

COMMONWEALTH OF PENNSYLVANIA



OFFICE OF CONSUMER ADVOCATE

555 Walnut Street, 5th Floor, Forum Place
Harrisburg, Pennsylvania 17101-1923
(717) 783-5048
800-684-6560

FAX (717) 783-7152
consumer@paoca.org

October 10, 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 Reply
Exceptions in the above-referenced proceeding.

Copies have been served per the attached Certificate of Service.

Very truly yours,

A handwritten signature in cursive script that reads "Christine Maloni Hoover".

Christine Maloni Hoover
Senior Assistant Consumer Advocate
PA Attorney I.D. # 50026
E-Mail: CHoover@paoca.org

Attachment

cc: Honorable Steven K. Haas, ALJ
Office of Special Assistants (e-mail only: ra-OSA@pa.gov)
Certificate of Service

CERTIFICATE OF SERVICE

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

I hereby certify that I have this day served a true copy of the following document, the Office of Consumer Advocate's Reply 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 10th day of October, 2017.

SERVICE BY E-MAIL & INTER-OFFICE MAIL

Carrie Wright, Esquire
Bureau of Investigation and Enforcement
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

SERVICE BY E-MAIL & FIRST CLASS MAIL, POSTAGE PREPAID

Thomas T. Niesen, Esquire
Thomas, Niesen & Thomas, LLC
212 Locust Street, Suite 600
Harrisburg, PA 17101

Alex Stahl, Esquire
Aqua America
762 West Lancaster Avenue
Bryn Mawr, PA 19010

Thomas S. Wyatt, Esquire
Dilworth Paxson LLP
1500 Market Street
Suite 3500E
Philadelphia, PA 19102

/s/ Christine Maloni Hoover
Christine Maloni Hoover
Senior Assistant Consumer Advocate
PA Attorney I.D. #50026
E-Mail: EGannon@paoca.org

Erin L. Gannon
Senior Assistant Consumer Advocate
PA Attorney I.D. #83487
E-Mail: CHoover@paoca.org

Counsel for Office of Consumer Advocate
555 Walnut Street
5th Floor, Forum Place
Harrisburg, PA 17101-1923
Phone: (717) 783-5048
Fax: (717) 783-7152
Dated: October 10, 2017

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

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

**REPLY EXCEPTIONS OF THE
OFFICE OF CONSUMER ADVOCATE**

Christine Maloni Hoover
Senior Assistant Consumer Advocate
PA Attorney I.D. # 50026
E-Mail: CHoover@paoca.org

Erin L. Gannon
Senior Assistant Consumer Advocate
PA Attorney I.D. # 83487
E-Mail: EGannon@paoca.org

Hayley E. Dunn
Law Clerk
E-Mail: HDunn@paoca.org

Counsel for:
Tanya J. McCloskey
Acting Consumer Advocate

Office of Consumer Advocate
555 Walnut Street
5th Floor, Forum Place
Harrisburg, PA 17101-1923
Phone: (717) 783-5048
Fax: (717) 783-7152

Dated: October 10, 2017

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I. INTRODUCTION

The Office of Consumer Advocate (OCA) submits this Reply to the Exceptions of Aqua Pennsylvania, Inc. (Aqua). The OCA urges the Public Utility Commission (Commission) to 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 approves Aqua's Application, the OCA submits that it should adopt the OCA's four adjustments to the appraisal values, in addition to the adjustments adopted by Administrative Law Judge (ALJ) Steven K. Haas, and decrease the ratemaking rate base to \$59,621,180. The Commission must also condition its approval as set forth by the ALJ. Recommended Decision (R.D). at 53.

II. REPLY EXCEPTIONS

Reply to Aqua Exception No. 1: The ALJ Properly Imposed Conditions on Aqua to Ensure That Aqua's Existing Customers Are Not Unfairly Burdened by Any Revenue Shortfalls Resulting From Limitations in the APA. R.D. at 18-20, 53; OCA M.B. at 46-48, 62-63; OCA R.B. at 15-17.

Aqua argues that, if the Commission approves Aqua's Application, it should not adopt the ALJ's conditions providing that: (1) the Commission retains the authority to allocate revenues, if appropriate to Limerick customers that are in excess of the restrictions in the Asset Purchase Agreement (APA), (2) Aqua and its shareholders should bear all risks of a shortfall between revenues it is permitted to recover under the APA and the costs of the Limerick system, and (3) to the extent Aqua is unable to charge costs in excess of the APA, the excess costs should be borne by shareholders. Aqua Exc. at 3-4; R.D. at 20, 53. Aqua asserts that these conditions address ratemaking concerns, which it claims "are routinely reserved for adjudication in a future base rate proceeding." Aqua Exc. at 4. Aqua's position is without merit.

Aqua primarily cites Joint Application of Pennsylvania-American Water Co., Docket No. A-2016-2537209 (Order entered Oct. 19, 2016) (Scranton Sewer). In Scranton Sewer, however, Pennsylvania-American Water Co. (PAWC) filed its application under Section 1102 of the Public Utility Code, rather than Section 1329, which was not yet enacted.¹ 66 Pa. C.S. § 1102. Here, Aqua elected to file its Application under Section 1329 and presented a rate stabilization plan, in doing so, the Company knowingly entwined rate issues in the proceeding. Aqua's Application contains, *inter alia*, a request to set the ratemaking rate base at \$75.1 million and freeze rates for Limerick customers for no less than three years. Thus, ALJ Haas properly considered the impact of the three-year rate freeze on Aqua's existing customers in this proceeding.

¹ The General Assembly enacted Section 1329 on April 14 2016, and the statute became effective 60 days thereafter. 66 Pa. C.S. § 1329. PAWC filed its application in Scranton Sewer on March 30, 2016. See Scranton Sewer at 3.

In addition, Aqua argues that the proposed condition is “not reflective of any existing or proposed tariff circumstances.” Aqua Exc. at 4. Although the exact impact of the rate freeze is not ascertainable at this time, the rate impact for Aqua’s existing customers and Limerick customers is likely to be substantial. OCA M.B. at 47-48; OCA St. 1S at 16; Aqua St. 1 at 13-16, Exhs. C, D. For instance, based on a ratemaking rate base of \$75.1 million, if Aqua files a rate increase request in Year 9, existing water and wastewater customers would see increases of approximately 9%, and, if Aqua files a rate increase request in Year 2, existing water and wastewater customers would see increases of approximately 64%.² OCA M.B. at 47.

Further, as ALJ Haas points out, in addressing similar concerns in Application of Aqua Pennsylvania Wastewater, Inc., Docket No. A-2016-2580061 (Order entered June 29, 2017, Final Order on Reconsideration entered Oct. 5, 2017) (New Garden), the Commission imposed conditions nearly identical to those imposed by the ALJ here. R.D. at 20-21. The Commission stated that it was “concerned that the acquisition might cause potential future cross-subsidization of New Garden customers by current Aqua customers,” although the “record was not developed on this issue.” See New Garden, Reconsideration Order at 13. The Commission reasoned that the conditions “will ensure that all Parties and the Commission will be informed of the overall rate impact that the acquisition will have on Aqua customers.” Id. at 14.

For the reasons above, the ALJ properly considered rate impacts in this proceeding and imposed the aforementioned conditions to ensure that Aqua’s existing customers would not be unfairly burdened by any revenue shortfalls stemming from the commitments in the APA. Therefore, the Commission should reject Aqua Exception No. 1.

² The percentage increase was calculated based on the “impact to existing customers” as shown on Aqua Exhibits C and D divided by \$12.1 million of existing revenues. OCA M.B. at 47; OCA St. 1S at 6.

Reply to Aqua Exception No. 2: The ALJ Properly Rejected Aqua’s Proposal to Split the \$75.1 Million Ratemaking Rate Base into a \$60 Million Initial Rate Base and a \$15.1 Million Regulatory Asset. R.D. at 22; OCA M.B. at 49-55; OCA R.B. at 8-9, 14-16.

Aqua maintains that 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 is “permitted, reasonable, and, ultimately, beneficial to customers.” Aqua Exc. at 8. Aqua’s position is inconsistent with the typical use of a regulatory asset.

Aqua proposes to amortize the \$15.1 million regulatory asset at a rate of \$2.1 million per year. OCA M.B. at 49; OCA St. 1 at 5. Depreciation begins, however, only when Aqua amortizes that amount into rate base, which would be at the time of its next base rate case. Id. For instance, if two years elapse before the Company’s next base rate case, \$4.2 million would be moved into rate base at the time of filing. Id. This proposal is not consistent with the typical use of regulatory asset. Regulatory assets are generally used for expense items, rather than deferring utility plant in service. OCA M.B. at 49-50; OCA St. 1 at 5-6. In addition, regulatory assets are amortized over a fixed period of time, not in increments. Id. Under Aqua’s proposal, it is impossible to know when the asset would be fully amortized and added to the rate base. As such, customers would be subject to uncertainty. OCA St. 1 at 5-6.

Further, Aqua alleges that its proposal is based on extremely conservative estimates and may “cross-over,” or benefit Aqua’s existing customers, in Year 15, but with less conservative assumptions, may benefit customers in Year 7. Aqua Exc. at 6. In Year 15, however, the benefit to customers is only 3 cents, compared to many years of substantially increased rates.³ OCA

³ Aqua claims that 15 years is “not a long period of time in the utility world.” Aqua Exc. at 6. 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). The benefits of a transaction should accrue to customers in some close time compared to the costs that are being expended so that existing ratepayers see some benefits from the acquisition and consolidation. The Commission has rejected normalization where it threatened to deny ratepayer a change to reap the benefit of normalization for 22 years. See Pa. P.U.C. v. Duquesne Light Co., 43 PUR4th 27, 69 (1982).

M.B. at 55; OCA R.B. at 14; OCA St. 1S at 3. Even if customers realize a benefit in Year 7, as Aqua admits, the reason would be ten years of “additional rate increases to Limerick customers,” who already experienced a rate increase from \$38 to \$70. OCA R.B. at 16; Aqua Exc. at 6; Aqua M.B. at 50. The harms to Aqua’s existing customers and Limerick customers are not outweighed by the purported benefits of Aqua’s proposal.

For the reasons set forth above, the ALJ correctly found that Aqua’s proposal to split the ratemaking rate base is not consistent with typical regulatory asset treatment. Therefore, the Commission should reject Aqua Exception No. 2.

Reply to Aqua Exception No. 3: The ALJ Correctly Found That Section 1329 Does Not Strip the Commission of Its Duty to Assure the Public Interest and Compliance With the Public Utility Code and That Other Parties are Permitted to Fully Review and Analyze the Fair Market Value Appraisals. R.D. at 23-26; OCA M.B. at 8-11; OCA R.B. at 3-7.

Aqua claims that the Commission “has no jurisdiction to consider . . . adjustments proposed by other parties.” Aqua Exc. at 11. Aqua also asserts that other parties, including the OCA, are not permitted to question the fair market value appraisals of the Utility Valuation Experts (UVE) and the proposed ratemaking rate base or submit expert witness testimony. Aqua Exc. at 8, 10. Aqua argues that “it is the General Assembly that protects the public interest and legislates the procedures for doing so” and that “in lieu of traditional debate . . . by the statutory advocates, the legislation required the two independent appraisals.” Aqua Exc. at 9-10. For the reasons set forth below, the Commission must reject Aqua’s position.

In New Garden, the Commission concluded that “Section 1329 permits the Commission and the Parties to develop a record pertaining to the review and analysis of the fair market value appraisals of the UVEs.” R.D. at 26 (citing New Garden, Order at 35). Here, ALJ Haas properly followed the Commission’s determination. R.D. at 25-26. He explained:

I find nothing in the language of Section 1329 or the commission's [Implementation Order] that strips from the Commission its statutory duty to assure that the public interest and compliance with the Public Utility Code and the Commission regulations in Section 1329 proceedings.

...

I disagree with Aqua that Section 1329 precludes review and analysis by the Commission or other parties of the UVE fair market value appraisals in an effort to ensure that the public interest is protected. I do not believe that the legislature, in enacting Section 1329, intended this result.

R.D. at 25-26. ALJ Haas further noted that the parties are permitted to **fully review** and analyze the fair market value appraisals. R.D. at 25.

Section 1329 creates a valuation process, which begins with two UVEs providing separate appraisals of fair market value. OCA R.B. at 3; 66 Pa. C.S. § 1329(a). As Aqua acknowledged, the "appraisals can and will likely vary to some degree." Aqua Exc. at 9. Section 1329 anticipates that the appraisals will differ and calls for an average of the two. OCA R.B. at 3; 66 Pa. C.S. § 1329(g). The fact that two UVEs, who both must comply with the USPAP, recommend different fair market values reveals that the process is not simply a formulaic, mathematical exercise. Rather, the UVEs make judgements, which may contain biases, in the Cost, Market, and Income approaches and in how much weight is given to each approach. Accordingly, the consumer interest can only be protected if the Commission may consider testimony submitted by other parties regarding errors and unsupported inputs and adjustments in the UVE appraisals. OCA R.B. at 3.

With regard to interpreting Section 1329, Aqua acknowledges that the intent of the General Assembly is to be effectuated, but ignores that all provisions of the statute should be given effect. OCA R.B. at 4; 1 Pa. C.S. § 1921(a). Section 1329 was established within Chapter 13 of the Public Utility Code and must be implemented consistent with the statutory mandate that all rates be just and reasonable. OCA R.B. at 4; 66 Pa. C.S. § 1301; 1 Pa. C.S. § 1932(b); See also Northern Tier Solid Waste Auth. v. Dep't of Revenue, 860 A.2d 1173, 1180 (Pa.

Commw. 2004) (Statutes must be construed in harmony with the existing law and as part of a general and uniform system of jurisprudence). Limiting the Commission's ability to investigate the reasonableness of the fair market value appraisals and make necessary adjustments would prevent the Commission from carrying out its obligation to ensure that rates are just and reasonable. OCA R.B. at 4; 66 Pa. C.S. § 1301.

In addition, the General Assembly did not intend that Section 1329 would restrict the Commission's review of UVE appraisals. Upon introducing this legislation, Representative Robert Godshall explained that the "Commission . . . **will review** the utility valuation expert appraisals and the proposed post-acquisition rates as part of this process" and that the "PUC may reduce the established fair market value." See Memorandum from Robert Godshall, Pennsylvania House of Representatives, to All House Members (May 26, 2015) (emphasis added). Moreover, upon consideration by the House of Representatives, when asked what consumer protections are included in the legislation, Representative Godshall stated that the "PUC determines if the acquisition is in the public interest, and the rates stay in place until all PUC rate cases are heard." See H. Journal. 199th Leg. - No. 71 at 1775 (Pa. 2015).

Further, if Section 1329 removes all authority from the Commission to determine rate base and delegates that authority to the UVEs, the statute would be unconstitutional. The Pennsylvania Constitution vests legislative power in the General Assembly. Pa. Const. Art. II, §1. The General Assembly may delegate authority and discretion in connection with the execution and administration of a law to an independent agency. OCA R.B. at 6; See Blackwell v. Commonwealth, State Ethics Comm'n, 567 A.2d 630, 637 (Pa. 1989). The legislative power over prices or rates, or that authority as vested within a particular commission, may not be

delegated to a private party.⁴ OCA R.B. at 6-7; See Carter v. Carter Coal Co., 298 U.S. 238, 310-11 (1936); A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 537, 541-42 (1935). Accordingly, the Commission cannot delegate its authority to determine ratemaking rate base to the UVEs.⁵ OCA R.B. at 7.

The OCA also submits that Aqua's position would result in a violation of due process. Customers are entitled to "notice and an opportunity to be heard to challenge the proposed action" before the Commission is permitted to make binding decisions likely to increase rates in a subsequent rate proceeding. OCA M.B. at 10; OCA R.B. at 5; See Barasch v. Pa. P.U.C., 546 A.2d 1296, 1306 (1988) (Milesburg). As the determination of ratemaking rate base in a Section 1329 proceeding will impact the calculation of revenue requirement, that determination can only be made by giving due notice and a **meaningful** opportunity to challenge the UVE appraisals, not just an opportunity for Aqua to submit its appraisals. OCA M.B. at 10; OCA R.B. at 5.

⁴ Arguably, under MCI Telecomm. Corp. v. American Telephone and Telegraph Co., the Commission has no authority to adopt such interpretation. 512 U.S. 218 (1994) (After finding that rate filings are an essential characteristic of rate-regulated industry, the Supreme Court held that the FCC's detariffing policy which exempted certain telephone carriers from tariff filing requirements, exceeded that Commission's authority).

⁵ Aqua's position also is inconsistent with the General Assembly's intent as it pertains to the role of the OCA generally. Pursuant to the OCA's enabling statute, 71 P.S. § 309-4, the OCA may intervene as of right in all matters properly before the Commission. See also Petition of Pennsylvania Elec. Co. Requesting Approval of Rate Recovery, 1997 Pa. PUC LEXIS 145 at *6 (April 21, 1997) (The Commission has stated that the OCA, of course, may intervene as of right). Upon consideration of this legislation by the Senate, Senator Franklin Kury explained:

"[T]his bill is a limited attempt, but I think a significant attempt, to see that in any major rate increases the PUC hears from not only the utility counsel but also from a staff of people representing the public at large, the small businessmen, the farmers and the residential users. This is an attempt to have a truly adversary proceeding in front of an impartial, in effect, court which has to decide the case in the broad public interest."

See S. Journal, 160th Leg. - No. 113 at 1767 (Pa. 1976) (S. Journal). The General Assembly's intent was that "the public which is not ordinarily represented before the PUC . . . have somebody there in an adversary capacity on its behalf" and, specifically, that the OCA participate in proceedings that impact the rates charged to consumers. Id.

Moreover, under Section 5.72 of the Commission's regulations, a Commonwealth officer or agency may intervene as of right in a proceeding involving an interest, which is not adequately represented, that may be directly affected or an interest of such nature that participation may be in the public interest. 52 Pa. Code § 5.72. Although the OCA may intervene as of right, the OCA's involvement in the instant proceedings is in the public interest, because, as identified by the General Assembly, in the absence of the OCA, "nobody [is] there on behalf of the residential user, the small businessmen or the farmers." See S. Journal at 1767.

Here, the determination of rate base may increase the future rates of Aqua's wastewater customers by up to 52%. OCA M.B. at 11. Therefore, the opportunity be heard logically includes the submission of testimony relating to the valuation.

Therefore, the ALJ properly rejected Aqua's argument that "there is no room and no legislated authorization" within Section 1329 (Aqua M.B. at 39) for the OCA to be involved in the Commission's determination of fair market value and that the Commission has limited jurisdiction to consider the OCA's adjustments. The Commission should reject Aqua Exception No. 3 and find that it may review the UVE appraisals and consider testimony submitted by other parties regarding errors and bias in the appraisals to ensure that the ratemaking rate base of the acquired utility will result in just and reasonable rates.

Reply to Aqua Exception No. 4: The ALJ Properly Adopted the Majority of the OCA's Adjustments to the HRG and Gannett Appraisal Values. R.D. at 28-40; OCA M.B. at 13-45; OCA R.B. at 7-8.

As an initial matter, Aqua asserts that the OCA's appraisal adjustments should not be adopted because the recommendations of Ms. Everette and Mr. Watkins are not supported by competent evidence or based on the Uniform Standards of Professional Appraisal Practice (USPAP), but rather are based on accepted utility financial standards. Aqua Exc. at 13.

The Commission has stated, however, that "Section 1329 contains no prohibitions on the ability of the Parties to review the UVE appraisals as to their **reasonableness.**" See New Garden, Order at 53 (emphasis added). The ratemaking approvals of Section 1329 must be reconciled with the requirement that each rate be just and reasonable. 66 Pa. C.S. § 1301. In addition, Section 1329 requires that UVEs adhere to the USPAP, but it does not state that the assumptions used by the UVEs in carrying out the USPAP standards may not be reviewed for reasonableness and conformance to the standards of the industry being valued. 66 Pa. C.S. §

1329(a)(3). Accordingly, Ms. Everette and Mr. Watkins properly employed standard financial and business models to correct assumptions within the UVE appraisals that are inconsistent with accepted utility financial practice.

Further, Aqua claims that its exception to the ALJ's adoption of the adjustments recommended by the OCA is unnecessary as the OCA's participation in this proceeding is inconsistent with the procedures set forth by the General Assembly. Aqua Exc. at 14. The OCA addresses this argument in detail in its Reply to Aqua Exception No. 3.

A. HRG Income Approach

1. Income Tax Expenses and Discount Rate

The OCA made two adjustments to HRG's Income Approach. The first adjustment corrected the calculation of the income tax expense and the second adjustment utilized a more appropriate discount rate of 6.97%. OCA M.B. at 24-28. ALJ Haas agreed with both adjustments finding that the OCA's discount rate of 6.97% reflects Limerick's true cost of capital compared to the "impropriety of the selected 2.5% discount rate." R.D. at 31-32. He found that this conclusion was further supported by Gannett Fleming's appraisal which found an appropriate discount rate range of 6.63% to 7.99%. R.D. at 32; Aqua Exh. Q at 28.

a. Income Tax Rate

In Exceptions, Aqua argues that the income tax adjustments recommended by OCA and adopted by the ALJ, would require adjustments to the revenue requirement calculated by HRG in its Income Approach. Aqua Exc. at 14-15. Aqua's argument is without merit and should be rejected. First, Ms. Vicari assumed that there were no federal or state income taxes for four years. Mr. Watkins explained the problem as follows:

The error in Ms. Vicari's logic is that the acquisition of Limerick by Aqua will result in only an incremental increase or decrease to Aqua's total taxable income. In other words, from Aqua's perspective, to the extent that Ms. Vicari's assumptions are indeed correct, this would simply be a reduction to Aqua's

overall cash income tax expense. Similarly, to the extent that these incremental cash flows produce additional taxable income, these will result in an additional tax expense to Aqua at the incremental income tax rate.

OCA St. 2 at 11-12. Second, Mr. Watkins corrected Ms. Vicari's use of a tax rate of 38.9% to reflect the appropriate incremental tax rate of 41.49%. OCA M.B. at 25. Mr. Watkins explained that only the incremental increase or decrease in total taxable income is relevant to Aqua, therefore only the incremental tax rate is relevant. The third correction was necessary because Ms. Vicari treated capital expenditures beginning in the fifth year as a tax deductible expense. OCA M.B. at 25-26. As Mr. Watkins noted, only the depreciation of the capital expenditures is tax deductible. Id. Ms. Vicari also erred by not including any deduction for depreciation expense or for interest expense. Id.

Regarding Aqua's argument that additional adjustments would be needed if OCA's income tax adjustments are adopted, Mr. Watkins explained, as follows:

This statement is simply a red herring. In my direct testimony, I identified and discussed numerous conceptual and calculation errors within Ms. Vicari's annual income tax expenses. In correcting these errors, I accepted all other inputs and assumptions embedded within Ms. Vicari's annual cash flows including revenues, expenses, and capital expenditures. With this acceptance of her assumptions, I simply calculated a more correct level of income taxes. My calculated income tax expenses are simply based on her assumptions for revenues and expenses. This has nothing to do with the required "revenue requirement" but rather, relate to an appropriate level of income tax expense based on her assumptions.

OCA St. 2S at 3. Contrary to Aqua's argument, there are no concomitant adjustments that need to be made as a result of Mr. Watkins' corrections to the income tax calculation. The ALJ properly adopted the OCA's adjustments to the income tax calculation. Aqua's Exception should be denied.

b. Discount Rate

In Exceptions, Aqua argues that the discount rate of 6.97%, recommended by OCA and adopted by the ALJ for use in the HRG Income method, should not be used because it is related

to Aqua's last base rate case which was many years ago and it does not reflect additional plant in service. Aqua Exc. at 15-16. Aqua's argument is without merit and should be rejected.

Ms. Vicari's discount rate of 2.5% does not represent Aqua's total cost of capital because it is substantially below any level of reasonable opportunity cost confronted by Aqua in the ownership and operation of its wastewater system. OCA M.B. at 26; OCA St. 2 at 8. Mr. Watkins explained that it is well-known and generally accepted that the appropriate discount rate is the firm's total cost of capital, which includes the weighted cost of debt and the weighted cost of equity. OCA M.B. at 26; OCA St. 2 at 13.

Mr. Watkins developed a more appropriate discount rate using Aqua's actual capital structure of 48.5% debt and 51.5% equity, Aqua's actual cost of debt of 4.5%, and a reasonable cost of equity of 9.3%.⁶ OCA M.B. at 27; OCA St. 2 at 12. This results in a total cost of capital (discount rate) of 6.97%. Aqua argues that the OCA's recommended discount rate is based on conditions at the time of the prior rate filing. Aqua Exc. at 16. This argument should be rejected. Mr. Watkins used Aqua's current actual cost of debt and capital structure and the most recently Commission-determined water utility return on equity.

Aqua also argues that the OCA's 6.97% discount rate, adopted by the ALJ, does not reflect investments made by Aqua since its last rate case and erosion of return. Aqua Exc. at 15-16. OCA witness Watkins explained that the "hurdle rate" is the opportunity cost that must be met before a project is considered, whether it be a project undertaken within a firm's operations

⁶ This cost of equity is based on the Commission's recent finding on the **market cost of equity** of a firm with similar risks. Pa. PUC v. City of Dubois – Bureau of Water, Docket No. R-2016-2554150, Order at 97-98 (Mar. 28, 2017). OCA M.B. at 27. The 9.3% cost of equity was found as the appropriate cost of equity before an adjustment for income taxes applicable to municipal utilities. Id.; OCA St. 2 at 13, n.12.

or the acquisition of another business enterprise.⁷ OCA M.B. at 27; OCA St. 2S at 2. He summarized:

Put simply, the appropriate discount rate is the rate at which a firm requires a return on its investment; i.e., its cost of capital. Aqua's historical or current performance (rate of return) on its existing business has absolutely nothing to do with its opportunity costs or a required hurdle rate in evaluating the risks and required return as a result of purchasing the Limerick Wastewater System. This of course would be true if Aqua was the buyer or some other IOU. Indeed, Ms. Vicari's position defies logic.

OCA M.B. at 27; OCA St. 2S at 2. Mr. Watkins provided a basic hypothetical to demonstrate this point. Consider a firm that has been earning inadequate returns on its existing operations such that its profitability is below that which is required to attract and maintain capital. As a result, the firm is evaluating new projects and/or acquisitions that will enable it to return to an acceptable level of profitability. In valuing various potential projects or acquisitions, this firm will not use its current deficient rate of return as its hurdle rate for these potential projects or acquisitions, but rather, its required rate of return. OCA M.B. at 28; *id.* Accordingly, the 9.3% cost of equity that Mr. Watkins utilized is the market-based cost of equity, as determined by this Commission, for a similarly situated utility. It is properly used in the calculation of the discount rate and, moreover, it produces a discount rate of 6.97%, compared to the unreasonably low discount rate of 2.5% applied by Ms. Vicari.

⁷ Mr. Watkins also rebutted Ms. Vicari's argument on the basis that it is a misstatement of the Commission's action in Aqua's most recent base rate case. He stated:

Ms. Vicari is not correct that a rate of return based on the revenue, expenses depreciation and rate base was authorized in Aqua's most recent rate case. That case was settled and the settlement approved by the Commission "is silent on the effective ROE as well as all other aspects of Aqua's capital structure"

OCA St. 2S at 2 (citing *Pa. PUC v. Aqua Pennsylvania, Inc.*, Docket No. R-2011-2267958 at 26-27 (Order entered June 7, 2012)).

The ALJ also found additional support for the OCA's recommended discount rate of 6.97% in the discount rate of 6.3% to 7.99% calculated by Gannett Fleming as the current pre-tax cost of capital as of December 31, 2016. R.D. at 32.

Therefore, the OCA submits that the ALJ's recommended discount rate of 6.97% is reasonable and appropriate. Aqua's Exception should be denied.

2. HRG "Going Value" Adder and Provision for Erosion of Cash Flow

HRG applied two adders to its Income Approach - a "going value" adder of \$4 million and a cash flow erosion deduction of \$370,000. The OCA removed both adjustments. OCA M.B. at 31-32. The ALJ adopted the OCA's recommended adjustments finding that the adders are not appropriate and should not be used. R.D. at 32-33. In its Exception, Aqua argues that the Recommended Decision is based on a misunderstanding of the adder and its purpose. Aqua Exc. at 16-17. As explained below, Aqua's Exception should be denied.

In its Exception and in HRG's appraisal, Aqua position is that there are avoided costs for the buyer of an existing business that should be added to cost value of the physical facilities. OCA M.B. at 19-20; Aqua Exh. R at 11-12. This value reflects the cost a new enterprise would incur to acquire a customer base, hire employees, develop an accounting and record keeping process, and develop operating and management policies and procedures. Id. Mr. Watkins explained that this does not reflect reality. He stated:

First, with respect to Ms. Vicari's assertion that there should be an additional value added as it relates to the avoided cost of the purchaser not being required to acquire and develop a customer base, Limerick is a regulated monopoly with a captive customer base. Residences, commercial, and industrial entities within Limerick's service area have no other choice than to obtain sewerage service from Limerick. As such, this customer base is known with certainty such that there are no costs required to attract customers to this business.

[Second, with] regard to Ms. Vicari's assertion that there should be an additional value added as it relates to the avoided cost of the purchaser not being required to hire employees, develop an accounting and record keeping process and develop operating and management policies and procedures, it must also be remembered

that Aqua is a large established corporation specializing in the services provided by Limerick. As indicated in its Application, Aqua already contains the resources and expertise required to effectively and efficiently operate the Limerick Wastewater System.

OCA M.B. at 19-20; OCA St. 2 at 14-15.

In its Exception, Aqua essentially repeats the arguments made by HRG. The ALJ properly found that the adder was inappropriate and adopted the OCA's removal of the adder. Aqua's Exception should be denied.

3. HRG Rate of Return/Rate Base Analysis

HRG included a rate of return/rate base analysis that resulted in a valuation of \$100,690,000 (including the net going value adder discussed above).⁸ OCA M.B. at 28. The OCA recommended that HRG's rate of return/rate base analysis be given no consideration due to the numerous flaws and unreasonable assumptions embedded in Ms. Vicari's analysis. OCA M.B. at 28-31. ALJ Haas agreed with the OCA's reasoning and recommendation that HRG's rate of return/rate base analysis should be disregarded in its entirety. R.D. at 33-34. In its Exception, Aqua argues that the flaws identified by OCA and adopted by the ALJ are not flaws and the methodology is not unreasonable. Aqua Exc. at 17-19. As discussed below, Aqua's Exception should be denied.

In its rate of return/rate base analysis, HRG used Cost of Reproduction New to develop its annual cost of service-based returns, rather than Limerick's actual embedded original cost rate base. R.D. at 33; OCA M.B. at 29; OCA St. 2 at 19. In its Exception, Aqua repeats its arguments that Section 1329 departs from traditional ratemaking practices because it uses fair market valuation. Aqua Exc. at 17-18. As explained by Mr. Watkins, it is circular to use Cost of Reproduction New to determine fair market value under Section 1329:

⁸HRG averaged the rate of return/rate base result with its DCF estimate of \$55,020,000 to arrive at an income approach value of \$77,855,000. OCA M.B. at 24.

To the extent that Section 1329 allows for a higher rate base than depreciated original cost, the resulting returns will be based on this higher rate base. This higher rate base will then be based on the lower of the purchase price or the average of the various valuation studies. Therefore, Ms. Vicari's rate base/rate of return analysis is not only circular, but meaningless and provides no value in this proceeding.

OCA St. 2 at 21-22.

Additionally, HRG used an annual rate of return of 7.5% on the "Cost of Reproduction New" rate base. Ms. Vicari did not provide any support for her calculation, while the OCA established that 6.97% is an appropriate cost of capital derived from Aqua's current cost of debt and capital structure, with a recently determined cost of equity. R.D. at 33; OCA M.B. at 29; OCA St. 2 at 20. Another problem with Ms. Vicari's 7.5% rate of return is that it is a mismatch with Ms. Vicari's discount rate of 2.5% used in her Income Approach. Id. It is universally accepted that a company's cost of capital is the appropriate discount rate. Id. As the ALJ noted, Ms. Vicari calculated annual cash flows based on a profit level of 7.5% but then only discounts those profits by 2.5%, which significantly overstates the resulting present value of the future cash flows. Id. In its Exceptions Aqua argues that its estimated 7.5% rate of return is similar to the OCA's calculated cost of capital of 6.97% and should not be disregarded. Aqua Exc. at 18. However, Ms. Vicari did not present any evidence to show how she calculated the 7.5% rate of return. Regarding the mismatch between her unsupported rate of return calculation and the discount rate, Aqua argues only that OCA did not take into account the changes since Aqua's last rate case. Aqua Exc. at 18. This argument is without merit and does not address Ms. Vicari's mismatch of her rate of return calculation and the discount rate. The OCA's calculation of 6.97% is based on current Aqua-specific debt cost and capital structure data and the return on equity is based on the most recently litigated water cost of equity determined in October 2016 by the Commission.

Ms. Vicari's rate base/rate of return analysis also contains errors identified by Mr. Watkins and adopted by the ALJ, regarding her estimated annual depreciation expenses. Depreciation is a non-cash expense and should be (and is) included within annual cash flows in Ms. Vicari's rate base/rate of return analysis. R.D. at 33-34; OCA M.B. at 29-30; OCA St. 2 at 20-21. Because Ms. Vicari's estimated annual depreciation expenses are based on the "Cost of Reproduction New" plant as opposed to actual depreciation expenses, however, they are severely overstated. Ms. Vicari estimated annual cash flow associated with depreciation expense of \$3,416,000. OCA M.B. at 30; Aqua Exh. R, Sch. G. Actual depreciation on existing plant is \$1,410,000 with an additional depreciation of about \$283,000 in future years associated with future capital investments. *Id.*; OCA St. 2 at 21; *see* OCA Sch. GAW-2. This means that Ms. Vicari's cash flows are overstated by approximately \$1,723,000 in every year. *Id.*; OCA St. 2 at 21 (\$3,416,000 - \$1,410,000 - \$283,000). In its Exception, Aqua argues again that Section 1329 departs from traditional ratemaking. Aqua Exc. at 18-19. However, Aqua's argument ignores that Ms. Vicari used reproduction cost to set the depreciation expense, not to set fair market value under Section 1329. As explained by Mr. Watkins, the reproduction cost was significantly higher than the average of the appraisals or the purchase price. OCA St. 1 at 21. The result is that the depreciation expense is overstated.

The arguments in Aqua's Exceptions repeat arguments already rejected by the ALJ and should be denied. HRG's rate base/rate of return analysis should be disregarded.

B. Cost Approach

1. HRG Reproduction Cost

Reproduction cost is derived by restating the original cost of depreciable utility plant to a current price level. OCA M.B. at 15; Aqua Exh. R at 6. Aqua witness Vicari used the original cost from the Pennoni engineering study and used the ENR Index to calculate reproduction cost.

Id.; OCA St. 1 at 24; Aqua Exh. R at 3, 6. She used the same methodology for all plant except for non-interceptor Collection System Mains. For that item, Ms. Vicari disregarded the ENR result and used “current costs developed from the other regional wastewater systems [specifically, Aqua].” OCA M.B. at 15; OCA St. 1 at 25; Aqua Exh. R at 6, Sch. C. The ALJ agreed with the OCA’s argument that Aqua had not established a reasonable basis for HRG’s treatment of this plant item. R.D. at 36-37. He agreed that the ENR index should be uniformly applied across all utility plant. Id. at 37. In its Exception, Aqua argues that it presented a reasonable explanation of why the collection system mains should be treated differently. Aqua Exc. at 19-20. As explained below, Aqua’s Exception should be denied.

Ms. Vicari indicates in her appraisal report that she considered the ENR results to be too low, so she found a different way to calculate the reproduction cost. OCA M.B. at 15; Aqua Exh. R at 6. She justified this deviation by stating that the original cost amount “represent[s] expenditures made by [Limerick] and may not include the cost of mains contributed by developers.” Id. In fact, the engineering study does include contributed mains. OCA M.B. at 16; OCA St. 1 at 26. Aqua witness Vicari presented no reasonable basis for treating this plant item differently to increase the overall reproduction cost. Ms. Everette explained that using an index will not reflect the exact trend of cost changes for every type of plant. Id. By using an index that treats every type of plant the same, however, it is likely that the actual reproduction cost for some will be higher while some will be lower. Here, Ms. Vicari identified the results of one part of the analysis and applied a different calculation that inflated the cost appraisal. Id.

In rebuttal, Ms. Vicari alleges – without explanation or elaboration – that HRG “suspected” that the value of “a number of units” in the Pennoni engineering report were “not properly stated.” OCA M.B. at 16; OCA St. 1S at 17-18; Aqua St. 4R at 7. Her Schedule C

shows that she accepts most of the results of the report, except where she adjusts the result by increasing the valuation for select plant accounts. OCA St. 1S at 18.

Ms. Vicari also alleges that the original cost of plant installed in other counties in a recent year is more accurate or representative of the reproduction cost of installing collection mains in Limerick's system over the last few decades. OCA M.B. at 16; Aqua St. 4R at 8. There is no reasonable basis, nor is one provided by Ms. Vicari, to conclude that another utility's costs are more accurate than the costs that have been specifically reported for the Limerick system. Id.; OCA St. 1S at 18. As stated by OCA witness Everette:

This deviation from the approach she used for the rest of the analysis simply increases her result.

Id. Contrary to Aqua's Exception, Ms. Vicari's analysis is unsupported and OCA witness Everette showed that contributed facilities are reflected in the original cost number utilized by Ms. Vicari for collection mains. Id. Aqua's Exception should be denied. When Aqua witness Vicari's analysis is applied uniformly to all types of plant, including collection mains, the reproduction cost is decreased by \$19,195,429. R.D. at 36-37; OCA M.B. at 16-17; OCA St. 1 at 26; OCA Exh. AEE-4 (line 14).

2. Future Capital Projects

In its Exception, Aqua argues that the ALJ erred in removing the \$4.5 million adder for future capital projects from the HRG Cost Approach. Aqua Exc. at 20. As the ALJ explains, however, the inclusion of future capital projects "is not appropriate" as the projects "do not add value to the Limerick system at the time of acquisition." R.D. at 37. Further, there is no logic in the concept that the value of a system would increase because it requires improvements. OCA St. 1S at 14. For instance, a home buyer would not pay more to purchase a "fixer-upper" than if the house needed no improvements. The addition of future capital projects for valuation

purposes results in Aqua “double recover[ing] for the same costs.” OCA M.B. at 44; OCA R.B. at 11; OCA St. 1S at 14-15. Aqua will later be compensated for capital expenditures through the traditional ratemaking methodology, and, as such, Aqua should not now be able to recover for the capital expenditures. Therefore, the ALJ properly rejected the adder.⁹

3. HRG “Going Value” Adder

Aqua witness Vicari applied a \$4,000,000 “going-value” adder to her reproduction cost analysis for the Cost Approach. Aqua Exc. at 21. The ALJ removed the adder consistent with the OCA’s recommendations. R.D. at 38. Aqua claims in its Exception that “the adder represents funds already spent - funds needed to get a system up and going.” Aqua Exc. at 21. As discussed in Section A.2 of OCA’s Reply to Aqua Exception 4, Aqua’s position does not comport with reality. Mr. Watkins explained Aqua witness Vicari’s analysis was flawed in that:

Ms. Vicari’s own analysis indicates that the Company’s cash flow in the early years may be somewhat deficient. As a result, and as will be discussed below, she then adds back these deficiencies within her “going value” add-on. To illustrate the illogical and contradictory nature of Ms. Vicari’s “going value” add-on, consider a hypothetical example in which an investor is considering entering into a new business enterprise.

...

Clearly, an investor will consider and recognize the risks and expectations of low profitability and cash flow during the early years when valuing the project or business. It would be illogical and contradictory for this investor to then be willing to pay more for this project or business under the rationale that losses and suboptimal cash flow in the early years should be ignored.

OCA St. 2 at 15-16. Further, Aqua witness Vicari’s calculation of the adder itself contained errors, including an unreasonable revenue growth rate and illogical “net income” calculation.

⁹ As identified in OCA Exception No. 2, ALJ Haas improperly declined to remove the adder for future capital projects in HRG’s Market Approach. ALJ Haas did not follow the reasoning that he set forth with regard to the adder for future capital projects in HRG’s Cost Approach. Instead, he claimed that the USPAP required consideration of such projects. “Consideration,” however, does not mandate that the market value be increased. Where future capital projects are paid for by the buyer, there is no basis to increase the value of system for the buyer. OCA St. 1 at 23; OCA St. 1S at 14.

OCA St. 2 at 16-17; OCA M.B. at 21. Accordingly, the ALJ properly found that the adder is “without merit and should not be considered.” R.D. at 38.

C. Market Approach

1. Projected Customers

In its Exception, Aqua asserts that the ALJ erred in determining that HRG’s use of a projected customer count of 7,246 in calculating the Market Approach is not appropriate. Aqua Exc. at 22. Aqua witness Vicari declined to use the current number of customers for the Limerick system, 5,434, although she calculated the average cost per customer of other acquisitions in her sample group using the respective current number of customers. OCA M.B. at 42; Aqua St. 1 at 5; Aqua Exh. R. at 7.

This is not an “apples-to-apples comparison” and such inconsistency distorts the market value. OCA M.B. at 42; OCA St. 1 at 22. Aqua witness Vicari attained an overstated cost per customer by using the current number of customers for other systems and multiplied this number by the projected numbers of customers for Limerick, compounding the initial error. *Id.* Aqua claims that the USPAP requires consideration of customer growth. Aqua Exc. at 22. Aqua fails to recognize, however, that “consideration” does not mean that the value should be inflated.

As the ALJ recognizes, using the current customer count for Limerick, the market value is \$47,060,000, rather than \$62,760,000. R.D. at 39; OCA St. 1 at 22-23. Therefore, the ALJ properly accepted the OCA’s first adjustment to HRG’s Market Approach.

D. Summary

For the reasons set forth above, the ALJ properly adopted the majority of the OCA’s adjustments. R.D. at 28-40. The Commission should reject Aqua’s Exception No. 4 in its entirety and adopt the ALJ’s adjustments, in addition to the remainder of the OCA’s adjustments as identified above and in the OCA’s Exceptions.

Reply to Aqua Exception No. 6: The ALJ Properly Imposed a Condition on Aqua Requiring That Aqua Submit a Cost-of-Service Study or Analysis At the Time of Filing of Its Next Base Rate Case. R.D. at 46-47, 53; OCA M.B. at 62-63; OCA R.B. at 16-17.

Aqua states that it does not except to the ALJ's condition requiring the company to file a cost-of-service study, but asks that the Commission "make clear that the study is required in the first base rate case in which Aqua includes the Limerick system." Aqua Exc. at 25. The clarification that Aqua seeks is unclear. If the Company seeks a finding that the cost-of-service study is required only in the first base rate case and not in future base rate cases, however, the Commission should decline to reach this finding and reject Aqua Exception No. 6.

ALJ Haas plainly stated: "That at the time of filing its **next base rate case**, 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." R.D. at 53 (emphasis added). He cited concerns about subsidization by Aqua's existing customers of the Limerick customers similar to the concerns that caused the Commission to require a cost-of-service study in New Garden, where it "directed that, 'Aqua shall develop and file a cost-of-service study in its **next rate case**.'" R.D. at 46 (citing New Garden, Order at 69-70) (emphasis added). The ALJ mirrored the Commission's language in New Garden here.

Therefore, Aqua is indisputably required to submit a cost-of-service study in its next base rate case, during which the filing requirements of the subsequent base rate case will be determined. The Commission should not now make a determination as to whether Aqua's submission of a cost-of-service study will be necessary many years into the future.

III. CONCLUSION

For the reasons set forth above and in its Exceptions, Main Brief, and Reply Brief, the Office of Consumer Advocate respectfully requests that the Public Utility Commission deny the Exceptions of Aqua. The OCA submits that the Commission should decline to find that the acquisition provides substantial, affirmative benefits and deny Aqua's Application. If the Commission approves Aqua's Application, however, the OCA submits that it should adopt the ALJ's adjustments to the appraisal values as well as the remaining adjustments recommended by the OCA for a ratemaking rate base of \$59,621,180. Further, the Commission must condition the approval by requiring that Aqua submit a cost-of-service study in its next base rate case, the Commission retains authority to allocate revenues to the Limerick Township customers in excess of the APA, and Aqua and its shareholders bear the risk of any shortfall. R.D. at 53.

Respectfully submitted,



Christine Maloni Hoover
Senior Assistant Consumer Advocate
PA Attorney I.D. # 50026

Erin L. Gannon
Senior Assistant Consumer Advocate
PA Attorney I.D. # 83487

Office of Consumer Advocate
555 Walnut Street
5th Floor, Forum Place
Harrisburg, PA 17101-1923
Phone: (717) 783-5048
Fax: (717) 783-7152

Hayley E. Dunn
Law Clerk

Counsel for:
Tanya J. McCloskey
Acting Consumer Advocate

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