## HOUSE OF REPRESENTATIVES STAFF FINAL BILL ANALYSIS

**BILL #:** CS/CS/HB 125 Utility System Rate Base Values
**SPONSOR(S):** Commerce Committee and Energy, Communications & Cybersecurity Subcommittee, McClain
**TIED BILLS:** **IDEN./SIM. BILLS:** CS/SB 194

**FINAL HOUSE FLOOR ACTION:** 112 **Y's** 2 **N's** **GOVERNOR'S ACTION:** Approved

### SUMMARY ANALYSIS


CS/CS/HB 125 passed the House on April 27, 2023, and subsequently passed the Senate on April 27, 2023.

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 would 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 at least 3 million gallons of drinking water per day) that 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 a petition to use this approach, a utility must provide the PSC certain information specified in the bill, including a rate stabilization plan if the requested relief would result in a significant individual rate increase. The bill provides a list of factors that the PSC must consider when reviewing a utility petition and authorizes the PSC to set reasonable performance goals based on these factors for review in a subsequent rate proceeding. Within 8 months of receiving a complete petition, the PSC must issue a final order granting the petition, in whole or in part or with modifications, 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 small or troubled utility systems, though this result is not required by the bill. 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, rate stabilization plans, and proposed improvement plans in its consideration of each petition.

The bill was approved by the Governor on June 26, 2023, ch. 2023-291, L.O.F., and will become effective on July 1, 2023.

# I. SUBSTANTIVE INFORMATION

A. EFFECT OF 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

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[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.

utility to be acquired.[10] If a contract for sale is made contingent upon PSC approval, the sale of the 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 lower[16] 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.

*Challenges for Small Water and Wastewater Utility Systems*

Some small water and wastewater systems may struggle to make needed investments. This can happen due to a variety of factors, such as:

- Lack of staff or managerial expertise;
- Lack of capital, or inability to access lower-cost capital, to invest in system infrastructure;
- Lack of economies of scale inherent in larger systems; and
- System abandonment due to disinterest of owners or management in running a system, death of the owner or operator of the system with no clear plan of succession, or frustration with an inability to meet water standards and other regulatory requirements.[19]

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[10] S. 367.071(1), F.S.
[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 25-30.0371(3), F.A.C.
[17] Rule 25-30.0371(2), F.A.C.
[18] *Id.*
[19] National Regulatory Research Institute (NRRI), *A Review of State Fair Market Value Acquisitions Policies for Water and Wastewater Systems*, Sep. 2021, at 8-11, *available at* https://pubs.naruc.org/pub/ED8E5710-1866-DAAC-99FB-B70190F3D64A).

These challenges can show up in system violations. Of the 38,853 Safe Drinking Water Act (SDWA)[20] violations in the United States in 2021, 30,153 (77 percent) were in very small systems. For Florida, of the 1,382 SDWA violations, 1,017 (73 percent) were in very small systems.

Given the potential issues with small water and wastewater systems, some states have explored ways to encourage system consolidation. Some states have adopted a rate mechanism referred to as fair market valuation (FMV), which is intended to encourage the acquisition of small or struggling water or wastewater utilities by other utilities that may be positioned to make investments in those systems and provide greater economies of scale, lower cost capital, and greater management and technical expertise.[21] FMV differs from the traditional "original cost" valuation method by allowing a purchasing utility to include in its rate base the "market" value of an acquired water or wastewater utility system, which may be estimated through appraisals. This mechanism may increase the allowable rate base associated with an acquisition.[22]

Proponents of the FMV mechanism state that the original cost methodology can sometimes make it difficult to acquire a struggling water or wastewater utility system because the seller may feel that the original cost methodology undervalues its system and is unwilling to sell.[23] The FMV mechanism also presents risks to an acquiring utility's ratepayers:

- The market forces that control prices in a competitive environment (i.e., buyers and sellers pressuring an acquisition price in opposing directions) are different in a monopoly utility environment. In a monopoly environment, buyers can benefit when a premium is reflected in the rate base upon which they earn a return through rates, and sellers can benefit from sales proceeds that exceed their investment. Thus, both buyers and sellers can benefit from higher purchase prices.[24]
- Monopoly utility assets can be difficult to value because there are not many comparable transactions to rely upon. There may also be a shortage of experts who can do these types of valuations, yet appraisers hold considerable power in the FMV process. FMV determinations can be affected by the party who selects the appraiser, whether the appraiser has a conflict of interest, the method used to determine the final value, the variation between appraisals (a single high appraisal may significantly increase the average price), and the qualifications of the appraiser.[25]
- Use of FMV may encourage utilities to swap assets and increase ratepayer costs without any guarantee of improvement of quality of service or increased cost efficiencies.[26]
- Acquisitions may result in "rate shock" for ratepayers, especially in systems that have been historically underinvested in.[27]
- Use of FMV encourages acquisitions that provide the greatest financial benefit to a purchasing utility, regardless of whether the acquired utility systems are small, struggling systems that may benefit from acquisition.[28]
- Increases in the underlying value of the land upon which the acquired utility is situated may result in significant rate increases solely based on real estate prices.[29]

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[20] The Safe Drinking Water Act, Pub. L. 93-523, is intended to ensure the quality drinking water by regulating public water systems in the United States. Under this Act, the EPA sets standards for drinking water quality and oversees the states, federally-recognized tribes, and territories that implement the United States' drinking water program.
[21] NRRI, *supra* note 19, at 1-11.
[22] *Id.*, at 1.
[23] *Id.*
[24] *See, e.g.,* Janice Beecher, *Water utility consolidation: is fair market value fair?*, Michigan State University Institute of Public Utilities, 2019, at 13, *available at* https://ipu.msu.edu/wp-content/uploads/2019/06/Beecher-Fair-Market-Value-Water-June-2019.pdf ; Scott Hempling, *Water Mergers: are they making economic sense?*, Jun. 2019 (*available at* https://energiahoy.com/2019/06/02/water-mergers-are-they-making-economic-sense/).
[25] NRRI, *supra* note 19, at 17.
[26] FPSC, *supra* note 7.
[27] NRRI, *supra* note 19, at 18; FPSC *supra* note 7, at 3.
[28] NRRI, *supra* note 19, at 18-19.
[29] FPSC *supra* note 7, at 5.

Given these risks, some states that use the FMV mechanism place restrictions on its use, including:

- Requiring the acquiring utility be of sufficient size.
- Requiring the acquired utility be municipal, small, or disadvantaged or distressed;
- Requiring acquisition benefit from economies of scale;
- Providing an initial moratorium or a limit on rate increases (i.e. "rate shock protection"); and
- Requiring disclosure of anticipated rate impacts in an FMV application.[30]

*Pending PSC Rulemaking Proceedings on Acquisition Adjustments*

On March 30, 2023, the PSC issued a rule development notice to amend its rules related to water and wastewater utility acquisition adjustments. The notice included a draft rule, and a rule development workshop was scheduled for April 13, 2023.

The draft rule creates two categories of positive acquisition adjustments based on whether the utility system being purchased is considered "viable" or "nonviable." Adjustments for the purchase of viable systems require a showing of a positive cumulative present value benefit over a 5-year period. Adjustments for the purchase of non-viable systems require a lesser showing that customers will benefit through improved quality of service, regulatory compliance, rate reductions or long-term rate stability, and/or cost efficiencies. Proof of "extraordinary circumstances" would no longer be required to obtain a positive acquisition adjustment.[31]

**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 use an alternative approach to establish rate base for the utility system being acquired.

The bill provides a legislative finding that:

> [I]t is in the public interest to promote consolidation efforts with water and wastewater utility systems in order to encourage economies of scale, better access to lower material and supply costs, better access to capital, improvement in utility infrastructure, and improvement in the quality of service overall.

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.[32]

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[30] NRRI, *supra* note 19, at 19-31.
[31] Notice of Development of Rulemaking, In re: Proposed Amendment of Rule 25-30.071, F.A.C., Acquisition Adjustments, Mar. 30, 2023, available at https://www.floridapsc.com/pscfiles/library/FILINGS/2023/02449-2023/02449-2023.pdf.
[32] 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 contains standards for all types of appraisal services, including real estate, personal property, business, and mass appraisal. *See* The Appraisal Foundation, *What is USPAP?*,

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.

If the relief requested in the petition will result in a significant individual rate increase during the 5-year period for which projected rate impacts are provided, the utility must also include a rate stabilization plan in its petition. Under the bill, a rate stabilization plan is the acquiring utility's plan to implement rate changes incrementally over a period of time to mitigate rate increases and to predictably achieve consolidated pricing over time.

The bill provides that the PSC must consider the following when considering a petition for use of the alternative valuation method:

- Improvements in quality of service.
- Improvements in compliance with regulatory requirements.
- Rate reductions or rate stability over a long-term period.
- Cost efficiencies.
- A demonstration that the purchase is being made as part of an arms-length transaction.
- Economies of scale to be generated by the transaction.
- A comparison of the acquiring utility's net book value, to the extent available, and the proposed rate base value of the utility being acquired.
- A demonstration that the acquiring utility has greater access to capital than the utility being acquired.

The bill authorizes the PSC to set reasonable performance goals based on these considerations and to review the utility’s performance in a rate proceeding.

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, in the public interest, grant the petition, in whole or in part or with modifications, or deny the petition. 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:

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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).

- 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, though the alternative approach authorized under the bill is not limited to use by utilities that operate in Florida. 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.

## 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 small or troubled utility systems, though this result is not required by the bill. 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.