

SUBJECT: Establishing a fair market valuation process for certain utility acquisitions

COMMITTEE: State Affairs — favorable, without amendment

VOTE: 12 ayes — Phelan, Hernandez, Deshotel, Guerra, Harless, Holland,
Hunter, P. King, Parker, E. Rodriguez, Smithee, Springer

0 nays

1 absent — Raymond

WITNESSES: For — Robert Laughman, Aqua America; (*Registered, but did not testify*:
Terry Franks and Buddy Garcia, Aqua Texas; Jamaal Smith, City of
Houston, Office of the Mayor; Matthew Bentley, San Jose Water Group
dba Canyon Lake Water Service Company; Jess Heck, SouthWest Water
Company)

Against — (*Registered, but did not testify*: Jamaal Smith, City of Houston,
Office of the Mayor)

On — (*Registered, but did not testify*: Tammy Benter, Public Utility
Commission of Texas)

BACKGROUND: Water Code sec. 13.301 requires a utility that provides water or sewer
services, on or before the 120th day before the effective date of an
acquisition of certain water or sewer systems, to file a written application
with the Public Utility Commission (PUC) and give public notice of the
action.

If an acquired public utility facility or system was constructed with the aid
of customer contributions through specific surcharges, the public utility
may not sell or transfer any of its assets or controlling interest, unless the
utility provides a written disclosure on the contributions to the purchaser
before the date of the sale or transfer. The disclosure must contain the
total dollar amount of the contributions and a statement that the
contributed property or capital cannot be included in invested capital or

allowed depreciation expense in rate-making proceedings.

Some have expressed concerns that a water utility may not be able to recover investments made to acquire a water or wastewater system, which inhibits mutually beneficial transactions. Stakeholders suggest removing those barriers to investment by creating an optional fair market valuation process.

DIGEST: HB 3542 would establish a process by which a Class A public utility providing retail water or sewer service could acquire a retail public utility, or the facilities of a utility, as the result of a voluntary arm's-length transaction.

Notice of intent. Under the bill, the acquiring utility and the selling utility could agree to determine the fair market value of the selling utility or facilities. Both utilities would have to notify the Public Utility Commission (PUC) of their intent to determine the fair market value.

The PUC would maintain a list of experts qualified to conduct economic valuations of utilities. Within 30 days of receiving a notice of intent to determine fair market value, PUC would select three experts from the list to perform the valuation.

Valuation. Each selected expert would perform an appraisal in compliance with Uniform Standards of Professional Appraisal Practice, employing the cost, market, and income approaches, to determine the fair market value of the utility or facility. The experts jointly would retain a licensed engineer to conduct an assessment of the tangible assets of the selling utility or facilities. Each valuation expert would incorporate the engineer's assessment into the appraisal and provide the completed appraisal to both the acquiring and selling utilities in a reasonable and timely manner. The fair market value would be the average of the three valuation expert appraisals.

The original sources of funding for any part of the water or sewer assets of the selling utility would not be relevant to determine the value of the

selling utility's assets. The costs of service would have to be incorporated into the revenue requirement of the acquiring utility's next rate base case proceeding.

Prohibited conduct. A valuation expert could not derive any material financial benefit from the sale, other than service fees, or be an immediate family member of a director, officer, or employee of either utility.

Fees. A fee paid to a utility valuation expert could be included in the transaction and closing costs associated with the utility acquisition. The fee could not exceed the lesser of 5 percent of the fair market value or an amount approved by PUC.

Rate base determination. The ratemaking rate base of the selling utility would be either the purchase price negotiated by the utilities or the fair market value, whichever was less. The bill would require the selling utility's ratemaking rate base to be incorporated into the rate base of the acquiring utility during the utility's next rate base case in a proceeding before the regulatory authority.

Application for acquisition. If the utilities used valuation experts to determine the fair market value, the acquiring utility would have to submit as attachments to an application for acquisition:

- copies of the three appraisals;
- the agreed-to purchase price;
- the ratemaking rate base;
- transaction and closing costs that would be included in the rate base; and
- a tariff containing a rate equal to the existing rates of the selling utility at the time of acquisition.

Upon approval of an application for acquisition, PUC would have to issue an order including the ratemaking rate base of the selling utility and any additional conditions for the acquisition.

A tariff submitted in an acquisition application would have to remain in effect until PUC approved new rates as part of a rate base case proceeding.

Post-acquisition costs. The acquiring utility's post-acquisition improvements would accrue an allowance of funds used during construction after the date the cost was incurred until either four years after the date the asset entered into service or the inclusion of the asset in the next rate base case, whichever was earlier.

HB 3542 would define "allowance of funds used during construction" as an accounting practice that recognized the capital costs, including debt and equity funds, that were used to finance the construction costs of an improvement to a selling utility's assets by the acquiring utility.

Depreciation of an acquiring utility's post-acquisition improvements would be deferred for book and ratemaking purposes.

The bill would take effect September 1, 2019.