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August 18, 2017

Via Electronic Filing

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17105-3265

In re: Docket No. A-2017-2605434
Application of Aqua Pennsylvania Wastewater, Inc. pursuant to Sections 1102 and 1329
of the Public Utility Code for Approval of its Acquisition of the Wastewater System Assets
of Limerick Township

Dear Secretary Chiavetta:

We are counsel for Aqua Pennsylvania Wastewater, Inc. in the above matter and are submitting, via electronic filing with this letter, the Company's Reply Brief in support of the Application. Copies of the Reply Brief are being served upon the persons and in the manner set forth on the certificate of service attached to it.

Very truly yours,

THOMAS, NIESEN & THOMAS, LLC

By

Thomas T. Niesen

cc: Certificate of Service (w/encl.)
Alexander R. Stahl, Esquire (via email, w/encl.)

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

The Honorable Steven K. Haas, Presiding

Application of Aqua Pennsylvania : Docket No. A-2017-2605434
Wastewater, Inc. Pursuant to Sections :
1102 and 1329 of the Public Utility Code :
for Approval of its Acquisition of the :
Wastewater System Assets of Limerick :
Township :

REPLY BRIEF OF
AQUA PENNSYLVANIA WASTEWATER, INC.

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DATED: August 18, 2017

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I. INTRODUCTION

This proceeding concerns the Application of Aqua Pennsylvania Wastewater, Inc. (“Aqua” or “Company”), filed with the Public Utility Commission (“Commission”) on May 19, 2017, pursuant to Sections 1102 and 1329 of the Public Utility Code.

Aqua submits this Reply Brief in accordance with the litigation schedule memorialized in the Order Establishing Litigation Schedule dated June 28, 2017.

Aqua’s Reply Brief is supplemental to its Main Brief and is limited to those matters which require additional discussion as a result of the Main Briefs filed by the Bureau of Investigation & Enforcement (“I&E”) and the Office of Consumer Advocate (“OCA”).¹

¹ The Argument headings herein correspond, generally, to the major Argument headings in the Main Briefs of I&E and the OCA.

II. SUMMARY OF ARGUMENT

The opposition of I&E and the OCA to the Company's Application as presented in their respective Main Briefs should be denied and rejected.

Section 1102 and Certificates of Public Convenience

Aqua is fit to acquire the Limerick Township ("Limerick" or "Township") wastewater system assets and to initiate wastewater service in Limerick. Aqua demonstrated through a preponderance of the evidence and substantial evidence that its acquisition of the assets and initiation of service in Limerick will affirmatively promote the service, accommodation, convenience, or safety of the public in substantial ways. Aqua's acquisition of the Limerick wastewater system and initiation of wastewater service in the Township will further the public interest.²

Section 1329, Ratemaking Rate Base and Rate Stabilization

Section 1329 addresses the valuation of municipal assets.

Section 1329 – Ratemaking Rate Base

As directed by the General Assembly in Section 1329(d)(1)(iii), the ratemaking rate base determined pursuant to Section 1329(c)(2) is \$75,100,000, being the lesser of the negotiated purchase price of \$75,100,000 and the average of \$78,494,000.³

Section 1329 – Rate Stabilization Plan

Aqua's proposed rate schedule tariff pages will leave rates unchanged until new rates are approved in the next base rate proceeding.⁴ Aqua's rate stabilization plan, which, ultimately, will be reviewed for reasonableness and approved in an Aqua base rate case, is a reasonable approach to address rate stabilization for Aqua's customers.⁵

² See also Aqua Main Brief, Section IV.

³ See also Aqua Main Brief, Section IV.

⁴ See also Aqua Main Brief, Section IV.

⁵ See also Aqua Main Brief, Section IV.

III. ARGUMENT

A. Reply to I&E Main Brief

I&E contends that Aqua failed to demonstrate that the Application serves the public interest; that Aqua failed to show that its rate stabilization plan to split the ratemaking rate base into an initial rate base amount of \$60,000,000 and a regulatory asset of \$15,100,000 is in the public interest; and that Aqua failed to seek requisite Section 507 approvals. In the alternative, I&E contends that the Commission, if it approves the Application, should require Aqua to file a separate cost of service study for the Limerick system in its next base rate filing.⁶

1. Aqua Will Provide a Separate Cost of Service Study, If Directed by the Commission

Addressing I&E's alternative proposal first, Aqua is not opposing I&E's request for a separate cost of service study for the Limerick system. Aqua will file the separate cost of service study if the Commission requires Aqua to file the study.⁷ The Commission, in *New Garden*,⁸ required Aqua to submit a similar separate cost of service study for the New Garden system. I&E's "alternative" proposal for resolution of the proceeding is acceptable to Aqua, if required by the Commission.

2. The Proposed Transaction Is in the Public Interest

a. The Acquisition Will Not Harm Aqua or Its Current Ratepayers

I&E contends that the acquisition will have a negative impact on Aqua's current financial condition and will negatively impact Aqua's current customers due to both purchase price and

⁶ I&E Main Brief at 4. In Section III of its Main Brief, I&E also states that "deficiencies" contained within the "filing" rendered I&E unable to determine whether the fair market value presented by Aqua is appropriate. There were no deficiencies in Aqua's filing and I&E does not pursue this contention further in its Main Brief.

⁷ Tr. 21, line 17, through 22, line 1.

⁸ *Application of Aqua Pennsylvania Wastewater, Inc. Pursuant to Sections 1102 and 1329 of the Public Utility Code for Approval of its Acquisition of the Wastewater System Assets of New Garden Township and the New Garden Township Sewer Authority*, Docket No. A-2016-2580061 ("*New Garden*"), Opinion and Order entered June 29, 2017.

the proposed rate stabilization plan.⁹

Contrary to I&E's contentions, Aqua will have positive net income of approximately \$2,000,000, on a total company basis following its acquisition of the Limerick system (contrary to the net income *loss* of \$1,700,000 claimed by I&E). Under the assumptions presented in its rate stabilization plan, Aqua will have positive net income of approximately \$2,400,000 (again, contrary to the net income *loss* of \$1,300,000 claimed by I&E).¹⁰

Aqua has not proposed any rate changes for existing customers that support I&E's claim that existing customers will subsidize the Limerick system. Aqua's proposed rate schedule tariff pages do not propose to change the rates for existing Aqua customers. The pages do no more than adopt the existing Limerick rates, similar to the Company's proposal accepted by the Commission in *New Garden*.

Consistent with the Final Implementation Order, Aqua's rate stabilization plan is non-binding and will be fully adjudicated in a future Aqua base rate case proceeding. While the Company's analysis is based on a residential rate of approximately \$70 per month, the Commission ultimately has the authority to set the final rate and, in-doing so, could change any rate analysis submitted in this proceeding.¹¹ Contrary to the contentions of I&E, Aqua's existing customers will possibly see a rate benefit by Year 7/8 after closing.¹²

I&E states, in regard to rate impact, that Aqua has not indicated that it will absorb any revenue shortfall but instead will spread any shortfall to existing customers. A revenue shortfall, however, is not at all certain. As set forth above, Aqua's existing customers will possibly see a rate benefit by Year 7/8 after closing. Additionally, Aqua has not proposed to change any

⁹ I&E Main Brief, Section IV.A.1.

¹⁰ See Aqua Main Brief, Section V.A.4.a.

¹¹ See Aqua Main Brief at 33 and Aqua St. No. 1R at 8, lines 3 through 12.

¹² See Aqua Main Brief, Section V.A.3.

existing customer rates. Aqua's rate stabilization is non-binding and will be fully adjudicated in a future Aqua base rate case proceeding.

I&E contends that a potential for cross subsidization is further highlighted by the level of rate base per customer for the Limerick system as compared to Aqua's existing system. Similar rate base comparisons were presented in opposition to the Company's Application in *New Garden*.¹³ The Commission, however, approved Aqua's New Garden Application with the directive that Aqua present a separate cost of service study for the New Garden system in the Company's next base rate filing.¹⁴

I&E's claim of potential harm to Aqua and its existing ratepayers should be rejected. Aqua has not submitted rate schedule tariff pages asking current customers to subsidize the Limerick system.

b. Aqua Demonstrated Substantial Affirmative Public Benefits for Existing Customers

I&E contends that the Application should be rejected because it will not provide affirmative public benefits for existing customers. Citing *City of York v. Pa. P.U.C.*, 295 A.2d 825 (Pa. 1972) ("*City of York*"), I&E contends that a demonstration of substantial affirmative public benefits is required. I&E argues, incorrectly, that Aqua has presented only unquantified and generalized assertions.¹⁵

As a threshold matter of applicable legal principles, I&E makes no mention of *Popowsky v. Pa. P.U.C.*, 937 A.2d 1040 (Pa. 2007) ("*Popowsky*"). In *Popowsky*, the Pennsylvania Supreme Court addressed the *City of York* standard and explained that the standard does *not* require binding legal commitments or a quantification of benefits:

¹³ *New Garden*, slip op. at 69.

¹⁴ *New Garden*, slip op. at 71.

¹⁵ I&E Main Brief, Section IV.A.2.

In summary, as indicated in *City of York*, the appropriate legal framework requires a reviewing court to determine whether substantial evidence supports the Commission's finding that a merger will affirmatively promote the service, accommodation, convenience, or safety of the public in some substantial way. In conducting the underlying inquiry, the Commission is not required to secure legally binding commitments or to quantify benefits where this may be impractical, burdensome, or impossible; rather, the PUC properly applies a preponderance of the evidence standard to make factually-based determinations (including predictive ones informed by expert judgment) concerning certification matters.¹⁶

Reinstating a Commission Order approving a Verizon/MCI merger, the Supreme Court in *Popowsky* came to the following conclusion:

In summary, we agree with Appellants that the PUC considered an extensive evidentiary record and the comprehensive findings of two federal agencies; made numerous, sufficiently detailed, and supported findings of fact concerning the Verizon/MCI merger's likely net affirmative public benefits, which appropriately subsumed an assessment of the merger's probable effect on competition in the Commonwealth; and correctly applied the *City of York* standard. Thus, we hold that the PUC's conclusion that the Verizon/MCI merger will affirmatively promote the service, accommodation, convenience, or safety of the Pennsylvania public in some substantial way should have been sustained.¹⁷

I&E's contention here that the Application will not provide affirmative public benefits is the same contention rejected by the Commission in *New Garden*. Citing the testimony of Aqua witnesses Packer and Bubel, the Commission in *New Garden* concluded that Aqua's acquisition of the New Garden system would "affirmatively promote the 'service, accommodation, convenience or safety of the public' in some substantial way."¹⁸

Proposed findings of fact, based on a preponderance of the evidence and substantial evidence, and addressing the many public benefits, were presented in Aqua's Main Brief.¹⁹ Benefits to *existing* Aqua customers were summarized as follows:²⁰

¹⁶ *Popowsky* at 1057 (footnote omitted).

¹⁷ *Popowsky* at 1061.

¹⁸ *New Garden*, slip op. at 67 and 68.

¹⁹ Aqua Main Brief, Section II, Paragraphs Nos. 31 through 45, and Section V.A.3.

²⁰ Aqua Main Brief, Section V.A.3.

Benefits to Existing Customers of Aqua

- Aqua will increase its customer base by approximately 27% as a result of the acquisition. With a larger customer base, future infrastructure investment across the state will be shared at a lower incremental cost per customer for all of Aqua's customers. Aqua St. No. 1 at 10, lines 8 through 12 and Aqua Exhibit No. 1, Application ¶ 45.f.
- The acquisition, moreover, comes with the expectation of significant future customer growth, which can be accommodated utilizing the current wastewater utility treatment infrastructure. The Township is billing approximately 7,300 EDUs but capacity of 8,400 EDUs has been purchased on the system which represents an approximate 15% increase in billing units. Aqua St. No. 1 at 10, lines 13 through 20 and Aqua St. No. 1R at 6, lines 8 through 12.
- Customer growth will allow for further spreading of the cost of service across even more customers improving economies of scale as the system is integrated into Aqua. Aqua and Aqua PA have a long history of acquiring and operating smaller and mid-size systems. Over the long term, acquisitions have benefitted existing (and acquired) customers as well as the Commonwealth of Pennsylvania. Aqua St. No. 1 at 10, line 13, through 11, line 2, Aqua St. No. 1R at 6, lines 8 through 12 and Aqua Exhibit No. 1, Application ¶ 45.f.
- Based on extremely conservative assumptions (a continuing rate for Limerick customers of \$70 per month and no further growth in customers beyond Year 10), Aqua's rate stabilization plan projects a positive rate benefit for existing customers, as early as Year 15/16. With less conservative assumptions (additional customer growth and additional rate increases to Limerick customers within the first ten years), the positive rate benefit easily occurs by Year 10 – within the Year 7/8 time frame. Tr. 22, line 2, through 23, line 2, and Tr. 24, line 10, through 25, line 9.

I&E's concern with potential rate effects is the very same contention argued by it and rejected by the Commission, first, in "*Scranton Sewer Authority*"²¹ and, later, in *New Garden*.

The Commission in *Scranton Sewer Authority* held as follows:

As to the concerns raised by I&E and the OCA regarding the alleged detriments of the acquisition to PAWC's existing customers, we note that these concerns center on the potential rate effects of the acquisition. However, we are not in a position to thoroughly adjudicate ratemaking issues relating to the acquisition in this proceeding. Nor do we find that this acquisition proceeding is the appropriate context for addressing these rate issues. The

²¹ *Joint Application of Pennsylvania-American Water Company and the Sewer Authority of the City of Scranton*, Docket No. A-2016-2537209, Opinion and Order entered October 19, 2016.

record does not contain sufficient evidence to allow us to evaluate the specific effects of the acquisition on PAWC's revenue requirement or to decide cost allocation and rate design matters. Such issues are better reserved for a future base rate proceeding.²²

In *New Garden*, as here, Aqua proposed a "tariff containing a rate equal to the existing rates of the selling utility."²³ Recognizing that Aqua was not proposing any rate changes and that rates would be addressed in the next base rate case, the Commission in *New Garden* rejected the rate impact concerns of I&E (and the OCA).²⁴

Once, again, even with the required determination of ratemaking rate base pursuant to Section 1329, Aqua is not proposing any change in the existing rates of either Limerick customers or Aqua's existing customers. The potential rate effects, rather, are reserved for a future base rate proceeding just as they were reserved for a future base rate proceeding in *New Garden* and *Scranton Sewer Authority*.

The Commission should reject I&E's contention that Aqua has failed to establish that its acquisition of the Limerick wastewater system is in the public interest.²⁵ The contention of I&E is not supported by either fact or law.

3. Aqua Presented a Rate Stabilization Plan

I&E contends, in the alternative, that, if the Commission approves the Acquisition, it should reject Aqua's proposal to split the ratemaking rate base of \$75,100,000 into an initial rate base amount of \$60,000,000 and a regulatory asset of \$15,100,000. I&E contends that the entire \$75,100,000 must be reflected in rate base during Aqua's next base rate proceeding.²⁶

Aqua presented a rate stabilization plan in Exhibit D to Aqua Statement No. 1. Through

²² *Scranton Sewer Authority*, slip op. at 50.

²³ *New Garden*, slip op. at 68.

²⁴ *New Garden*, slip op. at 68 – 71.

²⁵ See also Aqua Main Brief, Section V.A.

²⁶ I&E Main Brief, Section IV.A.3.

Exhibit D, the Company proposes to split the Section 1329 ratemaking rate base of \$75,100,000 into two parts: (1) an initial ratemaking rate base of \$60,000,000 and (2) a \$15,100,000 Regulatory Asset.²⁷ The plan is non-binding and will be fully adjudicated in a future base rate case proceeding.²⁸

If approved by the Commission in a future base rate proceeding, the rate stabilization plan would result in a delayed recovery of the portion of the ratemaking rate base attributed to the regulatory asset. The delay in rate base recognition benefits customers as it lowers the cost of service.²⁹ I&E, itself, notes that the delayed recognition would provide a “temporary benefit to customers.”³⁰

Aqua’s rate stabilization plan, including the use of a regulatory asset for a portion of the \$75,100,000 ratemaking rate base is permitted, reasonable, and, ultimately, beneficial to customers.

4. Aqua’s Application Seeks All Approvals, Certificates, Registrations and Relief, If Any, Under the Code for the Proposed Acquisition

I&E contends that the Application must be denied because Aqua did not seek Section 507 approval either for the APA or for contract assignments between Aqua and Limerick Township that will be entered into at closing.³¹ The I&E contention should be denied.

In the Wherefore Clause of its Application, Aqua asks the Commission for all such other approvals, certificates, registrations and relief, if any, that may be required with respect to Aqua’s acquisition of the Limerick wastewater system assets. Aqua’s request for all required

²⁷ Aqua St. No. 1 at 13, lines 14 through 16.

²⁸ Aqua St. No. 1R at 8, lines 3 through 12.

²⁹ Aqua St. No. 1R at 4, line 11, through 5, line 2.

³⁰ I&E Main Brief at 13. While acknowledging a temporary benefit to customers, I&E contends that it must also be recognized that, depending on when the Company files its next base rate case, the Company may end up recovering more from ratepayers than it would have if the full amount was included. Contrary to the I&E contention, with reasonable assumptions, a rate benefit for existing customers easily occurs by Year 10 – within the Year 7/8 time frame. See Aqua Main Brief, Section V.C.

³¹ I&E Main Brief, Section IV.D.

approvals includes Certificates of Filing, to the extent required by Section 507,³² for the APA and the assignments of contracts. The APA was included as Exhibit C to the Application and assignments of contracts are discussed in Paragraph 20 of the Application.³³

Scranton Sewer Authority does not support the I&E contention. The Commission in *Scranton Sewer Authority* did not reject the PAWC application for failure to seek Section 507 approval. The Commission, instead, explained that it had addressed the public benefit issues of the Scranton transaction and made a determination that it is in the public interest. Having done so, it saw no reason to deny the application. The Commission approved the Scranton municipal agreements and directed PAWC, “as a matter of administrative efficiency” to file the executed municipal agreements under separate “U” dockets.

Aqua submits that a similar approach is warranted here. The Commission should issue Certificates of Filing under Section 507, if Certificates are required. As noted above, the APA was included as Exhibit C to the Application. If the Commission concludes that the assignment agreements must be filed, Aqua, as a matter of administrative efficiency, can file the executed agreements after closing under separate “U” dockets.

B. Reply to OCA Main Brief

OCA contends that Aqua failed to demonstrate that the transaction would provide affirmative benefits because the claimed benefits do not outweigh the adverse impact to existing customers of Aqua; that the UVE fair market value appraisals must be revised to reflect “flaws;” and that, in addition to its proposed adjustment to the ratemaking rate base, the Commission, if it approves the transaction, should (1) deny the creation of the proposed regulatory asset and, if Aqua presents it in its next base rate case, require Aqua to submit a net present value analysis;

³² 66 Pa. C.S. § 507.

³³ Aqua Main Brief, Section V.D.

(2) retain the authority to allocate revenues, if appropriate, to Limerick customers in a manner other than as set forth in the APA; and (3) require Aqua and its shareholders bear all the risk of a revenue shortfall.³⁴

1. Through Section 1329, the General Assembly Created a Formula for Determination of Ratemaking Rate Base

a. Section 1329 Legal Issues

OCA discusses Section 1329 legal issues and submits that it would be inconsistent with the requirements of the Public Utility Code to “permit Aqua to simply present a rate base number, show that the appraisers chose numbers to fill in all the blanks in the formulas, and not permit any review or challenges of those inputs.”³⁵ The OCA’s characterization of the legislated process is contrary to the clear and unambiguous statutory language enacted by the General Assembly.

It is the General Assembly – not Aqua – that has enacted, through legislation, a “procedure” that “shall be used to determine the fair market value of the selling utility.”³⁶ In respect to the determination of fair market value, Section 1329(a)(2) directs as follows:

“Two utility valuation experts shall perform two separate appraisals of the selling utility for the purpose of establishing its fair market value.”³⁷

The legislated “procedure” is clear and unambiguous, requiring the efforts of *only* the UVEs “for the purpose of establishing fair market value.” Having directed that only the UVEs establish fair market value, the General Assembly then directed the method for its determination – requiring that fair market value appraisals be conducted “in compliance with the Uniform

³⁴ OCA Main Brief, Section III.

³⁵ OCA Main Brief, Section IV.A.2.

³⁶ Section 1329(a).

³⁷ Section 1329(a)(2).

Standards of Professional Appraisal Practice, employing the cost, market and income approaches.”³⁸

Once the UVEs have concluded their respective analysis in compliance with the Uniform Standards of Professional Practice (“USPAP”) employing the cost, market and income approaches, the ratemaking rate base is the formulaic lesser of the negotiated purchase price and the average of the fair market value appraisals.³⁹

OCA claims there is judgment involved. While that may be true, it is judgment of the UVEs that is involved, not the OCA, and the judgment of the UVEs is involved only in the preparation of the appraisals. Once the appraisals are in hand, the determination of the ratemaking rate base is determined by legislative formula – the lesser of the negotiated purchase price and the average of the fair market value appraisals.⁴⁰ The check on the judgment of the UVEs is not debate and litigation by OCA but rather the simple fact that the General Assembly required *two* appraisals.⁴¹

Allowing the OCA to debate and litigate the fair market value appraisals and the work product of the UVEs is precisely what the General Assembly sought to avoid with Section 1329.⁴² The Statutory Construction Act and established case law precedent require that the Commission implement the clear and unambiguous, express language of Section 1329.⁴³ The Commission must reject the Section 1329 and fair market value contentions of the OCA.

³⁸ Section 1329(a)(3).

³⁹ Section 1329(c).

⁴⁰ Section 1329(c).

⁴¹ See Section 1329(a)(2).

⁴² OCA witness Everette acknowledged that she did not perform a fair market value appraisal. She reviewed the appraisals of Gannett and HRG that were presented. Tr. 131, lines 8 through 20.

⁴³ See also Aqua Main Brief, Section V.B.1. The Statutory Construction Act of 1972 explains that “[t]he object of all interpretation and construction of statutes is to ascertain and effectuate the intention of the General Assembly.” 1 Pa.C.S. § 1921(a). In order to ascertain the intent of the General Assembly, the ruling body should first look at the plain language of the statute. *Commonwealth v. Segida*, 985 A.2d 871, 874 (Pa. 2009). When the language of the statute is free from all ambiguity, the letter of the statute is to be followed. 1 Pa.C.S. § 1921(b).

i. Due Process Claims Regarding Challenges to UVE Appraisals

The OCA submits further that Aqua’s view of Section 1329 would violate due process. The OCA argues that, unless it has the ability to challenge the UVE appraisals, approval of the ratemaking rate base would violate the due process protections of the Constitution.⁴⁴

It is well settled that due process principles apply to administrative proceedings and require a person be provided notice and an opportunity to be heard. *R.J.W. v. Dep’t of Human Servs.*, 139 A.3d 270 (Pa. Cmwlth. 2016). Due process, however, is a flexible concept and is not an absolute right. As the Commonwealth Court has stated:

Due process requires a person be provided notice and an opportunity to be heard prior to an adjudication affecting that person’s rights. It does not, however, confer an absolute right to be heard. Further, due process is a “flexible” concept, not a technical one, and it imposes only such procedural safeguards as the situation warrants. In addition, due process is a right that a party may waive.

Fountain Capital Fund, Inc. v. Pa. Securities Comm’n, 948 A.2d 208, 214 (Pa. Cmwlth. 2008).

The Pennsylvania Supreme Court has further explained the flexibility of Constitutional due process as it relates to Commission hearings in Chapter 11 application proceedings.

[C]onstitutional procedural due process is a flexible concept, and thus, implicates procedural protections as each particular situation demands. *See Burger v. Board of Sch. Dirs. of McGuffey Sch. Dist.*, 576 Pa. 574, 586, 839 A.2d 1055, 1062 (2003). The certification setting entails a unique regulatory process via which the General Assembly has imposed requirements upon certain utility service providers that would otherwise be subject only to dictates of the competitive marketplace and general law, along the lines of unregulated business activity. In this setting, while due process concerns implicating hearings certainly may arise in the course of particular certification proceedings, we do not regard the act of regulatory approval itself as the type of government activity that inherently requires a hearing to comport with constitutional doctrine.

Chester Water Authority v. Pa. P.U.C., 868 A.2d 384, 391 (Pa. 2005).

The OCA cites *Barasch v. Pa. P.U.C.*, 546 A.2d 1296 (Pa. Cmwlth. 1988) (“*Milesburg*”), in support of its due process arguments. In *Milesburg*, a utility filed a petition seeking a

⁴⁴ OCA Main Brief at 9 – 11 (citing U.S. Const. amend. XIV, § 1).

declaratory order from the Commission approving the terms and conditions of a contract for the purchase of energy and capacity, which order would then be published in the *Pennsylvania Bulletin* and followed by a thirty-day period in which interested persons could submit written comments on the decision. The petition was only served on the active parties to its most recent base rate proceeding. The Commission approved the contract terms, including the purchase rates, without holding a hearing or providing general notice to the utility's ratepayers. *Milesburg*, 546 A.2d at 1301-02.

On appeal, the Commonwealth Court concluded that the due process rights of the utility's customers were not adequately protected by the proposed procedure involving publication of the Commission's subsequent decision in the *Pennsylvania Bulletin*. *Id.* at 1306. In doing so, the Court stated that when an agency action is adjudicatory in nature and involves substantial property interests, due process requires the utility's customers to "be provided with notice of the proceedings and an opportunity to be heard to challenge the proposed action." *Id.*

Milesburg does not support the OCA's due process arguments and is distinguishable from the facts of the present proceeding. *First*, this proceeding does not involve the issue of due process and the propriety of privately negotiated contract rates. As discussed above, the General Assembly has established a clear process under Section 1329 for determining valuation and the ratemaking rate base, and Aqua has complied with these statutory obligations in all material ways. *Second*, unlike *Milesburg* where the utility proposed a unique procedure for providing notice, Aqua complied with the Commission's Secretarial Letter dated May 31, 2017 which directed Aqua to serve the application on certain parties and publish a prepared notice in a newspaper of general circulation and which advised that the notice of the application would be published in the June 10, 2017 edition of the *Pennsylvania Bulletin*. Further unlike *Milesburg*, a

hearing was held in this proceeding, and all parties, including the OCA, were given a meaningful opportunity to be heard, which included the submission of testimony, presentation of evidence, and participation in the development and presentation of their cases.

Third, the ratemaking rate base established in this proceeding will not result in an increase in rates, as was the case in *Milesburg*. The OCA contends that future rates could increase by “as much, or more than, 52%,”⁴⁵ but those contentions are speculative and neither relevant nor material to this proceeding. While ratemaking rate base is being established, Aqua has proposed no change to any customer rate as part of this proceeding. The Commission will ultimately decide the just, reasonable, and appropriate rates for Limerick and existing customers in Aqua’s next base rate case proceeding, at which time challenges to proposed rates can be lodged. Future changes, if any, in rates, terms, and conditions of service will be made in accordance with applicable Commission rules and notice requirements to ensure customers’ due process rights are adequately protected.

Ultimately, Aqua has filed an application requesting, *inter alia*, approvals pursuant to Sections 1102 and 1329 of the Public Utility Code. The procedure employed for setting the valuation and the ratemaking rate base, including the use of the UVE appraisals, is consistent with the clear, unambiguous, and express language of Section 1329 and the General Assembly’s intent in enacting Section 1329 to streamline the approval process and encourage consolidation in the water and wastewater industry in the Commonwealth. In arguing that the UVE appraisals should be subject to challenges from non-applicant parties, the OCA is attempting to dramatically alter the scope and operation of Section 1329 which would conflict with the purpose

⁴⁵ OCA Main Brief at 10-11.

and intent of the plain language of Section 1329.⁴⁶ The language under Section 1329(d)(1), moreover, expressly provides that a public utility must submit an application for a certificate of public convenience to acquire municipally-owned water or wastewater assets under Section 1102. A hearing was scheduled and held as permitted under Chapter 11 – the scope of which is well within the Commission’s exercise of its administrative discretion – and the OCA was given full and fair opportunity to be heard consistent with its constitutional due process rights. *See Chester Water Authority, supra*. Accordingly, the OCA’s due process pleas are without merit and should be denied.

ii. Due Process Claims Regarding The Six-Month Statutory Deadline

Finally, the OCA raises the issue of statutory construction and the application of the Section 1329 six-month statutory deadline to the affirmative benefits analysis of Section 1102⁴⁷ and contends that, as a result of the six-month deadline, it was not afforded a full and meaningful opportunity to develop and present its case.⁴⁸ According to the OCA, it would be inconsistent to require consideration of Section 1102 issues, which have no statutory deadline, to be completed within the same six-month statutory time frame established by Section 1329(d). Instead, the OCA submits, the Commission should “reconcile” Sections 1329 and 1102 and provide the parties with six months to address Section 1329 issues, followed by an open-ended period of time to consider and litigate Section 1102 issues.⁴⁹

The OCA’s approach, if adopted, would result in a bifurcation of this proceeding and subject Section 1329 applications to indefinite delays while the Commission addresses Section

⁴⁶ *See Pa School Boards Ass’n, Inc. v. Cmwlth., Public School Employees’ Retirement Bd.*, 863 A.2d 432, 439 (Pa. 2004) (concluding that tribunals are prevented from inserting or reading into the statute words that do not appear in the text if the existing text makes sense and the implied reading would change the existing meaning or the effect of the actual language).

⁴⁷ OCA Main Brief at 11-13.

⁴⁸ OCA Main Brief at 13 (citing U.S. Const. amend XIV, § 1).

⁴⁹ OCA Main Brief at 11-12.

1102 issues. It, moreover, would violate the clear, unambiguous, and express language of Section 1329(d)(2) and render the six month statutory deadline inapplicable.

These very same arguments were considered and soundly rejected by the Commission in *New Garden*.⁵⁰ Prior to the evidentiary hearing in *New Garden*, I&E sought interlocutory review and answer to the material question of whether “Section 1329 of the Public Utility Code impose[s] a six-month time limitation upon the Commission’s consideration of an Application by an acquiring public utility for a Certificate of Public Convenience under Section 1102 where no such time limitation previously existed and the purchaser is an existing, certificated public utility?”⁵¹ By Opinion and Order entered February 15, 2017, the Commission affirmatively answered the question and declined to bifurcate the proceedings so that Section 1102 issues could be adjudicated on a separate timeline from the Section 1329 issues.⁵²

In reaching its decision, the Commission relied on the clear, unambiguous, and express language of Section 1329(d), explaining as follows:

The language under Section 1329(d)(1) expressly provides that a public utility must submit an “*application*” for a certificate of public convenience to acquire municipally-owned water or wastewater assets under Section 1102 of the Code. If both the buyer and seller agree to proceed under Section 1329, the public utility “shall include as an attachment to its *application*” all of the information contained in Section 1329(d)(1)(i) to (v). Thereafter, 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) (emphasis added). We find this express language to be clear and unambiguous. It requires that once a utility applicant invokes Section 1329 and provides the information required under Section 1329(d), the Commission must issue an order within six months.

Because the language in Section 1329(d) is phrased in mandatory terms, there would appear to be no discretion to authorize an extension of the deadline period for a Commission decision as it relates to acquiring public utilities.

⁵⁰ *New Garden* was the first proceeding involving an application seeking approvals, *inter alia*, under Sections 1102 and 1329 of the Public Utility Code to be filed with and considered by the Commission.

⁵¹ *New Garden*, Opinion and Order entered February 15, 2017, slip op. at 2.

⁵² *Id.*

Moreover, the Commission is prevented from inserting or reading into the statute words that do not appear in the text if the existing text makes sense and the implied reading would change the existing meaning or the effect of the actual language. *Pa School Boards Ass'n, Inc. v. Cmwlth., Public School Employees' Retirement Bd.*, 580 Pa. 610, 621, 863 A.2d 432, 439 (Pa. 2004). If we were to read in words permitting a bifurcation, the six-month deadline under Section 1329(d)(2) would appear to be rendered inapplicable or superfluous. Under a bifurcated process there would be one proceeding under Section 1102 to determine the fitness without a Commission time limitation and a second proceeding to determine valuation under Section 1329 with a six-month time requirement. However, any time constraint under Section 1329 would become ineffectual or irrelevant if another integrated proceeding under Section 1102 could be extended for an indefinite time period.⁵³

The consideration of Section 1102 issues in the context of a Section 1329 application is clear: The Commission must act to issue a final order on all approvals sought within the statutorily prescribed six month timeframe. All parties to this proceeding, including the OCA, have been afforded full and meaningful opportunity to develop and present their cases on all issues in accordance with the timing set forth in Section 1329. The OCA's due process claims must be rejected.

b. Gannett and HRG Appraisals

In Section IV.A.3 of its Main Brief, the OCA presents an analysis of the Gannett and HRG Appraisal Reports and recommends ratemaking rate base of \$60,976,180.⁵⁴ The OCA's ratemaking rate base is contrary to clear and unambiguous statutory language. Its recommendation is *not* the lesser of the negotiated purchase price and the average of the fair market value appraisals as required by Section 1329(c). It is, instead, the lesser of the negotiated

⁵³ *New Garden*, Opinion and Order entered February 15, 2017, slip op. at 22-23.

⁵⁴ The OCA contends that neither Gannett nor HRG provided direct testimony to support their respective analysis. The Fair Market Value Appraisals Reports of Gannett and HRG were included with the Application as Exhibit Q and Exhibit R, as required by Section 1329(c). The Gannett Report is 244 pages. The HRG Report is 420 pages. The OCA does not explain how direct testimony (presumably in written, question and answer form) would have furthered the presentation of the UVEs. In fact, it would not have. OCA was able to prepare written direct testimony addressing the Gannett and HRG Reports from the two Exhibits. OCA makes no claim to the contrary. Any argument the OCA presents based on a claim that the UVEs were required to submit testimony along with their Appraisal Reports or that their respective analysis was incomplete should be rejected.

purchase price and the average of the fair market value appraisals *as adjusted by the OCA*. The OCA's recommendation must be rejected as inconsistent with the *procedures* enacted by the General Assembly.⁵⁵

In addition to being contrary to clear and unambiguous statutory language, the ratemaking rate base recommended by the OCA is not supported by legally competent analysis. As addressed in Section V.B.2.b of the Company's Main Brief, the appraisal testimony and adjustments of OCA witnesses Everette and Watkins were not performed or presented in compliance with USPAP as required by Section 1329. The OCA testimony and adjustments, accordingly, should be given no weight.

UVEs are the only entities legally qualified by the General Assembly and competent to address fair market value in a Section 1329 proceeding. Neither Ms. Everette nor Mr. Watkins is qualified to review or challenge appraisal "inputs."⁵⁶ Neither Ms. Everette nor Mr. Watkins is a UVE. Neither was employed by either Aqua or Limerick to conduct a fair market value appraisal. Neither is a member of the American Society of Appraisers. Neither Ms. Everette nor Mr. Watkins is an expert in utility valuation.

In its analysis of the Gannett and HRG Appraisals, the OCA is doing no more than selectively choosing appraisal "inputs" that are to its liking while jettisoning those "inputs" that are not. This is exactly what the General Assembly meant to avoid with the prescriptive procedure of averaging the appraisal performed by the two qualified UVEs. While we offer the following reply to the OCA's analysis, we submit that the reply is unnecessary inasmuch as the OCA's analysis is contrary to statutory law and the procedures enacted by the General Assembly as set forth above and should be rejected on that basis without further consideration.

⁵⁵ See Section 1329(a).

⁵⁶ See OCA Main Brief at 9.

i. Cost Approach

The OCA recommends four adjustments to the HRG cost approach results.⁵⁷ The four adjustments, which are based on the testimony of OCA witness Everette, were addressed in Aqua's Main Brief, pages 40 through 45. They are addressed further below.

HRG Reproduction Cost

HRG used the ENR Construction Cost Index as an indicator of general inflation in order to determine an approximate Reproduction Cost. The OCA claims that a uniform application of the HRG indexing to all types of plant, including collection system mains, decreases the Reproduction Cost by \$19,195,429.⁵⁸

The OCA contends that HRG unreasonably departed from the ENR results in respect to contributed and collection system mains.⁵⁹ The HRG appraisal explains, however, that it is apparent that the unit cost for collection system mains is not in-line with current industry unit costs for collection system main construction. The Pennoni asset listing states that the footage for mains was measured from maps of the system; however, the costs reported represent expenditures made by Limerick and may not include the cost of mains contributed by developers. The unit cost, consequently, appears to be understated.⁶⁰ For this reason, HRG believed that a representative sample of unit costs taken from regional municipalities would

⁵⁷ OCA Main Brief at 14. The OCA does not recommend adjustments to Gannett's cost approach results. OCA Main Brief at 15. While the HRG Cost Approach is higher than the Gannett Cost Approach, it is almost exactly the same, except for the Going Value addition. Yet, the OCA offers no criticism of the Gannett Cost Approach. This suggests that the OCA is not pursuing a determination of Fair Market Value but, rather, is simply attempting, inappropriately and contrary to Section 1329, to drive down one valuation in order to lower the "average" of the two to affect the determination of ratemaking rate base. Aqua St. No. 4R at 9, line 14, through 10, line 4.

⁵⁸ See OCA Main Brief at 17.

⁵⁹ OCA Main Brief at 15 and 16.

⁶⁰ HRG believes that the low unit price in the asset listing is because the cost does not include the value of the mains in residential subdivisions that were contributed. Units included in the asset listing were obtained from drawings and system maps and included contributed mains. Contributed mains are part of the transaction and have value which is why HRG chose an appropriate methodology for including them in the reproduction approach. Aqua St. No. 3R at 8, lines 11 through 15.

reflect a more realistic measure of Reproduction Cost value. HRG calculated the Reproduction Cost for collection system mains by multiplying the measured feet of main by the current costs developed from the other regional wastewater systems.⁶¹

Ms. Vicari expanded on HRG's reasoning in her rebuttal testimony. The use of an alternative valuation methodology for valuing collector mains is a special circumstance. The original cost of gravity collector sewer mains was \$15,213,236. There are 355,000 linear feet (L.F.) of main, which calculates to \$42.85 per linear foot. This is a very low number compared with historical construction costs and construction components. For this reason, HRG developed a profile of 2016 construction costs for sewer mains of various size installed in the Montgomery County and Chester County area based on public bidding information through the industry service, PennBID. These are actual costs for projects in the same general vicinity as Limerick and HRG believes it to be more representative than an index trending that appears to be a very low cost.⁶²

The OCA also contends that land should not be included in reproduction cost and proposes to adjust the HRG cost approach by \$756,159. The ENR index may not be directly applicable to land but, in the absence of a cost trend index, *each* parcel of land would have to be separately appraised based on its highest and best use. Separate land appraisals, however, were not performed. HRG chose to use the cost trend index to restate the value of the land in lieu of a separate land appraisal report. HRG's approach reasonably assumes that land values grew roughly along the lines of general inflation of the assets that it hosts further justifying the use of the ENR index.⁶³

⁶¹ Aqua Exhibit No. 1, Exhibit R at 6.

⁶² Aqua St. No. 4R at 8, lines 1 through 22.

⁶³ Aqua St. No. 4R at 9, lines 1 through 10.

HRG Future Capital Projects

The OCA criticizes HRG's inclusion of capital improvements of \$4,500,000 in the cost approach. The listing of Limerick assets prepared by Pennoni engineers identified \$4,533,000 in capital improvements planned by Limerick. HRG understood that the projects are, or will soon be, underway and are considered essential to the APA. The OCA's concern with rate impact is an issue for an Aqua base rate proceeding.⁶⁴

HRG "Going Value" Adder

Citing the testimony of its witness Watkins, the OCA disputes HRG's inclusion of a going value adder of \$4,000,000. Ms. Vicari provided a detailed rebuttal to the testimony of Mr. Watkins.⁶⁵

Mr. Watkins stated that the "add-ons" for going value (and erosion of cash flow) are illogical. Mr. Watkins, however, missed the point. Going value is separate and distinct from the calculated income and cost values. Going value is an estimate of the very real cost for a start-up business and for which a seller should receive compensation. It is a calculation of the working capital needed by the municipality to get to the point where it is operational without loss.⁶⁶

Going value is not related to acquiring customers as Mr. Watkins seems to believe. Again, going value represents the cost associated with forming the entity not a cost of marketing. The going value is unrelated to Aqua. It, instead, represents the costs incurred by Limerick when Limerick began operations – costs that are appropriately included in fair market value.⁶⁷

⁶⁴ Aqua St. No. 4R at 9, lines 10 through 13.

⁶⁵ Aqua St. No. 4R at 14, line 3, through 16, line 2.

⁶⁶ Aqua St. No. 4R at 14, lines 5 through 16. The OCA's characterization of the going value adder as an "additional" working capital requirement "resulting from the acquisition" is inaccurate. Ms. Vicari's rebuttal testimony clearly states that her use of the phrase working capital was in reference to the working capital needed to get a municipality to the point where it is operational without loss. In her experience as a professional engineer, a significant amount of funds is needed to get a system up and going and that Limerick Township should be compensated for that going value. Tr. 65, line 12, through 66, line 17.

⁶⁷ Aqua St. No. 4R at 14, lines 17 through 24.

The OCA contends, moreover, that there are flaws within the adder calculation and that HRG's assumed revenue growth of 20% "is beyond any range of reasonableness." That may or may not be the case. For example, a developer starting a new development typically constructs the on-site facilities at his own cost. His expectation is that it will be essentially fully developed in a relatively short period of time, say five to ten years. His interest is to sell houses within that time frame. The sale of each house represents an additional customer. In a period of strong economic activity, as has been the case in the region surrounding Limerick, a short period of development may occur.⁶⁸

The calculation of net income derived on HRG's Schedule I to Aqua Exhibit 1, Exhibit R, is logical. In order to provide service, certain "fixed costs" are necessary. As new areas are served, fixed costs increase but not in a linear relation such as is the case for variable costs. Mr. Watkins may disagree with the time frame and assumptions, but the logic of calculating net income by subtracting revenues from expenses is sound.⁶⁹

With regard to OCA witness Watkins' comment about going value double counting, if no discounting of revenue is reflected, the sum of negative income years: 2017 - \$1,023,786 plus \$405,149 equals \$1,428,935. To offset the initial years of negative income, the utility would need to have sufficient funds of at least \$1,430,000.⁷⁰

Conclusion – OCA Cost Approach Adjustments

The Commission should reject the adjustments proposed by the OCA to the HRG Cost Approach.

⁶⁸ Aqua St. No. 4R at 14, line 25, through 15, line 6.

⁶⁹ Aqua St. No. 4R at 15, lines 7 through 11.

⁷⁰ Aqua St. No. 4R at 15, lines 12 and 13.

ii. Income Approach

The OCA recommends adjustments to the income approach valuations of HRG and Gannett based on the testimony of its witness Watkins.⁷¹ Mr. Watkins' testimony was addressed in Aqua's Main Brief, pages 45 through 49, and is addressed further below.

HRG Discounted Cash Flow Method

The OCA states that Mr. Watkins has concerns with four "inputs" in the HRG analysis: income tax expense included as a deduction from net cash flows, a discount rate of 2.5%, a \$4,000,000 provision for "going value," and a deduction of \$300,000 as a provision for erosion of cash flow.⁷²

Mr. Watkins made changes to income tax rates that resulted in a lower fair market value with the income approach. His tax rate changes are not appropriate. Modifications to taxes would also result in changes to the Revenue Requirement which Mr. Watkins did not consider. To the extent that taxes increase, the Revenue Requirement increases. A regulated utility is permitted to recover the full cost of rendering utility service. The assumed rate increases would correspondingly increase, resulting in a greater income value than as developed by Mr. Watkins.⁷³ The analysis presented by the OCA in its Main Brief makes no allowance for any concomitant rate allowances as a result of its proposed changes to income tax rates.

The discount rate used by Mr. Watkins in his income approach is overstated in that it fails to reflect changes in utility plant additions and other changes that have occurred since the prior Aqua rate filing. In effect, these changes, if reflected, would result in a lower rate of return and a

⁷¹ OCA Main Brief at 22.

⁷² The "going value" adder and provision for erosion control were addressed in the foregoing section concerning the OCA's proposed adjustments to the HRG cost approach and are not addressed further in this section.

⁷³ Aqua St. No. 4R at 13, line 20, through 14, line 2.

lower discount factor. Obviously, the discount factor should be based on conditions that currently prevail, not conditions at the time of the prior rate filing.⁷⁴

Additionally, Mr. Watkins used Original Cost and associated depreciation in his analysis because “annual revenue requirements are established based on original costs and not the hypothetical cost of reproducing a new system at current construction costs.” While traditional rate making is based on original cost, Section 1329 departs from “traditional” rate making practices. As enacted by the General Assembly, fair market valuation under Section 1329 is not tied “to the original cost of construction minus accumulated depreciation.” Mr. Watkins unwillingness to accept the statutory directive is a critical failing in his analysis. His comments concerning using original cost and accumulating depreciation and depreciation expense should be ignored for Fair Market Value purposes and his rate base/rate of return conclusion should be given no weight.⁷⁵

Ms. Vicari presented the following summary of her criticisms of Mr. Watkins proposed adjustments to inputs used by HRG in its income approach:⁷⁶

- Mr. Watkins did not present a fair market value appraisal. He testified as to only the Income Approach, whereas Section 1329 considers Cost, Income and Market Approaches.
- Mr. Watkins’ initial consideration of both the seller’s and buyer’s perspectives as part of the Income Approach was incorrect. Only the purchaser’s perspective is relevant.
- Mr. Watkins improperly rejected HRG’s consideration of going-value.
- Mr. Watkins’ analysis modified the income tax rates but did not consider an increase in the revenue requirement that would support increased revenue, net income and a corresponding increase in value.

⁷⁴ Aqua St. No. 4R at 16, lines 15 through 19.

⁷⁵ Aqua St. No. 4R at 16, line 20, through 17, line 8.

⁷⁶ Aqua St. No. 4R at 17, lines 9 through 24.

- Mr. Watkins' analysis proposes a change in the discount rate applied to future cash flows based on his opinion of the rate of return on equity. He makes no mention of the return currently earned by Aqua, which may be substantially lower than his assumption due to changes in revenue, expenses and utility plant investment since Aqua's most recent general rate case.
- Mr. Watkins improperly rejected the HRG reproduction cost measure for FMV purposes.

The Commission should reject the adjustments proposed by the OCA to the HRG Income Approach.

Gannett Fleming Discounted Cash Flow Method

The OCA recommends two adjustments to the Gannett income approach based on the testimony of its witness Watkins: the use of a terminal value in the thirteenth year of the Gannett DCF model and the use of the municipality's cost of capital as the discount rate.⁷⁷ Mr. Watkins' testimony concerning the two adjustments were addressed in Aqua's Main Brief, pages 47 through 49. They are addressed further below.

Terminal Value

Mr. Watkins misunderstands the use of a "terminal value" in a DCF analysis. The use of a "terminal value" is reasonable and is in accordance with accepted valuation practice.

Within the DCF analyses, the "terminal value" is simply a point in the time in which the growth in annual Debt Free Net Cash Flows changes from multiple growth rates to a constant growth rate. Subsequent to time period 13 (year 2030), the growth in annual Debt Free Net Cash Flows is a constant growth rate. The use of a "terminal value" in a DCF analyses is a mathematical shortcut to avoid having to show and/or calculate annual Debt Free Net Cash Flows for hundreds of time periods, or hundreds of years, and is reasonable and is in accordance with accepted valuation practice. Schedule 2 of Aqua Statement No. 3R proves the results of the

⁷⁷ OCA Main Brief at 33.

DCF analyses are the same regardless if a “terminal value” is used or if the annual Debt Free Net Cash Flows are calculated for hundreds of time period, or hundreds of years.⁷⁸

The OCA and Mr. Watkins do more than disagree with Gannett’s use of a terminal value. The OCA also proposes an alternative calculation based on a 50 year modeling approach. The OCA’s alternative approach, which, essentially, caps the life of the business to 50 years is not in accordance with accepted valuation practice. By capping the business life to only 50 years, the OCA understates the value indicated by Mr. Watkins’ own model by 10% to 19% under his assumed Township ownership and by 10% to 14% based under his assumed Aqua ownership. It does not represent the valuation of a going concern.⁷⁹

The OCA attempts to support Mr. Watkins’ 50 year modeling approach by claiming that, after 40 or 50 years, the present value factor becomes very small. The information shown on Schedule 2, proves those statements are incorrect. Capping the business at 50 years affects the results greatly.

More specifically, as shown in Schedule 2, columns C through G, of Aqua Statement No. 3R the cash flow method advocated by Mr. Watkins produces a value of \$70,515,635 which is 19.5% higher than the \$56,757,041 value found in year 2057 (period 40) and is 12.7% higher than the \$61,545,840 value found in year 2067 (period 50) using the cash flow method. Similarly, as shown on Schedule 2, columns H through L, the 2% growth cash flow method advocated by Mr. Watkins produced a value of \$108,541,335 which is 40.3% higher than the

⁷⁸ Aqua St. No. 3R at 9, line 6, through 12, line 12, and Schedule 2. In Schedule 2, columns C through G, the “DCF With Capitalization of Terminal Value Model @ 4.37%,” or no growth model, from Exhibit Q’s Exhibit 8 (Aqua Exhibit No. 1, Exhibit Q, Exhibit 8), produced a value of \$70,519,292 which is only 0.52% higher than the \$70,515,635 value found using the cash flow method advocated by Mr. Watkins. Similarly, in columns H through L, the “DCF With Capitalization of Terminal Value Model @ 2.37%,” or 2% growth model, from Exhibit Q’s Exhibit 8 (Aqua Exhibit No. 1, Exhibit Q, Exhibit 8), produced a value of \$107,372,376 which is only 1.08% lower than the \$108,541,335 value found using the cash flow method advocated by Mr. Watkins.

⁷⁹ Aqua St. No. 3R at 4, lines 4 through 9.

\$64,805,279 value found in year 2057 (period 40) and is 31.9% higher than the \$73,871,009 value found in year 2067 (period 50) using the cash flow method.⁸⁰

In a further attempt to support its 50 year modeling approach, the OCA contends that the Limerick system will wear out and Gannett unreasonably assumes a service life of 125 years. In rejoinder testimony, Mr. Walker explained that the system must be valued as a going concern and cash flows, therefore, need to be considered in perpetuity. Mr. Walker stated the question as follows – does the model reflect the ability for the Limerick system to be valued as a going concern or does it reflect something else – an entity, as Mr. Watkins suggests, which will have extinguished assets at the end of 50 years?⁸¹

The model used by both Gannett and Mr. Watkins appropriately reflects the same 1.5% growth in capital expenditures and depreciation. Over the first fifty years, the model reflects \$77.3 million of capital investment. Over 100 years, the model reflects \$244 million of capital investment. That is how the math of the model works. The capital expenditure shown in the 13th year of the model is \$1.292 million and it almost matches dollar for dollar the depreciation shown on the line above it.⁸² If the dollars of capital investments being “plowed” back into the system are matching depreciation dollars then the system remains in a “state of good repair,” contrary to the contention of the OCA and the testimony of Mr. Watkins.⁸³

⁸⁰ Aqua St. No. 3R at 11, line 20, through 12, line 12, and Tr. 43, line 21, through 44, line 2.

⁸¹ Tr. 48, lines 9 through 14.

⁸² OCA St. No. 2, Schedule GAW-7 at 2.

⁸³ Tr. 47, line 8, through 50, line 17.

Discount Rates

Viewing the transaction, first, from Limerick's perspective, Mr. Watkins developed a discount rate using Township "equity" capital as well as debt.⁸⁴ Mr. Watkins' Township cost of capital is not reasonable and not in accordance with accepted valuation practice for five reasons.

First, Mr. Watkins developed his cost of capital for the Township based on methods used by witnesses who provide testimony before the Commission who are tasked with determining a cost of capital for a portion of a municipality's assets which provide utility service outside its corporate limits or boundaries. Simply put, only in such cases as when a portion of a municipality's assets provide utility service outside its corporate limits are municipalities treated as a business enterprise with respect to the cost of capital of those assets providing "outside" service. None of these circumstances is present in the current proceeding since the Township is not regulated by the Commission.⁸⁵

Second, Mr. Watkins indicated that he used the Township's embedded cost of debt or the historical cost of all debt issuances that were outstanding at 12/31/15. An embedded cost of debt, such as that used by Mr. Watkins, is only used in rate proceedings. Whereas the marginal cost of debt at the valuation date is in accordance with accepted valuation practice and used for market valuation purposes.⁸⁶

Third, Mr. Watkins indicated that he used the Township's book capitalization ratios (i.e., debt and equity ratios calculated from a balance sheet) at 12/31/15. Book capitalization ratios, such as those used by Mr. Watkins, are only used in rate proceedings. Whereas market value

⁸⁴ OCA Main Brief at 36 through 38.

⁸⁵ Aqua St. No. 3R at 6, lines 6 through 14.

⁸⁶ Aqua St. No. 3R at 6, lines 15 through 19.

capitalization ratios at the valuation date (i.e., 12/31/16) are in accordance with accepted valuation practice and used for market valuation purposes.⁸⁷

Fourth, Mr. Watkins included the Township's book equity in determining his cost of capital even though the Township, or any other municipal or government entity, can never marginally finance a project with equity. That is, the Township, or any other municipality, can only prospectively finance with debt capital, not equity capital. Accordingly, for market valuation purposes, municipal capital structure has to be 100% marginal debt.⁸⁸

Fifth, use of the Township's cost of capital does not conform to the "hypothetical buyer" or "hypothetical seller" of fair market valuation.⁸⁹

Viewing the transaction, next, from Aqua's perspective,⁹⁰ Mr. Watkins indicated that he used Aqua's book capitalization ratios (i.e., debt and equity ratios calculated from a balance sheet) to determine a discount factor. Book capitalization ratios, such as those used by Mr. Watkins, are only used in rate proceedings and are not in accordance with accepted valuation practice. Market value capitalization ratios at the valuation date (i.e., 12/31/16) as used by Gannett, on the other hand, are in accordance with accepted valuation practice used for market valuation purposes.⁹¹

As a final matter, the OCA contends that Gannett should have included "equity" capital in the cash flow method. In his oral rejoinder testimony, Mr. Walker emphasized that use of

⁸⁷ Aqua St. No. 3R at 6, line 20, through 7, line 2. For example, both the American Society of Appraisers, *ASA Business Valuation Standards*, 2009, and the National Association of Certified Valuation Analysts, *Professional Standards*, 2007, use the same definition: "Weighted Average Cost of Capital (WACC). The cost of capital (discount rate) determined by the weighted average, at market values, of the cost of all financing sources in the business enterprise's capital structure."

⁸⁸ Aqua St. No. 3R at 7, lines 3 through 7. For example, when a municipal or government entity, such as the Commonwealth of Pennsylvania, finances construction of a road or bridge, they only consider the marginal debt cost despite having "equity" reflected on their books (balance sheet).

⁸⁹ Aqua St. No. 3R at 7, lines 8 and 9.

⁹⁰ See OCA Main Brief at 38 and 39.

⁹¹ Aqua St. No. 3R at 7, line 13, through 8, line 2.

“equity” capital to develop a discount rate for Limerick Township as proposed by Mr. Watkins is simply wrong. Limerick Township, like all municipalities, does not have access to equity markets. It has access only to debt capital and the appropriate discount rate for valuation purposes is the marginal cost of debt. “Municipalities just don’t have the ability to invest equity capital They don’t use equity capital to build roads. They use debt capital. They don’t use equity capital to buy water or wastewater facilities. They use debt capital [T]he appropriate discount rate for a municipality [is] the marginal cost of debt.”⁹²

Conclusion – OCA Income Approach Adjustments

The Commission should reject the adjustments proposed by the OCA to the HRG and Gannett Income Approaches.

iii. Market Approach

The OCA recommends two adjustments to the HRG market approach.⁹³ The two adjustments, which are based on the testimony of OCA witness Everette, were addressed in Aqua’s Main Brief, pages 42 through 44. They are addressed further below.

Projected Customers

The OCA criticizes the customer growth considered by HRG in its market approach. The criticism is not appropriate. USPAP *requires* consideration of customer growth in the Fair Market Value Appraisal. Ms. Everette assumed, incorrectly, that 7,246 customers overstates today’s Fair Market Value. Customer growth is relevant because, not only does Aqua acquire the physical assets, the customer base, all related utility property and a franchise area, but also benefits from an ongoing mandatory connection ordinance. All future development that can be

⁹² Tr. 45, line 17, through 47, line 7.

⁹³ OCA Main Brief at 41. The OCA does not recommend adjustments to Gannett’s market approach results. OCA Main Brief at 41.

served by the System *must* connect to it or violate the Limerick Township ordinance.⁹⁴ Furthermore, while the Township is presently billing approximately 7,300 EDUs, there are approximately 8,400 EDUs already purchased.⁹⁵ The HRG analysis is not flawed nor does it contain errors. The analysis is consistent with USPAP in contrast to the OCA proposed adjustment which is not.

Purchase Price Values

The OCA criticizes the inclusion of capital improvements in the selling price of the systems included in the sample of transactions. Its criticism is not appropriate. USPAP and the Final Implementation Order *require* consideration of capital improvements in the Fair Market Value Appraisal. The listing of Limerick assets prepared by Pennoni engineers identified \$4,533,000 in capital improvements planned by Limerick. Ms. Everette faults the HRG analysis for failing to reflect \$8.3 million of capital improvements planned by Aqua but, contrary to Ms. Everette's testimony, HRG had no knowledge of that dollar figure. HRG had the asset list prepared by Pennoni and appropriately considered those dollars in its market approach to fair market value.⁹⁶ The HRG analysis is not illogical. The analysis is consistent with USPAP in contrast to the OCA proposed adjustment which is not.

Conclusion – OCA Market Approach Adjustments

The Commission should reject the adjustments proposed by the OCA to the HRG Market Approach.

c. OCA Recommendations Should Be Rejected

The OCA recommends a fair market value, ratemaking rate base of no more than \$60,976,180. Its recommendation must be rejected as set forth above.

⁹⁴ Aqua St. No. 4R at 5, line 18, through 6, line 2, and Tr. 62, line 1, through 63, line 23.

⁹⁵ Aqua St. No. 1 at 10, lines 18 and 19.

⁹⁶ Aqua St. No. 4R at 5, lines 1 through 17, and Tr. 60, line 24, through 61, line 25.

2. Rate Stabilization Plan and Asset Purchase Agreement

a. Asset Purchase Agreement: Rate Freeze

While the APA includes a contractual commitment freezing rates for Limerick customers for the first three years, Mr. Packer explained that the APA does not provide for any limitation on rate increases and that the Commission maintains the authority to set rates in Aqua's next base rate case.⁹⁷

The OCA proposes the following conditions if the Commission approves the Application.⁹⁸

1. The Commission retains the authority to allocate revenues, if appropriate to the Limerick Township customers that are inconsistent with the restrictions contained in the APA.
2. Aqua and its shareholders should bear all risk of a shortfall between the revenues Aqua is permitted to recover under its agreement with Limerick and the costs that the Company will incur with respect to the acquired system. To the extent that Aqua is unwilling or unable to charge costs in excess of the limitations provided in the Asset Purchase Agreement, the excess costs should be borne by shareholders and not spread to other ratepayers.

The OCA contention and proposed conditions assume that the Commission, at some future time, approves rates for Limerick customers that are different from the contract rates agreed to by Aqua and Limerick in the APA. The contention is not reflective of existing or proposed tariff circumstances. It is only through speculation that OCA creates a scenario where the tariff rate approved by the Commission differs from the contract rate.

The OCA's proposed conditions are ratemaking matters which should be addressed in the next Aqua base rate proceeding. The rate freeze is a contract provision. It does not attempt to

⁹⁷ Aqua St. No. 1 at 6, lines 13 through 18.

⁹⁸ OCA Main Brief, Section IV.B.1.

remove Commission discretion in setting rates. The Commission retains the ultimate authority in setting rates and the OCA's proposed conditions should be rejected.⁹⁹

b. Rate Impact of Section 1329 Ratemaking Exceptions

Aqua is planning capital projects totaling \$8,300,000 over the ten years after closing. The OCA identifies the projects but presents no recommendation in regard to them.¹⁰⁰ As directed in Section 1329(f), these post-acquisition improvements shall accrue AFUDC with depreciation deferred for book and ratemaking purposes.

c. Rate Stabilization Plan: Regulatory Asset Treatment

The OCA argues that the regulatory asset is atypical and recommends that it not be approved. OCA recommends further that, if Aqua chooses to present the regulatory asset in its next base rate case that it provide a net present value analysis and that Aqua should begin depreciating the ratemaking rate base that is approved immediately upon closing.¹⁰¹

Regulatory assets have a great deal of flexibility in their use and, in this case, the Company's proposal is reasonable and permitted. While typically used as a recovery mechanism of expenses over future periods, regulatory assets have been included as a component of rate base. The Company, in fact, has regulatory assets in rate base today, such as its FAS109 – Unfunded Deferred Income Taxes, and FAS 143 – Net Negative Salvage.¹⁰²

The Company's rate stabilization plan results in a delayed recovery of the portion of the ratemaking rate base attributed to the regulatory asset. The delay in rate base recognition benefits customers. With reasonable assumptions, a rate benefit for existing customers easily

⁹⁹ Aqua St. No. 1R at 11, line 6 through 12, line 2.

¹⁰⁰ OCA Main Brief, Section IV.B.2.

¹⁰¹ OCA Main Brief, Section IV.B.3.

¹⁰² Aqua St. No. 1R at 4, lines 3 through 10.

occurs by Year 10 – within the Year 7/8 time frame.¹⁰³

Aqua's rate stabilization plan, including the use of a regulatory asset, is permitted, reasonable, and, ultimately, beneficial to customers. The plan will be fully vetted and reviewed in the Company's next base rate case. The Commission should reject the recommendation of the OCA.

d. Revised DSIC Tariff and LTIIP

The OCA recommends that the Commission require Aqua to file DSIC tariff changes and a revised Long Term Infrastructure Improvement Plan within 30 days of the entry of an order in this proceeding if Limerick customers will begin paying a DSIC prior to Aqua's next base rate case. The tariff modifications filed with the Commission in Supplement No. 101 at R-2016-2576069 in accordance with the Supplemental Implementation Order¹⁰⁴ enable Aqua to apply its DSIC to Limerick customers. Aqua will amend its Long Term Infrastructure Improvement Plan before charging DSIC to Limerick customers but submits that the 30 day filing requirement is unnecessary.

3. Aqua Demonstrated that the Proposed Transaction Is in the Public Interest

Similar to I&E, OCA contends that Aqua failed to show that the transaction would provide affirmative public benefit and that the merits of applications arising under Section 1102 are measured by standards set forth in *City of York*.¹⁰⁵ Aside from a passing reference to *Popowsky* at page 53, the OCA makes no mention of *Popowsky* in its Main Brief. In *Popowsky*, however, the Supreme Court rejected the OCA's interpretation of *City of York*.¹⁰⁶ *Popowsky*

¹⁰³ Aqua St. No. IR at 4, line 11, through 5, line 2.

¹⁰⁴ Implementation of Act 11 of 2012, Docket No. M-2012-2293611, Supplemental Implementation Order (Sep. 15, 2016).

¹⁰⁵ OCA Main Brief, Section IV.C.

¹⁰⁶ *Popowsky* at 1054 – 1057.

explains that the *City of York* standard does *not* require binding legal commitments or a quantification of benefits.

The OCA contends that the transaction would be harmful to existing customers¹⁰⁷ and detrimental to Limerick customers after Year 3¹⁰⁸ and that adverse impacts on Aqua's existing customers and Limerick customers after Year 10 would outweigh benefits of the proposed transaction.¹⁰⁹

The OCA's contention is a concern with the potential rate effects of the transaction. The OCA's concern with potential rate effects is the very same contention argued by it and rejected by the Commission in *New Garden* and *Scranton Sewer Authority*. Its concern, likewise, should be rejected here. The Commission's holdings in *New Garden* and in *Scranton Sewer Authority* rejecting the OCA concern with potential rate effects are discussed in Section III.A.2, *supra*.

Even with the required determination of ratemaking rate base pursuant to Section 1329, Aqua is not proposing any change in the existing rates of either Limerick customers or Aqua's existing customers. The potential rate effects, rather, are reserved for a future base rate proceeding just as they were reserved for a future base rate proceeding in *New Garden* and in *Scranton Sewer Authority*.

The decisions in *New Garden* and in *Scranton Sewer Authority* are further noteworthy in reply to the OCA Main Brief because the Commission, in those proceedings, rejected similar OCA contentions that applicants failed to demonstrate public benefit. The many public benefits relied on by the Commission in *New Garden* and in *Scranton Sewer Authority* are, likewise, present here in support of Aqua's acquisition of the Limerick system.¹¹⁰

¹⁰⁷ OCA Main Brief, Section IV.C.1.

¹⁰⁸ OCA Main Brief, Section IV.C.2.

¹⁰⁹ OCA Main Brief, Section IV.C.3.

¹¹⁰ *See also* Aqua Main Brief, Section V.A.

IV. CONCLUSION

For the reasons set forth above and in its Main Brief, Aqua Pennsylvania Wastewater, Inc. requests that the Public Utility Commission approve its Application filed pursuant to Section 1102 and 1329 of the Public Utility Code, and:

- a. Issue Certificates of Public Convenience under Section 1102:
 - (1) Authorizing Aqua to acquire, by purchase, the wastewater system assets of Limerick; and
 - (2) Authorizing Aqua to begin to offer, render, furnish and supply wastewater service to the public in the Requested Territory.
- b. Authorize Aqua to file tariff revisions, effective upon one day's notice, to:
 - (1) Include within its territory all the Requested Territory;
 - (2) Adopt and apply within the Requested Territory, Limerick's rates as Aqua's Base Rates; and
 - (3) Apply Aqua's *Rules and Regulations* within the Requested Territory.
- c. As part of its Order approving the Application include a determination that the ratemaking rate base of the Limerick system is \$75,100,000 pursuant to Section 1329(c)(2); and
- d. Issue such other approvals, certificates, registrations and relief, if any, under the Public Utility Code as may be appropriate.

Respectfully submitted,

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Date: August 18, 2017

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

The Honorable Steven K. Haas, Presiding

Application of Aqua Pennsylvania : Docket No. A-2017-2605434
Wastewater, Inc. Pursuant to Sections :
1102 and 1329 of the Public Utility Code :
for Approval of its Acquisition of the :
Wastewater System Assets of Limerick :
Township :

CERTIFICATE OF SERVICE

I hereby certify that I have this 18th day of August, 2017, served a true and correct copy of the foregoing Reply Brief of Aqua Pennsylvania Wastewater, Inc. upon the persons and in the manner set forth below:

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