

The Texas Commission on Environmental Quality (TCEQ, agency, or commission) adopts the amendments to §291.31 and §291.34.

Section 291.31 is adopted *with changes* to the proposed text as published in the March 26, 2010, issue of the *Texas Register* (35 TexReg 2507). Section 291.34 is adopted *without changes* to the proposed text and will not be republished.

BACKGROUND AND SUMMARY OF THE FACTUAL BASIS FOR THE ADOPTED RULES

The 81st Legislature, 2009, passed Senate Bill (SB) 2306. SB 2306 amended Texas Water Code (TWC), Chapter 13, Subchapter E, by amending §13.131, which requires the commission by rule to allow water and/or sewer utilities to claim the book cost less net salvage of depreciable utility plant retired to be charged in its entirety to the accumulated depreciation account, consistent with accounting treatment of regulated electric and gas utilities in this state.

SECTION BY SECTION DISCUSSION

§291.31, Cost of Service.

The commission adopts the amendment to §291.31(b)(1)(B). This section was amended to include net salvage value in annual depreciation for determining allowable expenses in order to establish consistency of accounting. SB 2306 requires that rules adopted under the legislation be consistent with accounting treatment of regulated electric and gas utilities in this state. The regulatory practice for both industries includes determination of net salvage value in a depreciable utility plant when an asset is retired as well as in annual depreciation calculations relating to allowable expenses when an asset is placed into service.

That is because the "methodologies used to compute depreciation expense and accumulated depreciation

in rate base should be consistent. *City of Weslaco v. General Telephone Co. of S.W.*, 359 S.W.2d 260 (Tex. Civ. App.-San Antonio, 1962, writ ref'd n.r.e.)." *Natural Gas Rate Review Handbook*, Gas Services Division, Railroad Commission of Texas (June 2007, page 35). Additionally, the adopted amendment requires the utility to submit "reasonable" estimations of net salvage value. Reasonable is meant to include the submission of sufficient evidence to establish net salvage value, such as estimates of removal costs. This is consistent with the practice of electric and gas utility regulations in the state. "Determining a reasonably accurate estimate of the average or future net salvage value is not an easy task; estimates can be the subject of considerable discussion and controversy between regulators and utility personnel. When estimating future net salvage, every effort should be made to ensure that the estimate is as accurate as possible." {*Public Utilities Depreciation Manual*, NARUC, page 157 (1996)} (from the direct testimony of Nara V. Srinivasa, P.E., Infrastructure Reliability Division, Public Utility Commission of Texas, March 23, 2007, *Application of AEP Texas Central Company for Authority to Change Rates Before the State Office of Administrative Hearings*, SOAH Docket Number 473-07-0833, PUC Docket Number 33309). In response to comment and for further clarity the commission reworded §291.31(b)(1)(B).

The commission adopts the amendment to §291.31(c)(2)(A) to make a grammatical change.

The commission adopts §291.31(c)(2)(B). This change addresses the concern that a retired plant could no longer be included in the rate base under prior commission practices because it was not used and useful in providing utility service after retirement. Consistent with the practice in the regulated electric and gas utilities in this state, the new subparagraph clarifies that retired assets can be included in rate base through depreciation studies.

The commission reletters §291.31(c)(2)(A)(i) and (ii) to §291.31(c)(2)(B)(i) and (ii) for lettering consistency. The commission also adopts the amendment to §291.31(c)(2)(B)(i) and (ii) by adding language making it clear that the bookkeeping for accumulated depreciation, original cost, and salvage value apply to both §291.31(c)(2)(A) and (B). The commission further adopts the amendment to §291.31(c)(2)(B)(i) and (ii) to prescribe the methodology that will allow water and/or sewer utilities to include net salvage in depreciable utility plant retired to be charged in its entirety to the accumulated depreciation account, consistent with accounting treatment of regulated electric and gas utilities in this state. The adopted rule also includes language allowing group accounting of assets. SB 2306 requires that the rules adopted under it must be consistent with accounting treatment of regulated electric and gas utilities in this state. The electric and gas utility regulatory practice is to allow group accounting. The TCEQ has used itemized accounting because complete verification of whether or not an asset is used and useful is difficult to confirm for particular assets with group accounting. Group accounting involves the practice of averaging service lives and salvage values of all assets in a particular category. This methodology assumes the averaging of many assets in a category accurately reflects the real life depreciation of each utility asset. This methodology facilitates consistency with requirements of other governmental accounting regulations, both federal and state, applicable to utilities that operate in other states as well as this state. Also, this methodology may decrease a utility's expense in preparing an application and proving it in a contested case hearing. In order to create transparency of group accounting, the adopted rule requires accounting for all assets and their retirement to be supported by an approved accounting system. In the electric and gas utility industries such transparency is required. For instance, in the gas utility industry, "Historical Commission practice has been to disallow depreciation rate adjustments unless fully supported by a depreciation study. The study should include the average service lives of the property groups, salvage factors and adequacy of the present booked depreciation reserve."

Natural Gas Rate Review Handbook, Gas Services Division, Railroad Commission of Texas (June 2007, page 35). The new methods of including net salvage in depreciable utility plant will apply to applications declared administratively complete after the date that this rulemaking becomes effective. Because SB 2306 was not retroactive, only assets removed from service after June 19, 2009, (the date the bill became effective), are affected. Additionally, because assets may be retired outside of a test year, the amendment allows inclusion of retired assets in the first full rate application filed by a utility after the date on which the asset was removed from service, excluding alternative rate method applications, such as single issue rate change applications. Furthermore, the amendment requires the utility to bear the burden of proof and provide credible evidence on the decision to retire assets early, consistent with the methods for electric and gas utility regulations in the state. The adopted amendment also requires the utility to provide information to show that it used due diligence in recovering maximum salvage value of a retired asset. Examples include any insurance recovery, scrap value, warranty claims, and competitive bids for tear down and removal of retired assets. Additionally, because of concerns that affiliated interests might benefit from business transactions involving the retirement of the utility's assets, the adopted rules make it clear that the requirements of TWC, §13.185(e) also apply. In response to comment, the commission added language to §291.31(c)(2)(B)(i) to address the commenter's concern that the unrecovered portions of the investment in the prematurely retired asset may become an unrecoverable loss to the utility. The changes to this section allow losses from prematurely retired assets to be recovered by amortization. In response to comment, the commission also added language to §291.31(c)(2)(B)(i) to allow losses from prematurely retired assets to be recovered by amortization which will spread the cost over the remaining expected life of the asset. This change addresses the concern that customers may have been required to pay for the full unrecovered plant cost of a prematurely retired asset in the first rate case filed after retirement of the asset. Additionally, in response to comment, the commission expanded

§291.31(c)(2)(B)(i) to require depreciation studies to achieve more transparency in ratemaking to the customers. Further, in response to comment, the commission also expanded §291.31(c)(2)(B)(i) by listing the minimum requirements to be included in depreciation studies. This change addresses the comment that explained the standard requirements of depreciation studies used in electric and gas utility regulation in Texas. In response to comment, the commission revised §291.31(c)(2)(B)(i) to prohibit accelerated depreciation (including the use of equal life group procedure). Additionally, the changes also addressed concerns regarding how cost of removal should be allocated, the booking of depreciation expense after plant retirement, and the truing-up of over or under accruals in an account or for an asset. Further, in response to comment, the commission added §291.31(c)(2)(B)(i) by providing what depreciation studies should provide at a minimum. This change addresses the comment that explained the standard requirements of depreciation studies used in electric and gas utility regulation in Texas. In response to comment, the commission also changed §291.31(c)(2)(B)(i)(II) to require depreciation studies for utilities using group accounting. This change addresses the concern that if the commission required group accounting, it also must require depreciation studies to properly recognize net salvage for retired assets. In response to comment, the commission also added language to §291.31(c)(2)(B)(ii) to clarify that evidence regarding the reasonableness of retirement decisions for individual assets only applies to utilities using itemized accounting and to make it clear that the accounting for specific items retired in the first application after that retirement only applies to utilities practicing itemized accounting. Additionally, the commission amended the language in §291.31(c)(2)(B) to add the word "of" to correct a typographical omission with the language as originally proposed. Due to the complex nature and cost of an engineering or economic based depreciation study associated with group accounting, the commission will continue to allow water and/or sewer utilities the option of itemized accounting.

The commission relettered §291.31(c)(2)(B) to §291.31(c)(2)(C) to account for these changes previously outlined.

§291.34, Alternative Rule Methods

The commission adopts the amendment to §291.34(d)(2)(B) to allow water and/or sewer utilities that use a cash basis rate methodology to follow the same method prescribed in §291.31(b)(1)(B). The commission adopts this amendment in order to implement SB 2306.

FINAL REGULATORY IMPACT ANALYSIS DETERMINATION

The commission reviewed the adopted rulemaking in light of the regulatory analysis requirements of Texas Government Code, §2001.0225 and determined that the rulemaking is not subject to §2001.0225 because it does not meet the definition of a "major environmental rule" as defined in the Texas Administrative Procedure Act. A "major environmental rule" is a rule the specific intent of which is to protect the environment or reduce risks to human health from environmental exposure and that may adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, or the public health and safety of the state or a sector of the state. The intent of the rulemaking is to incorporate changes made by SB 2306 to TWC, §13.131(c). TWC, §13.131(c) requires the commission to "fix proper and adequate rates and methods of depreciation, amortization, or depletion of several classes of property of each utility and shall require every utility to carry a proper and adequate depreciation account in accordance with those rates and methods with any other rules the commission requires." SB 2306 added the following language: "Rules adopted under this subsection must require the book cost less net salvage of depreciable utility plant retired to be charged in its entirety to the accumulated depreciation account in a manner consistent with accounting treatment of regulated electric

and gas utilities in this state." The specific intent of the adopted rulemaking is to amend the commission's rules to incorporate recent legislative changes that account for net salvage value of utility property to be included in depreciation calculations. Therefore, the adopted rulemaking does not meet the definition of a "major environmental rule."

Even if the adopted rules were a major environmental rule, Texas Government Code, §2001.0225 still would not apply to this rulemaking because §2001.0225 only applies to a major environmental rule, the result of which is to: 1) exceed a standard set by federal law, unless the rule is specifically required by state law; 2) exceed an express requirement of state law, unless the rule is specifically required by federal law; 3) exceed a requirement of a delegation agreement or contract between the state and an agency or representative of the federal government to implement a state and federal program; or 4) adopt a rule solely under the general powers of the agency instead of under a specific state law. This rulemaking does not meet any of these four applicability criteria because it: 1) does not involve any standard set by federal law; 2) does not exceed the requirements of TWC, §13.131(c) or any other state law; 3) does not exceed a requirement of a delegation agreement or contract between the state and an agency or representative of the federal government to implement a state and federal program; and 4) is not adopted solely under the general powers of the agency, but rather specifically under TWC, §13.131(c), which requires the commission to adopt rules to implement the statute. Therefore, this adopted rulemaking does not fall under any of the applicability criteria in Texas Government Code, §2001.0225.

The commission invited public comment regarding the draft regulatory impact analysis determination during the public comment period. No comments were received on the draft regulatory impact analysis determination.

TAKINGS IMPACT ASSESSMENT

The commission evaluated this adopted rulemaking and performed an analysis of whether it constitutes a taking under Texas Government Code, Chapter 2007. The specific purpose of this rulemaking is to incorporate changes to TWC, §13.131(c) made by SB 2306. The adopted rules will substantially advance this stated purpose by incorporating the additional requirements of this statute into the commission's rules.

The commission's analysis indicates that Texas Government Code, Chapter 2007 does not apply to the adopted rules because this is an action that is reasonably taken to fulfill an obligation mandated by state law, which is exempt under Texas Government Code, §2007.003(b)(4). The commission is the regulatory agency for statutes found in TWC, Chapter 13, Subchapter E, which contains TWC, §13.131(c).

Nevertheless, the commission further evaluated the adopted rules and performed an assessment of whether it constitutes a taking under Texas Government Code, Chapter 2007. Promulgation and enforcement of the adopted rules would be neither a statutory nor a constitutional taking of private real property. Specifically, the subject adopted regulation does not affect a landowner's rights in private real property because this rulemaking does not burden nor restrict or limit the owner's right to property and reduce its value by 25% or more beyond that which would otherwise exist in the absence of the regulation. In other words, the adopted rules require compliance with a state statute to require the adoption of rules regarding how salvage value is to be included in depreciation calculations for utility rate applications and proceedings without burdening or restricting or limiting the owner's right to property and reducing its value by 25% or more. Therefore, the adopted rules do not constitute a taking under Texas Government Code, Chapter 2007.

CONSISTENCY WITH THE COASTAL MANAGEMENT PROGRAM

The commission reviewed the adopted rules and found that they are neither identified in Coastal Coordination Act Implementation Rules, 31 TAC §505.11(b)(2) or (4), nor will they affect any action/authorization identified in Coastal Coordination Act Implementation Rules, 31 TAC §505.11(a)(6). Therefore, the adopted rules are not subject to the Texas Coastal Management Program.

The commission invited public comment regarding the consistency with the coastal management program during the public comment period. No comments were received regarding the consistency of this rulemaking with the coastal management program.

PUBLIC COMMENT

The commission held a public hearing for this rulemaking on April 19, 2010, in Austin, Texas. At the hearing, the commission received comments from SouthWest Water Company, Texas Utilities (SWWC). The comment period closed on April 26, 2010.

The commission received written comments from: SWWC; Independent Water and Sewer Companies of Texas (IWSCOT); Epstein, Becker, Green, Wickliff & Hall, P.C. on behalf of the City of Houston (Houston); and Ferguson Associates. SWWC and IWSCOT both generally disapproved of the proposed rules. Houston generally approved of the proposed rules. Ferguson Associates generally approved of the proposed rules, but suggested clarification of complex accounting concepts.

RESPONSE TO COMMENTS

SWWC commented that the rules implementing SB 2306 have been "way over extended" and should be limited to repeating the words of the statute.

The commission responds that the statute requires detailed rules that reflect the practice of electric and gas utility regulation in Texas. Restating the statute in the rules would abrogate the responsibility and the charge the legislature gave the commission in the statute and the policy intent revealed in the bill analysis. SB 2306 specifically states "rules adopted under this subsection *must require* the book cost less net salvage value of depreciable utility plant retired to be charged in its entirety to the accumulated depreciation account *in a manner consistent with accounting treatment of regulated electric and gas utilities in this state*" (Emphasis added.) The statute contemplated that rules will be written reflecting the "accounting treatment of electric and gas utilities in this state." Simply restating the statute would not execute the charge. The commission made no change in response to this comment.

SWWC commented that the commission rules already have adequate flexibility to implement SB 2306 without detailing procedures in the rules and that such details can be worked out in individual contested case hearings.

The commission responds that working out the details in each contested case would lead to reinvestigating the phrase "consistent with accounting treatment of electric and gas utilities in this state" multiple times with possibly inconsistent results. The accounting treatment of electric and gas utilities in Texas is not memorialized in any Texas Public Utility Commission (PUC) or Railroad Commission rule, and interpretations of their practice and orders would have to be

litigated in each case, rather than determined by rule. The adopted rules have outlined the basic accounting treatment used in the regulation of electric and gas utilities in Texas. The executive director's staff has verified that this is the practice in electric and gas utility regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made regarding this adopted rulemaking. Further support for putting the details of implementing SB 2306 into the rules is found in the legislative history of the companion bill to SB 2306. The companion bill was House Bill (HB) 3610. The House Research Organization's Bill Analysis of HB 3610 revealed that opponents to the bill were concerned that "this bill would allow assets left in a depreciable account where a utility still could make a return." The HB 3610 bill analysis also showed that the supporters responded to this concern as follows: "Although this bill could allow assets to be left in a depreciable account where a utility still could make a return, the {Commission} could prevent this from happening through rulemaking." Therefore, the HB 3610 bill analysis reveals that the legislature contemplated the commission writing specific rules to address this concern. The commission made no changes in response to this comment.

SWWC further commented that "there is not a single word in the bill that says anything about salvage that should cause a complete set of rules to be written. Inclusion of the net salvage value - costs which can be either positive or negative values by the way - has always been an option available to utilities under the current rules. To my knowledge there have never been significant issues related to the improper treatment of salvage value in rate cases before the commission that would require such detailed rules."

The commission responds that the statute specifically requires the commission to adopt rules that require "book costs less net salvage of depreciable utility plant retired." Therefore, net salvage calculations must be an integral part of implementing the statute through rules. Contrary to SWWC's position that salvage value could be included in depreciable utility plant under current rules, the commission's current rules do not discuss net salvage value. Past commission practice has been to treat the cost of removal (part of net salvage value) as an expense. Consistent with this prior approach, revenues collected from the scrap sale of retired assets would have been included as income in the category "other revenues." This treatment of net salvage value is changed by the statute because SB 2306 requires that the rules adopted under it be "consistent with accounting treatment of regulated electric and gas utilities in this state." The gas and electric industries in Texas do not treat salvage values as income and expense items, but instead address these items in the calculation of depreciation. Because including net salvage value in the depreciation calculations is new to the commission, rules are required to be adopted explaining how this will be implemented. The commission made no changes in response to this comment.

SWWC also noted that the detail in the rules was unnecessary because the law relating to reports and records "directs utilities to maintain a system of accounts approved by the executive director which will be adequately informative for all regulatory purposes, or uniform system of accounts as adopted and amended by the National Association of Regulatory Utility Commissioners."

The commission responds that the rules to which SWWC referred discuss accounting practices and do not address how those accounting processes relate to how rates are set. The history of SB 2306 shows that the primary concern of the legislature was how retired assets relate to rates. Specifically,

supporters were concerned that utilities would not be allowed to get a return on early retired assets included in their rate calculations. While opponents to SB 2306 were concerned that they would pay rates reflecting a return on an asset that was no longer used and useful in providing customers utility service. Therefore, the rules have to explain how the accounting practices relate to how rates are set, because that was the concern SB 2306 addressed. The commission made no changes in response to this comment.

SWWC also noted that it disagreed with requiring all future applications to have "salvage incorporated in the value and if so depreciation must then be computed on a remaining life basis." SWWC expressed concern that most utility assets have zero salvage value and that it would over complicate the application process for utilities to include salvage value for assets that "might have a little salvage." SWWC stated that small utilities will be especially burdened.

The commission responds that accounting for net salvage value when salvage value is small may be cumbersome, but the statute requires such calculations. Specifically, SB 2306 provides "rules adopted under this subsection *must require* the book cost less net salvage value of depreciable utility plant retired to be charged in its entirety to the accumulated depreciation account *in a manner consistent with accounting treatment of regulated electric and gas utilities in this state*" (Emphasis added.) Therefore, because all assets will eventually become retired assets, the commission has no alternative but to write rules that require net salvage value calculations for all assets. Furthermore, the practice in both the electric and gas utility industry is to include net salvage in the depreciation schedules for assets. However, the commission recognizes that small utilities may find preparing salvage calculations to be burdensome. Therefore, as proposed in §291.31(c)(2)(B)(ii), adopted

§291.31(c)(2)(B)(ii) allows for a utility that finds net salvage calculations to be *de minimus* to declare net salvage to be zero and avoid having to make such calculations. The commission made no changes in response to this comment.

SWWC expressed concern that "Utilities should not be potentially penalized many years in the future for not including a salvage component initially as future circumstances may change."

The commission responds that utilities that have assets in previous rate applications would not have included net salvage values in their depreciation calculations because past practice has been to treat net salvage components as other income or expense items. Therefore, the rates the utility has been charging included a depreciation expense and a net plant calculation that did not incorporate net salvage. If the utility then changes its depreciation expense and net plant calculations to include net salvage, it will be changing how the assets are accounted for in rates. Rates charged by a utility are derived from the cost of service. The cost of service includes both annual depreciation (an allowable expense under §291.31(b)(1)(B)) and return on invested capital, which requires consideration of accumulated depreciation (an adjustment to invested capital under §291.31(c)(2)(B)). Therefore, if the utility changes its annual depreciation and accumulated depreciation by adding net salvage value, the customers would pay rates on shifting cost information. Because the utility would be changing the way it accounted for net salvage the rate would be skewed and inequitable to customers for different time periods. For consistency purposes, once a utility changes how an asset will be accounted for in rate calculations, the calculations need to be restarted with the remaining life. Therefore, if future circumstances change and the impact of depreciation on rates changes, the penalty would be on the customers rather than the utility. If the utility were allowed to shift the way

that customers are charged for the same asset over different time periods, it could create inequitable and confusing problems, such as including salvage value that had already been accounted for in another accounting category. The commission made no changes in response to this comment.

SWWC also commented that requiring group accounting to be supported by an approved accounting system could involve costly depreciation studies and added that would have a significant financial impact on small utilities.

The commission responds that depreciation studies will only be required for utilities using group accounting. Smaller utilities can use itemized accounting. As for the difficulties associated with depreciation studies that may be encountered by larger utilities that use group accounting, depreciation studies must be required, because SB 2306 requires the commission to adopt rules consistent with accounting treatment of regulated electric and gas utilities in this state. The requirement of depreciation studies is the practice in the electric and gas utility industries as illustrated in the Uniform System of Accounts (USOA). The executive director's staff has verified that this is the practice in electric and gas utility regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made on this rulemaking. The reason for requiring depreciation studies is that it is the only way to verify that average life computations and survival curves are accurate. As for utilities that claim salvage value but use itemized accounting, the adopted rules require procedures that allow for the estimates of net salvage values and service lives to be trued-up in the

first application filed after the asset is retired. Therefore, any expenses associated with depreciation studies could be avoided by using itemized accounting. The commission made no changes in response to this comment.

SWWC stated that language detailing "guidelines for determining whether the decision on retirement of an asset was 'reasonable or not,'" and language relating to affiliated interests was unnecessary. The concern was that it would "blunt the clear language of the law" and "the staff's discretion to review the early retirement transactions is already in the rules."

The commission responds that as explained previously, the clear language of SB 2306 is that the rules adopted by the commission must require that net salvage calculations be determined "in a manner consistent with accounting treatment of regulated electric and gas utilities in this state." Additionally, deciding details on a case by case basis would require reinvestigating the appropriate methodology multiple times with potentially inconsistent results. Furthermore, with group accounting the USOA creates the necessary transparency and verification of reasonableness with depreciation studies. In order to achieve clarity and completeness, details regarding reasonableness of decisions to retire assets and dealings with affiliated interests are necessary. The executive director's staff has verified that this is the practice in electric and gas utility regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made on this rulemaking. Only utilities claiming net salvage and using itemized accounting will need to provide information regarding the reasonableness of retirement decisions for individual assets and meet other

transparency requirements listed in the rules. In order to clarify that accounting for specific assets only applies to utilities claiming net salvage value not equal to zero and using itemized accounting, the rules have been clarified. In response to this comment, the commission has changed §291.31(c)(2)(B)(ii) to clarify when specific assets need to be accounted for.

SWWC disagreed with the provision found in §291.31(c)(2)(B)(ii) by stating: "Retired assets will be included in a utility's application for a rate change if the application is the first application for a rate change filed by the utility after the date the asset was retired."

The commission responds that requiring the asset to be included in the first rate application after the asset is retired is necessary to fully implement the policy underlying SB 2306. The problem discussed when SB 2306 was before the Texas Legislature was the utility's under-recovery of the value of the investment in an asset that is retired early. Specifically, the situation sought to be resolved is one in which the utility invests in an asset and then includes the asset in rate calculations based on the expected useful life of the asset. The asset, however, may be retired early. Prior commission practice was to take the asset out of rate calculations because the asset was no longer used and useful and TWC, §13.185(j) only allows depreciation for "all currently used, depreciable utility property." The utility then finds itself still having to pay the cost of the asset that was retired early but unable to recover this cost in rate design. It is important to note that the opposite also could occur, to wit, the asset may be retired late rather than early. In that case, the utility will continue to collect annual depreciation in its rates for an asset that is still used and useful even after the entire original cost of the item has been recovered when the expected life of the asset is expired, but the asset continues to be used. In order to ensure that the above referenced over-collections and

under-collections do not occur, a "truing-up" of the estimated service lives with the actual experienced service lives is necessary. In group accounting this "truing-up" occurs in depreciation studies that explain and show the average service life experienced. The requirements of the rules dealing with accounting for specific items relate only to itemized accounting because individual items are not separated out in group accounting. For itemized accounting the retired asset needs to be specifically accounted for in order to achieve this "truing-up." It must be included in the first application filed after the asset is retired to make sure the asset is trued-up while the evidence regarding the asset is still fresh. In response to this comment, §291.31(c)(2)(B)(ii) has been changed to make it clear that the accounting for specific items retired in the first application after that retirement only applies to utilities practicing itemized accounting.

SWWC noted that an asset may be retired after the date of filing an application and that the utility did "not want to be penalized for having to make hasty decisions simply to meet timing deadlines."

The commission responds that the timing deadline with applications is not unique to decisions to retire, but relates to the fact that applications are limited to information from the utility's test year. Therefore, the timing deadline observation relates to the requirement of a test year rather than rules implementing SB 2306. The rules actually make the test year limitation less problematic because the retirement is not required to occur within the test year in order to be included in the application under §291.31(c)(2)(B)(ii). Furthermore, changes in rate applications that are known and measurable and will occur in the 12 months following the test year are allowed in rate applications. Known and measurable adjustments are also allowed under §291.31(b), and the

application for rate change form provides that the adjustments are based on the 12 months following the test year. The commission made no changes in response to this comment.

SWWC requested deletion of the last sentence in §291.31(c)(2)(B)(ii) that states "the utility cannot include the retired asset in its net plant calculations in any subsequent application," and noted that "it neuters the whole intent of the law which is to ensure that the unrecovered portions of prematurely retired asset costs remain in rate base and not result in an unrecoverable loss to the utility."

The commission responds that TWC, §13.183(a)(1), allows a utility to collect a return on assets only if they are currently used and useful. The practice in the electric and gas utility industry is that a retired asset is accounted for by crediting the book cost to the utility plant account in which it is included. At the same time, accumulated depreciation is debited with the original cost and the cost of removal and credited with the salvage value and any other amounts recovered, such as insurance. The executive director's staff has verified that this is the practice in electric and gas utility regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made to this rulemaking. Therefore, the adjustments to net plant are completed upon retirement. For utilities using group accounting, the depreciation studies required by the USOA and the *Natural Gas Rate Review Handbook* do not require specific assets to be taken out of depreciation calculations because the studies provide transparency necessary to reveal the true average life of the assets. In order to address SWWC's concern that the unrecovered portions of the investment in the prematurely

retired asset may become an unrecoverable loss to the utility, the commission made changes to §291.31(c)(2)(B)(i) to allow losses from prematurely retired assets to be recovered by amortization.

SWWC commented that the rules should include the following provisions: retired plant can be included in rate base, the proper accounting treatment for retirement of assets is for book cost less net salvage of depreciable utility plant retired to be charged in its entirety to the accumulated depreciation account, and group depreciation is allowed.

The commission responds that the rules already provide that retired plant can be included in rate base in the first application filed after the asset is retired (§291.31(c)(2)(B)(ii)), that the proper accounting treatment for retirement of assets is for book cost less net salvage of depreciable utility plant retired to be charged in its entirety to the accumulated depreciation account (§291.31(c)(2)(B)(ii)), and group depreciation is allowed (§291.31(c)(2)(B)(i)). The commission made no changes in response to this comment.

IWSCOT commented that the proposed rules do not make ratemaking more transparent for the benefit of customers.

The commission responds that SB 2306 requires the commission to write rules implementing the statute that reflect the practice in the electric and gas utility industry in Texas. That practice requires details of retirement decisions, calculations, and their effect on depreciation. The executive director's staff has verified that this is the practice in electric and gas utility regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and

orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made to this rulemaking. Giving the details of retirement decisions, calculations, and their effect on depreciation is what creates transparency when itemized accounting is used. For group accounting, the transparency is achieved in the gas and electric industry through depreciation studies which are required by USOA. In response to this comment and in order to achieve transparency to the customers, §291.31(b)(1)(B) has been changed to require depreciation studies.

IWSCOT also stated that there was no need to restrict the retirement rule to rate applications found to be administratively complete after these rules are adopted.

The commission responds that the rules do not become final and enforceable until the commission issues an order adopting the rules in compliance with Texas Government Code, §2001.033, and after the expiration of 20 days after the adopted rule is filed in the Office of the Secretary of State pursuant to Texas Government Code, §2001.036. Attempting to apply the rules to rate applications filed before the rules are adopted could create confusion if the rules are changed before they are adopted. Therefore, the rules should only apply to rate application found to be administratively complete after the final rule language is adopted. The commission made no changes in response to this comment.

IWSCOT commented on the portion of the rules providing that retired assets will be included in the first full rate case following their retirement. Specifically, IWSCOT stated "Presumably, the retired asset would be depreciated for ratemaking purposes for the remainder of its useful life. This would spread the

rate impact over the same number of years customers would have experienced had the asset not been retired early. However, the next sentence of the rules says the assets can only be included in that first post-retirement rate case. There is no spreading of the cost of the retired asset over time. Therefore, to avoid confiscating capital, the {Commission} must allow the full unrecovered plant cost in that first rate case. This could mean a big financial hit to customers. It could mean over-recovery or further reconciliation if the utility does not have another rate case within one year."

The commission made several changes to the rules in response to this comment. Section 291.31(c)(2)(B)(ii) now requires specific assets to be accounted for in the first application after the asset is retired and prohibits future inclusion of the asset in rate base only for utilities using itemized accounting in order to reconcile estimations of retirement costs. The rule now provides that utilities using group accounting shall use depreciation studies to meet this goal (§291.31(c)(2)(B)(i)). For itemized accounting, TWC, 13.183(a)(1) only allows a utility to collect a return on assets that are currently used and useful. When an asset is retired, the practice in the electric and gas utility industry is to account for it by crediting the book cost to the utility plant account in which it is included. At the same time, accumulated depreciation is debited with the original cost and the cost of removal and credited with the salvage value and any other amounts recovered, such as insurance. The executive director's staff has verified that this is the practice in electric and gas utility regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made to this rulemaking. Therefore, the adjustments to net plant are completed upon retirement. In order to address IWSCOT's concern that the unrecovered portions of the investment

in the prematurely retired asset may become an unrecoverable loss to the utility, changes have been made to §291.31(c)(2)(B)(i) to allow losses from prematurely retired assets to be recovered by amortization. Amortization will spread the cost over the remaining expected life of the asset.

Houston commented that the intent of SB 2306 was to bring the commission's treatment of depreciation relating to the net salvage component of depreciation and retirement amounts in compliance with the accounting treatment of regulated electric and gas utilities.

The commission agrees that the focus of SB 2306 was to treat calculation of water and sewer utility depreciation relating to net salvage in a manner consistent with the treatment used by regulated electric and gas utilities. The commission made no changes in response to this comment.

Houston also provided comments illustrating how net salvage and retiring of assets are treated in the electric and gas regulation in Texas. Specifically, Houston explained as follows: "The overview of how the depreciation process works is relatively simple. The following examples may be helpful. When \$1,000 of plant is placed into service it is booked into Account 101. If the item has an average 10-year life and a 0% net salvage, then over the next ten years, \$100 of depreciation expense would be taken per year for a total of \$1,000 and booked into Account 108. When the plant retires after 10 years, assuming the 10-year life estimate was correct, the \$1,000 of plant removed from Account 101 and the same \$1,000 of retired plant is removed from Account 108. Thus, if everything worked as it was theoretically intended to, there would be \$0.00 of gross plant and \$0.00 of net plant. Net plant is the gross plant less the accumulated provision for depreciation. A second example assumes that the same \$1,000 of plant had a 10%, or \$100, assumed positive net salvage. This would imply that \$900 (\$1,000 original cost less \$100

net salvage) must be recovered over the estimated 10-year life producing a \$90 per year depreciation expense, with the assumption that \$100 would be collected at the time of retirement associated with salvage. Thus, after ten years, if everything works as theoretically intended, the Reserve would be at \$900 ($\$90 \times \10) and when the plant retires \$1,000 would be removed from both Account 101 and Account 108. At that point Account 108 would have a negative \$100 balance ($\$900 - \$1,000$). The negative \$100 would then be offset by the \$100 obtained from salvage, thus yielding a \$0 level of both Account 101 and Account 108. While the two above examples reflect how plant accounting is intended to work when historical estimates are accurate, this level of accurate forecasting is not normally the case. For example, the plant assumed to last for ten years might actually retire in year one or in year 15. In the past, when an item of plant in water/sewer systems in Texas would retire after year one, the utility would not have the ability to recover the remaining 90% of investment since the plant was assumed to be no longer used or useful. However, the accounting treatment afforded gas and electric utilities would result in the following situation. After one year, \$100 of accumulated depreciation would have been booked. When the \$1,000 plant was retired and removed from Account 101, the \$1,000 would also be removed from Account 108. This would leave a negative \$900 balance in Account 108. Since Account 108 is a 'contra' account, which simply means that it is subtracted from gross plant to obtain net plant, the net effect of such retirement would be to leave \$900 of rate base in place. The main component of rate base is net plant. Rate base is the investment level on which a utility is allowed to earn a return. Since the retired plant is no longer in service it would need to be amortized off the utility's books and records over some period of time. (footnote omitted) Thus, as directed by Senate Bill 2306, rather than the utility absorbing a \$900 loss on its investment, customers would be responsible for the return of the Company's un-depreciated investment of \$900 in this example. If a positive \$100 of net salvage were reflected in the example, then the remaining net amount necessary to be recovered from customers, which would still be reflected on the

Company's books through a negative reserve, would be \$800 (\$1,000 retired plant less \$100 of accumulation depreciation expense less \$100 of net salvage associated with the plant removed from service). A decision would then have to be made as to how best to amortize the remaining \$800 of investment such that the retired asset would be fully recovered on the utility's books and the customers who received benefits, to the best extent possible, pay such amount taking into account various regulatory principles (e.g., the matching principle and rate shock)." Houston further commented that utilities expressed concern at the Legislature regarding the prior system's failure to allow them to recover their investment in items of plant retired early. However, the accounting treatment reflected in the USOA for gas and electric utilities also recognizes that plant can last longer than the initial estimate. The normal practice is for a regulator to establish a depreciation rate and that rate is applied to the original cost as long as the plant is in service. Continuing with the previous example of a \$1,000 investment, if it were to last for 12 years (two years longer than the assumed ten-year average service life), the reserve would be \$1,200 at the time of retirement. Therefore, when the plant retired, assuming 0% net salvage, there would be a positive \$200 of reserve creating a negative \$200 of rate base, since the reserve is a 'contra' account. Under the concept of individual item accounting, the Company would earn a negative return on the \$200 of negative rate base, which would offset other revenue requirements. The negative rate base amount would normally be required to be paid back to customers over some period of time until the \$200 of negative rate base was extinguished. The treatment of under-recovery and over-recovery can be handled either through the continuation of itemized depreciation practices or through group accounting depreciation as normally employed by electric and gas utilities. Houston commented that the TCEQ has operated under the itemized depreciation process while electric and gas utilities normally operate under group accounting practices. Group accounting practices apply an average service life and an average net salvage value to all items in an account. Thus, while some items may retire in year one, two, three or

other years up to ten years, other items of the group may retire in years 11, 12, 13, or other number of years greater than ten years. However, if the average age of all retired plant was at ten years, all over and under-recoveries that transpired during the life of the group would hopefully net out to zero. If a utility were to continue to utilize an itemized depreciation approach under the new requirements of SB 2306, then a separate account would have to be established in order to capture both the over and under-recoveries of depreciation until the utility's next rate proceeding. At that time, the utility as well as the TCEQ staff and interveners could address the appropriate amortization period for any excess or deficiency in the separate account. This would add a limited level of increased accounting to the current process; however it would remain manageable for those utilities not prepared to undertake a full depreciation analysis associated with a group depreciation approach.

The commission agrees with Houston's analysis. This comment clearly explains the problem SB 2306 was meant to remedy. The executive director's staff has verified that this is the practice in electric and gas regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made on this rulemaking. Section 291.31(c)(2)(B)(i) has been changed in response to this comment by allowing amortization to recover losses and to remit over-recovery because of assets that either exceed or fall short of surviving for their expected lives.

Houston also commented that "For those utilities who are determined to migrate to a group accounting approach, compliance with the USOA's instructions regarding reliance on an engineering or economic based depreciation studies must be required. However, in either instance (itemization approach or group

accounting approach) the recognition of net salvage must also become an integral part of the depreciation process."

The commission agrees with this comment. The executive director's staff has verified that this is the practice in electric and gas utility regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made on this rulemaking. Section 291.31(c)(2)(B)(i)(II) has been changed in response to this comment by requiring depreciation studies for utilities using group accounting.

Houston also commented that "The commission should require those utilities seeking to implement group accounting to maintain their investment in homogeneous account groupings. In other words, meters should be separated from mains, which are separated from pumps and motors, etc. The need to maintain investment by homogeneous categories is necessary given the need to perform actuarial or semi-actuarial analyses to determine average service lives and corresponding dispersion patterns. A dispersion pattern simply identifies the expected pattern of retirements over the estimated average service life. The TCEQ should require the use of 'Iowa Survivor Curves' as the standard dispersion pattern. Iowa Survivor Curves are utilized by almost all regulatory authorities. Depreciation studies should provide, at a minimum, the following: A. The investment by homogeneous category; B. Expected level of gross salvage; C. Expected level of cost of removal; D. The accumulated provision for depreciation as appropriately reflected on the Company's books and records; E. The average service life; F. The remaining life; G. The Iowa Dispersion Pattern; H. All input on electronic medium; and I. A detailed narrative identifying the specific factors,

data, criteria, assumptions, etc. that were employed to arrive at the specific mortality proposal for each homogenous group of property."

The commission agrees with this comment. The executive director's staff has verified that this is the practice in electric and gas utility regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made on this rulemaking. Section 291.31(c)(2)(B)(i)(II) has been changed in response to this comment by incorporating the suggestions made in this comment.

Houston also commented that "The commission should further clearly prohibit all forms of accelerated depreciation, including but not limited to, the declining balance method, the sum of years digits, and the equal life group procedure." The studies should further provide a detailed narrative identifying the specific and significant factors employed to arrive at the proposed mortality characteristics (i.e., average service life, cost of removal and gross salvage). The narrative should clearly identify to what extent the result of actuarial and semi-actuarial results were relied upon, as well as other pertinent factors such as input from management or industry comparative data. The narrative should clearly identify how each component was incorporated into the final decision for that particular account. The study should be based on the test-year for depreciation purposes which should be no more than five years old in comparison to the test year for ratemaking purposes. As it applies to gross salvage, the amounts recognized must include all forms of salvage, including insurance proceeds, reimbursed retirements associated with situations where a third party reimburses the utility (e.g., retirements due to dig-ins, requests for relocations, etc.) as well as sale proceeds, whether related to scrap value sales or for sales of usable equipment, facilities or

systems. Cost of removal must reflect only those costs associated with cost of removal that can be justified. Costs that are normally anticipated to be incurred in instances where replacement activity transpires should be assigned and/or accounted for as cost of the new installation and added to gross plant in service. The costs assigned as cost of removal in a replacement project must be clearly substantiated and supported as being cost of removal, rather than costs associated with installing the replacement investment. In addition, the utility must demonstrate that it is in compliance with National Association of Regulatory Utility commissioners (NARUC) Interpretation No. 67. That interpretation specifically states the following: The reimbursement received shall be accounted for: a) by crediting operation and maintenance expenses to the extent of actual expenses occasioned by the plant changes; and b) crediting the remainder to the Reserve for depreciation, unless contractual terms definitively characterize residual or specific amounts applicable to the cost of replacement. In the latter event, appropriate credit should be entered into the plant accounts. Moreover, any amounts received as reimbursed retirements and assigned as contribution in aid of construction should not be included in gross plant where it would be depreciable. An example of potential interactions of the above concepts would be as follows. Assume a water line is to be retired and abandoned in place. A new replacement line is to be installed to provide service previously provided by the retired line. In this instance, no cost of removal or gross salvage would be anticipated. Alternatively, if the water service line is retired due to a contractor dig-in, the cost charged to the contractor is \$500. If there are no specific contract terms identifying which portion of the \$500, if any, is associated with the cost of the new investment; then, \$500 would first offset any operating expenses, if any, and the balance would be assigned to the Reserve. Alternatively, if a contract is entered into between the utility and the party that damaged the line, and that contract definitively identifies \$300 for the cost of the new installation as a contribution in aid of construction, and \$50 for O&M expense incurred in the retirement process with the remaining \$150 as reimbursement for cost of removal, then the Reserve would

only increase \$150, operating and maintenance expenses would be credited with \$50, and gross plant would not change other than for the property unit retired.

The commission agrees with this comment. The executive director's staff has verified that this is the practice in electric and gas regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made on this rulemaking. Section 291.31(c)(2)(B)(i) has been changed in response to this comment by incorporating many of the suggestions made by this comment. While much of the comment describes how the process under the rules should be administered, the commission has not memorialized all of this discussion in the rules.

Houston also commented that "Once a depreciation rate is established and approved by the {commission}, it must remain in place and applied to gross plant in service until subsequently changed in a rate proceeding or other designated proceeding by the {commission}. In no event should a utility be permitted to unilaterally change the rate explicitly or implicitly (e.g., ceasing the booking of depreciation which implicitly changes the rate to zero). The booking of depreciation expense is initiated once an item of plant is placed into service and the process stops only when plant is actually retired. Unlike non-regulated entities, utilities must continue booking depreciation expense to the Reserve even when a utility believes it is fully accrued. The continuation of depreciation expense will be accumulated on the Company's books and records and appropriately treated at the time of the utility's next rate proceeding in which a depreciation study recognizes the under or over-accrual of plant investment through the depreciation process. This process of rectifying or truing-up the over or under accruals in an account, or

for an item of plant, is specifically recognized as an appropriate regulatory process and is not and should not be considered a form of retroactive ratemaking."

The commission agrees with this comment. The executive director's staff has verified that this is the practice in electric and gas regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made on this rulemaking. Section 291.31(c)(2)(B)(i) has been changed in response to this comment by incorporating many of the suggestions made by this comment. While much of the comment describes how the process under the rules should be administered, the commission has not memorialized all of this discussion in the rules. By including the requirements of following several different procedures used by the PUC and the Railroad Commission in regulating electric and gas utilities, many of these details will already be required by the rules without having to specifically list them.

Houston also commented that "Under Senate Bill 2306 utilities are entitled to recognize the full reduction of the level of retirement in its Reserve at the time of retirement. Utilities are also required to recognize appropriate levels of cost of removal and gross salvage on an estimated basis in determining depreciation rates while recognizing cost of removal and gross salvage on an actual basis at the time of retirement of the asset. The Reserve should be increased in recognition of monthly depreciation expense accruals and actual gross salvage associated with plant, while it should be decreased for actual retirements of property units and actual costs of removal incurred at the time of retirement. It is recognized that depreciation is a process of estimation and must be trued-up as time progresses. The utility must maintain appropriate and

accurate records to permit the development and substantiation of depreciation studies as required by the USOA. The commission should require any utility to fully substantiate and support, both on a numerical and narrative basis, its request for depreciation based on homogeneous categories of investment. Such depreciation studies should not be more than five years old in comparison to the test year utilized for ratemaking purposes. The depreciation rates established in a rate case must remain in place until the commission adopts subsequent changes in a following rate proceeding."

The commission agrees with this comment. The executive director's staff has verified that this is the practice in electric and gas regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made on this rulemaking. Section 291.31(c)(2)(B)(i) has been changed in response to this comment by incorporating many of the suggestions made by this comment. While much of the comment describes how the process under the rules should be administered, the commission has not memorialized all of this discussion in the rules.

Ferguson Associates expressed surprise that the commission is just beginning to recognize that net salvage should be a component of depreciation based on his experience in "a career as a management consultant that included conducting depreciation studies for entities practicing the group concept of depreciation accounting" and noted that its depreciation practice was primarily for property of electric and gas utilities.

The commission agrees with this comment. Until recently, the commission and its predecessor agencies have exercised original jurisdiction primarily over small investor owned utilities that operate outside of city limits. Because the water and sewer utilities regulated by the commission have historically been small investor owned utilities, rate making procedures, including the treatment of depreciation in rate calculations, have developed with very simple models that less sophisticated utilities could understand. In recent years, larger entities have begun operating multiple systems in areas under the commission's original jurisdiction. These larger business entities have more assets to account for and have more financial sophistication. Therefore, the utilities regulated by the commission have become more analogous to electric and gas utilities. The commission's rules implementing SB 2306 will integrate the more sophisticated practices of the gas and electric utility industry into its ratemaking procedures including the inclusion of net salvage in depreciation, group accounting, and the depreciation studies that are part of group accounting. The commission made no changes in response to this comment.

Ferguson Associates noted that sometimes regulatory accounting has used cash treatment rather than depreciation treatment for net salvage and that approach usually results in increased costs borne by the ratepayers. Therefore, Ferguson Associates recommended against cash treatment for net salvage.

The commission responds that the rules include net salvage in depreciation calculations rather than with cash treatment. However, the commission anticipates that cases could arise in which the financial integrity of the utility and just and reasonable rates for the customer might require income or expense treatment for unusual net salvage situations. However, the rules do contemplate that the primary position of the agency will be to include net salvage in depreciation calculations

rather than to give net salvage cash treatment. The commission made no change to the rules in response to this comment.

Ferguson Associates commented that the proposed modification to §291.31(b)(1)(B) requires use of the remaining life rate calculation technique when net salvage is estimated to be different than zero, and does not require this technique when net salvage is estimated to be zero. This distinction is not rational, because whether the remaining life or the whole life technique is appropriate depends on the adequacy of the book reserve position; not on the mortality characteristics utilized to calculate depreciation rates and test the reserve position. If the book reserve is determined through a theoretical reserve calculation to be too high or too low, a common reaction is to amortize the calculated difference over the remaining life of the property through the use of remaining life rates. A more rational requirement would be to either require remaining life rates, no matter what the net salvage factors are, or to allow either whole life or remaining life rates.

The commission responds that the reason why remaining life is required for applications including net salvage different than zero is to keep treatment of assets consistent over time. Utilities that have assets in previous rate applications would not have included salvage values in their depreciation calculations because past practice has been to treat net salvage components as other income or expense items. Therefore, the rates the utility had been charging include a depreciation expense and a net plant calculation that did not incorporate net salvage. If the utility were allowed to shift the way that customers are charged for the same asset over different time periods, it could create inequitable and confusing problems such as including salvage value that had already been accounted for in another accounting category. Rates charged by a utility are derived from the cost

of service. The cost of service includes both annual depreciation (an allowable expense under §291.31(b)(1)(B)) and return on invested capital which involves accumulated depreciation (an adjustment to invested capital under §291.31(c)(2)(B)). Therefore, if the utility changes its annual depreciation and accumulated depreciation by adding net salvage value, the customers would pay rates on shifting cost information. Because the utility would be changing the way it accounted for net salvage the rate would be skewed and inequitable to customers for different time periods. For consistency purposes, once a utility changes how an asset will be accounted for in rate calculations, the depreciation calculations need to be restarted with the remaining life. Because many utilities that are subject to commission jurisdiction will still be small investor owned utilities and net salvage calculations for these small utilities will be negligible, the rules allow for simpler rate calculations for utilities claiming zero net salvage. Therefore, whole life is still available for these small utilities. For utilities using group accounting or claiming net salvage and using itemized accounting, remaining life is required. Section 291.31(c)(2)(B)(i) has been changed in response to this comment to authorize amortization of any theoretical reserve calculation that may prove to have been too high or too low.

Ferguson Association further commented that the proposed modification to §291(b)(1)(B) also requires that applicants including net salvage in depreciation provide evidence establishing the validity of the net salvage estimates. The financial statements of entities practicing the item concept of depreciation accounting disclose whether the depreciable lives are appropriate for the property. However, a special study is required for this determination by entities practicing the group concept, which is why regulators require support for the validity of proposed changes to depreciation rates, because USOA's specify that

jurisdictional entities practice the group concept. Therefore, basing the requirement for support solely on net salvage is not rational.

The commission agrees with the portion of the comment stating that group accounting requires depreciation studies. The executive director's staff has verified that this is the practice in electric and gas regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made to this rulemaking. Section 291.31(c)(2)(B)(i) has been changed in response to this comment by requiring depreciation studies for utilities using group accounting. Additionally, the commission has changed the rules to clarify that specific verification of salvage values for specific assets is limited to utilities practicing itemized accounting. Section 291.31(c)(2)(B)(ii) now requires evidence establishing the validity of net salvage estimates on individual items only for entities practicing itemized accounting. And §291.31(c)(2)(B)(i) now requires depreciation studies for entities using group accounting in order to validate net salvage estimates.

Ferguson Associates commented that among the proposed modifications to §291.31(c)(2)(A)(ii) is a requirement to provide evidence of the amount of accumulated depreciation up to the date each asset is taken out of service. Under the group concept of depreciation accounting that the {Commission} requires jurisdictional entities to practice, an average depreciation rate unique to each depreciable property group is applied to that group and each ordinary retirement from each such group is recorded as being fully depreciated upon retirement, regardless of the age at which the retirement occurs. Therefore, this requirement is meaningless and suggests that the {Commission} needs to improve its understanding of

the depreciation accounting practices imposed by its USOA's. The requirement to practice the group concept is inherent in the plant and depreciation accounting specified by the {Commission} USOA's, and is not specifically stated.

The commission agrees with the portion of the comment regarding how the depreciation studies used in group accounting deals with accumulated depreciation regardless of the date of retirement. The executive director's staff has verified that this is the practice in electric and gas regulation through discussions with the PUC's depreciation expert, from review of PUC Proposals for Decisions and orders, from review of the Railroad Commission of Texas' Gas Services Division's *Natural Gas Rate Review Handbook* (June 2007), and other comments made to this rulemaking. However, the commission disagrees that its rules have been interpreted to require group accounting. The adopted rules represent the first time the commission will explicitly allow group accounting (the rules still allow itemized accounting). Section 291.31(c)(2)(B)(i) has been changed in response to this comment by requiring depreciation studies for utilities using group accounting. Additionally, the commission has changed §291.31(c)(2)(B)(ii) to clarify that only entities practicing itemized accounting are required to provide evidence of the amount of accumulated depreciation up to the date each asset is taken out of service. The commission has also changed §291.31(c)(2)(B)(i) in response to this comment to require depreciation studies for entities using group accounting in order to validate accumulated depreciation totals.

SUBCHAPTER B: RATES, RATE-MAKING, AND RATES/TARIFF CHANGES

§291.31, §291.34

STATUTORY AUTHORITY

These amendments are adopted under Texas Water Code (TWC), §5.102, which establishes the commission's general authority necessary to carry out its jurisdiction; TWC, §5.103, which establishes the commission's general authority to adopt rules; TWC, §5.105, which establishes the commission's authority to set policy by rule; TWC, §13.041, which requires the commission to adopt and enforce rules reasonably required in the exercise of its powers and jurisdiction; and TWC, §13.132 and §13.181, which empower and require the commission to enforce the requirements contained in TWC, Chapter 13, Subchapters E and F, respectively.

The adopted amendments implement TWC, §13.131(c).

§291.31. Cost of Service.

(a) Components of cost of service. Rates are based upon a utility's cost of rendering service. The two components of cost of service are allowable expenses and return on invested capital.

(b) Allowable expenses. Only those expenses that are reasonable and necessary to provide service to the ratepayers may be included in allowable expenses. In computing a utility's allowable expenses, only

the utility's historical test year expenses as adjusted for known and measurable changes may be considered.

(1) Components of allowable expenses. Allowable expenses, to the extent they are reasonable and necessary, and subject to this section, may include, but are not limited to, the following general categories:

(A) operations and maintenance expense incurred in furnishing normal utility service and in maintaining utility plant used by and useful to the utility in providing such service (payments to affiliated interests for costs of service, or any property, right, or thing, or for interest expense are not allowed as an expense for cost of service except as provided in Texas Water Code (TWC), §13.185(e));

(B) depreciation expense based on original cost and computed on a straight line basis over the useful life of the asset as approved by the commission. Depreciation is allowed on all currently used depreciable utility property owned by the utility except for property provided by explicit customer agreements or funded by customer contributions in aid of construction. Depreciation on all currently used and useful developer or governmental entity contributed property is allowed in the cost of service. On all applications declared administratively complete after the effective date of these rules, the depreciation accrual for all assets must account for expected net salvage value in the calculation of the depreciation rate and actual net salvage value related to retired plant. The depreciation rate and expense must be calculated on a straight line basis over the expected or remaining life of the asset . Utilities must calculate depreciation on a straight line basis, but are not required to use the remaining life method if

salvage value is zero. When submitting an application that includes salvage value in depreciation calculations, the utility must submit sufficient evidence with the application establishing that the estimated salvage value, including removal costs, is reasonable. Such evidence will be included for the asset group in depreciation studies for those utilities practicing group accounting while such evidence will relate to specific assets for those utilities practicing itemized accounting;

(C) assessments and taxes other than income taxes;

(D) federal income taxes on a normalized basis (federal income taxes must be computed according to the provisions of TWC, §13.185(f), if applicable);

(E) reasonable expenditures for ordinary advertising, contributions, and donations; and

(F) funds expended in support of membership in professional or trade associations, provided such associations contribute toward the professionalism of their membership.

(2) Expenses not allowed. The following expenses are not allowed as a component of cost of service:

(A) legislative advocacy expenses, whether made directly or indirectly, including, but not limited to, legislative advocacy expenses included in professional or trade association dues;

(B) funds expended in support of political candidates;

(C) funds expended in support of any political movement;

(D) funds expended in promotion of political or religious causes;

(E) funds expended in support of or membership in social, recreational, fraternal, or religious clubs or organizations;

(F) funds promoting increased consumption of water;

(G) additional funds expended to mail any parcel or letter containing any of the items mentioned in subparagraphs (A) - (F) of this paragraph;

(H) costs, including, but not limited to, interest expense of processing a refund or credit of sums collected in excess of the rate finally ordered by the commission;

(I) any expenditure found by the commission to be unreasonable, unnecessary, or not in the public interest, including, but not limited to, executive salaries, advertising expenses, rate case expenses, legal expenses, penalties and interest on overdue taxes, criminal penalties or fines, and civil penalties or fines; and

(J) the costs of purchasing groundwater from any source if:

(i) the source of the groundwater is located in a priority groundwater management area; and

(ii) a wholesale supply of surface water is available.

(c) Return on invested capital. The return on invested capital is the rate of return times invested capital.

(1) Rate of return. The commission shall allow each utility a reasonable opportunity to earn a reasonable rate of return, which is expressed as a percentage of invested capital, and shall fix the rate of return in accordance with the following principles.

(A) The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

(B) The commission shall consider the efforts and achievements of the utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management, along with other relevant conditions and practices.

(C) The commission may, in addition, consider inflation, deflation, the growth rate of the service area, and the need for the utility to attract new capital. In each case, the commission shall consider the utility's cost of capital, which is the composite of the cost of the various classes of capital used by the utility.

(i) Debt capital. The cost of debt capital is the actual cost of debt..

(ii) Equity capital. The cost of equity capital must be based upon a fair return on its value. For companies with ownership expressed in terms of shares of stock, equity capital commonly consists of the following classes of stock.

(I) Common stock capital. The cost of common stock capital must be based upon a fair return on its value.

(II) Preferred stock capital. The cost of preferred stock capital is its annual dividend requirement, if any, plus an adjustment for premiums, discounts, and cost of issuance.

(2) Invested capital, also referred to as rate base. The rate of return is applied to the rate base. Components to be included in determining the rate base are as follows:

(A) original cost, less accumulated depreciation, of utility plant, property, and equipment used by and useful to the utility in providing service;

(B) original cost, less net salvage and accumulated depreciation at the date of retirement, of depreciable utility plant, property and equipment retired by the utility; and

(i) original cost under subparagraph (A) of this paragraph or this subparagraph is the actual money cost, or the actual money value of any consideration paid other than money, of the property at the time it was dedicated to public use, whether by the utility that is the present owner or by a predecessor. Assets may be booked in itemized or group accounting, but all accounting for assets and their retirements must be supported by an approved accounting system. On all assets retired from service after June 19, 2009, the original cost of an asset must be the book cost less net salvage value. If a utility calculates annual depreciation expense for an asset with allowance for salvage value, then it must account for the actual salvage amounts when the asset is actually retired. The utility must include the actual salvage calculation(s) in its net plant calculation(s) in the first full rate change application (excluding alternative rate method applications as described in §291.34 of this title (relating to Alternative Rate Methods)) it files after the date on which the asset was removed from service, even if it was not retired during the test year. Recovery of investment on assets retired from service before the estimated useful life or remaining life of the asset shall be combined with over accrual of depreciation expense for those assets retired after the estimated useful life or remaining life, and the net amount shall be amortized over a reasonable period of time taking into account prudent regulatory principles. The following list shall govern the manner by which depreciation will be accounted for.

(I) Accelerated depreciation is not allowed.

(II) For those utilities that elect a group accounting approach, all mortality characteristics, both life and net salvage, must be supported by an engineering or economic based depreciation study for which the test year for the depreciation is no more than five years old in comparison to the rate case test year. The engineering or economic based depreciation study must include:

(-a-) investment by homogenous category;

(-b-) expected level of gross salvage by category;

(-c-) expected cost of removal by category;

(-d-) the accumulated provision for depreciation as appropriately reflected on the company's books by category;

(-e-) the average service life by category;

(-f-) the remaining life by category;

(-g-) the Iowa Dispersion Pattern by category; and

(-h-) a detailed narrative identifying the specific factors, data, criteria and assumptions that were employed to arrive at the specific mortality proposal for each homogenous group of property.

(ii) reserve for depreciation under subparagraph (A) of this paragraph or this subparagraph is the accumulation of recognized allocations of original cost, representing recovery of initial investment, over the estimated useful life or remaining life of the asset. If individual accounting is used, a utility must continue booking depreciation expense until the asset is actually retired, and the reserve for depreciation shall include any additional depreciation expense accrued past the estimated useful or remaining life of the asset. If salvage value is zero, depreciation must be computed on a straight line basis over the expected useful life or remaining life of the item or facility. If salvage value is not zero, depreciation must also be computed on a straight line basis over the expected useful life or the remaining life. For an asset removed from service after June 19, 2009, accumulated depreciation will be calculated on book cost less net salvage of the asset. The retirement of a plant asset from service is accounted for by crediting the book cost to the utility plant account in which it is included. Accumulated depreciation must also be debited with the original cost and the cost of removal and credited with the salvage value and any other amounts recovered. Return is allowed for assets removed from service after June 19, 2009, that result in an increased rate base through recognition in the reserve for depreciation if the utility proves that the decision to retire the asset was financially prudent, unavoidable, necessary because of technological obsolescence, or otherwise reasonable. The utility must also provide evidence establishing the original cost of the asset, the cost of removal, salvage value, any other amounts recovered, the useful life of the asset (or remaining life as may be appropriate), the date the asset was taken out of service, and the accumulated depreciation up to the date it was taken out of service. Additionally, the utility must show that it used due diligence in recovering maximum salvage value of a retired asset. The requirements relating to the accounting for the reasonableness of retirement decisions for individual assets and the net salvage value calculations for individual assets only apply to those utilities using itemized accounting. For

those utilities practicing group accounting, the depreciation study will provide similar information by category. TWC, §13.185(e) relating to dealings with affiliated interests, will apply to business dealings with any entity involved in the retirement, removal, or recovery of assets. Assets retired subsequent to June 19, 2009, will be included in a utility's application for a rate change if the application is the first application for a rate change filed by the utility after the date the asset was retired and specifically identified if the utility uses itemized accounting. Retired assets will be reported for the asset group in depreciation studies for those utilities practicing group accounting, while retired assets will be specifically identified for those utilities practicing itemized accounting;

(iii) the original cost of plant, property, and equipment acquired from an affiliated interest may not be included in invested capital except as provided in TWC, §13.185(e);

(iv) utility property funded by explicit customer agreements or customer contributions in aid of construction such as surcharges may not be included in original cost or invested capital; and

(C) working capital allowance to be composed of, but not limited to, the following:

(i) reasonable inventories of materials and supplies, held specifically for purposes of permitting efficient operation of the utility in providing normal utility service;

(ii) reasonable prepayments for operating expenses (prepayments to affiliated interests) are subject to the standards set forth in TWC, §13.185(e); and

(iii) a reasonable allowance up to one-eighth of total annual operations and maintenance expense excluding amounts charged to operations and maintenance expense for materials, supplies, and prepayments (operations and maintenance expense does not include depreciation, other taxes, or federal income taxes).

(3) Terms not included in rate base. Unless otherwise determined by the commission, for good cause shown, the following items will not be included in determining the overall rate base.

(A) Miscellaneous items. Certain items that include, but are not limited to, the following:

(i) accumulated reserve for deferred federal income taxes;

(ii) unamortized investment tax credit to the extent allowed by the Internal Revenue Code;

(iii) contingency and/or property insurance reserves;

(iv) contributions in aid of construction; and

(v) other sources of cost-free capital, as determined by the commission.

(B) Construction work in progress. Under ordinary circumstances, the rate base consists only of those items that are used and useful in providing service to the public. Under exceptional circumstances, the commission may include construction work in progress in rate base to the extent that the utility has proven that:

(i) the inclusion is necessary to the financial integrity of the utility; and

(ii) major projects under construction have been efficiently and prudently planned and managed. However, construction work in progress may not be allowed for any portion of a major project that the utility has failed to prove was efficiently and prudently planned and managed.

(d) Recovery of positive acquisition adjustments.

(1) For utility plant, property, and equipment acquired by a utility from another retail public utility as a sale, merger, etc. of utility service area for which an application for approval of sale has been filed with the commission on or after September 1, 1997, and that sale application closed thereafter, a positive acquisition adjustment will be allowed to the extent that the acquiring utility proves that:

(A) the property is used and useful in providing water or sewer service at the time of the acquisition or as a result of the acquisition;

(B) reasonable, prudent, and timely investments will be made if required to bring the system into compliance with all applicable rules and regulations;

(C) as a result of the sale, merger, etc.:

(i) the customers of the system being acquired will receive higher quality or more reliable water or sewer service or that the acquisition was necessary so that customers of the acquiring utility's other systems could receive higher quality or more reliable water or sewer service;

(ii) regionalization of retail public utilities (meaning a pooling of financial, managerial, or technical resources that achieve economies of scale or efficiencies of service) was achieved; or

(iii) the acquiring system will become financially stable and technically sound as a result of the acquisition, or the system being acquired that is not financially stable and technically sound will become a part of a financially stable and technically sound utility;

(D) any and all transactions between the buyer and the seller entered into as a part or condition of the sale are fully disclosed to the executive director and were conducted at arm's length;

(E) the actual purchase price is reasonable in consideration of the condition of the plant, property, and equipment being acquired; the impact on customer rates if the acquisition adjustment

is granted; the benefits to the customers; and the amount of contributions in aid of construction in the system being acquired;

(F) in a single or multi-stage sale, the owner of the acquired retail public utility and the final acquiring utility are not affiliated. A multi-stage sale is where a stock transaction is followed by a transfer of assets in what is essentially a single sales transaction. A positive acquisition adjustment is allowed only in those cases where the multi-stage transaction was fully disclosed to the executive director in the application for approval of the initial stock sale. Any multi-stage sale occurring between September 1, 1997 and February 4, 1999 is exempt from the requirement for executive director notification at the time of the approval of the initial sale, but must provide such notification by April 5, 1999; and

(G) the rates charged by the acquiring utility to its preacquisition customers will not increase unreasonably because of the acquisition.

(2) The amount of the acquisition adjustment approved by the regulatory authority must be amortized using a straight line method over a period equal to the weighted average remaining useful life of the acquired plant, property, and equipment, at an interest rate equal to the rate of return determined under subsection (c) of this section. The acquisition adjustment may be treated as a surcharge and may be recovered using non-system-wide rates.

(3) The authorization for and the amount of an acquisition adjustment can only be determined as a part of a rate change application.

(4) The acquisition adjustment can only be included in rates as a part of a rate change application.

§291.34. Alternative Rate Methods.

(a) Alternative rate methods. To ensure that retail customers receive a higher quality, more affordable, or more reliable water or sewer service, to encourage regionalization, or to maintain financially stable and technically sound utilities, the commission may utilize alternate methods of establishing rates. The commission shall assure that rates, operations, and service are just and reasonable to the consumers and to the utilities. The executive director may prescribe modified rate filing packages for these alternate methods of establishing rates.

(b) Single issue rate change. Unless a utility is using the cash needs method, it may request approval to increase rates to reflect a change in any one specific cost component. The following conditions apply to this type of request.

(1) The proposed effective date of the single issue rate change request must be within 24 months of the effective date of the last rate change request in which a complete rate change application was filed.

(2) The change in rates is limited to those amounts necessary to recover the increase in the specific cost component and the increase will be allocated to the rate structure in the same manner as in the previous rate change.

(3) The scope of a single issue rate proceeding is limited to the single issue prompting a change in rates. For capital items this includes depreciation and return determined using the rate of return established in the prior rate change proceeding.

(4) The utility shall provide notice as described in §291.22(a) - (e) of this title (relating to Notice of Intent To Change Rates), and the notice must describe the cost component and reason for the increased cost.

(5) A utility exercising this option shall submit a complete rate change application within three years following the effective date of the single issue rate change request.

(c) Phased and multi-step rate changes. In a rate proceeding, the commission may authorize a phased, stepped, or multi-year approach to setting and implementing rates to eliminate the requirement that a utility file another rate application.

(1) A utility may request to use the phased or multi-step rate method:

(A) to include the capital cost of installation of utility plant items that are necessary to improve service or achieve compliance with commission regulations in the utility's rate base and operating expenses in the revenue requirement when facilities are placed in service;

(B) to provide additional construction funds after major milestones are met;

(C) to provide assurance to a lender that rates will be immediately increased when facilities are placed in service;

(D) to allow a utility to move to metered rates from unmetered rates as soon as meters can be installed at all service connections;

(E) to phase in increased rates when a utility has been acquired by another utility with higher rates;

(F) to phase in rates when a utility with multiple rate schedules is making the transition to a system-wide rate structure; or

(G) when requested by the utility.

(2) Construction schedules and cost estimates for new facilities that are the basis for the phased or multi-step rate increase must be prepared by a licensed professional engineer.

(3) Unless otherwise specified in the commission order, the next phase or step cannot be implemented without verification of completion of each step by a licensed professional engineer, agency inspector, or agency subcontractor.

(4) At the time each rate step is implemented, the utility shall review actual costs of construction versus the estimates upon which the phase-in rates were based. If the revenues received from the phased or multi-step rates are higher than what the actual costs indicate, the excess amount must be reported to the executive director prior to implementing the next phase or step. Unless otherwise specified in a commission order or directed by the executive director, the utility may:

(A) refund or credit the overage to the customers in a lump sum; or

(B) retain the excess to cover shortages on later phases of the project. Any revenues retained but not needed for later phases must be proportioned and refunded to the customers at the end of the project with interest paid at the rate on deposits.

(5) The original notice to customers must include the proposed phased or multi-step rate change and informational notice must be provided to customers and the executive director 30 days prior to the implementation of each step.

(6) A utility that requests and receives a phased or multi-step rate increase cannot apply for another rate increase during the period of the phase-in rate intervals unless:

(A) the utility can prove financial hardship; or

(B) the utility is willing to void the next steps of the phase-in rate structure and undergo a full cost of service analysis.

(d) Cash needs method. The cash needs method of establishing rates allows a utility to recover reasonable and prudently incurred debt service, a reasonable cash reserve account, and other expenses not allowed under standard methods of establishing rates.

(1) A utility may request to use the cash needs method of setting rates if:

(A) the utility is a nonprofit corporation controlled by individuals who are customers and who represent a majority of the customers; or

(B) the utility can demonstrate that use of the cash needs basis:

(i) is necessary to preserve the financial integrity of the utility;

(ii) will enable it to develop the necessary financial, managerial, and technical capacity of the utility; and

(iii) will result in higher quality and more reliable utility service for customers.

(2) Under the cash needs method, the allowable components of cost of service are: allowable operating and maintenance expenses; depreciation expense; reasonable and prudently incurred

debt service costs; recurring capital improvements, replacements, and extensions that are not debt-financed; and a reasonable cash reserve account.

(A) Allowable operating and maintenance expenses. Only those expenses that are reasonable and necessary to provide service to the ratepayers may be included in allowable operations and maintenance expenses and they must be based on the utility's historical test year expenses as adjusted for known and measurable changes and reasonably anticipated, prudent projected expenses.

(B) Depreciation expense. Depreciation expense may be included on any used and useful depreciable plant, property, or equipment that was paid for by the utility and that has a positive net book value on the effective date of the rate change in the same manner as described in §291.31(b)(1)(B) of this title (relating to Cost of Service).

(C) Debt service costs. Debt service costs are cash outlays to an unaffiliated interest necessary to repay principal and interest on reasonably and prudently incurred loans. If required by the lender, debt service costs may also include amounts placed in a debt service reserve account in escrow or as required by the commission, Texas Water Development Board, or other state or federal agency or other financial institution. Hypothetical debt service costs may be used for:

(i) self-financed major capital asset purchases where the useful life of the asset is ten years or more. Hypothetical debt service costs may include the debt repayments using an amortization schedule with the same term as the estimated service life of the asset using the prime interest rate at the time the application is filed; and

(ii) prospective loans to be executed after the new rates are effective.

Any pre-commitments, amortization schedules, or other documentation from the financial institution pertaining to the prospective loan must be presented for consideration.

(D) Recurring capital improvements, replacements, and extensions that are not debt-financed. Capital assets, repairs, or extensions that are a part of the normal business of the utility may be included as allowable expenses. This does not include routine capital expenses that are specifically debt-financed.

(E) Cash reserve account. A reasonable cash reserve account, up to 10% of annual operation and maintenance expenses, must be maintained and revenues to fund it may be included as an allowable expense. Funds from this account may be used to pay expenses incurred before revenues from rates are received and for extraordinary repair and maintenance expenses and other capital needs or unanticipated expenses if approved in writing by the executive director. The utility shall account for these funds separately and report to the commission as required by the executive director. Unless the utility requests an exception in writing and the exception is explicitly allowed by the executive director in writing, any funds in excess of 10%, shall be refunded to the customers each year with the January billing either as a credit on the bill or refund accompanied by a written explanation that explains the method used to calculate the amounts to be refunded. Each customer must receive the same refund amount. These reserves are not for the personal use of the management or ownership of the utility and may not be used to compensate an owner, manager, or individual employee above the amount approved for that position in the most recent rate change request unless authorized in writing by the executive director.

(3) If the revenues collected exceed the actual cost of service, defined in paragraph (2) of this subsection, during any calendar year, these excess cash revenues must be placed in the cash reserve account described in paragraph (2)(D) of this subsection and are subject to the same restrictions.

(4) If the utility demonstrates to the executive director that it has reduced expenses through its efforts, and has improved its financial, managerial, and technical capability, the executive director may allow the utility to retain 50% of the savings that result for the personal use of the management or ownership of the utility rather than pass on the full amount of the savings through lower rates or refund all of the amounts saved to the customers.

(5) If a utility elects to use the cash needs method, it may not elect to use the utility method for any rate change application initiated within five years after beginning to use the cash needs method. If after the five-year period, the utility does elect to use the utility method, it may not include in rate base, or recover the depreciation expense, for the portion of any capital assets paid for by customers as a result of including debt service costs in rates. It may, however, include in rate base, and recover through rates, the depreciation expense for capital assets that were not paid for by customers as a result of including debt service costs in rates. The net book value of these assets may be recovered over the remaining useful life of the asset.