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## Public Utility Commission of Texas

August 19, 2020

Dear Subscriber:

Enclosed is one new and three amended water rules as recently adopted:

### Chapter 24 — Substantive Rules Applicable to Water and Sewer Service Providers.

<u>Project</u>	<u>Section</u>	<u>Title</u>	<u>Action</u>	<u>Effective Date</u>
		Table of Contents	Amended pages V to VI and XVII to XX	08/20/20
49813	§24.41	Cost of Service.	New	08/20/20
49813	§24.238	Fair Market Valuation.	Amend	08/20/20
49813	§24.239	Sale, Transfer, Merger, Consolidation, Acquisition, Lease, or Rental	Amend	08/20/20
49813	§24.243	Purchase of Voting Stock or Acquisition of a Controlling Interest in a Utility	Amend	08/20/20

Please place the new and amended rules in your rulebook in the appropriate order. The order adopting the new and amended rules can be found on the Commission's Interchange System.

If you have any questions, please call (512) 936-7244 or e-mail [andrea.gonzalez@puc.texas.gov](mailto:andrea.gonzalez@puc.texas.gov). Thank you.





**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter A. GENERAL PROVISIONS.**

**§24.1. Purpose and Scope of this Chapter.**

- (a)
- (b)
- (c)
- (d)

**§24.2. Severability Clause.**

- (a)
- (b)

**§24.3. Definitions of Terms.**

**§24.4. Cooperative Corporation Rebates.**

**§24.5. Submission of Documents.**

**§24.6. Signatories to Applications.**

- (a)
- (b)

**§24.8. Administrative Completeness.**

- (a)
- (b)
- (c)
- (d)

**§24.9. Agreements to be in Writing.**

**§24.11. Financial Assurance.**

- (a) Purpose.
- (b) Application.
- (c)
- (d) Irrevocable stand-by letter of credit.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

- (e) Financial test.

**§24.12. Burden of Proof.**

**§24.14. Emergency Orders and Emergency Rates.**

(a)

(b)

(c)

(d)

(e)

(f)

(g)

**§24.15. Notice of Wholesale Water Supply Contract.**

(a)

(b)

(c)

## **CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

### **Subchapter B. RATES AND TARIFF CHANGES.**

#### **§24.25. Form and Filing of Tariffs.**

- (a) Approved tariff.
- (b) Requirements as to size, form, identification, minor changes, and filing of tariffs.
- (c) Composition of tariffs.
- (d) Tariff filings in response to commission orders.
- (e) Availability of tariffs.
- (f) Rejection.
- (g) Change by other regulatory authorities.
- (h) Effective date.
- (i) Tariffs filed by water supply or sewer service corporations.
- (j) Temporary water rate provision for mandatory water use reduction.
- (k) Multiple system consolidation.
- (l) Regional rates.
- (m) Exemption.
- (n) Energy cost adjustment clause.

#### **§24.27. Notice of Intent and Application to Change Rates.**

- (a) Purpose.
- (b) Contents of Application.
- (c) Notice requirements specific to applications filed by a Class A Utility under TWC §13.187.
- (d) Notice requirements specific to applications filed by Class B, C, and D utilities.
- (e) Line extension and construction policies.
- (f) Capital improvements surcharge.
- (g) Debt repayments surcharge.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**§24.29. Time between Filings.**

- (a) Application.
- (b)
- (c)

**§24.31. Jurisdiction over Affiliated Interests.**

- (a)
- (b)

**§24.33. Suspension of the Effective Date of Rates.**

- (a)
- (b)
- (c)
- (d)
- (e)
- (f)
- (g)

**§24.35. Processing and Hearing Requirements for an Application to Change Rates.**

- (a) Purpose.
- (b) Proceedings under TWC §13.187.
- (c) Proceedings under TWC §13.1871.
- (d)
- (e)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**§24.37. Interim Rates.**

- (a)
- (b)
- (c)
- (d)
- (e)
- (f)
- (g)
- (h)
- (i)
- (j)

**§24.39. Escrow of Proceeds Received under Rate Increase.**

- (a)
- (b)

**§24.41. Cost of Service.**

- (a) Components of cost of service.
- (b) Allowable expenses.
- (c) Return on rate base.
- (d) Recovery of positive acquisition adjustments.
- (e) Negative acquisition adjustment.
- (f)
- (g)

**§24.43. Rate Design.**

- (a) General.
- (b) Conservation.
- (c) Volume charges.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**§24.44. Rate-case Expenses.**

- (a)
- (b)
- (c)
- (d)
- (e)

**§24.45. Rates Charged by a Municipality to a District.**

- (a)
- (b)
- (c)

**§24.46. Fees Charged by a Municipality to a Public School District.**

- (a)
- (b)
- (c)

**§24.47. Jurisdiction of Commission over Certain Water or Sewer Supply Corporations.**

- (a)
- (b)

**§24.49. Application for a Rate Adjustment by a Class D Utility Under Texas Water Code §13.1872.**

- (a) Purpose.
- (b) Definitions.
- (c) Requirements for filing of the application.
- (d) Processing of the application.
- (e) Notice of Approved Rates.
- (f) Time between filings.



**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER  
SERVICE PROVIDERS.**

**Subchapter C: ALTERNATIVE RATE METHODS.**

**§24.75. Alternative Rate Methods.**

- (a) Alternative rate methods.
- (b) Phased and multi-step rate changes.
- (c) Cash needs method.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter D: RATE-MAKING APPEALS.**

**§24.101. Appeal of Rate-making Decision, Pursuant to the Texas Water Code §13.043.**

- (a)
- (b)
- (c)
- (d)
- (e)
- (f)
- (g)
- (h)
- (i)
- (j)

**§24.103. Contents of Petition Seeking Review of Rates Pursuant to the Texas Water Code §13.043(b).**

- (a)
- (b)
- (c)

**§24.105. Refunds During Pendency of Appeal.**

**§24.107. Seeking Review of Rates for Sales of Water Under the Texas Water Code §12.013.**

- (a)
- (b)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter E: RECORDS AND REPORTS.**

**§24.125. General Reports.**

- (a) Who shall file.
- (b) Report attestation.
- (c) Due dates of reports.
- (d) Information omitted from reports.
- (e) Special and additional reports.
- (f) Report amendments.
- (g) Penalty for refusal to file on time.

**§24.127. Financial Records and Reports--Uniform System of Accounts.**

**§24.129. Water and Sewer Utilities Annual Reports.**

- (a)
- (b) Contents of report.
- (c)

**§24.131. Maintenance and Location of Records.**

**§24.133. Management Audits.**

**§24.134. Financial, Managerial, and Technical Reports Required for Water and Sewer Utilities.**

- (a) Applicability.
- (b) Notification of violation.
- (c) Notification to utility.
- (d) Report required.
- (e) No additional report required.
- (f) Failure to report.

**§24.135. Regulatory Assessment.**

- (a)
- (b)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

- (c)
- (d)
- (e)

## **CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

### **Subchapter F: CUSTOMER SERVICE AND PROTECTION.**

#### **§24.151. Applicability.**

#### **§24.153. Customer Relations.**

- (a) Information to customers.
- (b) Customer complaints.
- (c) Telephone number.
- (d) Local office.

#### **§24.155. Resolution of Disputes.**

- (a)
- (b)

#### **§24.157. Refusal of Service.**

- (a) Grounds for refusal to serve.
- (b) Service Applicant's recourse.
- (c) Insufficient grounds for refusal to serve.

#### **§24.159. Service Applicant and Customer Deposit.**

- (a) Deposit on Tariff.
- (b) Customers not disconnected.
- (c) Applicants 65 years of age or older.
- (d) Interest on deposits.
- (e) Landlords/tenants.
- (f) Reestablishment of credit or deposit.
- (g) Records of deposits.
- (h) Refund of deposit.
- (i) Transfer of service.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**§24.161. Response to Requests for Service by a Retail Public Utility Within Its Certificated Area.**

- (a)
- (b)
- (c)
- (d) Easements.
- (e) Service Extensions by a Water Supply or Sewer Service Corporation or Special Utility District.

**§24.163. Service Connections.**

- (a) Water Service Connections.
- (b) Sewer Service Connections.
- (c) Line extension and construction charges.
- (d) Cost utilities and service applicants shall bear.
- (e) Other Fees for Service Applicants.

**§24.165. Billing.**

- (a) Authorized rates.
- (b) Due date.
- (c) Penalty on delinquent bills for retail service.
- (d) Deferred payment plan.
- (e) Rendering and form of bills.
- (f) Charges for sewer service.
- (g) Consolidated billing and collection contracts.
- (h) Overbilling and underbilling.
- (i) Estimated bills.
- (j) Prorated charges for partial-month bills.
- (k) Prorated charges due to utility service outages.
- (l) Disputed bills.
- (m) Notification of alternative payment programs or payment assistance.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

- (n) Adjusted bills.
- (o) Equipment damage charges.
- (p) Fees.
- (q) Payment with cash.
- (r) Voluntary contributions for certain emergency services.

**§24.167. Discontinuance of Service.**

- (a) Disconnection with notice.
- (b) Disconnection without notice.
- (c) Disconnection prohibited.
- (d) Disconnection due to utility abandonment.
- (e) Disconnection of water service due to nonpayment of sewer charges.
- (f) Disconnection for ill customers.
- (g) Disconnection upon customer request.
- (h) Service restoration.

**§24.169. Meters.**

- (a) Meter requirements.
- (b) Meter readings.
- (c) Access to meters and utility cutoff valves.
- (d) Meter tests on request of customer.
- (e) Meter testing.
- (f) Meter test prior to installation.
- (g) Bill adjustment due to meter error.
- (h) Meter tampering.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER  
SERVICE PROVIDERS.**

**§24.171. Continuity of Service.**

- (a) Service interruptions.
- (b) Record of interruption.



**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER  
SERVICE PROVIDERS.**

**Subchapter G: QUALITY OF SERVICE.**

**§24.201. Applicability.**

**§24.203. Requirements by Others.**

(a)

(b)

**§24.205. Adequacy of Water Utility Service.**

**§24.207. Adequacy of Sewer Service.**

(a) Sufficiency of service.

(b) Sufficiency of Treatment.

(c) Maintenance of facilities.

**§24.209. Standards of Construction.**

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter H: CERTIFICATES OF CONVENIENCE AND NECESSITY.**

**§24.225. Certificate of Convenience and Necessity Required.**

- (a)
- (b)
- (c)
- (d)
- (e)

**§24.227. Criteria for Granting or Amending a Certificate of Convenience and Necessity.**

- (a)
- (b)
- (c)
- (d)
- (e)
- (f)
- (g)
- (h)
- (i)
- (j)

**§24.229. Certificate of Convenience and Necessity Not Required.**

- (a) Extension of Service.
- (b) Construction of Facilities.
- (c) Single Certification Under TWC §13.255.
- (d) Municipal Systems in Unserved Area.
- (e) Water Utility or Water Supply Corporation With Less Than 15 Potential Connections.

**§24.231. Applicant.**

- (a)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

(b)

**§24.233. Contents of Certificate of Convenience and Necessity Applications.**

- (a) Application.
- (b)
- (c) Application within the municipal boundaries or extraterritorial jurisdiction of certain municipalities.
- (d) Extension beyond extraterritorial jurisdiction.
- (e) Area within municipality.

**§24.235. Notice Requirements for Certificate of Convenience and Necessity Applications.**

- (a)
- (b)
- (c)
- (d)
- (e)

**§24.237. Action on Applications.**

- (a)
- (b)
- (c)

**§24.238. Fair Market Valuation.**

- (a) Applicability.
- (b) Definitions.
- (c) List of qualified utility valuation experts.
- (d) Notice of intent to determine fair market value.
- (e) Selection of utility valuation experts.
- (f) Determination of fair market value.
- (g) Cost approach.
- (h) Income approach.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

- (i) Market approach.
- (j) Contents of utility valuation expert report.
- (k) Transaction and closing costs.

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

- (a) Application for approval of transaction.
- (b) Intervention period.
- (c) Notice.
- (d) Requirements for application with fair market valuation.
- (e)
- (f)
- (g)
- (h)
- (i)
- (j)
- (k)
- (l)
- (m)
- (n)
- (o)
- (p)
- (q)
- (r)

**§24.241. Foreclosure and Bankruptcy.**

- (a)
- (b)
- (c)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

(d)

(e)

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

(a)

(b)

(c)

(d)

(e)

(f)

(g)

(h)

(i)

**§24.245. Revocation of a Certificate of Convenience and Necessity or Amendment of a Certificate of Convenience and Necessity by Decertification, Expedited Release, or Streamlined Expedited Release.**

(a) Applicability.

(b) Definitions.

(c) Provisions applicable to all proceedings for revocation, decertification amendment, expedited release, or streamlined expedited release.

(d) Revocation or amendment by decertification.

(e) Decertification amendment for a municipality's service area.

(f) Expedited release.

(g) Determination of compensation to former CCN holder after revocation, decertification amendment or expedited release.

(h) Streamlined expedited release.

(i) Determination of compensation to former CCN holder after streamlined expedited release.

(j) Valuation of real and personal property of the former CCN holder.

(k) Mapping information.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

- (l) Additional conditions for decertification under subsection (d) of this section.

**§24.247. Requirement to Provide Continuous and Adequate Service.**

- (a)
- (b)
- (c)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**§24.249. Cessation of Operations by a Retail Public Utility.**

- (a)
- (b)
- (c)
- (d)
- (e)
- (f)
- (g)
- (h)
- (i)
- (j)

**§24.251. Exclusiveness of Certificates.**

- (a)
- (b)

**§24.253. Contracts Valid and Enforceable.**

- (a)
- (b)
- (c)

**§24.255. Contents of Request for Cease and Desist Order by the Commission Under TWC §13.252.**

- (a)
- (b)

**§24.257. Mapping Requirements for Certificate of Convenience and Necessity Applications.**

- (a)
- (b)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**§24.259. Single Certification in Incorporated or Annexed Areas.**

- (a) Applicability.
- (b) Definitions.
- (c) Notice of intent to provide service in incorporated or annexed areas.
- (d) Written agreement regarding service to area.
- (e) Application for single certification.
- (f) Notices for single-certification application.
- (g) Response to single-certification application.
- (h) Referral to SOAH.
- (i) Hearing at SOAH.
- (j) Interim order.
- (k) Administrative Completeness.
- (l) Valuation of real property.
- (m) Valuation of personal property.
- (n) Valuation Process.
- (o) Action after receipt of appraisals.
- (p) Appeal to district court judgment, and transfer of property.
- (q) Withdrawal of application for single certification.
- (r) Additional requirements regarding certain current CCN holders.
- (s) Notice of single certification.
- (t) Provision of notice.
- (u) Additional conditions.



**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter I: WATER UTILITY SUBMETERING AND ALLOCATION.**

**§24.275. General Rules and Definitions.**

- (a) Purpose and Scope.
- (b) Application.
- (c) Definitions.

**§24.277. Owner Registration and Records.**

- (a) Registration.
- (b) Water quantity measurement.
- (c) Plumbing system requirement.
- (d) Installation of individual meters.
- (e) Records.
- (f) Records retention.
- (g) Availability of records.

**§24.279. Rental Agreement.**

- (a) Rental agreement.
- (b) Requirements to provide rules.
- (c) Tenant agreement to billing method changes.
- (d) Change from submetered to allocated billing.
- (e) Waiver of tenant rights prohibited.

**§24.281. Charges and Calculations.**

- (a) Prohibited charges.
- (b) Dwelling unit base charge.
- (c) Customer Service charge.
- (d) Calculations for submetered utility service.
- (e) Calculations for allocated utility service.
- (f) Conversion to approved allocation method.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**§24.283. Billing.**

- (a) Monthly billing of total charges.
- (b) Rendering bill.
- (c) Submeter reading schedule.
- (d) Billing period.
- (e) Multi-item bill.
- (f) Information on bill.
- (g) Information on submetered service.
- (h) Due date.
- (i) Estimated bill.
- (j) Payment by tenant.
- (k) Overbilling and underbilling.
- (l) Disputed bills.
- (m) Late fee.

**§24.285. Complaint Jurisdiction.**

- (a) Jurisdiction.
- (b) Complaints.

**§24.287. Submeters or Point-of-Use Submeters and Plumbing Fixtures.**

- (a) Submeters or point-of-use submeters.
- (b) Plumbing fixtures.
- (c) Plumbing fixture not applicable.

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter J: WHOLESALE WATER OR SEWER SERVICE.**

**§24.301. Petition or Appeal Concerning Wholesale Rate.**

**§24.303. Definitions.**

**§24.305. Petition or Appeal.**

(a)

(b)

(c)

**§24.307. Commission's Review of Petition or Appeal Concerning Wholesale Rate.**

(a)

(b)

(c)

(d)

**§24.309. Evidentiary Hearing on Public Interest.**

(a)

(b)

(c)

(d)

**§24.311. Determination of Public Interest.**

(a)

(b)

**§24.313. Commission Action to Protect Public Interest, Set Rate.**

(a)

(b)

(c)

(d)

(e)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER  
SERVICE PROVIDERS.**

**§24.315. Determination of Cost of Service.**

(a)

(b)

**§24.317. Burden of Proof.**

**§24.319. Commission Order to Discourage Succession of Rate Disputes.**

(a)

(b)

(c)

**§24.321. Filing of Rate Data.**

(a)

(b)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter K: ENFORCEMENT, SUPERVISION AND RECEIVERSHIP.**

**§24.351. Enforcement Action**

**§24.353. Supervision of Certain Utilities.**

(a)

(b)

(c)

**§24.355. Operation of Utility that Discontinues Operation or is Referred for Appointment of a Receiver.**

(a)

(b)

(c)

(d)

**§24.357. Operation of a Utility by a Temporary Manager.**

(a)

(b)

(c)

(d)

(e)

(f)

(g)

(h)

(i)

**§24.359. Fines and Penalties.**

(a)

(b)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER  
SERVICE PROVIDERS.**

**§24.361. Municipal Rates for Certain Recreational Vehicle Parks.**

- (a)
- (b)
- (c)

**§24.363. Temporary Rates for Services Provided for a Nonfunctioning System.**

- (a)
- (b)
- (c)
- (d)

**CHAPTER 24: SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter L: PROVISIONS REGARDING MUNICIPALITIES.**

**§24.375. Jurisdiction of Municipality: Surrender of Jurisdiction.**

(a)

(b)

**§24.377. Applicability of Commission Service Rules Within the Corporate Limits of a Municipality.**

**§24.379. Notification Regarding Use of Revenue.**

**§24.381. Fair Wholesale Rates for Wholesale Water Sales to a District.**

(a)

(b)





**CHAPTER 24. SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter B. RATES AND TARIFFS.**

**§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.



## CHAPTER 24. SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.

### Subchapter H. CERTIFICATES OF CONVENIENCE AND NECESSITY.

#### §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.

## CHAPTER 24. SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.

### Subchapter H. CERTIFICATES OF CONVENIENCE AND NECESSITY.

#### §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.



**CHAPTER 24. SUBSTANTIVE RULES APPLICABLE TO WATER AND SEWER SERVICE PROVIDERS.**

**Subchapter H. CERTIFICATES OF CONVENIENCE AND NECESSITY.**

**§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.

