contract.

Petitioners also presented persuasive evidence that water conservation efforts were not a statewide priority at the time the Contract was signed in 1988. For example, in 1993 the TCEQ adopted rules requiring wholesale water suppliers and municipal water suppliers to develop water conservation plans. The TCEQ added requirements for drought contingency plans in 1999. In

[275] Pet. Ex. 7 (Glasscock Direct) at BG-15.

2007, the Texas Legislature amended Code § 13.146 to require potable water service providers to file water conservation plans with the TWDB.[276] The District's executive director testified as to the recent emphasis on conservation when asked about water usage in 2011, the driest year on record:

> A good thing has happened over the last—within the last decade, and that's statewide, and that's within our region, and that's within our cities, is conservation efforts and programs have taken on additional emphasis, and everyone has realized that we have to use water much more wisely than what we have done in the past.[277]

Because Petitioners are unlikely to consume enough water to meet their Annual Minimums, they will continue to pay more per gallon when consuming less water. This arrangement benefits the District by keeping the revenues from Petitioners high, while the cost to serve them remains low. For these reasons, the ALJs conclude that the lack of incentives to encourage water conservation evidences an abuse of monopoly power by the District.

f. Issue 5.c.vi: The [D]istrict's obligation to meet federal and state wastewater discharge and drinking water standards;

i. Arguments of Petitioners

Petitioners argue that they are obligated to pay for their Annual Minimums whether or not any water is delivered and regardless of whether any of that water meets federal and state drinking water standards.[278] Petitioners acknowledge that the District expends capital costs for its system to comply with drinking water standards, but argue that given the explosive increase in costs for the system—from $86 million in 2012 to nearly $600 million in 2017[279]—and Petitioners'

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[276] Pet. Ex. 9 (Totten Direct) at 26.

[277] Pet. Ex. 17 (Totten Rebuttal) at JT-R3.

[278] Pet. Ex. 4 (Dittman Direct) at JD-7 at 334.

[279] Pet. Ex. 18 (Hudson Rebuttal) at PH-RI at 19.

obligations to cover those costs, the Commission should examine whether the costs were appropriately incurred since those rising costs resulted in rate increases.[280]

ii. Arguments of District

The District argues that it expends capital costs to comply with federal and state drinking water standards and that, consistent with the trend in Texas and the U.S., the cost of complying with those increasingly stringent standards is on the rise.[281]

iii. ALJs' Analysis

The ALJs recognize that the District consumes capital in order to meet state and federal drinking water standards and that Petitioners are unconditionally obligated to make payments to the District. The ALJs find no evidence that this factor evidences an abuse of monopoly power by the District.

g. Issue 5.c.vii: The rates charged in Texas by other sellers of water service for resale;

The ALJs find compelling evidence of abuse of monopoly power when the rates charged by the District are compared to the rates charged by other Texas wholesale providers.

i. Arguments of Petitioners and Royse City

Petitioners' expert witness Dr. Bente Villadsen reviewed wholesale water supply contracts for seven other Texas entities: the City of Dallas, the City of Fort Worth, UTRWD, Tarrant Regional Water District (TRWD), Trinity River Authority, Colorado River Municipal Water District, and Lower Colorado River Authority (LCRA).[282] For UTRWD and TRWD, Dr. Villadsen reviewed separate contracts for the member and non-member customers of those

[280] Petitioners' Initial Brief at 34-35.

[281] District's Initial Brief at 32.

[282] Pet. Ex. 16 (Villadsen Rebuttal) at 41.

districts. All of these water suppliers have take-or-pay provisions in their contracts, but they differ from the Contract in important respects.

Most notably, Dr. Villadsen found that none of the providers she studied "charges rates under a take-or-pay provision that adjusts the designated purchase amount upwards but never downwards."[283] In other words, *none* of these providers has a structure comparable to the non-resetting Annual Minimum as used in the Contract. Each provider studied "usually resets [the designated purchase amount] to reward customers for reducing total or peak water usage through conservation efforts."[284]

Four providers Dr. Villadsen reviewed calculate the take-or-pay amount using a rolling average or maximum over a three- or five-year period.[285] Additionally, four of the providers reviewed apply the take-or-pay requirement to only the demand charge of their customers' bills, not to the volume charge.[286] Dr. Villadsen opined that these take-or-pay amounts "better reflect the provider's costs and capacity requirements" because they focus "exclusively on maximum daily demand or maximum hourly demand rather than consumption."[287]

Dr. Villadsen highlighted two other features she found distinctive. None of the seven providers she studied offer "lower rates for water consumed above the annual minimum," which is what happens in the District because the cost to a Member City of consuming water over its Annual Minimum is much lower per 1,000 gallons than the per-1,000 gallon rate for the water consumed up to the Annual Minimum.[288] She added that most of the other contracts had finite contract terms of 30-40 years.

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[283] Pet. Ex. 16 (Villadsen Rebuttal) at 42, BV-R8. For ease of reference, the ALJs have included Dr. Villadsen's exhibit BV-R8, which summarizes the contracts she reviewed, on "Attachment A - Figures Cited" to this PFD.

[284] Pet. Ex. 16 (Villadsen Rebuttal) at 42.

[285] Pet. Ex. 16 (Villadsen Rebuttal) at 42.

[286] Pet. Ex. 16 (Villadsen Rebuttal) at 47.

[287] Pet. Ex. 16 (Villadsen Rebuttal) at 47-48.

[288] Pet. Ex. 16 (Villadsen Rebuttal) at 48.

With respect to data cited by the District's expert witness, Carlos Rubinstein, Dr. Villadsen pointed out that a 2006 TWDB survey of take-or-pay contracts reflected contract terms of 20 to 50 years, and only two contracts that were "in force for the entire useful life of the system."[289] Without expressing an opinion on the ideal length for contracts, Dr. Villadsen testified that a finite contract would be preferable, from a Member City perspective, to "an indefinite contract that features minimums that never reset." The Contract as it is "imposes on customers a considerable risk" that Dr. Villadsen did not find "in any of the other wholesale contracts [she] reviewed."[290]

Dr. Villadsen ran models examining how allocations would vary if Annual Minimums were allowed to reset based on resetting minimums as used by other Texas wholesale providers.[291] In the aggregate, a five-year rolling average methodology would result in savings of $7.6 million for Petitioners, and a three-year rolling average would result in savings of about $8.4 million, all without reducing the total revenue to the District from the Member Cities. A five-year rolling maximum methodology would result in savings of $8.6 million, and a three-year rolling maximum would save close to $10 million for Petitioners.

Finally, as to the Nickel Premium (discussed further below), Dr. Villadsen noted that UTRWD charges a premium to non-member cities, but keeps the premium constant over time *on a percentage basis* versus at a set amount.[292] That causes UTRWD's premium, in Dr. Villadsen's view, to function as a true premium because it can increase as base rates increase.[293]

ii. Arguments of District and Intervenors

Mr. Stowe, the District's expert, rejected Dr. Villadsen's analysis, contending that she was "comparing apples to oranges because the Contract Annual Minimum Methodology used by the

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[289] Pet. Ex. 16 (Villadsen Rebuttal) at 48.

[290] Pet. Ex. 16 (Villadsen Rebuttal) at 49 (citing NTMWD Ex. 8 (Rubinstein Direct)).

[291] The information in this paragraph is drawn from Pet. Ex. 16 (Villadsen Rebuttal) at 42-47.

[292] Pet. Ex. 8 (Villadsen Direct) at 55.

[293] Pet. Ex. 8 (Villadsen Direct) at 56.

District and Member Cities is different from the methodology used by UTRWD" and the other suppliers she studied.[294] Mr. Stowe opined that the "only directly comparable rate in the region" was that charged by the Trinity River Authority, and it illustrated that the District's rates were lower by comparison.[295] Dr. Villadsen's analysis was a comparison of "rate methodologies . . . [not] the actual rates themselves."[296]

The District finds fault with Dr. Villadsen's models comparing rates that would be charged to Petitioners using three- or five-year rolling averages or rolling maximums. It points out that she looked at savings to Petitioners in the aggregate. However, if disaggregated, the results show that Garland would have paid more for water in FY 2017 under any of the models than it did under the Contract.[297] In fact, "Garland would have paid *more*—not less—under all four of these alternatives over the last twelve years."[298]

In the end, the District argues, Petitioners compare the District's rates to other wholesale providers' rates to "address rate design issues that may only be resolved through amendments to the [Contract]."[299] And, even with the adjusting feature of UTRWD's premium, UTRWD's rates would be higher than the District's rates. A presentation that the Richardson City Council heard in August 2017 indicated that in FY 2017, "UTRWD's rate per 1,000 gallons was $3.50 whereas the District's was $2.53."[300]

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[294] NTMWD Ex. 6 (Stowe Direct) at 86.

[295] NTMWD Ex. 6 (Stowe Direct) at 86.

[296] NTMWD Ex. 6 (Stowe Direct) at 87.

[297] District's Initial Brief at 33.

[298] District's Initial Brief at 38-39 (citations omitted) (emphasis in original).

[299] District's Reply Brief at 19.

[300] District's Reply Brief at 19 (citations omitted).

iii. ALJs' Analysis

The TNRCC, when adopting the Public Interest Rule and related rules, stated that "there are numerous reasons which may explain why one utility's rate may be higher than the rates imposed by another utility."[301] Therefore, the TNRCC did not intend to "be placing dispositive weight on the fact the protested rate is different than the rates charged by other utilities."[302] Rather, the TNRCC was interested "in broad terms why there are differences in rates."[303]

It is against this backdrop that the ALJs consider Dr. Villadsen's review of other wholesale water providers and her models of allocations based on rolling three- or five-year averages or maximums. The District is insisting that a comparison is meaningful only if the other wholesale sellers' rates are closely comparable to the rates charged under the Contract. However, the TNRCC concluded that "a requirement that rates must be comparable would unduly complicate the hearing[.]"[304] Useful information can be gleaned from a comparison between suppliers without requiring the rate methodology to be identical. Based on Dr. Villadsen's analysis, the ALJs find it instructive that none of the other providers she studied had non-resetting minimum purchase amounts like the Annual Minimums. It is also notable that none of these providers supply a disincentive to conserve by pricing water above the minimum purchase amount at a rate less costly than the base rate. Finally, few other contracts (from the 2006 TWDB study cited by the District) appear to have the indefinite term that the Contract features. When all three of these elements are present—the non-resetting minimum, the disincentive to conserve, and an indefinite term—and the lack of effective governance power is added to the mix, there is persuasive evidence of abuse of monopoly power by the District.

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[301] 19 Tex. Reg. 6229 (Aug. 9, 1994).

[302] 19 Tex. Reg. 6229 (Aug. 9, 1994).

[303] 19 Tex. Reg. 6229 (Aug. 9, 1994).

[304] 19 Tex. Reg. 6229 (Aug. 9, 1994).

As for the allocation models Dr. Villadsen used, they are an analytical aid, not a proposal for adoption by the Commission. The District argues Garland would have paid more under these models, though Petitioners deny that charge.[305] The mathematical answer is not dispositive. The point of an adverse public interest finding is not that those affected should necessarily pay *less*; it is that they should pay a *fair* amount as determined by the Commission.

Dr. Villadsen herself stated that she "offer[s] no opinion at this time on how specific costs should be quantified or allocated," because that is "ultimately up to the Commission."[306] Her models are useful, however, to show that alternative approaches could result in rate structures with more equitably distributed costs. Notably, Royse City, which set its Annual Minimum in 2016 and is a faster-growth city, runs the risk of having to pay more if the Commission decides to alter the District's rate-setting mechanism. Royse City accepts that possible outcome because it values a fairer allocation of costs and meaningful input to the District's governance by all Member Cities.

h. Issue 5.c.viii: The [D]istrict's rates for water service charged to its retail customers, if any, compared to the retail rates the [P]etitioners charge their retail customers as a result of the wholesale rate the [D]istrict demands from the [P]etitioners.

i. Arguments of Petitioners

Petitioners charge their retail customers rates structured as increasing block rates.[307] The District charges its retail customers increasing block rates. Petitioners point out that increasing block rates are considered conservation-oriented by the TCEQ. However, Petitioners argue that the rates charged by the District to Petitioners are not conservation-oriented.[308]

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[305] Petitioners' Reply Brief at 25.

[306] Pet. Ex. 16 (Villadsen Rebuttal) at 16.

[307] An increasing block rate structure charges increasing rates for successively higher blocks of consumption.

[308] Petitioners' Initial Brief at 36-37.

ii. Arguments of District

The District points out that its retail charges are comparable to the Petitioners' retail charges and argues that this fact confirms it has not abused monopoly power.

iii. ALJs' Analysis

The ALJs note that this factor is not simply a comparison of the District's retail rates to Petitioners' retail rates, but Petitioners' retail rates charged its customers *as a result of* the wholesale rate the District charges to Petitioners. As discussed above in the analysis of Issue 5.b., the ALJs conclude that the District's wholesale rates impaired Mesquite's and Garland's abilities to provide service to their retail customers based on financial integrity (evidenced by the downgrading of their bond ratings due in part to the District's rates) and impaired Mesquite's and Richardson's abilities to provide retail service based on operational capability (evidenced by their delaying and curtailing necessary capital improvements to their retail systems). Therefore, in order to provide retail rates comparable to the District's retail rates, Petitioners Mesquite, Garland, and Richardson have had to suffer impairment to their financial integrity and operational capability. Thus, for the same reasons discussed in Issue 5.b., the ALJs conclude that this factor evidences the District's abuse of its monopoly power.

4. Issue 5.d: Are the protested rates unreasonably preferential, prejudicial, or discriminatory, compared to the wholesale rate the seller charges other wholesale customers?

In FY 2017, the District sold water on a wholesale basis to the 13 Member Cities under the Contract, and to 34 Customer Cities[309] under individual contracts with each city. The ALJs find that—even though the protested rates are charged on the same basis to all Member Cities (*i.e.*, all Member Cities were charged a Member City Rate of $2.53 and an Excess Charge of $0.41 in FY 2017)—the protested rates are unreasonably preferential, prejudicial, or discriminatory when comparing the impact of the protested rates to Petitioners versus the impact to non-petitioning

[309] Pet. Ex. 9 (Totten Direct) at JT-12.

Member Cities (Non-Petitioning Member Cities).[310] The ALJs also find that the protested rates are unreasonably preferential, prejudicial, or discriminatory when the Member City Rate is compared to the wholesale rates the District charges Customer Cities.

For Non-Petitioning Member Cities versus Petitioners, the main drivers of disparities in rate impact are conservation and the use of historical Annual Minimums to establish Member City obligations. The Nickel Premium is the primary driver for the inequitable rate structure with respect to Customer Cities versus all Member Cities.

a. Arguments of Petitioners, Staff, and Royse City

i. Use of effective rates

Petitioners' expert witness Dr. Villadsen used the concept of effective rates to illustrate the comparison at the heart of this public interest criterion. She derived the effective rate by taking a purchasing city's total bill (including Excess Charges and rebates under the Rebate Policy, if any) and dividing by that city's actual consumption of water.[311] The result, when calculated for every wholesale customer of the District, is "one way of comparing what the District's customers are really paying per 1,000 gallons consumed."[312] Dr. Villadsen computed the effective rates for all 13 Member Cities for FY 2017.[313] Her analysis demonstrates that while the FY 2017 Member City Rate was set at $2.53 per 1,000 gallons, the Member Cities paid a range of effective rates based on actual usage.

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[310] In earlier sections of this PFD, the ALJs used "Intervenors" to designate all Member Cities other than Petitioners and Royse City, since Royse City aligned its interests with Petitioners. However, many of the calculations discussed in this section, when performed on an aggregate basis rather than a city-by-city basis, compare Petitioners to *all* non-petitioning Member Cities. Thus, in this section, "Non-Petitioning Member Cities" is used to refer to Intervenors plus Royse City.

[311] Pet. Ex. 8 (Villadsen Direct) at 29.

[312] Pet. Ex. 8 (Villadsen Direct) at 29.

[313] Pet. Ex. 8 (Villadsen Direct) at 30 (Figure 6).

Petitioners paid four of the six highest effective rates in FY 2017 (Mesquite $3.54; Richardson $3.30; Garland $3.28; and Plano $2.99), and Non-Petitioning Member Cities paid effective rates ranging from a high of $3.76 (Farmersville) to a low of $2.57 (Royse City). On average for FY 2017, Petitioners paid an effective rate of $3.17, compared to an average effective rate of $2.69 for Non-Petitioning Member Cities, an 18% disparity.[314] The effective rate paid by all other non-petitioning wholesale customers of the District (Non-Petitioning Cities, *i.e.*, Non-Petitioning Member Cities and Customer Cities combined) was $2.78.[315]

Dr. Villadsen calculated the effective rates for all years from 1988 (the inception of the Contract) to FY 2017.[316] She stated that, between 1988 and 2001, the effective rates for Petitioners and Non-Petitioning Member Cities were "roughly aligned."[317] However, for every year from 2001 to 2017, Petitioners' average effective rate exceeded the average effective rate of Non-Petitioning Member Cities, and the "gap has widened significantly since 2010."[318]

The non-resetting nature of Annual Minimums is one reason for the continuing and increasing disparity in effective rates. Another factor is the difference between the Member City Rate and the Excess Charge (for FY 2017, $2.53 and $0.41 per 1,000 gallons, respectively). The Excess Charge, as discussed above, is so low as to encourage use rather than conservation for cities that are close to using their Annual Minimums for a year. Conversely, the Rebate Policy (which is equal to the Excess Charge) does not do much to recoup costs paid for undelivered water by cities that are using far below their Annual Minimums.

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[314] Pet. Ex. 8 (Villadsen Direct) at 32 (Figure 7).

[315] Pet. Ex. 8 (Villadsen Direct) at 34 (Figure 9).

[316] Pet. Ex. 16 (Villadsen Rebuttal) at 8 (Figure R-1). For ease of reference, the ALJs have included Dr. Villadsen's Figure R-1 on "Attachment A - Figures Cited" to this PFD.

[317] Pet. Ex. 16 (Villadsen Rebuttal) at 8.

[318] Pet. Ex. 16 (Villadsen Rebuttal) at 8.

ii. Disconnect between future-oriented capital investment and past-focused allocation approach

Dr. Villadsen noted that the District "plans capital investment based on projected demand."[319] If "large capital investment costs are being incurred on the basis of future growth projections," Dr. Villadsen opined that "not allocating project costs in rates [on a similar basis] inevitably results in unreasonable discrimination to those customers with slower growth rates."[320] She pointed out that the District's expert witnesses, Mr. Ekrut and Mr. Stowe, expressed similar views in a paper they co-authored, which concluded that "beneficiaries of growth should bear the cost responsibility for infrastructure installations and improvements that were undertaken to provide them service" because that type of allocation "is equitable and abides by generally accepted rate making principles."[321]

Based on Dr. Villadsen's analysis, Petitioners contend that the District "embeds unreasonable discrimination" in its rates.[322] This is because the District "incurs significant capital costs based on (future) growth projections but allocates those costs in rates based on (historical) annual minimums, creating a disconnect between how costs are incurred and allocated."[323] Petitioners concede that Non-Petitioning Member Cities have slowed in their growth in more recent years, but they have still been growing at significantly faster rates than Petitioners have. Since 2001, the compounded annual growth rate for Petitioners was 1% versus 7% for Non-Petitioning Member Cities, and since 2010 the rate was 1% versus 4%.[324] In other words, even since 2010, the Non-Petitioning Member Cities have been growing at a rate quadruple that of Petitioners. Based on TWDB's 2017 estimates for water demand, Non-Petitioning Member Cities are "projected to dramatically increase their water demands in upcoming decades," while

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[319] Pet. Ex. 16 (Villadsen Rebuttal) at 15 (citations omitted).

[320] Pet. Ex. 16 (Villadsen Rebuttal) at 15-16.

[321] Pet. Ex. 16 (Villadsen Rebuttal) at 16, BV-R3 at 10.

[322] Petitioners' Initial Brief at 39.

[323] Petitioners' Initial Brief at 39.

[324] Pet. Ex. 8 (Villadsen Direct) at 36.

Petitioners' aggregate demand will increase, but not at the same precipitous rate.[325] Two of the Non-Petitioning Member Cities, Frisco and McKinney, were named by the U.S. Census Bureau as among the fastest-growing cities in the country, let alone in the District or the region.[326]

Staff agrees with Petitioners that the District's rates are unreasonably preferential toward the Non-Petitioning Member Cities. Staff's concern is "that the Member Cities that are growing the fastest are not paying their fair share."[327] According to Staff, the fastest-growing Member Cities "consumed 30.7% of the total water used in Water Year 2017, but their combined Annual Minimums only account for 26.5% of the aggregate Annual Minimum for all Member Cities."[328] Staff takes issue with the District's use of Annual Minimums as a metric "to determine what portion of the District's costs each Member City will bear," while using population growth projections as the planning tool for capital investments.[329] The Member City Rate has "increased more over the last five years than it did over the first twenty-four years the [Contract] was in effect," and while the rate increases have been driven by capital investment to meet future demand, the cost allocation is based "solely on how much water a Member City used in the past."

Royse City acknowledges that it is one of the faster-growing Member Cities that are "paying for less costs than they caused the District to spend."[330] Despite this financial advantage, Royse City submits that the District's rates are unreasonably discriminatory because slower-growth Member Cities such as Petitioners are "paying more than their fair share of the District's costs."[331] Royse City supports the positions of both Petitioners and Staff.

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[325] Pet. Ex. 16 (Villadsen Rebuttal) at 18 (Figure R-3). For ease of reference, the ALJs have included Dr. Villadsen's Figure R-3 on "Attachment A - Figures Cited" to this PFD.

[326] Pet. Ex. 19.

[327] Staff's Reply Brief at 8.

[328] Staff's Reply Brief at 8 (citing Staff Ex. 3 at 165).

[329] Staff's Initial Brief at 12.

[330] Royse City's Initial Brief at 12 (citations omitted).

[331] Royse City's Initial Brief at 12.

iii. Disconnect between Annual Minimums and conservation policy

Conservation programs affect the rate impact differential between Petitioners and Non-Petitioning Member Cities. Water conservation "wasn't unheard of in 1988," when the Contract was executed, per Petitioners' expert witness and former Commission employee, Jess Totten.[332] However, since 1988, drought conditions have caused the "statewide focus on water conservation to increase dramatically" and become "a focal point of state planning."[333] Petitioners have reduced consumption by their retail customers through conservation policies and thus have reduced the water they actually take from the District.

Non-Petitioning Member Cities have also participated in conservation measures, but their higher growth rates, combined with the fact that their Annual Minimums were set in more recent years, means that the amount of water Non-Petitioning Member Cities take from the District more closely approximates their historical Annual Minimums.[334] Petitioners, who established their Annual Minimums between 2001 (Plano, Richardson, and Mesquite[335]) and 2006 (Garland), are paying based on Annual Minimums established a decade or more prior to the years that Annual Minimums were set by Non-Petitioning Member Cities such as Allen, Princeton, and Rockwall (2011) or Frisco, Forney, McKinney, Royse City, and Wylie (2016).[336] The smallest Member City, Farmersville, is the only Non-Petitioning Member City to have set its Annual Minimum before 2011 (it did so in 2006).[337] Thus, Petitioners, argue, they can continue conserving and encouraging their citizens to do so, but none of their efforts will affect the rate disparity caused by Annual Minimums set in an era when conservation was not as clear a priority.

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[332] Pet. Ex. 9 (Totten Direct) at 26.

[333] Pet. Ex. 9 (Totten Direct) at 26.

[334] Pet. Ex. 16 (Villadsen Rebuttal) at 14.

[335] Pet. Ex. 16 (Villadsen Rebuttal) at 14. As previously mentioned, Mesquite's actual historical Annual Minimum was set in 2001 but was adjusted in 2008 based on a financing agreement under Policy No. 8.

[336] Pet. Ex. 4 (Dittman Direct) at JD-8.

[337] Pet. Ex. 4 (Dittman Direct) at JD-8.

iv. Rate disparity caused by static Nickel Premium

Petitioners contend that they—along with all other Member Cities—are unreasonably prejudiced by the rate the District charges Customer Cities. As previously discussed, the District's Revenue Requirement (allocated among Member Cities based on their Annual Minimums) is the Annual Requirement minus revenues from Customer Cities.[338] Every dollar of revenue collected from Customer Cities reduces by one dollar the amount that Member Cities collectively must pay. Given this direct relationship between Customer Cities' payments and Member Cities' obligations, Petitioners argue that the Nickel Premium results in rates that are unreasonably prejudicial to Member Cities and unreasonably preferential to Customer Cities.[339]

In 1970, the Nickel Premium represented a 21% premium over the $0.235 per 1,000 gallon rate the District charged Member Cities.[340] In FY 2017, the Nickel Premium represented a 2% premium over the $2.53 per 1,000 gallon Member City Rate.[341] In a 47-year period, Petitioners point out, the District raised the Member City rate by nearly 1,000% but the Nickel Premium remained the same.[342] Dr. Villadsen opined that, "simply on its face," the Nickel Premium is suspect; if it was a reasonable premium in 1970 at 21%, it is "not plausible that a premium of less than 2.0% is reasonable today."[343]

As a group, the Customer Cities are the second-largest users of the District's system, and their relative use is projected to increase from 17% in FY 2017 to 19% in 2020 and 24% in 2030.[344] Petitioners contend that arguments of the District for why the Nickel Premium has not changed

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[338] Smaller sources of revenue, such as retail customers and raw water purchases, also contribute to the Annual Requirement, but the Customer Cities are the primary driver of revenues apart from the Revenue Requirement.

[339] Petitioners' Initial Brief at 45.

[340] Pet. Ex. 16 (Villadsen Rebuttal) at 26.

[341] Pet. Ex. 16 (Villadsen Rebuttal) at 26.

[342] Petitioners' Initial Brief at 45; Pet. Ex. 16 (Villadsen Rebuttal) at 27.

[343] Pet. Ex. 18 (Villadsen Direct) at 26, 48-49 (citations omitted).

[344] Pet. Ex. 16 (Villadsen Rebuttal) at 17 (citations omitted).

are unpersuasive. Because the ALJs concur in Petitioners' assessment, those matters are discussed only under ALJs' Analysis, below, and are not included here.

b. Arguments of the District, Frisco & Forney, and McKinney

The District declares that it is in agreement with Petitioners and Staff "on one point: the beneficiaries of growth *should* bear the cost responsibility for infrastructure investment and improvements that were undertaken to provide service."[345] However, the District and Intervenors reject the use of effective rates as arbitrary, misleading, and contrary to the commitments in the Contract. They support the Annual Minimum rate-setting structure because it has a direct connection to actual use, whereas they say rate-setting tied to expected future growth is inherently more speculative and logically unsound. Finally, the District defends the Nickel Premium.

i. The effective rate is arbitrary, misleading, and contrary to the Contract commitments

There is no effective rate charged or demanded pursuant to the Contract, and the concept has not been used in any other public interest proceeding, to the District's knowledge.[346] The District and Intervenors characterize effective rates as misleading because they are based on consumption, which is under each Member City's control and therefore disconnected from the District's rates.[347] A city's consumption, and therefore its effective rates, may vary widely from year to year while the District continues to set rates in the same manner—meaning that the concept of effective rates does not illustrate unreasonable discrimination.[348] Petitioners paid lower effective rates when they were growing at a fast pace. Their slower growth and greater rainfall in recent years makes it logical that Petitioners' effective rates are higher than that of other

[345] District's Reply Brief at 21 (citations omitted) (emphasis in original).

[346] District's Initial Brief at 34.

[347] District's Initial Brief at 35; Frisco & Forney's Initial Brief at 18; McKinney's Initial Brief at 19.

[348] District's Initial Brief at 35; Frisco & Forney's Initial Brief at 18; McKinney's Initial Brief at 19.

Member Cities, but "none of those considerations relate to the rate actually demanded by the District" or make the District's rates unreasonably prejudicial.[349]

Even if effective rates were a valid analytical tool in this case, the District, joined by Frisco & Forney, denies that the effective rates show an unreasonable disparity in rate impact, because the percentage of total payments paid to the District and the percentage of total water consumed are closely aligned. If the amount paid for water actually consumed (*i.e.*, the counterpart to "undelivered water") is compared to the percentage of total Member City costs paid, the difference for each of the Petitioners is "less than a fraction of 1%," per calculations prepared by Frisco & Forney:[350]

	GARLAND		MESQUITE		PLANO		RICHARDSON	
Years	**% Total Water**	**% Total $**	**% Total Water**	**% Total $**	**% Total Water**	**% Total $**	**% Total Water**	**% Total $**
1988–2017	19.79%	20.18 %	10.26 %	10.93%	28.97 %	28.96 %	13.58 %	14.13 %
	Percentage Difference[351]							
1988–2017	(0.39%)		(0.67%)		.01%		(0.55%)	

On average from 1988 to 2017, Plano (the largest user of water in the District) benefitted slightly, by 0.01%, and the other three Petitioners were negatively affected by less than 0.7%.[352] For FY 2017 standing alone, the difference between Plano's percent share of water consumed and percentage share of charges to all Member Cities was 0.15%, equivalent to "only $350,000 out of total Member City charges of $233 million" in FY 2017.[353]

[349] District's Initial Brief at 36.

[350] Frisco & Forney Ex. 18 at att. B.

[351] The ALJs added this row (percentage difference) to the table.

[352] Frisco & Forney's Reply Brief at 13.

[353] District's Initial Brief at 38.

The District, Frisco & Forney, and McKinney also argue that effective rates ignore the regional focus of the District and the long-term commitments Member Cities made to each other through the Contract. Frisco & Forney state that the District has successfully met "the water needs of a vast and rapidly growing region" because of the "cooperative approach" the Member Cities all consented to adopt.[354] McKinney notes that in the earliest years of the District's operation (prior to the execution of the Contract), Petitioners consumed a much higher percentage of water and contributed a lower percentage of revenues relative to the Non-Petitioning Member Cities who were members at that time.[355] Between 1957 and 1969, McKinney paid $305,000 more for water than the per-1,000 gallon rate the District set for Member Cities. Instead of seeking to recover, "[a]s honorable gentlemen they [McKinney] have maintained their side of the contract and paid an additional cost of water over the past 13 years [up to 1969.]"[356] McKinney accuses Petitioners of not having the same respect for the Contract, saying Petitioners "now want to pull up the proverbial ladder after they no longer need it."[357] The District's expert Mr. Stowe agreed, stating that Petitioners are "now essentially trying to close the door behind them."[358]

If Member Cities simply honor their commitments to each other, any imbalances will be corrected over time, according to the District and Intervenors. Over the long-term, as faster-growth Member Cities set new Annual Minimums, the "overall share and cost burden for cities who are not setting new minimums decreases."[359] The District expects the change in relationships among Member Cities will "continue until all cities are fully grown out and the District's system is fully mature[,]" which is unlikely "to happen soon."[360] However, that is consistent with the varying times at which Member Cities experience growth and their related system demands. McKinney

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[354] Frisco & Forney's Reply Brief at 11.

[355] McKinney's Initial Brief at 22 (citing 1957 data).

[356] McKinney's Reply Brief at 14 (citing Pet. Ex. 7 (Glasscock Direct) at BG-16 at 277).

[357] McKinney's Reply Brief at 14.

[358] NTMWD Ex. 6 (Stowe Direct) at 21.

[359] District's Initial Brief at 36; NTMWD Ex. 7 (Ekrut Direct) at 49.

[360] NTMWD Ex. 5 (Sanderson Direct) at 54-55.

notes that, over time, "a city's contribution to the District's revenue balances out," and the "relationship between the Member Cities and the District is functioning as it should."[361]

ii. Annual Minimums are superior to growth projections as an allocation tool

The District contends Annual Minimums as a rate-setting mechanism are superior to rates tied to growth because Annual Minimums are based on "actual, measured use and quantified usage," whereas "expected growth," as proposed by Staff, is "a highly subjective metric for allocating costs."[362] From the District's perspective, Annual Minimums do not "embed unreasonable discrimination" into rates charged to Member Cities. Rather, the "costs already embedded in rates" are due to the historical and current actual usage by Petitioners.[363] Petitioners' growth over the last 50 years caused the District to incur "significant capital costs to meet [their] continually increasing demands."[364] The rates reflect the fact that Petitioners have been "the largest beneficiaries of growth in the District and continue to be the largest water consumers."[365] Thus, Annual Minimums "reasonably track [] long-term fluctuations in demand" but "'[e]ffective rates' do not."[366]

Frisco & Forney state that Petitioners, Staff, and Royse City all fail to provide "any objective analysis identifying the portion of the District's 2017 capital costs attributable to future growth." McKinney adds that, "at some point in time, a no-growth/slow-growth city is paying for

[361] McKinney's Initial Brief at 24.

[362] District's Reply Brief at 22.

[363] District's Reply Brief at 22.

[364] District's Reply Brief at 22.

[365] District's Reply Brief at 22; NTMWD Ex. 6 (Stowe Direct) at 21.

[366] District's Initial Brief at 36.

infrastructure 'caused' by a city in a growth phase."[367] However, that effect is "no more than the bargain the Member Cities struck" with each other.[368]

iii. Petitioners should have focused on conservation sooner

Petitioners are chided for not conserving water when they could have (prior to setting their Annual Minimums) and then claiming that conservation has a disparate impact on rates. The District describes Petitioners as attempting "to avoid responsibility for their own imprudent planning."[369] All cities had the opportunity to "mitigate the impact of their cost allocations by tempering water consumption" but Petitioners "significantly increased their usage between 2000 and 2006."[370] In response, the District made investments in infrastructure that "could not be 'uninstalled' once [Petitioners] realized their consumption habits resulted in higher water costs."[371] Frisco & Forney charge Petitioners with ignoring "the conservation rate signal" in the Contract and the Q&A Memo because they were prioritizing growth.[372] At the same time, according to Frisco & Forney, "Petitioners alone must bear responsibility for their continuing failure to conduct any evaluation of options for increasing their treated water sales" to other parties.[373]

iv. The Nickel Premium is appropriate

The Nickel Premium is defended by the District for reflecting the "subordinate level of service" that Customer Cities receive relative to Member Cities.[374] The District also notes that Member Cities, particularly Petitioners, continue to demand the lion's share of the District's water

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[367] McKinney's Reply Brief at 14.

[368] McKinney's Reply Brief at 14.

[369] District's Reply Brief at 25.

[370] District's Reply Brief at 25.

[371] District's Reply Brief at 25.

[372] Frisco & Forney's Reply Brief at 25. As previously noted, the Q&A Memo was issued by the District in 1988 to help answer questions posed by cities considering executing the Contract.

[373] Frisco & Forney's Initial Brief at 18.

[374] District's Initial Brief at 42.

and are the drivers of capital investment rather than Customer Cities. Specific arguments made by the District, and Petitioners' responses, are discussed below under ALJs' Analysis.

c. ALJs' Analysis

i. Effective rates provide a useful and appropriate lens for comparison of discriminatory rate impacts

The parties engaged in extensive discussion about the derivation, usefulness, and relevance of effective rates. The District and Intervenors see effective rates as distinct from the District's rates because effective rates are related to consumption. How much a Member City consumes is based on a number of factors that are not under the control of the District, such as weather and conservation incentives to retail customers. Therefore, the District and Intervenors posit, effective rates do not have a meaningful nexus to the Member City Rate and/or the Excess Charge. They describe effective rates as a fiction and an arbitrary metric.

Effective rates *do* measure how much water is consumed, and *will* vary based on consumption. However, effective rates cannot be derived without incorporating the Member City Rate as established by the District, in relationship to the Annual Minimum of each Member City. Minus those inputs, the effective rate cannot be calculated. And, the effective rate is not a concept dreamt up by Petitioners. For example, the District used effective rates in a 2017 Board meeting to note that the Annual Minimum and the Excess Charge are the "key drivers of effective rate differences."[375] District witness Mr. Stowe testified about the effective rate concept in public interest proceedings before the TCEQ.[376] It is not pertinent that the Contract does not charge (and the District does not demand) an effective rate; the purpose of the effective rate is as a tool to measure and examine disparities in impact.

[375] Pet. Ex. 8 (Villadsen Direct) at BV-4 at 86.

[376] Pet. Ex. 55 at 32.

The usefulness of effective rates as an analytical tool is evident when an apples-to-apples comparison is desired. The effective rate shows, for every city taking water from the District, how much each city is paying per 1,000 gallons of water supplied by the District, making it easy to compare the variable impact of the District's rates.

It is clear that the District "charges the same rate" to all Member Cities insofar as a single Member City Rate is set each year. It is insufficient for an adverse public interest finding to show merely that effective rates vary across Member Cities. However, effective rates are particularly relevant to the question posed by the Commission in Issue 5.d because, viewed over the life of the Contract, they show the rate impact is not only discriminatory but unreasonably so.

As Dr. Villadsen illustrated in her Figure R-1,[377] the effective rates paid by Petitioners versus those paid by Non-Petitioning Member Cities were roughly aligned from 1988 to 2001. After three of the four Petitioners set their Annual Minimums in 2001, Petitioners' average effective rate paid exceeded that of the Non-Petitioning Member Cities for every year through 2017. The disparity has widened significantly since 2010, showing a persistent and growing inequity in the amount Petitioners pay for water relative to how much other Member Cities pay.

The argument that the percentage of total water taken compared to the percentage of total Member City costs paid has a variance of less than 1% over the 1988-2017 period for Petitioners is superficially compelling, but masks significant underlying disparities. If this calculation is performed for FY 2017, Petitioners' share of costs exceeded their share of water taken by 4%, a total of $9.3 million.[378] That is not a minor sum. In the same year, the Non-Petitioning Member Cities consumed a share of water that exceeded their share of total costs by 4%. That indicates an 8% delta—a total difference of $18.6 million—between what was paid in FY 2017 by Petitioners and by Non-Petitioning Member Cities. Dr. Villadsen noted that Petitioners "are overpaying by $9.3 million, which means somebody else is underpaying by $9.3 million."[379] Clearly, small

[377] Dr. Villadsen's Figure R-1 is included on "Attachment A - Figures Cited" to this PFD.

[378] Frisco & Forney Ex. 20.

[379] Tr. at 473.

percentage differences are highly relevant in the context of a Revenue Requirement of $240 million (for FY 2017). Also, the calculation focuses on water taken—which masks the fact that Petitioners are also paying large sums for water they have never taken. Since they set their Annual Minimums, Petitioners have paid over $200 million for unused water.

The District and Intervenors call into question Petitioners' commitment to the success of the District as a collective, regional enterprise that is intended to benefit all Member Cities. They invoke colorful figures of speech, referring to Petitioners closing the door behind them or pulling up the proverbial ladder when it is no longer needed. Yet, when examined more closely, Petitioners have not taken unfair advantage.

Over time, Petitioners may have been the largest users of the District's system, but their contributions have nonetheless exceeded their proportional usage. When the payments made by each Member City to the District for undelivered water[380] were compared for all years from FY 1988 to FY 2017, Dr. Villadsen found that Petitioners paid the District "more than twice as much (in percentage terms relative to their respective total bills) for undelivered water as the nine Non-Petitioning Member Cities."[381]

Adjusted for inflation, roughly 13% of Petitioners' cumulative payments to the District between 1988 and 2017 were for undelivered water, versus 6% of Non-Petitioning Member Cities' cumulative payments.[382] Dr. Villadsen added that, though the disparity has "clearly widened since 2001," it was present even in the early years of the Contract, since 1992 or 1993.[383] The ALJs agree with Dr. Villadsen that this analysis refutes the claim that Petitioners need to take their "turn

[380] As previously mentioned, Petitioners use the term "undelivered water" to describe the amount of water they paid for (pursuant to the Annual Minimum) but did not actually take from the District. Dr. Villadsen calculated undelivered water as "each city's annual minimum minus its annual consumption, times the difference between the base rate and rebate rate." Pet. Ex. 16 (Villadsen Rebuttal) at 12.

[381] Pet. Ex. 16 (Villadsen Rebuttal) at 12.

[382] *See* Dr. Villadsen's Figure R-2, included on "Attachment A-Figures Cited" to this PFD.

[383] Pet. Ex. 16 (Villadsen Rebuttal) at 14.

to contribute to the [District's system] to facilitate growth" of other Member Cities.[384] Importantly, all of the Member Cities made their commitments to each other under a very different understanding of their governance power (through their appointment of Board members) than turned out to be correct.[385] Moreover, the District changed its position regarding the loyalties of Board members after the Contract was executed.

ii. The District's rates embed rate discrimination through the mismatch between cost drivers and cost allocation

The District's rate-setting requires Member Cities to pay for water they do not take from the District, to an extent that is prejudicial to Petitioners as compared to the other Member Cities. It is true that Annual Minimums are based on actual use. Critically, the Annual Minimums freeze that actual use at a single moment in time. As more time passes, the Annual Minimum can become so disconnected from current use as to cause a discriminatory impact. That is what has happened to Petitioners.

Plano is the largest single user of District water, and Petitioners collectively use more water than the other Member Cities. However, Petitioners pay an average effective rate per 1,000 gallons of water that is unreasonably greater than the average effective rate paid by the Non-Petitioning Member Cities, and the gap is growing. The unreasonable disparity can be expected to continue based on future growth projections and as the District embarks on $1.2 billion in new spending, so long as rate-setting is based on a city's historical Annual Minimum. Non-Petitioning Member Cities (and, as discussed below, Customer Cities) experiencing high rates of growth will continue to benefit unreasonably from rate subsidization at the expense of Petitioners. While the District and Intervenors contend that "it will all balance out in the end" at some point in the future, that balance is not certain to be achieved. In the interim, Petitioners have suffered and continue to suffer quantifiable economic harm and are unreasonably prejudiced by the extent to which they are subsidizing the water usage of faster-growth cities.

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[384] Pet. Ex. 16 (Villadsen Rebuttal) at 13.

[385] *See* discussion above, under Issue 5.c.i.

Here, it is appropriate for the ALJs to address arguments put forth by the District and Intervenors concerning Annual Minimums versus effective rates. Effective rates in this proceeding are used as an analytical tool, not a rate-setting mechanism. The ALJs are not recommending that the Commission require the District to abandon Annual Minimums in favor of effective rates, or future growth projections, or any other metric. In fact, the ALJs do not and cannot make any rate-setting recommendation at all, because that is a matter that will be addressed if and only if the Commission orders a cost-of-service proceeding. The ALJs also do not imply that the investment in the new reservoir is improper or unnecessary for regional water needs. Most of all, the ALJs are in no way suggesting that the Commission can or will release any Member City from the Contract or set rates at a level that would impair the District's ability to meets its debt obligations.

What the ALJs *are* doing is finding, based on the effective rate analysis and other evidence discussed above, that the District's rates are having an unreasonably prejudicial impact on Petitioners relative to the other Member Cities; Petitioners cannot change their position due to disparate bargaining power and monopoly power abuses by the District (discussed above); and, if the Commission does not intervene, the unreasonable discriminatory effective rate impact can be expected to continue and likely worsen as capital investment intensifies.

iii. Petitioners' relatively recent conservation measures do not justify the discriminatory rate impact of the District's rates

Petitioners' witness Mr. Totten testified regarding the evolution of water conservation as a state planning priority, as previously referenced.[386] The District and Frisco & Forney criticized Petitioners for not taking steps to conserve when it was possible to have an impact on their Annual Minimums. The ALJs see flaws in these criticisms.

[386] Pet. Ex. 9 (Totten Direct) at 26-27.