



# HOUSE BILL 219: Amend Water/Sewer Rate Adjustment Mechanisms.

2021-2022 General Assembly

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<b>Committee:</b>	House Rules, Calendar, and Operations of the House	<b>Date:</b>	March 17, 2021
<b>Introduced by:</b>	Reps. Arp, Paré, Szoka, Watford	<b>Prepared by:</b>	Jennifer McGinnis
<b>Analysis of:</b>	Second Edition		Staff Attorney

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## OVERVIEW: *House Bill 219 would:*

- *Authorize the State's Utilities Commission (Commission) to approve a "Water and Sewer Investment Plan" (Plan) for water or sewer utilities. Under a Plan, the Commission would:*
  - *Set water or sewer base rates, to include authorization of annual rate changes for a three-year period based on reasonably known and measurable capital investments and anticipated reasonable and prudent expenses approved under the plan without the need for a base rate proceeding during the plan period.*
  - *Set revenue requirements through banding of authorized returns.*
- *Modify an existing rate adjustment mechanism that allows a water or sewer utility to recover costs associated with investments for improvements to water and sewer systems.*

[As introduced, this bill was identical to S211, as introduced by Sen. Newton, which is currently in Senate Agriculture, Energy, and Environment.]

## CURRENT LAW:

G.S. 62-133 requires the Commission to fix rates for public utilities based upon the following criteria:

- Rates must be fair to both the public utilities and the consumer.
- The Commission must fix such rates to be charged by the public utility to earn, in addition to reasonable operating expenses, a rate of return fixed on the cost of the public utility's property. To establish such rates, the Commission must:
  - Ascertain the reasonable original cost or the fair value of the public utility's property used and useful, or to be used and useful within a reasonable time after a test period, less that portion of the cost that has been consumed by previous use recovered by depreciation expense.
  - Based on its determination of the reasonable original cost of a utility's property, fix a utility's rate of return as will enable the public utility to produce a fair return for its shareholders, considering changing economic conditions and other factors, to maintain its facilities and services in accordance with the reasonable requirements of its customers in the territory covered by its franchise, and to compete in the market for capital funds on terms that are reasonable and that are fair to its customers and to its existing investors. In fixing a utility's rate of return, the Commission must also:
    - Estimate the public utility's revenue under the present and proposed rates.

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# House Bill 219

Page 2

- Ascertain the public utility's reasonable operating expenses, including actual investment currently consumed through reasonable actual depreciation.

## Overview of ratemaking under G.S. 62-133:

- Based on the cost of service in the test period.
- Test period – financial data from a historical 12-month period, which serves as a proxy for the anticipated level of costs for the period the rates will be in effect.
- ***Rates are prospective, but are established based on what the utility has already spent – utilities typically do not recover expenses and capital costs in advance.***

### General Ratemaking Formula

- Revenue Requirement is determined as (Rate Base x Rate of Return) + Expenses.
- Rate Base – value of the property (net of depreciation) on which a utility may earn a rate of return. Property must be "used and useful" (power plants, transmission, and distribution lines, etc. actually used in providing service to customers).
- Rate of Return – % return that utility may earn on invested capital, including debt and equity investments.
- Expenses – can recover reasonable and prudent expenses based on an historical test year.

**G.S. 62-133.1** authorizes an alternative ratemaking mechanism (from G.S. 62-133) for water and sewer utilities, where the Commission may fix rates for such utilities based on the ratio of operating expenses to operating revenues.

**G.S. 62-133.12** authorizes the Commission to establish a rate adjustment mechanism in a general rate case under G.S. 62-133 that allows a water or sewer utility to recover costs associated with certain water or sewer system improvements through a system improvement charge. Allowable investments are limited to improvements listed under the statute, and only those found necessary by the Commission to enable the utility to provide safe, reliable, and efficient service in accordance with applicable water quality and wastewater standards. The mechanism is limited to 5% of the total annual service revenues approved by the Commission in a general rate case.

## BILL ANALYSIS:

### **Section 1:**

This section would provide that notwithstanding the methods for fixing rates established under G.S. 62-133 or G.S. 62-133.1, upon application of a water or sewer utility, the Commission may approve a Water and Sewer Investment Plan for the utility. Under a Plan, the Commission would:

- Set water or sewer base rates, to include authorization of annual rate changes for a three-year period based on reasonably known and measurable capital investments and anticipated reasonable and prudent expenses approved under the plan without the need for a base rate proceeding during the plan period.
- Set revenue requirements through banding of authorized returns.

Any rate adjustment allowed under an approved Plan could not exceed 5% of the utility's North Carolina retail jurisdictional gross revenues for the preceding plan year, on an annual basis for years two and three of the Plan. However, upon petition of a utility, the Commission could consider the addition of unplanned emergency capital investments that must be undertaken during a Plan term to address risk of

# House Bill 219

Page 3

noncompliance with primary drinking water or effluent standards, or to mitigate cyber or physical security risks, even if such expenditures would cause the above-referenced cap to be exceeded.

As defined in the bill, "banding of authorized returns" (banding) means "a rate mechanism under which the Commission sets an authorized return on equity for a water or sewer utility that acts as a midpoint and then applies a low- and high-end range of returns to that midpoint under which a water or sewer utility will not overearn if within the high-end range and will not underearn if within the low-end range." With respect to banding, the bill would:

- Prohibit any banding of the water or sewer utility's authorized return from exceeding 100 basis points above or below the midpoint.
- Provide that if a water or sewer utility exceeds the high-end range of the band that is approved by the Commission, the water or sewer utility must refund or credit earnings above that high-end range to customers in a manner to be prescribed by rules adopted by the Commission.
- If a water or sewer utility falls below the low-end range of the band that is approved by the Commission, the utility may file a general rate case.

A Plan, as filed by a water or sewer utility, must include performance-based metrics that benefit customers and ensure the provision of safe, reliable, and cost-effective service by the water or sewer utility.

The Commission could approve a Plan proposed by a water or sewer utility only upon a finding by the Commission that the Plan results in rates that are just and reasonable and are in the public interest. In evaluating a water or sewer utility's application, the Commission must consider whether the application:

- Establishes rates that are fair both to the customer and to the water or sewer utility.
- Reasonably ensures the continuation of safe and reliable utility services.
- Will not result in sudden substantial rate increases to customers annually or over the term of the plan.
- Is representative of the utility's operations over the plan term.
- Is otherwise in the public interest.

In approving an application, the Commission may impose any conditions in the implementation of a Plan that the Commission considers necessary to ensure that the utility complies with the Plan, and that the Plan and associated rates are just, reasonable, and in the public interest, and the plan reasonably ensures the provision of safe, reliable, and cost-effective service to customers. At any time, for good cause shown and after an opportunity for hearing, the Commission could modify or terminate an approved Plan if modification or termination is determined to be in the public interest.

The bill would require the Commission to adopt rules on several matters, no later than 120 days after the bill became law, to, among other things:

- Require reporting on an annual basis of performance-based metrics and evaluation of those metrics' results to ensure the utility continues to perform in a safe, reliable, and cost-effective manner.
- Develop banding of authorized returns. In setting a midpoint authorized rate of return on equity for banding of authorized returns pursuant to this section, the Commission may consider any decreased or increased risk to a water or sewer utility that may result from having an approved Plan.

# House Bill 219

Page 4

- Establish a methodology to annually review the costs subject to the adjustment mechanism, including the opportunity for public hearings.

## Section 2:

The bill would modify the existing list of eligible water system improvements under G.S. 62-133.12 as follows:

- Include replacement of hydro tanks and pumping equipment.
- Include equipment and infrastructure installed at the direction of the Commission to comply with health or environmental standards established by federal, State, or local governments, in addition to secondary drinking water standards.
- Substitute the term "roadway" for "highway" with respect to unreimbursed costs where relocation of water system improvements is required for roadway projects.

The bill would modify the existing list of eligible sewer system improvements under G.S. 62-133.12 as follows:

- Eliminate improvements necessary to reduce inflow and infiltration to the collection system to comply with applicable State and federal law and regulations.
- Substitute the term "roadway" for "highway" with respect to unreimbursed costs where relocation of water system improvements is required for roadway projects.
- Include replacement or improvement of force mains, gravity mains, service lines, pumps, and other electrical equipment.

In addition, the bill would increase the cap on a rate adjustment for system improvements available under G.S. 62-133.12 from 5% to 7.5% of the total annual service revenues approved by the Commission in the water or sewer utility's last general rate case. The bill, however, would specify that the unreimbursed costs for relocation of water or sewer improvements due to roadway projects would be exempt from the cap.

**EFFECTIVE DATE:** Section 1 of the bill would be effective when it becomes law and apply to any rate making mechanisms, designs, plans, or settlements filed by a water or sewer utility on or after the date that rules adopted by the Commission, as required by Section 1, have become effective. The remainder of the bill would be effective when it becomes law.