SUBJECT: Revising rate notices and rate-case proceedings for water utilities

COMMITTEE: Natural Resources — committee substitute recommended

VOTE: 10 ayes — Ritter, Beck, Creighton, Hopson, Keffer, Larson, Lucio, Martinez Fischer, D. Miller, Price

0 nays

1 absent — T. King

WITNESSES: For — David Frederick, Texans Against Monopolies' Excessive Rates; Bob Laughman, Aqua Texas; (*Registered, but did not testify:* Joe B. Allen, Allen Boone Humphries Robinson, LLP; George Freitag, Charles Profilet, Southwest Water Company; Mark Janay, SJWTX, dba Canyon Lake Service Co.; Monty Winn, Texas Municipal League)

Against — (*Registered, but did not testify:* Tom "Smitty" Smith, Public Citizen)

(*On committee substitute:*)
For — Tom Hodge, Canyon Lake Water Service Company

Against — David Frederick, Texans Against Monopolies' Excessive Rates

BACKGROUND: Current law authorizes the Texas Commission on Environmental Quality (TCEQ) to approve rate changes for investor-owned water and sewer utilities. Investor-owned water and sewer utilities must provide notice to their customers of a rate change at least 60 days before the proposed change. The customers have another 90 days after the proposed date to protest the rate change. If protests are received from the lesser of 10 percent or 1,000 affected customers, TCEQ or the other applicable regulatory authority must set the matter for a hearing.

DIGEST: CSHB 2400 would make various changes to the processes used by water and sewer utilities to change rates and provide notice of rate changes.

Consolidated tariffs. CSHB 2400 would allow a utility to consolidate systems under a single tariff on a regional basis and would remove the

requirement that single-tariff consolidation only occur among systems that were substantially similar in terms of facilities, quality of service, and cost of service.

Future test year to calculate new rates. The bill would require a regulatory authority to base a utility's expenses on information for either a historic test year that was the most recent 12-month period or a future test year of the 12-month period ending on the first anniversary of the rate application filing date.

Statement of intent to change rates. CSHB 2400 would prohibit a water and sewer utility from changing its rates except by delivering a statement of intent to each ratepayer and the regulatory authority at least 90 days, rather than 60 days, before the proposed effective date of the changes.

The bill would revise the content required in the statement of intent by requiring the statement to include, in addition to any other information required by the regulatory authority:

- the utility's name, address, current rates, and proposed rates;
- the effective date of the proposed rates;
- information on the procedure for protesting a rate change, the minimum number of protests needed to ensure a hearing, and the length of the protest period;
- contact information for TCEQ and the Office of Public Interest Counsel; and
- a brief description of the contested case hearing process.

The statement also would have to include a billing comparison of the existing water or sewer rate and a new water or sewer rate based on specified increments of usage, unless the utility proposed a flat rate for sewer service. The billing comparison would have to compare the existing water or sewer rate and the new water or sewer rate computed for the use of 5,000, 10,000, 15,000, and 30,000 gallons of water or sewer, rather than only 10,000 and 30,000 gallons of water or sewer.

Reduced timeline for contested rate cases. If the rates were contested, the regulatory authority would be required to hold the proposed rate increase hearing before the 61st day, rather than 91st day, after the date of the statement of intent. The regulatory authority would be allowed to set

the matter for a hearing anytime within 90 days, rather than 120 days, after the statement of intent was provided.

If a regulatory authority set a matter for a hearing on a proposed rate increase, it would have to suspend the date of the rate change until it made a final decision.

The administrative law judge would be required to issue a proposal for decision within 120 days of the last day of the preliminary hearing, after which TCEQ would have to issue the final decision within 60 days. If deemed necessary, the process could be extended to protect a party's right to due process or other constitutional right.

If the regulatory authority did not set a hearing on the proposed rate increase, the rates automatically would be approved as requested.

While current law prohibits a utility from filing a statement of intent to increase its rates more than once a year, the bill would prohibit a utility from doing so only for the same customer more than once a year.

Utility facilities construction and improvement (UFCI) charge. CSHB 2400 would allow a utility to assess a UFCI charge to recover the depreciation and return on investment of a UFCI project that:

- was completed and placed into service between two consecutive statements of intent to change the utility's rates or tariff; and
- served the utility's certificated service area, including a facility used for the production, transmission, storage, distribution, or provision of potable or recycled water to the public, or the collection, transportation, treatment, or disposal of sewage.

TCEQ, by rule, would have to require a utility that proposed to assess a UFCI charge to file a tariff establishing a just and reasonable way to calculate the charge and to receive the TCEQ executive director's approval of the tariff.

In adopting these rules, TCEQ would have to ensure that within 60 days of a utility's proposed inclusion of a charge or a proposed increase of a charge in a tariff, the utility submitted to the executive director for review of a project's eligibility a written notice that contained:

- the amount of the proposed charge or increase of a charge;
- the proposed implementation date;
- a list of completed, eligible capital projects and related depreciation and return on investment for which the utility sought reimbursement through the charge or increase of a charge; and
- a calculation of the projected total annual increase in revenue due to the charge or increase of a charge.

TCEQ also would have to ensure that:

- the total amount the utility was authorized to recover annually through the charge and the amount the utility actually recovered were subject to annual audit by the executive director;
- the amount of the charge the utility requested authorization to assess was based on the amount necessary to ensure that the charge yielded a rate of return on invested capital that was equal to the rate of return approved for the utility in its most recent approved base-rate or tariff-change application, or the rate of return proposed by the utility if the rates in its most recent base-rate or tariff-change application were approved by settlement;
- the cumulative annual amount the utility proposed to recover from the charge did not exceed 10 percent of the utility's annual revenue;
- the utility did not implement an increase more than twice every calendar year;
- the charge was applied to each customer included in the tariff;
- the utility provided each customer with written notice of the charge on the initial tariff filing that proposed to implement the charge; and
- the charge was subject to a true-up or reconciliation at the utility's next rate case.

The implementation or increase of an UFCI charge would not be subject to a contested case hearing.

A utility would be prohibited from collecting the charge after the first anniversary of the completion of a UFCI project.

These provisions would not apply to a utility that had a negotiated stay-out agreement in place on September 1, 2011.

Repealers. CSHB 2400 would repeal regulatory authority to set interim rates and to order a utility to refund money from proposed rates or to deposit money from rate increases into escrow accounts.

Executive director. CSHB 2400 would allow the executive director, not solely the commission, to dissolve and convert utility districts.

Effective date. The bill would take effect September 1, 2011. The provisions of this bill would apply only to a statement of intent filed on or after September 1, 2011.

SUPPORTERS SAY:

Consolidated tariffs. By allowing region-wide tariffs, CSHB 2400 would benefit existing and future customers by creating an economy of scale that would stabilize rates, make rates more affordable in the smaller-rate districts, and facilitate investment in water supply infrastructure and water treatment facilities.

Critics of regional rates argue that one water system should not subsidize another, but all ratemaking involves some degree of cost averaging. For many water systems, costs are averaged among customers within classes, without regard to variations in the cost of service associated with differences in elevation or different water sources and facilities. Cost averaging would level the sharp rate increases likely to occur on a stand-alone basis, since capital costs would be spread over a larger customer base. In time, every system will need a new plant and infrastructure improvements, and the same leveling of rate impact would occur.

Further, capital projects are financed at the company level, not system by system, and many systems share resources such as engineering, facilities planning, and water quality testing and control.

Future test year to calculate new rates. CSHB 2400 would allow a utility to choose to use a "future test year" in the calculation of new rates rather than a "historic test year." The current practice of utilizing historic test years in Texas for determining rates all but guarantees a utility will have no return on or recovery of capital that has been invested, or that needs to be invested, until the utility files another rate case. Using historic test years to set rates discourages the necessary investment by a utility and skews construction and capital investment timing because rates are set on historical or artificial test-year issues rather than actual system needs and actual replacement, improvement, or construction needs. This, in turn,

increases the risk and the cost of capital for utilities and often leads to balance-sheet issues for the utility. The use of a future or prospective test year would most accurately reflect the actual costs during the period the rates would most likely be effective.

The use of a future test year would give ratepayers due process in advance of the prospective rate's taking effect, which could eliminate costly and time-consuming litigation in contested rate cases. Litigation costs are typically passed through and incorporated into rates. In some cases, the expenses amount to millions of dollars and have become more common as larger systems continue to purchase smaller systems.

Several states currently use future test years in practice, and over 15 states allow a choice between historic and future tests years.

Utility facilities construction and improvement charge (UFCI). CSHB 2400 would allow a utility to assess a UFCI charge to recover the depreciation and return on investment of a project. The UFCI charge would allow drinking water and wastewater utilities to replace infrastructure needed to improve reliability, comply with environmental requirements, and create solutions to regional water supply problems in a timely, cost-effective manner. Capital costs typically are not the primary concern in a base-rate case because they are nonrevenue-producing, nonexpense-reducing projects. Also, the costs of extending facilities to serve new customers are not included in a base-rate case.

Water and wastewater utilities face a significant financial challenge to replace aging infrastructure and upgrade treatment as required on an increasingly stringent basis. The UFCI charge would allow adjustments to customer charges for one component of a utility's cost of providing public service without requiring a broad, costly, and time-consuming rate case. The UFCI charge could reduce rate-case expenses by extending the time between future base-rate filings.

The UFCI charge is not intended to bypass the traditional ratemaking process. Costs recovered would be subject to a reconciliation or true-up at the subsequent rate case. The true-up would compare revenue received to eligible costs. Also, the UFCI charge would more properly reflect the cost of water since the charge would be based on a "pay as you go" philosophy. The UFCI charge also would work to avoid "rate shock" since the rates

would be adjusted to reflect the cost of the improvements on a more immediate basis than occasional rate application filings.

OPPONENTS SAY:

Consolidated tariffs. By allowing region-wide tariff consolidation, CSHB 2400 would allow utilities that aggregated smaller utilities to place them all in one "system" and charge the same rates across the entire system, regardless of how much or how little the town or subdivision cost the utility. This would divorce the customer rate from the cost of serving the customer. This already has been done by certain utilities whose "regional" rate base now includes dissimilar utilities scattered throughout a portion of the state.

Future test year. CSHB 2400 would allow a utility to choose to use a "future test year" in the calculation of new rates rather than a "historic test year." The use of a future test year would allow a utility to make up a budget for a future year and collect rates adequate to fund that budget. This would completely remove any incentive the utility had to be efficient or cut costs, since it could likely find something on which to spend the money to justify the budgeted amount. CSHB 2400 would not require any audit to show that what actually came to pass, such as the number of customers paying bills, was as projected. Future test years would just help to drive rates upward faster than they already are rising.

The use of a future test year in calculating rates also would create a moving target. A ratepayer would not know what the rate increase would be until 12 months after the rate increase application was filed.

Utility facilities construction and improvement charge (UFCI). CSHB 2400 would allow a utility to assess a UFCI charge to recover the depreciation and return on investment of a project. This would place a burden on ratepayers by allowing an automatic, twice-a-year rider to be added to bills to recover costs such as depreciation and return on investment for capital plants placed in service since the last rate case. The amount that could be added each year would be up to 10 percent of the utility's revenue. It would be easy to connect almost any expense, such as meals and consultants' fees, to a capital project. Also, the bill would not require any sort of audit. Although the utility would have to submit its plan to TCEQ for true-up or reconciliation, TCEQ's lack of resources due to budget cuts would ensure that the true-up or reconciliation was superficial. The UFCI charge would not be subject to a hearing, so there would be almost no check on the charges.

Also, the bill would allow the UFCI charge requested by the utility to be based on the amount necessary to ensure a rate of return on capital investments that was equal to the rate of return approved for the utility in its most recent approved base-rate or tariff-change application. Many recent cases have shown a 12-percent return on equity. This provision could establish a perpetually high rate of return, which would lock ratepayers into paying excessive rates.

NOTES:

The Sunset Advisory Commission recommended moving the authority of ratemaking for water and wastewater utilities from TCEQ to the Public Utility Commission (PUC). The PUC sunset bill, HB 2134 by Solomons, which was left pending in the House State Affairs Committee on March 14, contains this provision.

According to the fiscal note, the bill would not have any fiscal implication to the state.

The committee substitute would allow a utility to choose the use of a future test year in the calculation of new rates and to consolidate more than one system under a single tariff on a regional basis, and would establish a UFCI charge.