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**PUC DOCKET NO. 50788
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| RATEPAYERS APPEAL OF THE DECISION BY WINDERMERE OAKS WATER SUPPLY CORPORATION TO CHANGE WATER AND SEWER RATES | § § § § § | PUBLIC UTILITY COMMISSION OF TEXAS |
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COMMISSION STAFF'S EXCEPTIONS TO THE PROPOSAL FOR DECISION

Dated: May 17, 2022

Respectfully submitted,

**PUBLIC UTILITY COMMISSION OF TEXAS
LEGAL DIVISION**

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Division Director

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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 EXCEPTIONS TO THE PROPOSAL FOR DECISION

I. INTRODUCTION

Certain ratepayers (Ratepayers) of Windermere Oaks Water Supply Corporation (Windermere) timely filed an appeal of the rates that the Windermere Board put into effect. Approximately 30% of the revenue requirement for the rates is for legal expenses. Those legal expenses are predominately related to a land transaction in which the Windermere Board sold a piece of property to a former Board member for what the plaintiffs in the underlying lawsuit assert was far less than market value.¹ In addition, Windermere’s insurance company has refused to provide coverage for the lawsuit, citing among other policy exclusions the Violation of Law exclusion, stating 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.²

The State Office of Administrative Hearings (SOAH) administrative law judge (ALJ) filed a proposal for decision (PFD), finding in favor of Windermere. The PFD concludes that the rates are not unreasonably preferential, prejudicial, or discriminatory; recommends dismissal of the appeal; and recommends a surcharge to allow recovery of Windermere’s expenses for this docket. In addition, the PFD recommends a remand if the Commission determines that the appeal should not be dismissed.³ Finally, while the PFD does not perform any analysis of the appealed rates, Staff has included its analysis as Section VII of these exceptions.

¹ First Amended Ratepayers Appeal of the Decision by Windermere Oaks Water Supply Corporation To Change Water And Sewer Rates at 2 (Apr. 30, 2020) (First Amended Appeal).

² Windermere Ex. 17 at 48-58; For ease of reference, the relevant pages of Exhibit 17 are attached to this pleading.

³ See PFD at 14.

Staff's primary concern is with the PFD's two dire implications—effectively granting a water supply corporation a blank check for any and all legal expenses incurred to defend a lawsuit that its own insurance company refuses to cover and erecting high barriers to retail water customers exercising their right to appeal to the Commission to set just and reasonable rates. The Commission should decline to adopt the PFD, instead issuing a final order fixing new rates for Windermere based on Staff's evidence: rates that exclude the legal fees related to the disputed land deal.

II. JURISDICTION, NOTICE, AND PROCEDURAL HISTORY

Not addressed.

III. SCOPE OF REVIEW

The Ratepayers filed this appeal under Texas Water Code (TWC) § 13.043(b)(1). As a result, under subsection (e) the Commission must hear the appeal de novo and must fix the rates the governing body should have fixed in the action from which the appeal was taken.

Citing *Texas Water Commission v. City of Fort Worth* in applying TWC § 13.043(j), the PFD incorrectly concludes that an initial determination must be made that the appealed rates are unreasonably preferential, prejudicial, or discriminatory before the Commission may fix just and reasonable rates. *TWC v. Fort Worth* is not applicable because that opinion involved an appeal of a contract between two utilities in which subsection (e), requiring de novo review, did not apply.⁴ Because that appeal addressed contractually negotiated rates, the court cited longstanding precedent that, because of constitutional limitations on laws affecting contractual obligations, an administrative agency cannot fix rates unless it first determines that the contract adversely affects the public interest.⁵ The final order cited by the PFD likewise concluded that the Commission must determine that rates appealed under TWC § 13.043(b) are unreasonably preferential, prejudicial, or discriminatory before setting just and reasonable rates.⁶ However, that decision is not precedent because the issue was not disputed; the utility agreed that the rates were unreasonably preferential, prejudicial, or discriminatory.

⁴ *Tex. Water Comm'n v. City of Fort Worth*, 875 S.W.2d 332, 335-336 (Tex. App.—Austin 1994, writ denied). (*TWC v. Fort Worth*).

⁵ *Id.*

⁶ *Ratepayers' Appeal of the Decision by Bear Creek Special Utility District to Change Rates*, Docket No. 49351, Order on Rehearing at 3, 20 (Conclusion of Law No. 8) (Nov. 19, 2021) (*Bear Creek*).

Relying on *TWC v. Fort Worth* and *Bear Creek* as well as the Preliminary Order citing those decisions, the PFD states that “[t]he Commission has construed [TWC § 13.043(j)] to require an initial finding that the appealed rates are unreasonably preferential, prejudicial, or discriminatory before the Commission may fix just and reasonable rates.” Staff respectfully urges the Commission to examine both *Bear Creek* and *TWC v. Fort Worth* and note the significant differences between those cases and the docket currently before the Commission. In *TWC v. Fort Worth*, the appealed rates were contractual,⁷ and in *Bear Creek* the issue was not disputed.⁸

Here, the Commission must consider an appeal of rates that were put in place by a Board, rather than contractually negotiated, that are not subject to the de novo review requirement of TWC § 13.043(e), and that are being vigorously defended by the utility. An initial screening of the appealed rates to determine whether they are unreasonably preferential, prejudicial, or discriminatory would conflict with the requirements in TWC § 13.043(e) that the Commission “shall hear the appeal de novo and shall fix in its final order the rates the governing body should have fixed in the action from which the appeal was taken.”

IV. BURDEN OF PROOF

The PFD correctly states that Windermere has the burden of proof to show its rates are just and reasonable.⁹ However, as discussed above in Section III, the PFD erroneously applies an initial screen to determine whether existing rates are unreasonably preferential, prejudicial, or discriminatory. In addition, the PFD incorrectly places an initial burden of proof for that determination on Ratepayers. If the Commission adopts Staff’s position that the initial screen conflicts with TWC § 13.043(e) and is therefore not applicable in this docket, then the PFD’s placement of the burden of proof on Ratepayers with respect to the initial screen is moot; a finding that the rates are unreasonably preferential, prejudicial, or discriminatory would not be a necessary prerequisite for an evaluation of Windermere’s rates. However, if the Commission does adopt the PFD’s initial screen, Windermere, not Ratepayers, should have the burden of proof with respect to the initial screen.

⁷ 875 S.W.2d at 335-336.

⁸ *Bear Creek*, Order on Rehearing at 3, 20 (Conclusion of Law No. 8) (Nov. 19, 2021)

⁹ PFD at 4.

The PFD in the current docket is inconsistent with the Commission's final order in *Town of Woodloch*, which was subject to TWC § 13.043(e). The PFD in that docket, which was adopted in relevant part in the Commission's final order stated: "Woodloch bears the burden to prove that the New Rates are 'not unreasonably preferential, prejudicial, or discriminatory,' but are 'sufficient, equitable, and consistent in application to each class of customers.'"¹⁰ Staff therefore respectfully requests that the Commission assign the burden of proof to Windermere.

V. DISCUSSION

A. The Rate Decision

Currently, Windermere's rates recover an annual revenue requirement of \$576,192.¹¹ Of that amount, approximately 30%— \$171,337—is for legal expenses primarily related to a land transaction in which the Windermere Board sold a piece of property to a former Board member for what the plaintiffs in the underlying action assert was far less than market value.¹² In addition, the appealed rates recover the entire \$171,337 through base rates.¹³ This means that Windermere would indefinitely recover \$171,337 per year for legal expenses that, as discussed below, are not properly categorized as recurring and are not even properly recoverable through rates.

B. Threshold Issue

The PFD recommends dismissal of the appeal based on a conclusion that existing rates are not unreasonably preferential, prejudicial, or discriminatory. As discussed above in Section III, the PFD misinterpreted the rate-setting standards that apply to this docket. Rather than performing an initial screen to determine whether existing rates are unreasonably preferential, prejudicial, or discriminatory, the Commission must hear the appeal de novo and must fix the rates the governing body should have fixed in the action from which the appeal was taken.

Nevertheless, assuming that an initial screen to determine whether existing rates are unreasonably preferential, prejudicial, or discriminatory is required, Staff's testimony proves that the current rates are unreasonably preferential, prejudicial, and discriminatory. The current rates

¹⁰ *Appeal of Water and Sewer Rates Charged by the Town of Woodloch CCN Nos. 12312 and 20141*, Docket No. 42862, Proposal for Decision at 37 (Oct. 29, 2015) (Rates established by the Town of Woodloch were appealed on the grounds that the rates were unjust) (*Town of Woodloch*); *Town of Woodloch* Order at 1.

¹¹ Staff Ex. 4 at 7, citing Windermere's response to RFI Staff 1-5, included as Attachment MG-4.

¹² Tr. Day 2 at 268, 5-11 (Gimenez Cross) (Dec. 2, 2021).

¹³ Windermere Ex. 2 at 13 (Gimenez Dir.).

recover an excessive percentage of fixed costs through base rates, which results in rates that are unreasonably preferential, prejudicial, and discriminatory to the detriment of low-volume customers. The current rates were changed by Windermere to recover \$171,337 in legal expenses—through base rates.¹⁴ Windermere’s current rates are designed to recover 85% of its revenue requirement through fixed rates and 15% from volumetric, 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,¹⁵ was unable to identify any other utility with such a split.¹⁶ As discussed below in Section VII, Staff recommends that 61% of Windermere’s revenue requirement be recovered through fixed rates and 39% be recovered through volumetric rates, as testified by Staff witness Stephen Mendoza. Therefore, even if the Commission should decide to apply an initial screen of existing rates, Mr. Mendoza’s testimony proves that Windermere’s current rates are unreasonably preferential, prejudicial, and discriminatory.¹⁷

C. Rate Case Expenses

TWC § 13.043(e) states that the Commission “shall fix in its final order the rates the governing body should have fixed in the action from which the appeal was taken and may include reasonable expenses incurred in the appeal proceedings.” The Commission therefore has discretion to determine whether and to what extent reasonable expenses incurred in this docket by Windermere should be recovered through rates.

1. Amount

Staff recommends that the Commission exercise its discretion to allow rate recovery of the costs of Windermere’s appeal by weighing those costs against, for example, the rates being defended, the size of the utility, and the number and type of consumers served.¹⁸

Here, the costs of appeal could easily exceed \$500,000, given that the PFD would grant approximately \$345,000, which does not even take into account the amount that will be incurred

¹⁴ Staff Ex. 2 at 5 (Bates 4).

¹⁵ Windermere Ex. 9.

¹⁶ Tr. Day 2 at 422, 21-24 (Rabon Cross) (Dec. 2, 2021).

¹⁷ See *West Texas Util. Co. v. Office of Pub. Util. Counsel*, 896 S.W.2d 261 (Tex.App.—Austin 1995, no writ) (the Commission has discretion to make rate design decisions that are supported by evidence taken at the hearing or on facts judicially noticed).

¹⁸ Commission Staff’s Initial Post-Hearing Brief at 8 (Dec. 30, 2021).

for the purposes of drafting exceptions, replies to exceptions, and attending the June 16, 2022 Open Meeting.¹⁹ The PFD, in fact, recommends that Windermere “file an affidavit or supplemental testimony closer in time to the Commission’s consideration of this matter reflecting the then-current total.”²⁰ Staff takes exception to the idea that it is appropriate for a utility to incur more than its annual revenue requirement in legal expenses, all in the attempt to justify the improper inclusion of outside legal expenses in its rates. Instead, Staff recommends a partial recovery of the costs of appeal incurred by Windermere.

In a docket where a utility’s costs of appeal far exceed the increase being appealed, Staff argues that the continued recovery of additional expenses would be unreasonable. While Staff was willing to recommend recovery of the \$281,575.65 identified in the supplemental direct testimony of Maxine Gilford, Staff is unwilling to extend that recommendation to the \$345,227.03 awarded in the PFD. Windermere’s filing of testimony indicating that an additional amount was spent is not the equivalent of a demonstration that those funds were reasonably expended. At some point, someone must turn off the tap of free-flowing legal expenses.

2. Recovery Mechanism

The PFD adopts a recovery period of 42 months.²¹ Staff takes exception to this recommendation and instead recommends adoption of a five-year recovery period, as recommended by Staff witness Gilford.²² A five-year recovery for rate case expenses is not uncommon, and it lessens the impact on the Ratepayers.

VI. CONCLUSION

The PFD misinterprets the legal standards that apply in this docket. Rather than performing an initial screen to determine whether existing rates are unreasonably preferential, prejudicial, or discriminatory as is done in the PFD, under TWC § 13.043(e) the Commission must hear the appeal de novo and must fix the rates the governing body should have fixed in the action from which the appeal was taken. Nevertheless, assuming that an initial screen to determine whether existing rates are unreasonably preferential, prejudicial, or discriminatory is required, Staff’s testimony proves that the current rates are unreasonably preferential, prejudicial,

¹⁹ PFD at 12.

²⁰ *Id.*

²¹ *Id.* at 13.

²² Staff Ex. 5 at 1-2 (Bates 3-4).

and discriminatory. Staff recommends only partial rate recovery of Windermere's costs for this docket; at some point, the Windermere's costs for this docket become unreasonable in comparison to the rate increase being appealed.

The PFD does not evaluate Staff's testimony recommending new rates because the PFD recommends dismissal of the appeal because of the PFD's erroneous conclusion that Windermere's current rates are not unreasonably preferential, prejudicial, or discriminatory. The PFD also recommends that, if a determination is to be made of whether the existing rates are just and reasonable, the determination be based on the existing record and argument in order to avoid additional rate-case expenses.²³ Staff agrees with the PFD that a final decision in the docket should be made using the existing evidentiary record. However, rather than remand, the Commission can make a final decision, resulting in less rate-case expenses.²⁴

Adoption of the PFD before the Commission has sweeping negative consequences for those ratepayers who are part of a system that includes only one class of customer. Further, 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. Staff's recommendations on rates that should be adopted in this docket are below in Section VII, Rates Fixed De Novo. As explained in Section VII, Staff recommends that the legal expenses incurred to defend a lawsuit that Windermere's own insurance company refuses to cover should not be recovered through rates.

VII. RATES FIXED DE NOVO

The primary issue at the hearing was whether Windemere should be allowed to recover through rates legal expenses of \$171,337: approximately 30% of the revenue requirement and predominately related to a lawsuit for which Windermere's insurance carrier has declined to cover.²⁵ Windermere asserts that it needs to recover these expenses through rates to maintain its financial integrity. Under TWC § 13.043(j), the Commission must "use a methodology that preserves the financial integrity of the retail public utility." However as stated in *Town of*

²³ PFD at 14.

²⁴ If the Commission does find that the burden of proof falls on the Ratepayers to demonstrate that the rates are not preferential/prejudicial, Staff notes that re-opening the record on a limited basis could be appropriate.

²⁵ Apart from the lawsuit, Windermere's legal expenses have been very small: 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. Windermere Ex. 2 at 072.

Woodloch when interpreting this provision, “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 [sic] water and sewer rates.”²⁶

Windermere’s insurer, Allied World Specialty Insurance Company, declined to provide coverage for legal expenses incurred by Windermere related to *Rene Ffrench, et al. v. Friendship Homes & Hangars, LLC, et al.*²⁷ Allied World cited multiple exceptions to excuse its duty to provide coverage. Allied World stated that it was not required to provide coverage because the expenses were due to “the insured gaining any profit, advantage, or remuneration to which the insured is not legally entitled.”²⁸ Amongst other exclusions, 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.²⁹ Windermere has challenged this denial of coverage.³⁰ The dispute between Windermere and Allied World is currently unresolved.³¹ Windermere paid for insurance to cover legal fees to defend it and its directors against lawsuits over actions taken by Windermere and directors in the lawful execution of their duties. If Windermere prevails against its insurance company, it will be reimbursed for reasonable legal expenses related to the lawsuit, which would result in double recovery if the Commission should choose to allow Windermere to also recover those expenses through rates. Alternatively, Windermere should not be allowed to recover through rates legal expenses for unlawful actions by Windermere or its board members.

A. Base-Rate Revenue Requirement

Staff recommends the revenue requirement for the rates that preceded the appealed rates. The difference between the base-rate revenue requirement for the appealed rates and for the rates that preceded them is the \$171,337 in external legal expenses predominately related to the lawsuit described above under section VII. Staff subtracted the amount of legal fees of \$171,337

²⁶ *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).

²⁷ Staff Exhibit 4 at 14-15.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

included in Windermere's requested annual revenue requirement in order to arrive at Staff's proposed base-rate revenue requirement of \$404,855.³²

B. Rate Design

Staff recommends that the Commission adopt its witnesses' recommended rates, including 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—some 61% of Windermere's revenue requirement, as recommended in the Texas Rural Water Association (TRWA) rate analysis provided to Windermere at Windermere's request, with the remaining 39% to be recovered through volumetric rates.³³ 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.

Windermere chose to forego TRWA's recommended allocation. Instead, Windermere dramatically increased its base rates to recover the increase to its revenue requirement—approximately \$171,000 in legal expenses. Windermere's appealed rates are designed to recover approximately 84.9% of its revenue requirement through fixed rates and 15.1% from volumetric, or gallonage, rates. Such an extreme split is unusual if not unprecedented; Windermere witness Grant Rabon, who filed rebuttal testimony addressing the allocation of revenue requirement between fixed and variable rates,³⁴ was unable to identify another utility with such a split.³⁵

Windermere's base rates for water and wastewater service are \$90.39 and \$66.41, respectively, with 271 and 245 connections, respectively.³⁶ These base rates, in combination with Windermere's volumetric rates, would generate an over-recovery of the revenue requirement that Windermere used to fix the appealed rates. These rates would generate a total of \$489,193 annually,³⁷ 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

³² Staff Exhibit 4 at 6 (Bates 8).

³³ Windermere Ex. 7 at Attachment MN-2 (Bates 24).

³⁴ Windermere Ex. 9.

³⁵ Tr. Day 2 at 422, 21-24 (Rabon Cross) (Dec. 2, 2021).

³⁶ Windermere Ex. 8 at 7 (Bates 7).

³⁷ $(\$90.39 * 271 * 12) + (\$66.41 * 245 * 12) = \$489,193$.

Mike Nelson, Windermere's projected volumetric recovery for the test year of 2019 was, in fact, \$107,006.³⁸

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." The legal expenses related to the lawsuit described above under section VII are non-recurring. Therefore, if the Commission allows rate recovery of those expenses, it should allow recovery of them through a four-year surcharge rather than through base rates, as recommended by Staff witness Maxine Gilford.³⁹ In addition, the Commission should order a five-year surcharge for Windermere's expenses for this docket, as recommended by Staff witness Maxine Gilford.⁴⁰

C. Depreciation Expense

The annual amount for depreciation expense included in the appealed rates was inappropriate because Windermere's rates based on the cash-needs methodology. As result, Staff witness English recommended that the resulting revenues of approximately \$56,273 be used to fund future plant investment and be recorded in Windermere's Capital Expenditure Reserve as customer-contributed capital, which Windemere did not rebut or otherwise challenge at the hearing.⁴¹

D. Refunds and Surcharges

As explained above in subsection B, the Commission should order a five-year surcharge to recover Windermere's \$281,575.65 of costs for this docket. In addition, if it allows Windermere to recover its civil litigations expenses for the lawsuit that Windermere's insurance company denied coverage for, the Commission should order a four-year surcharge to recover \$171,337. If the Commission adopts Staff's recommended rates, it should order a four-year refund under TWC § 13.043(e), which states: "The utility commission may establish the effective date for the utility commission's rates at the original effective date as proposed by the service provider, may order refunds or allow a surcharge to recover lost revenues, and may allow recovery of reasonable expenses incurred by the retail public utility in the appeal proceedings." As for any adverse financial impacts that Windermere may assert will be caused by these multi-

³⁸ *Id.* at MN-6, at 6 of 6 (Bates 17).

³⁹ Staff Ex. 4 at 16-17 (Bates 17-18).

⁴⁰ *Id.* at 18 (Bates 19).

⁴¹ Tr. Day 2 at 461-462 (Filarowicz Cross) (Dec. 2, 2021).

year recovery periods, the Commission should consider the availability of Windermere's assets, a line of credit, use of its cash reserves, cash flow from depreciation, and other income that is contributed by non-WSC customers.

Dated: May 17, 2022

Respectfully submitted,

**PUBLIC UTILITY COMMISSION OF TEXAS
LEGAL DIVISION**

Keith Rogas
Division Director

Robert Dakota Parish
Managing Attorney

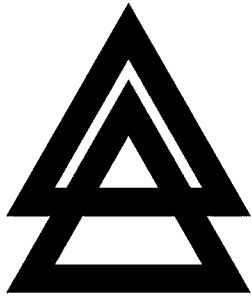
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CERTIFICATE OF SERVICE

I certify that, unless otherwise ordered by the presiding officer, notice of the filing of this document was provided to all parties of record on May 17, 2022 in accordance with the Order Suspending Rules filed in Project No. 50664.

/s/ Merritt Lander
Merritt Lander



APR CLAIMS

8055 Tufts Ave Suite 600 Denver, CO 80237

Phone: 877-533-1211 Fax: 720-529-9345

December 19, 2019

SENT VIA EMAIL AND CERTIFIED MAIL, RRR TO:

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|-----|----------------|--|
| Re: | Insured: | Windermere Oaks Water Supply Corporation |
| | Insurer: | Allied World Specialty Insurance Company |
| | Date of Loss: | 10/28/2016 |
| | Policy #: | 5105-0560-03 |
| | Policy Period: | 3/17/2016 to 3/17/2017 |
| | Subject: | Friendship Homes and Hangars |
| | Claim #: | 2017001776 |

DISCLAIMER OF COVERAGE

Dear Ms. Taylor and Mr. de la Fuente,

Network Adjusters, Inc. is the authorized third-party claims administrator for Allied World Specialty Insurance Company. Allied World issued a Commercial Water Plus Package Policy to Windermere Oaks Water Supply Corporation (hereinafter “WOWSC”) under policy number 5105-0460-03, which includes Public Official and Management Liability Coverage Form (Claims-Made) (the “POML Coverage Section”) for the Policy Period of March 17, 2016 through March 17, 2017 (the “Policy”).

This correspondence shall provide Allied World’s supplemental coverage position under the Policy in connection with a new filing that now comes forward as a Second Amended Original Petition, the style of which is Renee Ffrench, John Richard Dial, and Stewart Bruce Sorgen, Intervenor Plaintiffs vs. Friendship Homes and Hangars, LLC, Windermere Oaks Water Supply Corporation and its Directors, William Earnest, Thomas Michael Madden, Dana Martin, Robert Mebane, and Patrick Mulligan, Defendants, filed in District Court, Burnet County, Texas, 33rd Judicial District under Cause No. 48292.

This is the fourth filing on this matter going back to 2016. This newly filed Complaint contains new claims, adds additional Defendant parties, and seeks monetary damages and punitive damages from all of the current and former directors of Windermere Oaks Water Supply.

This current Pleading involves an allegation that WOWSC itself breached their fiduciary duty to WOWSC by approving the land sale and by failing to pursue claims related to the land sale, as well.

This matter arises out of certain sale of land by WOWSC to Friendship Homes and Hangars, LLC (Dana Martin.) Certain members of WOWSC have asserted that former Board members of WOWSC and WOWSC itself breached their fiduciary duty to WOWSC by approving the land sale and by failing to pursue claims related to the land sale respectively.

We have reviewed the information provided to us along with the relevant provisions of the Policy and completed our coverage investigation. **As discussed below, Allied World has determined that there is no coverage afforded for this action under the Policy.**

This correspondence is directed to you in your capacity as an authorized representative of the above-named Insured for insurance coverage purposes. To the extent that you are not acting on behalf of the Insured with respect to insurance matters, we request that you direct a copy of this letter to the appropriate representative and advise the undersigned accordingly.

To assist you in understanding this coverage analysis, we suggest that you review the Policy along with this letter. This letter does not modify any of the terms and conditions of the Policy. Allied World must reserve its right to decline or limit coverage should any of the exclusions, endorsements, or any other provision of the Policy prove to be applicable.

SUMMARY OF ALLEGATIONS

The summary of facts that follows is based upon the allegations contained within the documents and information received to date. We recognize that those allegations are unsubstantiated at this time, and nothing in this letter is intended to suggest or imply that they have any legal or factual merit.

Windermere Oaks Time Line of Events

FIRST PETITION

January 24, 2017

Correspondence was received involving a “potential” claim as a “situation” that is developing within Windermere. WOC sold a parcel of land to one of their board members Dana Martin and the sale is approved by the Board of Directors. According to standards in place by the BOC, the petition must have 10% of the ownership, signed to be accepted for review. This particular transaction only had 5% of membership and was not accepted by the Board of Directors.

MANDAMUS ACTION

December 22, 2017

Attorney Bill Aleshire, of Austin, Texas, representing TOMA, Integrity, Inc., filed a Mandamus Action seeking discovery requests and there is no demand for monetary damages. The style of the pleading is, Integrity, Inc. vs. Windermere Oaks Water Supply Corporation that was filed in the District Court of Barnett County, Texas, 33rd District Court under Cause number 47531. This Complaint reads that, on December 19, 2015, the WOWSC Board, acting without any competitive bid process or public announcement other intent, sold valuable property belonging to WOWSC to a business owned by one

of the Board members (Dana Martin). Additionally, the board also gave the board member a right of first refusal for the purchase of even additional WOWSC property. There is no item on the meeting agenda giving Fair Notice to the public, or WOWSC ratepayers, that any WOWSC property would be sold. They submit that this is a blatant violation of the Texas Open Meetings Act. Property was sold to Dana Martin for \$200,000.

This claim was analyzed under the Policy's General Liability coverage form and the Public Officials coverage form. It was a mandamus action seeking equitable and injunctive relief to avoid the action and decisions that the Windermere Oaks Water Supply Corporation made to sell a parcel of property to a Board member. Here, TOMA Integrity, Inc. filed the petition in seeking to enforce the application of the Texas Open Meetings Act. This was a one-count Complaint seeking that Mandamus action.

AMENDED COMPLAINT

April 10, 2017

Attorney Bill Aleshire filed his first amended complaint in the matter seeking the court to set the date on the mandamus action to reverse the violation of Toma public notice section 551.041 and declare avoid the action the WOWSC board took on December 19, 2015 to sell WOWSC property.

PETITIONER INTERVENTION

May 31, 2019

Attorney Bill Aleshire filed an Original Petition in Intervention in the matter. The Plaintiffs are René Ffrench, John Richard Dial, Stewart Sorgen as Intervenor Plaintiffs and as representatives for Windermere Oaks Water Supply Corporation vs Friendship Homes and Hangers, LLC, Windermere Oaks Water Supply Corporation and its Directors William Earnest, Thomas Michael Madden, Dana Martin, Robert Mebane and Patrick Mulligan as Defendants again in 33rd District Court. This Intervenor Pleading was filed to protect the interests of WOWSC and its members from the financial scar that was caused by the name Defendant WOWSC Directors. These Defendant Directors are said to have acted inconsistently with the limitation on their authority by selling the property to one of their own Board members for a very small fraction of the value of the property. This action that was taken by the Directors was done in a closed session. Intervenor members stand as representatives of WOWSC for the Corporation's claims against the name Defendant Directors for betraying WOWSC by exceeding their authority.

SECOND AMENDED ORIGINAL PETITION

November 5, 2019

Plaintiff-Intervenors in this case are three (3) members of WOWSC who filed this intervention seeking to protect the interests of WOWSC and its members from the financial harm that was caused by the named Defendant, WOWSC Directors. It is alleged that those Defendant Directors acted inconsistently with the limitation on their authority by selling WOWSC property to one of their own Board members for a small fraction of the value of the property and to challenge ownership by the Defendant, Friendship Homes, of certain property. Intervenor Plaintiff members stand as representatives of

WOWSC for the Corporation's claims against the named Defendant WOWSC Directors for betraying WOWSC members by exceeding their authority in the sale of this plot of land to another Director at a reduced price.

At a WOWSC Board meeting on December 19, 2015 and February 22, 2016, the Defendant WOWSC Directors approve the sale of WOWSC property, approximately 3.86 acres, along the west side of Piper Lane to Defendant, Friendship Homes and Hangars. The company, later created by then WOWSC Board member, Dana Martin, was the sale of this property which was done without public notice or competition for sale of the land and had been adjudged to have violated the Texas Open Meetings Act. These negotiations were done in closed session after an executive session was completed. The price approved by the Defendant, WOWSC Directors, for the property was to net \$200,000 to WOWSC. An appraisal of the property was commissioned by the Defendant, WOWSC Directors, and in particular, Dana Martin, herself, identifying the highest and best use of the property as "vacant land." The appraisal failed to recognize as Defendant Martin being a realtor herself who had sold similar properties in the area, that the property's highest and best use was division into several airport hangar lots, for which the value was actually \$700,000.

The Intervenor-Plaintiffs now seek to enjoin the performance of any act or the transfer of property by the WOWSC that 1) recognizes or facilitates the sale of Tract 1 (3 acres), and 2) that recognizes or facilitates the implementation of the unauthorized right of first refusal of Tract 2 (7 acres) without full and fair compensation to WOWSC. Additionally, they seek the sum of \$100,000.00.

Intervenor-Plaintiff members ask the Court to set aside and enjoin the land sale contract, enjoined implementation of Defendant, Friendship's right of first refusal and denial of an access easement from Tract 1 on to Tract 2; set aside and enjoin the performance of the land sale contract in Tract 1 as being inconsistent with the expressed limitation on the authority of the Defendant WOWSC Directors.

Causes of Action

As to the Causes of Actions in his Pleading, Plaintiffs allege:

- ... Ultra vires actions
- ... Unauthorized conveyance of property by current and former Directors
- ... Ultra vires use of cooperative assets by current and former Directors
- ... Adverse transactions
- ... Disbursement of cooperative funds for the benefit of Directors, current and former
- ... Breach of fiduciary duties
- ... Contractual fraud
- ... Conspiracy by Directors to disperse cooperative funds
- ... Exemplary damages
- ... Attorney fees

SUMMARY OF COVERAGE

We direct your attention to certain terms and conditions in the policy of insurance issued by Allied World that have affected coverage in this matter. As you know, the Policy is comprised of multiple coverage parts. Due to the nature of the underlying facts and allegations made therein and based upon the information received to date, it is Allied World's position that analysis of this matter is properly

conducted under Insuring Agreement (A) the POML Coverage Section of the Policy. We expressly note that the Commercial General Liability Coverage Section is inapplicable because the Petition does not allege “bodily injury” or “property damage” caused by an “occurrence” or “personal and advertising injury” caused by an offense and, therefore, the insuring agreement for the Commercial General Liability Coverage Section is not met. We further note that coverage under Insuring Agreement (B) of the POML Coverage Section is applicable, because the Petition seeks “damages”, defined to mean monetary damages, arising out of a “claim” for a “wrongful act”. If you disagree or would like us to review this matter under any other coverage section, please contact me.

Please note that the following observations concerning coverage are based on the information presently available and may be subject to change in the event Allied World becomes aware of additional information.

We direct your attention to the **PUBLIC OFFICIALS AND MANAGEMENT LIABILITY COVERAGE FORM WA-PO 00006 00 (03/12)**, a part of your Policy which states in pertinent part:

SECTION I. – COVERAGES

A. COVERAGE A. INSURING AGREEMENT – LIABILITY FOR MONETARY DAMAGES

1. We will pay those sums that the insured becomes legally obligated to pay as “damages” arising out of a “claim” for:

- a. a “wrongful act,” or
- b. an “employment practices” offense, or
- c. an offense in the “administration” of your “employee benefit plans,” to which this insurance applies.

We will have the right and duty to defend any “claim” seeking those “damages.” However, we will have no duty to defend the insured against any “claim” seeking “damages” for a “wrongful act” or an “employment practices” offense or an offense in the “administration” of your “employee benefit plans” to which this insurance does not apply. We may, at our discretion, investigate any “wrongful act,” “employment practices” offense or an offense in the “administration” of your “employee benefit plans,” and settle any “claim” that may result.

However:

The amount we will pay for “damages” is limited as described in **SECTION IV. – LIMITS OF INSURANCE**; and

Our right and duty to defend ends when we have used up the applicable limit of insurance in the payment of “damages” or “defense expenses” under **Coverages A. and B.**

No other obligation or liability to pay sums or perform acts or services is covered under this insurance unless explicitly provided for below under **Coverage A. Supplementary Payments.**

2. This insurance applies to “claims” for “wrongful acts” or offenses only if:

- a. The “wrongful act” or offense takes place in the “coverage territory,” and or after the retroactive date shown in the declarations and before the end of the policy period; and
- b. A “claim” is first made against any insured in accordance with paragraph 3.c. below, during the policy period or any Extended Reporting Period we provide according to **SECTION VII. – EXTENDED REPORTING PERIODS.**

SECTION II. – EXCLUSIONS

This insurance does not apply under either **Coverage A or Coverage B** to:

5. Attorney’s Fees and Court Costs

Any award of court costs or attorney’s fees which arises out of an action for “injunctive relief”

8. Claims Against Other Insured

Any actions for “injunctive relief” or “claims” brought:

- a. By a Named Insured against any other insured; or
- b. By one Named Insured against another Named Insured.

11. Contractual Liability

“Damages,” “defense expenses,” costs or loss based upon, attributed to, arising out of, in consequence of, or in any way related to any contract or agreement to which the insured is a party or a third-party beneficiary, including, but not limited to, any representations made in anticipation of a contract or any interference with the performance of a contract.

12. Criminal Acts

“Damages,” “defense expenses,” costs or loss arising out of or contributed to by any fraudulent, dishonest, criminal or malicious act of the insured (except for “sexual abuse” which is excluded in the Sexual Abuse exclusion below), or the willful violation of any statute, ordinance or regulation committed by or with the knowledge of the insured. However, we will defend the insured for covered civil action subject to the other terms of this Coverage Form until either a judgment or final adjudication establishes such an act, or the insured confirms such act.

15. ERISA, COBRA and WARN Act Liability

“Damages,” “defense expenses,” costs or loss arising out of or contributed to by any insured’s obligations under:

- a. The Employee Retirement Income Security Act of 1974 (ERISA);

19. Violation of Law

“Damages,” “defense expenses,” costs or loss arising from an insured’s willful violation of any federal, state, or local law, rule, or regulation.

27. Profit, Advantage or Remuneration

Any “Damages,” “defense expenses,” costs or loss based upon or attributable to the insured gaining any profit, advantage or remuneration to which the insured is not legally entitled.

SECTION VI. –CONDITIONS

Lastly, in addition to the foregoing, Allied World continues to reserve its rights, remedies, and defenses, including, without limitation, its right to disclaim or limit coverage as this matter continues to evolve, to the extent that:

1. the parties involved are not insureds;
2. this matter does not involve “wrongful acts”;
3. any amounts incurred in connection with do not constitute covered or insurable “damages” or “defense expenses”; and
4. this matter involves covered and uncovered matters or parties.

Please note that Section VI, Condition (6) of the Policy’s POML Coverage Section provides that if other valid and collectible insurance is available to the insured for a loss or “defense expenses” we cover under this Coverage Form, this insurance is excess over any of the other insurance and its deductible or self-insured retention provisions, whether primary, excess, contingent or on any other basis. Accordingly, please advise as soon as possible if there are any other insurance carriers that have been placed on notice of this matter. In addition, please forward us copies of any and all other coverage letters issued by any other insurance carrier(s) in connection with this “claim.” Allied World expressly reserves its rights related to other insurance.

SECTION VIII. – DEFINITIONS

3. “Claim” means:

- a.** written notice, from any party, that it is their intention to hold the insured responsible for “damages” arising out of a “wrongful act” of offence by the insured;
- b.** a civil proceeding in which “damages” arising out of an offence or “wrongful act” to which this insurance applies are alleged;
- c.** an arbitration proceeding in which “damages” arising out of an offense or “wrongful act” to which this insurance applies are claimed and to which the insured must submit or does submit with our consent;

- d. any other civil alternative dispute resolution proceeding in which “damages” arising out of an offense or “wrongful act” to which this insurance applies are claimed and to which the insured submits with our consent; or
- e. a formal proceeding or investigation with the Equal Employment Opportunity Commission, or with an equivalent state or local agency.

A “claim” does not mean any ethical conduct review or enforcement action, or disciplinary review or enforcement action.

5. “Damages” means monetary damages

6. “Defense expenses” means reasonable and necessary fees or expenses incurred by or on behalf of the insured for:

- a. Legal fees charged by the insured's attorney;
- b. Court costs;
- c. Expert witnesses; and
- d. The cost of court bonds, but we do not have to furnish these bonds.

“Defense expenses” do not include:

- (1) Any salaries, charges or fees for any insured, insured's “volunteer workers” or “employees,” or former “volunteer workers” or “employees”; or
- (2) Any expenses other than a., b., c. and d. above.

12. “Injunctive relief” means equitable relief sought through a demand for the issuance of a permanent, preliminary or temporary injunction, restraining order, or similar prohibitive writ against an insured, or order for specific performance by an insured.

25. “Wrongful act” means any actual or alleged error, act, omission, neglect, misfeasance, nonfeasance, or breach of duty, including violation of any civil rights law, by any insured in the discharge of their duties for the Named Insured, individually or collectively, that results directly but unexpectedly and unintentionally in “damages” to others.

EXPLANATION FOR ALLIED WORLD’S DISCLAIMER OF COVERAGE

Based on the foregoing Policy language and our review of the materials received, we have determined that the Policy will not afford coverage for the Complaint for several reasons. Please take note of seven (7) enumerated exclusions that will give preclusive effect to a coverage grant.

First, in the Petition, Plaintiff seeks equitable and injunctive relief to void the action and decisions that the Windermere Oaks Water Supply Corporation (WOWSC) initiated to sell a parcel of WOWSC property to a Board member. According to Section II of the Policy’s POML Coverage Section

Exclusion (27), this insurance does not apply under Coverage (A) to “damages,” “defense expense,” costs or loss based upon or attributable to the insured gaining any profit, advantage or remuneration to which the insured is not legally entitled.

Second, according to Section II of the Policy’s POML Coverage Section, Exclusion (19), this insurance does not apply under Coverage (A) to “damages,” “defense expense,” cost or loss arising from an insured’s willful violation of any federal, state, or local law, rule or regulation. In this matter, there were violations of the Texas Open Meetings Act (TOMA) as there was no public notice given to WOWSC members of the upcoming meeting nor items listed on the agenda. Given the allegations, Allied World further reserves its rights to limit coverage to the extent the insured willfully violated any federal, state, or local law, rule or regulation.

Third, we note that the Petition seeks attorney’s fees. According to Section II of the Policy’s POML Coverage Section, Exclusion (5), this insurance does not apply under Coverage (A) to any award of court cost or attorney’s fees which arises out of an action for “injunctive relief”. Allied World expressly disclaims coverage for any award of attorney’s fees which arise out of the Petition.

Lastly, Exclusion 8 “claims against another insured” is applicable. We submit that you refer the matter to your Directors and Officers (D and O) carrier for their review and consideration. This portion of the Pleading is better addressed under a Fidelity Liability Policy which is not specifically contained within the Policy form of your current Public Officials – Management Liability, as well as the General Liability coverage part. Nevertheless, the ERISA exclusion would apply as to fiduciary duties.

In the complaint, the plaintiffs have made a claim for punitive damages. Allied World denies any obligation to provide payment for punitive damages, or any other damages, that do not meet the definition of “loss” or “losses” as defined above and by the policy. You should, therefore, take whatever actions you deem appropriate to protect your interests, including notifying any prior carriers that may provide coverage for this loss.

Based on the above considerations, as to the Exclusions, Allied World denies the coverage grant for defense representation and indemnity under the Policy to WOWSC.

Allied World’s coverage position addressed herein is based upon the facts currently known, and Allied World will consider and evaluate any additional information you may present to it, which you believe to be relevant to its coverage determination.

Please understand that this letter is not intended to provide an exhaustive review of all Policy terms, conditions and exclusions and Allied World expressly reserves its right to rely upon and enforce additional Policy terms when appropriate. Allied World may revise its coverage position and raise any other coverage issues or coverage defenses without prejudice, waiver or estoppel. Furthermore, this letter does not constitute a waiver of any policy provisions or defenses available to Allied World. Allied World expressly reserves all of its rights and defenses under the Policy and applicable law. Additionally, Allied World reserves the right to seek a determination in a court of law regarding any issues of coverage discussed herein as well as those not raised by this letter, but of which Allied World may subsequently become aware.

If you have any questions or concerns regarding Allied World’s coverage position or anything stated herein, or if you have additional information which you believe may affect Allied World’s coverage

position, please do not hesitate to contact the undersigned at 303-221-9676 or by email pflynn@networkadjusters.com.

You may contact the Texas Department of Insurance
to obtain information on companies,
coverages, rights or complaints at

1-800-252-3439

You may write the Texas Department of Insurance

P.O. Box 149104

Austin, TX 78714-9104

FAX # (512) 475-1771

Web: <http://www.tdi.state.tx.us>

E-mail: ConsumerProtection@tdi.state.tx.us

Sincerely,

Pete Flynn

Pete Flynn

General Adjuster

Network Adjusters, Inc. on behalf of Allied World Specialty Insurance Company

pflynn@networkadjusters.com

303-221-9676

"Any person who knowingly presents a false or fraudulent claim for the payment of a loss is guilty of a crime and may be subject to fines and confinement in state prison."

cc: Sandy Batchelor (via email only)

AIA Insurance Agency, Inc.

sbatchelor@aiaagency.com