

October 3, 2017

Via Electronic Filing

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

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

Dear Secretary Chiavetta:

We are counsel to Aqua Pennsylvania Wastewater, Inc. in the above matter and are submitting, via electronic filing with this letter, the Company's Exceptions to the Recommended Decision of Administrative Law Judge Steven K. Haas. Copies of the Exceptions are being served upon the persons and in the manner set forth on the certificate of service attached to them.

Very truly yours,

THOMAS, NIESEN & THOMAS, LLC

By 

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cc: Certificate of Service (w/encl.)
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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

The Honorable Steven K. Haas, Presiding

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

EXCEPTIONS OF
AQUA PENNSYLVANIA WASTEWATER, INC.
TO THE RECOMMENDED DECISION OF
ADMINISTRATIVE LAW JUDGE STEVEN K. HAAS

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DATED: October 3, 2017

TABLE OF CONTENTS

I. INTRODUCTION 1

II. EXCEPTIONS 3

 EXCEPTION NO. 1 – RATE STABILIZATION PLAN
 RATE FREEZE..... 3

 EXCEPTION NO. 2 – RATE STABILIZATION PLAN
 REGULATORY ASSET TREATMENT 5

 EXCEPTION NO. 3 - RATE BASE VALUATION
 ABILITY TO CHALLENGE FAIR MARKET
 VALUE APPRAISALS 8

 EXCEPTION NO. 4 - RATE BASE VALUATION
 APPROVAL OF RATE BASE VALUE 11

 A. Income Approach 14

 1. Adjustments One and Two - Income Tax Expenses and Discount Rate 14

 2. Adjustments Three and Four - HRG “Going Value” Adder and
 Provision for Erosion of Cash Flow 16

 3. Adjustment Five - Disregarding the HRG Rate of Return/Rate Base
 Analysis 17

 B. Cost Approach 19

 1. HRG Reproduction Cost 19

 2. Inclusion of Future Capital Projects 20

 3. HRG “Going Value” Adder 21

 C. Market Approach 22

 1. Projected Customers 22

 D. Conclusion 23

 EXCEPTION NO. 5 - 66 Pa. C.S. § 507 APPROVAL 24

 EXCEPTION NO. 6 – SEPARATE COST OF SERVICE STUDY..... 24

III. CONCLUSION 26

TABLE OF CITATIONS

Cases

Commonwealth v. Segida,
985 A.2d 871 (Pa. 2009) 8

*Joint Application of Pennsylvania-American Water Company and the Sewer Authority
of the City of Scranton*,
Docket No. A-2016-2537209, Opinion and Order entered October 19, 2016 4, 24

Statutes, Regulations, Texts and Codes

52 Pa. Code § 5.533 2

1 Pa. C.S. § 1921(a) 8

1 Pa. C.S. § 1921(b) 8

66 Pa. C.S. § 1102 1, 26

66 Pa. C.S. § 1301 13

66 Pa. C.S. § 1329(a) 9, 10

66 Pa. C.S. § 1329(a)(1) 11

66 Pa. C.S. § 1329(a)(2) 9, 12

66 Pa. C.S. § 1329(a)(3) 9, 12, 13

66 Pa. C.S. § 1329(c) 9, 12

66 Pa. C.S. § 1329(c)(2) 1, 11, 26

66 Pa. C.S. § 1329(d)(1)(v) 3

66 Pa. C.S. § 1329(d)(4) 3

I. INTRODUCTION

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

The Application asks the Commission to approve Aqua’s acquisition of the wastewater system assets of Limerick Township (“Limerick” or “Township”) and allow Aqua to begin to provide wastewater service in Limerick Township.

The Application also asks the Commission for an order approving the acquisition that includes the ratemaking rate base of the wastewater system assets pursuant to Section 1329(c)(2) of the Public Utility Code.

The Application included responses to over 60 Application Checklist items and 35 Exhibits including a map and service territory description; the Asset Purchase Agreement (“Agreement” or “APA”); financial information of both Aqua and the Township; and numerous Department of Environmental Protection (“DEP”) Reports, Permits and Act 537 related documents.

As required by Section 1329(d)(1), the Application also included the Fair Market Value Appraisal Reports of Gannett Fleming Valuation and Rate Consultants, LLC (“Gannett”) and Herbert, Rowland & Grubic, Inc. (“HRG”); the negotiated purchase price; the ratemaking rate base determined pursuant to Section 1329(c)(2); a tariff containing a rate equal to the existing rates of the selling utility at the time of the acquisition; and a Rate Stabilization Plan.

The Bureau of Technical Utility Services (“TUS”), the Bureau of Investigation and Enforcement (“I&E”), the Office of Consumer Advocate (“OCA”) and the Office of Small Business Advocate (“OSBA”) were served with copies of the Application on May 19, 2017.

Thereafter, the Company filed and served supplemental information on May 30, 2017, in response to information requests from TUS.

By Secretarial Letter dated May 31, 2017, the Commission acknowledged receipt of the Application and advised that notice of its filing would be published in the *Pennsylvania Bulletin* on June 10, 2017. The Application was assigned Docket No. A-2017-2605434.

I&E filed a Notice of Appearance on June 9, 2017. OCA filed a Protest and Public Statement on June 9, 2017. On June 21, 2017, Limerick filed a Petition to Intervene in support of the Application.

Administrative Law Judge Steven K. Haas was assigned to preside over the matter. Evidentiary hearings were convened, as scheduled, on July 20 and 21, 2017 with Judge Haas presiding. Aqua, I&E, OCA and Limerick actively participated in the hearings.

By Recommended Decision dated September 18, 2017 (“Recommended Decision”), Judge Haas recommends that the Commission approve the Application, with certain conditions, and with a ratemaking rate base of \$64,373,378 for the acquired assets.¹

Aqua submits the following Exceptions to the Recommended Decision.²

¹ Recommended Decision, slip op. at 51.

² Pursuant to 52 Pa. Code Section 5.533, Aqua will incorporate into its Exceptions, by reference and citation, relevant pages of its previously filed Main and Reply Briefs.

II. EXCEPTIONS

EXCEPTION NO. 1 - RATE STABILIZATION PLAN RATE FREEZE

Aqua excepts to the recommendation that, as a condition for approval, the Commission retain the authority to allocate revenues, if appropriate, to Limerick Township customers in excess of the restrictions in the Asset Purchase Agreement and that Aqua and its shareholders bear all risk of a shortfall between revenues it is permitted to recover and costs it incurs with respect to the system. Recommended Decision, Section IV.E, pages 18 through 21, and Ordering Paragraph 3. Consistent with Section 1329(d)(1)(v), Aqua included, as Exhibit G to its Application, a tariff that establishes rates equal to the existing Limerick rates at the time of the acquisition. Consistent with Section 1329(d)(4) the tariff will remain in effect until new rates are approved by the Commission in a base rate proceeding. The Commission should not include the proposed condition in its final order.

The APA includes a three year “rate freeze,” which provides that Limerick customers will be charged the existing Limerick rates for a period of not less than three years. Consistent with the rate freeze and Section 1329(d)(1)(v), Aqua included, as Exhibit G to its Application, a tariff that establishes rates equal to the existing Limerick rates at the time of the acquisition.³ While the APA includes a three year rate freeze, there is no provision within the APA that provides for a limitation on rate increases.⁴

Addressing concerns raised by the OCA about the potential impact of the rate freeze on existing Aqua customers, the Recommended Decision proposes the following condition if the Commission approves the Application:⁵

That the Commission retains the authority to allocate revenues, if appropriate to the Limerick Township customers that are in excess of the restrictions outlined in the Asset Purchase Agreement. Aqua Pennsylvania Wastewater, Inc. and its shareholders should bear all risk of a shortfall between the revenues it is permitted to recover under its Asset Purchase Agreement with Limerick Township and the costs that Aqua Pennsylvania Wastewater, Inc. incurs with respect to the acquired system. To the extent

³ Aqua Exhibit No. 1, Exhibit G – Draft of Schedule of Rates Tariff Page.

⁴ Aqua St. No. 1 at 6.

⁵ Rec. Dec., slip op., Ordering Paragraph 3.

that Aqua Pennsylvania Wastewater, Inc. is unwilling or unable to charge costs in excess of the limitations provided in the Asset Purchase Agreement, the excess costs should be borne by its shareholders and not spread to other ratepayers.

The proposed condition assumes that the Commission, at some future time within the three year rate freeze period, approves rates for Limerick customers that are different from the contract rates agreed to by Aqua and Limerick in the APA. The proposed condition is not reflective of any existing or proposed tariff circumstances. It is only through speculation that a scenario is created where the approved rates for Limerick customers might differ from the contract rates.

More significantly, the proposed condition attempts to address ratemaking concerns. Such concerns are routinely reserved for adjudication in a future base rate proceeding. In *Joint Application of Pennsylvania-American Water Company and the Sewer Authority of the City of Scranton*, Docket No. A-2016-2537209, Opinion and Order entered October 19, 2016, slip op. page 50, the Commission held as follows:

As to the concerns raised by I&E and the OCA regarding the alleged detriments of the acquisition to PAWC's existing customers, we note that these concerns center on the potential rate effects of the acquisition. However, we are not in a position to thoroughly adjudicate ratemaking issues relating to the acquisition in this proceeding. Nor do we find that this acquisition proceeding is the appropriate context for addressing these rate issues. The record does not contain sufficient evidence to allow us to evaluate the specific effects of the acquisition on PAWC's revenue requirement or to decide cost allocation and rate design matters. Such issues are better reserved for a future base rate proceeding.

Aqua acknowledges that the Commission maintains the authority to set rates in Aqua's next base rate case.⁶ Aqua witness Packer testified that nothing that Aqua has proposed in this application proceeding is binding on the ratemaking authority of the Commission or limiting on

⁶ Aqua St. No. 1 at 6.

the Commission's ability to set rates.⁷ Potential rate effects, in other words, are reserved for a future base rate proceeding just as they were reserved for a future base rate proceeding in *Scranton Sewer Authority*.

Aqua's Exception No. 1 should be granted. The Commission should not include the proposed condition for approval in its final order.

EXCEPTION NO. 2 - RATE STABILIZATION PLAN
REGULATORY ASSET TREATMENT

Aqua excepts to the denial of its proposal to split the \$75.1 million ratemaking rate base into an initial rate base of \$60 million and a regulatory asset of \$15.1 million. Recommended Decision, Section IV.E.1, pages 21 and 22, and Conclusion of Law 13. Aqua's rate stabilization plan, including the use of a regulatory asset, is permitted, reasonable, and, ultimately, beneficial to customers. The plan should be fully vetted and reviewed in the Company's next base rate case.

Along with its proposed tariff implementing current Limerick rates, Aqua presented a rate stabilization plan in Exhibit D to Aqua Statement No. 1. The plan proposes to split the Section 1329 ratemaking rate base of \$75,100,000 into two parts: (1) a ratemaking initial rate base of \$60,000,000 and (2) a \$15,100,000 regulatory asset.⁸

Two calculations of the potential rate impact on existing customers of the splitting of the ratemaking rate base and creation of the regulatory asset are presented in Exhibit D:⁹

- a. The first calculation assumes a rate filing in year two, midway through the three year rate freeze period. The rate stabilization plan demonstrates that the Limerick system would need an approximate revenue increase of \$6,300,000 above anticipated revenues of \$4,800,000 in year two. If included in the context of a

⁷ Aqua St. No. 1R at 8.

⁸ The regulatory asset will be gradually transferred into rate base over approximately 7.2 years (\$15.1M / \$2.1M = 7.2 years) based on a composite depreciation rate of 3.5% (\$2.1M = \$60M x 3.5% composite depreciation rate). The portion of the regulatory asset recognized as rate base would then be amortized into income at the same rate as the rate base, which would begin after the first base rate case. Subsequent additions to the regulatory asset would not begin amortizing until the next base rate case. Aqua St. No. 1 at 5, 13 and 15 – 16.

⁹ Aqua St. No. 1 at 16.

consolidated rate filing, these costs would be spread amongst the Company's existing sewer and water customers. On a consolidated basis, the monthly cost impact on customers is \$1.16.

- b. The second calculation assumes increases in customers, operating expenses, and a projected gradually increasing rate base to year seven. It, also, assumes rates for Limerick customers of \$70 per month. Exhibit D shows that an approximate \$6,650,000 rate increase for the Limerick system would be required above present revenues of \$5,500,000, of which \$4,650,000 would be applied to Limerick customers in order to arrive at an approximately \$70 per month residential sewer bill. This would leave approximately \$2,000,000 of revenue requirement to be spread amongst the Company's existing sewer and water customers, as part of a consolidated base rate case. On a consolidated basis, the monthly cost impact on customers is \$0.37.

The rate stabilization plan is based on extremely conservative assumptions (a continuing rate for Limerick customers of \$70 per month and no further growth in customers beyond Year 10). Even under these assumptions, a "cross-over" occurs, with the rate impact on existing customers "going the other way," *i.e., benefitting existing customers*, as early as Year 15/16, not a long period of time in the utility world. With less conservative assumptions (additional customer growth and additional rate increases to Limerick customers within the first ten years), the "cross-over" point, *i.e., the benefit to existing customers*, easily occurs by Year 10 – within the Year 7/8 time frame.¹⁰

In its Final Implementation Order at M-2016-2543193, the Commission explained that "rate stabilization plans will be subject to review in each rate case for reasonableness and should not place long term burdens on the acquiring utility's existing ratepayers."¹¹ A rate stabilization plan, thus, is simply a proposal. The Company believes that the proposal reflected in Exhibit D is a reasonable approach to address rate stabilization for its customers.¹²

¹⁰ Tr. 22 through 25.

¹¹ Aqua St. No. 1 at 13; *See also* Rec. Dec., Section IV.E.

¹² Aqua St. No. 1 at 16 – 17.

The Recommended Decision denies the splitting of the ratemaking rate base and the creation of the regulatory asset. Citing the positions of I&E and the OCA, the Recommended Decision concludes that the proposal should not be approved “at this time;” that there is no provision in Section 1329 for splitting the ratemaking rate base; and that Aqua’s regulatory asset proposal is atypical.¹³

Aqua submits, however, that regulatory assets have a great deal of flexibility in their use and, in this case, the Company’s proposal is reasonable and permitted. While typically used as a recovery mechanism of expenses over future periods, regulatory assets have been included as a component of rate base. The Company, for example, has regulatory assets in rate base today, such as its FAS109 – Unfunded Deferred Income Taxes and FAS 143 – Net Negative Salvage.¹⁴

The proposed regulatory asset is not contrary to Section 1329 as suggested in the Recommended Decision. The regulatory asset is, once again, simply a proposal. Any further questions about it can be fully vetted in Aqua’s next base rate case.¹⁵

If approved by the Commission in a future base rate proceeding, the rate stabilization plan would result in a delayed recovery of the portion of the ratemaking rate base attributed to the regulatory asset.¹⁶ The delay in rate base recognition benefits customers as it lowers the cost of service.¹⁷ With reasonable assumptions as set forth above, the “cross-over” point, *i.e.*, *the benefit to existing customers*, easily occurs by Year 10 – within the Year 7/8 time frame.¹⁸

¹³ Rec. Dec., Section IV.E.1.

¹⁴ Aqua St. No. 1R at 4 and 17.

¹⁵ Aqua St. No. 1R at 17.

¹⁶ If the rate stabilization plan were approved in its next base rate case, Aqua would record a regulatory asset of \$15,100,000 on its balance sheet (not an “unspecified” account off the balance sheet as Ms. Maurer contends). The remaining portion, \$60,000,000, would be recorded as net utility plant and Aqua would begin depreciating it upon closing. The Company would forgo the carry cost on the unamortized portion of the regulatory asset until such time as the portion is recognized in a subsequent base rate case and amortization on it begins. Aqua St. No. 1R at 17.

¹⁷ Aqua St. No. 1R at 4 and 5.

¹⁸ Tr. 22 through Tr. 25.

Aqua's Exception No. 2 should be granted. The rate stabilization plan, which includes a splitting of the ratemaking rate base is permitted, reasonable, and, ultimately, beneficial to customers. The plan should be fully vetted and reviewed in the Company's next base rate case.

EXCEPTION NO. 3 - **RATE BASE VALUATION**
ABILITY TO CHALLENGE FAIR MARKET VALUE
APPRAISALS

Aqua excepts to the conclusion that review and analysis by the Commission and other parties of the UVE fair market value appraisals was intended by the General Assembly to protect the public interest. Recommended Decision, Section IV.F.1, pages 23-26. The General Assembly did not intend for fair market valuation to be a matter of traditional litigation. It, instead, created a new paradigm for Section 1329 proceedings where the acquiring utility and the selling municipality agree to use Section 1329 procedures with consumer protections built into the statute. Fair market value is determined by the UVEs. The statutory wording must be followed. The Recommended Decision must be reversed.

The Recommended Decision considers Section 1329 and concludes that it is appropriate to allow other parties to question the fair market value appraisals of the Utility Valuation Experts ("UVE") and the proposed rate base value of the acquired assets and to submit evidence and develop a record in support of their respective positions. This conclusion is contrary to clear and unambiguous statutory language and must be reversed.

The Statutory Construction Act of 1972 explains that "[t]he object of all interpretation and construction of statutes is to ascertain and effectuate the intention of the General Assembly."¹⁹ In order to ascertain the intent of the General Assembly, the ruling body should first look at the plain language of the statute.²⁰ When the language of the statute is free from all ambiguity, the letter of the statute is to be followed.²¹

¹⁹ 1 Pa. C.S. § 1921(a).

²⁰ *Commonwealth v. Segida*, 985 A.2d 871, 874 (Pa. 2009).

²¹ 1 Pa. C.S. § 1921(b).

Through Section 1329, the General Assembly enacted a “procedure” that “shall be used to determine the fair market value of the selling utility.”²² The procedure certainly does not eliminate Commission jurisdiction. However, it does provide a process and formula that *must* be used to determine the ratemaking rate base of the selling municipality when the acquiring utility and the selling municipality agree to the procedure. Because appraisals can and will likely vary to some degree, the General Assembly required that the two appraisals be averaged so that any variations or outliers be averaged together and then compared to the purchase price.

In respect to the determination of fair market value, the legislation directs as follows:

Two utility valuation experts shall perform two separate appraisals of the selling utility for the purpose of establishing its fair market value.²³

The legislated “procedure” is clear and unambiguous, requiring the efforts of *only* the UVEs “for the purpose of establishing fair market value.” Having directed that only the UVEs establish fair market value, the General Assembly then directed the method for its determination – requiring that fair market value appraisals be conducted “*in compliance with the Uniform Standards of Professional Appraisal Practice, employing the cost, market and income approaches.*”²⁴ Ratemaking rate base, again, by legislative directive, is then the lesser of the negotiated purchase price and the fair market value of the selling utility.²⁵

The Recommended Decision concludes, however, that other parties and the Commission must be allowed to review and analyze the UVE fair market appraisals to insure that the public interest is protected. Ultimately, however, it is the General Assembly that protects the public interest and legislates the procedures for doing so. Here, in a limited, subtype of transactions involving acquiring public utilities and selling municipalities, the General Assembly has

²² Section 1329(a).

²³ Section 1329(a)(2).

²⁴ Section 1329(a)(3) (emphasis added).

²⁵ Section 1329(c).

legislated a procedure involving UVEs, two appraisals and the Uniform Standards of Professional Appraisal Practice (“USPAP”).²⁶

The General Assembly acted entirely within its legislative purview by enacting the statute and legislating a *procedure*. Allowing review, analysis, debate and traditional litigation of the fair market value appraisals and the work product of the UVEs is precisely what the General Assembly sought to avoid with Section 1329. In lieu of traditional debate and additional costs of additional expert witnesses by the statutory advocates, the legislation required the two independent appraisals.

The Commission reviews and approves entities to serve as UVEs.²⁷ Therefore the UVEs have already proven the necessary technical licensure, expertise and experience. This is the safe guard built into the process to ensure the UVEs are able to make professional judgments and assumptions necessary to provide an analysis using USPAP standards. Witnesses hired by other parties, such as the OCA in this proceeding, do not have the same licensure, qualifications and experience.

Recognizing that appraisals can and will likely vary to some degree, the legislation required that the two appraisals be averaged so that any variations or outliers be averaged together and then compared to the purchase price. The Statutory Construction Act and established case law precedent require that the Commission implement the clear and unambiguous, express language of Section 1329, which is “phrased in mandatory terms.”²⁸

To be clear, we are not suggesting that the Commission is without jurisdiction. The Commission, for example, consistent with the statutory language, could review the appraisals to be sure that they comply with USPAP employing the cost, market and income approaches. We,

²⁶ Section 1329(a).

²⁷ See Rec. Dec., slip op. at 14.

²⁸ See also Aqua Main Brief, Section V.B and the statutory law and case law cited therein.

however, are contending that the Commission's jurisdiction is limited. Thus, where, as here, the presiding administrative law judge has determined that the appraisals were performed in compliance with USPAP employing the three approaches²⁹ the inquiry must end. The Commission has no jurisdiction to consider other approaches or adjustments proposed by other parties.

Aqua's Exception No. 3 should be granted. The Recommended Decision must be reversed as it is contrary to clear and unambiguous statutory language phrased in mandatory terms. Through Section 1329, the General Assembly created a new paradigm where the acquiring utility and the selling municipality agree to use the Section 1329 procedures. With carefully crafted and clear statutory wording phrased in mandatory terms, the General Assembly made it clear that fair market value is determined by the UVEs.³⁰ The statutory wording must be followed.

EXCEPTION NO. 4 - **RATE BASE VALUATION**
APPROVAL OF RATE BASE VALUE

Aqua excepts to the adjusting of the HRG fair market value appraisal based on testimony of OCA witnesses Everette and Watkins; to the recommended ratemaking rate base of \$64,373,378; and to the conclusion that ratemaking rate base of \$75,100,000 is not reasonable or in the public interest. Recommended Decision, Section IV.F.2; Ordering Paragraph 4; and Conclusion of Law 12. The adjusting of the HRG appraisal is not in compliance with USPAP, contrary to clear and unambiguous statutory language and contrary to the evidence of record. The ratemaking rate base of the acquired Limerick assets, based on the fair market value appraisals of the UVEs and the application of Section 1329(c)(2), is \$75,100,000.

After concluding that Section 1329 does not preclude other parties from reviewing and analyzing the UVE fair market value appraisals, the Recommended Decision conducts an

²⁹ Rec. Dec., Finding of Fact 52.

³⁰ 66 Pa. C.S. § 1329(a)(1).

analysis of the appraisals and adopts five OCA adjustments to the HRG income approach, three adjustments to the HRG cost approach and one adjustment to the HRG market approach.³¹ The conclusion and adjustment of the HRG appraisal are contrary to clear and unambiguous statutory language and must be given no weight for all the reasons presented above in Exception No. 3.³²

There is simply no legislated authorization within the carefully crafted and clear statutory language for the Commission to adjust the fair market value appraisal of a qualified UVE based on proposals from the OCA. Ratemaking rate base is determined by two separate UVE appraisals performed in compliance with USPAP, employing the cost, market and income approaches.³³ Once the UVEs have concluded their respective analysis, the ratemaking rate base is the formulaic lesser of the negotiated purchase price and the average of the fair market value appraisals.³⁴

The Recommended Decision, however, is not based on a calculated average of the fair market value appraisals. Instead, as presented in Table 4, page 31, the Recommended Decision is based on a calculated average that includes an appraisal *with OCA adjustments*, the end result being a recommended ratemaking rate base of \$64,373,378. This recommendation is more than \$10,000,000 less than ratemaking rate base based on the clear and unambiguous statutory language. It is contrary to statute and must be given no weight.

In addition to being contrary to clear and unambiguous statutory language, the OCA ratemaking rate base adjustments adopted by the Recommended Decision are not supported by

³¹ Rec. Dec., Section IV.F.2. Judge Haas does not recommend any adjustments to the Gannett fair market value appraisal. See Rec. Dec., slip op. Table 1 – Original Appraisals and Table 4 – Appraisals with Commission’s Accepted Adjustments.

³² Although the Recommended Decision in Section IV.F.2 adopts several OCA adjustments to the HRG appraisal, it appropriately finds in Finding of Fact 52 that the HRG fair market value appraisal and the Gannett fair market value appraisal were performed in compliance with the Uniform Standards of Professional Appraisal Practice using the cost, market and income approaches.

³³ Section 1329(a)(2) and (a)(3).

³⁴ Section 1329(c).

competent evidence. Section 1329(a)(3) requires that fair market valuation be determined in compliance with USPAP. The appraisal criticisms of OCA witnesses Everette and Watkins, which are the bases for the adjustments recommended by Judge Haas, are not based on USPAP but rather are based on the “just and reasonable” ratemaking standard found in Section 1301 of the Public Utility Code.³⁵

The testimony of OCA witness Everette testimony is clear. Ms. Everette specifically asks that the Commission consider the “just and reasonable” ratemaking standard in determining the outcome of this case.³⁶ She does not ask the Commission to consider USPAP. Ms. Vicari of HRG challenged the OCA’s attempt to depart from the USPAP standard:³⁷

“ ... The UVE is required to perform an appraisal to arrive at the Fair Market Value (FMV) of the System while considering three different approaches: Cost, Market, and Income. HRG’s Market Value Approach was lower than the other UVE’s, yet no adjustment was recommended to the other UVE’s analysis. It seems that the OCA’s approach is purely from a future rate making perspective and not a Fair Market Value perspective as called for in Section 1329 of the Code. The proposed adjustments to HRG’s Fair Market Value seems more related to lowering the ‘average’ appraisal than for ascertaining Fair Market Value of the Limerick Township System, which appears to be inconsistent with the intent of the legislation as it applies to the sale of municipal and authority water and wastewater systems.

The testimony of OCA witness Watkin is, likewise, clear. Mr. Watkins was not engaged to address fair market valuation in compliance with USPAP. The service agreement between the OCA and Mr. Watkins, which was admitted into the record as Aqua Cross Examination No. 1, makes no reference to, or mention of, USPAP.³⁸ The OCA stipulated that its service agreement with Mr. Watkins does not reference USPAP.³⁹

The valuation criticisms of OCA witnesses Everette and Watkins, which, once again, are

³⁵ 66 Pa. C.S. § 1301.

³⁶ OCA St. No. 1 at 18; *also see* Tr. 133.

³⁷ Aqua St. No. 4R at 2.

³⁸ Tr. 91 – 95.

³⁹ Tr. 95.

the bases for the adjustments recommended by Judge Haas, are *not based on USPAP* and, therefore, are neither relevant nor material to the determination of fair market value in *compliance with USPAP*. The adjustments to the HRG appraisal adopted in the Recommended Decision, which are based entirely on the testimony of the OCA witnesses, are entitled to no weight.

Ultimately, in their analyses of the HRG Appraisal, the OCA witnesses did no more than selectively choose appraisal “inputs” that are to their liking while jettisoning those “inputs” that are not. This is exactly what the General Assembly meant to avoid with the prescriptive procedure of averaging the appraisal performed by the two qualified UVEs.

While we offer the following exception to the HRG appraisal adjustments presented in the Recommended Decision, we submit that the exception is unnecessary inasmuch as the adjustments are contrary to statutory law and the procedures enacted by the General Assembly as set forth above and should be rejected on that basis without further consideration.

A. Income Approach

The Recommended Decision adopts five adjustments to the HRG income approach. Four adjustments relate to the DCF analysis within the income approach. The fifth adjustment disregards the HRG rate of return/rate base analysis. The HRG appraisal result under the income approach is \$77,855,000. The Recommended Decision adjusts the HRG appraisal result to \$36,560,000. The adjusted result of \$36,560,000 is \$10,000,000 less than the depreciated original cost value of \$46,153,867 and, thus, seemingly, unreasonable on its face.

1. Adjustments One and Two – Income Tax Expenses and Discount Rate

The Recommended Decision accepts two OCA adjustments to the HRG DCF analysis. The first adjustment is to the calculation of income taxes in the HRG DCF analysis. The second

adjustment is to the discount rate used in the analysis. HRG used a discount rate of 2.5%. The Recommended Decision adopts a discount rate of 6.97%, which it describes as reflective of the true cost of capital.⁴⁰ Both adjustments are based on OCA proposals. Neither adjustment is appropriate.

The adjustments to incomes taxes accepted in the Recommended Decision would necessarily result in concomitant adjustments to the revenue requirement used in the HRG DCF analysis. Ms. Vicari of HRG emphasized the need to make these concomitant adjustments in response to the testimony of OCA witness Watkins.⁴¹ To the extent that taxes increase, the revenue requirement increases. A regulated utility is permitted to recover the full cost of rendering utility service. The assumed rate increases would correspondingly increase, resulting in a greater income value. The Recommended Decision makes no allowance for any necessary, concomitant rate allowances as a result of its recommended changes to income tax rates.

Turning to the recommended discount rate of 6.97%, Ms. Vicari explained that it has been some time since Aqua's most recent rate case. At the time of that rate case, several years ago, a rate of return based on the revenue, expenses depreciation and rate base was authorized. Since that time, however, there have been changes in revenues, expenses and utility plant investment. For example, during the year 2015, utility plant in service increased by \$18,152,894, an increase in the return that will not be reflected in rate base until the next general rate increase.⁴²

The recommended discount rate of 6.97% is overstated in that it fails to reflect the foregoing changes in utility plant additions and other changes that have occurred since the prior Aqua rate filing. In effect, these changes, if reflected, would result in a lower rate of return and a

⁴⁰ Rec. Dec., slip op. at 32.

⁴¹ Aqua St. No. 4R at 13 – 14.

⁴² Aqua St. No. 4R at 13.

lower discount factor. Obviously, the discount factor should be based on conditions that currently prevail, not conditions at the time of the prior rate filing.⁴³ While the Recommended Decision increases the discount rate to a rate case level, it makes no estimate of, and no allowance for, erosion of return.⁴⁴

The Commission should decline to adopt the OCA's proposed adjustments to income taxes and the discount rate in the HRG DCF analysis within the income approach.

2. **Adjustments Three and Four – HRG “Going Value” Adder and Provision for Erosion of Cash Flow**

The Recommended Decision removes HRG's “going value” adder of \$4,000,000 from the HRG income approach.⁴⁵ The Recommended Decision, which adopts OCA assertions, is based on a misunderstanding of the adder and its purpose.

The “going value” adder represents the costs incurred by Limerick when Limerick began operations – start-up costs, in other words, that are appropriately included in a fair market value appraisal and for which Limerick Township should receive compensation.⁴⁶ It is not an estimate of expected working capital requirements as suggested in the Recommended Decision but, rather, a calculation of the working capital already expended by the municipality to become operational.⁴⁷

In support of the adder, Ms. Vicari explained that, in her experience as a professional engineer, a significant amount of funds is needed to get a system up and going. The expenditure of those funds is part of the value of the system for which Limerick Township should be

⁴³ Aqua St. No. 4R at 16.

⁴⁴ Aqua St. No. 4R at 13.

⁴⁵ Rec. Dec., slip op. at 32.

⁴⁶ Aqua St. No. 4R at 14.

⁴⁷ Aqua Reply Brief at 22 and 23.

compensated.⁴⁸ The evidence of record supports the inclusion of the “going value” adder in the HRG income approach to fair market value.

The Recommended Decision also removes the provision for erosion of cash flow between rate cases included by HRG in its income approach to value. The provision is a *negative* \$300,000 and, thus, as applied by HRG, is a reduction to fair market value.⁴⁹ Contrary to the Recommended Decision, erosion of cash flow is reasonably expected to occur between rate cases. The evidence of record supports the provision for erosion of cash flow included in the HRG income approach to fair market value.

The Commission should decline to adopt the OCA’s proposed removal of the going value adder and of the provision for erosion of cash flow from the HRG DCF analysis within the income approach.

3. Adjustment Five – Disregarding the HRG Rate of Return/Rate Base Analysis

HRG included a rate of return/rate base present value analysis within its income approach. The analysis estimated value at \$100,690,000, which HRG averaged with its DCF estimate of \$55,020,000 to produce an estimated fair market value – income approach of \$77,855,00.⁵⁰ The Recommended Decision accepts an OCA adjustment disregarding the rate of return/rate base analysis in its entirety because of alleged flaws and unreasonable assumptions in the HRG analysis.⁵¹

HRG’s use of reproduction cost new instead of original cost in its present value analysis is neither a flaw nor is it unreasonable. As explained by Ms. Vicari, while traditional rate

⁴⁸ Aqua St. No. 4R at 14. The OCA’s characterization of the going value adder as an “additional” working capital requirement “resulting from the acquisition” is inaccurate. Ms. Vicari’s rebuttal testimony explains that her use of the phrase working capital was in reference to the working capital needed to get a municipality to the point where it is operational without loss. Tr. 65 and 66.

⁴⁹ Aqua Exhibit No. 1, Exhibit R, Schedule F.

⁵⁰ Aqua Exhibit No. 1, Exhibit R, at 10 and 11.

⁵¹ Rec. Dec., slip op. at 33 and 34.

making is based on original cost, Section 1329 departs from traditional ratemaking practices – “fair market valuation is not tied to the original cost of construction minus accumulated depreciation.” HRG’s use of reproduction cost new is entirely consistent with the fair market value objectives of the legislation.⁵²

HRG also included an estimated rate of return of 7.5% in its present value analysis. Although it characterized the rate as “unsupported,” the Recommended Decision concludes that the OCA demonstrated that 6.97% is an appropriate cost of capital. The similarity between the two rates does not seem to be sufficiently different to warrant disregarding the HRG analysis and is neither a flaw nor unreasonable.

The Recommended Decision again cites the OCA’s criticism of HRG’s use of a discount rate of 2.5%. As pointed out above, however, Ms. Vicari explained that it has been some time since Aqua’s most recent rate case. At the time of that rate case, several years ago, a rate of return based on the revenue, expenses depreciation and rate base was authorized. Since that time, however, there have been changes in revenues, expenses and utility plant investment. OCA witness Watkins failed to account for these changes in his criticism of the HRG present value analysis.⁵³

Finally, HRG estimated annual and accumulated depreciation expense based on reproduction cost new. The estimation of depreciation components based on reproduction cost is consistent with HRG’s use of reproduction cost new for developing rate base and is neither a flaw nor is it unreasonable. While traditional rate making is based on original cost, Section 1329 departs from traditional ratemaking practices – “fair market valuation is not tied to the original

⁵² Aqua St. No. 4R at 16 and 17.

⁵³ Aqua St. No. 4R at 13 and 17.

cost of construction minus accumulated depreciation.” HRG’s use of reproduction cost new is entirely consistent with the fair market value objectives of the legislation.⁵⁴

The Commission should give full weight and consideration to the HRG rate of return/rate base present value analysis and decline to adopt the OCA’s proposed disregarding of the analysis.

B. Cost Approach

The Recommended Decision adopts three adjustments to the HRG cost approach. The HRG appraisal result under the cost approach is \$90,050,000. The Recommended Decision adjusts the HRG appraisal result to \$62,321,571.

1. HRG Reproduction Cost

The Recommended Decision agrees with an OCA argument that HRG did not establish a reasonable basis for separately valuing collector mains and decreases reproduction cost by \$19,195,429.⁵⁵

HRG used the ENR Construction Cost Index as an indicator of general inflation in order to determine an approximate Reproduction Cost for all plant items with the exception of collection system mains. Collection system mains were treated as a special circumstance because the original cost for those mains was significantly understated.

More specifically, as explained by Ms. Vicari of HRG, the original cost of gravity collection sewer mains, which totaled 355,000 linear feet, is \$15,213,236 or \$42.85 per linear foot. This is a very low number compared with historical construction costs and not at all in-line with current industry unit costs for collection system main construction.⁵⁶

⁵⁴ Aqua St. No. 4R at 16 and 17.

⁵⁵ Rec. Dec., slip op. at 36 and 37.

⁵⁶ Aqua St. No. 4R at 8. HRG believes that the low unit price in the asset listing is because the cost does not include the value of the mains in residential subdivisions that were contributed. Units included in the asset

To arrive at an appropriate reproduction cost value for collection system mains, HRG developed a profile of 2016 construction costs for sewer mains of various sizes installed in the Montgomery County and Chester County area. These *actual* costs for projects in the same general vicinity as Limerick are more representative than an index that produces an aberrational low cost.⁵⁷

Contrary to the Recommended Decision, the evidence of record presents an entirely reasonable explanation of why HRG chose to treat collection system mains as a special circumstance in the cost approach to valuation. The Commission should decline to adopt the OCA's proposed adjustment to the HRG valuation of collector mains within the cost approach.

2. Inclusion of Future Capital Projects

The Recommended Decision agrees with an OCA argument and removes \$4,500,000 of future capital projects from the HRG cost approach to value.⁵⁸ Although the Recommended Decision adopts the OCA's adjustment here, it rejects the very same OCA adjustment in its discussion of the market approach to value.⁵⁹

USPAP and the Final Implementation Order *require* consideration of future capital improvements in the Fair Market Value Appraisal.⁶⁰ In its discussion of HRG's treatment of future capital improvements in the market approach to value, the Recommended Decision appropriately recognizes that the listing of Limerick assets prepared by Pennoni Engineers identified \$4,533,000 in capital improvements planned by Limerick.⁶¹

listing were obtained from drawings and system maps and included contributed mains. Contributed mains are part of the transaction and have value which is why HRG chose an appropriate methodology for including them in the reproduction approach. Aqua St. No. 4R at 8.

⁵⁷ Aqua St. No. 4R at 8.

⁵⁸ Rec. Dec., slip op. at 37.

⁵⁹ Rec. Dec., slip op. at 39.

⁶⁰ Tr. 61.

⁶¹ Rec. Dec., slip op. at 39.

Future facilities are an integral part of the acquisition and needed to allow for future growth and additional revenue. It is reasonable to consider that, insofar as such improvements are not paid by Limerick, these capital improvements are a real cost to be borne by the acquiring entity and may be considered as part of the compensation. The failure to recognize future facilities would understate fair market value and the HRG appraisal.⁶²

The evidence of record and the Recommended Decision support the inclusion of future capital projects in the HRG cost approach to fair market value. The evidence and rationale that supports the inclusion of future capital projects in the HRG market approach support the inclusion of future capital projects in the HRG cost approach.

The Commission should decline to adopt the OCA's proposed adjustment removing future capital projects from the HRG cost approach.

3. HRG "Going Value" Adder

As it did with the HRG income approach to value, the Recommended Decision removes HRG's "going value" adder of \$4,000,000 from the HRG cost approach.⁶³ The Recommended Decision, which adopts OCA assertions, is based on a misunderstanding of the adder and its purpose as explained above in the discussion of the income approach to value. The "going value" adder is not illogical. It represents the costs associated with forming the entity. It is not, as suggested in the Recommended Decision, a marketing cost to acquire customers.

The "going value" adder represents the costs incurred by Limerick when Limerick began operations – start-up costs, in other words, that are appropriately included in a fair market value appraisal and for which Limerick Township should receive compensation.⁶⁴ The adder represents funds already spent – funds needed to get a system up and going. Limerick Township

⁶² Tr. 60 and 61.

⁶³ Rec. Dec., slip op. at 32.

⁶⁴ Aqua St. No. 4R at 14.

should be compensated for that going value.⁶⁵ The evidence of record supports the inclusion of the “going value” adder in the HRG cost approach to fair market value.

The Commission should decline to adopt the OCA’s proposed removal of the going value adder from the HRG cost approach.

C. Market Approach

The Recommended Decision adopts one adjustment to the HRG market approach to value. The HRG appraisal result under the market approach is \$62,760,000. The Recommended Decision adjusts the HRG appraisal result to \$47,064,553.

1. Projected Customers

The Recommended Decision agrees with an OCA argument that HRG’s use of a projected customer count of 7,246 customers is not appropriate. The Recommended Decision concludes that the customer count that should be used in the market approach to value is the current, actual customer count of 5,434.⁶⁶

USPAP *requires* consideration of customer growth in the Fair Market Value Appraisal. Customer growth is relevant because, not only does Aqua acquire the physical assets, the customer base, all related utility property and a franchise area, but also benefits from an ongoing mandatory connection ordinance. All future development that can be served by the System *must* connect to it or violate the Limerick Township ordinance.⁶⁷ Furthermore, while the Township is

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

⁶⁶ Rec. Dec., slip op. at 38 and 39.

⁶⁷ Aqua St. No. 4R at 5 and 6 and Tr. 62 and 63.

presently billing approximately 7,300 Equivalent Dwelling Units (“EDUs”), there are approximately 8,400 EDUs already purchased.⁶⁸

The Commission should decline to adopt the OCA’s proposed removal of projected customer count from the HRG market approach.

D. Conclusion

Aqua’s Exception No. 4 should be granted. The adjustments to ratemaking rate base presented in the Recommended Decision are contrary to clear and unambiguous statutory language, contrary to the fair market value appraisals of the UVEs and not supported by competent evidence. As presented in Table 1 of the Recommended Decision, the UVE appraisal values are:

Gannett	Value	HRG	Value
Income	\$75,204,407	Income	77,855,000
Cost	\$86,086,756	Cost	\$90,050,000
Market	\$79,002,980	Market	\$62,760,000
Recommendation	\$80,098,000	Recommendation	\$76,890,000

Gannett’s fair market value appraisal is \$80,098,000. HRG’s fair market value appraisal is \$76,890,000. The average of the two is \$78,494,000. As directed by the General Assembly in Section 1329(d)(1)(iii), the ratemaking rate base determined pursuant to Section 1329(c)(2) is \$75,100,000, being the lesser of the negotiated purchase price of \$75,100,000 and the average of \$78,494,000.

⁶⁸ Aqua St. No. 1 at 10.

EXCEPTION NO. 5 - 66 Pa. C.S. § 507 APPROVALS

The Recommended Decision requires Aqua to file all relevant municipal agreements it is assuming within 20 days of the entry of a final Opinion and Order. Recommended Decision, Section IV.J, page 50. Aqua can file the municipal agreements within 20 days of the entry of the final Opinion and Order. It could also file forms of the assignment agreements, but not the executed agreements, within 20 days.

The Recommended Decision requires Aqua to file all relevant municipal agreements it is assuming within 20 days of the entry of a final Opinion and Order.⁶⁹ Aqua can file the municipal agreements it is assuming within 20 days of the entry of the final Opinion and Order and, thus, does not except to this directive. If the Commission concludes that the assignment agreements also must be filed, Aqua, as a matter of administrative efficiency, can file the executed agreements after closing under separate “U” dockets⁷⁰ as was directed by the Commission in *Scranton Sewer Authority*.⁷¹

EXCEPTION NO. 6 - SEPARATE COST OF SERVICE STUDY

The Recommended Decision requires Aqua, at the time of filing of its next base rate case, to submit a cost of service study or analysis that separates the costs, capital and operating expenses of providing wastewater service to the customers of Limerick Township, as a separate class. Recommended Decision, Section IV.G, page 47, and Ordering Paragraph 2. Aqua will provide a separate cost of service study if directed by the Commission. Aqua asks that the Commission make it clear that the study is required in the first base rate case in which Aqua includes the Limerick system.

The Recommended Decision requires Aqua, at the time of filing of its next base rate case, to submit a cost of service study or analysis that separates the costs, capital and operating expenses of providing wastewater service to the customers of Limerick Township, as a separate

⁶⁹ Rec. Dec., Section IV.J.

⁷⁰ See Aqua Reply Brief, Section III.A.4.

⁷¹ See Rec. Dec., slip op. at 50.

class.⁷² Aqua does not except to this directive and will provide a separate cost of service study if the Commission requires Aqua to file the study.⁷³ Aqua asks that the Commission make it clear that the study is required in the first base rate case in which Aqua includes the Limerick system.

⁷² Rec. Dec., Section IV.G, page 47, and Ordering Paragraph 2.

⁷³ See Aqua Reply Brief, Section II.A.1.

III. CONCLUSION

The Public Utility Commission should grant Aqua's Exceptions and modify the Recommended Decision as aforesaid, approve Aqua's Application filed pursuant to Section 1102 and 1329 of the Public Utility Code, and:

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

Respectfully submitted,

AQUA PENNSYLVANIA WASTEWATER, INC.

By  _____

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Date: October 3, 2017

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

The Honorable Steven K. Haas, Presiding

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

CERTIFICATE OF SERVICE

I hereby certify that I have this 3rd day of October 2017, served a true and correct copy of the foregoing Exceptions of Aqua Pennsylvania Wastewater, Inc. upon the persons and in the manner set forth below:

VIA ELECTRONIC AND 1ST CLASS MAIL

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