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August 22, 2017

Rosemary Chiavetta, Secretary
PA Public Utility Commission
Commonwealth Keystone Building
400 North Street
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Re: Application of Pennsylvania American Water Company under Sections 1102 and 1329 of the Public Utility Code for Approval of its Acquisition of the Wastewater System Assets of the Municipal Authority of the City of McKeesport
Docket No. A-2017-2606103

Dear Secretary Chiavetta:

Attached for electronic filing please find the Office of Consumer Advocate's Main Brief in the above-referenced proceeding.

Copies have been served per the attached Certificate of Service.

Very truly yours,

Christine Maloni Hoover

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Attachment
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Certificate of Service
*238855

CERTIFICATE OF SERVICE

Application of Pennsylvania-American Water Company under Sections 1102 and 1329 of the Public Utility Code for Approval of its Acquisition of the Wastewater System Assets of The Municipal Authority of the City of McKeesport	:	Docket No. A-2017-2606103

I hereby certify that I have this day served a true copy of the following document, the Office of Consumer Advocate's Main Brief, upon parties of record in this proceeding in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant), in the manner and upon the persons listed below:

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Application of Pennsylvania-American Water Company Pursuant to Sections 1102 and 1329 of the Public Utility Code for Approval of its Acquisition of the Wastewater System Assets of McKeesport Authority of the City of McKeesport	: : : : : :	Docket No. A-2017-2606103

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I. INTRODUCTION

A. Procedural History

On May 24, 2017, the Applicant, Pennsylvania-American Water Company (PAWC), filed an application with the Pennsylvania Public Utility Commission (Commission), under Sections 1102 and 1329 of the Public Utility Code, by which it is seeking approval of: (1) the transfer, by sale, of The Municipal Authority of the City of McKeesport's (MACM) assets, properties, and rights related to MACM's wastewater collection and treatment system to PAWC, (2) the right to begin to offer, render, furnish, or supply wastewater service to the public in the areas served by MACM in the City of McKeesport, the City of Duquesne, Port Vue Borough, the Borough of Dravosburg, and a portion of West Mifflin Borough, Allegheny County, Pennsylvania, (3) the use of the lesser of the fair market value or the negotiated purchase price of the MACM assets related to the system for ratemaking purposes; (4) the collection of a distribution system improvement charge (DSIC) related to the system prior to the first base rate case in which the system plant-in-service is incorporated into base rate, (5) the accrual of Allowance for Funds Used During Construction (AFUDC) for post-acquisition improvements not recovered through the DSIC for book and ratemaking purposes, and (6) the deferral of depreciation related to post-acquisition improvements not recovered through the DSIC for book and ratemaking purposes. The filing was accepted on June 14, 2017. This is the third case to be filed under Section 1329.

On June 21, 2017, the Office of Consumer Advocate (OCA) filed a Protest. On June 28, 2017, the MACM and the City of McKeesport filed Petitions to Intervene. A prehearing conference was held on July 13, 2017. On July 17, 2017, the OCA served the direct testimony of

Ashley E. Everette[1] and Glenn A. Watkins.[2] The Applicant, MACM, and OCA served rebuttal testimony on July 26, 2017, and MACM, I&E, and the OCA served surrebuttal testimony on August 2, 2017. An initial hearing was held on August 3, 2017, where the Applicant's witnesses provided oral rejoinder testimony. Pursuant to the schedule, the OCA files this Main Brief in support of its position that the average appraisal amount is overstated and that the Applicant failed to meet the legal requirements of Section 1102 for approval of the acquisition. If the acquisition is to be approved the conditions set forth herein must be imposed to ensure compliance with the requirements of Section 1102.

B. Overview of the Proposed Transaction

PAWC proposes to acquire the sewer assets of the MACM for $162 million. PAWC chose to file its application under Section 1329 in addition to Section 1102 of the Public Utility Code. PAWC requests that the purchase price of $162 million be approved for ratemaking purposes as it is lower than the average of the two appraisals provided with its application. See 66 Pa. C.S. § 1329(c)(2). In addition, PAWC seeks approval of the Asset Purchase Agreement (APA) with the MACM and the City of McKeesport. PAWC App. A-24 (hereinafter cited as "APA"). In the APA, PAWC agreed to keep base rates frozen for MACM customers for no less

---

[1] Ms. Everette is a Regulatory Analyst employed by the OCA since 2012. She received a Master's degree in Business Administration and a Bachelor's degree in Economics both from the University of Illinois. She testified in numerous proceedings before the Commission with a primary specialty in accounting and finance issues. Ms. Everette's qualifications are attached as Appendix A to OCA Statement 1.

[2] Glenn A. Watkins is a Principal and Senior Economist with Technical Associates, Inc., an economics and financial consulting firm. Mr. Watkins conducts marginal and embedded cost of service, rate design, cost of capital, revenue requirement, and load forecasting studies involving numerous electric, gas, water/wastewater, and telephone utilities, and provided expert testimony in Alabama, Arizona, Delaware, Georgia, Illinois, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Vermont, Virginia, South Carolina, Washington, and West Virginia. Mr. Watkins obtained his B.S. in economics and M.B.A. from the Virginia Commonwealth University in 1982 and 1988, respectively. Mr. Watkins' curriculum vitae is attached to his Direct Testimony (OCA St. 2) as Schedule GAW-1.

than one year after closing. During this "rate stabilization" period, PAWC may seek approval from the Commission to increase MACM rates. APA, ¶ 7.05(b).

II. STATEMENT OF QUESTIONS PRESENTED

Q. Whether the proposed acquisition of the assets of the Municipal Authority of the City of McKeesport meets the requirements of Section 1102 of the Public Utility Code?

Suggested Answer: No.

Q. Whether the valuations provided pursuant to Section 1329 are reasonable under Chapter 13 of the Public Utility Code and accepted financial and ratemaking principles?

Suggested Answer: No.

III. LEGAL STANDARDS

A. Burden of Proof

Under Sections 315(c) and 332 of the Public Utility Code, the burden of proof rests with the Applicant. Section 332 states:

> (a) Burden of proof. - Except as may be otherwise provided in section 315 (relating to burden of proof) or other provisions of this part or other relevant statute, the proponent of a rule or order has the burden of proof.

66 Pa. C.S. § 332. Section 315(c) places the burden of proof upon the Applicant. It states that:

> In any proceeding upon the motion of the commission, involving the service or facilities of any public utility, the burden of proof to show that the service and facilities involved are adequate, efficient, safe, and reasonable shall be upon the public utility.

66 Pa. C.S. § 315(c). Therefore, it is the Applicant that has the burden of demonstrating by a preponderance of the evidence that the proposed acquisition by P meets the requirements of Pennsylvania law. See Lansberry v. Pa. PUC, 578 A.2d 600, 602 (Pa. Commw. 1990). More precisely, the Applicant's case must be more convincing than the case presented by the challenger. Se-Ling Hosiery, Inc. v. Margulies, 413 A.2d 845 (1950).

The Pennsylvania Supreme Court has stated that the party with the burden of proof has a formidable task to show that the Commission may lawfully adopt its position. Even where a party established a prima facie case, the party with the burden of proof must establish that "the elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary." Burleson v. Pa. PUC, 461 A.2d 1234, 1236 (Pa. 1983). Additionally, the evidence must be substantial and legally credible, and cannot be mere "suspicion" or a "scintilla" of evidence. Lansberry, 578 A.2d at 602.

Finally, the Applicant has the burden of proving that the acquisition will "affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way." City of York v. Pa. PUC, 295 A.2d 825, 828 (1972). 66 Pa. C.S. § 315(c).

B. Legal Standard for Section 1102 Approvals

Section 1102(a) of the Public Utility Code authorizes the Commission to permit a regulated public utility to begin to offer service in an additional territory and to acquire property used and useful in the public service. Section 1102(a) states:

> (a) General Rule. - Upon application of any public utility and the approval of such application by the commission, evidenced by its certificate of public convenience first had obtained, and upon compliance with existing laws, it shall be lawful:
>
> (1) For any public utility to begin to offer, render, furnish or supply within this Commonwealth service of a different nature or to a different territory than that authorized by:
>
> (i) A certificate of public convenience granted under this part…
>
> . . .
>
> (2) For any public utility . . . to acquire from, or to transfer to, any person or corporation, including a municipal corporation, by any method or device whatsoever, including the sale or transfer of stock and including a consolidation, merger, sale or lease, the title to, or the possession of, any tangible or intangible property used or useful in the public service.

66 Pa. C.S. § 1102(a)(1), (3).

The merits of applications filed under Section 1102 are measured by the standards set forth in City of York. In City of York, the Pennsylvania Supreme Court stated:

> Section [1103] of the Public Utility Law requires that those seeking approval of a utility merger demonstrate more than the mere absence of any adverse effect upon the public. Section [1103] requires that the proponents of a merger demonstrate that the merger will affirmatively promote the "service, accommodation, convenience, or safety of the public" in some substantial way.

295 A.2d at 828. This standard is the standard by which all mergers of and acquisitions by Pennsylvania utility companies must be judged.

In Middletown Township v. Pa. PUC, 482 A.2d 674 (Pa. Commw. 1984), the Commonwealth Court considered the City of York standard applicable through Section 1102 and Section 1103. The Court provided that "when the 'public interest' is considered, it is contemplated that the benefits and detriments of the acquisition be measured as they impact on all affected parties, and not merely on one particular group or geographic subdivision." Id. at 682. The Middletown Court emphasized that the "primary objective of the law in this area is to serve the interests of the public." Id.; See also Popowsky v. Pa. PUC, 937 A.2d 1040 (Pa. 2007).

Further, under Section 1103, the Applicant must demonstrate that it is technically, legally, and financially fit to own and operate the assets it will acquire. See Seaboard Tank Lines v. Pa. PUC, 502 A.2d 762, 764 (Pa. Commw. 1985); Warminster Twp. Mun. Auth. v. Pa. PUC, 138 A.2d 240, 243 (Pa. Super. 1958). There is a rebuttable presumption that a certified, existing public utility possess the requisite fitness. See South Hills Movers, Inc. v. Pa. PUC, 601 A.2d 1308 (Pa. Commw. 1992).

C. Legal Standard for Section 1329 Approvals

Pursuant to Section 1329, upon agreement by the acquiring public utility and the selling entity, "two utility valuation experts shall perform two separate appraisals of the selling utility for the purpose of establishing its fair market value" and each "shall determine fair market value" in compliance with the Uniform Standards of Professional Appraisal Practice (USPAP) based on the cost, market, and income approaches. 66 Pa. C..S. § 1329(a). "The ratemaking base shall be the lesser of the purchase price negotiated by the acquiring public utility . . . and selling utility or the fair market value of the selling utility." 66 Pa. C.S. § 1329(c)(2).

The Applicant must provide to the Commission copies of the appraisals, the purchase price, the ratemaking rate base, the closing costs, and, if applicable, a tariff and rate stabilization plan. 66 Pa. C.S. § 1329(d)(1). With regard to its rate stabilization plan, the Applicant must provide testimony, schedules, and work papers to establish a basis for the plan and its impact on

existing customers. See Implementation of Section 1329 of the Public Utility Code, Docket No. M-2016-254319, Final Order (Oct. 27, 2016). Rate stabilization plans will be evaluated based on reasonableness such that long-term burdens will not be placed on the utility's existing ratepayers. See New Garden at 16.

Regardless of whether the Applicant meets the requirements of Section 1329, the Applicant still has the burden of proving that it satisfies the requirements of Section 1102 and Section 1103 of the Public Utility Code as specified above. See Application of Aqua Pennsylvania Wastewater, Inc., Docket No. A-2016-2580061, Order at 12 (June 14, 2017) *reconsideration pending* New Garden, Order (July 20, 2017).

D. Legal Standard for Section 507 Approvals

Section 507 of the Public Utility Code governs agreements between a public utility and a municipal corporation. Unless an agreement provides that a corporation will provide service at regularly filed and published rates:

> [N]o contract or agreement between any public utility and any municipal corporation shall be valid unless filed with the commission at least 30 days prior to its effective date. Upon notice to the municipal authorities, and the public utility concerned, the commission may, prior to the effective date or such contract or agreement, institute proceedings to determine the reasonableness, legality, or any other matter affecting the validity thereof. Upon institution of such proceedings, such contract or agreement shall not be effective until the commission grants approval thereof.

66 Pa. C.S. § 507.

IV. SUMMARY OF ARGUMENT

The proposed transfer of the MACM wastewater system to PAWC was filed under Section 1102 and 1329 of the Public Utility Code. 66 Pa. C.S. §§ 1102, 1329. PAWC failed to show that the transaction would provide the required substantial affirmative benefits under Section 1102. The averred benefits of the transfer do not outweigh the substantial adverse impact on PAWC's existing wastewater customers (and potentially, its water customers) and on the MACM customers under PAWC ownership after the one year rate freeze. PAWC's current average wastewater rate base is $6,642 per customer, while the average rate base per MACM customer will be $12,676 per customer (based on the purchase price of $162 million for 12,780 customers) or nearly double the current average wastewater rate base. OCA St. 1 at 16. Ms. Everette calculated a $31 million annual revenue requirement to support the McKeesport system if the $162 million rate base is approved. See OCA St. 1 at 11. If the costs are applied only to McKeesport and PAWC's wastewater customers, it would require a 51% increase in revenues from PAWC wastewater customers. If the revenue requirement is recovered only from the McKeesport customers, it would be equivalent to a 137% rate increase as a result of the acquisition. Id. For all of these reasons and as discussed further herein, the OCA recommends that the Commission deny the transaction as proposed.

As it pertains to Section 1329, it should be emphasized that the statutory appraisal process is not a simple formulaic mathematical exercise. Review of the appraisals provided by PAWC and MACM show that there are judgments made in each type of analysis as well as in how much weight is given to each approach. The appraisals submitted by PAWC for the Seller and Buyer must be revised to reflect a number of flaws identified by the OCA. As a result of these corrections, the average of the two appraisals is less than the purchase price of $162

million. The appropriate amount for ratemaking purposes should be $151,949,698. Even at this lower level of ratemaking rate base, the OCA submits that there are not substantial affirmative public benefits.

In addition to the necessary adjustments to ratemaking rate base, the OCA has identified several conditions that should be imposed if the Commission determines to approve the proposed transaction.

V. ARGUMENT

A. Section 1102 Approvals (transfer of assets and rights, service territory)

1. Fitness

The OCA did not present any evidence regarding PAWC's fitness.

2. Public Benefits

a) The Application Does Not Meet the Statutory Standard For Approval Under Section 1102 Because It Does Not Provide Substantial Affirmative Public Benefits.

In addition to the requirements of Section 1329, the proposed transaction must satisfy Section 1102. 66 Pa. C.S. § 1102. PAWC has failed to show that the transaction would provide the required substantial affirmative benefits.

Indeed, as the OCA has shown, the transaction will result in considerable harm to PAWC's existing customers and to the MACM customers following the first rate case after acquisition. The Public Utility Code authorizes the Commission to permit a regulated public utility to begin to offer service in an additional territory and to acquire property used and useful in the public service, as is requested in this application.[3] 66 Pa. C.S. § 1102(a)(1), (3). The

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[3] Section 1102(a)(1) provides:

> (a) General Rule. Upon the application of any public utility and the approval of such application by the commission, evidenced by its certificate of public convenience first had and obtained, and upon compliance with existing laws, it shall be lawful:
>
> > (1) For any public utility to begin to offer, render, furnish or supply within this Commonwealth service of a different nature or to a different territory than that authorized by:
> >
> > > (i) A certificate of public convenience granted under this part...
> >
> > . . .
> >
> > (3) For any public utility... to acquire from, or to transfer to, any person or corporation, including a municipal corporation, by any method or device whatsoever, including the sale or transfer of stock and including a consolidation, merger, sale or lease, the title to,

merits of applications arising under Section 1102 are measured by the standards set forth in the City of York. In City of York, the Supreme Court addressed a proposed merger of three telephone companies. The Pennsylvania Supreme Court specifically cited Section 203, the predecessor statute to Section 1103, and set forth the standard as follows:

> Section [1103] of the Public Utility Law requires that those seeking approval of a utility merger demonstrate more than the mere absence of any adverse effect upon the public. Section [1103] requires that the proponents of a merger demonstrate that the merger will affirmatively promote the "service, accommodation, convenience, or safety of the public" in some substantial way.

295 A.2d at 828 (quoted in Application of Pennsylvania-American Water Co., Docket No. A-2016-2537209, Order at 11 (Oct. 19, 2016)); See also Popowsky v. Pa. PUC, 937 A.2d 1040, 1054 (Pa. 2007). This is the standard by which all mergers of Pennsylvania utility companies must be judged.

This standard was addressed by the Commonwealth Court in Middletown Township v. Pa. PUC, 482 A.2d 674 (Pa. Commw. Ct. 1984) (Middletown). In Middletown, in order to acquire part of the facilities of the Newtown Artesian Water Company, Middletown Township filed an application for a Certificate of Public Convenience. The ALJ determined that the acquisition would be a benefit to some customers, but would have an adverse impact on other customers. Id. at 679. The ALJ, therefore, denied the application. Id. The Commission adopted the ALJ's Initial Decision and the Township appealed. In hearing the appeal, the Commonwealth Court considered the City of York standard applicable through Section 1102 and Section 1103. The Court affirmed the Commission's decision to reject the merger stating, *inter*

> or the possession or use of, any tangible or intangible property used or useful in the public service.

Id. Section 1103 states that a certificate of public convenience will be granted only where necessary or proper for the service, accommodation, convenience or safety of the public. 66 Pa. C.S. § 1103(a).

alia, that "when the 'public interest' is considered, it is contemplated that the benefits and detriments of the acquisition be measured as they impact on all affected parties, and not merely on one particular group or geographic subdivision as might have occurred in this case." Id. at 682 (emphasis in original). The Court added that "the primary objective of the law in this area is to serve the interests of the public." Id.; See also Popowsky v. Pa. PUC, 937 A.2d 1040 (Pa. 2007).

In this proceeding, the Commission must fully consider the harms of this acquisition on three specific groups with respect to the traditional City of York affirmative public benefits test: (1) the existing PAWC wastewater customers, (2) the existing PAWC water customers – who may potentially bear costs of the MACM system, if the Commission permits costs to be shifted under 66 Pa. C.S. § 1311(c), and (3) the existing MACM Township customers who will be transferred to PAWC.

It is well-established that the City of McKeesport will benefit from the proposed transaction. See OCA St. 1 at 7-8. The City and MACM will receive $162,000,000 or 102% more than the net book value of the system. See APA Article III. PAWC anticipates spending $62.7 million for capital improvements to the MACM system during the next 10 years.[4] See OCA St. 1 at 21. In addition, the forty-six existing MACM union and non-union employees will be hired by PAWC to continue operating the MACM system. PAWC Appendix A-24, Sch. 7.03(a).

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[4] OCA witness Everette explained that Section 1329 allows PAWC to recover additional costs related to post-acquisition improvements. She clarified that any AFUDC and the deferral of depreciation for book and ratemaking purposes should be addressed in PAWC's *next* base rate case. OCA St. 1 at 3; 66 Pa. C.S. § 1329(f).

There is, however, no support for concluding that existing PAWC wastewater and water customers will receive any net benefit or that the MACM customers will see a net benefit after their rate freeze ends. In fact, the record shows that these customers will experience substantial harm that is outweighed by any purported benefits. As such, PAWC has failed to demonstrate the necessary public benefits required for approval of this Application.

(1) Harm to Existing PAWC Wastewater and Water Customers

An acquisition provides an affirmative benefit if the benefits of the transaction outweigh the adverse impacts of that transaction. Application of CMV Sewage Co., Inc., 2008 PaPUC LEXIS 950, *30 (CMV). In order to determine whether benefits meet this standard, the Commission may consider: "(1) the legal and technical fitness of the purchasing entity to provide service; (2) the public need for service; (3) the inadequacy of the existing service; and (4) any other relevant evidence." Application of North Heidelberg Water Co., 2010 PaPUC LEXIS 919, *20.

The OCA recommends that the Commission deny the application on the basis that the acquisition and the associated $162 million rate base (or even the $152 million rate base calculated by OCA) would harm existing and acquired ratepayers and would not provide substantial affirmative public benefit. OCA St. 1 at 7-18; OCA St. 1S at 2-16, 20. The benefits identified by PAWC for its existing customers are generalizations about economies of scale, and regionalization that are not supported and do not address the corresponding harm to existing PAWC wastewater and water customers, and to the MACM customers after acquisition. See, e.g., PAWC St. 1 at 15-17.

In this proceeding, PAWC alleges that the City of McKeesport and PAWC's existing water and wastewater customers will benefit from the proposed transaction. Regarding the City

of McKeesport, the OCA does not dispute that it will benefit from the transaction. The acquired customers, however, will see potentially higher rate increases than if MACM continued to provide service. In addition, the existing water and wastewater customers will bear higher costs as a result of the acquisition. Ms. Everette found that the acquisition is not in the public interest under Section 1102 for the following reasons:

- Loss of ratepayer benefit from grant funds;
- PAWC cost of ownership is greater than MACM cost of ownership;
- Customers in the Dravosburg and Duquesne systems will be unfairly and unreasonably burdened, and
- The Company's claims that the acquisition will "mitigate the level of net plant investment per customer" and "lower or slow the increase in the cost of operating the System" are unsupported.

OCA St. 1 at 8. Each of these will be discussed below.

Regarding the loss of the grant funding, Ms. Everette explained that MACM had received a $17,239,375 grant from the Pennsylvania Infrastructure Investment Authority (Pennvest) in 2011, along with an equal amount as a loan at 1% interest. OCA St. 1 at 9. PAWC is not eligible to assume the Pennvest loan so the MACM ratepayers will not continue to benefit from the Pennvest grant or loan over the life of the plant financed with the grant and loan. Id.

In rebuttal, PAWC witnesses Grundusky and Nevirauskas appear to argue that Pennvest financing is not a benefit[5] and that subsidization by PAWC's existing customers is superior to Pennvest financing. See PAWC St. 1-R at 17; PAWC St. 4-R at 16. If costs can be lowered with the use of low-cost Pennvest financing, it is a benefit that both MACM and PAWC ratepayers

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[5] It is interesting to note that despite these statements, PAWC has existing Pennvest loans of $43 million for water loans and $21.48 million of wastewater loans. Tr. 45-46.

should receive. Without Pennvest financing, costs would be higher. See OCA St. 1S at 4. Moreover, as Ms. Everette noted, not all of MACM's financing is from Pennvest. Id. The loss of the Pennvest loan and grant, regardless of whether Mr. Grundusky and Mr. Nevirauskas think Pennvest funding is appropriate, means that the debt costs will be higher after acquisition by PAWC.

Ms. Everette also found that the cost of ownership is greater under PAWC than under MACM. OCA St. 1 at 10-14. She explained, as follows:

> The cost of capital of an investor-owned utility is inherently higher than the cost of capital of a municipal corporation. MACM has no shareholders and is primarily funded through debt financing. According to its audited financial statement, MACM's long term debt has a weighted average interest rate of 3.66%. In 2015, MACM's expense for interest on long-term debt was $3,349,738.
>
> PAWC, on the other hand, has an overall cost of capital of 7.97%.Because PAWC is an investor owned corporation and not a municipality, it is also subject to income taxes. PAWC's income tax liability increases the cost of capital from 7.97% to 11.85%. Using the $162 million ratemaking rate base, the annual cost of return and income taxes alone under PAWC ownership is $19,197,000 ($162 million x 11.85%), or more than five times the interest expense under municipal ownership.

OCA St. 1 at 10 (footnotes omitted).

Ms. Everette found that, with a rate base valuation of $162 million, the annual revenues needed, including existing operating expenses, will be $31.1 million, even before the additional $62.7 million of capital expenditures.[6] OCA St. 1 at 11. She explained that revenues from MACM customers will not cover the annual revenues needed under PAWC ownership. Specifically, MACM has current revenues of approximately $13 million, so there will be an $18 million shortfall under PAWC ownership. OCA St. 1 at 11. She noted that the $31 million of costs are high because of both PAWC ownership and the proposed $162 million ratemaking rate

[6] $31.1 million = $19.2 million for return and taxes + $5.2 million of depreciation expense + $6.7 million of operating expenses. OCA St. 1 at 11.

base. Id. at 12. She stated, "This is a greater cost of service than cost of service under MACM ownership or under traditional ratemaking." Id. She explained that cost of service under PAWC ownership, but with traditional ratemaking, would be approximately $16.5 million which would still be about a 20% increase to McKeesport customers if the increase were to be placed only on McKeesport customers.[7]

As noted, Ms. Everette found that if MACM customers rates were raised to cover the cost of service under the agreed upon purchase price and PAWC ownership, those customers would see an increase of approximately 137%, or an increase in rates for a customer using 5,000 gallons per month, from $68.95 to $163 per month. OCA St. 1 at 13. PAWC has stated that it anticipates shifting some or all of this shortfall to its existing water customers using Section 1311(c). Id. Thus, existing water and wastewater customers would bear an increase to support the MACM acquisition.

In rebuttal, PAWC witness Nevirauskas stated that he did not agree with Ms. Everette's testimony and that the actual cost would be determined in a base rate case. Ms. Everette noted, however, that she had calculated an **estimated** total cost of ownership under PAWC, as stated in her direct testimony as the Company did not provide such information. OCA St. 1S at 2. Mr. Nevirauskas did not provide any specific disagreement with Ms. Everette's calculations. Regarding the issue of when the impact on existing customers should be addressed, PAWC argues that such impacts can be addressed in future rate cases. Ms. Everette explained that with the approval of the ratemaking rate base in this case, the rate impact of that approval must be addressed now. Ms. Everette testified on cross-examination:

Q. And among those issues would be revenue allocation and rate design, correct?

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[7] $16.5 million= $7.7 million of return and taxes + $2.1 million of depreciation expense + $6.7 million of operating expense. OCA St. 1 at 12-13. This is based on a net book value of $80,000,000 which is the net depreciated original cost of the MACM system, although without any deduction for contributed property. See id.

A. I think that is true except to the extent that it concerns the impact on existing PWC ratepayers; and this is where the public benefits test comes in because, if we are saying the only way this transaction can happen is if the costs are being spread to existing PWC ratepayers, then maybe we need to look at what the impact on those ratepayers would be to determine the harm to those ratepayers in order to do an analysis of the benefits.

Q. Is that not an analysis that can be conducted in a future base rate proceeding?

A. Except that if it ends up being so harmful to those ratepayers that at that point you can't go back and undo the transaction. And so the reason it has to be addressed now is that, once the determination is made that the purchase goes through and the company pays $162 million for it and in the next rate case in three or four years as we've estimated they want to recover the costs associated with that and if those costs are so high the McKeesport area customers are not expected the bear them all, then I think it matters what the costs would be for those customers.

Tr. 178-79.

PAWC witness Grundusky provided testimony regarding the alleged societal costs with local government ownership of utility systems. See PAWC St. 1-R at 4. PAWC also claims that MACM lacks oversight.[8] OCA St. 1S at 5. It is important to note that there is no testimony that MACM is unable to address any issues that might be present in its system. Further, PAWC witnesses have missed the point. The OCA is not debating public versus private ownership of utility systems. See OCA St. 1S at 2-3, 5. Rather, the OCA's testimony is concerned only with the issue presented in this Application regarding PAWC's ownership of the MACM system and whether that transaction has affirmative public benefits. The cost of PAWC ownership is one important component of that analysis. Ms. Everette explained, as follows:

My testimony demonstrated that the acquisition of MACM by PAWC for $162 million is *not* in the public interest. This is not the same as suggesting that public ownership is or will always be superior to an acquisition by private company.

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[8]As Ms. Everette explained, MACM is overseen and regulated by the Allegheny County Health Department and the Pennsylvania Department of Environmental Protection (DEP). Id. Further, MACM operates under the regulatory framework for municipal authorities, while the General Assembly has deemed a different economic framework is appropriate for investor-owned utilities. Id.

When considering any benefits of an acquisition, these benefits must be weighed against an analysis of the cost of the acquisition to the ratepayers. In this case, a ratemaking rate base of $162 million would produce unreasonable costs.

OCA St. 1S at 3.

Ms. Everette also addressed the specific impact on the Dravosburg and Duquesne system customers. OCA St. 1 at 14-15. Those customers would see a possible increase as described above, but those two municipalities would not see any share of the proceeds of the sale to PAWC. Id. Moreover, those systems were purchased by MACM in 2011 for $4.13 million, or approximately half the depreciated original cost of those systems at that time. Id. MACM will receive approximately $30 million for the same plant, or about seven times what MACM paid for it six years ago but no proceeds will be go to the Duquesne or Dravosburg municipalities. Id. Some of the other benefits that will be experienced by McKeesport, such as property taxes that will be paid by PAWC related to its ownership of the facilities, will not accrue to Dravosburg and Duquesne.

PAWC witness Kaufman criticizes Ms. Everette for not including the testimony on environmental compliance issues in assessing the public benefits of the transaction. See OCA St. 1S at 6. As Ms. Everette noted, there is no evidence that MACM could not undertake any necessary improvements, and coupled with the additional costs that will have to be covered just by the fact of PAWC ownership, there is a lack of affirmative public benefits.

Ms. Everette also noted that despite the environmental issues listed by PAWC, it paid more than twice the book value for the system. OCA St. 1S at 7. She reviewed other PAWC asset acquisitions and found that PAWC does not always pay more than book value for acquisitions. OCA St. 1S at 8-9. For example, in the current PAWC base rate proceeding, PAWC shows positive acquisitions for five of the nine acquisitions since the last rate case in

2013. Id. For those five acquisitions, Ms. Everette calculated that the total amount paid over depreciated original cost was $27.9 million (of which $25.6 million was for the Scranton Sewer Authority). OCA St. 1S at 8-9. Even when PAWC did pay more than book value, she is not aware of another situation where PAWC has paid $80 million over depreciated original cost. Id.

Ms. Everette found that PAWC's claims that the acquisition will "mitigate the level of net plant investment per customer" and "lower or slow the increase in cost of operating the system" are unsupported. OCA St. 1 at 8, 15-18. Ms. Everette calculated that the net plant per customer will increase as a result of the $162 million MACM acquisition. PAWC's current average wastewater rate base per customer is $6,642. OCA St. 1 at 16. The average MACM rate base per customer will be $12,676. Id. When the MACM rate base of $162 million is added to PAWC's wastewater rate base, the average wastewater rate base per customer will be $7,862 per customer, or an increase of $1,220 or 18%. Id.

In rebuttal, PAWC witnesses Grundusky and Nevirauskas both attempted to recalculate the average rate base per customer but neither witness produced an apples-to-apples comparison. See OCA St. 1S at 10-12. For example, PAWC witness Grundusky calculated a much higher customer count for MACM by counting each customer served through the bulk customer connection. That method, though, is inconsistent with the PAWC customer count in Mr. Grundusky's direct testimony, which is based on each bulk customer being counted as one customer. OCA St. 1S at 10. PAWC witness Grundusky also criticized Ms. Everette's calculation because she did not include $27.1 million of Construction Work in Progress (CWIP). Ms. Everette explained that CWIP is not included in the ratemaking rate base proposed for the MACM assets and CWIP is not included in rate base until the plant goes into service. Including CWIP, as Mr. Grundusky argued, is not an apples-to-apples comparison. OCA St. 1S at 10.

Despite the inconsistent rate base, Ms. Everette calculated the average plant per customer if CWIP is included in the PAWC net utility plant. The result is average wastewater rate base per customer of $6,603 for PAWC and for a combined PAWC and MACM rate base, average wastewater plant per customer is $7,754, which is $1,150, or 17% increase over the existing average plant per customer. OCA St. 1S at 10-11. The inclusion of CWIP in the PAWC rate base makes very little difference in the average plant per customer calculation.[9]

In the case of MACM, the purchase price is 102% ($80,085,602) over the net book value. OCA St. 1 at 4. The OCA projects that the estimated cost of service under PAWC ownership will be approximately $18 million over current MACM revenues. OCA St. 1 at 11. As PAWC has structured the transaction, PAWC's existing water customers are also at risk for supporting the costs of acquiring the MACM customers. The Company may seek approval under 66 Pa. C.S. § 1311(c) to allocate a portion of its wastewater revenue requirement to the combined water and wastewater customer base. It must be recognized that every other PAWC water customer already has to pay for wastewater disposal either to another provider, to PAWC, or with their individual wastewater system. Thus, adding additional costs onto these same customers due to the purchase price at 102% of book value is not reasonable or appropriate under traditional cost based ratemaking.

For all of these reasons, Ms. Everette concluded that the proposed transaction is neither fair to customers nor consistent with principles of cost-based ratemaking as detailed above. The terms of the transaction would not provide an affirmative benefit and would substantially harm PAWC's existing customers.

[9] Ms. Everette did not calculate a total cost per MACM customer including the planned improvements because the improvements are planned to be completed over ten years, and the $162 million will be partially depreciated during that time. OCA St. 1S at 12.

(2) Harm to MACM Customers after Year 1

The record does not show that MACM customers will affirmatively benefit from the proposed transaction. During the first year post-acquisition, PAWC will freeze rates for MACM customers, exclusive of the DSIC. APA, ¶7.05(b). If approved as proposed, PAWC would continue to charge MACM customers their then-effective sewer rate (currently $68.95 per month). OCA St. 1 at 13.

Ms. Everette discussed other impacts that the MACM customers will face. MACM was awarded a $17,239,375 grant by the Pennsylvania Infrastructure Investment Authority (Pennvest) in 2011 and an equal amount of a loan at 1% interest (Appendix A-19, 2014 Audited Financial Statements, page v). OCA St. 1 at 9. Pennvest provides funds for sewer, storm water and drinking water projects, primarily through low interest loans. In determining the interest rate and whether to award grant funding, Pennvest uses an affordability methodology to make otherwise prohibitively expensive projects affordable to users.[10] Id. If the user rates would become unaffordable when the system acquires a Pennvest loan, Pennvest can reduce the interest rate to as low as 1% and provide grants for a portion of the project cost. Id.

Ms. Everette explained that in 2011, Pennvest awarded MACM nearly $34.5 million of financing, half in the form of a grant and half in the form of a 1% interest loan. Id. It is her understanding that the subsidized interest rate and grant financing are used primarily to make a project affordable for the system's users. Id. The MACM ratepayers will not benefit from the Pennvest grant or low-cost loan under PAWC ownership because PAWC is not eligible to assume the Pennvest loan. This means that the loan will need to be repaid by McKeesport, PAWC supports the $34 million at its cost of capital, and ratepayers will lose the benefit of this low-cost source of financing. Id. Even if the grant is repaid to Pennvest, this ultimately harms

[10] See, e.g., Clean Water State Revolving Fund Intended Use Plan, FY 2009 at 8-10.

ratepayers because they would have received the benefit of the grant funding (and low-cost Pennvest debt) under MACM ownership, but will not under PAWC ownership. Id. at 9-10.

Ms. Everette summarized the impact on MACM customers, as follows:

> This increase in cost is largely because of the cost of return on the $162 million ratemaking rate base and the income taxes on that return. Additionally, the loss of Pennvest grant and low-cost loan financing increases costs to customers. The acquisition would particularly burden the customers in Dravosburg and Duquesne, which will face the increased costs but will not benefit from the $162 million sales price. In summary, PAWC has not supported that the acquisition provides substantial public benefit.

OCA St. 1 at 26. The record does not bear out PAWC's contention that MACM customers will receive a benefit that outweighs costs.

(3) The Adverse Impacts on PAWC's Existing Customers and the MACM Customers Outweigh the Benefits of the Proposed Transaction.

In the CMV case discussed above, the Commission concluded that the adverse impacts of the proposed transaction for the existing customers outweighed the benefits. 2008 Pa. PUC LEXIS 950, * 32. The customers proposed to be acquired were currently receiving service from a system that was in compliance with applicable environmental laws and regulations. While the CMV system might have required upgrades to comply with stricter environmental requirements at an unknown future date, there was no certain evidence on that point. The Commission stated:

> The advantages alleged by NCTSA do not outweigh the certain, immediate adverse impacts of this transaction. The proposed transaction will result in an immediate $1,800 cost for Colonial Crossings customers, which is in addition to an average rate increase of approximately $70 per quarter, or 54% compared to existing rates. We find that the ALJ correctly weighed the evidence before him, and concluded that the costs of the proposed transaction for the Colonial Crossings customers outweigh the benefits for those customers.

Id. at *32. As in CMV, the alleged benefits of acquiring the McKeesport system are disputed and the adverse impacts of the proposed acquisition outweigh any claimed benefits.[11]

Although PAWC references economies of scale, the Company has not provided any showing of cost reductions or efficiencies that will be produced by the acquisition of the MACM customers. OCA St. 1S at 9. Simply having more customers does not create economies of scale. Having PAWC's existing customers pay for improvements to part of the McKeesport system does not create economies of scale. As stated by OCA witness Everette:

> Economies of scale would require cost savings through the increase in customers, which PAWC has not demonstrated.

OCA St. 1S at 9. Stated otherwise, if the MACM customers do not pay even their full cost of service and there are no savings from the transaction related to operating the system, existing customers will pay for the MACM costs and MACM customer will not share the costs of infrastructure improvements for other parts of PAWC's service territory.

Further, PAWC provided no documentation that it can construct, operate and maintain the existing MACM system and make the anticipated improvements at a lesser cost than MACM. MACM does not have to pay income taxes or state and federal taxes on its equity earnings. MACM also has the advantage of being able to issue tax exempt debt. 26 U.S. Code § 115(1); 61 Pa. Code Chs. 5-6; 53 Pa. C.S. § 8005(c). Thus, it is not clear whether there will be any efficiencies in costs to run the system through PAWC's acquisition.

Any benefit gained from regionalization and consolidation, if any at all, is diminished where the costs of acquisition significantly exceed the average costs of PAWC's current

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[11] In CMV, the Commission was not persuaded that potential economies of scale provided a benefit that outweighed the known adverse impacts of the transaction. As the OCA pointed out in CMV, there is no guarantee that savings resulting from any economies of scale will be reflected in the rates charged to customers. Id. at *29-30. In this case, there are no savings because all employees will be transferred to PAWC and no other specific cost savings have been identified.

customers. Acquiring the 12,780 customers served by MACM for $162 million would increase costs substantially and disproportionately as discussed above. OCA St. 1 at 16-17. Under the proposed rate increase, the average cost per MACM customer is nearly double that of an existing PAWC wastewater customer, and, if the MACM rate base is combined with PAWC's existing wastewater rate base, the average rate base cost of PAWC's wastewater customers would increase by 17% per customer. OCA St. 1S at 11.

For these reasons, and those discussed above, PAWC and MACM have failed to show that the terms of the proposed transaction would result in any substantial, affirmative public benefits to PAWC's existing water and wastewater customers or the acquired MACM customers. The OCA submits, therefore, that the Commission must deny the Application.

(4) Recommended Conditions

As set forth above, the OCA recommends that the Commission deny the relief requested in the Application. If, however, the Commission permits the proposed acquisition, as to the issues discussed above, the OCA recommends the following conditions:

- The OCA's proposed adjustments to the appraisals are adopted, resulting in an overall ratemaking rate base of $151,949,698 (prior to closing and transaction costs).
- If PAWC seeks to have MACM customers begin paying a DSIC prior to effective date of rates established in PAWC's next base rate case, PAWC must file the required tariff changes and revised LTIIP no later than 30 days after entry of the Commission order in this proceeding. The revised LTIIP must be approved prior to PAWC charging the DSIC to the acquired customers. The proposed projects reflected in the revised LTIIP will be in addition to, and will not reprioritize, any capital improvements that the PAWC was already committed to undertake for existing customers.

OCA St. 1R at 11. The OCA sets forth additional conditions in Section A3 and B3 and presents a full set of recommended conditions in Section D.

3 Cost of Service Studies

The OCA supports I&E's recommendation that a separate MACM cost of service study that separates capital expenses and operating costs for the sanitary and storm water functions should be provided by PAWC in its next base rate case if the transaction is approved. I&E St. No. 2 at 20-22; I&E St. No. 2-SR at 14-18.

B. Section 1329 Approvals

1. Ratemaking Rate Base

a) Introduction

Section 1329 was enacted in April 2016 and became effective on June 29, 2016. Act 2016-12 (HB 1326). Section 1329 provides, *inter alia*, that when a regulated water or wastewater utility acquires a municipal water or wastewater provider, the regulated utility can ask for ratemaking treatment of the acquired utility's assets using fair market value. 66 Pa. C.S. § 1329. As set forth in Section 1329(a) and (b), the process for determining the fair market value is based on two separate appraisals each using the cost, market and income approaches. 66 Pa. C.S. § 1329(a)(3). The appraisals are then averaged to determine the fair market value, 66 Pa. C.S. § 1329(g) and the lesser of the purchase price or the fair market value is what the acquiring utility will present as the proposed rate base. 66 Pa. C.S. § 1329(c)(2). This is not a simple mathematical exercise. The appraisals reflect the judgments and choices made by each utility valuation expert as will be discussed below.

In this proceeding, the two appraisal values were $161,343,000 (AUS Consultants) and $190,840,000 (HRG).[12] The average of the two appraisals, using the revised HRG appraisal

[12] In the HRG Appraisal Report, the appraisal value was $207,010,000. PAWC Appendix A-5. In MACM witness Vicari's direct testimony, filed on July 17, 2017, she revised her number to $190,840,000. MACM St. 1 at 12.

value, is $174,236,272. OCA Exh. AEE-1R. PAWC has proposed a rate base of $162,000,000 (the purchase price) for the MACM assets it will acquire because the purchase price is lower than the average of the two appraisals. Using an engineering assessment performed by KLH Engineers, AUS Consultants shows the original cost of MACM's wastewater system and land to be $108,231,570, accumulated depreciation of $28,145,968, and a net book value of $80,085,602.[13] OCA St. 1 at 4; AUS Appraisal Report at 2.

As discussed below, the OCA submits that PAWC's proposed rate base is overstated due to errors and flaws in the appraisals, and the correct rate base number is $151,949,698 under the Section 1329 methodology. OCA St. 1 at 18-26; OCA St. 1R at 1-11; OCA St. 1S at 16-20; OCA St. 2 at 4-28; OCA St. 2S at 1-6.

b) Section 1329 - Legal Issues

This application is the third to be filed under both Section 1102 and Section 1329 of the Public Utility Code. 66 Pa. C.S. §§ 1102, 1329. The Commission issued an Implementation Order which looked at numerous aspects related to Section 1329, including, *inter alia,* the process for becoming a utility valuation expert, a template for the litigation schedule and many other issues. See Implementation of Section 1329 of the Public Utility Code, Docket No. M-2016-254319, Final Implementation Order at 3 (Oct. 27, 2016) (Final Implementation Order). As with any new section added to an existing statute, as the parties and the Commission become familiar with proceedings brought under the new section, issues will arise and need to be addressed. In this case, the OCA made a Motion to Strike testimony. See Tr. 102-03. Generally, these issues center on the procedure and timing of these cases and how Section 1329 fits in with other requirements of the Public Utility Code, such as Section 1102 and Section

[13]The net book value does not reflect an adjustment to remove customer contributions or Pennvest grant funds and thus is higher than it would be under normal ratemaking calculations.

1301. The rules of statutory construction require that "Every statute shall be construed, if possible, to give effect to all of its provisions." 1 Pa. C.S. § 1921.

(1) Challenges to UVE Appraisals

There is a threshold disagreement as to whether any party can challenge the appraisals that are provided in the Application and, if challenged, whether the challenges must be limited to whether the appraiser followed the Uniform System of Professional Appraisal Practice (USPAP). In addition, the ratemaking approvals of Section 1329 have to be reconciled with the requirement of Section 1301 of the Public Utility Code, 66 Pa. C.S. § 1301, requiring each rate to be just and reasonable and the requirements of Section 1102 that acquisitions provide substantial affirmative benefits. Many of the same issues arose in the first Sections 1102/1329 proceeding before the Commission, in an application filed by Aqua to acquire the wastewater assets of New Garden Township. Application of Aqua Pennsylvania Wastewater, Inc., Docket No. A-2016-2580061, Order (June 14, 2017) (New Garden). Aspects of the Commission's Order in that case, however, are pending reconsideration. New Garden, Order (July 20, 2017).

PAWC appears to argue that the non-applicant parties cannot challenge the appraisals on any basis other than whether the USPAP standards were met. The OCA submits that it would be inconsistent with the requirements of the Public Utility Code to permit PAWC 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. The rate impact of the request is not inconsequential. For example, to acquire the 12,780 MACM customers, the annual impact of the rate base determination, depreciation expense, and operation and maintenance expense in year two is approximately $31 million while the revenues from MACM customer will be approximately $13 million. See OCA St. 1 at 11. That evidence bears on the Commission's

determination of whether there are substantial affirmative benefits for existing PAWC customers under Section 1102 and whether the impacts of PAWC's requests on existing customers results in just and reasonable rates under Section 1301 of the Public Utility Code.

The OCA submits PAWC's view of Section 1329 would also violate due process. In Milesburg, the Court determined that customers are entitled to notice and opportunity to be heard before the Commission is permitted to make binding decisions likely to increase customers' rates in a subsequent rate proceeding. Barasch v. Pa. PUC, 546 A.2d 1296, 1306 (1988) (Milesburg). The Court stated:

> In our view, due process requires that, before the PUC may issue a declaration approving the legality of the terms and conditions of a contract for a utility's purchase of power from a QF that includes payments for capacity, the utility's customers must be provided with notice of the proceedings and an opportunity to be heard to challenge the proposed action.

Id. As the determination of ratemaking rate base will impact the calculation of revenue requirement, that determination can only be made by giving due notice and an opportunity to challenge the UVE appraisals.[14]

Regarding an opportunity to be heard, the Commonwealth Court in Milesburg found that the Commission's order was an adjudication because:

> in the present case, final affirmative approval is precisely what West Penn sought, and received, from the PUC. If the commission's order is affirmed by the courts, then the propriety of the contract's capacity cost credit rate will not be subject to later challenge in a complaint proceeding before the commission under section 701; that issue will have been fully adjudicated already in these proceedings.

Milesburg, 546 A.2d at 1306. An adjudication is defined as:

> Any final order, decree, decision, determination or ruling by an agency affecting personal or property rights, privileges, immunities, duties, liabilities or obligations of any or all of the parties to the proceeding in which the adjudication is made.

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[14] The OCA notes that direct notice was not provided to PAWC's existing customers.

2 Pa. C.S. § 101.

In this case, the Commission's order regarding the valuation is a final order and it affects the property interests and rights of the ratepayers. Specifically, the rates of the PAWC customers will be based in part on this final order for decades into the future. As the Commonwealth Court stated, the question is what process is due. See Milesburg, 119 Pa. Commw. at 104, 546 A.2d at 1307. Accordingly, the Commission's use of a hearing is appropriate. See id. A hearing must be a meaningful opportunity to be heard, however, not just an opportunity for PAWC to submit the appraisals. See Barasch v. Pa. PUC, 568 A.2d 276, 279 (1989) (Rivercrest) (there can be no doubt that an opportunity to be heard after due notice must be given to the affected parties before the PUC may enter an order fixing general rates.) The determination of rate base under Section 1329 may increase future rates by as much, or more than, 51% for MACM customers and existing PAWC wastewater customers.[15] As such, the opportunity to "challenge" and "be heard" in a Section 1329 proceeding certainly includes the submission of testimony relating to the valuation.

In further support, the OCA notes that the level of rate increase that is projected to result from the ratemaking rate base established in this proceeding would constitute a general rate increase for existing PAWC wastewater customers. 66 Pa. C.S. § 1308(d). Yet PAWC's existing wastewater customers received no notice regarding the proposed acquisition and Section 1329 proceeding. Nor did PAWC's existing water customers receive notice, although PAWC proposes to shift costs of the MACM acquisition (PAWC St. 4-R at 3-4) to those customers. Application of Pennsylvania-American Water Co., Docket No. A-2017-2606103, Secretarial

[15]Total operating revenues for PAWC Wastewater on its 12/31/16 income statement were $22.3 million. Adding the MACM revenues of $13 million (OCA St. 1 at 11) would mean total revenues of $35.3 million. The estimated increase for MACM and existing PAWC wastewater customers is at least 51% ($18 million ÷ $35.3 million). Id.

Letter (June 14, 2017) (McKeesport); McKeesport, PAWC Proof of Service and Publication (July 3, 2017). Unless parties have the ability to challenge the appraisals, approval of the proposed ratemaking rate base would violate the due process protections of the Constitution. U.S. Const. amend XIV, § 1.

Moreover, it is clear that the Commission has the authority to review and modify the UVE appraisals. The Commission cannot delegate its authority to determine ratemaking rate base to the UVEs. See Carter v. Carter Coal Co., 298 U.S. 238, 310-11 (1936); A.L.A. Schecter Poultry Corp. v. United States, 295 U.S. 495, 537, 541-42 (1935). Arguably, under MCI Telecomm. Corp. v. American Telephone and Telegraph Co., the Commission has no authority to adopt such interpretation. 512 U.S. 218 (1994) (After finding that rate filings are an essential characteristic of rate-regulated industry, the Supreme Court held that the FCC's detariffing policy which exempted certain telephone carriers from tariff filing requirements, exceeded that Commission's authority).

(2) Imposition of a Six-Month (Effectively Five-Month) Deadline

Another issue of statutory construction is the application of the Section 1329 six-month statutory deadline to the affirmative benefits analysis contained in Section 1102. 66 Pa. C.S. §§ 1102, 1329. While Section 1329(d) establishes a six-month statutory deadline for the Section 1329 determination, there is no language in the statute that imposes the same deadline on determinations made under any other provisions of the Public Utility Code and, specifically, Section 1102, which contains no statutory deadline. Requiring the Section 1102 statutory considerations to be completed in the expedited time frame of Section 1329(d) considerations is not consistent with the plain language of the statute. The OCA submits that Sections 1102 and 1329 could be reconciled and each given full effect, if the Commission and parties address the

Section 1329 issues in the six-month time frame, followed by consideration of the Section 1102 issues.

In this proceeding, the imposition of a six-month deadline to Section 1102 and 1329 determinations, applied to the Commission's schedule for Public Meetings, required a Commission Order before December 7, 2017, or less than six months from the accepted filing date of June 14, 2017 (the date of the Secretarial Letter served on PAWC). This compressed the schedule by an additional week.

Until notice that the Section 1329 Application has been accepted and docketed, the OCA and other interested parties do not have the ability to protest or intervene in the case or the right to begin discovery. As a practical matter, interested parties had 33 days to issue discovery, review responses, and serve written direct testimony from the date that PAWC's filing was accepted (June 14, 2017). Hearings were held 17 days after the OCA and I&E testimony was filed.[16] McKeesport Scheduling Order (July 13, 2017). The OCA's analyses reflect issues it was able to address given the limited time period for review.

As noted above, the question is what process is due. See Milesburg at 104. While the OCA met the scheduling deadlines established in this proceeding, the OCA submits that the parties were not afforded a full and meaningful opportunity to develop and present their case before the Commission. U.S. Const. amend XIV, § 1.

c) Appraisals

The appraisals were prepared by AUS Consultants (for PAWC) and Herbert, Rowland & Grubic, Inc. (HRG) (for MACM). PAWC Appendix A-5. AUS provided direct testimony with the Application. HRG did not provide direct testimony until the date that the non-applicant

[16] MACM waited until the same date, July 17 2017 to file testimony supporting its appraisal that was part of the application filed on June 24, 2017.

parties filed direct testimony. Section 1329 lists three approaches that must be used by each utility valuation expert: the cost approach, the income approach, and the market approach. 66 Pa. C.S. § 1329(a)(3). Shown below is a summary of the appraisals. AUS gives different weight to each approach while HRG appears to give equal weight to the Cost, Income, and Market approaches:

Cost Approach:	$160,301,491	50% weight
Income Approach:	$162,455,017	40% weight
Market Approach:	$162,108,612	10% weight
Result:	$161,343,614	
AUS Recommendation:	$161,343,000	

Cost Approach:	$170,040,000
Income Approach:	$212,360,000
Market Approach:	$190,130,000
HRG Recommendation[17]:	$190,840,000

OCA Exh. AEE-1R; OCA St. 1 at 18-19. PAWC originally agreed to pay the higher of $156,000,000 or the average of the two appraisals but renegotiated the purchase price after the appraisals were received. See PAWC St. 1 at 11.

The results under each approach vary from $9 million to $49 million.

Approach	**Range of Results**	**Difference**
Cost approach	$160,301,491-$170,040,000	$9,739,000
Income approach	$162,455,017-$212,360,000	$49,905,000
Market Approach	$162,108,612-$190,130,000	$28,021,000

It is important to note that the depreciated original cost or book value as determined by AUS, using an engineering assessment performed by KLH Engineers, is $80,085,602. OCA St. 1 at 4. Even before reviewing the specifics of each consultant's analyses, it is clear that judgment is involved in the inputs used, the weighting given to each approach and the determinations. That

[17] HRG's results were revised in Ms. Vicari's direct testimony filed on July 17, 2017. HRG's result is described as the "Average Fair Market Value" and is the mathematical average of the three results, rounded to the nearest ten thousand.

is why two Utility Valuation Engineers (UVEs) have reached different FMV results for the MACM system.

As such, the OCA submits that the Commission must carefully consider the flaws in the appraisal results identified in the OCA's testimony and must not approach this as a simple mathematical exercise. As discussed below, after reviewing each appraisal report, OCA witness Everette recommended one adjustment[18] be made to HRG's cost approach results (OCA St. 1 at 19-22; OCA St. 1R at 1-11) and two adjustments to HRG's market approach analysis (OCA St. 1 at 22-24). OCA witness Watkins adjusted AUS' Income Approach and HRG's Income Approach including correcting the calculation of income tax expense and the discount rate in the HRG discounted cash flow analysis under the Income Approach. Mr. Watkins also recommended that adders for "going value" and "erosion of cash flow" be denied for all of the appraisal methodologies. OCA St. 2 at 8-18. Mr. Watkins further recommended that no consideration be given to HRG's rate base/rate of return analysis in its Income approach. Id. at 18-21. Mr. Watkins also provided adjustments to the terminal value and discount rates used in AUS' DCF model in the Income approach analysis. Id. at 22-28.

After incorporating those adjustments and reflecting corrections made by HRG witness Vicari, OCA witness Everette calculated that the HRG appraisal result would be $153,794,190, and the AUS appraisal result would be $150,105,207. OCA St. 1R at 10-11; OCA Exh. AEE-1R (Revised). The recalculated average of the two appraisal results is $151,949,698, which is what Ms. Everette recommends be used by the Commission for establishing rate base under Section 1329 rather than $162,000,000 as proposed by PAWC. OCA St. 1R at 11; OCA Exh. AEE-1R (Revised).

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[18] In direct, Ms. Everette recommended additional adjustments to the HRG cost approach analysis. MACM witness Vicari revised the analysis in direct filed on July 17, 2017, the same day as Ms. Everette's direct testimony was filed. Therefore, Ms. Everette updated her adjustments in her rebuttal testimony.

(1) Cost Approach

The OCA did not recommend adjustments to AUS' Cost approach valuation. As such, the discussion in this section is limited to the Cost approach valuation conducted by MACM witness Vicari (HRG).

(a) HRG Reproduction Cost

The OCA originally identified two aberrations in Ms. Vicari's determination of reproduction cost under the Cost approach. Reproduction cost is derived by restating the original cost of depreciable utility plant to a current price level. PAWC App. A-5, HRG Appraisal Report at 6. MACM witness Vicari believed that the original cost data for the plant was lacking certain information so she modified the calculation results produced by her ENR Index analysis to calculate the reproduction cost. OCA St. 1 at 22. She did not calculate the accumulated depreciation by plant account. Rather, she simply showed a lump sum accumulated depreciation amount that was 20% of the reproduction cost. Id. The majority of the plant was installed in 1976 or earlier, so it is more than 40 years old which means that it is more than 20% depreciated. OCA St. 1 at 23.

In her direct testimony, filed at the same time as the OCA's direct testimony, Ms. Vicari revised her Cost Approach Analysis and thus her overall appraisal recommendation. Her revisions decreased her Cost Approach recommendation from $202,410,000 to $170,040,000 which reduced her overall recommendation from $207,010,000 to $190,840,000.[19]

[19] Specifically, Ms. Vicari changed the in-service date for 2,490 manholes from 1911 to 1960. No explanation was provided. OCA St. 1R at 1. She also calculated accumulated depreciation of 51% based on the year of installation rather than her initial conclusion that the plant is 20% depreciation. Id. at 2.

The revised HRG recommendation is as follows:

Cost Approach:	$170,040,000
Income Approach:	$212,360,000
Market Approach:	$190,130,000
Recommendation:	$190,840,000

OCA St. 1R at 2. The updated average of the HRG and AUS appraisals is $176,091,500. Id.

Ms. Vicari claimed that she was not aware of the dates of plant acquisition until a recent review. MACM St. 1 at 7. In fact, all in-service dates were the same in the initial appraisal report and the schedules that she attached to her direct testimony. OCA St 1 at 4. Ms. Everette provided a side-by-side comparison of a portion of the information contained in the Original Appraisal Report, Schedule F and the Direct Testimony (update), Schedule F. OCA St. 1R at 4-5. As can be seen, there is no change in the service dates. In her direct testimony, Ms. Vicari recalculated the depreciation reserve to reflect the in service dates in her appraisal report rather than her previous assumption of a 2008 in service date for all plant. OCA St. 1 at 5; OCA V-4. She also then increased the reproduction cost per linear foot by 20%. Id.

As explained above, Ms. Vicari originally assumed that the plant was 8 years old and had a remaining life of 42 years. OCA St. 1 at 6. After learning that the year of acquisition was 1959-60, rather than 2008, she still argued the plant has a remaining life of 42 years. Id. Thus, she increased her service life from 50 years to 85 years. Id. Ms. Everette explained the impact of Ms. Vicari's new assumptions:

> Under Ms. Vicari's initial premise that the plant was 8 years old (2016 – 2008), the plant would have been only about 16% depreciated if it had a 50-year life. When she updated her analysis to use actual service dates rather than the 2008 date, the average year in service would be 1973 (as explained above), which would mean the plant is 43 years old on average (2016 – 1973). Under Ms. Vicari's initial position that the plant has a 50 year service life, the plant would have been 86% depreciated (43 years / 50 years), which would have significantly decreased her reproduction cost

> result. By increasing the service life to 85 years, the plant is now only 51% depreciated.

OCA St. 1R at 6-7. Ms. Vicari assumes that the actual age of the plant is not related to the remaining life, *i.e.*, the plant has an identical remaining life whether it is 8 years old or 43 years old. OCA St. 1R at 6, ftnote 13. This assumption, that the remaining life is independent of the age of the plant in service is "faulty logic and renders the analysis unreliable" according to Ms. Everette. Id. The shift to a longer service life dramatically increases the value of Ms. Vicari's appraisal result. Id.

After revising her service lives in her direct testimony, Ms. Vicari then added a 20% overhead for collection sewers. Ms. Vicari's justification for this new overhead amount was that she eliminated values in the Industrial Appraisal Report and used current unit costs from recent construction bids in western Pennsylvania. She then added 20% to the reproduction cost-per-foot for collection sewers because she alleges that the prices did not include project overheads. See OCA St. 1R at 7; MACM St. 1 at 8. A review of her schedules shows that the source of the numbers did not change between her appraisal report and her direct testimony. OCA St. 1R at 7. The only difference between the originally filed Schedules E-H and Schedules E-H attached to her direct testimony is the increase of 20% in each per unit cost. Id. Ms. Vicari did not provide any specific documentation or supporting calculations of the 20% overhead. See OCA St. 1R at 8; OCA V-3. Instead, she provided a list of general cost categories but did not establish how she derived the 20% overhead. Based on the lack of explanation and support, Ms. Everette concluded that the increase of 20% to the cost per linear foot for overhead expenses be given no consideration in determining reproduction cost. OCA St. 1R at 8.

Based on Ms. Vicari's changes to her accumulated depreciation to reflect Ms. Everette's recommendations in direct testimony, Ms. Everette no longer recommended any changes to the

accumulated depreciation.[20] Thus, two areas of concern remain with Ms. Vicari's reproduction cost analysis: the 20% overhead adjustment and the going value adder (addressed in Mr. Watkin's testimony). Removing the 20% overhead addition results in an adjustment of $15,041,525 to the depreciated reproduction cost. OCA St. 1R at 9; OCA Exh. AEE-3R.

(b) HRG "Going-Value" Adder And Erosion of Cash Flow Adder

MACM witness Vicari applied a going-value adder and the erosion of cash flow adder to her reproduction cost approach analysis, as well as to her rate base/rate of return analysis and DCF analysis. OCA St. 2 at 13. Her "going-value" adder is $19,800,000[21] and her erosion of cash flow adder is a deduction of $930,000. OCA St. 2 at 6. Mr. Watkins explained that these provisions are not logical, contradictory to Ms. Vicari's analyses, and contain numerous double counts.[22] OCA St. 2 at 13-17; OCA St. 2S at 3-4.

Ms. Vicari claims that there are avoided costs for the buyer of an existing business that should be added to the cost value of the physical facilities. PAWC Appendix A-5 HRG Appraisal Report at 12-13. This value reflects the avoided cost of the purchaser not being required to acquire and develop a customer base. See OCA St. 2 at 14.

Mr. Watkins explained that this does not reflect reality. He stated:

> First, with respect to Ms. Vicari's assertion that there should be an additional value added as it relates to the avoided cost of the purchaser not being required to acquire and develop a customer base, McKeesport is a regulated monopoly with a captive customer base. Residences, commercial, and industrial entities within McKeesport's service area have no other choice than to obtain sewerage service

[20] Ms. Everette also noted that she would not pursue her recommended 70 year service life (based on PAWC's use of 70 year service life in a recent original cost study) in order to minimize the contested issues. OCA St. 1R at 9.
[21] Ms. Vicari originally reflected a going-value adder of $17.3 million. In her direct testimony, filed on July 17, 2017, she revised the going-value adder to $19.8 million. See OCA Exh. AEE-3R.
[22] Mr. Watkin's discussion of the flaws of the Going Value adder are in his testimony which focuses, *inter alia*, on HRG witness Vicari's Income Approach analysis. The flaws that he identifies are applicable in each circumstance where the Going Value adder is used by HRG witness Vicari.

> from McKeesport. As such, this customer base is known with certainty such that there are no costs required to attract customers to this business.
>
> [Second, with] regard to Ms. Vicari's assertion that there should be an additional value added as it relates to the avoided cost of the purchaser not being required to hire employees, develop an accounting and record keeping process and develop operating and management policies and procedures, it must also be remembered that PAWC is a large established corporation specializing in the services provided by McKeesport. As indicated in its Application, PAWC already contains the resources and expertise required to effectively and efficiently operate the McKeesport Wastewater System.

OCA St. 2 at 14.

In rebuttal, Ms. Vicari appeared to provide a new rationale for her "going-value" adder - - that it relates to the costs incurred by MACM when it began operations. See OCA St. 2S at 4; MACM St. 1-R at 8. Mr. Watkins found her logic to be unsound. He stated:

> On the one hand, Ms. Vicari indicates that she conducted her income approach (DCF analysis) from the perspective of the buyer (PAWC). Then she claims that PAWC should then be concerned with past expenses incurred by MACM many years ago. As an analogy, a potential buyer of real estate would not consider any costs that the current owner incurred many years ago relating to the transaction costs required to purchase that parcel of real estate; i.e., closing costs, recording fees, etc.

OCA St. 2S at 4.

Mr. Watkins explained that even the calculation of the adder itself contains fundamental flaws. First, Ms. Vicari calculates a five-year "annual revenue build-out" starting with the first year's revenues and assuming annual percentages of 10%, 25%, 45%, 70% and 100%. OCA St. 2 At 15. Mr. Watkins explained that these calculations make no sense because there is no "build out" for McKeesport because it is an established system, with established customers and approved rates and tariffs.

Second, Ms. Vicari estimates "start-up" costs that will be incurred over the five year period and separates those costs into variable and fixed operating expenses. For the variable

portion, Ms. Vicari multiplies the variable expenses by cumulative percentages of 10%, 25%, 45%, 70%, and 100%. Mr. Watkins explained this process:

> In other words: in the first year (2017), Ms. Vicari assumes that her start-up costs associated with variable expenses are 10% of annual variable expenses; in the second year (2018), Ms. Vicari assumes that her start-up costs associated with variable expenses are 15% of annual variable expenses plus the 10% from the prior year; in the third year (2019), Ms. Vicari assumes that her start-up costs associated with variable expenses are 20% of annual variable expenses plus 10% from the first year plus the 15% from the second year. This cumulative and double counting continues through the fifth year such that by year 5, her "start-up variable expenses" are equal to the total annual variable expenses incurred in that year. Notwithstanding the double, triple, and quadruple counting of these variable expenses, Ms. Vicari's inclusion of such expenses are illogical in that variable expenses are those that vary with the system's output and production. There are no so-called start-up costs with variable expenses such as sludge removal, purchase power, fuel, chemicals, etc. Indeed, Ms. Vicari's DCF analysis includes the full amount of all of these variable expenses each and every year within her analysis.

OCA St. 2 at 15. For the fixed portion of the "start-up costs", Ms. Vicari assumes annual growth of 60%, 70%, 80%, 90%, and 100%. She attributes the large annual growth to customer growth. See id. Her calculation of "start-up costs" should not include expenses for the sale by an ongoing entity or acquisition by an ongoing entity, as both have work forces in place. Moreover, these start-up costs are included in her DCF analysis each and every year. OCA St. 2 at 16.

Third, Ms. Vicari calculates "Debt Service Based on Fixed Costs" by assuming that there will be annual debt service cost of $7.103 million. She multiplies that annual Debt Service cost by 60% in the first year, 70% in the second year, 80% in the third year, 90% in the fourth year, and 100% in the fifth year. OCA St. 2 at 16. She includes the annual amounts in her going value calculation. Mr. Watkins explained this error as follows:

> The inclusion of these debt-related costs is at odds with all accepted financial analysis. That is, her DCF analysis already reflects the annual cash flows associated with the return on, and return of, investments. Therefore, the annual cash flows are those that will be generated in order to meet not only its debt service obligations but also recover interest expenses and required profit. To then

> have an add-on for annual debt service requirements is a double count within her DCF analysis. Moreover, the inclusion of this "Debt Service Based on Fixed Costs" has nothing to do with start-up costs nor does it have anything to do with any "going value" consideration of a firm.

OCA St. 2 at 16. Thus, in addition to the conceptual flaws with a "going-value" adder, Ms. Vicari's calculation should be rejected due to the numerous failures in the calculation of the adder itself including the double, triple, and quadruple counting of various items, incorporating additional expenses that will not be incurred over and above those already reflected in her DCF analysis and double counted debt-related costs. Id.

For all of the reasons discussed above, the OCA submits that Ms. Vicari's adder to her cost approach for "going value" is without merit and should not be considered for any of her appraisals. Mr. Watkins reduced the depreciated reproduction cost by $19,800,000 to reflect the removal of the going value adder included by Ms. Vicari as shown on OCA Exh. AEE-3R. The result is an adjusted depreciated reproduction cost of $135,202,468 rather than $150,240,000 as recommended by Ms. Vicari. Id.

MACM witness Vicari also reflects an "erosion of cash flow" adder which is a deduction of $930,000 from her going value adder discussed above. OCA St. 2 at 17; PAWC Appendix A-5, Sch. N. Mr. Watkins concluded that her adjustment is unnecessary and illogical because her DCF and other analyses reflect anticipated cash flows to be derived from the McKeesport operations and thus are already reflected in her valuation. OCA St. 2 at 17. There is no reason to make a further adjustment for her perceived inadequate cash flows in certain years. Id.

The going value adder of $19.8 million and the $930,000 erosion of cash flow deduction from Ms. Vicari's cost approach analysis should be removed from her cost approach analysis, and as discussed below, from her other analyses.

(c) Summary of OCA Cost Approach Adjustments

In summary, the OCA recommends the following adjustments to HRG's Cost Approach result:

1. A reduction of $15,041,525 to remove the unsupported overhead addition to the depreciated reproduction cost. OCA Exh. AEE-3R.

2. A reduction of $19,800,000 to reflect the removal of the unsupported going value add on. OCA Exh. AEE-3R.

Together, these adjustments produce a result of $135,202,468 rather than $150,240,000 as recommended by Ms. Vicari. As stated above, the OCA is not recommending adjustments to Gannett Fleming's Cost Approach result in this case.

(2) Income Approach

(a) Introduction

OCA witness Watkins reviewed and addressed the Income approach valuations conducted by HRG and AUS. He provided a basic summary of the Income approach:

> The conceptual framework underlying virtually all income approaches is to estimate the future cash inflows that will be generated from a business enterprise relative to the investment that will be required to procure or achieve the ability to engage in such business. The mathematics underlying this framework are relatively simple in that upfront investments are typically required to generate future cash inflows. In this regard, there is a time value of money associated with investments, cash expenses, and expected cash revenues.
>
> . . .
>
> In understanding the mathematics of valuations based on discounted cash flows, it is important to understand and to the extent that future net cash flows are generally positive, the higher is the discount rate, the lower is the valuation (present value). Conversely, the lower is the discount rate, the higher is the valuation. This is because with higher discount rates, positive cash flows well into the future are worth "less" than those in earlier periods. Therefore, the higher is the discount rate, the higher is the discount given to cash flows into the future. As such, if the discount rate were set at zero, the present value of all future cash flows are equal to the nominal values in that there is no discount.

OCA St. 2 at 2-4. Mr. Watkins noted that, in practice, business valuations have additional complications in order to recognize the realities of operating and maintaining a business. Id. at 4. He stated:

> For example, investor-owned businesses typically are subject to income taxes, while municipal and publicly-owned business enterprises are not subject to income taxes. In addition to annual cash operating expenses, business enterprises require the ongoing replacement and renewal of capital investments (also known as plant in service). Furthermore, the expected life of a given investment or enterprise is often uncertain such that the modeling of a long-term investment can introduce complexities within the valuation process.

Id. at 4.

OCA witness Watkins identified several conceptual and computational errors within the HRG income approach valuation conducted on behalf of MACM. OCA St. 2 at 4-21. Mr. Watkins showed that Ms. Vicari's selected discount rate of 2.50% is outside any reasonable range. Mr. Watkins also found a significant area of concern with Ms. Vicari's treatment and calculation of income taxes. Finally, Mr. Watkins recommended that Ms. Vicari's additional rate base/rate of return analysis be given no consideration because it contains several fundamental errors and provides no value to the development of a fair market value for the McKeesport system. Id. at 18-21. These corrections resulted in a more appropriate HRG income approach valuation of $165,550,000, which is the mid-point of the DCF valuation range of $122,420,000 and $208,690,000 compared to Ms. Vicari's $212,360,000. Id. at 13; OCA St. 2S at 1-3; OCA Exh. AEE-1R (Revised).

With respect to the income approach valuation by AUS on behalf of PAWC, Mr. Watkins showed that Mr. Weinert's 20-year model utilizing a forecasted terminal value of the firm in the twentieth year is unreasonable. Using a more appropriate 50-year modeling approach and

utilizing an appropriate discount rate, produced a valuation result of $134,359,000 as compared to AUS' $162,455,017. OCA St. 2 at 22-28; OCA St. 2S at 4-6; OCA Exh. AEE-1R(Revised).

(b) HRG Discounted Cash Flow Method

Mr. Watkins explained how Ms. Vicari reached her Income approach valuation as follows:

> Ms. Vicari's valuation utilizing the income approach is based on the average of two methodologies: the DCF; and Rate Base/Rate of Return methods. Ms. Vicari's DCF analyses produced a valuation of $211.340 million, while her Rate Base/Rate of Return analyses produced a valuation of $245.620 million. The average of these two methods results in her recommended valuation of $228.480 million under the income approach.

OCA St. 2 at 5.

PAWC witness Vicari's DCF analysis is contained in Schedule L of her appraisal report. PAWC Appendix A-5, Sch. L. Ms. Vicari selected a 20-year model in which she projected revenues, expenses, and future capital expenditures to estimate future net cash flows. OCA witness Watkins identified nine key assumptions and inputs utilized within Ms. Vicari's DCF analysis. OCA St. 2 at 5. He identified concerns with four of them:

- income tax expenses are included as a deduction from net cash flows
- a discount rate of 2.5% is utilized
- an add-on of $19.8 million is incorporated as a "provision for going value"
- a deduction of $0.930 million is incorporated as a "provision for erosion of cash flow"

OCA St. 2 at 5-6. Mr. Watkins observed that Ms. Vicari's treatment and calculation of income taxes and her selected discount rate of 2.5% do not comport with accepted financial theory or practice. OCA St. 2 at 6. Ms. Vicari's net add-on of $18.87 million ($19.8 million minus $0.930 million) for "going value" and "erosion of cash flow" were made outside her DCF model and are not appropriate. Id. at 6.

Because it was not clear from the HRG appraisal report, in his direct testimony, Mr. Watkins evaluated the DCF analysis from both a buyer's and seller's perspective (utilizing all of Ms. Vicari's other assumptions). In testimony filed at the rebuttal stage of the proceeding, Ms. Vicari clarified that she modeled her DCF analysis based on the perspective of a buyer (IOU, in this case). MACM St. 1-R at 6. Accordingly, Mr. Watkins responded that only his analysis from the buyer perspective should be utilized. See OCA St. 2S at 1.

(i) HRG DCF from Buyer's (PAWC) Perspective

From PAWC's perspective, the Company is subject to income taxes such that the incremental income taxes associated with this acquisition should be reflected in any DCF analysis. OCA St. 2 at 10. Mr. Watkins determined, however, that Ms. Vicari's calculated income tax expense contains numerous errors. First, Ms. Vicari has assumed an effective income tax rate of 38.9%, rather than the incremental tax rate of 41.49% that is relevant from PAWC's perspective. OCA St. 2 at 11; PAWC Appendix A-5, Sch. L. The incremental Pennsylvania State income tax rate is 9.99%, while the incremental Federal income tax rate is 35%. This results in a total incremental tax rate of 41.49%. OCA St. 2 at 11. Second, in developing her taxable income calculations, Ms. Vicari treated capital expenditures as a tax deductible expense. Only the depreciation of these capital expenditures is tax deductible. Id. In addition, Ms. Vicari's taxable income does not include any deduction for depreciation expense or reflect a deduction for interest expense. Id.

In rebuttal, MACM witness Vicari states that Mr. Watkins' corrections are "partially correct" but argues that any depreciation and interest expenses are the result of capital acquisitions. MACM St. 1-R at 7. She then states, "Also, it is sometimes difficult to distinguish

between a capital item and a maintenance expense for tax purposes." Id. In response, Mr. Watkins explained why Ms. Vicari's arguments are without merit, as follows:

> While there is no doubt that depreciation and interest expense are the result of capital acquisitions, the issue at hand is the determination of income tax expenses. As fully discussed in my direct testimony, Ms. Vicari's calculation of annual income taxes within her DCF analysis does not reflect a provision for the deductibility of depreciation or interest expenses. With regard to any difficulty distinguishing between capital items and maintenance expenses for tax purposes, the IRS Tax Code is clear as to the capitalization of investments. Moreover, Ms. Vicari explicitly shows her assumed level of capital expenditures within her DCF analyses.

OCA St. 2S at 3.

Mr. Watkins calculated each period's taxable income based on Ms. Vicari's level of revenues and cash expenses less depreciation expense associated with all assets (including those new capital investments and replacements), less interest expense based on PAWC's weighted cost of debt and net plant to generate taxable income. OCA St. 2 at 11-12. Taxable income was then multiplied by the appropriate incremental income tax rates. Id.; See also OCA Sch. GAW-3 (Mr. Watkins' annual income tax calculations).

With regard to the rate utilized to discount future cash flows (discount rate), Mr. Watkins explained that it is well-known and generally accepted that the appropriate discount rate is the firm's total cost of capital, which includes the weighted cost of debt and the weighted cost of equity. OCA St. 2 at 12. Ms. Vicari selected a discount rate of 2.5%, which is substantially below any level of reasonable opportunity cost confronted by PAWC in the ownership and operation of its wastewater system. Id. at 8. Mr. Watkins developed a more appropriate discount rate using PAWC's actual capital structure of 52% debt and 48% equity, PAWC's actual cost of

debt of 4.29%, and a reasonable cost of equity of 9.3%.[23] Id. at 12. This results in a total cost of capital (discount rate) of 6.70%.

In rebuttal, MACM witness Vicari objected to Mr. Watkins' cost of capital/discount rate. MACM St. 1-R at 7. She stated that the USPAP standards "allow the use of rates we deemed appropriate" and that she took into consideration the long term investment rate on 20-year treasury securities and the after tax interest rate a borrower would pay, concluding that her 2.5% discount rate was equal to a 4.10% market rate. Id. Mr. Watkins rebutted this opinion, explaining that "Economic and financial theory and universally accepted practice for selecting a discount rate are clear: the appropriate discount rate to be utilized for valuations is a firm's weighted cost of capital." OCA St 2S at 2-3. Mr. Watkins explained that it is universally recognized and accepted that the appropriate discount rate to be used when conducting DCF analyses is one that "reflects the risk associated with a particular project or business venture." Id. In this proceeding the business venture is the acquisition of MACM's wastewater operations.

In her rebuttal explaining how she derived her discount rate, Ms. Vicari refers to the USPAP standards. See OCA St. 2S at 2. Regarding the standards, Mr. Watkins noted that PAWC witness Weinert provided an excerpt from the American Society of Appraisers, Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets that is fully consistent with accepted practice in conducting DCF analyses. Id.

Accordingly, the 9.3% cost of equity that Mr. Watkins utilized is the market-based cost of equity, as determined by this Commission, for a similarly situated utility. It is properly used

[23] This cost of equity is based on the Commission's recent finding on the market cost of equity of a firm with similar risks. Pa. PUC v. City of Dubois – Bureau of Water, Docket No. R-2016-2554150, Order at 97-98 (Mar. 28, 2017). The 9.3% cost of equity was found as the appropriate cost of equity before an adjustment for income taxes applicable to municipal utilities. OCA St. 2 at 12, n.11.

in the calculation of the discount rate and, moreover, it produces a discount rate of 6.70%, compared to the insupportably low discount rate of 2.5% applied by Ms. Vicari.

(ii) HRG Rate Base/Rate of Return Analysis

Mr. Watkins summarized the premise underlying Ms. Vicari's rate base/rate of return analysis (PAWC Appendix A-5, Sch. M) as follows: as a public utility, MACM's revenues will recover its "cost of service" on an annual basis. A public utility's "cost of service" is defined as cash expenses plus depreciation expense plus a return on the utility's rate base (which is equal to the utility's weighted total cost of capital). OCA St. 2 at 18. Based on this premise, Ms. Vicari calculates annual cash flows, which include a return on rate base plus non-cash expenses (depreciation), and then discounted these amounts by 2.5% to arrive at a present value of future cash flows. Id. Ms. Vicari's "resulting market value" is $229,250,000. She then adds $19.8 million to this amount to reflect her provisions for "going value" and deducts $930,000 from this amount to reflect her provision for "erosion of cash flow" to arrive at a "Total Estimated Market Value" of $245.690 million. Id.

Mr. Watkins explained that, as a matter of simple arithmetic, Ms. Vicari's analysis is essentially circular:

> [U]nder traditional rate base/rate of return regulation in which a utility annually earns a fair rate of return at its "cost" of capital, if the annual cash flows are then discounted at this opportunity cost rate, the resulting present value is nothing more than the original cost of the rate base.

OCA St. 2 at 18-19.

Notwithstanding the lack of logic, there are numerous flaws and unreasonable assumptions embedded in Ms. Vicari's analysis. First, Ms. Vicari did not use MACM's actual embedded original cost of rate base in her analysis but instead utilized her "Cost of Reproduction New" rate base for developing her annual cost of service-based returns. OCA St. 2 at 19; PAWC

Appendix A-5, Sch. M. OCA witness Watkins explained that this is a fundamental error because, for regulated utilities, annual revenue requirements are established based on original cost and not the hypothetical cost of reproducing a new system at current construction costs. OCA St. 2 at 19. Second, Ms. Vicari assumed an annual rate of return of 7.5% on "Cost of Reproduction New" rate base. While Ms. Vicari states that 7.5% is based on "PAWC's estimated weighted cost of capital," she provided no support for that number. OCA St. 2 at 20. In contrast, Mr. Watkins has demonstrated that 6.97% is an appropriate total cost of capital, which is derived from PAWC's current cost of debt and a 9.3% cost of equity applied to PAWC's actual capital structure. Id.

There is a mismatch between Ms. Vicari's rate of return of 7.5%, which – according to Ms. Vicari – represents PAWC's cost of capital, and her discount rate of 2.5%. It is universally accepted that for discounting purposes, a company's cost of capital is the appropriate discount rate. From an arithmetic standpoint, Ms. Vicari calculates annual cash flows based on a profit level of 7.5% but then only discounts this high level of profits by 2.5%.[24] This error significantly overstates the resulting present value of future cash flows.

The final flaw in Ms. Vicari's rate base/rate of return analysis is her estimated annual depreciation expenses. As discussed in Mr. Watkins' testimony, depreciation is a non-cash expense and should be (and is) included within annual cash flows in Ms. Vicari's rate base/rate of return analysis. OCA St. 2 at 20. Because Ms. Vicari's estimated annual depreciation expenses are based on the "Cost of Reproduction New" plant as opposed to actual depreciation

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[24] Ms. Vicari effectively proposes, as a matter of arithmetic, that a utility should earn 500 basis points above its total cost of capital (7.5% earned return versus 2.5% discount cost rate). OCA St. 2 at 20. Instead, rates are based on the "cost" of providing service where "cost of service" includes a rate of return on its investment that is not excessive yet, will allow a utility to attract and maintain capital, *i.e.* no more than its market-based cost of capital. Id.; Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia, 262 U.S. 679, 692-93 (1923); Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).

expenses, however, they are severely overstated. Ms. Vicari estimated annual cash flow associated with depreciation expense of $8.365 million. PAWC Appendix A-5, Sch. M. Actual depreciation on existing plant is $2,654,000 with an additional depreciation of about $975,000 in future years associated with future capital investments. OCA St. 2 at 20; see OCA Sch. GAW-3. This means that Ms. Vicari's cash flows are overstated by approximately $4.7 million in every year. OCA St. 2 at 20-21 ($8,365,000 minus $2,654,000 minus $975,000).

OCA witness Watkins summarized Ms. Vicari's rate base/rate of return analysis as follows:

> If a utility earns its authorized fair rate of return on its investment over the life of the investment when the cash flows resulting from this ratemaking treatment are then discounted back to the present, the resulting value is the original cost of the investment. With this being said, when properly applied, Ms. Vicari's rate base/rate of return analysis is meaningless in that the appropriate present value of her rate base/rate of return is approximately $74.3 million, which is equal to the Company's original cost investment in plant as shown in Ms. Vicari's Schedule B. However, part of the purpose of this proceeding is to establish an allowable rate base for ratemaking purposes going forward.
>
> To the extent that Section 1329 allows for a higher rate base than depreciated original cost, the resulting returns will be based on this higher rate base. This higher rate base will then be based on the lower of the purchase price or the average of the various valuation studies. Therefore, Ms. Vicari's rate base/rate of return analysis is not only circular, but meaningless and provides no value in this proceeding.

OCA St. 2 at 21. Accordingly, the OCA recommends that no consideration should be given to Ms. Vicari's rate base/rate of return analysis. If the concept of Ms. Vicari's rate base/rate of return analysis is utilized in any way, however, a value of approximately $74.3 million (Vicari Schedule B) should be utilized instead of Ms. Vicari's overstated value of $245.620 million.[25]

[25] Ms. Vicari's Rate Base/Rate of Return result of $245.620 million includes $19.8 million for her "going-value" and deducts $930,000 from this amount to reflect her provision for "erosion of return." PAWC Appendix A-5 Sch. M. As discussed in the following section of the OCA's brief, these adders should be denied.

(iii) HRG "Going-Value" and "Erosion of Cash Flow" Adders

MACM witness Vicari applied two adders to her DCF analysis and Rate Base/Rate of Return analysis under the Income approach. Her "going-value" adder is $19.8 million. Her "Erosion of Cash Flow" is a negative amount of $930,000. She also applied the "going-value" adder to her reproduction cost approach analysis under the Cost approach as discussed above. OCA St. 2 at 13. Mr. Watkins explained that these provisions are not logical, contradictory to Ms. Vicari's analyses, and contain numerous double counts. OCA St. 2 at 13-17.

As discussed in more detail above, Ms. Vicari has no support for her "going-value" adder which does not comport with reality or relate in any way to expected working capital requirements, net income or cash flows. OCA St. 2S at 4. Moreover, the adder conflicts with Ms. Vicari's own cash flow analysis because she estimated annual revenues, expenses, profits and ultimate cash flows based on her expectations of MACM's operations. Id. As explained above, the calculation of the adder contains fundamental flaws. OCA St. 2 at 16-17.

The OCA also recommends that Ms. Vicari's proposal to deduct an amount to reflect that inflation and the absence of rate increases "erode" annual cash flows be rejected. PAWC Appendix A-5, Schs. L,N. Mr. Watkins explained that this adjustment is unnecessary and illogical because Ms. Vicari's DCF and other analyses reflect the anticipated cash flows that will be derived from the MACM operations. OCA St. 2 at 17. Her valuations already reflect her analyses of expected cash flows and there is no basis to make a further adjustment to reflect what Ms. Vicari perceives to be inadequate cash flows in certain years. Id.

For all of the reasons discussed above, the OCA submits that Ms. Vicari's adders for "going value" and "erosion of cash flow" are without merit and should not be considered for any of her appraisals.

(iv) Summary

Using all inputs and assumptions used by Ms. Vicari but correcting for her calculation of income taxes and using a more appropriate discount rate, Mr. Watkins determined that the DCF valuation result from PAWC's perspective is as follows:

	Interest Rate	**Resulting Market Value**
Discount Rate: Actual Capital Structure	6.70%	$122,420,000

OCA Sch. GAW-4. This amount compares to Ms. Vicari's DCF results (before her provision for going value and erosion of cash flow) of $211.340 million. The OCA recommends that $122,420,000 be utilized in place of Ms. Vicari's DCF result of $211,340,000.[26] OCA St. 2 at 13.

As discussed above, the OCA recommends that Ms. Vicari's Rate Base/Rate of Return result be rejected and, therefore, not averaged with the DCF result in developing an Income approach valuation. In addition, the OCA recommends that there be no "going-value" or "erosion of cash flow" added to the DCF result. Thus, the OCA's recommended DCF result is the same as the OCA's recommended Income approach result.

(c) AUS Discounted Cash Flow Method

On behalf of PAWC, Jerome Weinert with AUS Consultants (AUS) developed various a valuation analyses to arrive at a weighted average of the Cost, Market, and Income approaches resulting in an estimated fair market value of $161.343 million. OCA St. 2 at 22. The updated May 2017 AUS results are summarized below:

[26] As noted above, Ms. Vicari increased her indicated DCF result by $19.8 million to reflect her "going-value" and "erosion of cash flow" adders. The OCA recommends that the adders be rejected. OCA St. 2 at 6; OCA Exh. AEE-3R.

	Valuation	Weight	Weighted Value
Cost Approach	$160.301 million	50%	$80.151 million
Market Approach	$162.109 million	10%	$16.211 million
Income Approach	$162.455 million	40%	$64.982 million
Average Fair Market Value	--	100%	$161.344 million
Rounded	--	--	$161.343 million

OCA St. 2 at 22. AUS' valuation using the Income Approach is based on a DCF analysis. Id. In his direct testimony, Mr. Watkins discussed the structure and assumptions made in PAWC witness Weinert's Income Approach analyses. OCA St. 2 at 23. Mr. Watkins identified one area of disagreement discussed below: terminal values.

In Mr. Weinert's DCF analysis, he estimates annual revenues, expenses, depreciation, capital expenditures, and changes in working capital for each of the first 19 years to develop annual net cash flows. Id. Mr. Weinert then discounts the annual cash flows at 7% to arrive at the net present value for the first 19 years of operation. Id. Mr. Weinert then estimates the cash flows in perpetuity by estimating a "terminal value" in the twentieth year of his model and then discounting the terminal value back to the present. OCA St. 2 at 23. Mr. Weinert then adds the present value of the 19 years of net cash flows and the discounted terminal value to arrive at his valuation of $162.455 million. Id.

Mr. Watkins explained that terminal values are used but normally at the end of a project's useful life. He found that the AUS analysis has an unreasonable assumption (or error) that significantly overstates the terminal value of McKeesport's operations. Id.

Mr. Watkins conducted his DCF valuation using 50-years of discounted net cash flows (Debt Free Net Cash Flow) with no terminal value. In addition, Mr. Watkins provided more

appropriate discount rates using a municipal utility's cost of capital and an IOU's cost of capital. Id. at 27-28.

(i) AUS Terminal Value

Mr. Watkins presented a table that is a summary of the AUS updated DCF analysis. This table shows each component (income, depreciation, capital expenditures, etc.) and the net cash flow for each year, and the present worth or value for each year from year 1 through year 19. The final column shows the accumulated present value in each of the first 19 years and for year 20 and beyond. See OCA St. 2 at 24. In the row "20 and beyond", shows estimated net cash flows of $13.496 million, which is multiplied by 7.109 which reflects both the factor used to determine a terminal value as of the twentieth year and the discount factor used to bring the terminal value back to a present value. OCA St. 2 at 23-24. Mr. Watkins explained how the 7.109 factor is calculated, as follows:

> [T]he AUS factor of 7.109 is calculated by estimating a capitalization rate as well as applying the 7% discount rate in the twentieth year. In order to understand this concept, a firm's capitalization rate is equal to its cost of capital net of its growth rate, which in this instance, is 3.76%. For purposes of their analysis, AUS' assumed growth rate in perpetuity is their estimate of inflation of 3.12%. As such, the capitalization rate utilized by AUS can be considered as the "real" cost of capital, or cost of capital net of inflation.

OCA St. 2 at 25.

Mr. Watkins identified the unreasonable assumption, if not error, in AUS' estimation of a terminal value. The vast majority of investment in the McKeesport wastewater system is its investment in net plant which enables it to provide wastewater service to its customers. OCA St. 2 at 25. As with every type of depreciable plant or asset, the physical plant will wear out over time and must be replaced. Proper DCF valuation analyses must recognize that fact. Id. The AUS analysis does not reflect a reasonable level of capital expenditures. AUS assumed nominal

dollar capital expenditures in the twentieth year is $1.638 million. OCA St. 2 at 24. During the first 20 years of the AUS model, the cumulative capital expenditures only amount to $22.119 million (inflation-adjusted). OCA St. 2 at 24. It is important to note that AUS is estimating the cost of reproduction of the McKeesport system in today's dollars is $330.965 million and in the twentieth year would be $593.331. Id. Based on AUS' own assumption, the inflation adjusted capital expenditures of $22.119 million, invested to replace plant during the first 20 years, represents only 6.68% of the plant that will need to be replaced. OCA St. 2 at 26.

Mr. Watkins provided the following hypothetical example to demonstrate the conceptual bias this creates:

> [S]uppose a taxicab company has a fleet of five taxicabs with an expected life of ten years. In the eleventh year, these taxicabs must then be replaced in order to continue its operations and generate future cash flows. It would be an error to estimate the net cash flows from this fleet of existing taxicabs for ten years and then assume that the cash flows generated in the tenth year will continue in perpetuity without an extensive reinvestment of its plant in service (fleet of taxicabs) that needs to be replaced starting in the eleventh year. In other words, the net cash flows in the tenth year are fairly strong based on the almost worn out fleet of cabs. However, in the eleventh year, a significant capital investment will be required to replace this fleet of taxicabs, which will significantly impact (if not eliminate) the positive net cash flows in the eleventh year. This same concept is true for McKeesport's wastewater operations.

OCA St. 2 at 25-26. As Mr. Watkins noted, however, McKeesport's system has about 48% of its useful life remaining according to AUS' analysis. OCA St. 2 at 26. Thus, AUS' assumed level of real capital investment represents only 0.28% of the cost of replacing total plant in the twentieth year which implies an effective service life of new plant of 362 years which is unreasonable. Id. at 26-27. Mr. Watkins summarized this unreasonable AUS assumption as follows:

> Considering that the cost of replacing the McKeesport plant in service in the twentieth year is in excess of $550 million, an assumption that annual nominal dollar capital investments of only $1.6 million 20 years into the future, or 0.28% of total replacement costs is clearly unreasonable in that the McKeesport

> wastewater operations cannot possibly operate in perpetuity with such minimal levels of reinvestment to replace worn out plant. However, this is exactly what AUS' terminal value and estimation of value in perpetuity assumes and utilizes within its valuation model.

OCA St. 2 at 27.

In Mr. Watkins view, to value the McKeesport wastewater operations based on a reasonable level of plant in service as well as replacements in the foreseeable future, he recommended modeling annual net cash flows over a longer period of time. OCA St. 2 at 27. Accordingly, Mr. Watkins utilized 50 years of discounted cash flows with no terminal value. Id. at 27. Mr. Watkins explained:

> [D]ue to the exponential nature of present value discounting, as we move further into the future, the annual present value factors become exponentially smaller and smaller such that beyond 50 years, the present value factor becomes very small. Therefore, little weight would be given to projected net cash flows beyond 50 years.

OCA St. 2 at 27-28. Mr. Watkins accepted all annual revenue, expense, capital expenditures, and changes in working capital utilized by AUS for the first 20 years. OCA St. 2 at 27. For years 21 through 50, he increased net cash flows by AUS' assumed rate of inflation of 3.12%. Id. The result, using the same 7% discount rate as AUS, as well as annual growth in net cash flows of 3.12% in years 21 through 50 produces a DCF valuation of $134.359 million. OCA St. 2 at 28; Schedule GAW-5.

In rebuttal, AUS witness Weinert argued that Mr. Watkins' "limited life" DCF model does not adequately accomplish the valuation task of assessing the on-going business. PAWC St. 7-R at 3-4. This argument is without merit. Mr. Watkins has explained the flaws of PAWC witness Weinert's assumption that his terminal value is based on estimated cash flow during the twentieth year which is then assumed to continue into perpetuity and why those assumptions are unreasonable:

- Minimal level of capital expenditures in included to replace plant as it wears out;
- The minimal level of capital expenditures is assumed to continue in perpetuity;
- The resulting rate of investment of 0.28%: equates to an average service life of 350 years.

Accordingly, if and when terminal values are utilized, it must reflect a project's useful life such that cash flows reasonably reflect the capital investments required to maintain and continue a business enterprise's operations as a going concern, which Mr. Weinert's analysis does not do.

In rebuttal, Mr. Weinert reviewed the recent improvements made to the McKeesport system, which included a major improvement to the treatment plant and improvement and upgrades to several pumping stations. PAWC St. 7-R at 6-7. He also noted that the "majority of investment involves structure and improvements, excavation, concrete structures and basins which are items with long lives. Id. He also stated that collection mains have long service lives of 65-75 years and may be relined rather than replaced. Mr. Watkins noted that while these statements may be true, the realities are as follows:

- Mr. Weinert's own analysis shows that the McKeesport system has about 48% of its remaining useful life;
- McKeesport collection system with a 65-75 year useful life eventually will need to be replaced and it has about 48% of remaining life, or 31-36 year;
- A remaining life of 350 years, assumed by Mr. Weinert, is clearly unreasonable, and
- Annual cap ex for replacements equal to 0.28% cannot sustain the McKeesport system in perpetuity.

OCA St. 2S at 5-6.

In rebuttal, Mr. Weinert also claims that his DCF approach, including a terminal value calculation is consistent with the American Society of Appraisers manual. See OCA St. 2S at 6; PAWC St 7-R at 5-6. Mr. Watkins addressed this criticism, as follows:

> Apparently, Mr. Weinert overlooked the section entitled "Future Capital Expenditures" on pages 139 and 140 of the referred to manual (and provided in his Exhibit JCW-2). As indicated in the manual:
>
> > If real or inflationary growth is projected during the specific forecast or in the terminal period, the projected growth must be supported by capital expenditures in excess of depreciation.
>
> In this regard, and as shown on page 24 of my direct testimony, Mr. Weinert assumes capital expenditures of only $1.619 million in the twentieth year while his depreciation expense in that year amount to $4.230 million. Moreover, Mr. Weinert's DCF analysis does indeed include annual inflationary growth of 3.12% (Weinert rebuttal, page 5).

OCA St. 2S at 6. After review of the manual, including the section not cited by Mr. Weinert, Mr. Watkins concluded:

> The American Society of Appraisers manual is consistent with my observations and criticisms of Mr. Weinert's terminal value assumptions such that his terminal value is severely overstated.

OCA St. 2S at 6. By utilizing a 50-year model, Mr. Watkins considered the useful remaining life of McKeesport's system without totally (or significantly) replacing the system as it wears out after 50 years. The OCA submits that this approach is reasonable and Mr. Watkins adjustments to this aspect of the AUS DCF analyses should be adopted

(ii) Summary

In order to accommodate AUS' conceptual basis to value McKeesport's wastewater operations as a business enterprise that will continue many years into the future, Mr. Watkins expanded Mr. Weinert's 20-year model to a 50-year model with no terminal value and using all of Mr. Weinert's assumptions. This calculation produces a valuation of $134,359,000 of

McKeesport's wastewater operations under the Income Approach compared to AUS' recommended $162,455,000.

(3) HRG Market Approach

The OCA did not recommend adjustments to AUS' Market approach valuation. As such, the discussion in this section is limited to the Market approach valuation conducted by MACM witness Vicari (HRG).

MACM witness Vicari defines market value as "the value established in a public market by exchanges between willing sellers and willing buyers not under duress." PAWC Appendix A-5, Sch. J. Ms. Vicari calculated the per-customer market value for five acquisitions by Class A water utilities in Pennsylvania. OCA St. 1 at 19-20. She added the purchase price and capital improvements and then divided the result by the number of customers. She calculated an average market value per customer of $8,661 and then multiplied this amount by 21,953 McKeesport customers to arrive at her market value of $190,130,000. Id. There are multiple problems with Ms. Vicari's analysis, as discussed below.

First, Ms. Vicari selectively chose acquisitions that she used in her analysis. She claims that she used "recent wastewater system acquisitions with adequate documentation" and that HRG focused on "known transactions that have occurred after or in anticipation of the passage of Act 12 of 2016." OCA St. 1 at 20; OCA III-8. In fact, she used acquisitions that occurred as far back as December 2013 which is before the passage of Act 12 of 2016 which occurred in April 2016. In rebuttal, Ms. Vicari clarified that she used transactions before the passage of Act 12. OCA St. 1S at 17-18.

OCA witness Everette originally identified two flaws with the inputs used in this calculation. First, Ms. Vicari used an incorrect number of MACM customers. OCA St. 1 at 20-

21. Second, Ms. Vicari used inconsistent purchase price values to calculate the average costs per customer. Id. at 21-22.

(a) Incorrect Use of Projected Customers

Ms. Vicari used an incorrect number of customers for MACM. In Appendix A-17-a, it states that MACM has 12,780 customers, yet Ms. Vicari used 21,953 customers. OCA St. 1 at 20-21. She explained that she used that number because she counted the individual connections for each bulk customer. Id. She never supplied her calculation of the individual connections for the four bulk customers. Id.

Ms. Vicari does not necessarily apply that logic to the other acquisitions in her sample group by reflecting individual connections for any bulk customers. OCA St. 1S at 16-17. By using the actual number of customers for the other systems, she achieved a higher average cost per customer. She then multiplied this overstated cost per customer times the unsupported number of bulk customers' individual connection, compounding the error. Ms. Everette was not able to confirm whether all of the customer numbers in Ms. Vicari's sample group were consistently counted. She therefore used the 21,953 customer number used by Ms. Vicari to minimize the issues in the proceeding.

(b) Inconsistent Purchase Price Values

Similar to the problem with the customer count, MACM witness Vicari did not use consistent purchase price values. OCA St. 1 at 21-22. For the comparative acquisitions, she used the purchase price plus the value of capital improvements required by the agreement of sale. For MACM, however, she uses only the purchase price and does not consider the $62.7 million of capital investments that PAWC anticipates making over the next 10 years. Including the cost

of capital improvements distorts the results, making the market value unreliable. OCA St. 1 at 21-22. It also has the effect of artificially inflating the market value.

In rebuttal, Ms. Vicari claims that the $62.7 million of improvements "may or may not be undertaken since the system is fully functioning now". OCA St. 1S at 18; MACM St. 1R at 3. In addition to the fact that her statement is contrary to PAWC's position, it is an admission that her market analysis is not an apples-to-apples comparison. As Ms. Everette explained, using capital improvements for the other acquisitions but not for this current acquisition distorts the results and makes the market value analysis unreliable. OCA St. 1 at 21. Ms. Everette calculated the purchase prices for each acquisition without adding capital improvements. See OCA Exh. AEE-2. The corrected market value is $7,317 per customer. Even using the number of customers used by Ms. Vicari, which the OCA submits is without foundation, the estimated market value is $160,630,101, rather than $190,000,000 calculated by Ms. Vicari.[27] OCA St. 1 at 22.

(4) OCA Recommendations

Ms. Everette and Mr. Watkins recommended adjustments to Ms. Vicari's Cost, Income, and Market approaches modify the HRG appraisal result from $207,006,667 to $145,974,192. Mr. Watkins recommended adjustment to Mr. Weinert's Income approach modified the AUS appraisal result from $162,455,017 to $134,359,000. The recommended changes to the HRG and AUS results are summarized here:

	HRG	OCA Adjusted
Cost Approach	$202,410,000	$111,739,476
Income Approach	$228,480,000	$165,550,000
Market Approach	$190,130,000	$160,630,101
Appraised Value	$207,006,667	$145,973,192
Recommendation:	$207,010,000	$145,973,192

[27] Using the actual number of customers (12,780 x $7,317 per customer), the market value is $96, 511, 260.

	AUS	OCA Adjusted
Cost Approach	$160,301,491	
Income Approach	$162,455,017	$134,359,000
Market Approach	$162,455,017	
Appraised Value	$161,343,614	$151,105,207
Recommendation:	$161,343,000	$151,105,207

OCA Exh. AEE-1R(Revised). HRG's result is based on the average of the three results, so OCA followed the same weighting. AUS applied different weighting to its three approaches and the OCA followed the same weighting. The OCA averaged the two OCA adjusted appraisal results ,which resulted in an average of $151,949,698. OCA Exh. AEE-1R (Revised). Because this amount is less than the $162,000,000 purchase price, the OCA submits that the amount approved for ratemaking rate base pursuant to Section 1329 must be no more than $151,949,698, rather than $162,000,000 as proposed by PAWC.

2. DSIC, AFUDC and deferred depreciation

Section 1329(d)(4) permits the acquiring utility to collect a Distribution System Improvement Charge (DSIC) from the time that a tariff goes into effect until such time as new rates are approved for the acquiring utility in a base rate case. 66 Pa. C.S. § 1329(d)(4). Consistent with the Final Implementation Order implementing Act 11 of 2012, if PAWC determined to charge a DSIC to the MACM customers prior to establishing rates for those customers in a base rate proceeding, the Company should file a revised tariff to reflect this change and a revised Long Term Infrastructure Improvement Plan (LTIIP). Implementation of Act 11 of 2012, Docket No. M-2012-2293611, Final Implementation Order at 28 (Aug. 2, 2012). The OCA submits that if MACM customers will begin paying a DSIC prior to effective date of rates established in PAWC's next base rate case, the Commission should condition its approval

of the transaction by requiring that PAWC file the required tariff changes and revised LTIIP no later than 30 days after entry of the Commission order in this proceeding.

3. Rate Freeze/ No Rate Stabilization Plan

PAWC is asking for approval of its Asset Purchase Agreement, which includes a rate freeze that will be in place for the first year of PAWC's ownership. APA, ¶7.05(b). The APA contains a provision that freezes rates for MACM customers for the first year of PAWC ownership. Specifically, ¶7.05(b) states as follows:

> (b) Rate Stabilization. After Closing, Buyer shall begin charging Seller's current rates . . . as Buyer's base rates within the Service Territory, which base rates the Parties agree shall not be increased until after the first anniversary of the Closing Date (the "Stabilization Period").

APA, ¶7.05(b).

Further, as discussed above, under Section 1329(f)(2), PAWC is permitted to use special ratemaking treatment for its projected $62.7 million of post-acquisition improvements over 10 years, which will increase the shortfall in the MACM customers' rates relative to their actual cost of service. If the transaction is approved, the OCA recommends that the Commission adopt language to clarify its authority and discretion to mitigate the rate impact for PAWC's existing customers by potentially increasing rates for MACM customers, whether or not the rate freeze is in place at the time of the base rate case seeking to reflect this acquisition in rate base.

4. Revised *pro forma* tariff supplement

The OCA did not oppose the revised pro forma tariff supplement except to the extent it is inconsistent with the requirements related to charging the DSIC to MACM customers.

C. Section 507 Approvals

PAWC requests approval of the Asset Purchase Agreement (APA) and 18 contracts. See PAWC Appendices A24, B-1-B-18. According to Company witness Nevirauskas, "even during the one-year period in which MACM rates are to be in place -- PAWC may seek approval from the Commission to increase rates. PAWC was careful in negotiating the APA to respect the statutory authority to the Commission to set just and reasonable rates." PAWC St. 4 at 7. The OCA does not oppose the approval of the Asset Purchase Agreement so long as it is clear that such approval is not binding on any party in future cases.

The OCA did not take any position on whether the Commission should approve PAWC's requests for approval of the remaining agreements in Appendices A-24 and B-1-B-18.

D. Summary of the OCA's Recommendations

The OCA recommends that the Commission deny PAWC's application for a Certificate of Public Convenience to purchase the MACM combined wastewater assets and provide wastewater service. If the Commission finds sufficient affirmative public benefits to the existing PAWC customers and MACM customers, however, the OCA proposes the following Conditions:

- The OCA's proposed adjustments to the appraisals are adopted, resulting in an overall ratemaking rate base of $151,949,698 (prior to closing and transaction costs).
- If PAWC seeks to have MACM customers begin paying a DSIC prior to the effective date of rates established in PAWC's next base rate case, PAWC must file the required tariff changes and revised LTIIP no later than 30 days after entry of the Commission order in this proceeding. The revised LTIIP must be

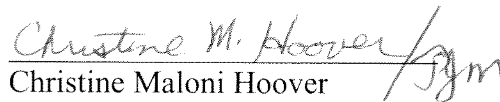
approved prior to PAWC charging the DSIC to the acquired customers. The proposed projects reflected in the revised LTIIP will be in addition to, and will not reprioritize, any capital improvements that PAWC was already committed to undertake for existing customers.

- PAWC must file a separate MACM cost of service study that separates capital expenses and operating costs of the sanitary and storm water functions in its next base rate case.
- Rate claims related to the accrual of Allowance for Funds used During Construction (AFUDC) for non-DSIC eligible, post-acquisition improvements will be made in the next PAWC base rate case following the plant additions.
- Deferral of depreciation for book and ratemaking purposes on non-DSIC eligible post-acquisition improvements will be made in the next PAWC base rate case following the plant additions.
- The Commission retains the authority and discretion to mitigate the rate impact for PAWC's existing customers by potentially increasing rates for MACM customers, whether or not the rate freeze is in place at the time of the base rate case seeking to reflect this acquisition rate base.

VI. CONCLUSION

The OCA's recommendation that the Commission deny PAWC's application for a Certificate of Public Convenience to purchase the MACM combined wastewater assets and provide wastewater service is intended to prevent PAWC's existing water and wastewater customers from bearing the costs of a transaction that does not provide affirmative benefits that outweigh the harms to customers. For the reasons set forth above, the Office of Consumer Advocate urges the Commission to find that the Application of PAWC does not satisfy the standards set forth in Section 1103(a) of the Public Utility Code and City of York. In the alternative, the Office of Consumer Advocate's proposed conditions should be adopted, including the OCA's proposed adjustments to the appraisals resulting in an overall ratemaking rate base of $151,949,698.

Respectfully Submitted,



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Proposed Findings of Fact

Parties

1. On June 21, 2017, the OCA filed a Protest.
2. On July 17, the OCA served the direct testimony of Ms. Everette and Mr. Watkins.
3. The OCA served rebuttal testimony on July 26, 2017, and surrebuttal testimony on August 2, 2017.
4. An initial hearing was held on August 3, 2017.

The MACM System

5. MACM is overseen and regulated by the Allegheny County Health Department and the Pennsylvania DEP. OCA St. 1S at 5. MACM operates under the regulatory authority framework for municipal authorities. Id.
6. The Dravosburg and Duquesne systems were purchased by MACM in 2011 for $4.13 million, or approximately half the depreciated original cost of those systems at that time. OCA St. 1 at 14-15.
7. PAWC anticipates spending $62.7 million for capital improvements to the MACM system during the next 10 years. OCA St. 1 at 21.
8. There is no testimony that MACM is unable to address any issues that might be present in its system.

The Asset Purchase Agreement and the First Amendment to the Asset Purchase Agreement

9. PAWC proposes to acquire the sewer assets of the MACM for $162 million, or 102% more than the net book value of the system. APA, Article III.
10. The forty-six existing MACM union and non-union employees will be hired by PAWC to continue operating the MACM system. PAWC Appendix A-24, Sch. 7.03(a).
11. PAWC agreed to keep base rates, exclusive of the DSIC, frozen for MACM customers for no less than one year after closing. APA, ¶ 7.05(b).
12. During the "rate stabilization" period, PAWC may seek approval from the Commission to increase MACM rates. APA, ¶ 7.05(b).

The Application and the UVE's Appraisals

13. On May 24, 2017, the PAWC filed an application with the Commission under Sections 1102 and 1329 of the Public Utility Code. This filing was accepted on June 14, 2017.

14. PAWC seeks approval of the APA with MACM and the City of McKeesport and 18 contracts. PAWC App. A-24, B-1-B-18.

15. PAWC requests that the purchase price of $162 million be approved for ratemaking purposes as it is lower than the average of the two appraisals that the Company provided with its application.

16. The UVE appraisals were prepared by AUS Consultants for PAWC and HRG for MACM. PAWC App. A-5. AUS gives different weight to each approach, while HRG appears to give equal weight to the Cost, Income, and Market approaches. OCA Exh. AEE-1R; OCA St. 1 at 18-19.

17. PAWC originally agreed to pay the higher of $156,000,000 or the average of the two appraisals, but renegotiated the purchase price after the appraisals were received. PAWC St. 1 at 11.

Witness Qualifications

18. Ms. Everette is a Regulatory Analyst employed by the OCA since 2012. OCA St. 1, App. A. Ms. Everette received a Master's degree in Business Administration and a Bachelor's degree in Economics both from the University of Illinois. Id.

19. Ms. Everette testified in numerous proceedings before the Commission with a primary specialty in accounting and finance issues. OCA St. 1, App. A.

20. Mr. Watkins is a Principal a Senior Economist with Technical Associates, Inc., an economics and financial consulting firm. OCA St. 1, GAW-1. Mr. Watkins obtained his B.S. in economics and M.B.A. from the Virginia Commonwealth University in 1982 and 1988, respectively. Id.

21. Mr. Watkins conducts marginal and embedded cost of service, rate design, cost of capital, revenue requirement, and load forecasting studies involving numerous electric, gas, water/ wastewater, and telephone utilities, and provided expert testimony in Alabama, Arizona, Delaware, Georgia, Illinois, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Vermont, Virginia, South Carolina, Washington, and West Virginia. OCA St. 1, GAW-1.

PAWC's Financial, Technical, and Legal Fitness

22. The OCA did not present any evidence regarding PAWC's fitness.

Affirmative Public Benefits of a Substantial Nature

23. The cost of ownership is greater under PAWC than MACM. OCA St. 1 at 10-14.

24. MACM had received a $17,239,375 grant from Pennvest in 2011, along with an equal amount as a loan at 1% interest. OCA St. 1 at 9. PAWC is not eligible to assume the Pennvest loan, so the existing MACM ratepayers will not continue to benefit from the Pennvest grant or loan over the life of the plant financed by the grant and loan. Id. Without Pennvest financing, costs would be higher. OCA St. 1 at 4.

25. The annual revenues needed for the MACM system, including existing operating expenses, will be $31.1 million, even before the $62.7 million of capital expenditures. OCA St. 1 at 11.

26. Revenues from MACM customers will not cover the annual revenues needed under PAWC ownership. MACM has current revenues of approximately $13 million, so there will be an approximate shortfall of $18 million under PAWC ownership. OCA St. 1 at 11.

27. If MACM customers rates were raised to cover the cost of service under the agreed upon purchase price and PAWC ownership, those customers would see an increase of approximately 137%, or an increase in rates for a customer using 5,000 gallons per month, from $68.95 to $163 per month. OCA St. 1 at 13.

28. PAWC has stated that it anticipates shifting some or all of this shortfall to its existing water customers using Section 1311(c). OCA St. 1 at 13. Existing water and wastewater customers would bear an increase to support the MACM acquisition.

29. The Dravosburg and Duquesne system customers would see a possible increase. OCA St. 1 at 14-15. The Dravosburg and Duquesne systems were purchased by MACM in 2011 for $4.13 million. OCA St. 1 at 14-15. MACM will receive approximately $30 million for the same plant, or about seven times what MACM paid for it six years ago but no proceeds will be go to the Duquesne or Dravosburg municipalities. Id.

30. Some of the other benefits that will be experienced by McKeesport, such as property taxes that will be paid by PAWC related to its ownership of the facilities, will not accrue to Dravosburg and Duquesne. OCA St. 1 at 14-15.

31. PAWC paid more than twice the book value for the system. OCA St. 1S at 7. The purchase price is 102% ($80,085,602) over the net book value that does not reflect any deduction for grant-financed plant. OCA St. 1 at 4.

32. The net plant per customer will increase as a result of the $162 million MACM acquisition. PAWC's current average wastewater rate base per customer is $6,642. OCA St. 1 at 16. The average MACM rate base per customer will be $12,676. Id. When the MACM rate base of $162 million is added to PAWC's wastewater rate base, the average wastewater rate base per customer will be $7,862 per customer, or an increase of $1,220 or 18%. Id.

33. If approved as proposed, PAWC will freeze rates and continue to charge MACM customers their then-effective sewer rate (currently $68.95 per month) for a one year period. OCA St. 1 at 13.

34. Pennvest provides funds for sewer, storm water and drinking water projects, primarily through low interest loans. OCA St. 1 at 9. In determining the interest rate and whether to award grant funding, Pennvest uses an affordability methodology to make prohibitively expensive projects affordable to users. Id. If the user rates would be unaffordable when the system acquires a Pennvest loan, Pennvest can reduce the interest rate to as low as 1% and provide grants for a portion of the project cost. Id.

35. The MACM received a Pennvest loan of $17,239,375. OCA St. 1 at 9. Under PAWC ownership, the Pennvest loan will need to be repaid by McKeesport. Id.

36. PAWC has not provided any showing of cost reductions or efficiencies that will be produced by the acquisition of the MACM customers. OCA St. 1S at 19.

37. PAWC provided no documentation that it can construct, operate, and maintain the existing MACM system and make the anticipated improvements at a lesser cost than MACM.

38. Under the proposed rate increase, the average cost per MACM customer is nearly double that of an existing PAWC wastewater customer and, if the MACM rate base is combined with PAWC's existing wastewater rate base, the average rate base cost of PAWC's wastewater customers would increase by 17% per customer. OCA St. 1S at 11.

39. PAWC anticipates using Section 1311(c) to spread the rate impact of the MACM system to other PAWC customers. OCA St. 1 at 12.

Cost of Service Studies

40. The OCA supports I&E's recommendation that a separate MACM cost of service study that separates capital expenses and operating costs for the sanitary and storm water functions should be provided by PAWC in its next base rate case. I&E St. No. 2 at 20-22; I&E St. No. 2-SR at 14-18.

Ratemaking Rate Base

41. Based on the engineering assessment performed by KLH Engineers, the original cost of MACM's wastewater system and land is $108,231,570, with accumulated depreciation of $28,145,968 for a net book value of $80,085,602. OCA St. 1 at 4. The net book value does not reflect an adjustment to remove customer contributions of Pennvest grant funds and thus is higher than it would be under normal ratemaking calculations. Id.

42. PAWC's proposed rate base is overstated due to errors and flaws in the appraisals, and the correct rate base number is $151,949, 698 under the Section 1329 methodology. OCA St. 1 at 18-26; OCA St. 1R at 1-11; OCA St. 1S at 16-20; OCA St. 2 at 4-28; OCA St. 2S at 1-6.

43. In her Cost approach analysis, Ms. Vicari did not provide any specific documentation or supporting calculations of the 20% overhead. OCA St. 1R at 8; OCA V-3. Removing the 20% overhead addition results in an adjustment of $15,041,525 to Ms. Vicari's depreciated reproduction cost. OCA St. 1R at 9; OCA Exh. AEE-3R.

44. Ms. Vicari's "going-value" adder is $19,800,000 and her erosion of cash flow adder is a deduction of $930,000. OCA St. 2 at 6. These provisions are not logical, contradictory to Ms. Vicari's analyses, and contain numerous double counts. OCA St. 2 at 13-17; OCA St. 2S at 3-4.

45. Mr. Watkins reduced the depreciated reproduction cost by $19,800,000 to reflect the removal of the going value adder included by Ms. Vicari as shown on OCA Exh. AEE-3R. The result is an adjusted depreciated reproduction cost of $135,202,468 rather than $150,240,000 as recommended by Ms. Vicari. Id.

46. Mr. Watkin's corrections to HRG's income approach valuation of $165,550,000, which is the mid-point of the DCF valuation range of $122,420,000 and $208,690,000, compares to Ms. Vicari's $212,360,000. OCA St. 2 at 13; OCA St. 2S at 1-3; OCA Exh. AEE-1R (Revised).

47. Mr. Watkins adjusted AUS's income approach by using a 50-year modeling approach and utilizing a discount rate, producing a valuation result of $134,359,000 as compared to AUS' $162,455,017. OCA St. 2 at 22-28; OCA St. 2S at 4-6; OCA Exh. AEE-1R (Revised).

48. Ms. Vicari's treatment and calculation of income taxes and her selected discount rate of 2.5% in her income approach do not comport with accepted financial theory or practice. OCA St. 2 at 6. Ms. Vicari's net add-on of $18.87 million ($19.8 million minus $0.930 million) for "going value" and "erosion of cash flow" were made outside her DCF model. Id. at 6.

49. The incremental Pennsylvania State income tax rate is 9.99%, while the incremental Federal income tax rate is 35%, resulting in a total incremental tax rate of 41.49%. OCA St. 2 at 11.

50. Only the depreciation of capital expenditures is tax deductible. Id.

51. It is well-known and generally accepted that the appropriate discount rate is the firm's total cost of capital, which includes the weighted cost of debt and the weighted cost of equity. OCA St. 2 at 12.

52. PAWC's actual capital structure of 52% debt and 48% equity, PAWC's actual cost of debt of 4.29%, and a reasonable cost of equity of 9.3% results in a total cost of capital (discount rate) of 6.70%. OCA St. 2 at 12.

53. Ms. Vicari did not use MACM's actual embedded original cost of rate base in her income approach analysis, but instead utilized her "Cost of Reproduction New" rate base for developing her annual cost of service-based returns. OCA St. 2 at 19; PAWC Appendix A-5, Sch. M.

54. Ms. Vicari assumed an annual rate of return of 7.5% on "Cost of Reproduction New" rate base. While Ms. Vicari states that 7.5% is based on "PAWC's estimated weighted cost of capital," she provided no support for that number. OCA St. 2 at 20. In contrast, Mr. Watkins has demonstrated that 6.97% is an appropriate total cost of capital, which is derived from PAWC's current cost of debt and a 9.3% cost of equity applied to PAWC's actual capital structure. Id.

55. Ms. Vicari's cash flows are overstated by approximately $4.7 million in every year. ($8,365,000 minus $2,654,000 minus $975,000). OCA St. 2 at 20-21.

56. If the concept of Ms. Vicari's rate base/rate of return analysis is utilized in any way, a value of approximately $74.3 million (Vicari Schedule B) should be utilized instead of Ms. Vicari's value of $245.620 million.

57. Ms. Vicari's "going value" adder conflicts with her own cash flow analysis because she estimated annual revenues, expenses, profits and ultimate cash flows based on her expectations of MACM's operations. Id.

58. Ms. Vicari's proposal to deduct an amount to reflect that inflation and the absence of rate increases "erode" annual cash flows is unnecessary and illogical because Ms. Vicari's DCF and other analyses reflect the anticipated cash flows that will be derived from the MACM operations. OCA St. 2 at 17; PAWC Appendix A-5, Sch. H.

59. The OCA recommends that $122,420,000 be utilized in place of Ms. Vicari's DCF result of $211,340,000. OCA St. 2 at 13.

60. In DCF analysis, terminal values are used but normally at the end of a project's useful life. AUS used a terminal value of 20 years. OCA St. 2 at 23.

61. Mr. Watkins conducted his DCF valuation using 50-years of discounted net cash flows (Debt Free Net Cash Flow) with no terminal value. Mr. Watkins provided discount rates using a municipal utility's cost of capital and an IOU's cost of capital. OCA St. 2 at 27-28.

62. Mr. Watkins found a valuation of $134,359,000 of McKeesport's wastewater operations under the Income Approach compared to AUS' recommended $162,455,000. OCA St. 2 at 22-28; OCA St. 2S at 4-6; OCA Exh. AEE-1R(Revised).

63. In her Market approach analysis, Ms. Vicari used an incorrect number of MACM customers. OCA St. 1 at 20-21. In Appendix A-17-a, it states that MACM has 12,780 customers yet Ms. Vicari used 21,953 customers. OCA St. 1 at 20-21.

64. Ms. Vicari also used inconsistent purchase price values to calculate the average costs per customer. Id. at 21-22.

65. For the comparative acquisitions, Ms. Vicari used the purchase price plus the value of capital improvements required by the agreement of sale. For MACM, Ms. Vicari used only the purchase price and did not consider the $62.7 million of capital investments that PAWC anticipates making. OCA St. 1 at 21-22. Including the cost of capital improvements distorts the results makes the market value unreliable. Id.

Rate Stabilization Plan

66. The rate freeze proposed in the APA will be in place for the first year of PAWC's ownership. APA, ¶7.05(b).

67. If PAWC uses special ratemaking treatment under Section 1329(f) for its projected $62.7 million of post-acquisition improvements over 10 years, the shortfall in the MACM customers' rates relative to their actual cost of service will increase.

DSIC, AFUDC and Deferred Depreciation

68. An acquiring utility may collect a DSIC from the time that a tariff goes into effect until such time as new rates are approved in a base rate case. 66 Pa. C.S. § 1329(d)(4)

Rates

69. Ms. Everette and Mr. Watkins recommend adjustments to Ms. Vicari's Cost, Income, and Market approaches modify the HRG appraisal result from $207,006,667 to $145,974,192. OCA Exh. AEE-1R (Revised).

70. Mr. Watkins recommended adjustment to Mr. Weinert's Income approach modified the AUS appraisal result from $162,455,017 to $134,359,000. OCA Exh. AEE-1R (Revised).

71. The average of the adjusted appraisal results is $151,949,698, which is less than the $162 million proposed by PAWC for ratemaking rate base. OCA Exh. AEE-1R (Revised).

Municipal Agreements

72. The Commission has the statutory authority to set just and reasonable rates and nothing in the APA will bind any party in future cases. PAWC St. at 7.

Appendix B
to OCA Main Brief

PROPOSED CONCLUSIONS OF LAW

1. The Public Utility Commission has jurisdiction over wastewater service. 66 Pa. C.S. §§ 102(1)(vii).

2. PAWC did not meet its burden of proving by a preponderance of the evidence that the proposed acquisition of the Municipal Authority of the City of McKeesport (MACM) assets and the proposed ratemaking terms will affirmatively promote the "service, accommodation, convenience, or safety of the public in some substantial way. 66 Pa. C.S. § § 316(c), 332.

3. The acquisition by PAWC is not in the public interest and does not provide substantial affirmative benefits. 66 Pa. C.S. §§ 1102(a)(2), 1103(a); City of York v. Pa. P.U.C., 449 Pa. 136, 141, 295 A.2d 825, 828 (1972).

4. The acquisition as proposed would result in the harm to existing customers and eventually to MACM customers outweighing any benefits and the proposed transfer is not in the public interest.

If the Commission determines that there are affirmative public benefits:

1. The Public Utility Commission has the authority to impose conditions on the grant of a certificate of public convenience. 66 Pa. C.S. § 1103.

2. The Application must have the following conditions:

   - The OCA's proposed adjustments to the appraisals are adopted, resulting in an overall ratemaking rate base of $151,949,698 (prior to closing and transaction costs).

   - If PAWC seeks to have MACM customers begin paying a DSIC prior to the effective date of rates established in PAWC's next base rate case, PAWC must file the required tariff changes and revised LTIIP no later than 30 days after entry of the Commission order in this proceeding. The revised LTIIP must be approved prior to PAWC charging the DSIC to the acquired customers. The proposed projects reflected in the revised LTIIP will be in addition to, and will not reprioritize, any capital improvements that PAWC was already committed to undertake for existing customers.

   - PAWC must file a separate MACM cost of service study that separates capital expenses and operating costs of the sanitary and storm water functions its next rate base case.

- Rate claims related to the accrual of Allowance for Funds used During Construction (AFUDC) for non-DSIC eligible, post-acquisition improvements will be made in the next PAWC base rate case following the plant additions.

- Deferral of depreciation for book and ratemaking purposes on non-DSIC eligible post-acquisition improvements will be made in the next PAWC base rate case following the plant additions.

- The Commission retains the authority and discretion to mitigate the rate impact for PAWC's existing customers by potentially increasing rates for MAMC customers, whether or not the rate freeze is in place at the time of the base rate case seeking to reflect this acquisition rate base.

PROPOSED ORDERING PARAGRAPHS

IT IS ORDERED:

1. PAWC Application is hereby denied because the Commission did not establish that there are substantial affirmative benefits. PAWC did not establish that the Application affirmatively promotes the service, accommodation, convenience or safety of the public in some substantial way.

If the Commission determines that there are affirmative public benefits:

IT IS ORDERED:

PAWC's Application is hereby approved, subject to the following conditions:

1. The OCA's proposed adjustments to the appraisals are adopted, resulting in an overall ratemaking rate base of $151,949,698 (prior to closing and transaction costs).
2. If PAWC seeks to have MACM customers begin paying a DSIC prior to the effective date of rates established in PAWC's next base rate case, PAWC must file the required tariff changes and revised LTIIP no later than 30 days after entry of the Commission order in this proceeding. The revised LTIIP must be approved prior to PAWC charging the DSIC to the acquired customers. The proposed projects reflected in the revised LTIIP will be in addition to, and will not reprioritize, any capital improvements that PAWC was already committed to undertake for existing customers.
3. PAWC must file a separate MACM cost of service study that separates capital expenses and operating costs of the sanitary and storm water functions in its next rate base case.

4. Rate claims related to the accrual of Allowance for Funds used During Construction (AFUDC) for non-DSIC eligible, post-acquisition improvements will be made in the next PAWC base rate case following the plant additions.
5. Deferral of depreciation for book and ratemaking purposes on non-DSIC eligible post-acquisition improvements will be made in the next PAWC base rate case following the plant additions.
6. The Commission retains the authority and discretion to mitigate the rate impact for PAWC's existing customers by potentially increasing rates for MAMC customers, whether or not the rate freeze is in place at the time of the base rate case seeking to reflect this acquisition rate base.