



COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA PUBLIC UTILITY COMMISSION
P.O. BOX 3265, HARRISBURG, PA 17105-3265

IN REPLY PLEASE
REFER TO OUR FILE

July 27, 2016

Secretary Rosemary Chiavetta
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

Re: Joint Application of Pennsylvania American Water Company (PAWC) and the Sewer Authority of the City of Scranton for approval of 1) the transfer, by sale, of substantially all of the Sewer Authority of the City of Scranton's Sewer System and Sewage Treatment Works assets, properties and rights related to its wastewater collection and treatment system to PAWC, and 2) the right of PAWC to begin to offer or furnish wastewater service to the public in the City of Scranton and the Borough of Dunmore, Lackawanna County, Pennsylvania
Docket No. A-2016-2537209

Dear Secretary Chiavetta:

Enclosed please find the Bureau of Investigation and Enforcement's (I&E) **Reply Brief** in the above-captioned proceeding.

Copies are being served on parties as identified in the attached certificate of service. If you have any questions, please contact me at (717) 783-7998.

Sincerely,

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ACK/GLL/sea
Enclosure

cc: ALJ Steven K. Haas
ALJ David A. Salapa
Certificate of Service

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Joint Application of Pennsylvania :
American Water Company (PAWC) and :
the Sewer Authority of the City of :
Scranton for approval of 1) the transfer, :
by sale, of substantially all of the Sewer :
Authority of the City of Scranton's Sewer :
System and Sewage Treatment Works : Docket No. A-2016-2537209
assets, properties and rights related to its :
wastewater collection and treatment :
system to PAWC, and 2) the right of :
PAWC to begin to offer or furnish :
wastewater service to the public in the :
City of Scranton and the Borough of :
Dunmore, Lackawanna County, :
Pennsylvania :

**REPLY BRIEF
OF THE
BUREAU OF INVESTIGATION AND ENFORCEMENT**

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Dated: July 27, 2016

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I. INTRODUCTION

A. History of the Proceeding

The procedural history of this proceeding is detailed in the Bureau of Investigation and Enforcement's (I&E) Main Brief filed on July 19, 2016. In its Main Brief, I&E presented the evidence and law in support of its recommendation that Pennsylvania-American Water Company's (PAWC) request for Commission approval to acquire the assets of The Sewer Authority of the City of Scranton (SSA or Authority) (collectively, Joint Applicants) be denied as currently structured because the terms and conditions contained in the Asset Purchase Agreement (APA) are not in the public interest. To ensure that the public interest is protected, approval of the Application must be conditioned upon adopting I&E's proposed recommendations concerning the ratemaking recovery of the Variance Adjustment payment and a stormwater cost of service study so that those costs can be properly allocated in PAWC's next base rate proceeding. This Reply Brief is supplemental to the Main Brief filed on behalf of I&E.

B. Evidentiary Standard and Burden of Proof

As discussed in I&E's Main Brief, the Joint Applicants retain the burden of proving that the requested certificates of public convenience affirmatively promote the service, accommodation, convenience or safety of the public in some substantial way.¹ This standard is well-established and recognized by the Commission and courts.² A review of the evidence and arguments presented by the parties demonstrates that the Joint

¹ I&E Main Brief at 3-4. 66 Pa. C.S. § 1103(a).

² I&E Main Brief at 3-4.

Applicants have failed in their burden because the terms contained in the APA are not in the interest of PAWC's ratepayers. The Commission has the authority to impose conditions on granting a certificate of public convenience to ensure that a transaction is in the public interest.³ Accordingly, if this transaction is approved, the public interest requires Commission approval of the following conditions: (1) PAWC will provide cost of service studies that separate sanitary sewer and stormwater flows, capital expenses and operating costs in its next base rate proceeding and (2) recovery of the Variance Adjustment from PAWC ratepayers is prohibited.

II. ARGUMENT

A. **The APA, As Currently Structured, Is Not In The Public Interest Because It Fails to Provide A Substantial Benefit to PAWC Customers**

When addressing the substantial public benefits of this transaction, the Joint Applicants go to great lengths to discuss the benefits to Scranton-area customers, the Authority and the City of Scranton (City) if this transaction is approved. The headings contained in the Joint Applicants' Main Brief addressing the substantial public benefits are as follows:

PAWC Ownership and Operation of the Combined Wastewater System in the Applied-For Service Territory Would Produce an Affirmative Public Benefit of a Substantial Nature

- a. Scranton-Area Customers Will Benefit from Enhanced Service.
- b. PAWC Has Better Access to Diverse Capital Sources than SSA.

³ 66 Pa. C.S. § 1103(a).

- c. Scranton-Area Customers Will Benefit from Being Part of Larger Customer Base.
- d. PAWC's Commitment to Create 100 New Jobs in the Scranton-Area Will Promote Economic Development
- e. Transaction Proceeds Will Help Ameliorate the City of Scranton's Financial Situation and Benefit the Authority's Customers.

As a result, one does not have to read beyond the table of contents to understand that remarkably absent from the Joint Applicants' public interest discussion is any mention of substantial public benefits that its current customers will experience through approval of this transaction. The Joint Applicants have filled the record with reasons why the acquisition will benefit SSA customers and the City, but the record is almost completely void of benefits for existing PAWC customers. This disparity is inappropriate because, as discussed at length in I&E's Main Brief, SSA customers, the Authority and the City are not properly included in the public interest consideration.⁴ In contrast, PAWC customers are undoubtedly a component of the public interest consideration before this Commission and the proposed recovery of stormwater costs and potential recovery of the Variance Adjustment payment through rates is not in their interest.

The Joint Applicants have made unquantified and generalized assertions that current customers will benefit from the economies of scale, but I&E submits that this is insufficient to overcome the detriment to PAWC's existing customers if stormwater and the Variance Adjustment are permitted to be recovered as a result of this transaction. For example, the Joint Applicants allege that "PAWC's other customers will benefit as more

⁴ I&E Main Brief at 4-7.

customers join PAWC's combined customer base because there will be more customers to help pay for future improvements of PAWC's system-wide facilities.”⁵ This argument is suspect because PAWC provides water service to 653,000 customers and wastewater service to more than 21,000 customers, while SSA will only add approximately 31,000 wastewater customers.⁶ As OCA demonstrated, almost all of SSA’s 31,000 wastewater customers are already currently PAWC water customers, so PAWC’s customer count will not be increased.⁷ For this slight addition, PAWC customers would be faced with projected stormwater-related capital investments totaling between \$146 million and \$199 million (in 2011 dollars) over the next 20 years⁸ and may also be expected to shoulder untold costs arising under rate subsidies due to the ratemaking limitations contained in the APA and the payment of the Variance Adjustment.⁹

Additionally, it is clear that reduction of costs is an undetermined benefit for existing PAWC customers given that PAWC witness Nevirauskas could only offer that “...over time these things will even out as they [SSA customers] share in the costs of other wastewater systems, and ultimately other water system investment.”¹⁰ I&E’s concern is that it may be a long time before this cost sharing occurs given that the Joint Applicants appear to recommend that the Commission disregard the rate impact for the foreseeable future. According to PAWC:

⁵ JA Main Brief at 50.

⁶ JA Main Brief at 12, 50.

⁷ OCA St. 2 at 34; OCA Main Brief at 32.

⁸ OCA St. 1 at 31 (citing PAWC Response to OCA II-6, Att. B, Table 2).

⁹ OCA Main Brief at 33.

¹⁰ Tr. at 122, 170.

the Commission should analyze the rate impact of this Transaction not from a 13-year perspective but from a 100-year perspective and recognize that other PAWC customers will benefit from the addition of over 31,000 wastewater customers.¹¹

The Joint Applicants reiterated the above recommendation in its Main Brief, but slightly modified it to recommend that the Commission analyze the rate impact from a 50-100 year perspective.¹² The proposed 50 year perspective, like the 100 year period, is contrary to the public interest because current ratepayers should not be harmed through higher rates as a result of this acquisition. Rather than look at this transaction from a 100 year perspective, the Commission should adopt I&E witness Cline's recommendation to "analyze the impact of this transaction from the perspective of each successive base rate increase after the Closing, as the impact will be felt by customers both in the short term and the long term."¹³ Indeed, the Public Utility Code mandates this perspective because the Commission is obligated to set just and reasonable rates now and in every PAWC base rate case filed 50 or 100 years from now.¹⁴

To ensure that the public interest is protected both now and in the future, I&E made specific recommendations in this proceeding to insulate PAWC ratepayers from costs arising under the APA. As such, approval of this transaction should be conditioned upon PAWC providing costs of service studies that separate sanitary sewer and stormwater flows, capital expenses and operating costs in its next base rate proceeding and disallowing the recovery of the Variance Adjustment from PAWC ratepayers.

¹¹ PAWC St. No. 4-R at 5.

¹² JA Main Brief at 12.

¹³ Tr. at 81-82.

¹⁴ 66 Pa. C.S. § 1301.

B. Allocating SSA's Stormwater Costs To PAWC Ratepayers Is Not In The Public Interest

The Joint Applicants condition the success of the acquisition upon the Commission's determination that Act 11 applies to combined wastewater service, and includes stormwater in the definition of "wastewater." The cost-spreading provisions upon which the Joint Applicants rely is grounded in Act 11 of 2012, which, inter alia, amended Chapters 13 of the Public Utility Code to allow jurisdictional wastewater utilities to allocate a portion of their revenue requirement to the combined wastewater and water utility customer base.¹⁵ Pursuant to Act 11, Section 1311(c) of the Public Utility Code was established and it provides as follows:

Segregation of property.--When any public utility furnishes more than one of the different types of utility service, the commission shall segregate the property used and useful in furnishing each type of such service, and shall not consider the property of such public utility as a unit in determining the value of the rate base of such public utility for the purpose of fixing base rates. A utility that provides water and wastewater service shall be exempt from this subsection upon petition of a utility to combine water and wastewater revenue requirements. **The commission, when setting base rates, after notice and an opportunity to be heard, may allocate a portion of the wastewater revenue requirement to the combined water and wastewater customer base if in the public interest.**¹⁶

Though the Joint Applicants stress that the intent of Act 11 was to encourage the acquisitions of troubled wastewater systems and regionalization, they avoid the fact

¹⁵ Act 11 of 2012, Final Implementation Order, M-2012-2293611 at 1(Entered on August 2, 2012).

¹⁶ 66 Pa.C.S.A. § 1311(c)(emphasis added).

that a public interest analysis must weigh in favor of Act 11's application. This attempt to spread SSA customers' stormwater costs to all PAWC customers is not in the public interest as such costs should be recovered specifically from the customers or entities that cause them.¹⁷

Despite the Joint Applicants' staunch insistence that ratemaking issues should not be interjected into this proceeding,¹⁸ they seek preapproval of stormwater cost recovery under 1311(c). Specifically, the Joint Applicants have concluded that, "the applicability of Act 11 to Combined Wastewater service [is] so fundamental to this Transaction that [it] must be resolved in this proceeding and cannot wait until a future PAWC base rate proceeding."¹⁹ The Joint Applicants' flawed rationale for this determination is three-fold because absent the Commission's preapproval of Act 11's cost-spreading provisions: (1) PAWC will incur significant stranded costs; (2) Scranton-area customers could experience significant rate increases; and (3) PAWC could have to pay a significant variance adjustment to the SSA.²⁰ I&E submits that none of these three reasons overcome Act 11's mandate that cost-spreading may only occur if doing so is in the public interest.

¹⁷ I&E St. No. 1, p. 15.

¹⁸ JA Main Brief at 80.

¹⁹ JA Main Brief at 10, 35.

²⁰ JA Main Brief at 36.

1. The Stranded Cost Argument Is Based On A False Dilemma Created By The Joint Applicants

The Joint Applicants argue that the Commission's failure to allow rate recovery of stormwater-related costs of combined wastewater service could result in significant stranded costs for PAWC.²¹ According to PAWC witness Nevirauskas,

This Transaction would not be in the public interest and cannot proceed to closing if the Commission is not prepared to indicate in this proceeding that PAWC will be entitled to recover in rates its prudently incurred capital and operating costs associated with the integrated stormwater service provided as part of the Combined System. **It would be unreasonable for PAWC to assume the risk and uncertainty of not knowing whether such cost recovery will be permitted.** PAWC would run the risk that it could be saddled with significant stranded costs associated with stormwater collection and treatment that are likely to have a significantly adverse effect upon PAWC's financial status.²²

While PAWC focuses on the "unreasonable risk" that PAWC faces absent the Commission's preapproval of stormwater rate recovery, that fatalistic view ignores other opportunities for cost recovery, such as recovery from SSA customers or from the City as the beneficiaries of this stormwater service.

Despite their attempt to minimize the existence of alternative recovery methods, I&E witness Cline exposed the Joint Applicants' false dilemma in his response to PAWC witness Nevirauskas:

It appears that Mr. Nevirauskas is requesting that PAWC be granted pre-approval to recover all unknown and unidentified

²¹ JA Main Brief at 36.

²² PAWC St. No. 4-R, p. 21 (emphasis added).

stormwater costs in this proceeding prior to its claim in the next base rate case. Furthermore, his self-determined and unsupported conclusion that anything less than full rate recovery would lead to PAWC incurring unreasonable stranded costs ignores other opportunities for cost recovery and incorrectly assumes that spreading the costs across PAWC's entire customer base is the only recovery method available.²³

It appears that the Joint Applicants concede witness Cline's point because they have now admitted that alternative recovery options exist and then quickly dismissed those options. More specifically, in their Main Brief, Joint Applicants identify two other options for recovering stormwater costs outside of passing them along to all PAWC ratepayers: (1) PAWC could enter into contracts with each customer to authorize stormwater service and charges or (2) PAWC could collect stormwater fees as a billing agency for a "yet to be created" stormwater authority.²⁴ Without any analysis, the Joint Applicants conclude that the first option, entering into contracts with each impacted customer for stormwater service and charges, is a near impossibility. After dismissing the first option, the Joint Applicants fail to evaluate the second option in their Main Brief.²⁵ However, PAWC witness Nevirauskas previously offered testimony admitting that "PAWC may be able collect a stormwater charge from [former SSA] customers on behalf of a municipality or municipal authority provided that the municipality or municipal authority has the statutory authority to impose the charge upon its citizens."²⁶

²³ Tr. at 89.

²⁴ JA Main Brief at 36.

²⁵ JA Main Brief at 36.

²⁶ PAWC St. No. 4-R at 21.

I&E submits that the Joint Applicants' failure to consider and evaluate other stormwater cost recovery methods is not a viable reason to look only to PAWC's existing ratepayers for funding. Furthermore, it cannot be ignored that PAWC knowingly entered into the APA despite the fact that the SSA had no plan to establish a stormwater authority, effectively eliminating the opportunity for appropriate recovery. Municipal recovery is an appropriate avenue, because as I&E explained, the costs of a stormwater system should be recovered specifically from the customers or entities that cause them.²⁷ In this case, OCA demonstrated that in an average year, approximately 1,346 MG of stormwater enters SSA's Combined Sewer System, resulting in a need to treat an average of 1.77 MG of stormwater each day.²⁸ Furthermore, the City of Scranton and the Borough of Dunmore are the largest contributors due to the stormwater runoff from their streets and roads.²⁹ The high volume of stormwater runoff is apparent in the fact that in the SSA's combined system, there are between 10,000 and 14,000 stormwater catch basins, while a standalone sanitary sewer system should not have any catch basins.³⁰ These facts highlight the impropriety of imposing SSA's stormwater costs on PAWC's existing ratepayers.

The Joint Applicants' have maintained that this transaction must close by October 31, 2016; otherwise, the City will face "an untenable 2017 budget."³¹ However, this transaction should not be rushed to the point that PAWC is granted preapproval to

²⁷ I&E St. No. 1, pp. 14-15. Tr. at 85-86.
²⁸ OCA St. No. 1 at 9-10; OCA Ex. TLF-7
²⁹ OCA St. No. 1 at 10.
³⁰ Tr. at 178-179.
³¹ JA Main Brief at 56.

recover stormwater costs from its current customers in this proceeding. While spreading these costs to PAWC's current ratepayers certainly satisfies the City's timeline, it is not in the public interest as PAWC's existing ratepayers do not contribute to stormwater costs. Accordingly, I&E maintains that PAWC must be required to provide a separate stormwater cost of service study in its next rate case so that costs can be appropriately allocated to SSA customers, to the City or, if necessary, to PAWC.

2. Scranton Customer Rates Cannot Be Used As A Justification To Improperly Increase PAWC Customer Rates

The Joint Applicants assert that allocating the stormwater component of the Combined Wastewater System entirely and directly to Scranton-area customers would result in the risk of significant rate increases for those customers.³² This claim is unsupported as the Joint Applicants have failed to offer any evidence that imposing stormwater costs upon the party that causes those costs, the Scranton-area customers, would result in rate shock. In fact, the Joint Applicants' lack of evidence on this point is telling because it reveals that they have failed to calculate or even identify these costs before seeking to impose them upon PAWC's existing ratepayers who do not benefit from stormwater service.

Furthermore, PAWC's concern about rate shock for SSA customers if they are required to pay stormwater costs is a bit disingenuous given that the rate provisions agreed upon in the APA will likely violate this ratemaking principle. Under Section 7.07 of APA, SSA customers will initially be rewarded with either artificially low rates for ten

³² JA Main Brief at 37.

years after the Closing or, if the Commission approves higher rate increases for SSA customers than contemplated in the APA, a potential pay-out under Section 7.07. In either case, these rewards will come at the expense of all other PAWC ratepayers. Despite this unfair subsidization, SSA customers may still be subject to rate shock, as explained by I&E witness Cline:

Depending on when PAWC files its base rate cases, the proposed method for merging rates as set forth in the APA could potentially cause SSA customers to incur rate increases in four consecutive years (years 10-13 after the Closing). The frequency of these increases may violate the concept of gradualism because rates will be suppressed in the initial ten year period and then merged quickly into Rate Zone 1 by year thirteen. Furthermore, the increase necessary for SSA customer rates to merge with PAWC Rate Zone 1 rates could be substantial enough to cause rate shock, even when phased in over three years.³³

Based on this analysis, potential rate shock for SSA customers is a reality under the APA regardless of the Section 1311(c) application to stormwater costs. Accordingly, the Joint Applicants' are using rate shock to obtain approval of the stormwater cost spreading recommendation, but are ignoring the very real possibility of rate shock that will arise in years 11 through 13 after Closing due to the terms they agreed to in the APA.

3. The Threat Of A Variance Adjustment Payment Cannot Justify Recovery Of Stormwater Costs From All PAWC Customers

The Joint Applicants argue that if 1311(c) is deemed inapplicable, PAWC may be forced to pay a significant Variance Adjustment.³⁴ The Variance Adjustment should not

³³ I&E St. No. 2, pp. 4-5.

³⁴ JA Main Brief at 37-38.

be recovered from PAWC ratepayers and it should not be used as a justification to improperly spread stormwater costs to PAWC customers.

The Variance Adjustment is an unprecedented term that has not been proposed or accepted by this Commission in any prior acquisition. I&E stands by the position that the risk of the Variance Adjustment should remain with PAWC, as explained in its Main Brief:

[the]Variance Adjustment... is a new term that is not consistent with sound ratemaking principles. The Variance Adjustment increases the \$195 million purchase price ten years after Closing if revenues increase above the agreed upon 1.9% Compound Annual Growth Rate (CAGR) benchmark. The Variance Adjustment is not an asset purchase or related to used and useful plant, but is additional compensation for SSA ten years after the Closing if revenues are higher than the arbitrary 1.9% CAGR. The risk for this unprecedented term should remain with the Company, not its customers. Moreover, the APA contains several ratemaking terms that are intertwined with the Variance Adjustment as it provides an incentive to keep SSA rates low for the ten year period. SSA rates must be designed according to proper ratemaking principles and not be limited for a decade due to the threat of the Variance Adjustment.³⁵

The Joint Applicants are now using the threat of the Variance Adjustment payment as a justification to spread SSA stormwater costs to all of PAWC's current customers. Using one improper ratemaking term to justify recovering another improper ratemaking term from customers is fundamentally flawed. The Joint Applicants' proposed transaction contains complex issues of first impression regarding the recovery of

³⁵

I&E Main Brief at 8.

stormwater and the creation of the Variance Adjustment. I&E recommended a cost of service study so that stormwater can be properly allocated to the customers who benefit from that service. The fact that this direct allocation may impact the Variance Adjustment is due to the unusual structure and terms contained in the APA, not because the allocation is improper. The Joint Applicants have continually asserted that their agreement upon Variance Adjustment provision of the APA and their undisclosed method for its calculation were “the result of arms-length negotiations.”³⁶ I&E assumes that PAWC’s assent to the Variance Adjustment provision of the APA was given only after a careful analysis of its risk. PAWC should be prepared to incur the detriment of its bargain, whether it concerns cost recovery of the Variance Adjustment from ratepayers or whether it concerns recovering stormwater costs through SSA rates. Accordingly, the threat of the Variance Adjustment payment is not an appropriate reason to spread stormwater costs to all of PAWC’s customers.

³⁶ I&E Ex. No. 1 at Sch. 1; Tr. at 115-116.

4. The *City of Lancaster* Decision Is Applicable

While the Joint Applicants' desire to distinguish the *City of Lancaster*³⁷ case from this proceeding and to discredit its basis of authority is understandable, their efforts fail to overcome the fact that *City of Lancaster* is an applicable authority. For ease of reference, I&E presents the pertinent summary of *City of Lancaster*, as appearing in the Joint Applicants' Main Brief:

In *City of Lancaster*, the city provided combined stormwater and wastewater services to customers within its corporate limits and only wastewater services to extra-territorial (and therefore Commission-jurisdictional) customers. The city developed a revenue requirement on a system-wide basis, including both jurisdictional and non-jurisdictional customers, and apportioned the total system's operating and maintenance expenses, depreciation expenses, and rate base to the jurisdictional customers based on a number of factors. The statutory advocates challenged the city's methodology, arguing that the costs of treating the city's stormwater should not be passed on to jurisdictional customers.... The Commission adopted OCA's methodology, and the City appealed. The Court affirmed in part but remanded to re-allocate costs of service to jurisdictional customers.³⁸

Importantly, *City of Lancaster* is the only case in which the Commission has addressed combined sanitary and storm systems. Ultimately, in its Final Order, the Commission ordered that that stormwater costs not be recovered from jurisdictional customers.³⁹

³⁷ *City of Lancaster v. Pennsylvania Public Utility Commission*, No. 1968 C.D. 2005 (Pa. Cmwlth. 2006).

³⁸ JA Main Brief at 32.

³⁹ *Pa. PUC v. City of Lancaster*, Docket No. R-00049862 (Order entered August 26, 2005).

A review of ALJ Melillo's Recommended Decision in the *City of Lancaster*

summarized OCA's position on stormwater costs, which was also adopted by I&E (then OTS):

OCA's position is that, while there are no sewers located in the jurisdictional area which collect stormwater, the City's sewer system is combined, and that combined stormwater and wastewater flows from the non-jurisdictional sewage system are conveyed, pumped, and treated in facilities whose costs are allocated to jurisdictional customers. It is OCA's position, and OTS' position through its adoption of Mr. Fought's testimony, that these costs associated with stormwater runoff are not properly recoverable as utility costs and must be removed from this rate case.⁴⁰

In her Recommended Decision, ALJ Melillo found increased conveying, pumping and treatment costs were produced by stormwater entering the City's combined sewer system through approximately 2,000 stormwater inlets⁴¹ and that these costs associated with stormwater were not properly recoverable from jurisdictional customers.⁴² The Commission agreed with ALJ Melillo, and as the Joint Applicants have indicated, the Commonwealth Court upheld the Commission's affirmed the Commission's decision in part and remanded to the Commission for a re-allocation of costs.

I&E rejects the Joint Applicants' notion that *City of Lancaster* is inapplicable merely because the Commonwealth Court's decision is unpublished and non-binding.⁴³ The *City of Lancaster* provides a meaningful analysis because it represents the only case in which the Commission has ever addressed combined sanitary and storm systems, thus

⁴⁰ *Pa. PUC v. City of Lancaster*, Docket No. R-00049862, Recommended Decision, p. 11 (June 23, 2005).

⁴¹ In this case, SSA has between 10,000 and 14,000 catch basins.

⁴² *Id.* at 12, 18.

⁴³ JA Main Brief at 32.

it provides pertinent guidance. Furthermore, the Joint Applicants neglect the fact the Commission's Final Order in *City of Lancaster* provides a source of persuasive authority that is relevant to this proceeding. Accordingly, while the Commonwealth Court's decision may have been unpublished and non-binding, it does not diminish the applicability of *City of Lancaster* to this proceeding.

Additionally, the Joint Applicants' attempt to dismiss *City of Lancaster* by pointing out that "[i]n the 10 years since the court decided the case, research has not revealed any cases relying on *City of Lancaster* as persuasive authority for the proposition that the Commission lacks jurisdiction over Combined Wastewater service.⁴⁴ These arguments are flawed for several reasons. First, the opportunity to rely upon *City of Lancaster* has simply not arisen, not because it is no longer persuasive authority, but because the circumstances of this case are an anomaly. This is an issue of first impression as no other investor owned utility has requested Commission approval to purchase a combined system. Aside from the City of Lancaster, no other combined sewer systems in Pennsylvania are regulated by the Commission; therefore, the Commission has no jurisdiction over their rates and service. Therefore, the fact that no other cases have cited to *City of Lancaster* is simply because there has been no reason to do so, not because the *City of Lancaster* shelf life has somehow expired as Joint Applicants' suggest. Second, the Joint Applicants' position is not entirely accurate as it ignores the fact that a subsequent Lancaster case in 2012 allocated stormwater costs solely to non-

⁴⁴ JA Main Brief at 32.

jurisdictional customers.⁴⁵ This case presented an opportunity for Lancaster to reargue the stormwater allocation issue and for the Commission to reconsider its position that stormwater costs should not be paid by jurisdictional customers. Neither of these events occurred as Lancaster allocated stormwater costs solely to non-jurisdictional customers and the Commission's just and reasonable rates did not include stormwater expense. Therefore, the Commission has approved the removal of stormwater costs from jurisdictional rates as recently as four years ago.

Furthermore, the Joint Applicants' self-serving determination that *City of Lancaster* is narrow is built on faulty logic. The distinction between municipal territorial customers and Commission jurisdictional customers is immaterial to the determination that stormwater costs cannot be imposed upon jurisdictional customers. As the OCA rightly indicates, *City of Lancaster* establishes not only that PUC-jurisdictional customers should not pay the costs associated with stormwater service to non-jurisdictional customers, but also that the costs of providing stormwater service are distinct from the costs of providing wastewater service, even if one system is providing two services.⁴⁶

Finally, despite the Joint Applicants' reliance upon the fact that Act 11 had not been in place when *City of Lancaster* was decided, the existence of Act 11 does not convert ineligible costs to recoverable costs. This is true despite the Joint Applicants' attempt to distinguish the instant case from *City of Lancaster* by invoking Act 11. As I&E previously explained, cost allocation under Act 11 is only permissible when it is in

⁴⁵ *Pa. PUC v. City of Lancaster- Sewer Fund*, Docket No. R-2012-2310366 (Order entered February 26, 2013). OCA St. No. 1, p. 12.

⁴⁶ OCA Main Brief at 15.

the public interest. It is not in the public interest to recover stormwater costs from PAWC's existing customers; therefore, the existence or nonexistence of Act 11 fails to make the *City of Lancaster* inapplicable to this proceeding.

C. The Commission Should Deny Recovery Of The Variance Adjustment In This Proceeding

The Joint Applicants argue that determining the ratemaking recovery of the Variance Adjustment is premature in this proceeding.⁴⁷ I&E disagrees and maintains that this issue cannot be delayed until a future rate case because recovery of the Variance Adjustment from PAWC customers is contrary to the public interest.

As discussed, the Commission can only approve this transaction if it is in the public interest.⁴⁸ Recovery of the Variance Adjustment through rates harms PAWC's current customers; therefore, this transaction should not be permitted to close unless the Commission expressly prohibits recovery of the Variance Adjustment from ratepayers. Contrary to the Joint Applicants' assertions, resolving the ratemaking recovery of the Variance Adjustment is timely in this proceeding because the public interest must be protected now rather than deferred to some later proceeding.

Moreover, it is in the interest of the regulated community as a whole to receive guidance about recovery of the Variance Adjustment through a determination in this proceeding. This is the first time a Variance Adjustment has been proposed, and the concern is that other utilities may contemplate incorporating this unusual term in future acquisitions. The Variance Adjustment will not be calculated until ten years after

⁴⁷ JA Main Brief at 85.

⁴⁸ I&E M.B. at 3-4.

Closing; therefore, if the Joint Applicants' requested delay is granted, PAWC will not know who is responsible for this cost for a decade. Determining the appropriate ratemaking recovery now will provide guidance to PAWC and other utilities who may contemplate incorporating this unusual term now rather than ten years from now.

Accordingly, the Joint Applicants' request to delay resolution of the ratemaking recovery of the Variance Adjustment in a future rate case must be denied as doing so is not in the interest of PAWC, its customers or the regulated community as a whole. Instead, I&E maintains that approval of this transaction must be conditioned on PAWC not being permitted to recover the currently undetermined Variance Adjustment payment from its customers.

D. SSA Rates Cannot Be Limited By The APA's Ratemaking Terms

The Joint Applicants argue that I&E's rate design concerns are unfounded, that it is premature to speculate about future rates and that it should not be used as a reason to deny the acquisition.⁴⁹

I&E has repeatedly stated that it does not know what PAWC's future rates will be as it is impossible to know what PAWC's rates will be years from now.⁵⁰ However, under the APA, SSA rates will be limited for ten years and then increased in years 11 through 13 to match Zone 1 rates. Suppressing rates for the initial ten years and increasing rates dramatically in the final three years may violate the concepts of gradualism and rate shock. Therefore, while I&E recognizes that it does not know the

⁴⁹ JA Main Brief at 82.

⁵⁰ I&E St. No. 2, p. 4; Tr. at 78-79.

PAWC's actual rates years into the future, it is important to put PAWC on notice that the framework contained in the APA appears to inappropriately design SSA customer rates over the thirteen year period.

The Joint Applicants take pains to make it clear that the APA rate terms do not bind the Commission or parties in future base rate proceedings, which is appropriate because the Commission is obligated to ensure that rates are just and reasonable and should not be restricted by terms set forth in the APA.⁵¹ However, the risk of paying a higher Variance Adjustment increases if the Commission approves rates that vary dramatically from the rate terms in the APA. Therefore, while the Commission is free to set rates that differ from the APA in theory, the concern is that deviating from the APA's rate limitations may impact the 1.9% CAGR and increase the Variance Adjustment. As a result, setting just and reasonable rates may prove to be costly if those rates exceed the arbitrary 1.9% CAGR. This further supports I&E's recommendation that Variance Adjustment cost recovery be excluded from rates as PAWC customers should not be burdened with any cost that simply results from setting reasonable rates in SSA's territory.

Although the APA's rate setting limitations are not binding on I&E or on the Commission, it is important to make clear now that SSA's rates cannot be held hostage over the next ten years due to the threat of the Variance Adjustment. Such a concern is valid because Joint Applicants are already using the Variance Adjustment as a justification to spread stormwater costs to all of its customers:

⁵¹ JA Main Brief at 87.

If the Commission fails to allow Act 11 treatment for PAWC's costs associated with the Combined Wastewater service, PAWC could significantly exceed the 1.9% CAGR and have to pay a significant Variance Adjustment.⁵²

PAWC could similarly argue in future rate cases that I&E's proposed rate design recommendations should not be adopted because increasing SSA rates in such a manner would exceed the CAGR and increase the Variance Adjustment. The arbitrary 1.9% CAGR and assorted ratemaking limitations contained in the APA cannot be the guiding principle to design SSA rates for the next decade because those customers, like all regulated customers, must pay just and reasonable rates based on proper ratemaking principles.

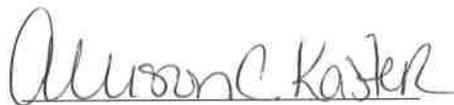
I&E is not recommending that the transaction be denied due to these ratemaking limitations contained in the APA; however, it is appropriate to put PAWC on notice and inform the Commission that such terms are potentially flawed and may prove costly. As a result, I&E's concerns are timely and properly expressed in this proceeding.

⁵² JA Main Brief at 38.

III. CONCLUSION

The proposed transaction as filed will not affirmatively promote the public interest in a substantial way. Conditions must be imposed prior to granting the requested certificates of public convenience to ensure that the interests of PAWC's customers are protected. Accordingly, if the transaction is approved, I&E respectfully requests that the ALJs recommend that the Commission condition its approval on (1) requiring PAWC to provide costs of service studies that separate sanitary sewer and stormwater flows, capital expenses and operating costs in its next base rate proceeding and (2) prohibiting the recovery of the Variance Adjustment from ratepayers.

Respectfully submitted,



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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Joint Application of Pennsylvania American :
Water Company (PAWC) and the Sewer :
Authority of the City of Scranton for approval of :
1) the transfer, by sale, of substantially all of the :
Sewer Authority of the City of Scranton's Sewer :
System and Sewage Treatment Works assets, : Docket No. A-2016-2537209
properties and rights related to its wastewater :
collection and treatment system to PAWC, and 2) :
the right of PAWC to begin to offer or furnish :
wastewater service to the public in the City of :
Scranton and the Borough of Dunmore, :
Lackawanna County, Pennsylvania :

CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing **Reply Brief** dated July 27, 2016, in the manner and upon the persons listed below, in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a party):

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