

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

Subchapter B. RATES, RATE-MAKING, AND RATES/TARIFF CHANGES.

§24.34. Alternative Rate Methods.

- (a) **Alternative rate methods.** To ensure that retail customers receive a higher quality, more affordable, or more reliable water or sewer service, to encourage regionalization, or to maintain financially stable and technically sound utilities, the commission may utilize alternate methods of establishing rates. The commission shall assure that rates, operations, and service are just and reasonable to the consumers and to the utilities. The commission may prescribe modified rate filing packages for these alternate methods of establishing rates.
- (b) **Phased and multi-step rate changes.** In a rate proceeding under TWC §13.187 or §13.1871, the commission may authorize a phased, stepped, or multi-year approach to setting and implementing rates to eliminate the requirement that a utility file another rate application.
- (1) A utility may request to use the phased or multi-step rate method:
 - (A) to include the capital cost of installation of utility plant items that are necessary to improve service or achieve compliance with TCEQ or commission regulations in the utility's rate base and operating expenses in the revenue requirement when facilities are placed in service;
 - (B) to provide additional construction funds after major milestones are met;
 - (C) to provide assurance to a lender that rates will be immediately increased when facilities are placed in service;
 - (D) to allow a utility to move to metered rates from unmetered rates as soon as meters can be installed at all service connections;
 - (E) to phase in increased rates when a utility has been acquired by another utility with higher rates;
 - (F) to phase in rates when a utility with multiple rate schedules is making the transition to a system-wide rate structure; or
 - (G) when requested by the utility.
 - (2) Construction schedules and cost estimates for new facilities that are the basis for the phased or multi-step rate increase must be prepared by a licensed professional engineer.
 - (3) Unless otherwise specified in the commission order, the next phase or step cannot be implemented without verification of completion of each step by a licensed professional engineer, agency inspector, or agency subcontractor.
 - (4) At the time each rate step is implemented, the utility shall review actual costs of construction versus the estimates upon which the phase-in rates were based. If the revenues received from the phased or multi-step rates are higher than what the actual costs indicate, the excess amount must be reported to the commission prior to implementing the next phase or step. Unless otherwise specified in a commission order, the utility may:
 - (A) refund or credit the overage to the customers in a lump sum; or
 - (B) retain the excess to cover shortages on later phases of the project. Any revenues retained but not needed for later phases must be proportioned and refunded to the customers at the end of the project with interest paid at the rate on deposits.
 - (5) The original notice to customers must include the proposed phased or multi-step rate change and informational notice must be provided to customers and the commission 30 days prior to the implementation of each step.
 - (6) A utility that requests and receives a phased or multi-step rate increase cannot apply for another rate increase during the period of the phase-in rate intervals unless:
 - (A) the utility can prove financial hardship; or
 - (B) the utility is willing to void the next steps of the phase-in rate structure and undergo a full cost of service analysis.

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- (c) **Cash needs method.** The cash needs method of establishing rates allows a utility to recover reasonable and prudently incurred debt service, a reasonable cash reserve account, and other expenses not allowed under standard methods of establishing rates.
- (1) A utility may request to use the cash needs method of setting rates if:
- (A) the utility is a nonprofit corporation controlled by individuals who are customers and who represent a majority of the customers; or
- (B) the utility can demonstrate that use of the cash needs basis:
- (i) is necessary to preserve the financial integrity of the utility;
- (ii) will enable it to develop the necessary financial, managerial, and technical capacity of the utility; and
- (iii) will result in higher quality and more reliable utility service for customers.
- (2) Under the cash needs method, the allowable components of cost of service are: allowable operating and maintenance expenses; depreciation expense; reasonable and prudently incurred debt service costs; recurring capital improvements, replacements, and extensions that are not debt-financed; and a reasonable cash reserve account.
- (A) **Allowable operating and maintenance expenses.** Only those expenses that are reasonable and necessary to provide service to the ratepayers may be included in allowable operations and maintenance expenses and they must be based on the utility's test year expenses as adjusted for known and measurable changes and reasonably anticipated, prudent projected expenses.
- (B) **Depreciation expense.** Depreciation expense may be included on any used and useful depreciable plant, property, or equipment that was paid for by the utility and that has a positive net book value on the effective date of the rate change in the same manner as described in §24.31(b)(1)(B) of this title (relating to Cost of Service).
- (C) **Debt service costs.** Debt service costs are cash outlays to an unaffiliated interest necessary to repay principal and interest on reasonably and prudently incurred loans. If required by the lender, debt service costs may also include amounts placed in a debt service reserve account in escrow or as required by the commission, Texas Water Development Board, or other state or federal agency or other financial institution. Hypothetical debt service costs may be used for:
- (i) self-financed major capital asset purchases where the useful life of the asset is ten years or more. Hypothetical debt service costs may include the debt repayments using an amortization schedule with the same term as the estimated service life of the asset using the prime interest rate at the time the application is filed; and
- (ii) prospective loans to be executed after the new rates are effective. Any pre-commitments, amortization schedules, or other documentation from the financial institution pertaining to the prospective loan must be presented for consideration.
- (D) **Recurring capital improvements, replacements, and extensions that are not debt-financed.** Capital assets, repairs, or extensions that are a part of the normal business of the utility may be included as allowable expenses. This does not include routine capital expenses that are specifically debt-financed.
- (E) **Cash reserve account.** A reasonable cash reserve account, up to 10% of annual operation and maintenance expenses, must be maintained and revenues to fund it may be included as an allowable expense. Funds from this account may be used to pay expenses incurred before revenues from rates are received and for extraordinary repair and maintenance expenses and other capital needs or unanticipated expenses if approved in writing by the commission. The utility shall account for these funds separately and report

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to the commission. Unless the utility requests an exception in writing and the exception is explicitly allowed by the commission in writing, any funds in excess of 10%, shall be refunded to the customers each year with the January billing either as a credit on the bill or refund accompanied by a written explanation that explains the method used to calculate the amounts to be refunded. Each customer must receive the same refund amount. These reserves are not for the personal use of the management or ownership of the utility and may not be used to compensate an owner, manager, or individual employee above the amount approved for that position in the most recent rate change request unless authorized in writing by the commission.

- (3) If the revenues collected exceed the actual cost of service, defined in paragraph (2) of this subsection, during any calendar year, these excess cash revenues must be placed in the cash reserve account described in paragraph (2)(E) of this subsection and are subject to the same restrictions.
- (4) If the utility demonstrates to the commission that it has reduced expenses through its efforts, and has improved its financial, managerial, and technical capability, the commission may allow the utility to retain 50% of the savings that result for the personal use of the management or ownership of the utility rather than pass on the full amount of the savings through lower rates or refund all of the amounts saved to the customers.
- (5) If a utility elects to use the cash needs method, it may not elect to use the utility method for any rate change application initiated within five years after beginning to use the cash needs method. If after the five-year period, the utility does elect to use the utility method, it may not include in rate base, or recover the depreciation expense, for the portion of any capital assets paid for by customers as a result of including debt service costs in rates. It may, however, include in rate base, and recover through rates, the depreciation expense for capital assets that were not paid for by customers as a result of including debt service costs in rates. The net book value of these assets may be recovered over the remaining useful life of the asset.