

SUBJECT: Classifying investor-owned water utilities, transfer ratemaking to PUC

COMMITTEE: Natural Resources — committee substitute recommended

VOTE: 9 ayes — Ritter, Ashby, D. Bonnen, Callegari, T. King, Larson, Lucio,
Martinez Fischer, D. Miller

0 nays

2 absent — Johnson, Keffer

WITNESSES: **(On original bill)**

For — David Frederick, Texans Against Monopolies Excessive Rates;
Jack Millikan, Kerrville Community Action Group; Larry Westfall,
Kerrville South Community Action Group; *(Registered, but did not testify:*
Jim Boyle, City of Blue Mound, Texas; Leonardo Coelho, Travis County;
Chloe Lieberknecht, The Nature Conservancy

Against — Charles Proffitt, Southwest Water Co.; Melanie Oldham

On — Tom Hunter and Brian Lloyd, Public Utility Commission of Texas

(on committee substitute)

For — Art Smith, Country Bend Homeowners Association; *(Registered,*
but did not testify: Brandon Aghamalian, City of Pflugerville; Joshua
Houston, Texas Impact; Chloe Lieberknecht, The Nature Conservancy;
Jerry Valdez, Texas Alliance of Water Providers; David Weinberg, Texas
League of Conservation Voters)

Against — Charles Proffitt, Southwest Water Co.

On — Tom Hunter, Public Utility Commission of Texas; *(Registered, but*
did not testify: Sheri Givens, Office of Public Utility Counsel)

BACKGROUND: The Public Utility Commission of Texas (PUC) was established in 1975 to
oversee the operations of electric, water, and telecommunications utilities.
In 1986, the Legislature transferred responsibility for water utility
regulation to the Texas Water Commission, now the Texas Commission
on Environmental Quality (TCEQ).

The state exercises original rate-setting jurisdiction over investor-owned utilities (IOUs) serving customers in unincorporated areas of the state and within cities if the city surrenders its jurisdiction to the TCEQ. IOUs are typically monopolies in the areas they serve. IOUs are required to obtain a certificate of convenience and necessity (CCN) certifying their service area, in most cases making them the sole provider in the area. The CCN grants the IOU the exclusive right to provide water or wastewater within the area and the obligation to provide service that is safe, adequate, efficient, and reasonable.

When proposing to change its rates, an IOU must file an application with the TCEQ or other regulatory authority having original jurisdiction. The IOU may begin charging customers the requested new rate within 60 days of providing notice to customers and may continue charging the proposed rates while the case proceeds through the hearing process. Refunds plus interest may be required if the proposed rates are not granted. Customers have 90 days from the effective date to protest the proposed rates. If the lesser of 1,000 or 10 percent of the customers protest or the TCEQ staff has concerns with the proposed rate change, the matter is referred to the State Office of Administrative Hearings (SOAH) and a preliminary hearing is scheduled. Otherwise, the rates are approved administratively.

DIGEST:

CSHB 1307 would transfer responsibilities for regulating water and wastewater rates and services, as well as certificates of convenience and necessity (CCNs), to the Public Utility Commission (PUC) from the Texas Commission on Environmental Quality (TCEQ). The bill also would establish certain classes of investor-owned utilities (IOUs) based on the number of connections and provide timelines within each of these classes to update the rate-making process. Finally, CSHB 1307 would give the Office of Public Utility Counsel (OPUC) authority to intervene in water rate cases on behalf of residential and small commercial customers.

Transfer water and wastewater rate regulation. Starting September 1, 2014, the PUC would assume responsibility from the TCEQ for rate-making and other economic regulation, such as the issuance of certificated of convenience and necessity, for water and wastewater. The agencies would be required to enter into a memorandum of understanding (MOU) guiding the transfer by August 1, 2014, and rules to implement CSHB 1307 by September 1, 2015. The MOU would detail the applicable powers and duties transferred under the bill and would establish a detailed plan for

transferring resources to PUC from TCEQ related to economic regulation of water and sewer service.

The TCEQ would continue regulating water and sewer utilities to ensure safe drinking water and environmental protection. The TCEQ and the PUC would establish a transition team to ensure a smooth transfer of the ratemaking and CCN functions from TCEQ to PUC as well as to establish guidelines to ensure agency cooperation in meeting federal drinking water standards, maintaining adequate water supplies, meeting established design criteria for wastewater treatment plants, demonstrating the economic feasibility of regionalization, and serving economically distressed communities. The transition team would provide monthly updates to the executive directors of the TCEQ and the PUC and would provide a final report by September 1, 2014.

Beginning September 1, 2013, the TCEQ could propose rules, forms, policies, and procedures related to water and wastewater authority. Any TCEQ rules, forms, policies, and procedures would remain in effect until it was replaced or amended by the PUC.

Office of Public Utility Counsel (OPUC). CSHB 1307 would allow the OPUC to represent the interests of residential and small commercial consumers regarding water and wastewater rates and services beginning September 1, 2013.

Under the bill, OPUC would:

- assess the effect of utility rate changes and other regulatory actions on residential consumers in Texas;
- advocate a position determined to be most advantageous to a substantial number of residential consumers;
- be entitled to the same access as a party, other than PUC staff, to records gathered by the PUC; and
- be entitled to discovery of any non-privileged matter that was relevant to the subject matter of a proceeding or petition before PUC.

OPUC could:

- appear or intervene on behalf of a residential consumer or small business consumer;

- initiate or intervene in a judicial proceeding that involved an action taken by an administrative agency in certain circumstances;
- represent an individual residential or small commercial consumer with respect to the consumer's disputed complaint concerning retail services that were unresolved before the PUC;
- recommend legislation that it determined would serve the interests of residential and small commercial consumers; and
- conduct consumer outreach and education programs for residential and small commercial consumers.

The bill would not affect a duty the office was required to perform under other law. The PUC's authority would not be limited to represent residential or small commercial consumers nor would it preclude the appearance of other parties on their behalf.

Utility classification. Three classes of investor-owned water utilities would be created based on the utilities' number of taps or connections, and the bill would set up a rate structure for each class.

1. *Class A utilities* (10,000 connections or more) would send a statement of intent to change rates to each ratepayer at least 35 days before the effective date of the proposed change. The utility would then file an application for a rate change detailing its costs, rate schedules, and written testimony explaining the need for the requested rate increase. The PUC would be required to make a final rate determination within 185 days from the statement of intent.

The PUC could establish interim rates or bond rates to be in effect during the suspension period. If the PUC did not establish interim rates or bond rates, the rates in effect when the application for a rate change was filed would continue in effect.

2. *Class B utilities* (500 to 10,000 connections) would send a statement of intent to change rates to each ratepayer at least 35 days before the effective date of the proposed change. The utility would then file an application for a rate change detailing its costs and rate schedules. The application would be less burdensome and complex than was required for a class A utility and would not require written testimony explaining the need for the requested rate increase. If an application became contested, the matter would be referred to a hearing that could be informal, and written testimony could be provided. The PUC would be

required to make a final rate determination within 240 days from the statement of intent.

3. *Class C utilities* (fewer than 500 connections) would be allowed the option to request an annual rate adjustment based on a predetermined index not to exceed a 5 percent increase. Adjustments could go into effect without a hearing 30 days after proper notice to customers if the adjustment was equal to or lower than the PUC's established water utility index for that year. If the adjustment was greater than the established index, the rate application would follow the class B process. A class C utility would be allowed only one adjustment every year and no more than four total adjustments between class B rate proceedings.

Effective date. This bill would take effect September 1, 2013.

**SUPPORTERS
SAY:**

CSHB 1307 would help ensure fairness for water utility customers by, among other things, giving the Office of Public Utility Counsel standing to intervene and represent the interests of residential and small commercial consumers in water rate cases. The bill also would end the current practice of allowing the utilities to charge proposed rates while the case proceeds through the hearing process.

Water utilities also would benefit under the bill, which would establish three classes of investor-owned utilities and would provide time lines to guide the ratemaking process. This would give utilities more certainty on the time line for obtaining a final rate determination and give the smallest IOUs a mechanism to keep up with rising costs without going through a costly rate proceeding.

Investor-owned utilities have been the subject of study for multiple interims in both the House and Senate, as well as the Sunset Advisory Commission. It is clear that Texas' regulatory practices have not kept up with the changes in the industry and business models for water systems. They no longer serve the best interests of utilities or customers. The state must protect the public from the potential for monopoly abuse and foster public trust. Current rules create contentious and adversarial rate proceedings where customers in unincorporated areas have no ability to recover rate expenses. The need for reform is past due when one considers changing industry practices, the rising costs of water infrastructure, and the challenges of extended droughts.

Transfer of water and wastewater rate regulation to PUC. While the ownership of some of the state's largest IOUs has changed and the financial structures and accounting has grown increasingly complex, the laws and TCEQ's staff and resources have not kept pace. TCEQ is not adequately equipped with the mission, resources, or rules necessary to protect the public against the potential for monopoly abuse of an IOU.

In contrast, the PUC's structure and expertise are focused on fair and efficient rate-related regulation. The PUC's mission is to protect customers, foster competition, and promote high-quality infrastructure, while TCEQ's mission is to protect the state's public health and natural resources. It would be seamless to transfer water and wastewater utility rate regulation to the PUC because the agency regulates the state's electric and telecommunications utilities, implements respective legislation, and offers customer assistance in resolving complaints. Transferring these functions to PUC would take advantage of PUC's regulatory focus and processes and allow TCEQ to better focus on its core mission of ensuring environmental quality. Many of the class A utilities doing business in Texas operate in other states that have a separate regulatory structure for environmental and economic regulation, similar to what is being proposed in this bill.

Those concerned that the PUC process would increase rate case expenses, ultimately costing the customers more, should compare what is spent now on a case that can drag on indefinitely to a case that may require more paperwork but would be resolved in 185 days. The intent of CSHB 1307 would certainly not be to raise costs. If the implementation of this bill resulted in higher costs for rate cases, those issues could be addressed in the future with the addition of streamlined mechanisms for all utility classes.

Utility classification and rate setting. CSHB 1307 would modernize the rate setting process and move away from the "one-size-fits-all" approach employed by TCEQ. Current law and TCEQ's rules were designed for small, stand-alone systems. However, throughout the past decade an increasing number of small, privately owned public water and wastewater utility systems have been acquired by national corporations and investment funds. While the ownership of water utilities has evolved, the state's role in regulating the rates customers pay has not.

The bill would update the rate-making process by distinguishing between classes of IOUs based on the number of connections. The bill also would provide timelines within each of these classes to update the rate-making process. This would give utilities more certainty on how long it would take to obtain a final rate determination and give the smallest IOUs a mechanism to keep up with rising costs without going through a costly rate proceeding.

Because contested rate cases take from one-and-a-half to three years to complete at the TCEQ, IOUs are allowed to begin charging customers the requested increased rates within 60 days of providing the notice of the new rates to consumers. This has harmed consumers who lack the resources needed to disprove a utility's request for a larger-than-justified increase. CSHB 1307 would correct this by no longer allowing utilities to charge a proposed rate increase until the increase had been finally approved. The only way for a utility to begin charging its new rate before the final determination would be if the PUC established an interim rate or bonded rate. These would be rare allowances in PUC rate making, and require evidence of financial hardship at the utility. Not allowing utilities to charge a proposed rate increase until it had been finally approved would discourage the activity of inflating rates before settling with customers in mediation.

While there could be some value in streamlining the rate-making process with the use of periodic rate adjustments, it would allow an opportunity for a utility to bypass the traditional rate-making process.

Office of Public Utility Counsel (OPUC). Many IOUs are located in rural, unincorporated areas and it has become increasingly common for the largest IOUs to seek annual rate increases and charge double or triple the rates charged by a nearby member-owned or municipally owned utility system. This pattern of recurring and dramatically escalating rate increases has led to many dissatisfied customers and negatively impacted property values.

A fully litigated rate case can take several years to resolve and customers face the prospect of paying their own costs plus the costs the utility incurred during the process through a surcharge on their bill. The majority of rate cases result in a settlement in large part because customers simply lack the resources to participate in the process. The Legislature created a

process for the Office of Public Utility Counsel (OPUC) to represent customers in gas and electric utility rate cases, but there is no equivalent advocate for water utility customers. The TCEQ's Office of Public Interest Counsel does not have the statutory authority to adequately represent individuals in rate cases. Because there is no state agency representing the exclusive interest of the water utility customers, customers' only protection is organizing the community to petition for protest, raising funds, and pooling resources to hire private attorneys, accountants, rate experts, and engineers and undertaking a long and expensive contested rate case. Ratepayers in unincorporated areas have no means to recover costs, while IOUs can recover their costs through customer assessments.

The bill would give OPUC authority to intervene and represent residential and small commercial customers in water rate cases. This would result in a process that is fair and balanced for water and sewer utilities and their customers.

OPPONENTS
SAY:

Transfer of water and wastewater rate regulation. Moving water utility regulation to the Public Utility Commission (PUC) from the Texas Commission on Environmental Quality (TCEQ) would not result in cost savings, better governance, or relief to ratepayers. In fact, because the economic aspects of regulation cannot clearly be separated from the environmental aspects, CSHB 1307 would complicate regulating water and sewage service in Texas.

Rate setting in water utility matters is highly prescriptive, with many issues — including cost recovery — stipulated in state law. Moving to the PUC the economic regulation of the state's retail water utilities, many of which are substantially smaller than large telecommunications and electric utilities, would not address consumer concerns about water rates.

Texas has an advantage in that the same regulators who review and establish water rates also regulate the quality of service to customers, establish minimum operational and capacity requirements, and ensure environmental compliance for the IOUs. The TCEQ is in a unique position to ensure that capital investments are prudent investments.

The classification system under CSHB 1307 would place a more intense and expensive rate case process on the largest water utilities that have, typically, invested the most capital in the state. This could create a disincentive for utilities to continue to invest in the infrastructure

necessary to serve their rate base and provide adequate service. It also could increase the cost of purchasing water systems, making it less likely that under-performing systems would be purchased and brought up to standard.

If rate-making jurisdiction is transferred to PUC, then PUC rate filing requirements for electric utilities should be adapted for water and sewer utilities. The PUC rate application filing requirements are more extensive than at the TCEQ and would require a greater expenditure at the outset because the PUC requires expert written testimony submitted with the application. At the TCEQ, written testimony is deferred until hearing dates at the State Office of Administrative Hearings (SOAH) are scheduled. Since most cases settle prior to hearing, the costly expense of providing written testimony is not often realized. CSHB 1307 would ensure an upfront cost that would only have been incurred in the event of a contested case hearing. Rate case expenses could be significantly higher than what is seen today.

Also, while the PUC offers a shorter timeframe for a final rate determination, the PUC discovery rules allow for unlimited levels of discovery, the costs of which would be significant.

OTHER
OPPONENTS
SAY:

The rate-setting process under CSHB 1307 should be modified to better manage significantly larger rate case expenses by including periodic rate adjustments by utilities based on changes in a utility's invested capital. This would provide for consumer protection and give utilities the same adjustment mechanism Texas electric and gas utilities already have. The periodic rate adjustment mechanism would encourage streamlined rate-making by allowing for adjustments to customer charges for approved and spent capital investments, without the requirement of a costly and time-consuming full-scale rate case. Extending the time between future base rate filings would allow utilities to continue to invest capital in needy systems and reduce rate-case expenses that customers ultimately must pay in their rates. It also would reduce the "sticker shock" to customers after a rate case that may reflect 4 to 5 years of capital improvements by allowing for rates to be raised a little at a time, rather than all at once.

Periodic rate adjustments would not bypass the traditional rate-making process. To the contrary, periodic rate adjustments would be handled through an agency process that included a reconciliation or "true-up" at the next general rate application.

NOTES:

According to the Legislative Budget Board's fiscal note, CSHB 1307 would result in no financial impact through the biennium ending in 2015. However, implementation of CSHB 1307 would require the transfer of general revenue dedicated water resource management account funds from TCEQ to the PUC and to OPUC.

Transfer of water and wastewater rate regulation. Transferring responsibilities for regulating water and wastewater rates and services, as well as certificates of convenience and necessity (CCNs) from the Texas Commission on Environmental Quality (TCEQ) to the Public Utility Commission (PUC), would result in the transfer of \$1.4 million in general revenue dedicated water resource management account funds and 20 full-time-equivalent employees (FTEs) from the TCEQ to the PUC beginning in fiscal 2015.

Also, to implement the modified rate-making process beginning in fiscal 2016, the PUC would require \$1.1 million per year in general revenue dedicated water resource management account funds and 12 FTEs, with total salary of \$762,000. Additional expenses would include \$30,480 in other personnel costs, \$33,528 in rent-machine costs, and estimated benefit costs of \$226,619 per year.

A transfer of \$184,000 in general revenue dedicated water resource management account funds to the PUC from the TCEQ beginning in fiscal 2015 also would be necessary to cover the cost of the contract with the State Office of Administrative Hearings for water and wastewater utility case hearings.

Office of Public Utility Counsel (OPUC). A contingency rider included in the House version of SB 1 would provide the OPUC \$499,680 in annual appropriations from the TCEQ and five FTEs for representation of customers in water utility proceedings. According to the OPUC, this would provide the agency with enough resources to fully litigate 3 to 5 cases per year beginning in fiscal 2014. Funds would include \$330,000 in annual salary costs, \$150,000 in professional services, \$2,500 in travel costs, and \$17,180 in other operating expenses. The LBB fiscal note would include estimated benefit costs of \$98,142 each year not included in the contingency rider.