

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.