COMMONWEALTH OF PENNSYLVANIA

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October 3, 2017

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Bldg.
400 North Street
Harrisburg, PA 17120

Re: 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
Docket No. A-2017-2605434

Dear Secretary Chiavetta:

Attached for electronic filing please find the Office of Consumer Advocate's Exceptions 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
cc: Honorable Steven K. Haas, ALJ
Office of Special Assistants (e-mail only: ra-OSA@pa.gov)
Certificate of Service

*240459

CERTIFICATE OF SERVICE

Re: Application of Aqua Pennsylvania Wastewater, Inc. pursuant to Sections 1102 and 1329 of the Public Utility Code for approval of the acquisition by Aqua of the wastewater system assets of Limerick Township	:	Docket No. A-2017-2605434

I hereby certify that I have this day served a true copy of the following document, the Office of Consumer Advocate's Exceptions, 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:

Dated this 3rd day of October, 2017.

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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	: : : : : :	Docket No. A-2017-26054734

EXCEPTIONS OF THE OFFICE OF CONSUMER ADVOCATE

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Dated: October 3, 2017

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I. INTRODUCTION

On December 15, 2016, Aqua Wastewater Pennsylvania, Inc. (Aqua) 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 acquisition of the wastewater system assets of Limerick Township, (2) the right to begin to offer, render, furnish, or supply wastewater service to the public in portions of Limerick Township, Montgomery County, Pennsylvania, and (3) an order approving the acquisition, including a ratemaking rate base pursuant to Section 1329(c)(2) of the Pennsylvania Public Utility Code. This is the second case to be filed under Section 1329.

The Office of Consumer Advocate (OCA) filed a Protest on June 9, 2017. In testimony, the OCA argued that the average appraisal amount under Section 1329 was overstated and Aqua had failed to meet the legal requirements of Section 1102. The OCA argued that, if affirmative public benefits were found, certain conditions should be imposed on the grant of the certificate of public convenience. The OCA also argued that, under Section 1329(d)(2), the proposed rate base valuation was overstated and should be reduced from $75,100,000 to $59,621,180. A comprehensive procedural history of the case is found in the OCA's Main Brief. OCA M.B. at 1-2.

On September 18, 2017, the Office of Administrative Law Judge issued the Recommended Decision (R.D.) of Administrative Law Judge (ALJ) Steven K. Haas. The ALJ found that the transaction provides sufficient affirmative public benefits under Section 1102 based on the Commission's Order in Application of Aqua Pennsylvania Wastewater, Docket No. A-2016-2580061 (June 29, 2017) *reconsideration pending* (July 20, 2017) (New Garden). The ALJ agreed with the majority of the OCA's adjustments to the appraisals, but declined to adopt

four of the OCA's recommendations. The ALJ recommended approval of Aqua's application and made adjustments to the ratemaking rate base, decreasing it to $64,373,378.

The OCA files these Exceptions on the basis that the ALJ erred in finding that the transaction provides affirmative public benefits, and that the ALJ erred in rejecting four of the OCA's appraisal value adjustments. As discussed in the OCA's Main Brief and Reply Brief, Aqua has not proven that the acquisition provides substantial, affirmative public benefits that outweigh harms to Aqua's existing customers and Limerick customers in the future.

With regard to the appraisal values, the inclusion of land in the reproduction cost analysis of Herbert, Rowland & Grubic, Inc.'s (HRG) Cost approach is not appropriate and the adder for future capital improvements should be removed from the purchase price value of HRG's Market approach. In addition, Gannett Fleming Valuation and Rate Consultant, LLC's (Gannett or GF) appraisal results should be reduced by $20.5 million due to biases in the DCF model with regard to the use of a terminal value and the calculation of discount rates. With these adjustments and those adopted by the ALJ, the ratemaking rate base under Section 1329 should be found to be $59,621,180.

If the Commission finds, however, that the transaction warrants approval, the OCA submits that it must condition its approval as set forth in the ALJ's recommended decision. The Commission must require the following: (1) Aqua shall 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, (2) 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 (APA), and (3) Aqua and its shareholders should bear all risks of a shortfall between revenues it is permitted to recover under the APA and the costs that Aqua incurs with respect to the acquired system; to the extent that

Aqua is unwilling or unable to charge costs in excess of the APA, the excess costs should be borne by its shareholders and not spread to other ratepayers. R.D. at 53.

II. EXCEPTIONS

A. Appraisal Adjustments - Introduction

The ALJ properly rejected Aqua's arguments that the appraisals could not be adjusted and found that the rate base of the acquired system for ratemaking purposes is $64,373,378. R.D. at 40. While the ALJ properly adopted the majority of the OCA's adjustments, he erred in not adopting the following OCA adjustments to HRG's appraisal results:

Cost Approach

1. Remove the inflation of the cost of land.

Market Approach

2. Remove the adder for future capital projects from the purchase price value.

R.D. at 37-39; OCA St. 1 at 17-18, 23; OCA Exhs. AEE-4, 5; OCA St. 1S at 13-14, 19.

The OCA also submits that the ALJ erred in not adopting the following OCA adjustments to Gannett's appraisal results:

Income Approach

3. Expand model used in DCF valuation from 13 to 50-years with no terminal value.

4. Use a municipal utility's and IOU's cost of capital to determine discount rates.

R.D. at 34-36; OCA St. 2 at 24-28; OCA Schs. GAW-5, 6, 7; OCA St. 2S at 8-10.

As discussed below, the OCA's adjustments are reasonable and should be adopted.

When these adjustments are made, in conjunction with the other OCA adjustments that the ALJ recommended be adopted, the resulting average of the appraisal results is $59,621,180. R.D. at 30-31. That amount is less than the purchase price and therefore should be used for ratemaking purposes. 66 Pa. C.S. § 1329(c).

Appraisals with the OCA's Recommended Adjustments	
HRG	**Gannett**
Income $36,560,000[1]	Income $54,735,000
Cost $61,565,412	Cost $86,086,756
Market $39,775,212	Market $79,002,980
Recommendation $45,966,875	Recommendation $73,275,485
Average: $59,621,180	

B. Appraisal Adjustments - Exceptions

OCA Exception No. 1: The ALJ Properly Adopted Most of the OCA's Adjustments to the HRG and Gannett Appraisal Valuations But Erred in Not Adopting the Removal of Land From HRG's Cost Approach. R.D. at 36-38; OCA M.B. at 15-18; OCA R.B. at 10-13.

Section 1329 lists three approaches that must be used by each utility valuation expert: the cost approach, the market approach, and the income approach. 66 Pa. C.S. § 1329(a)(3). After reviewing each appraisal report, OCA witness Everette recommended four adjustments be made to HRG's cost approach results. OCA St. 1 at 24-28. The ALJ adopted three of those adjustments but did not adopt a fourth adjustment to remove land from Ms. Vicari's determination of reproduction cost under the Cost approach. R.D. at 37. The OCA submits that this adjustment is reasonable and should be adopted. Specifically, Aqua witness Vicari included land in her reproduction cost analysis the cost of which was escalated using the ENR Index. Aqua Exh. R, Sch. C; OCA St. 1 at 26-27. OCA witness Everette explained that this inclusion is faulty for two reasons:

[1] The OCA notes that the ALJ correctly identified an error in a table attached to the OCA's Main Brief. R.D. at 30. As stated by the ALJ, "for HRG's income approach, OCA recommends that the DCF value of $36,560,000 be used as the income approach value (OCA Main Brief, p. 32-33). However, OCA's final recommendation is based on an income approach value of $44,690,000, rather than $36,560,000." R.D. at 30. The table above reflects the OCA's figures, consistent with its recommendation, which produces its recommendation of $59,621,108.

> First, it assumes that land would or could be "reproduced." Land is specific to its location and cannot be recreated or reproduced. Second, as stated above, Ms. Vicari used the Construction Cost Index (CCI) to calculate her trend index. The information Ms. Vicari provided on the ENR Index in response to OCA-III-14 states "The CCI can be used when labor costs are a high proportion of total costs." This is not true of land. Therefore, even if calculating a reproduction cost of land were appropriate, Ms. Vicari's own documentation indicates that this index is inappropriate for the calculation.

Id. The ENR Index is a construction index which provides cost trends "when labor costs are a high proportion of costs." OCA St. 1 at 27 (citing the report provided by Ms. Vicari in response to OCA-III-14). As Ms. Everette further explained, labor costs have no direct relation to the cost of land and land, unlike plant like mains, cannot be reproduced. Id.; OCA St. 1S at 19.

The ALJ disagreed with the OCA's argument on the basis that (1) it is reasonable to treat land the same as all other type of plant and (2) he "saw no reason why determining the reproduction cost of land to be the land's original cost is more appropriate than the method HRG used." R.D. at 37. There are two flaws in this conclusion. First, the purpose of the reproduction cost analysis is to restate the original cost of depreciable utility plant to a current price level. OCA M.B. at 15; Aqua Exh. R at 6. Specifically, you apply a trend factor to the original cost of depreciable plant to determine the replacement cost. Aqua Exh. Q at 25. Land does not depreciate[2] and, therefore, its original cost – without increasing it by a trend factor – is an appropriate measure of its current price level. See 40 P.L.E. PUBLIC UTILITIES § 74, 2346 ("Depreciated reproduction costs. In determining the present fair value of a public utility's property, the reproduction costs new, at fair average present prices, less accrued depreciation, is of great use and should be properly considered as to the public utility's plant and structure, **exclusive of land**") (emphasis added). Second, because land is not depreciable and differs from all of the other types of plant in Ms. Vicari's analysis, it is appropriate to use its original cost

[2] See, e.g., Application of Columbia Gas of Pa., Inc., 2006 Pa. PUC LEXIS 683, *3 (Opinion entered Dec. 27, 2006); Application of Columbia Gas of Pa., Inc., 2007 Pa. PUC LEXIS 616, *4 (Opinion entered Mar. 1, 2007).

without applying a trend factor. The OCA submits that the ALJ erred in rejecting Ms. Everette's adjustment to remove the escalation of the land cost by the ENR Index in HRG's cost approach analysis. This adjustment decreases the cost approach result by $756,159, as shown on line 15 of Exhibit AEE-4.

OCA Exception No. 2: <u>The ALJ Properly Adopted Most of the OCA's Adjustments to the HRG and Gannett Appraisal Valuations But Erred in Not Adopting the Removal of the Adder For Future Capital Projects From the Purchase Price Value in HRG's Market Approach</u>. R.D. at38-40; OCA M.B. at 41-44; OCA R.B. at10-13.

OCA witness Everette identified two flaws with the inputs used in HRG's calculation of Market approach result. Ms. Everette's first adjustment, to correct the number of customers for Limerick, was adopted by the ALJ. He failed to adopt her second adjustment which relates to the purchase price values used to calculate the average cost per customer. OCA St. 1 at 23. Aqua witness Vicari used the purchase price plus the value of capital improvements required by the agreement of sale to calculate the purchase price values for comparable acquisitions. Aqua St. 4R at 6. For Limerick, however, she used only the purchase price and does not account for the $8.3 million of capital investments that Aqua anticipates making. Aqua Exh. V at 8. Ms. Vicari's approach distorts this market comparison.

First, the purchase price values of the comparable systems versus the Limerick system are inconsistent. In looking at the comparable systems, Ms. Vicari includes future capital improvements but for Limerick, she does not. Moreover, Ms. Vicari did not even include future capital improvements for <u>all</u> of the comparable systems – the $195 million value she used for the acquisition of the Scranton system omits capital improvements. Aqua Exh. R, Sch. D at 21; <u>See Joint Application of Pennsylvania American Water Co. and the Sewer Authority of the City of Scranton</u>, Docket No. A-2016-2537209 at 7-8 (Opinion entered Oct. 19, 2016) (the purchase

price is $195 million, the consent decree commits PAWC to invest $140 million in capital improvements over 25 years).

The second problem is that the addition of future capital improvements for valuation purposes creates a double-count. Adding the cost of future improvements to the value of rate base and then adding these same improvements again after Aqua makes the capital expenditures would be to include the same costs twice, to the detriment of ratepayers. OCA St. 1S at 13-15.

Third, the costs of capital improvements to be paid for by Aqua are not a benefit to Aqua. OCA St. 1S at 14. There is no logic in the concept that the value of a system would increase because it requires capital improvements. A home buyer would not pay **more** to purchase a fixer-upper than the home buyer would if the house needed no improvements. In such a case, the buyer would pay **less**. In the context of the Cost approach, for this same reason, the ALJ adopted the OCA's adjustment to remove the cost of future improvements from the result. There, he stated:

> The OCA avers that these projects should not increase the appraisal value or market valuation since these projects will be paid for by Aqua postacquisition; these projects do not add value at the time of acquisition; and that Aqua will be compensated for the capital expenditures through the traditional ratemaking methodology, and including these values in the appraisal value would allow Aqua to double recover for the same costs. (OCA Main Brief at 18-19).
>
> I agree with the OCA. HRG's inclusion of future capital projects is not appropriate, as these future capital projects do not add value to the Limerick system at the time of acquisition.

R.D. at 37.

Yet, the ALJ does not adopt the same reasoning for the Market approach. The ALJ indicates that this is based on Aqua's claim that the Uniform Standards of Professional Appraisal Practice (USPAP) and the Final Implementation Order[3] "require consideration of capital

[3] Implementation of Section 1329 of the Public Utility Code, Docket No. M-2016-2543193 (Order entered October 27, 2016).

improvements" in the Fair Market Value Appraisal. R.D. at 39 (citing Aqua M.B. at 43). Aqua provided no specific citations to either the USPAP or the Final Implementation Order in support. With regard to the USPAP, giving "consideration" does not mandate that the market value must be **increased**; they could be determined to decrease or have no effect on market value. In this situation, where the future capital improvements are to be paid for **by the buyer**, there is no reasonable basis to conclude that they would increase the value of the system to buyers in the market. OCA St. 1 at 23. For the seller, the future capital improvements are an avoided cost, which is a benefit to Limerick Township but not something for which it should be compensated through an inflation of the market value appraisal. OCA St. 1S at 14.

Review of the Final Implementation Order, likewise, does not support Aqua's claim. The Order mentions post-acquisition improvement costs in only one context – that Section 1329(f) allows post-acquisition improvement costs to be deferred for book and ratemaking purposes if they are not recovered through a Distribution System Improvement Charge (DSIC). See Implementation Order at 1-3, 28, 30, 40; 66 Pa. C.S. § 1329(f). The Final Implementation Order does not otherwise address future capital improvements and does not support the conclusion that market value should increase where the buyer plans to make future capital improvements. In a variation on the analogy above, a home buyer would not pay more for a home because the home buyer plans to remodel the kitchen in the future.

For all of these reasons, the OCA's recommended adjustment to remove the adder for future capital improvements to the Market approach result should be adopted. This produces a corrected market value per customer of $7,317. OCA Exh. AEE-5. Using Limerick's actual number of customers, which was recommended by the OCA and adopted by the ALJ, the resulting market approach result is $39,775,212 ($7,317 x 5,436 customers). Id.; OCA St. 1 at 23; R.D. at 40.

OCA Exception No. 3: <u>The ALJ Properly Adopted Most of the OCA's Adjustments to the HRG and Gannett Fleming Appraisal Valuations But Erred in Not Adopting the Removal of the Terminal Value For the Gannett Fleming Income Approach</u>. R.D. at 34-36; OCA M.B. at -33-36; OCA R.B. at 10-13.

The OCA identified two areas of disagreement with respect to the Income approach valuation by Gannett Fleming. Specifically, in all of Gannett Fleming's DCF analyses, Mr. Walker used a "terminal value" in the thirteenth year of his model. Aqua Exh. Q, Exh. 8 at 4. OCA witness Watkins showed that utilizing a forecasted terminal value is unreliable and produces unreasonable results. <u>Id.</u> at 24-25. Mr. Watkins conducted his DCF valuation using 50-years of discounted net cash flows (Debt Free Net Cash Flow) with no terminal value. The OCA submits that this adjustment should be adopted.

1. <u>Terminal Value</u>

Aqua witness Walker's approach is to calculate discounted cash flows net of capital expenditures and changes in working capital (i.e., Debt Free Net Cash Flow). OCA St. 2 at 24. Mr. Walker only calculates and discounts these annual Debt Free Net Cash Flows for 13 years, however, and then estimates a "terminal value" after which annual cash flows are projected to grow at a constant rate. <u>Id.</u>; OCA St. 2S at 8. There are two problems with this approach. First, Mr. Walker's estimation of Limerick's market value is extremely speculative and uncertain: he calculates terminal values ranging from $44.084 million to $137.436 million. Aqua Exh. Q, Exhs. 8, 9. This very large range in his calculated terminal values has a significant impact on his ultimate DCF valuations. OCA St 2 at 24.

Second, pursuant to standard financial and business concepts, the terminal value used must reflect a project's useful life such that cash flows (projected to grow at a constant rate) reasonably reflect the capital investments required to maintain and continue the entity's operations as a going concern. OCA St. 2S at 8. Aqua witness Walker's 13-year DCF model

reflects very little capital expenditures – the cost of replacing the Limerick plant in service in the thirteenth year is in excess of $161 million[4] and Mr. Walker's assumed annual capital investments after year 13 are only **0.80%** of that total replacement cost. OCA St. 2S at 8-9. The Limerick system cannot reasonably be expected to operate in perpetuity at this level of reinvestment to replace worn out plant; however, that is the assumption utilized in Mr. Walker's valuation model. Moreover, it implies an effective service life of new plant of 125 years, which is clearly unreasonable. OCA St. 2S at 8-9.

To address these concerns, the OCA recommended using 50 years of discounted net cash flows with no terminal value. By using a longer investment horizon than 13 years, the ultimate DCF valuation incorporates the going concern aspects of Limerick's wastewater operations. OCA St. 2 at 24. This model makes more reasonable assumptions regarding the useful remaining life of Limerick's system without total or significant replacement as it wears out over 50 years. Id. at 26.

In response, the Company argued that the model used by both GF and the OCA reflects the same 1.5% growth in capital expenditures and depreciation and that the capital expenditures shown in the 13th year of the model almost exactly match the depreciation displayed for the same time, meaning the capital investments being put back into the system are matching depreciation and thereby the system remains in a state of good repair. Aqua R.B. at 26-28. Aqua also argued that using a 50-year modeling approach without a terminal value would cap the life of the business at 50 years, which would understate the value indicated by the OCA's own model. Id. The ALJ accepted this reasoning and, therefore, accepted GF's use of a 13-year terminal value. R.D. at 36.

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[4] This amount is calculated from Mr. Walker's assumptions within his DCF and Cost of Reproduction New analyses. OCA St. 2S at 8.

Both of the Company's arguments should be dismissed. First, while there is no disagreement that Mr. Walker's annual capital expenditures and historical book depreciation are roughly the same, that does not bear on the issue. The point of the DCF model is to evaluate the necessary investment relative to the life of particular plant to determine how long that level of investment will maintain the plant without a significant capital investment to totally replace it. OCA St. 2S at 8-9. OCA witness Watkins used taxicabs as a means of illustrating the problem with Mr. Walker's use of a terminal value in year 13. Id.

> [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 Limerick's wastewater operations. However, Mr. Walker's terminal value calculations assume that the minimal level of capital expenditures reflected in the thirteenth year of his DCF analysis will continue in perpetuity. Such an assumption is clearly unreasonable, which in turn, significantly overstates Mr. Walker's assumed terminal value of Limerick's wastewater operations.

OCA St. 2S at 8-9. While the Limerick system has a longer service life than a taxicab, it cannot be operated in perpetuity with minimal levels of investment – but that is the assumption underlying Aqua witness Walker's use of a terminal value and estimate of value in perpetuity.

2. 50-Year Model

Aqua's argument against using a 50-year modeling approach should also be rejected. OCA witness Watkins' use of 50 years is well supported and reasonable. OCA St. 2, Schedule GAW-5, page 5, line 35 shows that the present value factor (using a 6.89% discount rate) is 3.70%. This means that every $100 of cash flow in year 50 is valued at only $3.70. Thus, if the

actual service life of the Limerick system is longer than 50 years, it makes a negligible difference to the result.

For these reasons and as discussed above, the OCA's 50-year model without a terminal value is more reasonable and appropriate than using a terminal value in the 13th year.

OCA Exception No. 4: <u>The ALJ Properly Adopted Most of the OCA's Adjustments to the HRG and Gannett Fleming Appraisal Valuations But Erred in Not Adopting the OCA's More Reasonable Discount Rates</u>. R.D. at 28-36; OCA M.B. at -36-41; OCA R.B. at 10-13.

The ALJ declined to adopt the OCA's alternative discount rates on the basis that the OCA did not show that Gannett Fleming's discount rates were unreasonable. R.D. at 29. The OCA submits that there is ample evidence demonstrating that Aqua witness Walker's failure to include equity in the discount rate (from a municipal utility perspective) is not reasonable and serves to inflate the appraisal result. In addition, Mr. Watkins provided more appropriate discount rates using a municipal utility's cost of capital and an IOU's cost of capital. <u>Id.</u> at 29-28.

1. <u>Municipal Utility Seller's Perspective</u>

From a municipal utility seller's perspective, Aqua witness Walker used a 4.37% discount rate based on the December 2016 municipal revenue bond yield. Aqua Exh. Q at 28. The OCA showed that this is not appropriate because a firm's cost of capital should reflect the financial and business risks that the firm confronts, meaning that it should reflect both the cost of debt and the opportunity cost of equity. OCA St. 2 at 25. Further, the OCA noted that Mr. Walker has, in numerous water and wastewater rate cases, argued on behalf of municipalities for a significantly higher cost of equity than either the embedded or marginal cost of debt. <u>Id.</u> at 25-26. His position was based on the premise that there is a business risk associated with operating a utility and that business risk should be reflected in the total cost of capital by reflecting an

equity return well above the cost of debt. OCA St. 2 at 26. If the same premise is applied to this appraisal, the cost of capital (here, the discount rate) should reflect both debt and equity.

As such, OCA witness Watkins developed a discount rate using equity as well as debt. OCA St. 2 at 9-10, 26. Mr. Watkins used the actual cost of equity for a municipal water utility found by the Commission in a recent, fully litigated rate case. He used Limerick's actual embedded cost of debt of 3.39%, which is conservative compared to the current cost of municipal bonds. OCA St. 2 at 9-10, 26. Next, Mr. Watkins used Limerick's actual capital structure and a hypothetical 50% debt/50% equity capital structure. OCA St. 2 at 9. This, too, was a conservative input. Id. at 10. The determination of the weighted cost of capital under these two capital structures results in total costs of capital of 6.89% and 5.50%, respectively. Id. at 10. This compares to Mr. Walker's discount rate of 4.37%. OCA St. 2 at 26, 27, 29, OCA Schs. GAW-5, GAW-6.

The Company's arguments against the OCA's discount rates, which were accepted by the ALJ, should be rejected. R.D. at 35; Aqua R.B. at 29-30. First, Aqua argued against using equity in determining the discount rate (from the municipal perspective) because municipal entities like the Township cannot prospectively finance with equity capital, only debt capital. This ignores that Limerick's wastewater operations are financed with 83% equity and 17% debt. OCA St 2S at 6. The Township, like any other business enterprise uses this equity capital to fund capital expenditures and working capital. Id. While Aqua argues that some types of projects, like road or bridge construction, are typically funded with debt financing (Aqua R.B. at 30, n.88), those are not the types of projects financed by a revenue-producing municipal wastewater operation that operates as a business enterprise. OCA St. 2 at 6. To this point, if Limerick were only concerned with recovering its debt cost, it would offer to sell its wastewater

operations at the level of its outstanding debt. Instead, Limerick has attempted to maximize the proceeds from the sale of its wastewater system. Id.

Aqua also criticized the OCA's use of embedded versus marginal cost of debt. Aqua argues that the embedded cost of debt is used for rate proceedings and marginal is used for valuations. Aqua R.B. at 29. The OCA's witness agreed that marginal cost of debt is appropriate but explained that he used the embedded cost of debt (3.39%) instead of Gannett Fleming's marginal cost of debt (4.37%) because the embedded cost of debt **is lower**. That is, using the higher marginal cost of debt would have resulted in a higher cost of capital and therefore, a higher discount rate, which would have **reduced the DCF valuations**. OCA St. 2S at 6. Thus, if Aqua's adjustment to the OCA valuation is made, the result is that the OCA's recommended Income approach valuation will be lower. The OCA's input produces a more conservative, higher valuation. Id.

For these reasons, the ALJ erred in adopting Aqua's discount rate. The OCA's recommended valuation from the municipal utility perspective, of $51,320,000 is reasonable and the OCA submits that it should be adopted. OCA M.B. at 38, OCA St. 2 at 29, OCA Schs. GAW-5, GAW 6.

2. IOU Buyer's Perspective

The ALJ also declined to adopt the OCA's alternative discount rate from a buyer's perspective on the basis that the OCA did not show that Gannett Fleming's discount rate was unreasonable. R.D. at 29. As with the valuation performed from the municipal utility perspective, however, there is ample evidence demonstrating that Aqua witness Walker's discount rate from a buyer's perspective is not reasonable and serves to inflate the appraisal result.

For purposes of his DCF analysis under an Investor-Owned Utility's (IOU) perspective, Mr. Walker used an estimate of an IOU's total cost of capital using a capital structure of 24.5% debt/75.5% equity. OCA St. 2 at 27. The use of an equity ratio of 75.5% is based on market ratios instead of book ratios. However, Aqua will be financing Limerick with a combination of book equity and book debt. OCA St. 2 at 28. Therefore, Mr. Watkins recommended using Aqua's actual book equity ratio of 51.5%, which produces a more reasonable valuation result.

Aqua witness Walker developed a cost of equity range of 7.96% to 9.76%, which the OCA's witness determined to be within the range of reasonableness. OCA St. 2 at 28. OCA witness Watkins recommended a number within that range, 9.3%, which was the recent cost of equity authorized for a similar operation. See Pa. PUC v. City of Dubois – Bureau of Water, Docket No. R-2016-2554150 at 97-98 (Order entered Mar. 28, 2017). This results in a total cost of capital of 6.09% after reflecting net of tax cost of debt, and produces the OCA's adjusted Income valuation of $55,864,000. OCA St. 2S at 6-7.

The Company's argument against the OCA's discount rate from a buyer's perspective, which was accepted by the ALJ, should also be rejected. R.D. at 35-36. Aqua argues against the OCA's use of a Commission-authorized return on equity because the Township is not regulated by the Commission. Aqua R.B. at 29. Since this analysis is to reflect the buyer's perspective and the operation of Limerick will be regulated once acquired, a Commission-authorized return is necessary for this analysis. The Commission's recent finding on the market cost of equity of a firm with similar risks is appropriate in these circumstances. More important, however, the return on equity that the OCA used is **within the range of return on equity developed by Aqua's witness**. OCA St. 2S at 7. Therefore, the Company's opposition has no impact on the OCA's valuation result.

For these reasons, Aqua's argument should be rejected. The OCA's recommended result from the IOU perspective, of $55,864,000 is reasonable and the OCA submits that it should be adopted. OCA M.B. at 39, OCA St. 2S at 6-7, OCA Sch. GAW-7.

3. Summary

The OCA's overall recommendation for the Income approach is $54,735,000 compared to Gannett Fleming's recommended $75,204,407, which is $20.5 million higher. The OCA has demonstrated that certain conceptual biases within the DCF model relating to use of a terminal value and calculation of discount rates produced this difference. The OCA's adjustments provide a more reasonable and appropriate result and should be adopted.

C. Appraisal Adjustments - Summary

The OCA submits that its adjustments, as discussed above, along with those adopted by the ALJ should be adopted by the Commission. As set forth in the table below, the resulting valuation is $59,621,180.

Appraisals with the OCA's Recommended Adjustments	
HRG	**Gannett**
Income $36,560,000[5]	Income $54,735,000
Cost $61,565,412	Cost $86,086,756
Market $39,775,212	Market $79,002,980
Recommendation $45,966,875	Recommendation $73,275,485
Average: $59,621,180	

[5] The OCA notes that the ALJ correctly identified an error in a table attached to the OCA's Main Brief. R.D. at 30. As stated by the ALJ, "for HRG's income approach, OCA recommends that the DCF value of $36,560,000 be used as the income approach value (OCA Main Brief, p. 32-33). However, OCA's final recommendation is based on an income approach value of $44,690,000, rather than $36,560,000." R.D. at 30. The table above reflects the OCA's figures, consistent with its recommendation, which produces its recommendation of $59,621,108.

D. Affirmative Public Benefits

OCA Exception No. 5: The ALJ Erred in Finding That Aqua Has Proven That the Transaction is in the Public Interest and Provides Affirmative Benefits Sufficient to Warrant Approval of Its Application. R.D. at 44-47; OCA M.B. at 51-62; OCA R.B. at 13-16.

The ALJ found that "Aqua has shown sufficient public benefits to support approval of the application in this proceeding." R.D. at 45. The ALJ based his decision solely on the Commission's finding of affirmative public benefits in New Garden. R.D. at 45-47. For the reasons set forth below, the Commission should find that Aqua failed to prove that the transaction provides substantial, affirmative benefits.

The ALJ correctly explained in his Recommended Decision in New Garden he found that the benefits were insufficient to warrant the approval of Aqua's application. R.D. at 44. In particular, the ALJ stated:

> In my recommended decision, I disagreed with Aqua and recommended denial of the application on the basis that, although the transaction provided benefits to New Garden Township and its customers, it did not provide affirmative benefits to Aqua's existing customers. To the contrary, I found that the detriments to Aqua's existing customers were sufficient to overcome any benefits realized. Therefore, I recommended that the application be denied.

Id.

Here, however, the ALJ relied on "Commission guidance on the issue of affirmative benefits from the New Garden proceeding" in recommending approval of Aqua's application. R.D. at 45. The ALJ noted that the arguments Aqua made in New Garden were the same as here so he gave substantial weight to the New Garden decision. The substantial weight given to the Commission's decision in New Garden is inappropriate as the Commission's reconsideration order remains pending. In its reconsideration order, the Commission may evaluate "considerations which appear to have been overlooked or not addressed." See Duick v. Pennsylvania Gas and Water Co., 1982 Pa. PUC LEXIS 4 at *13 (1982). The Commission's

decision in New Garden also remains subject to the possibility of judicial appeal. Pa. R.A.P. 1701(b)(3)(ii) (Where a timely order of reconsideration is entered, the time for filing a petition or review begins to run anew after entry of the decision on reconsideration).

The ALJ did not evaluate the Section 1102 application on a stand-alone basis to ensure that the transaction will "affirmatively promote the 'service, accommodation, convenience, or safety of the public." See City of York v. Pa. PUC, 295 A.2d 825, 828 (Pa. 1972). (City of York). The public interest analysis required by City of York is not satisfied by claiming that the transaction provides sufficient benefits merely because the Commission approved another unrelated transaction in which the utility claimed similar benefits. No two transactions are alike; each acquisition involves a different acquisition value, a different wastewater system, and, most importantly, a different water and wastewater customer base.

Because the ALJ's analysis compared Aqua's acquisition of the Limerick system to the New Garden acquisition rather than on a stand-alone basis, the ALJ overlooked aspects that were also discounted by the Commission in the New Garden Order. In particular, the ALJ did not consider the substantial harm to customers as a result of the transaction and improperly concluded that long-term cost sharing and a lack of adverse impact on management and operations equate to affirmative public benefits. R.D. at 44-47. There is no substantial evidence of these benefits, rather there are simply assertions backed by nothing.

With regard to the substantial harm to customers, 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." See Middletown v. Pa. PUC, 482 A.2d 674, 682 (Pa. Commw. 1984) (Middletown). In Middletown, the ALJ determined that the acquisition would benefit some customers, but harm others. Accordingly, the ALJ denied the application and the Commission adopted the decision, which the Commonwealth Court subsequently affirmed. Id. at 679.

Here, the ALJ identified cost sharing and the lack of adverse impact on existing operations as the benefits of the transaction.[6] R.D. at 45-46. As a general rule, however, it is inequitable and economically unsound to ask one generation of captive ratepayers to bear the cost of providing service to another. See Re Minnegasco, Inc., 143 PUR4th 416, 426 (Minn. 1993); See also Barasch v. Pa. P.U.C., 491 A.2d 94, 98, 104 (1985). Benefits should accrue shortly after the time at which costs are expended as to be realized by existing ratepayers. See Pa. PUC v. Duquesne Light Co., 43 PUR4th 27, 69 (1982). Additionally, the benefits of a transaction must be evidenced by "more than the mere absence of any adverse effect upon the public." See City of York at 828. It is insufficient to claim that the lack of adverse impact on Aqua's existing operations is an affirmative benefit. R.D. at 46.

The ALJ did not address many of the harms that will result from the acquisition. For instance, acquiring 5,343 customers for $75.1 million, a purchase price 63% over net book value, will increase costs substantially. The average rate base cost of each Limerick customer will be $13,820 or nearly four times that of an existing Aqua customer at $3,595. OCA St. 1 at 16-17; OCA M.B. at 56-57. In other words, the number of customers would increase by only 27%, while Aqua's average rate base cost would increase by 60% per customer. Id. Moreover, Aqua's rate stabilization plan includes a $70 per month rate for Limerick customers at the conclusion of the rate freeze, which is an increase from the current rate of $38. Aqua M.B. at 50; OCA St. 1 at 11-12, 14; OCA M.B. at 58. Aqua stated that this number is an "extremely conservative" estimate, meaning that rates will likely be higher than $70 per month and even greater harm will result to Limerick customers from the acquisition. Aqua M.B. at 50.

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[6] The ALJ did not state that he found economies of scale to be a benefit that supports approval as argued by Aqua. R.D. 45-46. In Application of CMV Sewage Co., Inc., 2008 Pa. PUC LEXIS 950 at *29-30, the Commission was not persuaded that economies of scale provided a benefit that outweighed known adverse impacts of the transaction.

The only harm acknowledged by the ALJ is the "potential for cross-subsidization" by Aqua's existing customers of the Limerick customers. R.D. 46-47. Existing customers will bear the cost of the shortfall for 15 years until Limerick customers begin paying the full cost of the acquired system, after which Aqua predicts only a three-cent monthly savings to existing customers. Aqua St. 1, Exh. C; OCA St. 1S at 3, OCA M.B. at 11, 47-48, 55, 58. In this regard, the ALJ correctly imposed a condition requiring a cost-of-service study in Aqua's next rate base case. The ALJ, however, did not weigh the harm of cross-subsidization or any other harm against the purported benefits of the transaction as required by Middletown. See Middletown at 679, 682. As mentioned above, the ALJ merely stated that the benefits were sufficient here because the Commission found them to be sufficient New Garden. R.D. at 44-45.

Therefore, the Commission should find that Aqua's acquisition of the Limerick system does not provide substantial, affirmative public benefits that outweigh the harms of the transaction, which will negatively impact Aqua's existing customers and Limerick customers.

E. Deadlines for Consideration and Compliance

OCA Exception No. 6: The ALJ Erred in Finding That the Section 1329 and 1102 Considerations Must Be Concluded Within Six Months. R.D. at 47-48; OCA M.B. at 11-13.

The ALJ found that the six-month deadline set forth in Section 1329(d)(2) of the Public Utility Code applies to both the Section 1329 and 1102 considerations in this proceeding. R.D. at 48. To support this finding, the ALJ cited Commission's determination as to I&E's Petition for Interlocutory Review filed in New Garden that, where the acquiring entity is a certificated public utility, there would be no bifurcation and a decision on the application must be issued within six months. Id.

The language of Section 1329(d)(2), nonetheless, provides that the Commission "shall issue a final order on an application submitted under **this section** within six months of the filing

date of an application." 66 Pa. C.S. § 1329(d)(2). The Rules of Statutory Interpretation provide that "[w]hen the words of a statute are clear and free from all ambiguity, the letter of it is not to be disregarded under the pretext of pursuing its spirit." 1 Pa. C.S. § 1921(b). It is clear from the plain language of Section 1329(d)(2), that the General Assembly intended the six-month deadline to apply only to "this section," or Section 1329. 66 Pa. C.S. § 1329(d)(2). No language in the statute supports a finding that the deadline applies to Section 1102 determinations.

In addition, the Rules of Statutory Construction provide that "statutes are to be construed in harmony with the existing law and as part of a general and uniform system of jurisprudence." See Northern Tier Solid Waste Auth. v. Dep't of Revenue, 860 A.2d 1173, 1180 (Pa. Commw. 2004); 1 Pa. C.S. § 1932(b). It is feasible to reconcile and give full effect to the provisions of Section 1329 and the provisions of Section 1102. 1 Pa. C.S. § 1921(a). For example, the Commission could resolve the Section 1329 considerations of an application within the six-month deadline and subsequently address whether a transaction provides the requisite substantial, affirmative benefits under Section 1102. See City of York at 828.

Moreover, applying the deadline for Section 1329 determinations to Section 1102 determinations restricts the Commission's ability to review a full and meaningful record in performing its public interest analysis. Pursuant to the City of York standard, when the public interest is considered the Commission must evaluate the "benefits and detriments of the acquisition . . . as they impact on all affected parties, and not merely one particular group." See Middletown at 682. Interested parties, however, have a limited time to investigate and develop testimony, meaning that the record may not fully address the impact of the transaction on all affected constituencies. Therefore, applying the six-month deadline to Section 1102 is not consistent with the "well established principle that the primary objective of the law in this area is to service the interest of the public." See Middletown at 682.

For the reasons set forth above, the Commission should find that the six-month deadline set forth in Section 1329(d)(2) applies only to the determinations under Section 1329, whereas no deadline restricts the time in which the Commission may make Section 1102 determinations.

OCA Exception No. 7: <u>The ALJ Erred in Declining to Include a Requirement That Aqua File Its Tariff Changes and Revised LTIIP Within 30 Days of the Entry of the Commission's Order as a Condition of Approval.</u> R.D. at 48-50, OCA M.B. at 51, OCA R.B. at 17.

The ALJ found that, with regard to Section 1329(d)(4) of the Public Utility Code, it is not necessary to include a requirement that Aqua comply with the directives identified in the Commission's Implementation Order as a condition of approval of the application. R.D. at 49. The ALJ, however, concluded that "Aqua will be expected to fully comply with the requirements set forth in the [Implementation Order]." <u>Id.</u> For the reasons set forth below, the Commission should include in its order in this proceeding a condition requiring that Aqua file the required tariff changes as well as a revised LTIIP no later than 30 days following the entry of the order.

Pursuant to Section 1329(d)(4), from the time that a tariff goes into effect until the time at which new rates are approved for the acquiring utility in a base rate case, a public utility "may collect a distribution system improvement charge . . . as approved by the commission." 66 Pa. C.S. § 1329(d)(4). The Commission's Implementation Order specifies that a "public utility that seeks approval to apply the DSIC to the customers acquired through acquisitions under Section 1329 will have to change its existing tariffs" and, "[i]n conjunction, the public utility would also need to amend its LTIIP." <u>See</u> <u>Implementation Order</u> at 27-28.

Aqua argued that its tariff modifications filed with the Commission in 2016 are sufficient as it pertains to the requirement that Aqua change its existing tariffs. R.D. at 48. Aqua, however, failed to revise its LTIIP in conjunction with its tariff as required by the Commission's

Implementation Order. See Implementation Order at 28. Thus, a 30-day deadline is reasonable and necessary to ensure that Aqua does so before charging a DSIC to Limerick customers.

It is not uncommon for the ALJs and the Commission to include conditions of approval that reaffirm or mandate a public utility's adherence to the requirements of the Public Utility Code, the Commission's regulations, or prior Commission orders. For instance, here, the ALJ required that Aqua "file the APA and all relevant municipal agreements it is assuming . . . with the Commission under separate 'U' dockets within 20 days of the entry of a final Opinion and Order in this proceeding," although Aqua is already required to file these agreements with the Commission pursuant to Section 507. R.D. at 50; 66 Pa. C.S. § 507. The Commission is authorized to "impose such conditions as it may deem to be just and reasonable" in granting the certificate of public convenience requested by Aqua. 66 Pa. C.S. § 1103(a).

Further, the Commission has previously imposed a 30-day deadline for the filing of a revised LTIIP. In Petition of Peoples Natural Gas Co., LLC, 2016 Pa. PUC LEXIS 147 at 43 (Order entered March 10, 2016) (Peoples), the Commission ordered: "That within 30 days of the date of entry of this Order, the Peoples Natural Gas Company, LLC, shall file a new or revised LTIIP consistent with the directives in this Order." The Commission cited Section 1352 of the Public Utility Code, which provides that it shall order a revised LTIIP when a proposed plan is not sufficient to maintain safe, reliable, and reasonable service. Id. at 40; 66 Pa. C.S. § 1352(a)(7). Although not required by this statute or otherwise, the Commission imposed a 30-day filing deadline. Peoples at 43. Here, the ALJ stated that, because the Implementation Order "does not include the 30-day time deadline," he does not believe it is necessary to include as a condition of approval. R.D. at 49. The Commission may, nonetheless, impose a 30-day deadline as it did in Peoples. 66 Pa. C.S. § 1103(a).

Therefore, if the Commission approves Aqua's application and Limerick customers will begin paying a DSIC prior to the effective date of rates established in Aqua's next base rate case, the Commission should condition its approval on Aqua's filing of the required tariff changes and revised LTIIP within 30 days after the entry of the Commission order in this proceeding.

III. CONCLUSION

For the reasons set forth above and in the OCA's Main and Reply Briefs, the OCA respectfully files these Exceptions to the Recommended Decision of ALJ Haas. The Commission should find that Aqua's acquisition of the Limerick Township wastewater system does not provide substantial, affirmative public benefits and deny Aqua's Application. If the Commission nonetheless approves Aqua's Application, the OCA submits that it should adopt the OCA's four above-mentioned adjustments to the appraisal values, in addition to the adjustments adopted by the ALJ, and decrease the ratemaking rate base to $59,621,180. The Commission must also condition its approval by requiring a cost-of-service study, retaining authority to allocate revenues in excess of the APA, and requiring Aqua and its shareholders to bear all risk of a shortfall between revenues its recovers under the APA and costs its incurs as to the acquired system. R.D. at 53.

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