

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

BACKGROUND AND SUMMARY OF THE FACTUAL BASIS FOR THE PROPOSED 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 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

The commission proposes to amend §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 proposed 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).

The commission proposes to amend §291.31(c)(2)(A) to make a grammatical change.

The commission proposes to add new §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 if they were used and useful in providing utility service before retirement.

The commission proposes to renumber §291.31(c)(2)(A)(i) and (ii) to §291.31(c)(2)(B)(i) and (ii) for numbering consistency. The commission also proposes to amend §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 amended §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 proposed 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. Language allowing group accounting is included in the proposed rule to provide public notice of this change and to allow for maximum flexibility in the implementation of SB 2306. The TCEQ has not made a practice of allowing the use of group accounting for assets, but instead has used itemized 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 proposed rules require 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 proposed rules do not require any particular supporting documents. Other possible support could be

provided by documents, such as continuing property records and/or professional certifications. 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. In order to address the concern that a utility will be able to collect a return on an asset long after the asset has been retired; the proposed amendments provide that the utility cannot include the retired asset in its net plant calculations in any subsequent rate applications. Furthermore, the amendments require 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 proposed amendments also require 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 proposed rule makes it clear that the requirements of TWC, §13.185(e) also apply.

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

The commission also proposes to amend §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 proposes these amendments in order to implement SB 2306.

FISCAL NOTE: COSTS TO STATE AND LOCAL GOVERNMENT

Nina Chamness, Analyst, Strategic Planning and Assessment, determined that, for the first five-year period the proposed rules are in effect, no significant fiscal implications are anticipated for the agency. The proposed rules will allow water and sewer utilities to use a depreciation methodology similar to the accounting practices of regulated electric and gas utilities when applying for a rate adjustment for their services. The proposed rulemaking is not expected to affect local governments that own or operate water or sewer utilities since their rate setting activities do not fall under the jurisdiction of the agency.

The proposed rules implement the provisions of SB 2306, which requires the agency, as a part of its rate making duties, to require book cost less net salvage of a depreciable utility plant asset retired to be charged in its entirety to the accumulated depreciation account consistent with the accounting treatment for state regulated electric and gas utilities. Current rules allow water and sewer utilities to include depreciation as a cost of service when applying for a rate change. The proposed rules amend §291.31 and §291.34 to require a depreciation methodology of charging the entirety of book cost less net salvage value of utility plant assets, when retired, to depreciation costs as a part of the cost of service considered when rates for services are set by the agency.

Specifically, for rate applications declared administratively complete after the date that these rules become effective, water and sewer utilities are required to: decide if salvage value (including removal

costs) will be included in depreciation calculations; submit sufficient evidence to establish that salvage estimates are reasonable; account for actual salvage value when the asset is actually retired in the first rate application filed after the date on which the asset was removed from service, even if it was not retired during the test year; and provide evidence of original cost, salvage value, removal costs, and any other amounts, such as insurance, that is recovered. If a water or sewer utility decides that the salvage value of an asset is zero, depreciation is computed on a straight line, remaining life basis.

Typically, rate change requests are filed with the agency once every two to three years. The proposed rules will allow for the recovery of remaining investment in capital plant assets as a part of cost of service by allowing the remaining depreciation of a retired asset to be included in its entirety in that cost. The agency has little jurisdiction over the rates charged by utilities owned by local governments. Therefore, the proposed rules will not have a significant impact on local governments.

PUBLIC BENEFITS AND COSTS

Nina Chamness also determined that for each year of the first five years the proposed rules are in effect, the public benefit anticipated from the changes seen in the proposed rules will be compliance with state law and continued and adequate water and sewer utility service to customers by allowing water and sewer utilities to recover more of their investment in capital assets.

There may be fiscal implications for individuals who are water or sewer customers of investor owned utilities due to the implementation of the proposed rules. These individuals may see an increase in the rates they pay for water or sewer service. Investor owned utilities may benefit from the proposed rules as they would be able to adjust their fees based upon how their cost of service is determined.

The proposed rules may allow for rates for some customers of investor owned utilities to increase depending on how a water or sewer utility accounts for the value of a capital asset. The exact fiscal impact of the proposed rules depends on many factors, including the type of capital equipment used by the utility, cost of that equipment, salvage value and removal costs, when the equipment is retired, and other operating costs. Some customers could experience significant rate increases, but exact impacts of the rule cannot be determined until all factors of rate determination are evaluated. If salvage value of equipment is determined to be zero, then customers may not experience a significant fiscal impact as a result of the proposed rules. If the utility estimates salvage value, which includes removal costs, when determining the cost of an asset, depreciation costs, and remaining value, then rates could increase.

The proposed rules may have a significant fiscal impact on investor owned utilities by allowing them to recover costs invested in capital assets when they apply for a rate change. Staff estimates there are 746 investor owned water and sewer utilities, all of which are considered to be small businesses. The fiscal impact to these utilities will be discussed in the SMALL BUSINESS AND MICRO-BUSINESS ASSESSMENT of this fiscal note.

SMALL BUSINESS AND MICRO-BUSINESS ASSESSMENT

No adverse fiscal implications are anticipated for small or micro-businesses as a result of the proposed rules. Staff estimates that there may be as many as 746 investor owned water and sewer utilities that are considered to be small businesses in the state. These small businesses may experience benefits, which could be significant, in recovering their investments in capital assets under the proposed rules when they request a rate change. The exact fiscal impact of the proposed rules will depend on the particular

operating environment and capital investments of each investor owned utility.

SMALL BUSINESS REGULATORY FLEXIBILITY ANALYSIS

The commission has reviewed this proposed rulemaking and determined that a small business regulatory flexibility analysis is not required because the proposed rules are required to comply with state law and do not adversely affect a small or micro-business in a material way for the first five years that the proposed rules are in effect.

LOCAL EMPLOYMENT IMPACT STATEMENT

The commission has reviewed this proposed rulemaking and determined that a local employment impact statement is not required because the proposed rules do not adversely affect a local economy in a material way for the first five years that the proposed rules are in effect.

DRAFT REGULATORY IMPACT ANALYSIS DETERMINATION

The commission reviewed the proposed 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 proposed 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 proposed rulemaking does not meet the definition of a "major environmental rule."

Even if the proposed 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 proposed 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 proposed rulemaking does not fall under any of the applicability criteria in Texas Government Code, §2001.0225.

The commission invites public comment regarding this draft regulatory impact analysis determination. Written comments on the draft regulatory impact analysis determination may be submitted to the contact person at the address listed under the SUBMITTAL OF COMMENTS section of this preamble.

TAKINGS IMPACT ASSESSMENT

The commission evaluated this proposed 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 proposed 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 proposed 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 proposed rules and performed an assessment of whether it constitutes a taking under Texas Government Code, Chapter 2007. Promulgation and enforcement of the proposed rules would be neither a statutory nor a constitutional taking of private real property. Specifically, the subject proposed 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 proposed 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 proposed rules do not constitute a taking under Texas Government Code, Chapter 2007.

CONSISTENCY WITH THE COASTAL MANAGEMENT PROGRAM

The commission reviewed the proposed 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 proposed rules are not subject to the Texas Coastal Management Program.

Written comments on the consistency of this rulemaking may be submitted to the contact person at the address listed under the SUBMITTAL OF COMMENTS section to this preamble.

ANNOUNCEMENT OF HEARING

The commission will hold a public hearing on this proposal in Austin on April 19, 2010, at 2:00 p.m. in Building E, Room 201S, at the commission's central office located at 12100 Park 35 Circle. The hearing is structured for the receipt of oral or written comments by interested persons. Individuals may present oral statements when called upon in order of registration. Open discussion will not be permitted during

the hearing; however, commission staff members will be available to discuss the proposal 30 minutes prior to the hearing.

Persons who have special communication or other accommodation needs who are planning to attend the hearing should contact Charlotte Horn, Office of Legal Services at (512) 239-0779. Requests should be made as far in advance as possible.

SUBMITTAL OF COMMENTS

Written comments may be submitted to Devon Ryan, MC 205, Office of Legal Services, Texas Commission on Environmental Quality, P.O. Box 13087, Austin, Texas 78711-3087, or faxed to (512) 239-4808. Electronic comments may be submitted at: <http://www5.tceq.state.tx.us/rules/ecomments/>. File size restrictions may apply to comments being submitted via the eComments system. All comments should reference Rule Project Number 2009-042-291-OW. The comment period closes April 26, 2010. Copies of the proposed rulemaking can be obtained from the commission's Web site at http://www.tceq.state.tx.us/nav/rules/propose_adopt.html. For further information, please contact Brian Dickey, Water Supply Division, Utilities and Districts Section, at (512) 239-0963.

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

§291.31, §291.34

STATUTORY AUTHORITY

These amendments are proposed 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 proposed 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 net salvage value before the depreciation rate is calculated, and the depreciation must be calculated on a straight line, remaining life method. Utilities must calculate depreciation on a straight line basis, but are not required to use the remaining life method if salvage value is zero. Calculations of net salvage value in rate applications must be reasonable;

(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, 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 removed 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 30 TAC §291.34) it files after the date on which the asset was removed from service, even if it was not retired during the test year;

(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 salvage value is zero, depreciation [Depreciation] must be computed on a straight line basis over the expected useful life of the item or facility. If salvage value is not zero, depreciation must be computed on a straight line, remaining life basis. 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, after their removal from service 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. 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. 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 utility cannot include the retired asset in its net plant calculations in any subsequent applications;

(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) [(B)] 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.