

MEMORANDUM

To: Montana Energy and Telecommunications Interim Committee
From: Montana Public Service Commission
Re: Small water and sewer utility regulation
Date: September 13, 2017

I. PURPOSE

The purpose of this memorandum is to offer background information to the 2017 Energy and Telecommunications Interim Committee (“ETIC”) about the rate regulation of privately owned water and sewer utilities in Montana by the Montana Public Service Commission (“Commission”). The Commission encourages ETIC to study the issue of the appropriate level and scope of rate and service quality regulation of small water and sewer utilities. ETIC should consider reviewing the amount of resources that should be committed to the growing number of private water and sewer utilities that are being developed as part of new residential subdivisions as part of its interim work plan.

II. BACKGROUND

The Commission regulates public utilities which include every corporation, company, individual, or association of individuals that own, operate, or control any plant, equipment, or water right for furnishing of water or sewer service to other persons or associations. Mont. Code Ann. § 69-3-101. This statute exempts privately owned and operated water, sewer, or water and sewer systems that do not serve the public, county or consolidated city and county water or sewer districts, and municipal sewer or water systems established by the governing body of a municipality. Montana law states that every public utility in Montana is required to furnish reasonably adequate service and facilities, and all charges made for their services and in connection with any public utility shall be reasonable and just. *Id.* § 69-3-201. Further, the Commission is invested with the full power of supervision, regulation, and control of such public utilities. *Id.* § 69-3-102. As part of its statutory authority, the Commission may receive and act upon complaints against public utilities. *Id.* § 69-3-321. The Montana Consumer Counsel has statutory and constitutional authority to participate and represent the interests of utility ratepayers in rate proceedings. *Id.* § 69-2-204 and Mont. Admin. R. 38.2.2528. The Montana Department of Environmental Quality regulates the operation and

testing of public drinking water and wastewater systems. The Montana Department of Natural Resources and Conservation regulates a utility's water right allocation.

Montana case law also clarifies the Commission's regulatory role over water utilities. In *Lockwood Water Users Association v. Anderson*, Lockwood Water Users Association provided water service to its members on a nonprofit cost-sharing basis. *Lockwood v. Anderson* 168 Mont. 303, 308, 542 P.2d 1217, 1220 (1975). The defendant was the owner of a mobile home development with an agreement for water service with the association. Only members are authorized to use the system and by joining the association, they agree to be bound by its rules. When the association filed suit to enforce the terms of the agreement, the defendant argued he was not subject to the contract and argued that his water service was in fact subject to the jurisdiction of the Montana Public Service Commission. *Id.* at 308309. The Montana Supreme Court stated “the most important test used in determining whether such an organization or group is in fact a public utility in this respect is the factor of serving or willingness to serve the entire public within the area in which the facilities of the organization are located.” *Id.* at 309 (citing 64 AmJur2d. Public Utilities, § 5, p 553). The Montana Supreme Court upheld the trial court’s finding that the association’s service was not held out to be willing to service the public, and was rendered only to members who share the costs of operation, therefore the service was contractual and the association was not a public utility. *Id.* at 309.

The Commission implemented initial administrative rules regarding the rates, terms, and service quality of water and sewer utilities in 1982. *See* Mont. Admin. R. 38.5.2501 through 38.5.2514. Based on its research and Montana Department of Environmental Quality documents, the Commission estimates that since 1982, the number of privately owned water utilities has grown substantially to somewhere between 200 and 500 water utilities. The only large water or sewer utility that the Commission has recently regulated was the Mountain Water Company in Missoula until the City of Missoula took ownership of it earlier this year. Years ago, water system development primarily occurred through several methods: a municipal utility providing water service, a homeowners association, a local water district, or a house was developed with a private well and septic system. However, now it is much more common for development to occur in subdivisions in which the developer builds and operates a small water and sewer system which then meets the requirements to be regulated pursuant to Montana

law. A small water or sewer utility is defined as a utility with less than 500 customers. The Commission has focused its efforts involving small water and sewer utility regulation on consumer complaints and identification through the regulatory process. The Commission also has a rule that directs persons to file a complaint with the Commission if they seek to challenge the standard rate tariff, Mont. Admin. R. 38.5.2528(4) and 38.2.2101. As of today, about 25 small water and sewer utilities are in compliance with Commission rules, with Commission-approved rates on file.

III. STATUTORY AND RULEMAKING CHANGES

The Commission is aware there are likely many more private water utilities that the Commission should bring into compliance. In 2013, in anticipation of that process, the Commission worked with the Legislature to pass legislation requiring property developers to submit as part of the preliminary plat process a statement of whether the water and sewer systems are subject to regulation or exempt from Commission jurisdiction and an explanation for any exemption. Mont. Code Ann. § 76-3-622 (1)(b)(ii). However, only in one instance since that time has the Commission been notified consistent with that required process even though many subdivisions have likely been developed since then. In 2014 the Commission conducted research on how other states set rates for small water and sewer utilities and the scope of this regulation. The Commission initiated a rulemaking process, received public comment, and held a rulemaking hearing. Following that hearing, the Commission implemented new rules governing the simplified regulatory rate treatment options available to small water and sewer utilities. *See* Mont. Admin. R. 38.5.2526 through 38.5.2531.

“When initiating the rulemaking process for the simplified regulatory treatment options for small water and sewer utilities, the Commission was interested in simplifying the process of filing for rates and minimizing the regulatory costs to ratepayers.” 4 Mont. Admin. Reg. 396–397 (Feb. 27, 2014). The Commission agreed with one commenter who stated:

“...there are benefits to systems and consumers in having a reasonable, affordable, and streamlined system for charging rates, which outweighs any potential benefits achieved by a more expensive, burdensome, and granular case-by-case ratemaking process intended for large utilities. The commenter supported having the standard rate subject to rate examination in rulemaking

instead of by an individual basis during a rate case. The simplified standard rate also decreases the demand for agency services and is a more productive use of limited agency resources.”

Id. at 397 (see Comment 3 and Response 3). The Commission recognized that most small water and sewer utilities will not want to undertake a traditional cost of service rate case based on the substantial cost for rate consultants and legal assistance. *Id.* at 398. In some past small water utility rate cases, the utilities spent between \$15,000 and \$35,000 on rate case expense between consultants, attorneys, and hearing preparation, which would ultimately be paid by ratepayers in the Commission approved rates over a three to six year amortization period. For some small utilities, this would amount to a rate payer paying hundreds of dollars over a three to five year period just for the cost of the utility filing for a rate case.

In its Comments during the rulemaking process, the MCC opposed the adoption of standard rates for small water and sewer utilities, arguing that the number of small water and sewer filings is not unmanageable at this time. MCC Comments, *In the Matter of the Adoption of New Rules I through VII Pertaining to Simplified Regulatory Options for Small Water and Sewer Utilities 1* (Oct. 4, 2013). However, the Commission is aware that there may be a substantial number of water utilities currently operating without commission-approved rates that need to establish rates with the Commission. 4 Mont. Admin. Reg. at 398.

The Commission appreciated the MCC comments and concerns during the rulemaking process, but ultimately found that the previous regulatory regime gave small water and sewer utilities the incentive to avoid establishing commission-approved rates because of the substantial regulatory cost. *Id.* These rules were established to reduce the regulatory cost to ratepayers and to establish initial rates in some manner when utilities first start serving customers or start the compliance process. The Commission found that because the small water and sewer utilities generally have limited financial information prior to regulation and when they first start operating, the best way to establish initial rates is to offer standard rates until complete financial information is available. *Id.*

Recently, one investor-owned small water utility argued small water and sewer utilities should be able to recover costs from consultants and attorney fees in proceedings before the Commission, have standard rates be tied to an outside source, and that they be eligible to receive a return on investment under the simplified regulatory treatment rules. All public utilities regulated by the Commission, including these investor-owned small water utilities eligible for

simplified regulatory treatment, can seek cost recovery for consultant and attorney fees, as well as a return on their investment if they seek rates by filing a full rate case with the Commission. However, these costs are not authorized under the simplified regulatory treatment rules due to their simplified and standard nature, but that does not prohibit a small water utility from utilizing outside resources at their own cost.

Standard water rates are established at \$50 per month per customer for non-metered water service. The standard water rates are \$40 per month per customer for metered customers using up to 10,000 gallons of water, and \$2 per 1000 gallons after that, for up to the first three years. Standard sewer rates are \$30 per month per customer. The Commission based these rates on the analysis it conducted during the rulemaking process, including rates for other water utilities in Montana, standard rates in other states, financial analyses it conducted, and comments during the rulemaking process. The Montana Statewide Water and Wastewater Rate Study conducted by the Rural Community Assistance Corporation states that water and wastewater systems that serve less than 500 people and are regulated by self-governing councils or boards have a monthly water rate average of \$49.98 and a monthly average sewer rate of \$26.27. This also helps confirm the appropriateness of these initial standard rates.¹ Further, the Commission rules state that the utility may be required to implement the standard rate in increments over a reasonable time period if either of the two simplified regulatory options would result in increased rates to customers. Mont. Admin. R. 38.5.2527(3).

“A standard rate tariff adopted by a small water or sewer utility expires three years after its effective date.” Mont. Admin. R. 38.5.2528. The utility must notify the Commission at least three months prior to the expiration date that it will file either: an extension to keep the standard rate tariff, a rate case, or an application to adopt the operating ratio method. *Id.* At that time, the Commission will have three years of the utility’s financial information to consider when evaluating the utility’s rate request.” Order 7537a ¶24.

IV. PSC RECOMMENDATION

The Commission has contemplated initiating a compliance process to bring the hundreds of small water utilities into compliance as regulated water utilities.

¹ See 2016 Statewide Water and Wastewater Rate Study (Mont. Dept. of Natural Res. & Conservation 2016), available at <http://dnrc.mt.gov/divisions/carrd/news/2016-statewide-water-and-wastewater-rate-study>.

However, the Commission would like ETIC to study this issue during the 2017 interim and provide direction for possible legislation for the 2019 legislative session, specifically on what level of regulation may be appropriate and the amount of resources needed to commit to small water and sewer utility rate regulation. As the Commission has researched small water and sewer utility rate treatment in other states it has found that some states have decided to have the public utility regulator set standard utility rates for small water and sewer utilities, some have simplified the rate setting process, and some have chosen not to rate regulate small water and sewer utilities at all. ETIC may want to study how these options have worked in other states and whether it has interest in reviewing small water and sewer utility rate regulation further.

If the Commission initiates this compliance process, it will likely double the number of utilities it regulates and substantially increase the workload at the Commission. The Commission has lost five positions that have been cut from the Commission's budget over the last two legislative sessions and the Commission would request that ETIC study the appropriate scope of regulation for small water and sewer utilities going forward, based on the current resource constraints.