

The Honorable Senator Hegar
PO Box 12068
Austin, Texas 78701

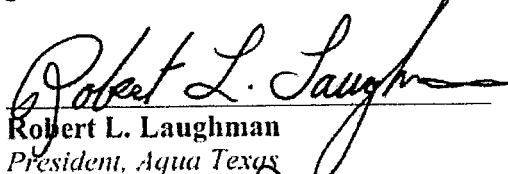
Dear Senator Hegar:

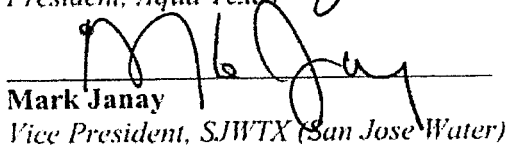
The current rate case structure in Texas is a source of frustration for consumers, the Commission, and the utilities alike. Commission staff are strained and litigation over rate cases often pend for significant periods of time and costs reach in the millions, which are ultimately passed through to consumers in the rate approved by the Commission.

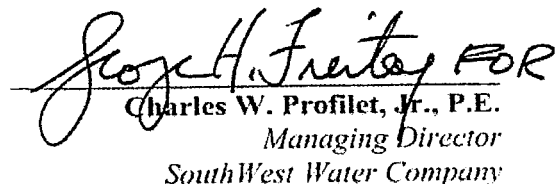
The Sunset Commission recommendation to move rate cases from the TCEQ to the Public Utilities Commission (PUC) will do little to address these frustrations. The time is right for the legislature to consider rate reforms to address these issues. The attached recommended reforms should accomplish the following:

- (1) **Allow for adequate due process for ratepayers to provide input:**
- (2) **Allow Utilities to conduct planning for needed capital investment for system improvements and anticipate compliance issues with systems in need of improvement:**
- (3) **Reduce litigation and contested rate cases, which produce significant costs to Utilities and are passed through into rates paid by rate payers:**
- (4) **Avoid overwhelming regulatory staff.**
- (5) **Promote economically viable utilities and continue to encourage capital investment and create a regulatory atmosphere to reduce nonviable water systems.**

Ultimately, these proposed reforms would **promote faster and more efficient infrastructure replacement and compliance with state and regulatory mandates** that require the Utility to make capital investments. The undersigned companies are committed to meetings these concerns and supporting rate reforms which will meet these goals and look forward to working with the 82nd Legislature to achieve these goals.


Robert L. Laughman
President, Aqua Texas


Mark Janay
Vice President, SJWTX (San Jose Water)


Charles W. Profilet, Jr., P.E.
Managing Director
SouthWest Water Company

RATE REFORM RECOMMENDATIONS

Texas should Use Prospectively Relevant Test Years

Utilizing a future or “prospective” test year would most accurately reflect the actual costs during the period the rates are most likely to be effective and accomplish the following:

(1) **Allow for adequate due process for ratepayers to provide input;**

(2) **Allow Utilities to conduct planning for needed capital investment for system improvements and anticipate compliance issues with systems in need of improvement;**

(3) **Reduce litigation and contested rate cases, which produce significant costs to Utilities and are passed through into rates paid by rate payers;**

(4) **Avoid overwhelming regulatory staff.**

(5) **Promote economically viable utilities and continue to encourage capital investment and create a regulatory atmosphere to reduce nonviable water systems.**

(6) **Promote faster and more efficient infrastructure replacement and compliance with state and regulatory mandates that require the Utility to make capital investments.**

RECOMMENDATIONS FOR RATE REFORM

Reduce Rate Lag, Rate Case Expenses, Provide Due Process for Ratepayers And Promote Capital Investment by Utilities in Texas

On July 27, 2005, the NARUC Board of Directors (“National Association of Regulatory and Utility Commissioners”) passed a Resolution supporting consideration of regulatory policies considered “**Best Practices.**”

The following recommendations for rate reform are developed from the Best Practices resolution adopted by NARUC in 2005.

Challenges and Concerns with Current Rate Process

- *Customer Protection and Due Process for ratepayers*
- *Upward Cost Pressures on Utilities*
- *Depressed Economic Conditions*
- *Reliability of Service and Improved Infrastructure*
- *Financially Healthy and Solvent Utilities*

Water utilities are unique in a free-market economy. Water utilities cannot supply new services or products, nor can a utility abandon an existing market without approval from the relevant regulatory authority. A regulatory authority determines what a utility may charge for service, but that same regulatory authority does not regulate the cost of service – meaning what the utility must pay to provide service. For example, water utilities cannot adjust its sales price immediately to reflect the changing cost of capital, labor, plant and equipment. Instead, a utility must await the relevant regulatory authority to approve a rate increase before it can recover its capital costs already expended. This gap between a utility incurring increased costs or capital investments and recovering those costs through increased rates is known as “**regulatory lag**”.

Overall, the current method of adopting new rates for water utilities in Texas causes significant “**regulatory lag**”. The current system for setting rates causes “**rate shock**” among ratepayers and truly does not allow consumers to have adequate due process prior to a new rate taking affect.

Of the three major retail water companies in Texas, each Utility has invested over \$100 million in capital expenditures in the last 6 years combined with little to no recovery due to the historical rate making process.

As a result, utilities have significant challenges related to infrastructure replacement and compliance with water quality requirements are ever increasing and meeting these requirements puts **upward pressure on rates**. The Texas regulatory environment should *encourage the purchase of smaller systems to improve them, encourage compliance, protect ratepayers and give due process to rate payers in the process of applying for and setting the utility's rates.*

However, the current practice of utilizing “**historic test years**” in Texas for determining rates, all but guarantees a Utility will not recover invested capital (or needs to be invested) *until the utility files another rate case*. The use of historic test years to set rates discourages the necessary investment by a Utility and skews construction and capital investment timing, because rates are set on historical or artificial test year issues rather than *actual system needs* and actual system replacement, improvement, or construction needs. This, in turn, increases the risk and the cost of capital for Utilities and often leads to balance sheet issues for the Utility.

Texas needs to adopt rate reform to:

- (1) Allow for adequate due process for ratepayers to provide input;
- (2) Allow for Utilities to conduct efficient planning for needed capital investment for system improvements or anticipated compliance issues with systems in need of improvement;
- (3) Eliminate litigation and contested rate cases, to the extent practical, which have become significant costs to Utilities and are typically passed through by the Commission and ultimately incorporated into the new rates paid by rate payers;
- (4) Avoid overwhelming regulatory staff.

Texas should Use Prospectively Relevant Test Years

The undersigned utilities believe, from a regulatory and public policy perspective, the selection of a future or “prospective” test year would most accurately reflect the actual costs during the period the rates are most likely to be effective.

The undersigned propose to define the relevant test year as a 3-year rate cycle.

As such, Utilities would be required to project capital investment requirements over a future 3-year period for which the Utility is requesting a new applicable rate. During each of the years of the current rate cycle, annual adjustments or “**true-ups**” of rates need to be authorized with Commission approval. Annual true-ups would **reflect actual invested capital** or other costs and expenses incurred outside of the Utility’s control (such as Hurricanes, Tornadoes or other acts of God), subject to review and approval of the Commission to assure that the capital has actually been invested.

Advantages of Future Test Year

(1) We propose a “lay out” period of 12 months to review the proposed rate plan by the Utility, during which notice would be provided to affected ratepayers wherein ratepayers could individually, or through representation, offer input.

This would mean that **automatic rates would be eliminated** and any affected ratepayer would have the right to challenge the Utility’s projections. This gives ratepayers due process in advance of the prospective rate taking effect.

(2) In turn, this system would practically **eliminate costly litigation** in contested rate cases. Litigation costs are typically passed through and incorporated into rates. In some cases, the expenses are in the millions of dollars and are becoming more common as larger systems continue to purchase smaller systems.

(3) Annual adjustments or “true-ups” during the rate cycle would allow for incremental recovery of capital actually invested and allow Utilities a return on invested capital to **avoid rate shock**. Annual adjustments would, in turn:

(a) Would **allow for predictability of expenses and rates for ratepayers** for a rate application and likely allow for a cap or eliminate entirely the need for a Utility to recover expenses associated with rate cases;

(b) Would **significantly reduce or eliminate “rate lag” altogether** due to the litigation and contest of rate cases and **significantly reduce the complexity and cost of rate proceedings**;

(c) Would **remove a significant portion of these matters from SOAH dockets** and eliminate this cost to the State;

(4) When considering the purchase of a small or troubled system, a Utility would be required to file a prospective rate plan with the Commission to identify **clear and predictable acquisition/cost adjustments**. **Advance notice can be provided to ratepayers in the subject system, giving them input and due process**. However, under certain circumstances, the legislature should authorize a “Plant improvement surcharge”, subject to Commission approval, that may be collected from customers of the acquired system to temporarily offset extraordinary improvement costs.

(5) Would **promote faster and more efficient infrastructure replacement and compliance with state and regulatory mandates** that require the Utility to make capital investments.

Meeting the Needs of Low Income Ratepayers

With prospective test years, the legislature could authorize the Commission to adopt rules to authorize a low income or “special tariff” rate for low income and/or economically challenged ratepayers.

Despite increasing costs to replace aging infrastructure and maintain regulatory compliance and statewide mandates, water service remains, on the average, the lowest cost of all utility services.

The Legislature or the Commission can implement rules to determine eligible ratepayers and yet maintain quality water and reliable infrastructure, systems, and service.

States with Future Test Years in Practice

- **California**
- **Hawaii**
- **Michigan**
- **Ohio**

- **Arkansas ***
- **Colorado ***
- **Florida ***
- **Illinois ***
- **Kansas ***
- **Kentucky ***
- **Mississippi ***
- **Nebraska ***
- **New Mexico ***
- **New York ***
- **Pennsylvania ***
- **Tennessee ***
- **Utah ***
- **Virginia ***
- **Washington**
- **Wisconsin ***

** Utility has choice of historic test year or future test year*