PROJECT NO. 49813

REVISION OF RULES AND FORMS RELEVANT TO FAIR MARKET VALUE	**§ § §**	**PUBLIC UTILITY COMMISSION OF TEXAS**

ORDER ADOPTING REPEAL OF 16 TAC §24.41, NEW 16 TAC §§24.41 AND 24.238, AND AMENDMENTS TO 16 TAC §§24.239 AND 24.243 AS APPROVED AT THE JULY 31, 2020 OPEN MEETING

The Public Utility Commission of Texas (commission) repeals 16 TAC §24.41, relating to cost of service, and adopts new 16 TAC §24.41, relating to cost of service, new 16 TAC §24.238, relating to fair market value, and amendments to 16 TAC §24.239, relating to sale, transfer, merger, consolidation, acquisition, lease or rental, and 16 TAC §24.243, relating to purchase of voting stock or acquisition of a controlling interest in a utility with changes to the proposed text as published in the May 1, 2020 issue of the *Texas Register* (45 Tex. Reg. 2795). New rule §24.238 implements House Bill 3542 (HB 3542), passed in the 86th Legislature, Regular Session, which established a fair market valuation process that may be used by a Class A or Class B water or sewer utility that is acquiring another retail public utility or the facilities of another retail public utility. New rule §24.41 incorporates relevant aspects of proposed new rule §24.238 and will replace existing §24.41. New rule §24.41 also includes clarifying changes. The amendments to §24.239 incorporate relevant aspects of proposed new rule §24.238. The Commission adopts the repeal, new rules, and amendments in Project No. 49813.

No public hearing was requested so no public hearing was held.

The Texas Association of Water Companies (TAWC) and National Association of Water Companies (NAWC) jointly submitted comments on the proposed new rule. The Office of Public Utility Counsel (OPUC), CSWR-Texas Utility Operating Company (CSWR Texas), and SJWTX, Inc. d/b/a Canyon Lake Water Service Company, LLC (CLWSC) also submitted comments.

TAWC and NAWC jointly submitted reply comments. OPUC, CSWR Texas, and the City of Houston (Houston) also submitted reply comments.

General Comments

TAWC and NAWC generally supported the proposed §24.238 and requested changes intended to improve the new fair market valuation process and encourage regionalization of Texas water and sewer systems. OPUC supported the overall important policy objectives behind the passage of HB 3542 and the proposed new rule. OPUC believed it is necessary to carefully evaluate the potential rate impacts of the proposed new fair market valuation rule. OPUC supported the creation of safeguards and criteria to help protect consumers from potential rate increases or other unintended consequences. CSWR Texas supported adoption of the proposed rule but encouraged the commission to consider certain changes to make the valuation procedures and the sale, transfer, merger (STM) approval process more efficient and cost-effective when the acquisition involves smaller water or wastewater systems in need of immediate investment to address critical water quality concerns.

In reply comments, TAWC and NAWC provided a general statement in support of the section-specific initial comments submitted by CLWSC and CSWR Texas.

Commission Response

The commission will respond to comments related to specific rule provisions in the discussion of those provisions.

§24.41(c)(2)(C)(i), Estimates and Trending Studies

Proposed §24.41(c)(2)(C)(i) provides that the commission may adjust rate base and the rate of return on equity associated with cost of plant and equipment that has been estimated by trending studies or other methods not based on historical records. TAWC and NAWC requested language that would permit the use of estimated or trending studies in lieu of historical records without a potential "penalty" detrimental to the financial integrity of the utility. TAWC and NAWC commented that often historical records are not available or are not reliable for a variety of reasons, and suggested that the fair market value process could be viewed as one method of estimation of original cost, and as such, the proposed rule language would conflict with new Texas Water Code (TWC) §13.305. Alternatively, TAWC and NAWC suggested that §24.41(c)(2)(C)(i) could be eliminated altogether because there is no similar language in TWC Chapter 13.

OPUC generally advised caution when using trending studies or other methods that are not based on historical documentation to establish original cost. OPUC recognized that adequate historical records and documentation are not always available for older and smaller water utility systems

and supported allowing the use of trending studies or other estimation methods for older and smaller water utilities, as long as ratepayers are protected from use of potentially speculative methods to establish original cost.

In reply comments, TAWC and NAWC stated that they interpreted OPUC's comments as generally supportive of trending studies or other estimation methods for original cost. However, TAWC and NAWC sought clarification that there will not be a risk of incurring a potential "penalty" detrimental to the financial integrity of the utility, such as an adjustment to rate base or rate of return on equity simply for using these types of estimation methods.

CSWR Texas stated that OPUC's position encouraging the commission to use a higher standard of review for "overly speculative" valuations that are not supported by historical records and documentation is antithetical to the Legislature's intent to remove roadblocks to the acquisition of smaller older systems.

CSWR Texas supported inclusion of TAWC and NAWC's proposed changes. CSWR Texas also stated its support for the use of alternative valuation methods, such as real estate appraisals, that can be performed more quickly and at a lower cost than the fair market value process. CSWR Texas stated that the commission should encourage use of alternative valuation methods to incentivize the acquisition of smaller, older systems and that "threatening to penalize" a utility's rate base or rate of return when the utility may have no other choice but to utilize trending studies or other methods to set rate base does not provide such encouragement. CSWR Texas further stated that the commission already has the authority to deny rate base amounts it

finds unreasonable so there is simply no need for the commission to "threaten" to reduce a utility's rate of return when it can simply deny costs it finds unreasonable.

Commission Response

Proposed §24.41(c)(2)(C)(i) is substantively the same as existing §24.41(c)(2)(B)(i). The commission currently allows original cost of plant and equipment to be based on trending studies or other estimation methods when historical records are unavailable, but may adjust rate base or rate of return when appropriate to ensure just and reasonable rates. The commission agrees with CSWR Texas that the commission has the authority to exclude unreasonable costs from rate base. The commission also has the authority to adjust the rate of return applied to the rate base. For example, TWC §13.184(b) requires the commission to consider, among other things, the quality of the utility's management in fixing a reasonable return on invested capital. Absence of records relating to original cost of plant or equipment could, in some cases, be a sign of the quality of the utility's management. The proposed rule does not require the commission to make adjustments to rate base or rate of return, but reflects the commission's authority to do so.

In situations where the fair market valuation process is not used, TWC §13.185(b) requires rates to be set based on original cost of the facilities unless the commission uses alternative ratemaking approaches authorized under TWC §13.183(c). While the commission's rules permit original cost to be set based on trending studies or other estimation methods when historical records are unavailable, use of real estate appraisals is not an appropriate way to estimate the original cost of facilities because such appraisals estimate market value.

Proposed §24.41(c)(2)(C)(i) is not in conflict with TWC §13.305 because it does not apply to the ratemaking rate base established under §24.238, which is governed by §24.41(c)(2)(A). The commission adopts §24.41(c)(2)(C)(i) as proposed.

§24.41(c) and (d), Return on Rate Base and Positive Acquisition Adjustments

CSWR Texas encouraged the commission to include language in the proposed rules that would allow entities that are not Class A or Class B utilities "to take advantage of the benefits of the fair market value process, even if they are not permitted to take advantage of the fair market value process itself." CSWR Texas stated that in other states it has relied on real estate appraisals to help establish rate base for systems it hopes to acquire and that use of real estate appraisals would also be considerably less expensive and time-consuming than the fair market value approach. CSWR Texas noted that "other estimating methods" are already anticipated in proposed §24.41(c)(2)(c)(i) and that use of real estate appraisals, or other reasonable estimating methods, would provide a more efficient and cost-effective alternative to the fair market value approach when the acquisition involves a smaller system, and is particularly necessary when the acquiring entity would be ineligible to participate in the fair market value process.

CSWR Texas also encouraged the commission to clarify the appropriateness of using positive acquisition adjustments, particularly where the acquiring entity is not eligible to participate in the fair market value process. CSWR Texas requested that the commission include language in the rules that would allow entities that invest in smaller systems to accrue Allowance of Funds Used During Construction (AFUDC) and defer depreciation for post-acquisition improvements in the same way provided for under the proposed rules for eligible utilities. CSWR Texas further stated

that even when an acquiring utility is eligible to participate in the fair market value process, the purchase price for some systems is so small, it is unlikely the fair market value process would be used. CSWR Texas urged that acquiring entities should still be able to take advantage of the ability to accrue AFUDC and defer depreciation on post-acquisition improvements without having to spend the time and expense to seek unnecessary appraisals. CSWR Texas recommended that providing alternatives to the fair market value approach to rate base valuation for smaller water or wastewater systems, particularly when the acquiring entity is not eligible to utilize the fair market value approach, would provide flexibility and ratemaking clarity to entities seeking to acquire and upgrade those systems and ultimately result in safer, more reliable service.

Commission Response

The Commission declines to make the changes requested by CSWR. In enacting TWC §13.305, the Legislature set the parameters for use of fair market valuation to determine the ratemaking rate base purchased by the acquiring utility, including the type of utility that may use this process. The proposed rule reflects these limitations and requirements. If the fair market valuation process is not used, TWC §13.185(b) requires rates to be set based on original cost of the facilities unless the commission uses alternative ratemaking approaches authorized under TWC §13.183(c). While the commission's rules permit original cost to be set based on trending studies or other estimation methods when historical records are unavailable, use of real estate appraisals is not an appropriate way to estimate the original cost of facilities.

§24.41(g), Intangible Assets

Proposed §24.41(g) relates to the evidence that must be used to support the inclusion of intangible assets in rate base. In both initial and reply comments, TAWC and NAWC requested that proposed §24.41(g) be removed. TAWC and NAWC stated that neither TWC Chapter 13 nor the commission's rules applicable to electric utilities contain this language and that intangible assets are routinely allowed as part of rate base for other utilities without the conditions included in this rule. TAWC and NAWC stated that intangible assets will necessarily be valued as part of the appraisals prepared for fair market value determinations and §24.41(g) should be eliminated. Alternatively, TAWC and NAWC suggested this subsection be revised to simply state that intangible assets, including but not limited to a source of supply such as water rights, must be allowed in rate base and repeated this suggestion in reply comments.

OPUC supported the commission's treatment of intangible assets under new §24.41(g), stating that intangible assets are difficult to value and quantify. OPUC stated that intangible assets have some level of value and agreed with the safeguards and requirements in the proposed rule. OPUC encouraged the commission to keep these safeguards and requirements for the protection of ratepayers from overly speculative claims about the value of intangible assets.

In both its initial and reply comments CSWR Texas objected to proposed §24.41(g) because the requirement is not included in the TWC and does not apply to electric utilities under the Public Utility Regulatory Act (PURA) or the commission's rules. CSWR Texas stated it is not clear why such a heightened burden is applied to water or wastewater utilities. CSWR Texas further commented that intangible assets like land rights are simple to appraise, contribute to the real

value of a system, are included in the definition of "facilities" used to provide service under TWC §13.002(9), and also may be the only undepreciated assets that a smaller, older distressed system owns. CSWR Texas stated that this subsection should be eliminated and encouraged the commission to include language in §24.238 that permits appraisers to consider intangible assets as part of their fair market valuations.

In reply, TAWC and NAWC disagreed with OPUC that there is any justification for intangible asset or rate base qualifiers when there are no such qualifiers in place for other types of utilities the commission regulates. TAWC and NAWC argued that intangible assets are not difficult to value and quantify as OPUC contended and are routinely valued by qualified appraisers and valuation experts. TAWC and NAWC further commented that OPUC offered no specific legal or factual basis in support of what it described as "safeguards."

In reply comments, OPUC stated that the commission already disallows intangible assets unless a water utility can meet certain requirements in §24.41(f). OPUC observed that new subsection (g) is a continuation of the commission's existing treatment of intangible assets with which water utilities should already be well familiar. OPUC supported the commission's proposed requirements for intangible assets in new subsection (g) because water utilities should be required to prove through documentation and testimony the reasonableness and necessity of costs that they are seeking to pass on to ratepayers. OPUC stated that these proposed requirements are important and necessary safeguards because intangible assets should not be allowed in a water utility's rate base without a robust assessment of the asset's reasonableness, necessity, and benefits to the utility's ratepayers.

Houston disagreed with TAWC's and NAWC's request that proposed §24.41(g) be removed. Houston noted that TAWC and NAWC requested removal of a requirement that already exists in the commission's rules at §24.41(f) and stated that TAWC's and NAWC's proposal falls outside the scope intended within HB 3542. Houston commented that intangible assets, and specifically the value of water rights, are issues unique to water utilities that could have a significant impact on allowable rate base. Houston stated that inclusion of intangible assets without limitation could result in a rate base that is not reflective of the actual investment made by a utility. Therefore, Houston encouraged the commission to reject TAWC's and NAWC's proposal.

CSWR Texas stated in reply comments that electric utilities commonly include in rates the value of intangible assets like software, franchises, and organizational costs, which should not be difficult to value or require a heightened burden of proof. CSWR Texas agreed with TAWC and NAWC that §24.41(g) should be eliminated. Alternatively, CSWR Texas agreed with TAWC and NAWC's proposed changes. In addition, CSWR Texas encouraged the commission to include express language in §24.238 that intangible assets should be considered as part of fair market valuations.

Commission Response

As OPUC noted, proposed §24.41(g) is substantively the same as current §24.41(f). The commission acknowledges that 16 TAC Chapter 25, which governs electric utilities, is silent on intangible assets. However, setting rates for water utilities presents issues and challenges that differ from electric utilities and the proposed rule reflects the need for different rules in some areas. Proposed §24.41(g) requires that the utility provide

documentation for the amount and nature of the asset; establish through testimony that the amount is reasonable, necessary and a benefit to customers; and establish through testimony that the amount requested is properly included as a rate base asset. These basic requirements for recovery of costs from customers are included in the rule to provide guidance to water and sewer utilities that seek to include intangible assets in rate base. The commission adopts the subsection as proposed.

The commission responds to comments about inclusion of intangible assets in fair market valuations in relation to comments on §24.238(b).

§24.238(b), Definitions—Intangible Assets

TAWC and NAWC expressed concern that intangible assets, such as water rights, will not be considered during the fair market value appraisal process use to establish ratemaking rate base. TAWC and NAWC stated that while TWC §13.305(c)(4) limits the engineer's assessment to tangible assets of the selling utility, intangible assets can be equally or even more valuable and are ordinarily considered in assessing a utility's fair market value and its purchase price. TAWC and NAWC recommended that the utility valuation experts conducting appraisals should be instructed to specifically consider intangible assets. TAWC and NAWC suggested changing the definition of ratemaking rate base to include both tangible and intangible assets.

OPUC replied that TAWC's and NAWC's requested change to §24.238(b)(4) is unnecessary because the definition of "facilities" in TWC §13.002(9) includes intangible assets.

Commission Response

The commission declines to change the definition of ratemaking rate base as requested by TAWC and NAWC. As OPUC pointed out, the definition of "facilities" in TWC §13.002(9) includes intangible assets. However, to further clarify this point, the commission modifies §24.238(f)(2) to expressly state that the appraisal performed by the utility valuation expert will include intangible assets, as appropriate.

§24.238(b), Definitions—Selling Utility

OPUC recommended that the commission modify the definition of "selling utility" in subsection (b)(5) to limit the rule's applicability to the sale of Class C and D utilities. OPUC cited Chairman Dade Phelan's statements at the House State Affairs Committee meeting on April 1, 2019 to establish that the intent of HB 3542, which enacted TWC §13.305, was to help drive investment by private companies in small communities that have an urgent need for water system infrastructure, but cannot afford needed system upgrades. OPUC maintained that HB 3542 was not intended to include the acquisition of large Class A and Class B utilities, which do not face the same financial hurdles as smaller Class C and D utilities due to economies of scale and access to more financial resources. OPUC argued that allowing the fair market value of larger, well-functioning and financially healthy Class A and B utilities in the ratemaking rate base of purchasing Class A and B utilities would result in higher costs for ratepayers.

TAWC and NAWC objected to OPUC's recommendation that the proposed rule's definition of "selling utility" should be restricted to Class C and D utilities, stating that the suggestion is contrary to the plain language of the fair market value statute. TAWC and NAWC argued that it

is well established in Texas that where text is clear, text is determinative of the Legislature's intent and that the words the Legislature chooses should be the surest guide to legislative intent. TAWC and NAWC contended that if enforcement of the plain language of a statute produces an absurd result or is ambiguous, then other considerations may come into play, such as legislative history, but OPUC did not contend there is ambiguity or an absurd result produced by TWC §13.305, and thus, it is not appropriate to look to the legislative history. Moreover, TAWC and NAWC continued, comments by a single legislator about one purpose for a statute does not show the exclusion of other purposes or reflect the collective intent of the entire legislative body. TAWC and NAWC concluded that not only does the plain language of TWC §13.305 not contemplate the type of limitation OPUC suggested, it specifically makes the fair market value process available to acquisitions of retail public utilities, which include water and sewer providers that are not investor owned.

CSWR Texas opposed the limitations on the definition of selling utility proposed by OPUC. CSWR Texas stated that because it is not a Class A or B utility, it appears CSWR Texas is precluded from using the fair market valuation process and other incentives in the proposed rules. CSWR Texas argued that there is no reason that large, adequately capitalized, well-established entities seeking to bring new investment to smaller community-based water and wastewater systems in Texas should be excluded from such incentives, which were specifically designed to encourage the investment CSWR Texas seeks to make in Texas. CSWR Texas encouraged the commission to allow "capable" entities to utilize the fair market value procedures and to take advantage of other incentives.

Commission Response

The commission declines to change the definition of selling utility as recommended by OPUC because TWC §13.305 clearly does not limit the availability of the fair market value process to acquisitions of Class C and Class D water and sewer utilities. Similarly, the commission declines to change the definition as recommended by CSWR Texas, because TWC §13.305 limits use of the fair market valuation process to acquisitions by Class A and Class B utilities.

§24.238(c)(2), List of Qualified Utility Valuation Experts

OPUC supported the utility valuation expert disclosure requirements in proposed §24.238(c)(2). However, OPUC recommended that the commission also require a utility valuation expert to provide a list of all previous water utility-related employers to provide more transparency. OPUC stated that this additional disclosure requirement would help the commission determine whether a utility valuation expert has been employed by a water utility that is subject to the fair market valuation process and whether a utility valuation expert should be disqualified from the selection process.

OPUC contended that the additional disclosure requirement would provide the commission with more context on the utility valuation expert's past water utility-related experience when considering the expert's report. OPUC argued that while a utility valuation expert may not have been employed by a water utility in the previous year to warrant disqualification under proposed §24.238(e)(2)(B), the utility valuation expert may have been employed by a water utility several years ago and that past experience could affect the expert's analysis and report. OPUC stated

that while a utility valuation expert's past water utility-related experience may not warrant disqualification, the commission should nonetheless be aware of the expert's water utility-related employment history in order to make an informed decision with more transparency in the fair market valuation process.

In reply, TAWC and NAWC opposed OPUC's proposed addition to §24.238(c)(2). TAWC and NAWC commented they do not believe that disclosure is necessary, noting that OPUC stated such experience would not necessarily call for disqualification. TAWC and NAWC stated that proposed §24.238(c)(2)(E) already requires a detailed description of a utility valuation expert's experience and OPUC's proposed language seemed overly broad and vague.

In reply comments, CSWR Texas expressed its concern that there will not be a sufficient number of participating appraisers to satisfy the potential demand for the new fair market valuation process and disagreed with any requirements that will discourage or limit the ability of a willing and available appraisal expert to participate in the fair market value process. CSWR Texas stated that the rules already include restrictions on who may participate as an appraiser, and prior employment by a water utility should not be grounds for disqualification of an appraiser or cause to dismiss or question the appraiser's conclusions. CSWR Texas further commented that the commission should clarify that providing consulting services as a third party vendor does not constitute "employment" under the rule because many qualified valuation experts may have worked as an outside consultant to a utility or other "utility-related" entities such as the commission, commission staff, OPUC, municipalities, or any number of other industry groups. CSWR Texas stated that requiring disclosure of an expert's prior work as an outside consultant

could breach confidentiality agreements or otherwise discourage experts from taking part in the appraisal process. CSWR Texas opposed OPUC's proposed changes to §24.238(c)(2) and urged the commission to consider ways to encourage appraisers to participate in the fair market value process.

Commission Response

The commission declines to change the disclosure requirements as suggested by OPUC and CSWR Texas. Instead, the commission adds §24.238(e)(2)(C) to state that a utility valuation expert selected by the executive director or the executive director's designee must not have received compensation under a contract for consulting or other services with the acquiring or selling utility, or executed a contract with either utility, within one year of the date the utility valuation expert is selected. This additional language creates a clear distinction between the term "employment" as used in §24.238(e)(2)(B) and work as a third party contractor and sets reasonable parameters on when a utility valuation expert's previous work as a third party contractor poses a conflict of interest.

§24.238(d), Notice of Intent to Determine Fair Market Value

Proposed §24.238(d)(3) provides that a notice of intent to determine fair market value must not include the purchase price agreed upon by the acquiring utility and selling utility. Proposed §24.238(f)(4) provides that the appraisals performed by the utility valuation experts must not consider the purchase price negotiated by the acquiring utility and selling utility. TAWC and NAWC commented that the acquiring and selling utility should be permitted to share an agreed-upon purchase price with the utility valuation experts conducting appraisals. TAWC and NAWC

stated that utility valuation experts should be able to consider all available information they believe is relevant to their appraisal task, which may include considering an established purchase price along with other available purchase price information in the market. TAWC and NAWC further stated that in light of the statutory five percent cap on compensation, the purchase price may provide an approximation of the amount the prospective utility valuation experts may be paid. TAWC and NAWC suggested revising the proposed rule to provide that the notice of intent may include the purchase price agreed upon by the acquiring utility and the selling utility.

OPUC disagreed with TAWC's and NAWC's recommendation that the acquiring and selling water utility should be permitted to share their agreed-upon purchase price with the utility valuation experts conducting the appraisals. OPUC stated that permitting the acquiring and selling utilities to share their agreed-upon purchase price with the utility valuation experts would introduce subjectivity and bias into a process that is intended to be an independent, neutral and objective evaluation of the fair market value of a selling utility or selling utility's facilities. OPUC commented that HB 3542 included several provisions that speak to the Legislature's intent to create a voluntary fair market valuation process that is independent, neutral and objective, including conflict of interest protections with regard to the utility valuation experts; selection of utility valuation experts by the commission, rather than the selling and acquiring utilities; appointment of three utility valuation experts to perform the fair market valuation appraisal; and the use of the average of the three utility valuation experts' appraisals, rather than relying upon a single appraisal, to determine fair market value. OPUC urged the commission not to allow the acquiring and selling utilities to share their agreed-upon purchase price with the utility valuation experts in the fair market valuation process.

CSWR Texas agreed with TAWC and NAWC that participating utilities should be permitted to disclose the purchase price of a system to the selected utility valuation experts for consideration as part of the fair market value process. CSWR Texas commented that there is often a lack of available cost information or market data necessary to appraise smaller water or wastewater systems and appraisers should be able to consider all available information they consider relevant to their appraisal report, including the purchase price reached by willing parties to a transaction, as long as their deliberations are consistent with the Uniform Standards of Processional Appraisal Practice. CSWR Texas further commented that by requiring the averaging of three separate appraisals, the proposed rule already has sufficient protections to ensure reasonable valuations based on all available information. CSWR Texas supported TAWC's and NAWC's proposed changes to this subsection.

Commission Response

TWC §13.305(c)(3) requires that utility valuation experts perform appraisals using certain approaches that do not include consideration of the agreed-upon purchase price. To protect the integrity of the valuation process, the commission declines to change the rule as requested by TAWC and NAWC and supported by CSWR Texas.

§24.238(e), Selection of Utility Valuation Experts

Proposed §24.238(e)(1) requires the commission's executive director to select three utility valuation experts who will perform appraisals after a notice of intent to use the fair market value process is filed. TAWC and NAWC commented that with respect to this subsection, it is helpful to consider what other jurisdictions with fair market value legislation have done regarding

appraisals. TAWC and NAWC stated that they recognized the limitations of TWC §13.305(c)(2), which says the commission is to "select three utility valuation experts" from its list but stated that the statute does not prohibit recommendations from the buyer and seller regarding valuation experts that the commission should consider. TAWC and NAWC commented that it is important for the buying and selling parties to have input on the selection of the utility valuation expert because they are closest to the transaction and requested that the proposed rule be modified to require the commission's executive director or the executive director's designee to accept and consider one recommended utility valuation expert included in the list maintained under subsection (c) of this section from the acquiring utility and one from the selling utility with the notice of intent filed under subsection (d).

CLWSC requested that the rule explicitly provide that once the commission has selected the utility valuation experts, the selling and acquiring utilities are to contract with the utility valuation experts without involvement by the commission. CLWSC stated that would help all parties involved by allowing the parties to provide assurances to the appraisers about negotiation of terms.

CSWR Texas agreed with TAWC and NAWC that it is important for the buying and selling utilities to each have input as to the selection of the utility valuation experts. CSWR Texas supported TAWC's and NAWC's proposed changes to this subsection. OPUC opposed TAWC's and NAWC's proposed changes arguing that allowing the buying and selling utilities input into the selection of the utility valuation experts introduces subjectivity and bias into what is intended to be an independent, neutral, and objective process.

Commission Response

The commission declines to change the proposed rule as requested by TAWC and NAWC and supported by CSWR Texas. In developing the proposed rule, the commission reviewed the processes used by other jurisdictions, as suggested by TAWC and NAWC. TWC §13.305 places responsibility for selecting the utility valuation experts solely with the commission. Selection of the utility valuation experts by the executive director or the executive director's designee, without input from persons who have an interest in the transaction, will contribute to preserving the integrity of the fair market valuation process.

In response to CLWSC's comments, the commission modifies proposed §24.238(e)(4) to clarify that once the commission has appointed the utility valuation experts, the acquiring utility must proceed to enter agreements with the selected experts.

§24.238(f), Determination of Fair Market Value—Engineering Assessment

Proposed §24.238(f) requires the three utility valuation experts to retain a licensed engineer to assess the tangible assets of the selling utility or the facilities to be sold to the acquiring utility. TAWC and NAWC recommended that the rule allow the seller and buyer to agree to rely on an engineering assessment that one or both has already conducted as part of the due diligence process rather than have another assessment performed. TAWC and NAWC suggested that proposed §24.238(f)(1) be modified to provide that if the commission is informed by verified affidavit of either the acquiring or selling utility that an engineering assessment was previously undertaken and is in compliance with §24.238(f)(1)(A) through (C), then upon acceptance by the

commission's executive director or the executive director's designee, the requirement for a new engineering assessment is waived.

In reply comments, OPUC once again stated its concern that the involvement of the selling and acquiring water utility in aspects of the fair market valuation process introduces bias and subjectivity into a process intended to be independent, neutral, and objective. OPUC maintained that the conflict of interest provisions in HB 3542 show that the utility valuation experts are supposed to be independent parties in the fair market valuation process. OPUC argued that TAWC's and NAWC's recommendation to use an engineering assessment performed during the utility's due diligence process conflicts with the intent of the legislation and should not be adopted by the commission.

Houston recognized that the avoidance of duplicative engineering work can save time and potentially reduce transactional costs passed on to ratepayers, but recommended inclusion of additional requirements to provide for verification of the assessment by the engineer if the commission modifies the proposed rule as recommended by TAWC and NAWC. Houston proposed that the engineer responsible for conducting the assessment provide an affidavit in addition to the affidavit recommended by TAWC and NAWC. Houston further recommended that the rule require the engineer to attach the engineering assessment report to the affidavit and require the report to bear the professional engineer's seal and signature to authenticate the engineering assessment as accurate and independent. Houston provided recommended amendments to the §24.238(f)(1) language proposed by TAWC and NAWC.

CSWR Texas agreed with TAWC's and NAWC's recommendation that the appraisers be permitted to utilize complete and accurate engineering studies or appraisals that have already been performed by the acquiring or selling utility. CSWR Texas expressed concerns that for smaller systems with fewer assets, the cost of fair market value appraisals could far exceed the caps imposed under the statute. CSWR Texas stated that the cost of hiring an engineer as part of the fair market value process will be a significant driver of these appraisal costs, so to the extent the buyer and seller agree to the use of such information, the commission should permit the acquiring and selling utilities to provide such information to the appraisers and allow the appraisers to determine whether such information can be reasonably substituted for an entirely new engineering analysis. CSWR Texas agreed with TAWC's and NAWC's proposed changes to this subsection.

Commission Response

TWC §13.305(c)(4) requires the three utility valuation experts selected under §13.305(c)(2) to jointly retain a licensed engineer to conduct an assessment of the tangible assets of the selling utility or the facilities to be sold. The statute does not provide for use of a previous engineering assessment. The proposed rule appropriately reflects the statutory process; therefore, no amendments are necessary.

§24.238(f), Determination of Fair Market Value—Filing of Notice of Intent and Sale, Transfer, Merger (STM) Application

CSWR Texas commented that the commission should allow the acquiring and selling utilities to file their STM applications concurrently with the fair market value appraisal process. CSWR

Texas also encouraged the commission to find other ways to compress the schedule as much as possible. In addition, CSWR Texas encouraged the commission to require appraisers to complete appraisals for Class D utilities within 60 days after appointment.

Commission Response

The commission addresses the timing of filing the notice of intent and STM application in relation to proposed §24.239. The commission declines to shorten the time period for the utility valuation experts to file their reports when the selling utility is a Class D utility. The commission retains the proposed time period as an outer limit to ensure the utility valuation experts have adequate time to prepare their reports.

§24.238(f), Determination of Fair Market Value—Engineer's Role

TAWC and NAWC recommended that the rule should specifically identify the engineering "assessment" as an inventory of the assets being sold rather than any type of valuation. TAWC and NAWC suggested that proposed §24.238(f)(1)(C) be modified to specify that the engineer should develop an inventory of the used and useful utility plant assets to be transferred that is compiled by year and account, separately identify any utility plant that is being held for future use, and develop a list of all non-depreciable property such as land and rights-of-way. Further, TAWC and NAWC recommended that the rule should require that the inventory must be developed from available records, maps, work orders, debt issue closing documents funding construction projects, and other sources to ensure an accurate listing of utility plant inventory by utility account.

Houston commented that although it supports clarity regarding the engineering assessment process, TAWC's and NAWC's proposal is too narrow and inappropriately limits the role of the engineer. Houston stated that it is common for the appraiser to consider both the age and condition of the asset within the subject transaction. Houston commented that the engineer conducting the engineering assessment may be the most qualified individual to assess the condition of the assets in question, and that the engineer should not be limited in providing their opinion. Houston recommended amendments to the language proposed by TAWC and NAWC.

Commission Response

The commission declines to change the proposed rule as recommended by TAWC and NAWC. The commission agrees with Houston that the recommendation inappropriately limits the role of the engineer.

§24.238(f), Determination of Fair Market Value—Consideration of Purchase Price

For the reasons discussed with respect to proposed §24.238(d)(3), which prohibits including the agreed upon purchase price in the notice of intent to determine fair market value, TAWC and NAWC requested that proposed §24.238(f)(4) be modified to provide that the appraisal may consider the purchase price negotiated by the acquiring utility and the selling utility.

CLWSC stated that the commission lacks authority to prevent selling or acquiring utilities from sharing the purchase price or the process of arriving at the purchase price with the appointed utility evaluation experts. CLWSC stated that information is an important indicator of market value, especially when appraising assets that are not widely traded, and nothing in the statute

authorizes the commission to limit information flow between a utility and a utility valuation expert. CLWSC noted that the statute merely holds utility valuation experts to the Uniform Standards of Professional Appraisal Practice and dictates the methods of valuation each expert is to employ. CLWSC took issue with the assumption that an appraisal will fail to be independent if the utility valuation expert receives information from the selling or acquiring utilities about the facilities in question. CLWSC further commented that the statute does not call for an "independent" appraisal, but reads "...each utility valuation expert shall perform an appraisal in compliance with Uniform Standards of Professional Appraisal Practice, employing the cost, market, and income approaches, to determine the fair market value...."

Commission Response

The commission declines to make changes to the proposed rule. TWC §13.305 provides an alternative, voluntary method for determining the appropriate rate base value for an acquired retail public utility or facilities. The statute does not expressly address the flow of information between the utility valuation experts and the acquiring and selling utility. Further, it does not expressly prohibit the commission from enacting rules to ensure that the information shared does not jeopardize the independence of the utility valuation experts and their appraisals. Although TWC §13.305 does not use the word "independent," it is reasonable to require that the appraisals provided by the utility valuation experts not be influenced by the agreed-upon purchase price or the methodologies or process used to arrive at the purchase price. The commission modifies §24.238(f)(4) to further clarify what information must not be considered by the utility valuation expert.

§24.238(f), Determination of Fair Market Value—Engineer's Fee

TAWC and NAWC stated that the proposed rule is unclear whether the fee for the engineer retained by the three selected utility valuation experts described in proposed §24.238(f)(1)(D) is subject to the same fee limitations expressed in subsection (k). TAWC and NAWC suggested additions to subsection (k) intended to clarify this issue.

Commission Response

The commission declines to make changes to the rule in response to TAWC's and NAWC's comments. TWC §13.305(e) specifically refers to fees paid to utility valuation experts. Because the utility valuation experts will retain and compensate the engineer, proposed §24.238(f)(2)(D) provides that the engineer's fee may be included in the utility valuation expert's compensation under subsection (k). Therefore, under the proposed rule, the engineer's fee is indirectly subject to the five percent cap, and no changes are necessary.

§24.238(f), Determination of Fair Market Value—Information Used by Utility Valuation Expert

TAWC and NAWC asked the commission to specify that the utility valuation experts and engineer should confer with the acquiring utility and selling utility to obtain available valuation and asset information as part of the fair market valuation determination process. TAWC and NAWC stated that ultimately the utility valuation experts will prepare their appraisal reports independently, but it is important for the best information available to be considered. TAWC and NAWC stated that most often, the acquiring and selling utilities will have that information, so the utility valuation experts should be compelled to request and consider information from the acquiring and selling utilities to the extent it is available.

Commission Response

The rule as proposed does not preclude the utility valuation experts from communicating with the selling and acquiring utilities to obtain information needed to perform the cost, market, and income analyses. However, the commission declines to expressly require that they do so.

§24.238(g) through (i), Cost Approach, Income Approach, and Market Approach

CSWR Texas commented that the requirements for the three valuation methodologies exceed the statutory requirements because TWC §13.305 does not prescribe any specific methodologies or requirements for the cost approach, income approach and market approach. Rather, it only requires the utility valuation experts to comply with the Uniform Standards of Professional Appraisal Practice. CSWR Texas stated that the proposed rule's appraisal process may be appropriate for larger, more sophisticated systems with adequate records, but it would be "inefficient or ineffective" for appraising smaller systems that lack data or comparable sales. CSWR Texas noted that the proposed rule does not appear to allow the utility valuation experts any discretion to apply their individual and specialized expertise to determine the most appropriate manner to determine fair market value. CSWR Texas was also concerned that the requirements on how appraisals must be performed could conflict with the Uniform Standards of Professional Appraisal Practice, with which the utility valuation experts are required to comply under TWC §13.305(c)(3), proposed §24.238(f)(2), their state licensing requirements, and the industry's ethical standards. Such a conflict could discourage utility valuation experts from participating in the fair market value process. To resolve these concerns, CSWR Texas encouraged the commission to include language in subsections (g), (h) and (i) that allows the

utility valuation experts to use "other reasonable methodologies that are consistent with the Uniform Standards of Professional Appraisal Practice" to perform each of the three approaches. In addition, CSWR Texas recommended that the commission clarify that an appraiser has discretion to use only those appraisal analyses the appraiser determines will result in reasonable or accurate valuations. According to CSWR Texas, allowing use of discretion is consistent with the Uniform Standards of Professional Appraisal Practice, would result in more accurate valuations, and would eliminate the time and expense of performing unnecessary or ineffective analyses.

Proposed §24.238(g)(1) states that a cost approach appraisal performed must be based on the investment required to replace or reproduce future service capability or the original cost of the facilities. TAWC and NAWC commented that there are other cost approach valuation methods that could potentially be utilized and paragraph (g)(1) should be revised to permit a cost appraisal to be based on other reasonable cost approach valuation methods in addition to those listed in the proposed rule.

Commission Response

TWC §13.305(c)(3) requires the utility valuation experts to perform appraisals using the cost, market, and income approaches. The proposed rule appropriately incorporates the statutory requirements; therefore, the commission declines to change the rule as recommended by CSWR Texas. The commission also declines to allow use of other cost approach valuation methods. Original cost and replacement cost are generally accepted

methods for determining the value of facilities and are sufficient for the purposes of the fair market valuation process.

§24.238(h), Income Approach

Proposed §24.238(h)(2) provides that an appraisal that uses the income approach must exclude consideration of future capital improvements. TAWC and NAWC commented that future capital improvements are used in the development of the discounted cash flow method and excluding consideration of them will artificially increase the overall income approach value. TAWC and NAWC stated that proposed §24.238(h)(2) should be deleted.

Commission Response

The commission declines to delete or change §24.238(h)(2) because consideration of future capital improvements unnecessarily introduces additional uncertainty and inaccuracy into the income method.

§24.238(j), Contents of Utility Valuation Expert Report

OPUC supported the commission's inclusion of the conflict of interest provisions for engineers in subparagraph (f)(1)(A) of the proposed rule. Additionally, OPUC supported the required information sharing between the engineer and utility valuation expert in proposed §24.238(f)(1)(B). OPUC, however, noted that the engineer's information is shared with only the utility valuation experts and the utility valuation experts are not obligated to disclose the engineer's information in their reports. OPUC commented that transparency and holistic commission oversight are essential to the new fair market valuation process, and the engineer's

information is just as important as the utility valuation expert's information for purposes of ensuring a non-biased valuation of a retail public utility or the facilities of a retail public utility. OPUC recommended that the commission modify proposed §24.238(j) to require the disclosure of information provided by the engineer to the utility valuation expert pursuant to §23.238(f)(1)(B) in the utility valuation expert's report.

In reply comments, TAWC and NAWC stated that OPUC's proposed addition to §24.238(j) that would require inclusion in the utility valuation expert's report of "the information submitted by the licensed engineer under subsection (f)(1)(B) to the utility valuation expert" may not be necessary given that proposed §24.238(j)(3) requires the utility valuation expert's report include "a detailed list of the utility plant assessed by the engineer."

Commission Response

In response to OPUC's comments, the commission modifies §24.238(j)(3) to require that the utility valuation expert's report must include the assessment prepared by the licensed engineer under §24.238(f)(1), including a detailed list of the utility plant assessed by the engineer.

§24.238(k),Transaction and Closing Costs

TAWC and NAWC expressed concern that proposed §24.238(k), which allows a fee paid to a utility valuation expert to be included in the transaction and closing costs associated with an STM, leaves open for future determination in a rate case the amount of transaction and closing costs, the acquiring utility may recover in rates. TAWC and NAWC stated that they think the

intent of the statute is that the five percent cap should represent a total amount for all appraisal work and engineer fees. Further, TAWC and NAWC requested the commission not leave to a future case the determination of whether a fee amount other than the five percent will be approved. TAWC and NAWC noted that TWC §13.305(g) and (h)(3) require ratemaking rate base to be established for incorporation into the acquiring utility's rate base in its next rate case and be included in the STM application for the transaction, but TWC §13.305(h)(4) specifies that transaction and closing costs to be included in the acquiring utility's rate base are to be included in a fair market value STM application. TAWC and NAWC offered revisions to proposed §24.238(k)(2) that would require the commission to approve the collective fee amounts as part of the fair market value determination proceeding.

CSWR Texas commented that the actual costs for the utility valuation experts to perform appraisals could be significantly higher than five percent of the purchase price. For example, for a smaller system with a fair market value of $100,000, the appraisal and engineering fees would likely far exceed the five percent cap. CSWR Texas stated that it agrees reasonable caps should be placed on appraisal costs, but it will be difficult to find appraisers willing to engage in this process and hire outside engineers to assess these much smaller systems if their costs are not recoverable. The fact that the statutorily mandated caps may not allow valuations of these smaller systems supports adoption of more expedient and cost-effective alternatives to the proposed fair market valuation approach.

CLWSC commented that the five percent cap should apply to the combined fees paid to all three appraisers, and that the rule could state that combined fees of up to five percent is the maximum

that may be recovered in rates, while allowing the acquiring utility to agree to whatever fees they negotiate with the appraisers. CLWSC stated this approach would allow the appraisers to be assured of a fee that they deem to be acceptable, but it would create a limit more in line with market conditions on how much of those fees could be expected to be passed on to ratepayers.

With respect to the appraisal fee referenced in TWC §13.305(e)(2), CLWSC advocated for a published fee schedule to be promulgated by the commission to create clarity and certainty in the fair market value determination process. The fee schedule would not be a requirement for what utilities must pay an appraiser, but rather would aid utilities in understanding what costs are recoverable once the utility has completed the fair market value determination process and proceeded with its STM application.

In reply comments, OPUC agreed with the concerns raised by TAWC, NAWC, and CLWSC relating to the five percent cap on fee amounts included in transaction and closing costs that are recoverable in rates. Although TWC §13.305(e) sets a five percent cap for recovery of utility valuation expert fees, TWC § 13.305(e) does not specify whether the five percent cap applies collectively or individually to the utility valuation expert and licensed engineer fees. OPUC agreed that the suggested language revisions to §24.238(k) proposed by TAWC and NAWC are consistent with the legislative intent of HB 3542 and that the five percent cap should apply collectively to the utility valuation expert and licensed engineer fees. OPUC stressed that the revised language proposed by TAWC and NAWC allows flexibility for the selling and acquiring water utility to negotiate a higher contractual price for the services of the utility valuation expert and licensed engineer, but limits the costs passed on to ratepayers.

Houston replied to TAWC's and NAWC's concern that transaction and closing costs associated with the fair market value process will not be considered by the commission until the rate case in which the fees are requested for recovery. Houston noted that as support for including transaction and closing costs in the fair market valuation process, TAWC and NAWC refer to the requirements of TWC §13.305(h)(4) that the STM application must include the transaction and closing costs incurred by the acquiring utility that will be included in the utility's rate base. Houston agreed that if the transaction and closing costs are to be included in rate base through the fair market valuation process in accordance with the proposed language in §24.41(c)(2)(A), then it does follow that the fair market valuation process would need to include consideration of these costs.

Houston expressed concern that considering these costs as part of the fair market valuation would circumvent the typical rate-making process and effectively deny ratepayers the opportunity to comment on the reasonableness and necessity of these costs. Houston further commented that if included, the costs would continue to be a component of the fair market value rate base until depreciated over the life of the plant assets without having had the same scrutiny that is afforded affected parties in general rate proceedings. Houston noted that the use of system-wide or region-wide rates by Class A and B utilities complicates the situation. Houston stated it would need to intervene in all STM filings that could potentially result in a change in rate base underlying the rates charged to customers within its municipal limits to ensure adequate protection to ratepayes within Houston's original jurisdiction. Houston expressed uncertainty about whether it would have standing to intervene in such proceedings. Houston stated that,

should intervention be granted, it could further complicate and delay the STM process, which could further hamper and delay much needed improvements in service to customers.

Houston agreed with TAWC and NAWC that the proposed rules appear to create confusion on when the transaction and closing costs associated with fair market value determination would be calculated and approved. However, Houston stated that the STM should not be conflated with the ratemaking processes and strongly urged the commission to ensure that ratepayers maintain the ability to comment on the reasonableness and necessity of the transaction and closing costs within the standard ratemaking process as opposed to including it within the fair market valuation or STM process.

Commission Response

The statutory framework for the fair market value process requires the commission to establish the ratemaking rate base in the STM proceeding. The commission's role in establishing the ratemaking rate base is not adjudicatory. No hearing on the issue will be required or permitted because the ratemaking rate base must be based on the utility valuation experts' reports or the purchase price. In contrast, determination by the commission of reasonable and necessary transaction and closing costs, including utility valuation expert fees, to be recovered in rates will be an adjudicatory process that may require a hearing. The proposed definition of ratemaking rate base in §24.238(b)(4) clarifies that transaction and closing costs are not part of ratemaking rate base, and therefore, are not required by TWC §13.305 to be determined in the STM case. The

commission does not determine in the STM case the amount of transaction and closing costs properly included in rates.

The commission agrees with the commenters that the five percent cap should apply to the overall amount of utility valuation expert fees, including the engineer's fee, that may be recovered through rates and clarifies §24.238(e)(4) accordingly. The commission also has the authority under TWC §13.305(e)(2) to approve a different amount. The acquiring and selling utilities will negotiate the fees of the utility valuation experts, and as with other costs incurred by utilities, bear the risk of a commission finding that the fees are not reasonable, necessary, or recoverable through rates. The determination of the amount of transaction and closing costs that may be included in rates is properly carried out in a rate case where affected persons such as Houston, OPUC, and utility customers may intervene.

The commission declines to adopt a fee schedule as suggested by CLWSC because the reasonableness of the closing costs, including the utility valuation experts' fees, is appropriately decided on a case-by-case basis.

The commission declines to make changes to the proposed rule in response to CSWR's comments. The proposed rules implement HB 3542 and make corresponding changes to existing rules. Changing the proposed §24.238 to provide for more expedient and cost-effective alternatives to the fair market value approach is beyond the scope of this project and the authority granted in HB 3542. The rule precludes rate recovery of amounts for

utility valuation expert fees that exceed the five percent cap, but does not prevent utilities from paying utility valuation experts fees that exceed that cap.

§24.239 Sale, Transfer, Merger, Consolidation, Acquisition, Lease or Rental—Timing of Fair Market Valuation and STM Application

TAWC and NAWC expressed concern about the extended length of time it could take to complete an acquisition using the §24.238 fair market valuation process if the STM application could not be filed until after the valuation was determined by the commission.

TAWC and NAWC stated that the commission's determination of the appropriate fair market valuation and approval of a transaction itself under §24.239 should occur at the same time and in the same proceeding. TAWC and NAWC stated that until valuation is settled, the buyer will not know if it can earn a return of and on capital used to acquire the property of the seller such that an STM cannot be consummated until after the fair market valuation is pronounced by the commission. TAWC and NAWC recommended that this determination should occur as promptly and efficiently as possible. TAWC and NAWC stated that customers and employees also benefit from the STM proceeding not lingering too long because existing management may be less likely to approve capital improvements and make other decisions that would benefit service during the pendency of a sale of the system, while employees will be operating under the uncertainty of their continuing positions with the new owner. TAWC and NAWC cited TWC §13.305(h) as indicative of clear legislative intent to consider the asset acquisition and its proper valuation in the same proceeding. TAWC and NAWC recommended that the commission should also recognize TWC §13.305(i), which specifies that the commission's order approving

the acquisition must determine the acquiring company's ratemaking rate base. TAWC and NAWC commented that TWC §13.305(h)(4) also requires inclusion of the "transaction and closing costs incurred by the acquiring utility that will be included in the utility's rate base." TAWC and NAWC proposed that the commission replace proposed §24.239(d)(2) with language that would require approval of transaction and closing costs in the STM proceeding rather than deferring consideration to the next rate case.

CSWR Texas encouraged the commission to include language in proposed §24.239(d) that would allow an entity to file its STM application concurrently with its fair market value appraisal and to supplement the application to include the appraiser reports and costs once the fair market valuation is finalized. This would expedite the acquisition time by four to five months, increase regulatory certainty, and reduce costs.

In reply comments, CSWR Texas agreed with TAWC and NAWC that the commission should include language in the rule that allows a utility to engage in the fair market value process and file its STM concurrently. CSWR Texas noted that an STM proceeding can already take over a year, and the fair market valuation process could add an additional five to six months.

Commission Response

The commission disagrees that concurrent filing of the notice of intent to use the fair market value process and the associated STM application will result in the efficiencies projected by TAWC, NAWC, and CSWR Texas. TWC §13.305 clearly contemplates a two-step process. TWC §13.305(c) requires the acquiring utility and selling utility to notify

the commission of their intent to use the fair market valuation process so that the commission may select the utility valuation experts. TWC §13.305(h) requires an acquiring utility that uses the fair market valuation process to submit copies of the three utility valuation expert appraisals in the STM application submitted under TWC §13.301. The commission cannot set an intervention date, provide for notice, determine whether a hearing is necessary, or evaluate the merits of the STM application without a complete application.

Further, the fair market valuation process is voluntary and any concerns about the additional time required to complete this process before filing an STM application can be weighed against the benefits of obtaining a fair market valuation before filing a notice of intent initiating the process. Therefore, the commission adopts the rule as proposed.

§24.239 Sale, Transfer, Merger, Consolidation, Acquisition, Lease or Rental—Ability to Contest Appraisals

TAWC and NAWC requested that parties to an STM proceeding have the opportunity to contest a fair market valuation based upon the existence of fact and mathematical errors in the appraisals or engineer's assessment. TAWC and NAWC stated that there is no indication that the legislature intended to eliminate the commission's ability to analyze and challenge the appraisals and the resulting rate base value. TAWC and NAWC commented that the appraisal process involves facts and assumptions that may be incorrect and in need of revision; the process is not simply the mathematical exercise of taking three appraisals without inquiry and dividing the sum

of them by three. Rather, TAWC and NAWC stated that the commission has a statutory duty to assure the public interest and compliance with the TWC and commission rules.

TAWC and NAWC suggested adding a new paragraph to §24.239(d)(3) that provides that parties to an application proceeding that includes a fair market valuation may challenge the facts and assumptions made in an appraisal or engineering assessment relied upon in an appraisal.

CSWR Texas agreed with TAWC and NAWC that there should be a process to allow parties to identify and correct mathematical errors or underlying data in the appraisal reports or engineer analyses. While TAWC and NAWC recommended including language in §24.239 to address this within the context of an STM proceeding, CSWR Texas suggested allowing the utilities to communicate any errors to the appraisers once their reports are issued and allowing the appraisers to issue a corrected report within a reasonable amount of time. Allowing for correction of errors will improve the fair market valuation process and protect both the utility and customers.

In reply comments, OPUC expressed concern that including language in the proposed rule that permits challenges to the facts and assumptions of an appraisal or engineering assessment in the fair market valuation process will create an opportunity for parties to modify the results of the appraisal and engineering assessment and could result in unnecessary litigation that will negate the intended legislative purpose of incentivizing private investment in water and wastewater infrastructure in smaller communities that are in critical need of the infrastructure. OPUC recognized the validity of the concern raised by TAWC and NAWC, but stated that their

proposed language exceeds the scope of their concern. OPUC provided language for a proposed new subsection if the commission wants to address TAWC's and NAWC's concern that allows for the opportunity to "correct factual and mathematical errors" rather than the opportunity to "challenge the facts and assumptions made."

Commission Response

The commission disagrees with TAWC and NAWC regarding the legislature's intention to eliminate the commission's ability to analyze and challenge the appraisals and the resulting rate base value. TWC §13.305(g) states that the ratemaking rate base is the lesser of the purchase price or the fair market value. TWC §13.305(f) states that the fair market value is the average of the three utility valuation experts appraisals.

However, factual or mathematical errors could be present in an appraisal report prepared by a utility valuation expert. Therefore, the commission modifies §24.238(f)(5) to require the acquiring and selling utilities to review the reports for mathematical and factual errors and notify the utility valuation experts of any mathematical or factual errors they identify, regardless of whether the errors increase or decrease the appraisal. The utility valuation expert may promptly revise the report in response to the utilities' notification. This change builds the review into the fair market valuation process before the adoption of a ratemaking rate base rather than waiting until the STM proceeding, which occurs after the ratemaking rate base is set.

All comments, including any not specifically referenced herein, were fully considered by the commission. In adopting this section, the commission makes other modifications for the purpose of clarifying its intent.

This repeal, new rules and rule amendments are adopted under the Texas Water Code §13.041, which provides the commission with the authority to make and enforce rules reasonably required in the exercise of its powers and jurisdiction; and §13.305, which establishes a voluntary process for the valuation of utilities or facilities acquired by Class A or Class B utilities.

Cross reference to statutes: Texas Water Code §§13.041 and 13.305.

§24.41. Cost of Service. [REPEAL]

§24.41. 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 rate base.

(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 test year expenses as adjusted for known and measurable changes will be considered. A change in rates must be based on a test year as defined in §24.3(37) of this title, relating to Definitions of Terms. 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).

(1) **Components of allowable expenses.** Allowable expenses, to the extent they are reasonable and necessary, 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.

(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.

(i) Depreciation expense is allowed on all currently used and useful depreciable utility property owned by the utility and depreciable

utility plant, property and equipment retired by the utility, subject to the requirements of subparagraph (c)(2)(C) of this section. Depreciation expense is not allowed for property provided under explicit customer agreements or funded by customer contributions in aid of construction. Depreciation expense is allowed for all currently used and useful developer or governmental entity contributed property. A utility must calculate depreciation on a straight-line basis over the expected or remaining life of the asset, but is not required to use the remaining life method if salvage value is zero. A utility that does not use group depreciation and proposes to change the useful life of an asset with an accumulated depreciation balance must not change the accumulated depreciation balance and must adjust depreciation expense going forward based on the changed useful life.

(ii) 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 utility must submit sufficient evidence with the application establishing that the estimated salvage value, including removal costs, is reasonable. For a utility that uses group accounting, salvage value will be applied to the asset group in depreciation studies. For a utility that uses itemized accounting, salvage value will be applied to specific assets.

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

(F) Advertising, contributions and donations. The actual test year expenditures for advertising, contributions, and donations may be allowed as a cost of service provided that the total sum of all such items allowed in the cost of service must not exceed three-tenths of 1.0% (0.3%) of the gross receipts of the utility for services rendered to the public. The following expenses are the only expenses that may be included in the calculation of the three-tenths of 1.0% (0.3%) maximum:

(i) funds expended advertising methods of conserving water;

(ii) funds expended advertising methods by which the consumer can achieve a savings in total utility bills; and

(iii) funds expended advertising water quality protection.

(G) Credit card and electronic payment processing fees. Expenditures or fees charged by banks or companies for accepting and processing credit card, debit card or other forms of electronic payment from customers for water and sewer utility service may be allowed as a cost of service.

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

(H) interest expense of processing a refund or credit of sums collected in excess of the rate 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 rate base.** The return on rate base is the rate of return times rate base.

(1) **Rate of return.** The commission will allow each utility a reasonable opportunity to earn a reasonable rate of return, which is expressed as a percentage of invested capital, and will 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 will 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, plus adjustments for premiums, discounts, and refunding and issuance costs.

(ii) Equity capital. 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.

(C) The commission will 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.

(D) The commission may consider inflation, deflation, the growth rate of the service area, and the need for the utility to attract new capital.

(2) **Rate base.** The rate of return is applied to the rate base. Assets retired before June 19, 2009, must be removed from rate base before the rate of return is applied to the rate base. Components to be included in determining the rate base are as follows:

(A) If a utility or its facilities were valued using the process for establishing fair market value in Texas Water Code (TWC) §13.305, the dollar value of the "ratemaking rate base," as defined in TWC §13.305(a)(2) and §24.238(b)(4) of this title, relating to Fair Market Valuation, less accumulated depreciation.

(i) The installation date of the ratemaking rate base is the filing date of the commission's final order approving the acquisition of the ratemaking rate base in an application filed under TWC §13.301.

(ii) The ratemaking rate base will include an accrual for Allowance for Funds Used During Construction (AFUDC), as defined in §24.238(b)(2) of this title, relating to Fair Market Valuation, for any post-acquisition improvements to the ratemaking rate base.

The accrual will begin on the date the improvement cost was incurred and end on the earlier of:

(I) the fourth anniversary of the date the improvement was placed in service; or

(II) the filing date of the commission order in which the ratemaking rate base is first approved by the commission as part of the rate base set in a base rate proceeding.

(iii) For book and ratemaking purposes, depreciation on any post-acquisition improvement to the ratemaking rate base will be deferred and considered in the utility's next base rate proceeding.

(iv) Transaction and closing costs associated with the acquisition will be reviewed in the acquiring utility's first base rate proceeding after the transaction has been concluded.

(B) Original cost, less accumulated depreciation, of utility plant, property, and equipment used by and useful to the utility in providing service.

(C) Original cost, less net salvage and accumulated depreciation at the date of retirement, of depreciable utility plant, property and equipment retired by the utility.

(i) For original cost under this subparagraph or subparagraph (B) of this paragraph, the commission may adjust rate base and the rate of return on equity associated with the cost of plant and equipment that has been estimated by trending studies or other methods not based on or verified by historical records.

(ii) Original cost in this subparagraph or subparagraph (B) of this paragraph 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 current 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.

(iii) On all assets retired from service, 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 in its net plant calculation in the first full rate change application, excluding alternative rate method applications as described in §24.75 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 must be combined with over-accrual of depreciation expense for those assets retired after the estimated useful life or remaining life and

the net amount must be amortized over a reasonable period of time taking into account prudent regulatory principles.

(iv) Accelerated depreciation is not allowed.

(v) For a utility that uses group accounting, 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:

(I) investment by homogenous category;

(II) expected level of gross salvage by category;

(III) expected cost of removal by category;

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

(V) the average service life by category;

(VI) the remaining life by category;

(VII) the Iowa Dispersion Pattern by category; and

(VIII) 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.

(vi) Reserve for depreciation under this subparagraph or subparagraph (B) of this paragraph 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. Depreciation must be computed on a straight-line basis over the expected useful life or remaining life of the item or facility regardless of whether the salvage value is zero or not zero.

(I) If individual accounting is used, the following requirements apply to retirements:

(-a-) Accumulated depreciation must be calculated based on book cost less net salvage value of the asset.

(-b-) The utility must 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.

(-c-) The utility must show that it used due diligence in recovering maximum salvage value of a retired asset.

(-d-) The utility must continue booking depreciation expense until the asset is actually retired, and the reserve for depreciation must include any additional depreciation

expense accrued past the estimated useful or remaining life of the asset.

(-e-) 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.

(-f-) Retired assets must be specifically identified.

(-g-) The requirements relating to the accounting for the reasonableness of retirement decisions for individual assets and the net salvage value calculations for individual assets apply only to a utility using itemized accounting.

(II) For a utility that uses group accounting, the depreciation study must provide the information in subclause (I) except that retirements may be accounted for by category. Retired assets must be reported for the asset group in depreciation studies.

(III) TWC §13.185(e) applies to utility business transactions with affiliated interests involved in the retirement, removal, or recovery of assets.

(IV) For assets retired after June 19, 2009, the retired assets must be included in the utility's first application for a rate change

after the date the asset was retired and must be specifically identified if the utility uses itemized accounting.

(vii) 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);

(viii) utility property funded by written customer agreements or customer contributions in aid of construction such as surcharges must not be included in original cost or invested capital.

(D) 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 for cash working capital. The following will apply in determining the amount to be included in invested capital for cash working capital:

(I) Cash working capital for utilities must not exceed one-eighth of total annual operations and maintenance expense, excluding amounts charged to operations and maintenance expense for materials, supplies, fuel, and prepayments.

(II) For Class C and Class D utilities, one-eighth of operations and maintenance expense excluding amounts charged to operations and maintenance expense for materials, supplies, expenses recovered through a pass-through provision or through charges other than base rate and gallonage charges, and prepayments will be considered a reasonable allowance for cash working capital.

(III) For Class B utilities, one-twelfth of operations and maintenance expense excluding amounts charged to operations and maintenance expense for materials, supplies, expenses recovered through a pass-through provision or charges other than base rate and gallonage charges, and prepayments will be considered a reasonable allowance for cash working capital.

(IV) For Class A utilities, a reasonable allowance for cash working capital, including a request of zero, will be determined by the use of a lead-lag study. A lead-lag study will be performed in accordance with the following criteria:

(-a-) The lead-lag study will use the cash method. All non-cash items, including but not limited to depreciation, amortization, deferred taxes, prepaid items, and return, including interest on long-term

debt and dividends on preferred stock, will not be considered.

(-b-) Any reasonable sampling method that is shown to be unbiased may be used in performing the lead-lag study.

(-c-) The check clear date, or the invoice due date, whichever is later, will be used in calculating the lead-lag days used in the study. In those cases where multiple due dates and payment terms are offered by vendors, the invoice due date is the date corresponding to the terms accepted by the utility.

(-d-) All funds received by the utility except electronic transfers will be considered available for use no later than the business day following the receipt of the funds in any repository of the utility, e.g., lockbox, post office box, branch office. All funds received by electronic transfer will be considered available the day of receipt.

(-e-) The balance of cash and working funds included in the working cash allowance calculation will consist of the average daily bank balance of all non-interest bearing demand deposits and working cash funds.

(-f-) The lead on federal income tax expense must be calculated by measurement of the interval between the mid-point of the annual service period and the actual payment date of the utility.

(-g-) If the cash working capital calculation results in a negative amount, the negative amount must be included in rate base.

(V) If cash working capital is required to be determined by the use of a lead-lag study under subclause (IV) of this clause and either the utility does not file a lead-lag study or the utility's lead-lag study is determined to be unreliable, in the absence of persuasive evidence that suggests a different amount of cash working capital, zero will be presumed to be the reasonable level of cash working capital.

(VI) A lead lag study completed within five years of the application for a rate or tariff change is adequate for determining cash working capital unless sufficient persuasive evidence suggests that the study is no longer valid.

(VII) Operations and maintenance expense does not include depreciation, other taxes, or federal income taxes, for purposes of subclauses (I), (II), (III) and (V) of this clause.

(3) Deduction of certain items from rate base. In the consideration of applications filed under TWC §13.187 or §13.1871, the commission will deduct certain items from rate base, including but not limited to the following:

(A) accumulated reserve for deferred federal income taxes;

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

(C) contingency and property insurance reserves;

(D) contributions in aid of construction; and

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

(4) Construction work in progress (CWIP). The inclusion of CWIP is an exceptional form of relief. 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 CWIP in rate base to the extent that the utility has proven that:

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

(B) major projects under construction have been efficiently and prudently planned and managed.

(5) Requirements for post-test year adjustments.

(A) A post-test year adjustment to test year data for known and measurable rate base additions may be considered only if:

(i) the addition represents a plant which would appropriately be recorded for investor-owned utilities in National Association of Regulatory Utility Commissioners (NARUC) account 101 or 102;

(ii) the addition comprises at least 10% of the utility's requested rate base, exclusive of post-test year adjustments and CWIP;

(iii) the addition is in service before the rate year begins; and

(iv) the attendant impacts on all aspects of a utility's operations, including but not limited to, revenue, expenses and invested capital, can with reasonable certainty be identified, quantified and matched. Attendant impacts are those that reasonably result as a consequence of the post-test year adjustment being proposed.

(B) Each post-test year plant adjustment described by subparagraph (A) of this paragraph will be included in rate base at the reasonable test year-end CWIP balance, if the addition is constructed by the utility, or the reasonable price, if the addition represents a purchase, subject to original cost requirements, as specified in TWC §13.185.

(C) Post-test year adjustments to historical test year data for known and measurable rate base decreases will be allowed only if:

(i) the decrease represents:

(I) plant which was appropriately recorded in NARUC account 101 or 102;

(II) plant held for future use;

(III) CWIP, not including mirror CWIP; or

(IV) an attendant impact of another post-test year adjustment.

(ii) the decrease represents a plant that has been removed from service, sold, or removed from the utility's books prior to the rate year; and

(iii) the attendant impacts on all aspects of a utility's operations, including but not limited to, revenue, expenses and invested capital, can with reasonable certainty be identified, quantified and matched. Attendant impacts are those that reasonably result as a consequence of the post-test year adjustment being proposed.

(d) **Recovery of positive acquisition adjustments.**

(1) When a utility acquires plant, property, or equipment for which commission approval is required under §24.239 of this title, relating to Sale, Transfer, Merger, Consolidation, Acquisition, Lease or Rental, 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 retail 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 transaction:

(i) the customers of the system being acquired will receive higher quality or more reliable retail 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 retail 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 utility 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 acquisition are fully disclosed to the commission 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; and

(F) the rates charged by the acquiring utility to its pre-acquisition customers will not increase unreasonably because of the acquisition.

(2) The owner of the acquired retail public utility and the final acquiring utility must not be affiliated. In a multi-stage transaction in which a purchase of voting stock or acquisition of controlling interest transaction under §24.243 of this title, relating to Purchase of Voting Stock or Acquisition of Controlling Interest in a Utility, is followed by a transfer of assets in what is essentially a single sales transaction, a positive acquisition adjustment is allowed only where the multi-stage transaction was fully disclosed to the commission in the application for approval of the initial stock or change of controlling interest transaction.

(3) 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.

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

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

(e) **Negative acquisition adjustment.** When a utility acquires plant, property, or equipment under §24.239 of this title, relating to Sale, Transfer, Merger, Consolidation, Acquisition, Lease or Rental, and the original cost of the acquired property less depreciation exceeds the actual purchase price, the utility must record the negative acquisition adjustment separately from the original cost of the acquired property. For purposes of ratemaking, the following will apply:

(1) If a utility acquires plant, property, or equipment from a nonfunctioning retail public utility through a sale, transfer, or merger, receivership, or the utility is acting as a temporary manager, a negative acquisition adjustment must be recorded and amortized on the utility's books with no effect on the utility's rates.

(2) If a utility acquires plant, property, or equipment from a retail public utility through a sale, transfer, or merger and paragraph (1) of this subsection does not

apply, the commission may recognize the negative acquisition adjustment in the ratemaking proceeding, by ordering the amortization of the negative acquisition adjustment through a bill credit for a defined period of time or by other means determined appropriate by the commission. Except for good cause found by the commission, the negative acquisition adjustment will not be used to reduce the balance of invested capital.

(3) Notwithstanding paragraph (2) of this subsection, the acquiring utility may show cause as to why the commission should not account for the negative acquisition adjustment in the ratemaking proceeding.

(f) Subsections (d) and (e) of this section do not apply to plant, property, or equipment acquired through a transaction based on the fair market valuation process set forth in §24.238 of this title, relating to Fair Market Valuation.

(g) Intangible assets will not be allowed in rate base unless the requirements in paragraphs (1), (2) and (3) of this subsection are met. If the requirements in paragraphs (1) and (2) of this subsection are met, but the requirement in paragraph (3) of this subsection is not met, the amount will be amortized over a reasonable period and the amortization will be allowed in the cost of service as a non-recurring expense. Unamortized amounts will not be included in rate base. The requirements are as follows:

(1) The amount requested has been verified by documentation as to amount and exact nature;

(2) Testimony establishes the reasonableness and necessity and benefit of the expense to the customers; and

(3) Testimony establishes how the amount is properly considered an actual asset purchased or installed, or a source of supply, such as water rights.

§24.238. Fair Market Valuation.

(a) **Applicability.** This section applies to a voluntary arm's length transaction between an acquiring utility and a retail public utility under TWC §13.305 for which approval is required under TWC §13.301. This section does not apply to a transaction between a utility and its affiliate.

(b) **Definitions.** In this section, the following words and terms have the following meanings, unless the context indicates otherwise.

(1) **Acquiring utility** -- A Class A or Class B utility that is acquiring a selling utility, or the facilities of a selling utility.

(2) **Allowance for funds used during construction (AFUDC)** -- An accounting practice that recognizes the capital costs, including debt and equity funds, that are used to finance a transferee's construction costs of an improvement to a purchased asset.

(3) **Fair market value** -- The average of the three appraisals conducted under subsection (f) of this section.

(4) **Ratemaking rate base** -- The dollar value of the selling utility or the sold facilities of a selling utility that is incorporated into the rate base of the acquiring utility for post-acquisition purposes. The ratemaking rate base is the lesser of the purchase price negotiated by an acquiring utility and a selling utility or the fair

market value. The ratemaking rate base does not include transaction and closing costs.

(5) **Selling utility** -- A retail public utility that is being purchased by an acquiring utility or is selling facilities to an acquiring utility.

(c) **List of qualified utility valuation experts.** The commission will maintain a list of qualified utility valuation experts to perform appraisals to determine a fair market value of a selling utility or facilities of a selling utility.

(1) A utility valuation expert may request to be included on the commission's list by submitting, under the control number designated for that purpose, the required information.

(2) The request filed by the utility valuation expert must include:

(A) The expert's name, mailing address, telephone number, and email address;

(B) The name of the company with which the expert is employed or associated, or the name under which the expert conducts business;

(C) The names of the principal officers of the company with which the expert is employed or associated, if applicable;

(D) The name and mailing addresses of any affiliates of the company with which the expert is employed or associated, if applicable; and

(E) A detailed description of the utility valuation expert's qualifications, such as professional licensing, certifications, training or past experience conducting economic evaluations of water and sewer utilities.

(3) The utility valuation expert must update the information in its request on file with the commission within ten business days of a material change to the information.

(4) A utility valuation expert who wishes to be removed from the list maintained by the commission under this subsection must file a letter with the commission requesting to be removed from the list. This letter must be filed under the control number designated for that purpose. The commission will acknowledge the removal request in writing.

(d) **Notice of intent to determine fair market value.**

(1) A selling utility and an acquiring utility that agree to use the fair market valuation process described in subsection (f) of this section must file a notice of intent to determine fair market value in the control number designated for that purpose.

(2) The notice of intent must include the following:

(A) The name and certificate of convenience and necessity (CCN) number of the acquiring utility. If the acquiring utility holds multiple CCN numbers, the acquiring utility must provide all the CCN numbers.

(B) The name and contact information of the acquiring utility's representative.

(C) The number of connections served by the acquiring utility.

(D) The name and CCN number of the selling utility.

(E) The name and contact information of the selling utility's representative.

(F) The number of connections served by the selling utility.

(G) The estimated closing date of the planned acquisition.

(H) A list of the utility valuation experts on the commission's list of qualified experts who, as of the date of the notice of intent, are precluded under subsection (e)(2)(B) of this section from performing an appraisal of the transaction.

(3) The notice of intent must not include the purchase price agreed upon by the acquiring utility and the selling utility.

(e) **Selection of utility valuation experts.**

(1) The commission's executive director or the executive director's designee will select three utility valuation experts from the list maintained under subsection (c) of this section no later than 30 days after the filing of a notice of intent to determine fair market value that meets the requirements of subsection (d) of this section.

(2) The utility valuation experts selected under paragraph (1) of this subsection may not:

(A) derive material or financial benefit from the sale other than fees for services rendered;

(B) be or have been within the year preceding the date the service contract is executed a director, officer, or employee of the acquiring utility or the selling utility or an immediate family member of a director, officer, or employee of the acquiring utility or the selling utility; or

(C) have received compensation under a contract for consulting or other services with the acquiring or selling utility, or executed a contract for consulting or other services with the acquiring or selling utility, within the year preceding the date the utility valuation expert is selected.

(3) The commission's executive director or the executive director's designee will base the selection of utility valuation experts on the following:

(A) Qualifications of the utility valuation expert.

(B) Availability of the utility valuation expert during the required time frame.

(C) Absence of conflicts of interest described in paragraph (2) of this subsection.

(D) Other factors relevant to a utility valuation expert's ability to perform an appraisal under this section.

(4) The acquiring utility must contract directly with the selected utility valuation experts and the commission will not be a party to the contract. Subsection (k)(2) of this section, which limits the amount of transaction and closing costs that may be recovered in rates, does not apply to the fees for service agreed to in the contract. If the acquiring utility and any of the utility valuation experts selected under subsection (e)(1) of this subsection are unable to reach agreement on the terms and conditions for performing the appraisal, including the amount of the service fee, the acquiring utility or utility valuation expert may submit a request for selection of a different utility valuation expert under the control number designated for that purpose. If the commission's executive director or the executive director's designee selects a different utility valuation expert, the time period for all utility valuation expert to submit a report under subsection (f)(5) of this section begins when the different utility valuation expert is selected.

(f) **Determination of fair market value**.

(1) The three utility valuation experts selected under subsection (e) of this section jointly must retain a licensed engineer to conduct an assessment of the tangible assets of the selling utility or the facilities to be sold to the acquiring utility.

(A) The engineer may not be or have been within one year preceding the date the service contract is executed a director, officer, or employee of the acquiring utility or the selling utility or an immediate family member of a director, officer, or employee of the acquiring utility or the selling utility.

(B) The engineer must provide the following information to the valuation experts:

(i) Qualifications that demonstrate the engineer's ability to provide the requested assessment;

(ii) The engineer's fees for other similar assessments; and

(iii) Other relevant information requested by the utility valuation experts.

(C) The engineer's assessment must include a separate assessment for each type of facility based on the applicable National Association of Regulatory Utility Commissioners (NARUC) account for the facility.

(D) The fee charged by the engineer must be shared and paid equally by the three utility valuation experts and may be included as part of the utility valuation expert compensation under subsection (k) of this section.

(2) Each utility valuation expert must perform an independent appraisal of the selling utility, including the valuation of intangible assets as appropriate, in compliance with Uniform Standards of Professional Appraisal Practice, using the cost, market, and income approaches in accordance with subsections (g) through (i) of this section.

(3) The appraisal must not take into account the original sources of funding, including developer contributions or customer contributions in aid of construction, for any of the utility plant that is assessed by the engineer or the utility valuation experts.

(4) The appraisal must not take into account the purchase price negotiated by the acquiring utility and the selling utility or methodologies or process used to arrive at the purchase price.

(5) Each utility valuation expert must submit a completed report to the acquiring utility and the selling utility no later than 120 days after the date the commission's executive director or the executive director's designee selects the utility valuation expert under subsection (e) of this section. Before the submission of the report, the acquiring and selling utilities must review the report for mathematical and factual errors, and notify the utility valuation expert of any mathematical any factual errors they identify. The utility valuation expert may promptly revise the report in response to the utilities' notification.

(6) The ratemaking rate base established under this section will be the rate base for the system or facilities acquired in the transaction. Nothing in this section alters the requirements for multiple system consolidation in §24.25(k) of this title, relating to Form and Filing of Tariffs.

(g) **Cost approach.**

(1) A cost approach appraisal performed under this section must be based on one of the following:

(A) the investment required to replace or reproduce future service capability; or

(B) the original cost of the facilities as adjusted for depreciation.

(2) A cost approach appraisal performed under this section must:

(A) incorporate the results of the assessment performed by the engineer selected under subsection (f)(1) of this section;

(B) exclude from consideration overhead costs, future improvements, and going concern value; and

(C) use a consistent rate of inflation for all classes of assets unless use of different rates is reasonably justified.

(h) **Income approach.**

(1) An income approach appraisal performed under this section must be based on one of the following:

(A) capitalization of earnings or cash flow; or

(B) the discounted cash flow method.

(2) An income approach appraisal performed under this section must exclude consideration of the following:

(A) going concern value;

(B) future capital improvements; and

(C) erosion of cash flow or erosion on return.

(3) An income approach appraisal performed under this section must be supported by the following:

(A) an explanation of how the capitalization rate was calculated, if a capitalization rate was used;

(B) an explanation of the basis for the discount rates used; and

(C) an explanation of the capital structure, cost of equity and cost of debt used.

(i) **Market approach.**

(1) A market approach appraisal performed under this section must be based on the following:

(A) the current connection count of the selling utility at the time of the appraisal;

(B) use of a proxy group that includes companies that have made acquisitions that were not based on a fair market valuation methodology; or

(C) comparable sales that did not include the value of future capital improvement projects in the selling price.

(2) A market approach appraisal performed under this section must not consider the following:

(A) a net book financials multiplier or speculative growth adjustments;

(B) the value of future capital improvement projects; or

(C) a value or adjustment for the goodwill of the selling utility.

(j) **Contents of utility valuation expert report.** A report submitted under paragraph (f)(5) of this section must include:

(1) a copy of the service contract executed by the utility valuation expert and the acquiring and selling utilities;

(2) the fee charged by the utility valuation expert along with documentation supporting the amount of the fee;

(3) a copy of the engineer's report, including a detailed list of the utility plant assessed by the engineer;

(4) an explanation of how the cost, market, and income approaches were incorporated into the calculation of the fair market value of the selling utility or the selling utility's facilities; and

(5) a notarized affidavit stating that:

(A) the appraisals described in the report were conducted in compliance with the most recent edition of the Uniform Standards of Professional Appraisal Practice;

(B) the utility valuation expert will not derive material or financial benefit from the sale other than the fee for services rendered;

(C) the utility valuation expert is not currently and was not within the year preceding the date of the contract for service executed between the utility valuation expert and the acquiring and selling utilities, a director, officer, or employee of the acquiring utility or the selling utility or an immediate family member of a director, officer, or employee of the acquiring utility or the selling utility; and

(D) the utility valuation expert did not receive compensation under a contract for consulting or other services with the acquiring utility or selling utility, or execute a contract for consulting or other services with the acquiring or selling utility, within the year preceding the date the utility valuation

expert was selected to perform the appraisal that is the subject of the report.

(k) **Transaction and closing costs.**

(1) A fee paid to a utility valuation expert to perform an appraisal under subsection (f) of this section may be included in the transaction and closing costs associated with a transaction approved under §24.239 of this title, relating to Sale, Transfer, Merger, Consolidation, Acquisition, Lease or Rental.

(2) The commission will review the transaction and closing costs, including fees paid to utility valuation experts, in the rate case in which the acquiring utility requests rate recovery of those costs. The fee amounts included in transaction and closing costs that are recoverable in the acquiring utility's rates may not exceed the lesser of:

(A) five percent of the fair market value; or

(B) the fee amounts approved by the commission in the rate case in which the acquiring utility requests rate recovery of the transaction and closing costs.

§24.239. Sale, Transfer, Merger, Consolidation, Acquisition, Lease, or Rental.

(a) **Application for approval of transaction.** Any water supply or sewer service corporation, or water and sewer utility, owned by an entity required to possess a certificate of convenience and necessity (CCN) must, and a retail public utility that possesses a CCN may, file a written application with the commission and give public notice of any sale, transfer, merger, consolidation, acquisition, lease, or rental at least 120 days before the effective date of the transaction. The 120-day period begins on the most recent of:

(1) the last date the applicant mailed the required notice as stated in the applicant's affidavit of notice; or

(2) the last date of the publication of the notice in the newspaper as stated in the affidavit of publication, if required.

(b) **Intervention period.** The intervention period for an application filed under this section must not be less than 30 days. The presiding officer may order a shorter intervention period for good cause shown.

(c) **Notice.**

(1) Unless notice is waived by the commission, proper notice must be given to affected customers and to other affected parties as required by the commission on the form prescribed by the commission. The notice must include the following:

(A) the name and business address of the utility currently holding the CCN (transferor) and the retail public utility or person that will acquire the facilities or CCN (transferee);

(B) a description of the requested area;

(C) the following statement: "Persons who wish to intervene in the proceeding or comment upon the action sought should contact the Public Utility Commission, P.O. Box 13326, Austin, Texas 78711-3326, or call the Public Utility Commission at (512) 936-7120 or (888) 782-8477. Hearing- and speech-impaired individuals with text telephones (TTY) may contact the commission at (512) 936-7136. The deadline for intervention in the proceeding is (date 30 days from the mailing or publication of notice, whichever occurs later, unless otherwise provided by the presiding officer). If you wish to intervene, the commission must receive your letter requesting intervention or motion to intervene by that date."; and

(D) if the transferor is a nonfunctioning utility with a temporary rate in effect and the transferee is requesting that the temporary rate remain in effect under TWC §13.046(d), the following information:

(i) the temporary rates currently in effect for the nonfunctioning utility; and

(ii) the duration of time for which the transferee is requesting that the temporary rates remain in effect.

(2) The transferee must mail the notice to cities and neighboring retail public utilities providing the same utility service whose corporate limits or certificated service area boundaries are within two miles from the outer boundary of the requested area, and any city with an extraterritorial jurisdiction that overlaps the requested area.

(3) The commission may require the transferee to publish notice once each week for two consecutive weeks in a newspaper of general circulation in each county in which the retail public utility being transferred is located. The commission may allow published notice in lieu of individual notice as required by paragraph (2) of this subsection.

(4) The commission may waive published notice if the requested area does not include unserved area, or for good cause shown.

(d) **Requirements for application with fair market valuation.**

(1) An application filed under this section for approval of a transaction that includes a fair market valuation of the transferee or the transferee's facilities that was determined using the process established in §24.238 of this title, relating to Fair Market Valuation must include:

(A) copies of the three appraisals performed under §24.238(f);

(B) the purchase price agreed to by the transferor and transferee;

(C) the transaction and closing costs incurred by the transferee that will be requested to be included in the transferee's rate base; and

(D) if applicable, a copy of the transferor's commission-approved tariff that contains the rates in effect at the time of the acquisition.

(2) The commission will review the transaction and closing costs, including fees paid to appraisers, in the rate case in which the transferee requests rate recovery of those costs

(e) A retail public utility or person that files an application under this section to purchase, transfer, merge, acquire, lease, rent, or consolidate a utility or system must demonstrate

adequate financial, managerial, and technical capability for providing continuous and adequate service to the requested area and the transferee's certificated service area as required by §24.227(a) of this title, relating to Criteria for Granting or Amending a Certificate of Convenience and Necessity.

(f) If the transferee cannot demonstrate adequate financial capability, the commission may require that the transferee provide financial assurance to ensure continuous and adequate retail water or sewer utility service is provided to both the requested area and any area already being served under the transferee's existing CCN. The commission will set the amount of financial assurance. The form of the financial assurance must meet the requirements of §24.11 of this title relating to Financial Assurance. The obligation to obtain financial assurance under this title does not relieve an applicant from any requirements to obtain financial assurance to satisfy another state agency's rules.

(g) The commission will, with or without a public hearing, investigate the sale, transfer, merger, consolidation, acquisition, lease, or rental to determine whether the transaction will serve the public interest. If the commission decides to hold a hearing, or if the transferee fails either to file the application as required or to provide public notice, the transaction proposed in the application may not be completed unless the commission determines that the proposed transaction serves the public interest.

(h) Before the expiration of the 120-day period described in subsection (a) of this section, the commission will determine whether to require a public hearing to determine if the transaction will serve the public interest. The commission will notify the transferee, the transferor, all intervenors, and the Office of Public Utility Counsel whether a hearing will be held. The commission may require a hearing if:

(1) the application filed with the commission or the public notice was improper;

(2) the transferee has not demonstrated adequate financial, managerial, and technical capability for providing continuous and adequate service to the requested area and any area already being served under the transferee's existing CCN;

(3) the transferee has a history of:

(A) noncompliance with the requirements of the Texas Commission on Environmental Quality (TCEQ), the commission, or the Texas Department of State Health Services; or

(B) continuing mismanagement or misuse of revenues as a utility service provider;

(4) the transferee cannot demonstrate the financial ability to provide the necessary capital investment to ensure the provision of continuous and adequate service to the requested area; or

(5) there are concerns that the transaction does not serve the public interest based on consideration of the following factors:

(A) the adequacy of service currently provided to the requested area;

(B) the need for additional service in the requested area;

(C) the effect of approving the transaction on the transferee, the transferor, and any retail public utility of the same kind already serving the area within two miles of the boundary of the requested area;

(D) the ability of the transferee to provide adequate service;

(E) the feasibility of obtaining service from an adjacent retail public utility;

(F) the financial stability of the transferee, including, if applicable, the adequacy of the debt-equity ratio of the transferee if the transaction is approved;

(G) environmental integrity;

(H) the probable improvement of service or lowering of cost to consumers in the requested area resulting from approving the transaction; and

(I) whether the transferor or the transferee has failed to comply with any commission or TCEQ order. The commission may refuse to approve a sale, transfer, merger, consolidation, acquisition, lease, or rental if conditions of a judicial decree, compliance agreement, or other enforcement order have not been substantially met.

(i) If the commission does not require a public hearing, the sale, transfer, merger, consolidation, acquisition, lease, or rental may be completed as proposed:

(1) at the end of the 120-day period described in subsection (a) of this section; or

(2) at any time after the transferee receives notice from the commission that a hearing will not be required.

(j) Within 30 days of the commission order that approves the sale, transfer, merger, consolidation, acquisition, lease, or rental to proceed as proposed, the transferee must provide a written update on the status of the transaction, and every 30 days thereafter, until the transaction is complete. The transferee must inform the commission of any material changes in its financial, managerial, and technical capability to provide continuous and adequate service to the requested area and the transferee's service area.

(k) If there are outstanding customer deposits, within 30 days of the actual effective date of the transaction, the transferor and the transferee must file with the commission, the following information supported by a notarized affidavit:

(1) the names and addresses of all customers who have a deposit on record with the transferor;

(2) the date such deposit was made;

(3) the amount of the deposit; and

(4) the unpaid interest on the deposit. All such deposits must be refunded to the customer or transferred to the transferee, along with all accrued interest.

(l) Within 30 days after the actual effective date of the transaction, the transferee and the transferor must file a signed contract, bill of sale, or other appropriate documents as evidence that the transaction has closed as proposed. The signed contract, bill of sale, or other documents, must be signed by both the transferor and the transferee. If there were outstanding customer deposits, the transferor and the transferee must also file documentation that customer deposits have been transferred or refunded to the customers with interest as required by this section.

(m) The commission's approval of a sale, transfer, merger, consolidation, acquisition, lease, or rental of any water or sewer system or retail public utility expires 180 days following the date of the commission order allowing the transaction to proceed. If the sale has not been completed within that 180-day time period, the approval is void, unless the commission in writing extends the time period.

(n) If the commission does not require a hearing, and the transaction is completed as proposed, the commission may issue an order approving the transaction.

(o) A sale, transfer, merger, consolidation, acquisition, lease, or rental of any water or sewer system or retail public utility required by law to possess a CCN, or transfer of customers or service area, owned by an entity required by law to possess a CCN that is not completed in accordance with the provisions of TWC §13.301 is void.

(p) The requirements of TWC §13.301 do not apply to:

(1) the purchase of replacement property;

(2) a transaction under TWC §13.255; or

(3) foreclosure on the physical assets of a utility.

(q) If a utility's facility or system is sold and the utility's facility or system was partially or wholly constructed with customer contributions in aid of construction derived from specific surcharges approved by the regulatory authority over and above revenues required for normal operating expenses and return, the utility may not sell or transfer any of its assets, its CCN, or a controlling interest in an incorporated utility, unless the utility provides a written disclosure relating to the contributions to both the transferee and the commission before the date of the sale or transfer. The disclosure must contain, at a minimum, the total dollar amount of the contributions and a statement that the contributed property or capital may not be included in invested capital or allowed depreciation expense by the regulatory authority in rate-making proceedings. This subsection does not apply to a utility facility or system sold as part of a transaction where the transferor and transferee elected to use the fair market valuation process set forth in §24.238 of this title, relating to Fair Market Valuation.

(r) For any transaction subject to this section, the retail public utility that proposes to sell, transfer, merge, acquire, lease, rent, or consolidate its facilities, customers, service area,

or controlling interest must provide the other party to the transaction a copy of this section before signing an agreement to sell, transfer, merge, acquire, lease, rent, or consolidate its facilities, customers, service area, or controlling interest.

§24.243. Purchase of Voting Stock or Acquisition of a Controlling Interest in a Utility.

(a) A utility may not purchase voting stock, and a person may not acquire a controlling interest, in a utility doing business in this state unless the utility or person files a written application with the commission no later than the 61st day before the date on which the transaction is to occur. A controlling interest is defined as:

(1) a person or a combination of a person and the person's family members that possess at least 50% of a utility's voting stock; or

(2) a person that controls at least 30% of a utility's voting stock and is the largest stockholder.

(b) A person acquiring a controlling interest in a utility is required to demonstrate adequate financial, managerial, and technical capability for providing continuous and adequate service to the requested area and to the person's certificated service area, if any.

(c) If the person acquiring a controlling interest cannot demonstrate adequate financial capability, the commission may require the person to provide financial assurance to ensure continuous and adequate utility service is provided to the service area. The commission will set the amount of financial assurance. The form of the financial assurance must be as specified in §24.11 of this title relating to Financial Assurance. The obligation to obtain financial assurance under this chapter does not relieve an applicant from any requirements to obtain financial assurance in satisfaction of another state agency's rules.

(d) The commission may require a public hearing on the transaction if a criterion prescribed by §24.239(k) of this title relating to Sale, Transfer, Merger, Consolidation, Acquisition, Lease, or Rental applies.

(e) Unless the commission requires that a public hearing be held, the purchase or acquisition may be completed as proposed:

(1) at the end of the 60-day period; or

(2) at any time after the commission notifies the person or utility that a hearing will not be required.

(f) If a hearing is required or if the person or utility fails to make the application to the commission as required, the purchase of voting stock or acquisition of a controlling interest may not be completed unless the commission determines that the proposed transaction serves the public interest. A purchase or acquisition that is not completed in accordance with the provisions of this section is void.

(g) The utility or person must notify the commission within 30 days after the date that the transaction is completed.

(h) Within 30 days of the commission order that allows a utility's purchase of voting stock or a person's acquisition of a controlling interest to proceed as proposed, the utility purchasing voting stock or the person acquiring a controlling interest must file a written update on the status of the transaction. A written update must also be filed every 30 days thereafter, until the transaction has been completed.

(i) The commission's approval of a utility's purchase of voting stock or a person's acquisition of a controlling interest in a utility expires 180 days after the date of the commission order approving the transaction as proposed. If the transaction has not been completed within the 180-day time period, and unless the utility purchasing voting stock or the person acquiring a controlling interest has requested and received an extension for good cause from the commission, the approval is void.

This agency certifies that the adoption has been reviewed by legal counsel and found to be a valid exercise of the agency's legal authority. It is therefore ordered by the Public Utility Commission of Texas that the repeal of 16 TAC §24.41, relating to cost of service, and the adoption of new 16 TAC §24.41, relating to cost of service, adoption of new 16 TAC §24.238, relating to fair market value, and amendments to 16 TAC §24.239, relating to sale, transfer, merger, consolidation, acquisition, lease or rental, and 16 TAC §24.243, relating to purchase of voting stock or acquisition of a controlling interest in a utility are hereby adopted with changes to the text as proposed.

Signed at Austin, Texas the _____ day of July 2020.

PUBLIC UTILITY COMMISSION OF TEXAS

DEANN T. WALKER, CHAIRMAN

ARTHUR C. D'ANDREA, COMMISSIONER

SHELLY BOTKIN, COMMISSIONER

q:\cadm\txr-rules management\rules\rulemaking projects\ch 24 water\40xxx\49813\49813adt.doc