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|  | **PENNSYLVANIA****PUBLIC UTILITY COMMISSION****Harrisburg, PA 17105-3265** |  |

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|  | Public Meeting held September 20, 2018  |
| Commissioners Present: |  |

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| --- | --- |
| Gladys M. Brown, Chairman  |  |
| Andrew G. Place, Vice Chairman |  |
| Norman J. Kennard, Statement |  |
| David W. Sweet |  |
|  John F. Coleman, Jr. |  |
| Implementation of Section 1329of the Public Utility Code  | M-2016-2543193 |

**TENTATIVE SUPPLEMENTAL**

 **IMPLEMENTATION ORDER**

**BY THE COMMISSION:**

On April 14, 2016, Governor Wolf signed into law Act 12 of 2016, which amended Chapter 13 of the Pennsylvania Public Utility Code by adding a new Section 1329 to become effective June 13, 2016. 66 Pa. C.S. § 1329. On July 21, 2016, the Commission issued a Tentative Implementation Order regarding Section 1329 and on October 27, 2016, issued the Final Implementation Order (FIO) to guide stakeholders in the application of provisions of Section 1329. The Commission will not reiterate the FIO here or re-open that Order except to the extent discussed herein.

While Section 1329 has encouraged the sale of public water and wastewater assets for at market rates, our experience to date in adjudicating these Section 1329 applications indicates that our procedures and guidelines can be improved in order to create more certainty in the process, to improve the quality of valuations, to ensure that the adjudication process is both fair and efficient and, ultimately, to reduce litigation regarding the Commission’s final determinations.

Aside from fundamental stakeholder disagreement over appropriate utility valuation principles, there are difficulties related to the six-month consideration period made available to the applicants under Subsection 1329(d)(2). That is, the six-month statutory deadline comes at the price of an accelerated litigation schedule for the applicant, interested parties, and ultimately the Commission itself. In addition, the Commission has observed, in some cases, substantial variances in valuations and in the underlying assumptions related to the same property. In this regard, further guidance can provide more consistency in the final valuations as well as the direct testimony submitted in support of the valuations. Lastly, to aid in the fair and efficient adjudication of Section 1329 applications, the initial application should include enough relevant information so that statutory advocates and other stakeholders can examine the application and present their cases within the strict statutory timelines under Section 1329.

To help address these issues, the Commission staff and affected stakeholders have worked informally to develop proposed revisions to the standard materials required for applications seeking Section 1329 treatment, guidelines for utility valuations and testimony, and procedural guidelines to assist the Commission and stakeholders to better manage the demands of an appropriate review within the limited time frame for the litigation of Section 1329 applications.

Accordingly, the Commission issues this Tentative Supplemental Implementation Order with the benefit of approximately two years’ experience applying Section 1329 to applicable transfers of control under Chapters 11 and 13 of the Public Utility Code and Commission regulations, as well as the revisions proposed informally by the Commission staff and stakeholders. The Commission invites interested persons to provide formal comments and to offer recommendations for consideration on its proposals to improve the processes, evidence and guidelines for Section 1329 applications.

**Background and Purpose of 66 Pa. C.S. § 1329**

Section 1329 addresses the sale of water and wastewater systems owned by “Selling Utilities,” which are defined as water or wastewater companies owned by municipal corporations or authorities. 66 Pa. C.S. § 1329(g). Section 1329 contemplates that Selling Utility transfers of control will occur with either an “Acquiring Public Utility” or an “Entity.” These are respectively defined as a regulated public utility or person, partnership, or corporation seeking to become a regulated public utility subject to Chapter 11 of the Public Utility Code. *Id*. Section 1329 does not alter the requirements of Chapter 11 of the Public Utility Code in that all proposed transfers of control between a Seller and a Buyer must be necessary or proper for the service, accommodation, convenience or safety of the public, i.e., be in the public interest. 66 Pa. C.S. § 1103(a). To avoid tedious repetition the Acquiring Public Utility or Entity is hereafter generally referred to as the Buyer. Likewise, the Selling Utility is generally referred to as the Seller. While questions of whether any proposed transaction is in the public interest is not entirely dependent on the value of the proposed transfer, there can be no reasoned argument that valuation does not play a significant role in such considerations.

 It is not necessary for the Commission to make a final determination on valuation before approving or denying a transfer of control application under Chapter 11 as determinations on valuation are often reserved for subsequent base rate proceedings subject to Chapter 13 of the Public Utility Code. However, parties to Chapter 11 proceedings are often eager to resolve this pivotal issue because the value of acquired jurisdictional property is determinative in rate setting proceedings conducted pursuant to Chapter 13. That is, until valuation is settled, the Buyer will not know if it can earn a return of and on capital used to acquire the property of the Seller.

Prior to the promulgation of Section 1329, Public Utility Code Section 1311(b), *method of valuation*, mandated that the Commission use only the original cost of the jurisdictional property when first devoted to public service less applicable accrued depreciation to establish such value. 66 Pa. C.S. § 1311(b). In practice, unless a Chapter 11 acquisition application was filed and consolidated with a base rate filing under Chapter 13, neither the buyer nor seller would know if the agreed-to sale price was accepted for purposes of Section 1311(b). For the reasons explained below, Section 1311(b) worked to discourage the sale of public water and wastewater assets even when such sales might otherwise be in the long-term public interest.

The General Assembly promulgated Section 1329 to provide a procedure by which a Seller and Buyer could voluntarily propose a Chapter 13 ratemaking value concurrent with Commission consideration of the public interest benefits of the proposed acquisition under Chapter 11 and established a six-month timeframe under which these considerations would occur. Section 1329 works to: (1) provide certainty as to the value of acquired utility property; (2) remove regulatory barriers to the prudent sale of public water and wastewater assets; (3) protect a Seller from having to offer public assets for sale at below-market rates; and (4) allow a Buyer to recover market-based investment in those public assets through regulated rates.

The development of water and wastewater service throughout the Commonwealth over the years has led to the creation of large numbers of geographically dispersed water and wastewater systems owned by municipal corporations or authorities.  For these systems, sale to a larger, well-capitalized and well-run regulated public utility or entity can be prudent because it can facilitate necessary infrastructure improvements and access to capital markets, and, ultimately, it can ensure the long-term provision of safe, reliable service to customers at reasonable rates.

Prior to the enactment of Section 1329, however, the Public Utility Code worked to discourage the acquisition of these systems because Section 1311(b) requires, for rate setting purposes, that the Commission value acquired property at the original cost of construction less accumulated depreciation, in short, at depreciated original cost. In the context of utility acquisitions, Section 1311(b) discourages utilities from paying more than depreciated original cost for acquired systems because the Public Utility Code greatly restricts return of or on acquisition investment on water or wastewater systems above depreciated original cost. 66 Pa. C.S. § 1327; 52 Pa. Code § 69.711(b)(2).

As to municipalities and authorities, applying the “depreciated original cost” valuation method is problematic for multiple reasons. First, the municipality or authority is an extension of state government and generally does not use depreciation deductions for tax avoidance because it has no tax expense. Also, these systems are not required to employ regulated cost-plus-profit rate setting methods like investor-owned public utilities. As a result, a Seller will not generally have records on which to base a depreciated original cost valuation. In any event, the value of the *post hoc* depreciated original cost valuation, i.e., the original cost study conducted for purpose of sale, has been subject to considerable debate. 52 Pa. Code § 69.721; *Final Policy Statement on Acquisitions of Water and Wastewater Systems*, Docket No. M-00051926, 251 P.U.R. 4th 187 (Order Entered August 17, 2006).

Next, the assets and book value of most every Seller are inextricably linked to the historical development of the political subdivision it serves. That is, most municipal systems in the Commonwealth are of vintages that would be nearly, if not fully, depreciated if an accurate original cost study were used to establish system valuation. Also, municipalities and authorities will often have used government grants or contributions in aid of construction (both excluded from rate base) as tools to finance system expansions and improvements over that time. Because of this lack of rate base eligible infrastructure, traditional ratemaking principles would dictate a low net tangible asset value, and thus, little regulatory yield at sale.

In contrast to mandating depreciated original cost valuation, Section 1329 seeks to examine valuation from a market-based perspective. As a business, a municipal or authority system is often a viable concern able to generate adequate future cash flow to provide essential utility service to its customers in the near term. Section 1329 recognizes that no reasoned argument would propose that these public assets are of marginal value simply because the book value and the Commission’s traditional rate setting methodology dictate as much. Rather, the valuation methods of Section 1329 provide municipalities and authorities with a wholistic recognition of the fair market value of the public assets they seek to sell based on a balancing of accepted business valuation principles, specifically, the cost, market, and income approaches. 66 Pa. C.S. § 1329(a). Thus, for sale purposes, Section 1329 works to value public assets as the businesses they are as opposed to what their value might be under regulatory accounting for depreciated utility assets.

From the perspective of the Buyer, paying more than depreciated original cost for these public assets has been problematic. Except under the limited circumstances noted above, if a regulated public utility paid a fair market value for these public assets, the Public Utility Code and precedent argued against recovery of what was arguably an investment that did not benefit all its ratepayers. *Middletown Twp. v. Pa. Public Utility Commission*, 482 A.2d 674, 683 (1984). Thus, the Public Utility Code and applicable precedent would put the Seller and Buyer at loggerheads over valuation, and therefore, price. That is, a municipality could know that a sale was prudent long-term but could not justify selling its assets at what appeared to be a “fire sale” depreciated original cost, and the regulated utility could do no more than pay depreciated original cost for fear of experiencing a financial loss in a subsequent Chapter 13 rate proceeding.

Section 1329 mitigates these risks to both the Seller and to the Buyer. Section 1329 enables a Seller to price its public assets at a market value based on reasonable business valuation principles and enables a Buyer to recover its investment in those public assets at that market-based value. In sum, Section 1329 encourages a realistic approach to the sale of public assets based upon the fair market value of those assets.

The Commission issues this Tentative Supplemental Implementation Order in support of the goals of Section 1329 and to refine and improve on the procedures developed in the FIO.

**Discussion**

 After nearly two years and the experience of approximately seven Section 1329 applications submitted to the Commission, the Commission has determined to incrementally improve its approach to its Section 1329 procedures. This Tentative Supplemental Implementation Order proposes refinements to the procedures outlined in the FIO. The requirements of the FIO remain intact, subject to modifications herein and in any Final Supplemental Implementation Order issued after the receipt of stakeholder comments. In line with this approach, this Tentative Supplemental Implementation Order will address only those areas subject to modification or revision. It will also organize its proposed revisions in sequential order, that is, in the timeline stakeholders would normally experience events in an application submitted under the provisions of Section 1329.

**Checklist for Applications Requesting Section 1329 Approval**

 Subsections 1329(d)(1)(i) – (v) enumerate categories of information that a Buyer is obligated to provide as a part of a Section 1102 application requesting Section 1329 approval. The Commission will not accept such an application, which would initiate the six-month consideration period of Section 1329(d)(2), until the Buyer has shown that the application is complete. In short, an applicant must demonstrate that it qualifies for expedited consideration under Section 1329(d) before it is able to obtain that regulatory relief. To assist applicants in this process the Commission developed an Application Filing Checklist, which it requires applicants to attach to the application at the time of filing. The current iteration of the Application Filing Checklist may be found at the Commission’s website.[[1]](#footnote-1)

 A proposed revised Application Filing Checklist is attached to this Order as Appendix A. General changes include formatting for ease of future edits and the sequencing of checklist items to reflect the chronology in which checklist items may be compiled. Checklist instructions also clarify that an individual document may be used to satisfy more than one checklist item, but appropriate cross-references must be used to direct attention to exactly where the required information may be found in the filing. The general instructions also provide that service of an accepted filing on affected political subdivisions may be accomplished electronically if the recipient can accept electronic service. While stakeholders should review the entire attached Checklist for individual areas of concern, specific revisions include:

Item 2. Authorized employees may verify information contained in the proposed application

Item 3. Hand delivery of the proposed application to statutory advocates constitutes acceptable service

Item 4. Modified to address responses to Standard Data Requests

Item 7. Support for Utility Valuation Expert (UVE) fee amounts

Item 8. Verification of UVE independence

Item 9. Verifications from buyer and seller UVE of no affiliation with either buyer or seller, fair market valuation performed in compliance with most recent edition of the Uniform Standards of Professional Appraisal Practice, and that appropriate jurisdictional exceptions applied to submitted appraisal.

Item 10. Estimate of transaction and closing costs buyer will propose to include in rate base.

Item 13. Seller to provide testimony supporting transaction, if any. Unless the Buyer and Seller agree otherwise, the Seller will be responsible for its own testimony.

Item 14. Buyer to provide testimony supporting transaction. Unless the Buyer and Seller agree otherwise, the Buyer will be responsible for its own testimony.

Item 17. Current, five year, and if available ten year, projections of customers by class and gallons treated

Item 18. Notice sent to affected customers describing the filing and the anticipated effect on rates

Item 19. Two most recent audited financial statements, adopted budgets, and seller’s most recent annual report filed with DCED

Item 20. Address distinction between DEP violations and Notices of Violation

Item 22. Municipal and county comprehensive plan information if application proposes to expand service footprint beyond existing plant.

Item 25. Copies of municipal and affiliate contracts assumed by buyer and a list and dollar value of other contracts.

While not listed above, the Commission would clarify Item 5 of the Application Checklist addressing UVE appraisals of the fair market value of the Seller business. Sellers and Buyers must independently sponsor their respective UVE report and supporting data pursuant to Subsections 1329(a)(2) and 1329(b)(1)(i)-(ii). The validity of the market-derived value contemplated by Section 1329 is premised on arm’s length negotiation and two wholly independent UVE evaluations. 66 Pa. C.S. § 1329(c)(2). Other than a shared interest in closing the proposed transaction, Sellers and Buyers choosing to proceed under Section 1329 are independent actors regarding the validity of the two proposed fair market values or the value the Commission may ultimately adopt. Also, a Seller and Buyer may have differing views as to the acceptability of any “conditions of approval” the Commission may impose. 66 Pa. C.S. § 1329(d)(3)(ii). Therefore, while Sellers and Buyers may proceed jointly, each party is expected to retain appropriate independent representation in accordance with both the expectations of Section 1329 and Commission regulations. 52 Pa. Code § 1.21.

Despite apparent similarity, Item 8 and 9 are distinct. Item 8 is addressed to the Buyer and Seller regarding the UVE selection process. Item 9.a through 9.f are addressed to the respective UVEs. Each is expected to submit a verification supporting their independence and submitted appraisal.

Items 13 and 14 make clear that, if Buyer and Seller wish to submit individual direct testimony in support of the proposed acquisition, the testimony must be filed concurrent with the application. Each party must sponsor their individual testimony unless the Buyer and Seller expressly agree otherwise and include that agreement with the application. The six-month consideration period of Section 1329(d)(2) justifies requiring direct testimony to be filed concurrent with the application. Also, as is discussed in more detail below, the Seller and Buyer UVE will submit written direct testimony in support of their respective appraisals. Absent a showing of extenuating and extraordinary hardship late-filed direct testimony will not be considered in support of an application seeking Section 1329 valuation. A request to submit late-filed direct testimony shall be considered a request to extend the six-month consideration period to provide for appropriate due process.

Item 17 is revised to account for the five-year planning horizon municipalities use to estimate Act 537 planning modules. Item 18 is revised to make clear that Section 1329 applicants are to provide notice to affected customers contemporaneously with the proposed application, not after closing, such that affected customers receive adequate notice of the proposed transaction and have the opportunity to participate in the proceeding. Item 19 is revised to reflect the reality that a Selling Utility may not have annual audited financial statements or budgets.

Item 20 is revised to recognize the distinction between substantiated violations of DEP regulations and Notices of Violation which may not in fact be substantiated violations of law. Item 22 is revised to reflect the reality that, while an expansion of the existing footprint of a water or wastewater plant is of concern to the Commission regarding municipal or county comprehensive planning, the existing footprint of the plant is less subject to Commission review on that basis. Item 25 is revised to account for production of jurisdictional municipal and affiliate contracts as opposed to simple identification and description of contracts adopted in the normal course of business.

The Commission requests that interested stakeholders provide comments on the attached revised checklist. Commenters are requested to provide comment on whether the attached revised checklist is too broad, is complete, or should be expanded to include additional items. As is noted elsewhere in this Order, the Commission has retained all those elements of the FIO not addressed herein.

**Public Meetings and The Section 1329(d)(2) Six-Month Consideration Period**

Statutory Advocates have stated that Section 1329 procedural schedules are particularly difficult because of the relationship between the mandatory Section 1329(d)(2) six-month consideration period and the investigation, analysis and effort demanded to provide competent representation in these proceedings. The Commission understands that this affects litigants and the OALJ alike. An additional concern is caused by the relationship between the mandatory six-month consideration period and the Public Meeting calendar to which that consideration period is applied. Regarding that period, Section 1329(d)(2) provides:

The commission shall issue a final order on an application submitted under this section within six months of the filing date of an application meeting the requirements of subsection (d)(1).

66 Pa. C.S. § 1329(d)(2). These types of statutory deadlines require the presiding Administrative Law Judge and stakeholders to “back-into” a procedural schedule to coordinate the Section 1329 filing date with the last Public Meeting that falls within the proscribed six-month window. Problems may arise if there is only one public meeting in a month or if a public meeting is rescheduled or canceled. The Commission understands that these considerations may produce a litigation schedule as much as 30 days short of what is an already ambitious consideration period.

 The Commission proposes several options as a remedy. First, applicants should consider the effect of any specific filing date including consideration of the ten-day review of the Application Checklist established in the FIO. Publication deadlines at the Pennsylvania Bulletin present additional time constraints. Mundane considerations such as filing on a Wednesday, as opposed to a Friday, will assist in avoiding days wasted awaiting publication in the Pennsylvania Bulletin. Similarly, applicants should avoid submitting filings on dates where the six-month consideration period stands to run afoul of scheduled Public Meetings. In addition, applicants may also consider extending the consideration period to avoid undue time pressure for either litigants or Commission bureaus charged with evaluating the proceeding.

Next, the Commission acknowledges that the duration of the Application Checklist review, and thus the filing date, is not entirely within the control of applicants. To that end, while the Bureau of Technical Utility Services (TUS) will generally review applications requesting Section 1329 valuations within ten days, the Commission will permit TUS to hold accepting an application for up to an additional (5) calendar days if doing so will avoid the problem of establishing a consideration period of 170 days or less.

Lastly, there may be circumstances in which the above measures fail to produce a consideration period in excess of 170 days. The Commission invites comment regarding whether it should consider using planned notational voting to consider and adjudicate Section 1329 applications to permit the use of the entire six-month period that Section provides. *See* 4 Pa. Code § 1.43(c).

**Public Notice of Accepted Section 1329 Applications**

The Commission understands that stakeholders may have been unaware that certain Section 1329 applications had been accepted for filing by the Commission and that those stakeholders could not fully commence review of the applications before that time. The Commission also understands that this relates to the fact that the Commission does not assign a docket number to an acquisition application seeking Section 1329 valuation until *after* TUS determines that the applicant(s) has satisfied the Application Checklist and that the application is suitable to accept for filing. Once accepted for filing, the mandatory six-month consideration period of Section 1329 begins to toll as addressed above. The Commission understands that Stakeholders interested in monitoring or participating in applications seeking Section 1329 valuation would like to learn that the Commission has accepted a Section 1329 filing and that the six-month consideration period has begun to run.

The Commission understands that this notice issue is an artifact of the Application Checklist process. Because no docket is assigned until acceptance, interested stakeholders and potential parties cannot enter a notice of appearance until after the filing is accepted by the Commission and a docket number is assigned. Even then, e-filing and e-service are unavailable to notify some stakeholders e.g., the statutory advocates, as e‑service requires at least pending party status at a discrete docket. These stakeholders have no timely way to know that they can file a notice of appearance and that tolling of the six-month consideration period has begun. The Commission understands that a three or four-day delay in notice of acceptance can make a palpable difference in the context of the six-month consideration period.

To address this situation the Commission would direct stakeholders to make full use of the generic aspects of the Commission’s e-filing system. After obtaining an e-filing account a stakeholder (or member of the public for that matter) may create generic e-filing subscriptions that will provide the user with an electronic email alert when the Commission accepts a Section 1329 filing. The key to creating a generic Section 1329 e‑filing alert is to create what would otherwise appear to be an incomplete e-filing subscription request.

For example, a generic Section 1329 subscription will focus on the type of document and not on a docket number. When creating a custom *New Subscription*, e-filing users should leave the *Docket Number* input box blank, while specifying the *Document Type* as *Transfer of Assets and/or Control*. Users seeking email notices for all accepted Section 1329 filings should establish a *New Subscription* for each *Utility Type* under which such a filing may be registered by an applicant: *Water (Private)*, *Water (Municipal)*, or *Wastewater*. The staff of the Secretary’s Bureau is available during Commission office hours to assist members of the public who wish to use the Commission’s e-filing system and are specifically aware of the instruction contained here.

**Standard Data Requests for Applications Seeking Section 1329 Valuation**

Based on its experience with Section 1329 proceedings, the Commission understands that the pressure of the mandatory six-month consideration period of Section 1329(d)(2) is particularly acute regarding information that the applicant(s) may have to produce upon request of TUS pursuant to 66 Pa. C.S. §§ 503 – 505 or as a part of discovery practice pursuant to 66 Pa. C.S. § 333 and Commission regulations at 52 Pa. Code §§ 5.321 – 5.372. Indeed, the process of obtaining relevant information, or such information that will lead to relevant and admissible information, is a frequent cause of concern for stakeholders in the six-month proceedings envisioned by Section 1329.

The Commission would clarify here that the Bureau of Technical Utility Services does not review the veracity or substantive quality of information that an applicant may submit to fulfill the threshold requirements of the Application Checklist. The Bureau of Technical Utility Services is to evaluate only whether the Application Checklist is complete and responsive to the data requested. It shall not refuse to perfect an application on the basis that the Bureau is dissatisfied with the quality of items submitted in response, or whether additional information may later be required.

Rather, in accordance with the FIO, TUS reviews whether the applicant has included, in good faith, the information required by the Commission for the initial filing such that the six-month consideration period of Section 1329(d)(2) may begin without causing (1) the applicant to suffer a summary rejection if the application were to remain under TUS review and (2) due process and other procedural concerns before the Office of Administrative Law Judge if the application is to proceed to an initial decision. Applicants should also note that TUS is not precluded from asking subsequent data requests, provided that these are issued before the Commission receives a protest or opposition filing regarding the application.

Nevertheless, to accommodate the process outlined in the FIO and here, the Commission will incorporate TUS standard data requests into Item No. 4 of the Application Checklist. These standard data requests are based, in large measure, on the initial data requests that are propounded by the statutory advocates. Rather than to await formal acceptance of the Section 1329 filing and the parties’ agreement to discovery protocols, responses to these standard date requests are designed to make the process of investigation and analysis of the Section 1329 application more efficient by providing this key information at the outset of the application proceeding.

The Section 1329 Application Standard Data Requests shall replace the previous language of Item No. 4 which required the applicant to provide electronic working documents (i.e., Excel spreadsheets) for the filing’s schedules, studies, and working papers. To the extent that responses to these Standard Data Requests may be found elsewhere within the filing applicants should clearly indicate where with appropriate cross-references. The proposed Section 1329 Application Standard Data Requests, along with instructions, are attached as Appendix B. As explained herein, the Commission believes that the submission of this data at the time of filing will, along with other initiatives discussed here, work to address issues created by the six-month consideration period of Section 1329(d)(2).

As to additional discovery, the Commission is receptive to the voluntary modification of its discovery regulations at 52 Pa. Code §§ 5.321 – 5.372 due to the six-month consideration period. While the Commission is hesitant to establish a standard whereby all Section 1329 discovery responses have a deadline of, perhaps, five days, and objections within two days, the Commission strongly encourages applicants to propose discovery rules and conditions suitable for Section 1329 proceedings. Likewise, the Office of Administrative Law Judge should not hesitate to impose appropriate discovery modifications on parties to Section 1329 valuation requests if applicants do not propose such modifications on their own.

**The Uniform Standards of Professional Appraisal Practice**

The fair market value provision of Section 1329(a) is a significant departure from the Commission’s current depreciated original cost rate base valuation principle. Section 1329 provides for three (3) data points to confirm that the acquisition price for a Seller is a reasonable approximation of the fair market value of the business being sold: (1) the arms-length price negotiated between the Seller and the Buyer; (2) an independent market-based appraisal of the Seller’s system by the Utility Valuation Expert hired by the Seller; and (3) an independent market-based appraisal of the Seller’s system by the Utility Valuation Expert hired by the Buyer. Section 1329(g) defines UVEs as persons independently hired by a Seller and Buyer to conduct the required economic valuation of the Selling Utility’s system to determine its fair market value.

Section 1329 (c) mandates that the valuation of the Seller that may be incorporated into the ratemaking rate base of the Buyer is the lesser of: (1) the arms-length price negotiated between the Seller and Buyer or (2) the fair market value of the Seller. However, Section 1329(g) further defines Fair Market Value for that comparison as the *average* of the two independent UVE valuations. 66 Pa. C.S. § 1329(g). Therefore, three mandatory market-based valuations are ultimately reduced to two data points, the *lesser* of which is incorporated in the Buyer’s ratemaking rate base.

The Commission expects that Buyers will use UVE valuations to serve as a confirmation of sound business judgement particularly on the part of an Acquiring Public Utility. In this regard, the quality of the fair market appraisals represents the most important feature of the Section 1329 process and key driver for the fairness of the price to be paid by the Acquiring Public Utility. The Commission has observed substantial variances, in some case, for the fair market valuation of the same properties due to inconsistent assumptions and flaws in the appraisal methodology. As such, to the extent that the Commission can establish appropriate guidelines and consistent assumptions for Section 1329 appraisals by the UVEs, it can be expected that any future variances in the fair market value appraisals for the same property can be reduced and, concomitantly, the Commission and stakeholders can have a greater degree of confidence in the fairness and reasonableness of the negotiated purchase price.

As a related matter, stakeholders are invited to discuss the range of values Section 1329 proceedings have developed to date and to provide comment on whether the Commission should use that data as a check on the reasonableness of the negotiated purchase price. For example, if an Acquiring Public Utility’s average rate base cost per customer were approximately $3,500, what multiple of that amount represents a reasonable acquisition price given that a Section 1329 fair market value implicitly endorses that some subsidy will occur?

As is briefly discussed above, the two independent UVEs are to appraise the Seller’s business through the application of three distinct business valuation methods -- the cost, market, and income approaches. In addition, Section 1329(a)(3) mandates that each UVE develop these three approaches in compliance with the Uniform Standards of Professional Appraisal Practice (USPAP). The USPAP are developed by the federally authorized Appraisal Standards Board comprising entities involved with federally guaranteed lending. The USPAP seek to professionalize the appraisal industry and are designed to foster integrity in various types of property and business appraisals. However, the Appraisal Standards Board is not a government entity and lacks the power to make, judge, or enforce law.

Nevertheless, regarding Section 1329, all UVEs must comply with all USPAP standards as a matter of law because Section 1329(a)(3) mandates as much. To be clear, the Commission does not interpret Section 1329 to require that a UVE be a state-licensed or certified appraiser within the meaning of Banks and Banking provisions of United States Code. 12 U.S.C. § 3345. Rather, Section 1329 mandates that the valuations submitted by UVEs must be USPAP compliant.

The Commission understands that the Appraisal Standard Board updates the USPAP every two years and that the revisions take effect on January 1 of even numbered years. Because of this frequent revision, the Commission interprets the language of Section 1329(a)(3) to mandate that UVEs verify the use of *the* USPAP, i.e., the edition effective when the UVE developed the submitted appraisal. Appraisals based on outdated or expired USPAP versions cannot support valuations under Section 1329 and will not be accepted as competent evidence.

**Jurisdictional Exceptions**

The USPAP contain a Jurisdictional Exception Rule as a form of a saving or severability clause intended to preserve the balance of the USPAP if compliance with one or more of its parts is, in this instance, in conflict with Pennsylvania law. *See* *Uniform Standards of Professional Appraisal Practice*, 2016-2017 Edition, page 16. In short, a Section 1329 appraisal is compliant with the USPAP, and thus Section 1329, when it resolves a conflict between the USPAP and Pennsylvania law by giving preference to Pennsylvania law. For the purposes of requests for a Section 1329 valuation, Pennsylvania law includes the Pennsylvania Constitution, statutes, regulations, court precedent, and administrative rules and orders issued by Pennsylvania administrative agencies.

In order to establish appropriate guidelines and consistent assumptions for Section 1329 appraisals by the UVEs, in order to comply with Commission precedent and to reduce variances in the fair market value appraisals for the same property in further Section 1329 applications, the Commission, through this Tentative Order, and a subsequent Final Supplemental Implementation Order, proposes to establish several jurisdictional exceptions that UVEs will apply when developing the cost, market, and income valuation approaches pursuant to the USPAP as required of Section 1329 appraisals. These jurisdictional exceptions are summarized in Appendix C and address each of the valuation approaches authorized by Section 1329: the cost approach, the income approach and the market approach.

Cost approach measures value by determining the amount of money required to replace or reproduce future service capability of the system; this approach develops the total cost less accrued depreciation. Regarding the cost approach, the Seller and Buyer UVE may measure value by:

a. determining investment required to replace or reproduce future service capability

b. developing total cost less accrued depreciation for Selling Utility assets

c. determining the original cost of the system

In addition, cost approach materials must:

a. explain the choice of reproduction cost vs. replacement cost

b. not adjust the cost of land by the ENR index

c. exclude overhead costs, future capital improvements, and going concern value

d. use consistent rate of inflation for all classes of assets, unless reasonably justified

The income approach is based on the principle that capitalizing or discounting a future income stream to a present value can indicate the value of a business; two methods can be used: (1) capitalization of earnings or cash flow and (2) discounted cash flow (DCF) method. Regarding the income approach, UVEs should measure value by:

a. Capitalization of earnings or cash flow

b. Discounted cash flow (DCF) method

UVEs should exclude from the income approach:

a. Going concern value

b. Future capital improvements

c. Erosion of cash flow

d. Rate base/rate of return estimates

The market approach is based on the principle that the value of the system to be acquired can be estimated by comparison to: (1) the market value of companies in the same or similar line of business (market multiples method) or (2) by comparisons to purchases or sales of businesses in the same or similar line of business (selected transactions method). When calculating valuation under the market approach, UVEs should use the current customer count of the Selling Utility, should exclude capital improvements anticipated to occur after sale, and should exclude any type of adjustment or adder in the nature of a “going concern” or goodwill.

In addition, there are other minor examples of jurisdictional exceptions applicable to utility water service. An example is the recovery of public fire hydrant costs in utility rates pursuant to 66 Pa. C.S. § 1328. Under that section, political subdivisions of the Commonwealth are assessed twenty-five percent of the total cost of regulated utility fire hydrants with the remaining seventy-five percent recovered as a part of the service charge applicable to customers of the utility. A Selling Utility, as a political subdivision, may or may not have recognized these types of revenues as payable to itself. While this type of cost allocation may not be unique to Pennsylvania, UVEs should nevertheless be cognizant of the peculiar facets of Pennsylvania law and adjust appraisals accordingly. As mentioned above, where the valuations are based on reasonable and consistent assumptions and where flaws in the methodology are eliminated, the Commission and stakeholders can expect more consistency in the appraisals and purchase price.

**UVE Direct Testimony**

Another area of stakeholder concern involves the supporting data and process employed by the Seller and Buyer UVE to develop valuations. The Commission notes that its regulations mandate that expert witnesses file written direct testimony when testifying in rate cases. 52 Pa. Code § 5.412. While not a rate case, no principled argument would conclude that Section 1329 applications do not directly and substantially involve rate cases in that Section 1329 definitively sets the value of certain rate base components, a role traditionally reserved to the rate case.

 Competent expert testimony submitted in response to Section 5.412 not only describes conclusions drawn by the expert, but also discusses how the expert arrived at a conclusion and details the data used to support the conclusion. Similarly, Section 1329 requires experts to present detailed evidence in specific categories before the Commission may approve a Buyer’s request for the fair market valuation of rate base assets that will be used to establish rates. To this end, the Commission concludes that, as experts testifying to the valuation of rate base assets, UVEs must submit written direct testimony in support of any appraisal completed pursuant to Section 1329(a)(5) and submitted in support of a request for fair market valuation for rate setting purposes.

 UVE direct testimony should describe the conclusions drawn by the UVE, how the UVE arrived at those conclusions, and details on the data used to support conclusions consistent with the USPAP. In particular, the direct testimony should explain the weightings applied to each valuation approach and, most important, the reasons for the weighting chosen by the UVE. To the extent that any single approach is weighted in excess of 50%, we expect a strong and reasoned justification in the direct testimony to accord such significant weight to a single valuation approach.

UVE direct testimony must be filed as a part of the Application and will be a part of the Application Checklist. The Commission will not accept untimely direct testimony, or untimely testimony in the nature of direct, regarding a UVE appraisal. To assist potential Sellers, Buyers, and UVEs, the Commission has included a direct testimony template as Appendix D that UVEs may follow to develop suitable direct testimony.

UVE direct testimony should be provided in the form established by 52 Pa. Code § 5.412. The testimony should identify itself on its coversheet with a statement number and have line numbers in the left-hand margin on each page containing narrative text. The testimony should provide the name of the UVE and business address and clearly indicate the party on whose behalf the UVE prepared the appraisal.

 UVEs should provide other mandatory information as a part of the UVE direct testimony. This may include items required in the Application Checklist, such as responses to Application Standard Data Requests, a copy of the UVE individual appraisal, UVE fees and fee arrangements, and various required verifications. If items from the Application Checklist are included in UVE direct testimony the Application Checklist should indicate the testimony page and line number where the information may be found.

In addition to providing a format that UVEs may use to structure their direct testimony, Appendix D also provides examples of the types of substantive issues that UVEs should address in direct testimony. To this end, the UVE direct testimony will be a narrative accompaniment to the appraisal required by Section 1329(a)(5). Using Appendix D as a prerequisite for minimum compliance will greatly assist applicants and UVEs as it will cut down on the need for discovery (and related discovery litigation) on the topics addressed. As is discussed above, UVE direct testimony may also be used to satisfy items in the Application Checklist and Standard Data Requests. Stakeholders are asked to examine Appendix D and to provide useful comments on how it may be improved to make Section 1329 applications more efficient for applicants, litigants, and the Commission.

**Conclusion**

While 66 Pa. C.S § 1329 has proven useful as a tool to ensure that the price paid for public business assets by private interests reflect market rates, it is not without its challenges. As explained previously, the Commission seeks to create more certainty in the Section 1329 application process, to improve the quality of UVE valuations, to ensure that the adjudication process is both fair and efficient and, ultimately, to reduce litigation regarding the Commission’s final determinations.

To that end, the Commission seeks formal stakeholder input and comment on the proposals contained herein. The Final Implementation Order issued at the above-referenced docket will remain in effect subject to modification in a Final Supplemental Implementation Order issued after the receipt of stakeholder comment; **THEREFORE,**

 **IT IS ORDERED:**

1. That the Commission hereby tentatively adopts the procedures and guidelines as set forth herein.

2. That the Commission hereby tentatively adopts the Application Checklist attached as Appendix A and as set forth herein.

3. That the Commission hereby tentatively adopts the Standard Data Requests attached as Appendix B and as set forth herein.

4. That in addition to others as may be appropriate, the Commission hereby tentatively adopts the jurisdictional exceptions to the Uniform Standards of Professional Appraisal Practice attached as Appendix C and as set forth herein.

5. That the Commission tentatively concludes that Utility Valuation Experts registered pursuant to 66 Pa. C.S. § 1329(a)(1) shall submit written direct testimony substantially in the form of Appendix D, and at a minimum, addressing the topics contained in Appendix D to accompany all applications for fair market valuation pursuant to Section 1329.

6. That any interested party may submit comments regarding this Tentative Supplemental Implementation Order within thirty (30) days of publication in the *Pennsylvania Bulletin* and reply comments fifteen (15) days thereafter.

7. That all pleadings, comments, or other filings shall be filed in Microsoft Word-compatible format with the Commission’s Secretary Bureau at Docket No. M‑2016-2543193.

8. That a copy of this Tentative Implementation Order shall be published in the *Pennsylvania Bulletin* and posted on the Commission’s website at [www.puc.pa.](http://www.puc.pa.)gov.

9. That a copy of this Tentative Supplemental Implementation Order be served on all jurisdictional water and wastewater companies, the National Association of Water Companies – Pennsylvania Chapter, the Pennsylvania State Association of Township Supervisors, the Pennsylvania State Association of Boroughs, the Pennsylvania Municipal Authorities Association, the Pennsylvania Rural Water Association, the Commission’s Bureau of Investigation and Enforcement, the Office of Consumer Advocate, and the Office of Small Business Advocate.

 **BY THE COMMISSION**

 Rosemary Chiavetta

 Secretary

(SEAL)

ORDER ADOPTED: September 20, 2018

ORDER ENTERED: September 20, 2018

1. The Application Filing Checklist – Water/Wastewater may be accessed from the Commissions website at <http://www.puc.pa.gov/filing_resources/issues_laws_regulations/section1329_applications.aspx>. [↑](#footnote-ref-1)