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**SOAH DOCKET NO. 473-20-4071.WS
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RATEPAYERS APPEAL OF THE	§	BEFORE THE STATE OFFICE
DECISION BY WINDERMERE	§	
OAKS WATER SUPPLY	§	OF
CORPORATION TO CHANGE	§	
WATER AND SEWER RATES	§	ADMINISTRATIVE HEARINGS

COMMISSION STAFF'S INITIAL BRIEF

Dated: January 25, 2022

Respectfully submitted,

**PUBLIC UTILITY COMMISSION OF TEXAS
LEGAL DIVISION**

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The question before the Commission is simple: can a water supply corporation include unlimited legal expenses related to civil lawsuits filed against and filed by the water supply corporation? If the Commission is bound to establish rates that are just and reasonable, the answer must be no.3

Ratepayers allege that Windermere’s base rates recover approximately \$171,337 in legal expenses that were incurred to defend Windermere and its Board Members, both past and current, in external civil litigation. Ratepayers further allege that the rates are designed to recover legal expenses for actions that the Board filed, against both Windermere’s insurance provider, which declined to provide coverage for legal expenses related to the same external lawsuits, and the Texas Office of the Attorney General.3

The Commission has de novo jurisdiction over this appeal, and, in evaluating Windermere’s rates, must review only the information available to the Board at the time it set the rates that are the subject of this complaint. As the Commission will see, the rates established by Windermere do not satisfy Texas Water Code (TWC) § 13.043(j) and 16 Texas Administrative Code (TAC) § 24.101(i). However, should the Commission find that the rates satisfy those requirements, those rates are improperly designed, recovering variable costs in base rates and resulting in recovery of an amount over and above Windermere’s current revenue requirement. Therefore, Staff recommends adoption of its proposed revenue requirement, which excludes the entirety of the approximately \$171,000 in legal expenses.3

Should the Commission find that recovery of some or all of the external legal expenses is appropriate, Staff recommends, at a minimum, that the base and volumetric rates be redesigned to recover Windermere’s actual revenue requirement and that the legal expenses, which are variable costs, be recovered through gallonage (or volumetric) rates. Finally, Staff recommends that—because of the nature of Windermere’s unusual request in this docket, which included depreciation expense in a request based on the cash-needs methodology—the Commission require Windermere to record the amounts it recovers through annual depreciation expense in a fund held for future plant investment.3

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Windermere’s rates do not satisfy the requirements of TWC § 13.043(j) and 16 TAC § 24.101(i) because those rates are unjust and unreasonable. Texas Water Code § 13.043(j)

and 16 TAC § 24.101(i) establish three parameters for the Commission’s review of appealed rates. First, the Commission must “ensure that every appealed rate is just and reasonable.” Second, the Commission must ensure that rates are not “unreasonably preferential, prejudicial, or discriminatory.” Third, the Commission must ensure that rates are “sufficient, equitable, and consistent in application to each class of customers.” If the appealed rates fail to satisfy any of those three requirements, then the rates themselves fail. As noted in Docket No. 42862, in which customers appealed the rates charged by the Town of Woodloch, “[w]hen setting rates, the Commission must use a ‘methodology that preserves the financial integrity of the retail public utility.’ Considerations of financial integrity cannot, however, be treated as a trump card that overrides the utility’s obligation to comply with the standard requirements for proving is water and sewer rates.” A utility’s rates are not just and reasonable simply because the utility has debts to pay.....4

Here, Windermere’s rates include approximately \$171,000 in external legal expenses that were incurred to defend the water supply corporation, past board members, and current board members in civil litigation. Further expenses continue to accrue. Staff cannot, in good conscience, recommend approval of rate-making policy that allows Windermere’s board of directors carte blanche, which ratepayers must cover indefinitely, for legal expenses.4

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Finally, should the Commission find that Windermere’s current rates are not just and reasonable and have therefore resulted in over-recovery, Staff recommends that the amount over-recovered be refunded to customers over a five-year period. Staff recommends this extended refund period with an eye toward maintaining the financial integrity of the utility, as required by TWC § 13.043(e) and 16 TAC § 24.101(i).9

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I. INTRODUCTION

The question before the Commission is simple: can a water supply corporation include unlimited legal expenses related to civil lawsuits filed against and filed by the water supply corporation? If the Commission is bound to establish rates that are just and reasonable, the answer must be no.

Ratepayers allege that Windermere's base rates recover approximately \$171,337 in legal expenses that were incurred to defend Windermere and its Board Members, both past and current, in external civil litigation. Ratepayers further allege that the rates are designed to recover legal expenses for actions that the Board filed, against both Windermere's insurance provider, which declined to provide coverage for legal expenses related to the same external lawsuits, and the Texas Office of the Attorney General.¹

The Commission has *de novo* jurisdiction over this appeal,² and, in evaluating Windermere's rates, must review only the information available to the Board at the time it set the rates that are the subject of this complaint. As the Commission will see, the rates established by Windermere do not satisfy Texas Water Code (TWC) § 13.043(j) and 16 Texas Administrative Code (TAC) § 24.101(i). However, should the Commission find that the rates satisfy those requirements, those rates are improperly designed, recovering variable costs in base rates and resulting in recovery of an amount over and above Windermere's current revenue requirement. Therefore, Staff recommends adoption of its proposed revenue requirement, which excludes the entirety of the approximately \$171,000 in legal expenses.

Should the Commission find that recovery of some or all of the external legal expenses is appropriate, Staff recommends, at a minimum, that the base and volumetric rates be redesigned to recover Windermere's actual revenue requirement and that the legal expenses, which are variable costs, be recovered through gallonage (or volumetric) rates. Finally, Staff recommends that—because of the nature of Windermere's unusual request in this docket, which included depreciation expense in a request based on the cash-needs methodology—the Commission require Windermere

¹ Tr. Day 2 at 314, 5-11 (Gimenez Cross) (December 2, 2021).

² Texas Water Code (TWC) § 13.043(a).

to record the amounts it recovers through annual depreciation expense in a fund held for future plant investment.

- II. **ISSUE 1: VALIDITY OF THE PETITION (UNCONTESTED)**
- III. **ISSUE 2: NOTICE BY WINDERMERE (UNCONTESTED)**
- IV. **ISSUE 3: INTERIM RATES (UNCONTESTED)**
- V. **ISSUE 4: EVALUATING WINDERMERE’S RATES UNDER TWC § 13.043(j) AND 16 TAC § 24.101(i)**

Windermere’s rates do not satisfy the requirements of TWC § 13.043(j) and 16 TAC § 24.101(i) because those rates are unjust and unreasonable. Texas Water Code § 13.043(j) and 16 TAC § 24.101(i) establish three parameters for the Commission’s review of appealed rates. First, the Commission must “ensure that every appealed rate is just and reasonable.” Second, the Commission must ensure that rates are not “unreasonably preferential, prejudicial, or discriminatory.” Third, the Commission must ensure that rates are “sufficient, equitable, and consistent in application to each class of customers.” If the appealed rates fail to satisfy any of those three requirements, then the rates themselves fail. As noted in Docket No. 42862, in which customers appealed the rates charged by the Town of Woodloch, “[w]hen setting rates, the Commission must use a ‘methodology that preserves the financial integrity of the retail public utility.’ Considerations of financial integrity cannot, however, be treated as a trump card that overrides the utility’s obligation to comply with the standard requirements for proving its water and sewer rates.”³ A utility’s rates are not just and reasonable simply because the utility has debts to pay.

Here, Windermere’s rates include approximately \$171,000 in external legal expenses that were incurred to defend the water supply corporation, past board members, and current board members in civil litigation.⁴ Further expenses continue to accrue.⁵ Staff cannot, in good conscience, recommend approval of rate-making policy that allows Windermere’s board of directors *carte blanche*, which ratepayers must cover indefinitely, for legal expenses.

³ *Appeal of Water and Sewer Rates Charged by the Town of Woodloch CCN Nos. 12312 and 20141*, Docket No. 42862, Order at Conclusion of Law 13 (Mar. 7, 2016).

⁴ Windermere Ex. 7 at 16.

⁵ Tr. Day 2 at 268, 5-11 (Gimenez Cross) (Dec. 2, 2021).

A. Just and Reasonable Rates

It cannot be just and reasonable to allow the board of a water supply corporation to, without limit and without check, incur hundreds of thousands of dollars in legal expenses and expect ratepayers to back that debt. The question of whether Windermere's rates are just and reasonable lies at the heart of this appeal, and, while evaluating the justness and reasonableness of rates is often a simple numbers game, the determination here requires a slightly more nuanced approach. Often, when examining the expenses included in a utility's rates, the question is whether the cost for a good or a service was reasonable and necessary to provide service to the ratepayers. Here, the question is slightly different. Here, the question is whether it was reasonable to contract for legal services, to the tune of \$171,000, at all.

Under 16 TAC § 24.41(b), components of allowable expenses that can be included in just and reasonable rates consist of those incurred in furnishing normal utility service and in maintaining utility plant used by and useful to the utility in providing such service. As there is no similar rule governing water supply corporations, this language serves as a useful guideline for evaluating what expenses are appropriately included in Windermere's rates. Generally, expenditures that can be considered unreasonable, unnecessary, or not in the public interest, may include executive salaries, advertising expenses, rate case expenses, legal expenses, penalties and interest on overdue taxes, criminal penalties or fines, and civil penalties or fines.

In evaluating whether it was reasonable for the Board to incur hundreds of thousands of dollars in legal expenses and then pass those expenses on to the ratepayers, the Commission may look to precedent outside the universe of water supply corporations. In Docket No. 35717, *Application of Oncor Electric Deliver Company, LLC for Authority to Change Rates*, the Commission held that a self-insured electric utility could not include the cost of insurance for "liability coverage for intentional torts or for employee misconduct" in its rates.⁶ The parallel here is clear; if Oncor could not make customers pay for insurance that would be triggered when an Oncor employee behaved badly, then Windermere cannot make customers pay for legal expenses incurred to defend Board members against allegations of bad behavior.

This is especially true where the Board's insurance provider, Allied World, has declined coverage to Board members. In its denial of coverage, Allied World cited multiple exclusions,

⁶ *Application of Oncor Electric Deliver Company, LLC for Authority to Change Rates*, Docket No. 35717, Order on Rehearing at Finding of Fact No. 99 (Nov. 30, 2009).

including the “Profit, Advantage or Remuneration” exclusion, which relieves Allied World of its duty to provide coverage where expenses are incurred due to “the insured gaining any profit, advantage, or remuneration to which the insured is not legally entitled.”⁷ Allied World also raised the “Violation of Law” exclusion, claiming that it had no duty to provide coverage for damages, defense expenses, costs, or loss arising from the insured’s willful violation of any federal, state, or local law, rule, or regulation.⁸ Applying *Oncor*, it follows that the Board would not have been able to pass on to ratepayers the cost of insurance that would cover such behavior. Therefore, it is logically inconsistent to assert that it is just and reasonable for the Board to, instead, directly pass on the cost of covering the types of expenses that the prohibited insurance would cover.

If the Commission finds that Windermere’s rates are just and reasonable, the practical implication is that a water supply corporation can charge ratepayers for unlimited legal expenses. While it is reasonable for the Commission to be wary of wading into the morass of underlying litigation, in this case, it is Staff’s position that the Commission must do so in order to protect the public interest. If the Commission refuses to examine the source of the legal expenses included in Windermere’s rates, the takeaway is that recovery of unreasonably incurred legal expenses is permissible. It takes little imagination to see the pitfalls of this position.

B. Unreasonably Preferential, Prejudicial, or Discriminatory

C. Sufficient, Equitable, and Consistent Rates for Each Class of Customers

VI. ISSUE 5: DISMISSAL IF THE APPEALED RATES SATISFY TWC § 13.043(j) AND 16 TAC § 24.101(i)

As discussed above, Windermere’s rates are unjust and unreasonable. Therefore, dismissal of this appeal is inappropriate.

VII. ISSUES 6, 7, and 11: WINDERMERE’S JUST AND REASONABLE RATES

A. Revenue requirement

Staff proposes a revenue requirement of \$404,855. Windermere’s existing rates are set to recover an annual revenue requirement of \$576,192.⁹ Staff subtracted the amount of legal fees of \$171,337 included in Windermere’s requested annual revenue requirement, in order to arrive at

⁷ Staff Ex. 4, Direct Testimony of Maxine Gilford, at 15, 275; Windermere Ex. 3 at Attachment JG 26 at 9-12.

⁸ *Id.*

⁹ Staff Ex. 4 at 7, citing Windermere’s response to RFI Staff 1-5, included as Attachment MG-4.

Staff's proposed revenue requirement. Based on the rate analysis provided by Windermere, approximately 60% of Windermere's service revenue is generated by water services, with the remaining 40% being generated by wastewater services.¹⁰ Applying these percentages to Staff's proposed revenue requirement, Windermere's water and wastewater annual revenue requirements equate to \$242,913 and \$161,942, respectively.

B. Rate design and allocation

Staff recommends that the Commission establish a water base rate of \$45.92 and a wastewater base rate of \$33.87. These base rates are designed to recover an appropriate amount of fixed costs through base rates—some 61% of Windermere's revenue requirement, as proposed in the Texas Rural Water Association (TRWA) rate analysis provided by Windermere, with the remaining 39% to be recovered through variable rates.¹¹ Otherwise stated, Staff's proposed base rates recover approximately \$149,347 in revenue from water services and \$99,564 in revenue from wastewater services. Again, these are the amounts to be recovered in base rates only.

Because Windermere's volumetric, or gallonage, rates were not changed when Windermere increased its rates on March 23, 2020, Staff did not redesign those rates. Generally, fixed rates and volumetric rates are not created in a vacuum, but that is the approach that Windermere took in deciding to forego TRWA's proposed allocation. Instead, Windermere dramatically increased its base rates to recover the increase to its revenue requirement—approximately \$171,000 in legal expenses. Windermere made no adjustment to its volumetric rates.¹²

Despite the allocation of variable and fixed charges proposed in the TRWA rate analysis, Windermere's current rates are designed to recover approximately 84.9% of its revenue requirement through fixed rates and 15.1% from variable, or gallonage, rates. Such a split is highly uncommon; in fact, Windermere witness Grant Rabon, who filed rebuttal testimony addressing the allocation of revenue requirement between fixed and variable rates,¹³ was unable to identify a single utility, other than Windermere, that “has that particular division.”¹⁴

¹⁰ *Id.*, citing Windermere's response to RFI Staff 1-16, included as Attachment MG-5.

¹¹ Windermere Ex. 7 at Attachment MN-2 (Bates 24).

¹² Staff Ex. 2 at Attachment SJM-2 (Bates 14)

¹³ Windermere Ex. 9.

¹⁴ Tr. Day 2 at 422, 21-24 (Rabon Cross) (Dec. 2, 2021).

Windermere's base rates for water and wastewater service are \$90.39 and \$66.41, respectively, with 271 and 245 connections, respectively.¹⁵ These base rates would generate a total of \$489,193 annually,¹⁶ which is approximately 85% of \$576,192, leaving approximately 15.1%, or \$86,999, to be recovered through volumetric charges. However, as shown in the rebuttal testimony of Mike Nelson, Windermere's projected volumetric recovery for the test year of 2019 was, in fact, \$107,006.¹⁷ Even if the Commission *does* find that Windermere should be allowed to recover its external legal expenses, the base rates designed by Windermere result in an over-recovery of more than \$20,000.¹⁸ For this reason, Staff recommends that, at a minimum, Windermere's rates be redesigned so as to recover no more than its stated revenue requirement, and that the rates be redesigned to more appropriately allocate variable costs, such as its extraordinary legal expenses, to volumetric, or gallonage rates.

Staff further recommends that annual recovery of approximately \$171,000 to cover legal expenses is inappropriate. In 2017, Windermere incurred \$2,247 in legal and appraisal fees that were not lawsuit-related; in 2018, it incurred \$12,501, and in 2019, \$7,411.¹⁹ Under 16 TAC §24.41, [i]n computing a utility's allowable expenses, only the utility's test year expenses as adjusted for known and measurable changes will be considered." It is not possible for Windermere to have known that it would incur \$171,000 in legal expenses per year, going forward every year from the 2019 test year. All of its legal battles might have resolved in April of 2020, only a month after the new rates were put in place. Perhaps the legal expenses would have otherwise increased or decreased. It is simply not possible to predict the outcome of litigation or the legal strategy that the Board might adopt. For this reason, Staff recommends that the appropriate mechanism for recovery of any unknown, non-recurring expenses would be through either the sale of assets that are not being used in the provision of service, or, if the sale of assets is not feasible or proves inadequate, through the assessment that is required by Windermere's tariff.²⁰

¹⁵ Windermere Ex. 8 at 7 (Bates 7).

¹⁶ $(\$90.39 * 271 * 12) + (\$66.41 * 245 * 12) = \$489,193$.

¹⁷ *Id.* at MN-6, at 6 of 6 (Bates 17).

¹⁸ $\$107,006 - \$86,999 = \$20,007$.

¹⁹ Windermere Ex. 2 at 072.

²⁰ Windermere Ex. 2 at VOLUMINOUS Attachment JG-1 – Tariff at 44-45.

C. Depreciation Expense

With regard to the depreciation expense included in Windermere's current rates, the Commission should adopt Staff's unopposed recommendation to require Windermere to record the amounts it recovers through annual depreciation expense in a fund held for future plant investment. The annual amount for depreciation expense included in Windermere's request in this docket is \$56,273. Because of the nature of Windermere's unusual request in this docket, which included depreciation expense in a request based on the cash-needs methodology, the Commission should require Windermere to use the revenues it collects from depreciation expense to fund future plant investment and to record those revenues in its Capital Expenditure Reserve as customer-contributed capital. This recommendation accords with basic accounting theory, too, as depreciation expense both reflects the history of invested capital and the need for future investment as current fixed asset outlive their useful lives. Staff describes this recommendation as unopposed because Windermere did not respond to the recommendation from Mr. English's direct testimony in its rebuttal testimonies (even though Windermere responded to other aspects of Mr. English's testimony) and because Windermere did not substantively discuss or ask questions about the issue when it briefly arose during the hearing on the merits.²¹

D. Refunds and surcharges

Finally, should the Commission find that Windermere's current rates are not just and reasonable and have therefore resulted in over-recovery, Staff recommends that the amount over-recovered be refunded to customers over a five-year period. Staff recommends this extended refund period with an eye toward maintaining the financial integrity of the utility, as required by TWC § 13.043(e) and 16 TAC § 24.101(i).

VIII. ISSUE 8: INCLUSION OF EXTERNAL LEGAL EXPENSES (UNCONTESTED)

IX. ISSUE 9: RECOVERY OF WINDERMERE'S REASONABLE APPEAL EXPENSES

A. Commission approval of recovery

Staff recommends that Windermere be allowed to recover \$281,575.65, which was incurred between May 1, 2020, and October 31, 2021,²² as the reasonable cost of this appeal. Under TWC § 13.043(e) and 16 TAC 24.101(e)(2) and (5), the Commission may allow a utility to recover

²¹ Tr. Day 2 at 461-462 (Filarowicz Cross) (Dec. 2, 2021).

²² Windermere Ex. 6 at 4.

reasonable expenses incurred by the retail public utility in an appeal proceeding. While there are no specific guidelines for determining what constitutes “reasonable expenses” in a rate appeal, 16 TAC § 24.44, which articulates the criteria for review of rate-case expenses, is illustrative.

Under 16 TAC § 24.44(b), a utility must provide evidence that demonstrates the following in order to recover its claimed expenses:

- (1) the nature, extent, and difficulty of the work done by the attorney or other professional in the rate case;
- (2) the time and labor expended by the attorney or other professional;
- (3) the fees or other consideration paid to the attorney or other professional for the services rendered;
- (4) the expenses incurred for lodging, meals and beverages, transportation, or other services or materials;
- (5) the nature and scope of the rate case, including:
 - (A) the size of the utility and number and type of consumers served;
 - (B) the amount of money or value of property or interest at stake;
 - (C) the novelty or complexity of the issues addressed;
 - (D) the amount and complexity of discovery;
 - (E) the occurrence and length of a hearing; and
- (6) the specific issue or issues in the rate case and the amount of rate-case expenses reasonably associated with each issue.

Based on the Direct, First Supplemental, and Second Supplemental Testimony of Jamie Mauldin, counsel for Windermere, Staff believes that Windermere has provided the evidence necessary to evaluate the criteria set out on 16 TAC § 24.44(b).

After considering Ms. Mauldin’s testimony, and the entirety of the record, the Commission can then look to 16 TAC § 24.44(c) for guidance, which provides:

The Commission must decide whether and the extent to which the evidence shows that:

- (1) the fees paid, tasks performed, or time spent on a task were extreme or excessive;
- (2) the expenses incurred for lodging, meals and beverages, transportation, or other services or materials were extreme or excessive;
- (3) there was duplication of services or testimony;
- (4) the utility’s proposal on an issue in the rate case had no reasonable basis in law, policy, or fact and was not warranted by any reasonable argument for the extension, modification, or reversal of commission precedent;
- (5) rate-case expenses as a whole were disproportionate, excessive, or unwarranted in relation to the nature and scope of the rate case addressed by the evidence pursuant to subsection (b)(5) of this section; or
- (6) the utility failed to comply with the requirements for providing sufficient information pursuant to subsection (b) of this section.

Based on Ms. Mauldin's testimony, Staff recommends that the \$281,575.65 requested by Windermere is reasonable and should be recovered. However, Staff's recommendation is not a comment on the reasonableness of any expenses incurred following October 31, 2021.

B. Appropriate mechanism for recovery

Much as rate-case expenses are recovered through a surcharge, Staff recommends that whatever costs of appeal, if any, the Commission might find are recoverable should be recovered through a surcharge over the course of five years. Given the financial burden placed on Windermere's ratepayers since March 2020, Staff believes that this extended recovery period will avoid subjecting ratepayers to another substantial jump in their monthly water and wastewater bills. In the alternative, Staff recommends that the amount be recovered through an assessment, as provided in Windermere's tariff.²³

X. ISSUE 11: APPROPRIATE EFFECTIVE DATE OF RATES DETERMINED BY THE COMMISSION (UNCONTESTED)

XI. CONCLUSION

A water supply corporation cannot incur unlimited legal fees and then include those expenses in the calculation of its rates. The limit *must* exist, and Windermere's ratepayers look to the Commission to articulate appropriate guidelines. Legal expenses that stem from a questionable land transaction, for which Windermere's own insurance company has refused to provide coverage, and related PIA requests should not be charged to ratepayers. They receive no benefit and no improvement in service. For this reason, Staff believes that approximately \$171,000 should be deducted from Windermere's revenue requirement and that the utility's rates should be recalculated to properly allocate recovery of its reduced revenue requirement between fixed and variable rates.

²³ Windermere Ex. 2 at VOLUMINOUS Attachment JG-1 – Tariff at 44-45.