

HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: CS/HB 125 Utility System Rate Base Values

SPONSOR(S): Energy, Communications & Cybersecurity Subcommittee, McClain

TIED BILLS: IDEN./SIM. **BILLS:** SB 194

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Energy, Communications & Cybersecurity Subcommittee	18 Y, 0 N, As CS	Walsh	Keating
2) State Administration & Technology Appropriations Subcommittee			
3) Commerce Committee			

SUMMARY ANALYSIS

When a water or wastewater utility regulated by the Public Service Commission (PSC) acquires an existing water or wastewater utility system, the PSC establishes a rate base value for the acquired utility system. The rate base value established by the PSC is the amount upon which the acquiring utility may earn a rate of return. This value is determined using the acquired utility's net book value, i.e., the original cost of the utility's assets when first dedicated to public service, less depreciation. This valuation method is called the "original cost" method.

If the purchase price of a utility system is greater than its net book value, no part of the difference is included in the acquiring utility's rate base absent a showing of extraordinary circumstances, which may include anticipated cost efficiencies and improvements in service quality and regulatory compliance, among other things. If the PSC determines that extraordinary circumstances exist, it will allow the acquiring utility to include all or part of the difference in its rate base as a "positive acquisition adjustment." This adjustment will be reflected in the utility's rates that are set during the utility's next general rate case.

As an alternative to the current process, the bill allows certain PSC-regulated water and wastewater utilities (those with over 10,000 customers or those that are permitted to produce 3 million gallons of drinking water per day) who acquire an existing system to petition the PSC to establish rate base for the acquired system based on the lesser of: (1) the purchase price negotiated by the two utilities; or (2) the average of three appraisals of the system conducted by licensed appraisers chosen from a list established by the PSC. Appraisal fees and transaction costs may also be included. An engineering assessment must be conducted and provided to the appraisers to be used for purposes of the appraisal. To support its request to use this approach, the utility must provide the PSC certain information specified in the bill. Within 8 months of receiving a complete petition, the PSC must issue a final order granting the petition, in whole or in part, or denying the petition, consistent with the public interest.

The bill is not expected to have a fiscal impact on state or local governments. The bill may encourage transactions involving the purchase of water or wastewater utility systems by eligible utilities. These transactions may lead to needed infrastructure improvements, cost efficiencies, and improvements in service quality and regulatory compliance. For acquisitions by PSC-regulated utilities that petition to use the alternative valuation process created in the bill, the PSC may consider potential rate impacts and proposed improvement plans in its consideration of each petition.

The bill provides an effective date of July 1, 2023.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Present Situation

Regulated Water and Wastewater Utilities

In various areas throughout Florida, water and wastewater services are provided through privately-owned and operated utilities. These privately-owned utilities, sometimes referred to as investor-owned utilities, range in size from very small systems, owned by individuals as sole proprietorships and serving only a few dozen customers in a small neighborhood, to a few systems owned by large interstate corporations which serve tens of thousands of customers in multiple Florida counties.

For privately-owned utilities operating within a single Florida county, the county has the option to regulate rates and service or allow the Public Service Commission (PSC) to regulate those utilities.¹ Regardless of whether the county has opted to regulate those utilities, the PSC has jurisdiction over all water and wastewater utility systems whose service transverses county boundaries, except for systems owned and regulated by intergovernmental authorities.² As of 2021, the PSC had jurisdiction over 124 investor-owned water/wastewater utilities in 38 counties.³ Still, the vast majority of water and wastewater customers in the state are served by water and wastewater utilities not regulated by the PSC, primarily by systems owned, operated, managed, or controlled by governmental authorities.

For each utility within its jurisdiction, the PSC has exclusive authority to regulate the utility's rates and service.⁴ The PSC must establish rates that are just, reasonable, compensatory, and not unfairly discriminatory.⁵ In doing so, the PSC must consider the value and quality of the service and the cost of providing the service, which includes, but is not limited to: debt interest; the requirements of the utility for working capital; maintenance, depreciation, tax, and operating expenses incurred in the operation of all property used and useful in the public service; and a fair return on the investment of the utility in property used and useful in the public service.⁶ The PSC has consistently interpreted the "investment of the utility" to be the original cost of the utility's property when first dedicated to public service.⁷ Land is included in the original cost at the time it was first dedicated to public use, meaning that under current accounting practices used to establish a utility's rate base, appreciation of the land's value is not considered.⁸

Acquisition of Water and Wastewater Utility Systems by Regulated Utilities

Each water or wastewater utility subject to the PSC's jurisdiction must obtain a certificate of authorization to provide water or wastewater service.⁹ A PSC-regulated utility may not sell, assign, or transfer its certificate of authorization, facilities, or majority organizational control without approval by the PSC. Likewise, PSC approval is required for the transfer of a utility system exempt from PSC jurisdiction, such as a system owned or operated by a governmental authority, to a PSC-regulated utility. To grant approval, the PSC must determine that the sale, assignment, or transfer is in the public interest and that the acquiring utility will fulfill the commitments, obligations, and representations of the utility to be acquired.¹⁰ If a contract for sale is made contingent upon PSC approval, the sale of the

¹ S. 367.171, F.S. If a county chooses to allow regulation by the PSC, it may rescind this election only after 10 continuous years of PSC regulation.

² *Id.*

³ Florida Public Service Commission, *Facts and Figures of the Florida Utility Industry*, p. 28 (Apr. 2022).

⁴ S. 367.011, F.S.

⁵ S. 367.081, F.S.

⁶ *Id.*

⁷ Florida Public Service Commission (FPSC), Agency Analysis of 2023 House Bill 125, p. 1 (Feb. 10, 2023).

⁸ *Id.* at 5.

⁹ S. 367.031, F.S.

¹⁰ S. 367.071(1), F.S.

utility may occur prior to such approval.¹¹ The PSC considers, among other things, the financial ability of the buyer to maintain and operate the acquired utility and the technical ability of the buyer to provide service.¹²

When the PSC approves a sale, assignment, or transfer of an existing utility system to a PSC-regulated utility, the PSC may establish the rate base for the utility being transferred.¹³ The PSC establishes the value of an existing utility's rate base using "original cost." Using original cost, the value of a utility's rate base is determined using the depreciated original cost, or net book value, of the property devoted to the public service. Contributions in aid of construction (CIAC) are deducted from rate base to ensure that costs are not imposed on current customers for infrastructure that was contributed to the utility without the utility's direct investment.¹⁴ This rate base is the amount upon which the utility may earn a fair return, as established by the PSC.¹⁵

A utility system may be acquired at a price higher or lower¹⁶ than the net book value of its assets. If the purchase price is greater than net book value, no part of the difference is included in a utility's rate base absent a showing by the utility of extraordinary circumstances.¹⁷ In determining whether a utility has demonstrated extraordinary circumstances, the PSC will consider evidence including:

- Anticipated improvements in quality of service;
- Anticipated improvements in compliance with regulatory mandates;
- Anticipated rate reductions or rate stability over a long-term period;
- Anticipated cost efficiencies; and
- Whether the purchase was made as part of an arms-length transaction.¹⁸

If the PSC determines that extraordinary circumstances exist, it will allow the acquiring utility to include all or part of the difference in its rate base as a "positive acquisition adjustment." This adjustment will be reflected in the utility's rates that are set during the utility's next general rate case.

Effect of Proposed Changes

The bill allows certain PSC-regulated water and wastewater utilities who acquire an existing water or wastewater utility system to petition the PSC to establish rate base for the utility system being acquired, without regard to the system's original cost.

Using the alternative approach provided by the bill, an acquiring utility may petition the PSC to establish rate base for the system being acquired based on the lesser of: (1) the negotiated purchase price; or (2) the average of three appraisals of the system conducted by licensed appraisers chosen from a list established by the PSC. The rate base established for the system being acquired may also include reasonable transaction and closing costs incurred by the acquiring utility and reasonable fees paid to appraisers. If the rate base established through this approach exceeds the net book value of the system being acquired, this excess will be reflected in customer rates set during the utility's next general rate case, thus putting upward pressure on rates.

The bill provides that three appraisers will be chosen from a list established by the PSC, and the appraisals will be paid for by the buyer. The bill requires each appraiser to provide an appraisal of the value of the utility system being acquired, in a manner consistent with the Uniform Standards of Professional Appraisal Practice.¹⁹

¹¹ FPSC, *supra* note 7, at 1.

¹² Rule 25-30.037 (2), F.A.C.

¹³ S. 367.071(5), F.S.

¹⁴ FPSC, *supra* note 7, at 2.

¹⁵ *Id.* at 1.

¹⁶ When the purchase price is equal to or less than 80 percent of net book value, a negative acquisition adjustment must be included in rate base. Rule 25-3-.0371(3), F.A.C.

¹⁷ Rule 25-30.0371(2), F.A.C.

¹⁸ *Id.*

¹⁹ The Uniform Standards of Professional Appraisal Practice (USPAP) are the generally recognized ethical and performance standards for the appraisal profession in the United States. USPAP was adopted by Congress in 1989, and

Under the bill, the acquiring utility and the utility system being acquired must jointly retain a licensed engineer to assess the tangible assets of the system being acquired. The bill specifies that this assessment must be provided to the three chosen appraisers for use in determining the value of the system being acquired.

A utility that wishes to use this alternative approach must include the following in a petition to the PSC:

- The requested rate base value for the utility system being acquired;
- Copies of the three required appraisals performed by the chosen appraisers, including the average of the valuations produced by each appraisal;
- A copy of the required engineering assessment of tangible assets;
- A 3-year plan to address each deficiency identified in the engineering assessment, which must address impact on quality of service and address any planned improvements to water quality;
- The 5-year projected rate impact on the customers of the utility system being acquired, including, but not limited to the rate impact of any expected cost efficiencies and the rate impact of using of the alternative valuation approach in lieu of the original cost method;
- The contract of sale;
- The estimated value of fees and the estimated transaction and closing costs to be incurred by the acquiring utility; and
- A tariff, including rates equal to the rates of the utility system being acquired.

Within 8 months of receiving a complete petition to use this alternative approach, the PSC must issue a final order on the petition. The PSC may grant the petition, in whole or in part or with modifications in the public interest, or the PSC may deny the petition if denial of the petition is in the public interest. The PSC may not approve a rate base value higher than that requested in the petition.

The bill specifies that it applies only to acquiring utilities that:

- Provide water service, wastewater service, or both, to more than 10,000 customers and are engaged in an arms-length acquisition of a water system, wastewater system, or both types of systems; or
- Are permitted to produce 3 million gallons a day of drinking water and are engaged in an arms-length acquisition of a water system, wastewater system, or both types of systems.

Currently, it appears that there are three PSC-regulated utilities to which the bill may apply.²⁰ All other PSC-regulated utilities that acquire a water or wastewater system, or both, would continue to operate under the PSC's current rules that use the original cost approach to establish rate base and that allow a positive acquisition adjustment only upon a demonstration of extraordinary circumstances.

If the alternative approach created by the bill is used to establish rate base for an acquired utility system, that rate base value must be used by the PSC to establish rates during the acquiring utility's next general rate case. The bill specifies that the PSC, in setting future rates for customers of the acquired system, may classify the system as a separate entity, consistent with the public interest.

B. SECTION DIRECTORY:

Section 1. Creates s. 367.0811, F.S., providing an alternative process to establish rate base for an acquired water or wastewater utility system.

Section 2. Provides an effective date of July 1, 2023.

contains standards for all types of appraisal services, including real estate, personal property, business, and mass appraisal. See The Appraisal Foundation, *What is USPAP?*, https://www.appraisalfoundation.org/imis/TAF/Standards/Appraisal_Standards/Uniform_Standards_of_Professional_Appraisal_Practice/TAF/USPAP.aspx?hkey=a6420a67-dbfa-41b3-9878-fac35923d2af (last visited Feb. 9, 2023).

²⁰ FPSC, *supra* note 7, at 4. As noted in the *Drafting Issues or Other Comments* section of this analysis, this provision of the bill could be clarified as to its specific application.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

None.

2. Expenditures:

None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

The bill may encourage transactions involving the purchase of water and wastewater utility systems by eligible utility systems. These transactions may lead to needed infrastructure improvements, cost efficiencies, and improvements in service quality and regulatory compliance. For acquisitions by PSC-regulated utilities that petition to use the alternative valuation process created in the bill, the PSC may consider potential rate impacts and proposed improvement plans in its consideration of each petition. Use of the alternative valuation process may lead to higher rates for the affected customers.

D. FISCAL COMMENTS:

None.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

Not applicable. This bill does not appear to require counties or municipalities to spend funds or take action requiring the expenditures of funds; reduce the authority that counties or municipalities have to raise revenues in the aggregate; or reduce the percentage of state tax shared with counties or municipalities.

2. Other:

None.

B. RULE-MAKING AUTHORITY:

The bill requires the PSC to adopt implementing rules.

C. DRAFTING ISSUES OR OTHER COMMENTS:

Drafting Issues

The bill is unclear as to whether the total customer and daily gallonage eligibility options are intended to include only customers served and permitted gallonage production within Florida or, in the case of an acquiring utility with operations in at least one other state, all customers served by the utility and all permitted gallonage production by the utility.

As noted by the PSC, it is not clear how CIAC will be treated under the alternative valuation process created by the bill. The PSC also indicates that it is unclear how the deficiency-related projects identified by the 3-year plan interacts with the alternative valuation process.²¹

Other Comments

As previously noted, land is included in a utility's rate base at its original cost when dedicated to service for public use. Over time, customers of the utility pay down that cost through rates. Under the alternative valuation method created in the bill, appreciation in land values alone could result in significant increases in rate base, putting upward pressure on customer rates.²²

The PSC notes that it has no expertise in property appraisal and suggests that an agency with such expertise may be a more appropriate choice to establish the list of approved appraisers required by the bill.²³

IV. AMENDMENTS/COMMITTEE SUBSTITUTE CHANGES

On February 15, 2023, the Energy, Communications & Cybersecurity Subcommittee adopted an amendment and reported the bill favorably as a committee substitute. The amendment:

- Corrects a drafting error in the title.
- Revises language to clarify that the Public Service Commission may deny a petition *if denial of the petition* is in the public interest.
- Clarifies the following eligibility requirements for acquiring utilities:
 - The gallonage eligibility option is based on permitted production of drinking water.
 - The arms-length acquisition requirement applies to both the total customer eligibility option and the gallonage eligibility option.

This analysis is drafted to the committee substitute as passed by the Energy, Communications & Cybersecurity Subcommittee.

²¹ *Id.* at 4.

²² *See Id.* at 5.

²³ *Id.*