**PENNSYLVANIA**

**PUBLIC UTILITY COMMISSION**

**Harrisburg, PA 17105-3265**

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|  | Public Meeting held November 8, 2017 |
| Commissioners Present:  Gladys M. Brown, Chairman  Andrew G. Place, Vice Chairman, Statement, dissenting  David W. Sweet  John F. Coleman, Jr., Statement | |
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Application of Aqua Pennsylvania Wastewater, Inc. A-2017-2605434

Pursuant to Sections 1102 and 1329 of the

Public Utility Code for Approval of its Acquisition

of the Wastewater System Assets of Limerick Township

**OPINION AND ORDER**

Table of Contents

[I. History of the Proceeding 2](#_Toc499121821)

[II. Background 4](#_Toc499121822)

[A. Section 1329 and Valuation of Assets 4](#_Toc499121823)

[B. Transaction Overview 6](#_Toc499121824)

[III. Discussion 9](#_Toc499121825)

[A. Legal Standards 9](#_Toc499121826)

[B. Recommended Decision 12](#_Toc499121827)

[1. Applicant’s Fitness 12](#_Toc499121828)

[2. Rate Stabilization Plan 13](#_Toc499121829)

[3. Regulatory Asset Treatment 16](#_Toc499121830)

[4. Ability to Challenge Fair Market Value Appraisals 18](#_Toc499121831)

[5. Rate Base Value 19](#_Toc499121832)

[6. Public Interest / Affirmative Public Benefit 23](#_Toc499121833)

[7. Imposition of 6-Month Statutory Deadline 23](#_Toc499121834)

[8. Revised DSIC Tariff and LTIIP 24](#_Toc499121835)

[9. 66 Pa. C.S. § 507 Approvals 24](#_Toc499121836)

[10. Separate Cost of Service Study 25](#_Toc499121837)

[C. Rate Stabilization Plan 25](#_Toc499121838)

[1. Rate Stabilization Plan – Rate Freeze 25](#_Toc499121839)

[2. Rate Stabilization – Regulatory Asset Treatment 31](#_Toc499121840)

[D. Approval of Rate Base Value 35](#_Toc499121841)

[1. Ability to Challenge Fair Market Value Appraisals 35](#_Toc499121842)

[2. Rate Base Valuation 37](#_Toc499121843)

[E. Public Interest and Affirmative Public Benefits 67](#_Toc499121844)

[F. Imposition of 6-Month Statute of Limitations 69](#_Toc499121845)

[G. 66 Pa. C.S. § 507 – Contracts between Public Utilities and Municipalities 70](#_Toc499121846)

[H. Separate Cost of Service Study 77](#_Toc499121847)

[I. Revised DSIC Tariff and LTIIP 79](#_Toc499121848)

[IV. Conclusion 82](#_Toc499121849)

**BY THE COMMISSION:**

Before the Pennsylvania Public Utility Commission (Commission) for consideration and disposition are the Exceptions to the Recommended Decision (R.D.) of Administrative Law Judge (ALJ) Steven K. Haas issued on September 18, 2017, which were filed by the following Parties on October 3, 2017: Aqua Pennsylvania Wastewater, Inc. (Aqua, the Company, or the Applicant); the Commission’s Bureau of Investigation and Enforcement (I&E); and the Office of Consumer Advocate (OCA). On October 10, 2017, Aqua, I&E and the OCA filed Replies to Exceptions. For the reasons below, we shall deny the Exceptions of Aqua, I&E, and the OCA and adopt the Recommended Decision.

# I. History of the Proceeding

On May 19, 2017, Aqua filed an Application seeking approval of: (1) the acquisition, by Aqua, of the wastewater system assets of Limerick Township, Montgomery County, Pennsylvania (Township), (2) the right of Aqua to begin to offer, render, furnish and supply wastewater service to the public in portions of the Township, and (3) an order approving the acquisition that includes the ratemaking rate base of the Township’s wastewater system assets pursuant to Section 1329(c)(2) of the Pennsylvania Public Utility Code (Code), 66 Pa. C.S. § 1329(c)(2). By Secretarial Letter dated May 31, 2017, the Commission acknowledged receipt of the completed Application.

On June 9, 2017, I&E filed a notice of appearance and the OCA filed a protest to the Application. The Commission published a notice of the Application in the *Pennsylvania Bulletin* on June 10, 2017. 47 *Pa. B.* 3324. On June 21, 2017, the Township filed a Petition to Intervene. By Order issued June 28, 2017, the ALJ granted the Township’s Petition and established a litigation schedule.

The ALJ conducted an evidentiary hearing on July 20-21, 2017, at which each Party was represented by counsel. During the hearing, testimony and exhibits were presented and cross examination was conducted. Aqua offered five statements and seven exhibits, which were admitted into the record. I&E presented four statements and two exhibits that were admitted into the record. The OCA presented four statements and one exhibit, all of which were admitted into the record.

The Parties filed Main Briefs on August 11, 2017, and Reply Briefs on August 18, 2017. On August 18, 2017, the record was closed upon receipt of the Reply Briefs.

In the Recommended Decision issued on September 18, 2017, the ALJ recommended approving the Application with an adjustment to the proposed rate base value and with certain conditions. As noted above, Aqua, I&E, and the OCA filed Exceptions on October 3, 2017. On October 10, 2017, Aqua, I&E and the OCA filed Replies to Exceptions.

# II. Background

## A. Section 1329 and Valuation of Assets

On April 14, 2016, Governor Wolf signed Act 12 of 2016 into law, which amended Chapter 13 of the Code by adding a new Section 1329, 66 Pa. C.S. § 1329. The new provision became effective on June 13, 2016.

Section 1329 of the Code addresses the valuation of the assets of municipally or authority-owned water and wastewater systems that are acquired by investor-owned water and wastewater utilities or entities. It is a voluntary process to determine the fair market value of an acquired water or wastewater system at the time of acquisition. For ratemaking purposes, the valuation will be the lesser of the fair market value (*i.e.*, the average of the buyer’s and seller’s independently conducted appraisals) or the negotiated purchase price. Specifically, Section 1329 enables a public utility or other acquiring entity to use fair market valuation which is not tied to the original cost of construction of the facilities minus the accumulated depreciation. Section 1329 also allows the acquiring entity’s post-acquisition improvement costs not recovered through a distribution system improvement charge to be deferred for book and ratemaking purposes. In sum, Section 1329 helps mitigate the risk that a utility will not be able to fully recover its investment when water or wastewater assets are acquired from a municipality or authority.

If the parties agree to the Section 1329 process, an “acquiring public utility”[[1]](#footnote-2) and the seller of the municipal system each select a utility valuation expert (UVE) from a list of such experts established and maintained by the Commission. The selected UVEs conduct economic valuations of the selling utility system to establish its fair market value. Also, the acquiring public utility and the seller select one licensed engineer to conduct an assessment of the tangible assets of the seller which is incorporated into the valuations of the UVEs.

As set forth in Section 1329(a) and (b), fair market value is determined by the results of two separate, independent appraisals conducted by UVEs. Each UVE determines fair market value in compliance with the Uniform Standards of Professional Appraisal Practice (USPAP), employing the cost, market and income approaches. 66 Pa. C.S. § 1329(a)(3). The appraisals are then averaged to determine the fair market value. 66 Pa. C.S. § 1329(g). The lesser of the negotiated purchase price or the fair market value is the value the acquiring utility will use as the rate base for the acquired assets in its next base rate case. 66 Pa. C.S. § 1329(c)(2).

After receiving the valuations, the acquiring public utility must apply for a Certificate of Public Convenience (Certificate) under Section 1102 of the Code and include the following as an attachment to the Section 1102 application: copies of the UVE appraisals; the agreed purchase price; the ratemaking rate base; the transaction and closing costs incurred by the acquiring public utility that will be included in its rate base; and a tariff containing a rate equal to the existing rates of the selling utility at the time of the acquisition and a rate stabilization plan, if applicable. 66 Pa. C.S. § 1329(d)(1).

For applications involving an acquiring public entity under Section 1329(d)(1), the Commission has a deadline for issuing a determination as follows: “The [C]omission shall issue a final order on an application submitted under [Section 1329(d)(1)] within six months of the filing date of an application meeting the requirements of subsection (d)(1).” 66 Pa. C.S. § 1329(d)(2).

On July 21, 2016, the Commission issued proposed procedures and guidelines to begin the implementation of Section 1329. *Implementation of Section 1329 of the Public Utility Code, Tentative Implementation Order*, Docket No. M‑2016-2543193 (Order entered July 21, 2016) (*Tentative Implementation Order*). Due to the six-month timeline required in Section 1329, the *Tentative Implementation Order* contained a proposed guideline and assumed that the last public meeting before the six-month deadline would be fifteen days prior to that deadline. *Id.* at 14-15. As noted above, the Commission issued the *Final Implementation Order* on October 27, 2016. In the *Final Implementation Order*, the Commission indicated that the proposed model timeline was only a guideline for achieving a Commission final order within the six-month deadline, but the parties are free to propose modifications to the presiding ALJ within the context of the specific Section 1329 proceeding. *Final Implementation Order* at 35.

## B. Transaction Overview

Aqua is a subsidiary of Aqua Pennsylvania, Inc. (Aqua PA), which provides water and wastewater utility service to approximately 455,000 customers. Aqua’s wastewater service involves the collection, transportation, treatment and disposal of wastewater for the public to approximately 20,000 customers in Adams, Bucks, Carbon, Chester, Clearfield, Delaware, Lackawanna, Luzerne, Monroe, Montgomery, Pike, Schuylkill, and Wyoming Counties. Aqua operates thirty-four wastewater treatment plants in Pennsylvania. Both the Company and Aqua PA employ approximately 600 individuals with expertise in water and wastewater service. Aqua Stmt. No. 2 at 3.

The Township owns and operates a wastewater system that provides service to 5,434 customers within a portion of the municipality. The Township’s wastewater system is comprised of two service areas: the King Road Wastewater Treatment Plant (King Road) service system and the Possum Hollow Wastewater Treatment Plant (Possum Hollow) service system. The King Road system is an AeroMod activated sludge biological treatment system with two-stage aeration and clarification. In-line ultra violet units facilitate effluent disinfection and two aerobic digesters and holding tanks accomplish sludge handling for the King Road system. The Possum Hollow system also uses an AeroMod activated sludge biological treatment system with two-stage aeration and clarification. However, Possom Hollow conducts sludge handling by hauling the thickened liquid to the Pottstown Wastewater Treatment Plant for processing and disposal. The permitted capacity of the King Road system is 1.70 million gallons per day (MGD) and the Possum Hollow system is 0.70 MGD. Aqua Stmt. No. 2 at 3-4.

Aqua selected Gannett Fleming Valuation and Rate Consultants, LLC (Gannett) and Limerick selected Herbert, Rowland & Grubic, Inc. (HRG) as their respective UVEs to prepare fair market value appraisals of Limerick’s sewage collection and treatment system assets. Based on Gannett’s appraisal, the fair market value for Limerick’s wastewater system was $80,098,000. HRG calculated a fair market value of $76,890,000. Both appraisals were prepared using the USPAP employing the cost, income, and market approaches to value. The fair market value average of the two appraisals was $78,494,000. Application at 15.

On November 16, 2016, Aqua executed an Asset Purchase Agreement (APA) with the Township to purchase the Township’s wastewater utility assets for $75.1 million. Pursuant to the APA, Aqua will operate the Township’s system as a standalone system from its Southeastern Division office in Bryn Mawr, Pennsylvania, which presently operates seventeen other wastewater systems within the division. Also, Aqua is prevented from increasing the rates of the acquired customers for at least three years following the closing date of the transaction. Application at 8. Additionally, Aqua proposes spending approximately $8.3 million on capital project upgrades for the King Road and Possum Hollow systems and for IT transition costs. Aqua Stmt. No. 2 at 7-8.

Aqua filed its Application under Sections 1102 and 1329 of the Code, 66 Pa. C.S. §§ 1102 and 1329. Pursuant to Section 1329, the Company requests that the Commission approve the purchase price of $75.1 million as the rate base value of the assets to be acquired for ratemaking purposes. Aqua submits that it is permitted to use the negotiated purchase price because it is lower than the average of the two appraisals provided with the Application pursuant to Section 1329(c)(2).

This is Aqua’s second Application proceeding under Sections 1102 and 1329 being considered by the Commission. In the first proceeding, the Commission approved Aqua’s Application to acquire the wastewater system assets of New Garden Township and New Garden Sewer Authority (Aqua-New Garden proceeding). *See Application of Aqua Pennsylvania Wastewater, Inc. pursuant to Sections 1102 and 1329 of the Public Utility Code for Approval of its Acquisition of the Wastewater System Assets of New Garden Township and the New Garden Township Sewer Authority*, Docket No. A-2016-2580061 (Order entered June 29, 2017) (*Aqua - New Garden Application Order*) and the Order on Reconsideration of the *Aqua - New Garden Application Order*, Docket No. A-2016-2580061 (Order entered October 5, 2017) (*Aqua - New Garden Reconsideration Order*).[[2]](#footnote-3)

# III. Discussion

## A. Legal Standards

As the proponent of a rule or order in this proceeding, Aqua has the burden of proof to establish that it is entitled to the relief it is seeking. 66 Pa. C.S. § 332(a). The Applicant must establish its case by a preponderance of the evidence. *Samuel J. Lansberry, Inc. v. Pa. PUC*, 578 A.2d 600 (Pa. Cmwlth. 1990), *alloc. denied,* 529 Pa. 654, 602 A.2d 863 (1992). That is, the Applicant’s evidence must be more convincing, by even the smallest amount, than that presented by any opposing party. *Se-Ling Hosiery, Inc. v. Margulies*, 364 Pa. 45, 70 A.2d 854 (1950). Additionally, this Commission’s decision must be supported by substantial evidence in the record. More is required than a mere trace of evidence or a suspicion of the existence of a fact sought to be established. *Norfolk & Western Ry. Co. v. Pa. PUC,* 489 Pa. 109, 413 A.2d 1037 (1980).

In this case, the Applicant requests approval of: (1) the acquisition, by Aqua, of the wastewater system assets of the Township; (2) the right of Aqua to begin to offer, render, furnish and supply wastewater service to the public in portions of the Township; and (3) an order approving the acquisition that includes the ratemaking rate base of the Township’s wastewater system assets pursuant to Section 1329(c)(2) of the Code, 66 Pa. C.S. § 1329(c)(2). Accordingly, Aqua has the burden of proving it satisfies the requirements of the Code, particularly Sections 1102 and 1103 of the Code, 66 Pa. C.S. §§ 1102 and 1103. Section 1102(a) provides that the Commission must issue a Certificate as a legal prerequisite to a public utility offering service or abandoning service and certain property transfers by public utilities. The Code provides the following, in pertinent part:

Upon the application of any public utility and the approval of such application by the commission, evidenced by its certificate of public convenience first had and obtained, and upon compliance with existing laws, it shall be lawful:

\* \* \*

(3) For any public utility . . . to acquire from, or to transfer to, any person or corporation, including a municipal corporation, by any method or device whatsoever, including the sale or transfer of stock and including a consolidation, merger, sale or lease, the title to, or the possession or use of, any tangible or intangible property used or useful in the public service.

66 Pa. C.S. § 1102(a)(3).

The Commission will only grant a Certificate“if the Commission shall find or determine that the granting of such certificate is necessary or proper for the service, accommodation, convenience or safety of the public.” To ensure that a transaction is in the public interest, the Commission may impose conditions in granting a Certificate that it deems to be just and reasonable. 66 Pa. C.S. § 1103(a).

In order for the Commission to approve the proposed transaction under Sections 1102 and 1103 of the Code, the Applicant must demonstrate that the proposed acquisition will “affirmatively promote the ‘service, accommodation, convenience, or safety of the public’ in some substantial way.” *City of York v. Pa. PUC*, 449 Pa. 136, 141, 295 A.2d 825, 828 (1972) (*City of York*). The Pennsylvania Supreme Court explained the *City of York* standard as follows:

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

*Popowsky v. Pa. PUC*, 594 Pa. 583, 611, 937 A.2d 1040, 1057 (2007) (*Popowsky*).

Additionally, pursuant to Section 1103 of the Code, the Applicant must show that it is technically, legally, and financially fit to own and operate the assets it will acquire from New Garden. *Seaboard Tank Lines v. Pa. PUC*, 502 A.2d 762, 764 (Pa. Cmwlth. 1985); *Warminster Twp. Mun. Auth. v. Pa. PUC*, 138 A.2d 240, 243 (Pa. Super. 1958). As a certificated public utility, there is a rebuttable presumption that Aqua possesses the requisite fitness. *South Hills Movers, Inc. v. Pa. PUC*, 601 A.2d 1308, 1310 (Pa. Cmwlth. 1992).

Before addressing the Exceptions, we note that any issue or Exception that we do not specifically delineate shall be deemed to have been duly considered and denied without further discussion. It is well settled that the Commission is not required to consider expressly or at length each contention or argument raised by the parties. Consolidated Rail Corp. v. Pa. PUC, 625 A.2d 741 (Pa. Cmwlth. 1993); *also* see, generally, [University of Pennsylvania v. Pa. PUC, 485 A.2d 1217 (Pa. Cmwlth. 1984).](file://C:\research\buttonTFLink?_m=69761b6202cb4178e2a6e6fe02f5751b&_xfercite=%3ccite%20cc=%22USA%22%3e%3c!%5bCDATA%5b2000%20Pa.%20PUC%20LEXIS%2067%20%5d%5d%3e%3c\cite%3e&_butType=3&_butStat=242&_butNum=6&_butInline=1&_butinfo=%3ccite%20cc=%22USA%22%3e%3c!%5bCDATA%5b485%20A.2d%201217%5d%5d%3e%3c\cite%3e&_fmtstr=FULL&docnum=5&_startdoc=1&_startchk=1&wchp=dGLSzS-lSlbz&_md5=9b1cc8319afd12440738bb82d74455ef)

## B. Recommended Decision

ALJ Haas made fifty-two Findings of Fact and reached thirteen Conclusions of Law. R.D. at 5-11, 51-52. The Findings of Fact and Conclusions of Law are incorporated herein by reference and are adopted without comment unless they are either expressly or by necessary implication rejected or modified by this Opinion and Order.

### 1. Applicant’s Fitness

The ALJ began with an examination of whether Aqua possesses the technical, legal and financial fitness to provide the proposed service. The ALJ explained that as an existing, certificated public utility, the Company enjoys a presumption of fitness in this proceeding. Here, no Party presented evidence to challenge Aqua’s fitness. Additionally, the ALJ acknowledged that the Company offered sufficient record evidence that it possesses the requisite technical, legal and financial fitness to provide the proposed service. R.D. at 16.

Regarding technical fitness, the ALJ outlined Aqua’s evidence that it currently provides wastewater service to approximately 20,000 customers in thirteen Pennsylvania counties. The Company also operates thirty-one wastewater treatment plants in Pennsylvania with seventeen of those systems located in Aqua’s Southeast Division, which are in close proximity to the Township. Further, the ALJ noted the size of Aqua PA, the Company’s parent. Aqua PA is the second largest investor owned water and wastewater utility operating in Pennsylvania. The ALJ highlighted the number of water customers (455,000) and wastewater customers served by Aqua PA and the number of employees (600) who possess expertise in providing water and wastewater service. *Id.* at 16-17.

Next, the ALJ summarized the Company’s evidence pertaining to its legal fitness explaining that there are no pending legal proceedings challenging Aqua’s ability or propensity to operate safely and legally. As to financial fitness, the ALJ first noted the assets of Aqua PA which is a Class A water utility in Pennsylvania. The ALJ indicated that Aqua PA has total assets of $3.9 billion and had $418 million in annual revenues in 2016. Aqua PA also had operating income of approximately $213 million and net income of $173 million. Regarding the Company’s financial fitness, the ALJ stated that Aqua is a Class A wastewater utility in Pennsylvania with total assets of $111 million and annual revenue of $12 million. Its financial statements indicated a net income of $2 million for 2015. As to its acquisition of Limerick’s wastewater assets, Aqua intends to finance the transaction using existing short-term credit lines with a likely conversion to a mix of long-term debt and equity capital in the future. *Id.* at 17-18.

According to the ALJ, Aqua demonstrated by a preponderance of the evidence that it is technically, legally and financially fit to own and operate New Garden’s assets and to provide the proposed service to the public. *Id.* at 18.

### 2. Rate Stabilization Plan

The ALJ explained that Section 1329(g) of the Code defines a rate stabilization plan as a “plan that will hold rates constant or phase rates in over a period of time after the next base rate case.” He also noted our direction in the *Final Implementation Order* that rate stabilization plans will be reviewed for reasonableness in each rate case so as not to place long-term burdens on the acquiring utility’s existing ratepayers. In order to facilitate such a review, an applicant must provide testimony, schedules, and work papers to establish a basis for the plan and its impact on existing customers who would need to cover the shifting revenue requirement. R.D. at 18-19 (citing *Final Implementation Order* at 27).

The ALJ stated that the Agreement contains the following rate related provision:

After closing, Aqua will implement the Limerick Township sanitary wastewater rates in effect at closing as reflected on Schedule 7.05(a) of the Agreement and inclusive of any approved surcharge or pass-through costs as its effective sanitary sewer rates, provide that such rates shall not be lower than the rates in effect on the execution date of the agreement. The Agreement further provides that Aqua’s Base Rate may not increase until after the third anniversary of the Closing date.

R.D. at 19 (quoting Application at ¶ 29). Additionally, the ALJ explained that the rate provisions referenced in the Application are reflected in Section 7.05(b) of the APA which provides: “Rate Stabilization. After closing, Buyer shall begin charging the Base Rate as Buyer’s rates within the Service Area, which Base Rate the Parties agree may not be increased until after the third anniversary of the Closing Date (the “Stabilization Period”).” R.D. at 19 (quoting Application, Exh. C at ¶ 7.05(b)).

Aqua acknowledged in the instant proceeding that the Commission has the final authority over the rates charged to utility customers. Specifically, Aqua’s witness, William Parker testified that “[w]hile the APA includes a period of three years over which rates are to remain unchanged at seller’s rates, there is no provision within the APA that changes the purchase price, or provides for a limitation on rate increases. In addition, I note that the Commission maintains the authority to set rates in [Aqua’s] next base rate case.” R.D. at 19-20 (quoting Aqua Stmt. 1 at 6). Mr. Packer further testified that, “nothing that Aqua has proposed in this application proceeding is binding on the ratemaking authority of the Commission or limiting the Commission’s ability to set rates.” R.D. at 20 (quoting Aqua Stmt. 1R at 8).

The OCA, on the other hand, recommended that if the Application is approved by the Commission, conditions should attach to the approval that place the risk of any revenue shortfall from the acquired customers caused by the APA on Aqua’s shareholders. Specifically, the OCA recommended the following conditions:

The Commission retains the authority to allocate revenues, if appropriate, to the Limerick Township customers that are inconsistent with the restrictions contained in the APA.

Aqua and its shareholders should bear all risk of a shortfall between revenues it is permitted to recover under its agreement with Limerick and the costs that the Company will incur with respect to this system. To the extent that Aqua is unwilling or unable to charge costs in excess of the limitations provided in the Asset Purchase Agreement, the excess costs should be borne by shareholders and not spread to other ratepayers.

R.D. at 20 (citing OCA M.B. at. 47-48).

The ALJ explained that in the Aqua-New Garden proceeding, Aqua proposed freezing rates to New Garden customers for at least two years and, within the first ten years, limiting future rate increases to those customers so as not to exceed a compounded annual growth rate of 4%. The ALJ pointed out that the Commission concluded in that proceeding that the rate commitments contained in the APA did not constitute a rate stabilization plan. The ALJ, however, acknowledged that the Commission, in its effort to address similar concerns raised by the other Parties about the potential rate impact of the rate commitments on Aqua’s existing customers, imposed the following conditions:

The Commission retains the authority to allocate revenues, if appropriate, to the New Garden Township customers that are in excess of the restrictions contained in the APA.

Aqua and its shareholders should bear all risk of a shortfall between revenues it is permitted to recover under its agreement with New Garden and the costs that the Company will incur with respect to this system. To the extent that Aqua is unwilling or unable to charge costs in excess of the limitations provided in the Asset Purchase Agreement, the excess costs should be borne by shareholders and not spread to other ratepayers.

R.D. at 20-21 (quoting *Aqua - New Garden Application Order* at 70-71).

Therefore, similar to the Aqua-New Garden proceeding, the ALJ recommended that the conditions proposed by the OCA be applicable in the instant proceeding as well. The ALJ reasoned that by attaching these conditions to the approval of this Application, the acquired customers will enjoy the benefits of the rate commitments negotiated and memorialized in the APA while also making sure that Aqua’s existing customers are not unfairly burdened by any revenue shortfalls resulting from those commitments. R.D. at 21.

### 3. Regulatory Asset Treatment

Aqua proposed to split the $75.1 million ratemaking rate base into two parts, an initial rate base of $60 million and a regulatory asset of $15.1 million. More specifically, Aqua proposed to amortize the $15.1 million regulatory asset at a rate of $2.1 million per year, which would be moved into rate base at the time the company files a base rate case. R.D. at 21-22 (citing Aqua Stmt. No. 1 at 15). The regulatory asset would not depreciate; rather, depreciation would begin when Aqua amortizes it into rate base. R.D. at 22.

However, both I&E and the OCA opposed the regulatory asset treatment proposed by Aqua on the basis that it is not consistent with the typical use of a regulatory asset as a ratemaking tool. Both I&E and the OCA argued that regulatory assets are typically used for expense items, not for deferring utility plant in service. I&E argued, “[r]egulatory assets are used to defer the recognition of an expense that would otherwise have been included on the income statement during a certain timeframe and appears in the deferred debit portion of a balance sheet.” *Id.* (quoting I&E M.B. at 12). The OCA further argued that Aqua’s proposal to amortize the asset in increments as it decides to file base rate cases means that it would not be possible to know when the asset would be fully amortized and included in rate base, creating uncertainty and unnecessary risk for customers.” R.D. at 22 (citing OCA Stmt.1 at 5-6). I&E and the OCA averred that the entire ratemaking rate base approved by the Commission should be treated as rate base by Aqua and that Aqua should begin depreciating it for accounting purposes immediately upon closing. R.D. at 22 (I&E M.B at 14; OCA M.B. at 49-50).

The ALJ agreed with I&E and the OCA’s position that Aqua’s 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 should not be approved at this time. According to the ALJ, Section 1329(c)(1) is clear in its intent to incorporate the full ratemaking rate base of the selling utility into the rate base of the acquiring utility during the acquiring utility’s next base rate case. There is no provision for the splitting of the full rate base amount. The ALJ also noted that a regulatory asset typically represents specific incurred costs that a regulatory agency permits a public utility to defer to its balance sheet because recovery will come through future rates, amounts that would otherwise be required to appear on the company's income statement and be charged against current expenses. The ALJ explained that the circumstances of this case did not involve the inclusion of such costs. Based on the aforementioned reasons, the ALJ recommended that Aqua’s 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 be denied. R.D. at 22.

### 4. Ability to Challenge Fair Market Value Appraisals

Next, the ALJ addressed the continuing dispute as to whether the Commission or other Parties may challenge the appropriateness of the fair market value determinations of the UVEs determined pursuant to Section 1329. According to Aqua, the procedures under Section 1329, including the independent appraisals by the UVEs, provide the mechanism for determining the rate base value of the acquired assets. The Company asserted that there is no allowance under Section 1329 for the other Parties to challenge or question the appropriateness of the rate base value proposed by the Applicant. R.D. at 23.

On the other hand, the OCA argued that it would be inconsistent with the Code to allow the Company to submit its valuation proposal, supported by two reports, without allowing any review or challenge to those reports. Additionally, the OCA asserted due process arguments that the determination of the ratemaking rate base impacts the calculation of the revenue requirement which can only be made by giving due notice and an opportunity to challenge the UVE appraisals. According to the OCA, the rate base determination under Section 1329 will impact future rates for years to come and the Parties must have the opportunity to challenge the determination through the submission of testimony related to appropriateness of the rate base valuation.

The ALJ acknowledged that neither Section 1329 nor the *Final Implementation Order* directly address this issue. However, the ALJ expressed his view that the legislature did not intend to eliminate completely the Commission’s ability to analyze and challenge the UVE appraisals and the rate base value proposed by the Applicant. Noting the finding in the *Aqua – New Garden Application Order* that Section 1329 permits the Commission and the Parties to develop a record pertaining to a review and an analysis of the fair market appraisals of the UVEs. Accordingly, the ALJ found it appropriate in this proceeding to allow the Parties to question or challenge the fair market value appraisals and the proposed rate base value of the acquired assets, and to submit evidence and develop a record in support of their respective positions. R.D. at 26.

1. **Rate Base Value**

**a. HRG’s Appraisal**

The ALJ adopted several adjustments to the fair market value appraisal prepared by HRG, Limerick’s UVE. Specifically, the ALJ made five adjustments to the income approach, three adjustments to the cost approach, and one adjustment to the market approach within the appraisal determination made by HRG.

In the first income approach adjustment, the ALJ agreed with the OCA that HRG’s income tax expense contained many errors, including: (1) HRG’s assumption of no federal or state incomes taxes for the first four years of its DCF analysis; (2) HRG’s use of a 38.9% tax rate when an incremental tax rate of 41.49% should have been used based on the state income tax rate of 9.99% and the federal income tax rate of 35%; (3) HRG’s treatment of capital expenditures as a tax deductible expense, when only the depreciation of those capital expenditures should be tax deductible; and (4) the failure of HRG to include any deduction for depreciation expense or to reflect a deduction for income expense. R.D. at 31-32.

Second, the ALJ adjusted the discount rate used in the income analysis. HRG used a discount rate of 2.5% and the ALJ adopted a discount rate of 6.9%, which he described as reflective of a true cost of capital.The ALJ considered HRG’s discount rate of 2.5% to be improper when compared with Gannett’s appraisal which found an appropriate discount rate ranging from 6.63% to 7.99%. R.D. at 32.

In the third and fourth income adjustments, the ALJ adopted the OCA’s recommendations to remove the “going value” adder of $4 million and the “erosion of cash flow” deduction of $370,000. In the fifth income adjustment, the ALJ also agreed with the OCA’s recommendation that because of flaws and unreasonable assumptions in HRG’s rate of return/rate base analysis no consideration should be given to the overstated value of $100.69 million. R.D. at 32-34.

As a result of the adjustments to disregard HRG’s Rate of Return/Rate Base analysis, to correct the income tax expense calculations, to use a 6.97% discount rate, and to remove the “going value” and “erosion of cash flow” adders, the ALJ calculated HRG’s income approach value as $36,560,000. *Id.* at 34.

The ALJ adopted three adjustments to the reproduction cost approach used by HRG in its fair market valuation. First, the ALJ agreed with the OCA’s argument that HRG did not establish a reasonable basis for separately valuing collector mains. Accordingly, the ALJ decreased HRG’s reproduction cost calculation by $19,195,429. Second, the ALJ adopted the OCA’s recommendation to remove $4.5 million of future capital projects from the HRG reproduction cost approach because the inclusion of these projects did not add value to the Township system at the time of the acquisition. Third, the ALJ removed HRG’s “going value” adder of $4 million from the HRG reproduction cost approach. The ALJ agreed with the OCA’s arguments that the inclusion of the adder is not logical, is contradictory to HRG’s analyses, and contains numerous double counts. R.D. at 36-37.

However, the ALJ rejected the OCA’s recommendation that would have removed land from the HRG reproduction cost analysis and would have reduced the HRG reproduction cost approach by $756,159. The ALJ explained that he was applying the ENR[[3]](#footnote-4) index to land consistent with all other utility plant. Although recognizing that the ENR index may not be the most appropriate index, the ALJ declined to determine that the land’s original cost was a more appropriate method than the analysis used by HRG. R.D. at 37.

Under the market approach evaluation, the ALJ made one adjustment HRG’s appraisal determination. The ALJ adopted the OCA’s argument that HRG’s use of a projected customer count of 7,246 customers was not appropriate. HRG applied an average customer cost ($8,661 per customer) to the projected customer count and obtained a market value of $62,760,000. Instead, the ALJ found that the current, actual customer count of 5,434 should be used. By applying the average customer cost to the actual customer count, the ALJ concluded that the market value should be $47,060,000. R.D. at 38-39.

Alternatively, however, the ALJ rejected the OCA’s proposed market approach adjustment to remove the cost of future capital improvements from the purchase prices of comparable systems. The ALJ agreed with Aqua that HRG’s calculation correctly included an adder for future capital improvements, identified as $4,533,000 in the engineering report. R.D. at 39.

**b. Gannett’s Appraisal**

The ALJ rejected two of the OCA’s arguments challenging Gannett’s income approach calculations within its fair market value appraisal. Regarding the 13‑year terminal value, the ALJ explained that Gannett obtained a value under the income approach based on several DCF averages conducting two DCF analyses each from both a buyer’s and a seller’s perspective. The OCA objected to Gannett’s use of a 13-year terminal value and proposed a DCF valuation using 50 years of discounted net cash flow with no termination value. The ALJ agreed with Aqua’s position and accepted Gannett’s income valuation of $75,204,407. R.D. at 34-36. Second, the ALJ rejected the OCA’s alternative discount rates on the basis that the OCA did not show that Gannett’s discount rates were unreasonable. *Id.* at 35-36.

**c. Summary of Adjustments**

The following table summarizes the original appraisals filed by HRG and Gannett:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **HRG** | Value |  | **Gannett** | Value |
| Income |  |  | Income |  |
| Cost |  |  | Cost |  |
| Market |  |  | Market |  |
|  |  |  |  |  |
| Average |  |  | Average |  |
| **Recommendation** |  |  | **Recommendation** |  |

The following table summarizes the fair market value appraisals with the adjustments recommended by the ALJ:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **HRG** | Value |  | **Gannett** | Value |
| Income |  |  | Income |  |
| Cost |  |  | Cost |  |
| Market |  |  | Market |  |
|  |  |  |  |  |
| Average |  |  | Average |  |
| **Recommendation** |  |  | **Recommendation** |  |

The average of the two valuations is $64,373,378. The ALJ noted that he did not make any changes to the weight applied to each approach. R.D. at 31.

### 6. Public Interest / Affirmative Public Benefit

Next, the ALJ considered the Commission’s guidance in Aqua’s prior application in the *Aqua - New Garden* *Order* and determined that the Company has proven that the transaction is in the public interest and that the public at large, including Aqua’s existing customers, will realize affirmative public benefits sufficient to warrant approval of its Application. The affirmative public benefits shown by Aqua coupled with the conditions – requiring a cost of service study in the next rate case and Aqua’s shareholders bearing the risk of any shortfall between revenue from the Limerick customers and the cost of providing service – will assure that the requirements of Chapters 11 and 13 of the Code are satisfied. R.D. at 40-47.

### 7. Imposition of 6-Month Statutory Deadline

The OCA argued that Section 1329(d) establishes a 6-month deadline for the Section 1329 determination but does not require the same 6-month limit for the Section 1102 determination. The ALJ held that the Commission already decided this issue in the *Aqua - New Garden* *Order* that when the acquiring entity is a certificated public utility there will be no bifurcation and a decision on the Application must be issued within the statutory 6-month deadline. R.D. at 47-48.

### 8. Revised DSIC Tariff and LTIIP

The ALJ explained that Section 1329(d)(4) authorizes an acquiring utility to begin collecting a Distribution System Improvement Charge (DSIC) from the time a tariff goes into effect until new rates are approved for the purchaser in a base rate case. 66 Pa. C.S. § 1329(d)(4). If an acquiring utility decides to charge its customers a DSIC prior to its next base rate case, it is required, pursuant to the Commission’s *Final Implementation Order*, to file a revised tariff to reflect the charge, as well as a revised Long Term Infrastructure Improvement Plan (LTIIP). R.D. at 48.

The ALJ noted the OCA’s argument that if the Limerick customers begin paying a DSIC charge prior to the effective date of rates established in Aqua’s next base rate case, the Commission should require, as a condition of approval of the application, that Aqua file the required tariff changes and revised LTIIP no later than thirty days after entry of the final Commission Order in this proceeding. The ALJ rejected the OCA’s proposed finding that it was not necessary to include a requirement mandating compliance with the Commission’s *Final Implementation Order*. R.D. at 48-49.

### 9. 66 Pa. C.S. § 507 Approvals

The ALJ directed Aqua to file the APA and all relevant municipal agreements it is assuming under the APA with the Commission under separate “U” dockets within 20 days of Order entry. The ALJ indicated that this filing requirement is for the purpose of administrative efficiency and completeness and is consistent with the disposition of the Section 507 issue in the *Joint Application of Pennsylvania-American Water Company and the Sewer Authority of the City of Scranton*, Docket No. A-2016-2537209 (Order entered October 19, 2016) (*PAWC Scranton Order*). R.D. at 50.

### 10. Separate Cost of Service Study

Within the discussion of the affirmative public benefits disposition, the ALJ emphasized that this proceeding contains concerns of subsidization by Aqua’s existing customers of the Limerick customers. According to the ALJ, the Commission expressed similar concerns in the *Aqua – New Garden Order* and determined that a cost of service study was necessary to address the issue in that proceeding. Similarly, here the ALJ concluded that Aqua, at the time of filing its next base rate case, must submit a cost of service study or analysis that separates, costs, capital, and operating expenses of providing wastewater service to the Limerick customers as a separate class. R.D. at 47.

## C. Rate Stabilization Plan

### 1. Rate Stabilization Plan – Rate Freeze

**a. Aqua’s Exceptions**

In its Exception No. 1, Aqua disputes the ALJ’s recommendation that, as a condition for approval of the instant Application, the Commission retains the authority to allocate revenues, if appropriate, to Limerick customers in excess of the restrictions in the APA[[4]](#footnote-5) and that Aqua and its shareholders bear all risks of a shortfall between revenues it is permitted to recover and costs it incurs with respect to the Limerick system.[[5]](#footnote-6) Aqua Exc. at 3 (citing R.D. at 18-21, 53). Aqua contends that consistent with Section 1329(d)(1)(v), it included, as Exhibit G to its Application, a tariff that establishes rates equal to the existing Limerick rates at the time of the acquisition. Aqua further notes that consistent with Section 1329(d)(4), the tariff will remain in effect until new rates are approved by the Commission in a base rate proceeding. Aqua Exc. at 3 (citing Aqua Stmt. 1 at 6).

In arguing against the ALJ’s recommended conditional approval, Aqua is of the opinion that the proposed condition assumes that the Commission will, at sometime within the three-year rate freeze period, approve rates for Limerick customers that are different from the contract rates agreed to by Aqua and Limerick in the APA. Aqua believes the proposed condition is not reflective of any existing or proposed tariff circumstances and that the assumption that the Commission might approve rates that are different from the contract rates is purely speculative. Aqua Exc*.* at 3-4.

Aqua further argues that the proposed condition in the instant proceeding attempts to address ratemaking issues which are supposed to be reserved for adjudication in a future base rate proceeding. *Id.* at 4 (citing *PAWC Scranton Order* at 50). Aqua, nonetheless, acknowledges the Commission’s authority to set rates in Aqua’s next base rate case and that nothing Aqua has proposed in this application proceeding is binding on the ratemaking authority of the Commission or limiting on the Commission’s ability to set rates. Aqua Exc. at 4-5 (citing Aqua Stmt. 1 at 6; Aqua Stmt. 1R at 8). Therefore, Aqua argues the Commission should not include the proposed condition in its Final Order. Aqua Exc. at 3-5.

**b. OCA’s Replies to Aqua’s Exceptions**

In its Replies to Aqua Exception No. 1, the OCA avers that ALJ Haas appropriately imposed conditions for approval of the Application and that Aqua’s reference to the PAWC-Scranton proceeding as a basis for its argument against the conditions is misguided. Specifically, the OCA points out that unlike the PAWC-Scranton proceeding, the instant proceeding is filed under both Sections 1102 and 1329, in which Aqua requested that the purchase price be included in Aqua’s ratemaking rate base. Furthermore, the OCA argues that the fact that Aqua included a rate stabilization plan in the instant filing makes Aqua’s argument baseless. OCA R. Exc. at 2. In responding to Aqua’s argument that the proposed condition is “not reflective of any existing or proposed tariff circumstances,” the OCA retorts that although the impact of the rate freeze cannot be ascertained at this time, the rate impact of the freeze on Aqua’s existing customers and Limerick’s customers may be substantial.[[6]](#footnote-7) OCA R. Exc. at 3 (citing Aqua Exc. at 4; OCA M.B. at 47-48; OCA Stmt. 1S at 16; Aqua St. 1 at 13-16; Aqua Exhs. C and D).

OCA points out that in the Aqua-New Garden proceeding, the Commission imposed similar conditions stating it was concerned that the acquisition might cause potential future cross-subsidization of New Garden customers by current Aqua customers. According to the OCA, 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.” OCA R. Exc. at 3 (quoting *Aqua* – *New Garden* *Reconsideration Order* at 13-14). Thus, the OCA requests that the Commission deny Aqua’s Exception No. 1 and adopt the ALJ’s recommendation regarding this matter. OCA R. Exc. at 3.

**c. Disposition**

Based on our review of the record, the positions of the Parties, and the applicable law, we will deny Aqua’s Exception No. 1. We agree with the ALJ’s adoption of the OCA’s suggested conditions of approval of the instant Application in his Recommended Decision. We disagree with Aqua’s comparison of this case with the PAWC-Scranton proceeding as a basis for its argument against the conditions for approval. We concur with the OCA’s contention that both cases are not entirely analogous. First, we note that while the PAWC-Scranton proceeding involved a Section 1102 proceeding, the instant proceeding is a Section 1102 as well as a Section 1329 proceeding, where the purchase price or appraised fair market value of the selling utility may be considered the ratemaking rate base of the acquiring utility in its next base rate case proceeding. 66 Pa. C.S. § 1329(c).

Specifically, our *Final Implementation Order* highlights the ratemaking rate base as follows:

Generally, Section 1329(c) allows for the rate base of the selling utility to be incorporated into the rate base of the acquiring utility during the acquiring utility’s next rate base rate case or the initial tariff filing of an entity. The rate base to be incorporated will be the lesser of the purchase price or the fair market value of the seller.

We acknowledged that there is some ambiguity in Section 1329. First, subsection (c)(1)(ii) could be construed to require that the “ratemaking rate base” be immediately incorporated into the entity’s initial rates. However, subsections (e) and (d)(1)(v) could be construed together to require entities to file a tariff with rates equal to the existing rates of the selling utility. In the interest of equity, the Commission tentatively proposed that entities be required to file tariffs consistent with (d)(1)(v). This was in no way to inhibit the right of a newly certificated utility to incorporate the ratemaking rate base into its tariff via a Section 1308 proceeding.

*Final Implementation Order* at 15, 28-29. We note that in the instant proceeding, Aqua requests that the Commission issue an Order establishing the ratemaking rate base of the acquired assets at $75.1 million, pursuant to Section 1329.

Second, in the *PAWC Scranton Order*, we stated as follows:

Nevertheless, we note that the OCA argued that, even without the variance adjustment, the $195 million purchase price set forth in the APA is more than the book value of all of [Scranton Sewer Authority’s (SSA’s)] property, plant and equipment.[[7]](#footnote-8) OCA M.B. at 33. However, the Joint Applicants have indicated that following closing and prior to its next base rate filing, PAWC would prepare an original cost study of the plant-in-service, which would then be used to make a determination of the need for an acquisition adjustment claim for this transaction in a future base rate proceeding. Joint Applicants’ M.B. at 83-84. Consequently, due to the significant difference in the book value of SSA’s wastewater plant and the purchase price of this transaction, should PAWC claim an acquisition adjustment in its next rate case filing, the original cost study may be reviewed to determine the reasonableness of the claim, consistent with Section 1327(a) of the Code, 66 Pa. C.S. § 1327(a), and the Commission’s policy statement at 52 Pa. Code § 69.721, regarding acquisitions of viable water and wastewater systems.  This review may also address any contributions-in-aid-of-construction.

*PAWC Scranton Order* at 69.

We note that the original cost study, which is reviewed to determine the reasonableness of a utility’s acquisition adjustment claim in a future base rate proceeding, consistent with Section 1327(a) of the Code, 66 Pa. C.S. § 1327(a), and the Commission’s policy statement at 52 Pa. Code § 69.721, regarding acquisitions of viable water and wastewater systems, is not applicable in a Section 1329 proceeding. Accordingly, while the record evidence in the instant proceeding places the depreciated value of Limerick’s wastewater system at $46,153,867, Aqua has requested that the Commission issue an Order establishing the ratemaking rate base of Limerick’s wastewater assets at $75.1 million pursuant to Section 1329. Application at 17; Aqua Exh. Q. Particularly, Section 1329 allows the rate base of the municipal system being purchased to be incorporated into the rate base of the purchasing investor-owned utility at the lesser of either the purchase price or the fair market value established by the independent appraisals conducted by two UVEs. *Final Implementation Order* at 15; 66 Pa. C.S. § 1329(c). Therefore, to the extent that Aqua is comparing the ratemaking rate base in the instant proceeding to the PAWC-Scranton case, we see no correlation between the two cases.

Additionally, in our *Aqua – New Garden Application Order* and the *Aqua – New Garden Reconsideration Order,* we reasoned that the ALJ’s determination about the rate commitment provision contained in the APA did not trump the Commission’s ultimate authority to set and allocate rates. We explained Aqua’s acknowledgement that the Commission will ultimately decide the appropriate rates for the customers of the acquired utility in Aqua’s next base rate case proceeding and that Aqua and its shareholders will bear any rate differential during the contract period stipulated in the APA. Explaining that the provision was an arm’s length negotiation between two independent parties, we determined that it does not bind the future rate-setting authority of the Commission. Thus, we adopted the ALJ’s alternative recommendations pertaining to the revenue requirement allocation to the New Garden customers that might be in excess of the restrictions outlined in the APA. *Aqua – New Garden Application Order* at 42; *Aqua – New Garden Reconsideration* at 10-11. Similarly, we believe the same conditions apply in this case and we see no reason to overturn the ALJ’s Recommended Decision that imposes similar conditions in the instant proceeding. As such, we shall deny Aqua’s Exception No. 1.

### 2. Rate Stabilization – Regulatory Asset Treatment

**a. Aqua’s Exceptions**

In its Exception No. 2, Aqua disagrees with the ALJ’s denial of its proposal to split the $75.1 million ratemaking rate base into an initial rate base of $60 million and a regulatory asset of $15.1 million. Aqua Exc. at 5 (citing Aqua Stmt. 1R at 8). Aqua argues that its proposal is a reasonable approach to address rate stabilization for its customers and is consistent with the Commission’s explanation in the *Final Implementation Order* that rate stabilization plans will be subject to review in each rate case for reasonableness and should not place long-term burdens on the acquiring utility’s existing ratepayers.[[8]](#footnote-9) Aqua Exc. at 5-6 (citing Exh. D; Tr. at 22-25; Aqua Stmt. 1 at 13; Aqua Stmt. 1 at 16-17). Aqua disagrees with the fact that the ALJ denied the proposal because it is atypical and there is no provision in Section 1329 for splitting rate base. Aqua contends that contrary to the ALJ’s determination, the proposal does not conflict with the provisions of Section 1329 because it is just a proposal at this time and that any further questions about the proposal can be fully vetted in Aqua’s next base rate case proceeding. Aqua further argues that regulatory assets have a great deal of flexibility in their use and that its proposal is reasonable and should be permitted.[[9]](#footnote-10) Aqua Exc. at 7. According to Aqua, if approved by the Commission in a future base rate proceeding, the rate stabilization plan would result in a delayed recovery of the portion of the ratemaking rate base attributed to the regulatory asset. Aqua believes the delay in rate base recognition benefits customers as it lowers the cost of service. *Id.* at 7-8.

**b. I&E’s Replies to Aqua’s Exceptions**

In its reply to Aqua’s Exception No. 2, I&E avers the ALJ correctly determined that Aqua’s 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 inconsistent with the procedural requirements articulated in Section 1329 and with traditional ratemaking principles. I&E R. Exc. at 2. I&E asserts that Aqua’s argument that the regulatory asset was “simply a proposal” that can be fully vetted in its next base rate case proceeding undermines the fact that the proposal, in of itself, violates the clear language of Section 1329. *Id.* (citing Aqua Exc. at 6-7). Specifically, I&E argues that Section 1329(c)(1) mandates that:

1. The ratemaking rate base of the selling utility shall be incorporated into the rate base of:
2. the acquiring public utility during the acquiring public utility’s next base rate case; or
3. the entity in its initial tariff filing.

I&E R. Exc. at 2 (citing 66 Pa. C.S. § 1329(c)(1)).

I&E avers that as clearly indicated above, Aqua’s proposal is contrary to the clear language of Section 1329, which states that the ratemaking rate base “shall be” incorporated into the rate base of the acquiring entity during the next base rate case or in its initial tariff filing. I&E asserts there is no need to vet questions about Aqua’s proposal as the ALJ has rightly determined that the proposal violates the plain language of Section 1329. I&E R. Exc. at 2-3.

Additionally, I&E argues that the ALJ also correctly found that Aqua’s regulatory asset proposal is inconsistent with longstanding ratemaking principles. I&E contends that regulatory assets are typically used for expense items to prevent a sudden steep increase in costs for certain expenses and are not used for deferring rate base recognition of utility plants. I&E R. Exc. at 3 (citing R.D. at 22; I&E Stmt. 2 at 4). Furthermore, I&E points out that delaying the $15.1 million through the regulatory asset mechanism will cause a mismatch between the expected life of the asset and the period over which the asset is recovered, especially for utility plants, which are generally depreciated over thirty to forty years. I&E R. Exc. at 3-4 (citing I&E Stmt. 2 at 6-7).

**c. OCA’s Replies to Aqua’s Exceptions**

In its Replies to Aqua’s Exception No. 2, the OCA also disputes Aqua’s argument stating that Aqua’s proposal is inconsistent with the typical use of a regulatory asset. OCA R. Exc. at 4. Similar to I&E’s arguments against the proposal, the OCA avers that regulatory assets are generally used for expense items – not deferring utility plant in service – and that regulatory assets are amortized over a fixed period of time and not in increments. The OCA argues Aqua’s proposal should be denied because it would be impossible to know when the asset would be fully amortized and added to rate base which would subject Aqua’s customers to some form of uncertainty. *Id.* (citing OCA M.B. at 49-50; OCA Stmt. 1 at 5-6). In addition, the OCA indicates that because the benefits Aqua claims are associated with the proposal do not outweigh the potential harm the proposal may cause to Aqua’s customers, the Commission should deny the proposal. OCA R. Exc. at 4-5 (citing OCA M.B. at 50, 55; OCA R.B. at 14, 16; OCA Stmt. 1S at 3).

**d. Disposition**

Based on our review of the record, the positions of the Parties, and the applicable law, we will deny Aqua’s Exception No. 2. We agree with the ALJ’s recommendation and the arguments put forth by the opposing Parties regarding this issue. We concur that Aqua’s proposal is inconsistent with the procedural requirements articulated in Section 1329 and with traditional ratemaking principles. We agree that the circumstances for allowing a regulatory asset does not prevail in the instant proceeding. Accordingly, we do not believe Aqua’s regulatory asset proposal is appropriate in this proceeding. As such, we will deny Aqua’s Exception No. 2.

## D. Approval of Rate Base Value

### Ability to Challenge Fair Market Value Appraisals

**a. Aqua’s Exceptions**

The Parties dispute the interpretation of Section 1329 and whether the Commission and the litigants are permitted to challenge the appropriateness of the fair market value determinations of the UVEs in their appraisals and the rate base value proposed by the Applicant for those assets for ratemaking purposes. In its Exception No. 3, Aqua contends that the General Assembly did not intend for fair market valuation to be a matter of traditional litigation. Rather, in Section 1329 proceedings the acquiring utility and the selling municipality agree to use Section 1329 procedures which contain consumer protections built into the statute. According to the Company, the statutory language, requiring fair market value to be determined by the UVEs, must be followed and the Recommended Decision should be reversed. Aqua Exc. at 8-11.

**b. OCA’s and I&E’s Replies to Aqua’s Exceptions**

In response, both I&E and the OCA argue that the ALJ correctly found that Section 1329 does not strip the Commission of its duty to assure the public interest and compliance with the Code. They are of the opinion that other parties are permitted to fully review and analyze the fair market appraisals. I&E R. Exc. at 4-6; OCA R. Exc. at 5-9.

**c. Disposition**

In the *Aqua – New Garden Order*, we 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. Here, the ALJ appropriately relied on our prior ruling in allowing the Parties to question and challenge the fair market value appraisals and the proposed rate base value of the acquired assets, and to submit evidence and develop a record in support of their respective positions. We find no error in the ALJ’s handling of the evidentiary record and shall deny Aqua’s Exception No. 3.

In the beginning of Aqua’s Exception No. 4, below, pertaining to the adjustments of HRG’s income approach valuation, the Company repeats its arguments that the adopted adjustments are contrary to the clear intent of the Section 1329 and that the Parties’ should not be able to challenge the fair market value appraisals. Aqua further argues that because the OCA’s adjustments are based on the “just and reasonable” ratemaking standard rather than the USPAP standard, they should be rejected and the ALJ’s recommendations should be denied. Aqua Exc. at 11-14.

In response, the OCA states that “Section 1329 contains no prohibitions on the ability of the Parties to review the UVE appraisals as to their *reasonableness*.” OCA R. Exc. at 9 (citing *Aqua – New Garden Application Order* at 53). The OCA also notes that while Section 1329 requires that UVEs adhere to the USPAP standards in their valuations, the legislation does not prohibit a review of the assumptions utilized by the UVEs for reasonableness and conformance to the standards of the industry being valued. OCA R. Exc. at 9-10 (citing 66 Pa. C.S. § 1329(a)(3)). We agree that Section 1329 does not prevent a review of the UVE assumptions for reasonableness, and for the reasons discussed below, we find that the ALJ appropriately considered several of the recommendations to the fair market appraisals of the Limerick system.

1. **Rate Base Valuation**

As stated earlier, the OCA made certain adjustments to both Gannett and HRG’s fair market appraisals, some of which were adopted by the ALJ in his

Recommended Decision. In particular, the OCA made two adjustments to Gannett’s income approach but the ALJ did not adopt them. The OCA also made five adjustments to HRG’s income approach, all of which were adopted by the ALJ. In addition, the OCA made four adjustments to HRG’s cost approach, three of which were adopted by the ALJ. Lastly, the OCA made two adjustments to HRG’s market approach. The ALJ adopted one of the adjustments regarding customer count and rejected the OCA’s adjustment regarding the inclusion of future capital improvements under HRG’s market approach. R.D. at 27-31.

**a. HRG’s Income Approach**

**(1) Income Tax Expenses and the Discount Rate**

**(i) Aqua’s Exceptions**

The ALJ adopted all five adjustments that the OCA made under HRG’s income approach. Four of the adjustments relate to the DCF analysis within the income approach while the fifth adjustment disregards HRG’s rate of return/rate base analysis. HRG’s appraisal under the income approach is $77,855,000. The ALJ adopted the OCA’s adjustment of HRG’s appraisal from $77,855,000 to $36,560,000. According to Aqua, the adjusted value of $36,560,000 is $10,000,000 less than the depreciated original cost value of $46,153,867 for the Limerick system, which makes it unreasonable even on its face. Aqua Exc. at 14.

With regard to the ALJ’s adoption of the OCA’s adjustments to income tax expenses and the discount rate in HRG’s DCF analysis under the income approach, Aqua avers that the ALJ’s adoption of the OCA’s adjustments is inappropriate.[[10]](#footnote-11) *Id.* at 14-15. On the income tax expenses, Aqua avers that to the extent that the taxes increase, the revenue requirement also increases, which makes the adjustments to income taxes a concomitant adjustment to the revenue requirement used in HRG’s DCF analysis. Aqua argues that because a regulated utility is permitted to recover the full cost of rendering utility service, the assumed rate increases would correspondingly increase, and result in a greater income value. Aqua believes, the ALJ’s recommended changes to income tax rates leaves no room for any necessary concomitant rate allowances. *Id.* at 15.

Regarding the ALJ’s recommended discount rate of 6.97%, Aqua asserts that due to the changes in revenues, expenses and utility plant investments following its most recent base rate case, which was several years ago, the recommended discount rate of 6.97% is overstated in that it fails to reflect the aforementioned changes. According to Aqua, in 2015 alone, its utility plant in service increased by $18,152,894, which is an increase in the return that will not be reflected in base rates until Aqua’s next general rate increase. *Id.* (citing Aqua Stmt. 4R at 13). From Aqua’s point of view, a reflection of these changes would result in a lower rate of return and a lower discount factor.[[11]](#footnote-12) According to Aqua, while the ALJ’s recommendation increases the discount rate to a rate case level, it makes no estimate of, and no allowance for erosion of return. Aqua Exc. at 15-16 (citing Aqua Stmt. 4R at 13). Therefore, Aqua requests that the Commission reject ALJ Haas’ recommended adjustments to income taxes and the discount rate in HRG’s DCF analysis under the income approach. Aqua Exc. at 16.

**(ii) OCA Replies to Aqua’s Exceptions**

In reply, the OCA avers that Aqua’s argument regarding the adjustments is without merit and should be rejected. On the issue of income tax expenses, the OCA highlights several problems with the assumptions in HRG’s analysis including the fact that HRG assumed there were no federal or state income taxes for the first four years of its DCF analysis. The OCA reiterates its arguments that HRG used a tax rate of 38.9%, whereas a total incremental tax rate of 41.49% should have been used, based on the Pennsylvania income tax rate of 9.99% and the Federal income tax rate of 35%. The OCA further argues that HRG treated capital expenditures as a tax-deductible expense, when only the depreciation of those capital expenditures should be tax deductible. Moreover, the OCA argues that HRG’s taxable income did not include any deduction for depreciation expense or reflect a deduction for interest expense. OCA R. Exc. at 10-11. Lastly, the OCA states that contrary to Aqua’s averments, there are no concomitant adjustments that need to be made as a result of its adjustments to HRG’s income tax calculation. *Id.* at 11.

With regard to the discount rate, the OCA argues that the 2.5% discount rate used by HRG in its analysis is significantly lower and does not represent Aqua’s total cost of capital, which includes the weighted cost of debt and the weighted cost of equity. OCA R. Exc. at 11-12. The OCA contends that its witness, Mr. Watkins, developed a more appropriate discount rate using Aqua’s actual capital structure of 48.5% debt and 51.5%, Aqua’s actual cost of debt of 4.5%, and a reasonable cost of equity of 9.3%. According to the OCA, this results in a total cost of capital or a discount rate of 6.97%. *Id.* at 12. The OCA further contends that, contrary to Aqua’s argument that the OCA’s recommended discount rate is based on conditions at the time of Aqua’s prior rate filing, its proposed discount rate is based on Aqua’s current actual cost of debt and capital structure and the most recently Commission-determined water utility return on equity. *Id.* (citing Aqua Exc. at 16). In addition, the OCA disputes Aqua’s argument that the 6.97% discount rate does not reflect investments made by Aqua since its last rate case and erosion of return. OCA R. Exc. at 12. The OCA asserts that its witness, Mr. Watkins, addressed this issue as follows:

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 R. Exc. at 12-13 (citing OCA M.B. at 27; OCA Stmt. 2S at 2). Thus, the OCA asserts that the Commission should deny Aqua’s Exceptions regarding this matter because the ALJ appropriately adopted the OCA’s adjustments to HRG’s income tax calculation and the discount rate. OCA R. Exc. at 11, 13.

**(iii) Disposition**

Upon consideration of the record evidence, we will adopt the ALJ’s recommended discount rate of 6.97% and income tax expense adjustments under HRG’s income approach. We are not convinced by Aqua’s arguments opposing the OCA’s adjustments that were adopted by the ALJ. We agree that contrary to Aqua’s proposed discount rate of 2.5%, the 6.97% discount rate more appropriately reflects Aqua’s total cost of capital. We also note that the 6.97% discount rate is within the range of rates (6.63% to 7.99%) Gannett indicated is the appropriate IOU discount rate and the current pre-tax overall cost of capital on December 31, 2016. Aqua Exh. Q at 28. As such, we shall deny Aqua’s Exceptions regarding the ALJ’s recommendation concerning the income tax expense and the appropriate discount rate under HRG’s income approach.

**(2) “Going Value” Adder and Cash Flow Deduction**

**(i) Aqua’s Exceptions**

With regard to the ALJ’s recommended removal of the “going value” adder of $4,000,000 from HRG’s income approach, Aqua believes this adjustment was made as a result of the OCA’s misunderstanding of the adder and its purpose. Aqua states that the “going value” adder represents the costs incurred by Limerick when it began operations including start-up costs, which can legitimately be included in a fair market value appraisal, and for which Limerick Township should be compensated. Aqua Exc. at 16 (citing R.D. at 32; Aqua Stmt. 4R at 14). According to Aqua, contrary to the ALJ’s suggestion that it is the estimate of expected working capital requirements, the “going value” adder is a calculation of the working capital already expended by Limerick to become operational. Aqua argues that the record evidence supports the inclusion of this adder in HRG’s income approach. Aqua Exc. at 16 -17 (citing Aqua R.B. at 22-23; Aqua Stmt. 4R at 14).

Aqua also disagrees with the ALJ’s removal of the provision for erosion of cash flow between rate cases that HRG included in its income approach appraisal.[[12]](#footnote-13) Aqua contends that contrary to the ALJ’s recommendation, erosion of cash flow is reasonably expected to occur between rate cases and that the record evidence supports its inclusion in the income approach valuation as proposed by HRG. Therefore, Aqua requests that the Commission reject the ALJ’s recommended removal of the going value adder and the provision for cash flow erosion from HRG’s DCF analysis under the income approach. Aqua Exc. at 17.

**(ii) OCA’s Replies to Aqua’s Exceptions**

In reply, the OCA asserts that its witness, Mr. Watkins disputed Aqua’s arguments above stating:

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 R. Exc. at 14-15 (citing OCA M.B. at 19-20; OCA Stmt. 2 at 14-15). The OCA concludes that because Aqua essentially repeats the same arguments the ALJ already considered in reaching his decision to adopt the OCA’s adjustments, Aqua’s Exceptions regarding this matter should be denied. OCA R. Exc. at 15.

**(iii) Disposition**

Upon consideration of the record evidence, we will deny Aqua’s Exceptions and adopt the ALJ’s recommended removal of the “going value” adder in the amount of $4,000,000 and the cash flow deduction of $370,000 under HRG’s income

approach appraisal of the Limerick system. We are not convinced by Aqua’s argument and HRG’s basis for including this adder in its analysis. We agree with the OCA that unlike other businesses, Limerick is a regulated monopoly with a captive customer base that does not need investments in time and resources to acquire new customers. Moreover, because Limerick’s investment in its collection, treatment and disposal plant has already been accounted for in its original cost analysis, we do not see a need for this adder. Therefore, we agree that the adders are not appropriate and should not be utilized for the appraisal of the Limerick system under HRG’s income approach appraisal. R.D. at 33.

**(3) Rate of Return/Rate Base Analysis**

**(i) Aqua’s Exceptions**

With regard to the ALJ’s adjustment which disregards HRG’s rate of return/rate base analysis in its entirety due to flaws and unreasonable assumptions in HRG’s income approach analysis, Aqua disagrees.[[13]](#footnote-14) Aqua Exc.at 17 (citing R.D. at 33‑34). Aqua argues that HRG’s use of reproduction cost new instead of original cost in its present value analysis is neither flawed nor unreasonable. Aqua reiterates its argument that while traditional ratemaking is based on original cost, Section 1329 departs from traditional ratemaking practices and that “fair market valuation is not tied to the original cost of construction minus accumulated depreciation.” Aqua Exc.at 17-18. Aqua believes HRG’s use of reproduction cost new is consistent with the fair market value objectives of Section 1329. *Id.* at 18-19 (citing Aqua Stmt. 4R at 16-17). Aqua further acknowledges the ALJ’s adoption of the OCA’s proposed 6.97% rate of return rather than HRG’s estimated rate of return of 7.5% in its present value analysis. Aqua, however, questions the ALJ’s recommendation which describes HRG’s analysis as flawed and unreasonable when the two rates of return are almost the same. Aqua Exc. at 18. Aqua further questions the ALJ’s reliance on the OCA’s criticism of HRG’s use of a discount rate of 2.5% as a basis for his recommended adjustment. Aqua argues that the OCA failed to acknowledge in its criticism of HRG’s present value analysis, the changes in revenues, expenses and utility plant investments that have occurred since Aqua’s most recent base rate case. Aqua, therefore, requests that the Commission reject the ALJ’s recommendation and adopt HRG’s rate of return/rate base present value analysis. *Id.* at 18-19.

**(ii) OCA’s Replies to Aqua’s Exceptions**

In reply, the OCA disagrees with Aqua’s argument that Section 1329 departs from traditional ratemaking practices because it uses fair market valuation. OCA R. Exc. at 15 (citing Aqua Exc. at 17-18). The OCA disputes Aqua’s view regarding Section 1329 and HRG’s rate of return/rate base analysis stating:

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 R. Exc. at 15-16 (citing OCA Stmt. 2 at 21-22). Furthermore, responding to Aqua’s argument that its proposed rate of return of 7.5% should be considered because it is almost the same as the OCA’s 6.97% rate of return, the OCA reiterates its argument that while it established that the 6.97% rate of return is the appropriate cost of capital derived from Aqua’s current cost of debt and capital structure, with a recently determined cost of equity, HRG failed to present any evidence or support for its proposed 7.5% rate of return. OCA R. Exc. at 15-16. In addition, the OCA argues that Aqua’s rate base/rate of return analysis is also riddled with several errors including overstated estimated annual depreciation expenses. For instance, the OCA avers that while HRG showed an estimated annual cash flow associated with depreciated expense of $3,416,000, the 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. The OCA notes that based on the above, HRG’s annual cash flows are overstated by approximately $1,723,000.[[14]](#footnote-15) OCA R. Exc. at 17. The OCA asserts that because Aqua essentially repeats the same arguments that were considered and rejected by the ALJ in his Recommended Decision, Aqua’s Exceptions should be denied. *Id.*

**(iii) Disposition**

Upon review, we will deny Aqua’s Exceptions and adopt the ALJ’s recommendation that disregards HRG’s rate of return/rate base analysis in its entirety. We agree with the OCA and the ALJ that the record evidence does not support Aqua’s proposed rate of return/rate base analysis. We will therefore adopt the ALJ’s recommended adjusted income of $36,560,000 for HRG’s income approach appraisal.

**b. Gannett’s Income Approach**

**(1) Calculation and Reasonableness of the Terminal Value**

**(i) OCA’s Exceptions**

In its Exception No. 3, the OCA disagrees with the ALJ’s failure to adopt its proposed removal of the terminal value under Gannett’s income approach. The OCA avers its proposal stems from the fact that utilizing a forecasted terminal value as used by Gannett’s witness, Mr. Walker, is unreliable and produces unreasonable results. Alternatively, the OCA’s witness, Mr. Watkins, conducted his DCF valuation using fifty years of discounted net cash flows (Debt Free Cash Flow) with no terminal value. OCA Exc. at 10 (citing Aqua Exh. 8 at 4, 24-25). Specifically, the OCA asserts that while Mr. Walker calculated discounted cash flows net of capital expenditures and changes in working capital or Debt Free Net Cash Flow, he nonetheless discounted these annual Debt Free Net Cash Flows for 13 years, and then estimated a terminal value after which annual cash flows are projected to grow at a constant rate. OCA Exc. at 10 (citing OCA Stmt. 2 at 24; OCA Stmt. 2S at 8).

The OCA highlights two problems with Mr. Walker’s analysis. First, the OCA avers that Mr. Walker’s estimation of Limerick’s market value is extremely speculative and uncertain because he calculated the terminal values ranging from $44.084 million to $137.436 million. OCA Exc. at 10 (citing Aqua Exh. Q). The OCA believes this large range in Mr. Walker’s calculated terminal values significantly impacts his ultimate DCF valuations. OCA Exc. at 10 (citing OCA Stmt. 2 at 24). Second, the OCA avers that pursuant to standard financial and business concepts, the terminal value must reflect the capital investments required to maintain and continue an entity’s operations as a going concern. However, according to the OCA, the 13-year DCF model reflects minimal capital expenditures because the cost of replacing Limerick’s plant-in-service in the thirteenth year is in excess of $161 million[[15]](#footnote-16) but the assumed annual capital investments after year thirteen are only 0.80 percent of that total replacement cost. OCA Exc. at 10-11 (citing OCA Stmt. 2S at 8-9).

The OCA argues that the underlying assumption in Mr. Walker’s valuation model that the Limerick system will operate in perpetuity at that level of reinvestment, with an effective service life of new plant of 125 years, is flawed and unreasonable. OCA Exc. at 11 (citing OCA Stmt. 2S at 8-9). According to the OCA, to address these concerns, it proposed using a 50-year model with no terminal value. The OCA asserts that the use of a longer investment horizon allows the ultimate DCF valuation to incorporate the going concern aspects of Limerick’s wastewater operations. It also allows for more reasonable assumptions regarding the useful remaining life of Limerick’s system without total or significant replacement as it wears out over 50 years. OCA Exc. at 11 (citing OCA Stmt. 2 at 24, 26).

The OCA also dismisses Aqua’s argument in favor of the 13-year model.[[16]](#footnote-17) OCA Exc. at 11 (citing R.D. at 36). The OCA argues that the annual capital expenditure and historical book depreciation are similar for both models, and are thus irrelevant in this case. The OCA illustrates the problem with Aqua’s 13-year model as follows:

[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 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 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 the 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 Exc. at 12 (citing OCA Stmt. 2S at 8-9). The OCA states that contrary to the underlying assumptions in Aqua’s 13-year model, while the Limerick system has a longer service life than a taxicab, it cannot be operated in perpetuity with minimal levels of investment. OCA Exc. at 12. The OCA also discounts Aqua’s argument against the 50‑year model stating that the present value factor (using a 6.89% discount rate) is 3.7%. OCA Exc. at 12 (citing OCA Stmt. 2, Sch. GAW-5). According to the OCA, this means every $100 of cash flow in year 50 is valued at only $3.70. Hence, an actual service life beyond the 50-year mark would make little or no difference to the result. Thus, the OCA requests that the Commission adopt its recommended 50-year model without a terminal value and reject the ALJ’s recommended 13-year model. OCA Exc. at 13.

**(ii) OCA’s Replies to Aqua’s Exceptions**

In reply, Aqua states that the OCA’s argument against the 13-year model is based on a lack of understanding regarding the use of the terminal value. Aqua explains that within the DCF analyses “the ‘terminal value’ is simply a point in time in which the growth in annual Debt Free Net Cash Flows changes from multiple growth rates to a constant growth rate.” Aqua R. Exc. at 11. According to Aqua, subsequent to time period 13 or year 2030, the growth in annual Debt Free Net Cash Flows is a constant growth rate. Aqua clarifies that the use of a terminal value in a DCF analysis is a mathematical shortcut to avoid having to show and/or calculate annual Debt Free Net Cash Flows for hundreds of time periods, or hundreds of years, which Aqua believes is a reasonable and generally accepted valuation practice. *Id.* (citing Aqua Stmt. 3R at 9-12; Aqua Sch. 2).

Furthermore, Aqua argues that the OCA’s proposed 50-year model, is not in accordance with accepted valuation practice and fails to represent the valuation of a going concern. According to Aqua, this model understates the OCA’s indicated value by 10% to 19% under the OCA’s assumed Limerick ownership and by 10% to 14% under the OCA’s assumed Aqua ownership. Aqua R. Exc. at 11 (citing Aqua Stmt. 3R at 4). Aqua reiterates its argument that both the 13-year and 50-year models appropriately reflect the same 1.5% growth in capital expenditures and depreciation. Aqua asserts that over the first fifty years, the model reflects $77.3 million of capital investment and over 100 years, the model reflects $244 million of capital investment. Aqua avers that the capital expenditure shown in the thirteenth year of the model is $1.292 million and almost matches dollar for dollar the depreciation shown on the line above it. Aqua concludes that contrary to the OCA’s argument, if the dollars of capital investment being reinvested into the system are matching the depreciation dollars, there is every possibility that the system would remain in a “state of good repair.” R. Exc. at 12 (citing OCA Stmt. 2; OCA Sch. GAW-7 at 2; Tr. at 47-50). Thus, Aqua requests that the Commission reject OCA Exception No. 3, because the OCA has failed to demonstrate that Gannett’s income approach methods are unreasonable. Aqua R. Exc. at 12 (citing R.D. at 36).

**(iii) Disposition**

Upon review of the record evidence and the arguments regarding this issue, we will deny OCA Exception No. 3. We are convinced by Aqua’s arguments in support of the 13-year model. Further, we agree with the ALJ that the OCA has not provided sufficient evidence, or the necessary reasoning, to determine that Gannett’s income approach methods are unreasonable. Accordingly, we find that Gannett’s income approach valuation of $75,204,407 as filed is just and reasonable.

**(2) Discount Rates**

**(i) OCA’s Exception**

With regard to the OCA’s Exception No. 4, involving alternative discount rates, the OCA disagrees with the ALJ’s refusal to adopt the rates on the basis that the OCA did not show that Gannett’s discount rates were unreasonable. The OCA argues that there is ample evidence demonstrating that Gannett’s failure to include equity in the discount rate from a municipal utility perspective and an IOU buyer’s perspective is unreasonable and serves to inflate the appraisal result. OCA contends its witness provided more appropriate discount rates using a municipal utility’s cost of capital and an IOU’s cost of capital. OCA Exc. at 13 (citing R.D. at 28-29).

For emphasis, the OCA asserts that from a municipal utility seller’s perspective, Aqua’s use of a 4.37% discount rate based on the December 2016 municipal revenue bond yield is inappropriate because a firm’s cost of capital should reflect both its financial and business risks or the cost of debt and the opportunity cost of equity. OCA Exc. at 13 (citing Aqua Exh. Q at 28; OCA Stmt. 2 at 25). The OCA points out that Gannett’s witness, has, on numerous occasions in water and wastewater rate case proceedings, argued on behalf of municipalities for a significantly higher cost of equity than either the embedded or marginal cost of debt. OCA Exc. at 13-14 (citing OCA Stmt. 2 at 25-26). On the other hand, the OCA contends its witness developed a discount rate that utilized both equity and debt. OCA Exc. at 14.

Additionally, the OCA indicates that Mr. Watkins used the actual cost of equity for a municipal water utility that was recently involved in a fully litigated base rate case with the Commission. The OCA notes that Mr. Watkins also used Limerick’s actual embedded cost of debt of 3.39%, which is a conservative rate compared to the current cost of municipal bonds. According to the OCA, Mr. Watkins then used Limerick’s actual capital structure and a hypothetical 50% debt/50% equity capital structure, which was also a conservative input. The OCA avers that the weighted cost of capital under these two capital structures results in total costs of capital of 6.89% and 5.50%, respectively. OCA Exc. at 14 (citing OCA Stmt. 2 at 9-10, 26-29; OCA Sch. GAW-5, GAW-6). Also, the OCA contends that it decided to use the embedded cost of debt rather than Gannett’s marginal debt because it is lower. The OCA posits that using a higher marginal cost of debt would have resulted in higher cost of capital and ultimately, a higher discount rate and a reduction in the DCF valuations. The OCA believes its proposed discount rate produces a more conservative and higher valuation. OCA Exc. at 14-15. Based on the above, the OCA asserts that its recommended valuation from the municipal utility perspective of $51,320,000, is reasonable and should therefore be adopted. *Id.* at 15 (citing OCA M.B. at 38; OCA Stmt. 2 at 29; OCA Sch. GAW-5, GAW-6).

From an IOU buyer’s perspective, the OCA contends there is sufficient evidence in the record to show that Mr. Walker’s discount rate is unreasonable and serves to inflate the appraisal value. OCA Exc. at 15. The OCA argues that rather than using Mr. Walker’s capital structure of 24.5% debt/75.5% equity, which is based on market ratios instead of book ratios, it recommended using Aqua’s actual book equity ratio of 51.5% because Aqua will be financing the Limerick transaction with a combination of book equity and book debt. From the OCA’s point of view, the use of book equity ratio would produce a more reasonable valuation result. OCA Exc. at 15-16 (citing OCA Stmt. 2 at 27-28). Further, the OCA avers that its proposed cost of equity of 9.3%, which is also within Aqua’s equity range of 7.96% to 9.76%, is derived from the most recent base rate case of a comparable municipal entity. OCA Exc. at 16 (citing *Pa. P.U.C. City of Dubois – Bureau of Water,* Docket No. R-2016-2554150 (Order entered March 28, 2017) at 97-98). According to the OCA, this results in a total cost of capital of 6.09% after considering net of tax cost debt, and produces the OCA’s adjusted income valuation of $55,864,000. OCA Exc. at 16 (citing OCA Stmt. 2 at 28; OCA Stmt. 2S at 6-7). The OCA further rejects Aqua’s argument that the OCA’s proposed rates are unreasonable because Limerick is not regulated by the Commission. The OCA argues that because Limerick will be regulated by the Commission once this transaction is finalized, it is appropriate to use a Commission-authorized return for the analysis. Thus, the OCA requests that the Commission reject the ALJ’s recommendation and adopt the OCA’s proposed valuation of $55,864,000. OCA Exc. at 16-17.

**(ii) Aqua’s Replies to the OCA’s Exceptions**

In reply, Aqua avers that the OCA’s proposed discount rate, which is based on Township equity capital and debt, is neither reasonable nor in accordance with accepted valuation practice for the following reasons. First, the Company contends that the OCA’s proposed cost of capital is “based on methods used by witnesses who provide testimony before the Commission who are tasked with determining a cost of capital for *a portion* of the asset of a municipality that provides utility service *outside* its corporate limits or boundaries.” Aqua R. Exc. at 13. Aqua avers that unlike those municipalities, Limerick is not regulated by the Commission. *Id*. Aqua also asserts that the embedded cost of debt and the book capitalization ratios used by the OCA in its analysis are used only in rate proceedings, whereas the marginal cost of debt and market value capitalization ratios used by Gannett are the most appropriate and generally accepted measures for market valuation. *Id*. at 13-14 (Aqua Stmt. 3R at 6-7). In addition, Aqua disagrees with the OCA’s use of book equity in determining the cost of capital since Limerick or any other municipal or government entity can never marginally finance a project with equity. Aqua contends that municipal entities can only finance with debt capital not equity capital. Aqua argues that for market valuation purposes, municipal capital structure must be 100% marginal debt. Finally, Aqua asserts that the OCA’s use of Limerick’s cost of capital does not conform to the “hypothetical buyer” or “hypothetical seller” of fair market valuation. Aqua R. Exc. at 14 (citing Aqua Stmt. 3R at 6-7).

**(iii) Disposition**

Upon review of the record evidence and the arguments put forth by the Parties, we will adopt the ALJ’s recommendation regarding this matter and deny the OCA’s Exception No. 4. We are not convinced that the OCA provided sufficient evidence to demonstrate that Gannett’s discount rate calculations are unreasonable from a municipal seller or IOU buyer’s perspective. As such, we will deny the OCA’s Exceptions and accept Gannett’s income approach valuation of $75,204,407 as filed.

**c. HRG’s Cost Approach.**

**(1) Valuation of Collection System Mains**

**(i) Aqua’s Exceptions**

As stated, the ALJ adopted three out of four adjustments the OCA made to HRG’s cost approach. Based on these adjustments, HRG’s reproduction cost approach appraisal was reduced from $90,050,000 to $62,321,571. However, Aqua disagrees with the ALJ’s recommended adoption of the adjustments. Aqua Exc. at 19.

Specifically, regarding HRG’s reproduction cost valuation, Aqua disputes the ALJ’s adoption of the OCA’s argument that HRG did not establish a reasonable basis for separately valuing collector mains, thereby decreasing the reproduction cost by $19,195,429. *Id.* (citing R.D. at 36-37). In this case, HRG used the ENR Construction Cost Index (CII) as an indicator of general inflation in order to determine an approximate reproduction cost for all plant items with the exception of collection system mains. According to Aqua, collection system mains were treated as a special circumstance because the original cost for those mains was significantly understated. For instance, Aqua notes that the original cost of Limerick’s gravity collection sewer mains which totaled 355,000 linear feet, and is valued at $15,213,236 or $42.85 per linear feet, is a very low number when compared to historical construction costs and is also not in line with current industry unit costs for collection system main construction. Aqua Exc. at 19 (citing Aqua Stmt. 4R at 8).[[17]](#footnote-18) Aqua asserts that to arrive at an appropriate reproduction cost value for collection system mains, HRG developed a profile of 2016 construction costs for wastewater mains of various sizes installed in the Montgomery and Chester County area. Aqua avers that these actual costs for projects in the same vicinity as Limerick, are more representative than the cost reflected in the ENR Index. Aqua Exc. at 20 (citing Aqua Stmt. 4R at 8). Hence, Aqua argues that HRG presented sufficient basis for the treatment of collection system mains as a special circumstance under the cost approach. Therefore, Aqua requests that the Commission reject ALJ Haas’ recommendation regarding this matter. Aqua Exc. at 20.

**(ii) OCA’s Replies to Aqua’s Exceptions**

In reply, the OCA reiterates its position that Aqua failed to present any reasonable basis for treating collection system mains differently. The OCA contends that contrary to Aqua’s argument, the engineering study does include contributed mains. OCA R. Exc. at 17-18 (citing OCA M.B. at 15-16; Aqua Exh. R at 6; OCA Stmt. 1 at 26). The OCA also disputes HRG’s use of sample costs from regional municipalities to reflect a more realistic measure of the reproduction cost value. The OCA argues that HRG failed to provide a reasonable basis to conclude that the unit costs from the surrounding municipalities are more accurate than the costs that have been specifically reported for the Limerick system. OCA R. Exc. at 18-19. Thus, the OCA requests that the Commission deny Aqua’s Exceptions to the ALJ’s recommendation regarding the reproduction cost under HRG’s cost approach. *Id.* at 19.

**(iii) Disposition**

Upon review of the record evidence and the arguments put forth by the Parties, we will deny Aqua’s Exceptions and adopt the ALJ’s recommendation regarding the reproduction cost under HRG’s cost approach. We agree that Aqua failed to provide any reasonable basis or any convincing evidence as to why the collection system mains should be treated differently or as a special circumstance in HRG’s valuation under the reproduction cost approach. We also agree that the ENR Index should, similarly, be applied across all utility plant. As such, Aqua’s Exceptions regarding this matter are hereby denied.

**(2) Disallowance of Future Capital Projects**

**(i) Aqua’s Exceptions**

With regard to the ALJ’s adoption of the OCA’s recommended removal of the cost of future capital projects in the amount of $4,500,000 under HRG’s reproduction cost approach, Aqua questions why the ALJ adopted the OCA’s adjustment of this item under the reproduction cost approach, yet rejected the same adjustment under HRG’s market approach. Aqua Exc. at 20 (citing R.D. at 37, 39). Aqua argues that the USPAP and the *Final Implementation Order* require consideration of future capital improvements in a fair market valuation and that even the ALJ recognized Limerick’s planned capital improvements in the amount of $4,533,000 in the engineering report. Aqua Exc. at 20 (R.D. at 39; Tr. at 61). Aqua asserts that these future improvements are germane to the acquisition and are needed for future growth and additional revenue. Aqua contends that as long as these improvements will not be paid for by Limerick but by Aqua, they should be considered a real cost for compensation. The Company believes that failure to do so would result in an understatement of the fair market value of the system. Aqua Exc. at 21 (citing Tr. at 60-61). Therefore, Aqua requests that the Commission reject the ALJ’s recommended removal of the cost of future capital projects from HRG’s reproduction cost approach. Aqua Exc. at 21.

**(ii) OCA’s Replies to Aqua’s Exceptions**

In reply, the OCA reiterates its argument that the inclusion of the cost of future capital projects in the valuation of the Limerick system is not appropriate as the projects do not add value to the Limerick system at the time of acquisition. OCA R. Exc. at 19 (quoting R.D. at 37). The OCA further contends that adding these costs for valuation purposes would permit Aqua to double-recover the same costs since Aqua would later be compensated for capital expenditures through the traditional ratemaking methodology. OCA R. Exc. at 19-20 (citing OCA M.B. at 44; OCA R.B. at 11; OCA Stmt. 1S at 14-15). The OCA therefore requests that the Commission adopt the ALJ’s recommendation which removes the cost of future capital projects in HRG’s valuation of the Limerick system under the reproduction cost approach.[[18]](#footnote-19) OCA R. Exc. at 20.

**(iii) Disposition**

Upon review of the record evidence, we will deny Aqua’s Exceptions and adopt the ALJ’s recommendation. We agree with the ALJ that future capital projects do not add value to the Limerick system at this time and because Aqua will be compensated for the capital expenditures in the future through the traditional ratemaking methodology, there is no basis to include these costs in Limerick’s current valuation, as reflected in HRG’s reproduction cost approach. R.D. at 37. Moreover, while Limerick identified the necessary future capital improvements in this transaction, no funds have been expended by Limerick for any improvements that would require us to permit compensation to Limerick in the instant proceeding. Further, while we agree that the USPAP and the *Final Implementation Order* did require the appraiser to take into consideration future improvements, we are not convinced that Limerick should be compensated prior to expending funds for such improvements; nor do we believe it is reasonable to do so at this time. Tr. at 60-61. As such, we will deny Aqua’s Exceptions regarding this matter.

**(3) “Going Value” Adder**

**(i) Aqua’s Exceptions**

With regard to the ALJ’s adoption of the OCA’s proposal that the “going value” adder in the amount of $4,000,000 be removed from HRG’s cost approach, similar to its argument in the income approach, Aqua believes this recommendation was made as a result of the OCA’s misunderstanding of the adder and its purpose, and should therefore be rejected. Aqua Exc. at 21 (citing R.D. at 32). Aqua argues that contrary to the ALJ’s suggestion that the adder is a marketing cost to acquire customers, it represents the costs associated with forming an entity. Aqua avers the “going value” represents the costs incurred by Limerick when it began operations or a start-up cost that should be appropriately included in the fair market value appraisal. Aqua Exc. at 21 (citing Aqua Stmt. 4R at 14). Aqua argues that because these costs represent funds that have already been expended by Limerick Township to get the system up and going, Limerick should be compensated for the “going value.” Aqua Exc. at 21-22 (citing Aqua Stmt. 4R at 14). Therefore, Aqua requests that the Commission reject the ALJ’s recommended removal of the going value adder from HRG’s cost approach. Aqua Exc. at 22.

**(ii) OCA’s Replies to Aqua’s Exceptions**

In reply, the OCA disagrees, stating that Aqua’s reasoning for including the “going value” adder does not comport with reality. The OCA asserts that HRG’s analysis regarding the “going value” adder is beset with contradictions and flaws. OCA further asserts that HRG’s calculation of the adder itself contained errors including an unreasonable revenue growth and an illogical “net income” calculation. OCA R. Exc. at 20. Therefore, the OCA requests that the Commission adopt the ALJ’s determination that the adder is without merit and should not be considered. OCA R. Exc. at 20-21 (citing R.D. at 38).

**(iii) Disposition**

Upon review, we will deny Aqua’s Exceptions and adopt the ALJ’s recommendation regarding the “going value” adder under HRG’s cost approach. We agree with the ALJ and the OCA that there is no basis for including this adder in the valuation of the Limerick system. As such, Aqua’s Exception regarding this matter is hereby denied.

**(4) Cost of Land**

1. **OCA’s Exceptions**

In its Exception No. 1, the OCA avers that the ALJ erred in failing to adopt its adjustment to and proposed removal of the cost of land from HRG’s fair value determination of reproduction costs. OCA Exc. at 5 (citing R.D. at 37). The OCA argues that HRG included an inflated value for land using the ENR Index in its reproduction cost analysis. OCA Exc. at 5 (citing Aqua Exh. R; Sch. C; OCA Stmt. 1 at 26-27). According to the OCA, its witness, Ms. Everette, explained two reasons why land should not be included in the reproduction cost:

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 documen-tation indicates that this index is inappropriate for the calculation.

OCA Exc. at 5-6 (citing Aqua Exh. R; Sch. C; OCA Stmt. 1 at 26-27). The OCA argues that based on the above, labor costs have no direct relation to the cost of land, and unlike other plant items, land cannot be reproduced. OCA Exc. at 6 (citing Aqua Exh. R; Sch. C; OCA Stmt. 1 at 26-27; OCA Stmt. 1S at 19).

The OCA also disagrees with the ALJ’s explanation that it is reasonable to treat land the same as all other types of plant and that 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.” OCA Exc. at 6 (citing R.D. at 37). First, the OCA explains that the purpose of the reproduction cost analysis is to restate the original cost of depreciable utility plant to a current price level, which is done by applying a trend factor to the original cost of depreciable plant to determine the replacement cost. Nevertheless, per the OCA, because land does not depreciate, its original cost is an appropriate measure of its current price level. OCA Exc. at 6 (citing OCA M.B. at 15; Aqua Exh. R at 6; Aqua Exh. Q at 25).[[19]](#footnote-20) Secondly, the OCA argues that because land is not depreciable and differs from all other types of plant, its original cost should be used without applying a trend factor. The OCA, therefore, requests that the Commission reject the ALJ’s recommendation and adopt its proposal which reduces HRG’s reproduction cost approach appraisal by $756,159. OCA Exc. at 6-7.

**(ii) Aqua’s Replies to OCA’s Exceptions**

In reply, Aqua states that the record evidence and the Recommended Decision support the application of the ENR Index to land. According to Aqua, HRG explained that, in the absence of a cost trend index such as ENR, each parcel of land would have had to have been separately appraised based on its highest and best use.[[20]](#footnote-21) Aqua asserts that HRG chose to use the cost trend index to restate the value of the land in lieu of a separate land appraisal report. Per Aqua, HRG’s approach reasonably assumes that land values grow roughly along the lines of general inflation of the assets that it hosts, further justifying the use of the ENR Index. Thus, Aqua requests that the Commission reject the OCA’s proposed adjustment to remove land from HRG’s cost approach. Aqua R. Exc. at 8-9.

**(iii) Disposition**

Upon review, we will deny the OCA’s Exception No. 1. We agree with the ALJ that, while the ENR index may not be the most appropriate index, there is no basis for finding that the land’s original cost is more appropriate than using HRG’s method for determining reproduction cost. By utilizing an index that treats all plant the same, it is likely that some elements will be higher while some may be lower. Here, the ALJ found that consistent with all other utility plant, the ENR index should be used. We agree and shall adopt the ALJ’s finding in this regard.

**c. HRG’s Market Approach**

**(1) Current Customer Count v. Projected Customer Count**

**(i) Aqua’s Exceptions**

The ALJ adopted one OCA-requested adjustment to HRG’s market approach appraisal. Based on this adjustment, HRG’s market approach appraisal was reduced from $62,760,000 to $47,064,553. However, Aqua disagrees with the ALJ’s adoption of the adjustment and the ALJ’s recommendation regarding HRG’s market approach. Aqua Exc. at 22 (citing R.D. at 38-39). Here, the ALJ recommended the use of Limerick’s current actual customer count of 5,434 rather than the projected customer count of 7,246 used by HRG. Aqua Exc. at 22 (citing Aqua Stmt. 4R at 5-6; Tr. at 62‑63). Aqua argues that the USPAP requires consideration of customer growth in the fair market value appraisal because not only does Aqua acquire the physical assets, the customer base, all related utility property, and a franchise area in the transaction, but Aqua also benefits from an ongoing mandatory connection ordinance.[[21]](#footnote-22) Aqua avers that while Limerick is currently billing 7,300 Equivalent Dwelling Units (EDUs), there are approximately 8,400 EDUs already purchased. Aqua Exc. at 22-23 (citing Aqua Stmt. 1 at 10). Therefore, Aqua requests that the Commission reject the ALJ’s recommendation regarding the customer count under HRG’s market approach. Aqua Exc. at 23.

**(ii) OCA’s Replies to Aqua’s Exceptions**

In reply, the OCA points out the inconsistencies in HRG’s analysis stating that not only did HRG elect to use a projected rather than a current customer count for the Limerick system valuation, HRG calculated the average cost per customer using the respective current number of customers of other acquisitions in its sample group. The OCA avers that HRG compounded the initial error by using the current number of customers for other systems and multiplying this number by the projected number of customers for the Limerick system which resulted in an overstated cost per customer. The OCA states that while Aqua claims the USPAP requires consideration of customer growth, Aqua fails to recognize, however, that “consideration” does not mean that the value should be inflated. OCA R. Exc. at 21. Therefore, the OCA requests that the Commission adopt the ALJ’s recommended appraisal market value of $47,060,000, rather than HRG’s market approach appraisal of $62,760,000. *Id.*

**(iii) Disposition**

Upon review of the record evidence and the arguments put forth by the Parties, we will deny Aqua’s Exceptions and adopt the ALJ’s recommended value of $47,060,000 rather than Aqua’s $62,760,000 market approach appraisal. We agree with the ALJ that Limerick’s current customer count of 5,434 is more appropriate for its valuation rather than the projected customer count of 7,246 used by HRG in its analysis. In her argument for utilizing projected customer growth in HRG’s market approach appraisal of the Limerick system, Ms. Vicari explained that Limerick is giving up future revenue stream from future customer growth that would have resulted from its mandatory connection ordinance in this transaction. Tr. at 63. We are not convinced by her argument and we see no reason to include such a projection in the appraisal of Limerick’s system at this time. We note that this purported projected future revenue stream was not a sufficient incentive for Limerick to continue operating its system or prevent Limerick from deciding to sell its system. As such, Aqua’s Exception is hereby denied.

**(2) Adder for Future Capital Improvements**

**(i) OCA’s Exceptions**

In its Exception No. 2, the OCA submits that the ALJ erred by not adopting its adjustment pertaining to the purchase price values used to calculate the average cost per customer. OCA Exc. at 7 (citing OCA Stmt. 1 at 23). According to the OCA, although HRG 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, HRG used only the purchase price for the valuation of Limerick’s assets and did not include the $8.3 million of capital investments that Aqua anticipates making. The OCA believes this distorts the market comparison. OCA Exc. at 7 (citing OCA Stmt. 4R at 6; Aqua Exh. V at 8). Moreover, the OCA argues that HRG did not include future capital improvements for all the comparable systems. For instance, according to the OCA, the $195 million value HRG used for the acquisition of the Scranton system excludes the capital improvements for Scranton. OCA Exc. at 7-8 (citing Aqua Exh. R, Sch. D at 21).[[22]](#footnote-23)

Second, the OCA argues that the addition of future capital improvements for valuation purposes creates a double-count. In the OCA’s view, adding the cost of future improvements to the value of rate base and then adding the same improvements after Aqua makes the capital expenditures would amount to including the same costs twice, which is not favorable to Aqua’s ratepayers. OCA Exc. at 8 (citing Aqua Stmt. 1S at 13-15). Third, the OCA argues that because the cost of capital improvements would be paid for by Aqua and is not beneficial to Aqua or its existing customers, it should not be included in the valuation. The OCA questions why the ALJ adopted the OCA’s adjustment to remove the cost of future improvements from HRG’s reproduction cost approach yet refused to make the same adjustment under HRG’s market approach. OCA Exc. at 8.

The OCA disagrees with the ALJ’s reasoning that his recommendation is based on Aqua’s claims that the USPAP and the *Final Implementation Order* require consideration of capital improvements in the fair market value appraisal. OCA Exc. at 8‑9 (citing R.D. at 39). According to the OCA, Aqua did not provide any specific citations to either the USPAP or the *Final Implementation Order* supporting its argument. Moreover, the OCA contends that going by Aqua’s argument, giving “consideration” as defined in the USPAP does not mandate an increase of the market value. The OCA asserts that, in this case, while future capital improvements are an avoided cost and a benefit to Limerick Township, because Aqua will pay for these improvements, there is no basis to conclude that they would increase the value of the system to buyers in the market.[[23]](#footnote-24) OCA Exc. at 9 (citing OCA Stmt. 1 at 23; OCA Stmt. 1S at 14).

The OCA further contends that a review of the *Final Implementation Order* does not support Aqua’s claim. The OCA avers that while the *Final Implementation Order* mentions post-acquisition improvements only in one context, *i.e.,* Section 1329(f) allows post-acquisition improvement costs to be deferred for book and ratemaking purposes if they are not recovered through a DSIC, the *Final Implementation Order* does not address future capital improvements or the issue of whether market value should be increased if the buyer plans to make future improvements. OCA Exc. at 9 (citing *Final Implementation Order* at 1-3, 28, 30, 40; 66 Pa. C.S. § 1329(f)). Thus, the OCA requests that the Commission adopt its recommended removal of the adder for future capital improvements to HRG’s market approach. OCA Exc. at 9.

**(ii) Aqua’s Replies to OCA’s Exceptions**

In its Replies to the OCA Exception No. 2, Aqua reiterates its argument that the USPAP and the *Final Implementation Order* require consideration of future capital improvements in the fair market value appraisal. Aqua R. Exc. at 9-10 (citing Tr. at 61). Aqua argues that the ALJ appropriately acknowledged the listing of Limerick assets and the planned capital improvements in the amount of $4,533,000 in the engineering report. Aqua R. Exc. at 10 (citing R.D. at 39). According to Aqua, future facilities are an integral part of the acquisition and are needed to allow for future growth and additional revenue. Aqua argues that as long as the improvements will not be paid for by Limerick but by Aqua, they are a real cost and may be considered for compensation. Aqua believes failure to recognize these costs would result in an understatement of the fair market value of the system. Aqua R. Exc. at 10 (citing Tr. at 60-61). Aqua concludes that the record evidence supports the inclusion of future capital projects in the fair market valuation under HRG’s market approach. Therefore, Aqua requests that the Commission reject the OCA’s Exception No. 2. Aqua R. Exc. at 10.

**(iii) Disposition**

Upon review, we will deny OCA’s Exception No. 2. We agree with the ALJ’s finding that the calculation made by HRG should include an adder for future capital improvements. In the assessment of the tangible assets conducted by the licensed engineers selected by Aqua and the Township, the engineers identified capital improvements planned by Limerick. The ALJ correctly determined that it is reasonable to consider that, if such improvements are not paid by Limerick, the capital improvements constitute a real cost to be borne by an acquiring entity and may be considered part of the compensation under the market approach.

## E. Public Interest and Affirmative Public Benefits

**1. I&E’s and OCA’s Exceptions**

I&E argues that the ALJ erred by basing his decision solely on the Commission’s decision in the *Aqua -* *New Garden Order*. According to I&E, Aqua’s Application failed to identify any affirmative benefits for existing customers. I&E outlines the detriments in which Aqua’s existing ratepayers will be required to subsidize the Limerick customers and that Limerick’s customers will be expected to pay substantially higher rates after the 3-year rate freeze. I&E asserts that Limerick is not a system that needs to be acquired to prevent it from facing financial hardship. The OCA argues that the ALJ compared Aqua’s acquisition of the Limerick system to the New Garden acquisition rather than reviewing Limerick on a stand-alone basis. The OCA contends, in part, that the ALJ did not consider the substantial harm to customers and improperly concluded that long-term cost sharing and lack of adverse impact on management and operations equate to affirmative public benefits. I&E Exc. at 3-8; OCA Exc. at 18-21.

**2. Aqua’s Replies to I&E’s and OCA’s Exceptions**

In response, Aqua outlines its asserted public benefits and proffers that there is no basis to contend that the ALJ erred. The Company argues that even with the required ratemaking rate base determination, Aqua is not proposing any change to existing rates of either Limerick customers or Aqua’s existing customers. Rather, any potential rate effects are reserved for a future rate proceeding. Aqua contends that I&E’s opinion that Section 1329 is limited to financially troubled systems has no statutory support. Aqua R. Exc. at 13-15.

**3. Disposition**

Upon review, we shall deny the Exceptions of I&E and the OCA. Although the ALJ considered our guidance in the *Aqua – New Garden Order*, the ALJ independently evaluated the record in this proceeding and determined that the Company established that the transaction is in the public interest and that the public at large, including Aqua’s existing customers, will realize affirmative public benefits for purposes of the Application. We agree that the affirmative public benefits shown by the Company and the additional conditions outlined in the Recommended Decision – requiring a cost of service study in the next rate case and mandating that Aqua’s shareholders bear the risk of any shortfall between revenue from Limerick’s customers and the cost of providing service – will assure that the public interest obligations under the Code are satisfied and that the Application will result in affirmative public benefits.

## F. Imposition of 6-Month Statute of Limitations

**1. OCA’s Exceptions**

During the proceeding, the OCA argued that although Section 1329(d) of the Code establishes a six-month deadline for the Section 1329 determination, there is no similar six-month deadline for the Section 1102 determination pertaining to the application for a certificate of public convenience. The ALJ indicated that the Commission had already decided this issue in the Aqua – New Garden proceeding in ruling on I&E’s Petition for Interlocutory Review and Answer to a Material Question.[[24]](#footnote-25) Thus, consistent with the Commission’s prior determination, the ALJ concluded that where the acquiring entity is a certificated public utility, there will be no bifurcation and a decision on the Application must be issued within the statutory six-month deadline. R.D. at 48.

In its Exception No. 6, the OCA contends that under the Rules of Statutory Construction, the six-month deadline applies only to the Section 1329 determination and that no language in the statute supports a finding that the deadline applies to a Section 1102 determination. The OCA also asserts that applying the deadline to a Section 1102 determination restricts the Commission from conducting a full and meaningful review of the record to perform the public interest analysis. According to the OCA, the Commission should find that no deadline restricts the time in which the Commission may make Section 1102 determinations. OCA Exc. at 21-23.

**2. Aqua’s Replies to OCA’s Exceptions**

In its reply, the Company cites to the *Interlocutory Review Order* in the Aqua – New Garden proceeding and argues that the express language of the statute is clear and unambiguous and phrased in mandatory terms. The Company contends that Section 1329 and Section 1102 considerations must both be concluded within the six-month statutory limit. Aqua R. Exc. at 17-18.

**3. Disposition**

We agree with the ALJ and shall deny the OCA Exception No. 6. In this proceeding, and consistent with our prior determination in the Aqua – New Garden proceeding, both, the Section 1329 and 1102 considerations must be concluded within the six-month deadline set forth in Section 1329(d)(2).

## G. 66 Pa. C.S. § 507 – Contracts between Public Utilities and Municipalities

**1. Approval of Municipal Contracts**

**a. I&E’s Exceptions**

In its Exception No. 2, I&E asserts that Aqua failed to request approvals regarding the municipal agreements it plans to assume in this transaction pursuant to Section 507. I&E finds fault in Aqua’s assertion that its Application contained a catch-all clause requesting any approvals, certificates, registrations and relief that the Commission deemed necessary. I&E Exc. at 8-9 (citing 66 Pa. C.S. § 507). I&E argues that, as the party seeking relief in the instant proceeding, Aqua has the burden of proof to provide substantial evidence in support of its Application. I&E believes the catch-all phrase argument put forth by Aqua, is Aqua’s way of shifting the burden of determining what contracts need Section 507 approvals to the Commission. I&E also deems ineffective, the ALJ’s directive that Aqua file the APA and all other relevant municipal agreements it is assuming within twenty days of entry of the Commission’s Final Order in the instant proceeding. I&E Exc. at 9 (citing R.D. at 50). I&E avers that the Commission may, prior to the effective date of the contract, institute proceedings to determine the reasonableness, legality, or any other matter affective of the contract or agreement. According to I&E, the Commission and the Parties to this proceeding will be deprived of these opportunities if the APA and the municipal contracts are not filed twenty days after the Final Order. Therefore, I&E seeks the Commission’s denial of the instant Application for Aqua’s failure to request all the required approvals in the instant proceeding. I&E Exc. at 9-10.

**b. Aqua’s Replies to I&E’s Exceptions**

In reply, Aqua states the ALJ appropriately rejected I&E’s request for a denial of the instant Application based on Aqua’s failure to comply with Section 507 and the assignment of municipal contracts. Aqua R. Exc. at 4 (citing R.D. at 50-51). Aqua avers the ALJ’s recommendation is consistent with the Commission’s recent decision in the *Aqua – New Garden Reconsideration Order* regarding Section 507, where the Commission included relevant ordering paragraphs and stated that:

Aqua is correct that it complied with the filing requirements of Section 507 by submitting the contracts within thirty days prior to the effective date of the contract or agreement. The Company filed copies of the APA, its amendments, and all agreements being assigned or assumed by Aqua in its Application filing. Aqua also acknowledges that the municipal agreements contained as exhibits to the APA will not become effective until after closing of the APA which is well beyond the thirty-day filing period set forth in Section 507. Moreover, the municipal agreements are part of the evidentiary record and we are aware of no Party finding an issue with them or providing an objection to them being assigned or assumed by the Company. Although I&E and the OCA raised objections to provisions of the APA, we ultimately approved the Application as being in the public interest. There was no evidentiary basis upon which to find that the APA, as amended, or the municipal agreements being assigned or assumed by Aqua failed to satisfy the Section 507 standard pertaining to reasonableness, legality or any other matter effecting the validity of the agreement. Thus, we decline to exercise our discretion to modify our decision to find the APA or the agreements as being ineffective.

However, we shall modify the *June 2017 Order* by approving the subject agreements pursuant to 66 Pa. C.S. § 507. We emphasize that our approval of the APA is subject to the additional conditions of approval pursuant to 66 Pa. C.S. § 1329(d)(3)(ii) and set forth in the ordering paragraphs of the *June 2017 Order*. Furthermore, in order to enable the Commission to track future proceedings involving municipal agreements, we will, as a matter of administrative efficiency,

direct the Company to file the executed municipal agreements under separate “U” docket numbers.

Aqua R. Exc. at 4-6 (citing *Aqua – New Garden Reconsideration Order* at 24-25).

Aqua argues that the circumstances in the instant proceeding are similar to the issues in the *Aqua – New Garden Reconsideration Order*. Aqua highlights that it specifically referenced, in the instant proceeding, the agreements to be assigned in the APA and addressed them in Paragraph 20 of the Application. Aqua states that it also filed the agreements with the Commission as Confidential Exhibit F to the Application. Aqua R. Exc. at 6 (citing Aqua Exh. 1; Application ¶ 20; Confidential Exh. F).[[25]](#footnote-26) In addition, Aqua notes the agreements will not become effective until closing of the APA, which is well beyond the thirty-day filing period set forth in Section 507. Aqua, therefore, requests that the Commission deny I&E’s Exception No. 2, because no party had an evidentiary issue or objection to the assignment or assumption of the agreements by Aqua and there is no basis upon which to find that the APA or the municipal agreements being assigned or assumed failed to satisfy the Section 507 standard pertaining to reasonableness, legality or any other matter effecting the validity of the agreements. Aqua R. Exc. at 6-7. Accordingly, Aqua requests that the Commission include, in the instant proceeding, as paraphrased from Ordering Paragraphs 2, 3 and 4 of the *New Garden Reconsideration Order*, the following directives in its Final Order that:

1. The Commission’s Secretary issue a Certificate of Filing under Section 507 of the Public Utility Code, 66 Pa. C.S. § 507, for the Asset Purchase Agreement Between Limerick Township and Aqua Pennsylvania Wastewater, Inc. filed with the Commission on May 19, 2017.
2. The Commission’s Secretary issue a Certificate of Filing under Section 507 of the Public Utility Code, 66 Pa. C.S. § 507, for the assignment and assumption agreement filed with the Commission on May 19, 2017, for the Agreement Between the Borough of Royersford, the Royersford Borough Authority, the Township of Limerick and the Limerick Township Municipal Authority Providing for Sewer Service for the Township of Limerick, dated December 4, 1967, and the later Extension of Agreement, dated November 30, 1976.[[26]](#footnote-27)
3. The municipal agreements set forth in Paragraph No. 2, shall be filed under separate “U” docket numbers.

**Aqua R. Exc. at 6-7.**

**2. Filing Date for Executed Municipal Contracts**

**a. Aqua’s Exceptions**

In its Exception No. 5, in response to the ALJ’s recommendation that Aqua file all relevant municipal agreements that it is assuming within twenty days of the entry of a Final Order in the instant proceeding, Aqua retorts that while it can file the municipal agreements or forms of assignment agreements within twenty days of the entry of the Final Order, it cannot file executed agreements within twenty days of the Final Order. Aqua proposes, however, that if the Commission concludes that the assignment agreements also must be filed, Aqua would, as a matter of administrative efficiency, agree to file the executed agreements after the closing of the transaction under separate “U” dockets similar to the PAWC-Scranton proceeding. Aqua Exc. at 24 (citing R.D. at 50).

**b. I&E Replies to Aqua’s Exceptions**

In its Replies to Aqua Exception No. 5, I&E disagrees that the ALJ’s recommendation cures Aqua’s failure to request such approvals in its Application. Citing to its Exceptions regarding this issue, I&E avers that although this proceeding is almost concluded, the Parties have not been apprised of which municipal agreements Aqua is seeking approval to assume under Section 507. I&E R. Exc. at 6-7 (citing Aqua Exc. at 24; I&E Exc. at 8-10). Per I&E, “pursuant to Section 507, the Commission may, prior to the effective date of the contract, institute proceedings to determine the reasonableness, legality, or any other matter effecting the validity of the contract or agreement.” I&E argues that the Commission and Parties to this proceeding will be deprived of these opportunities if the municipal contracts are not filed until twenty days after the Final Order in the instant proceeding. I&E finds fault with approving the instant application without knowing what agreements Aqua is assuming. I&E R. Exc. at 7.

**3. Disposition**

Upon review, we shall deny I&E’s Exception No. 2. Our position regarding this issue is similar to our disposition in the *Aqua – New Garden Reconsideration Order*. Thus, similar to our action in the *New Garden Reconsideration Order*, we shall decline to find that the APA or the filed agreements in this proceeding are ineffective.

Aqua has complied with the filing requirements of Section 507 by submitting the contracts within thirty days prior to the effective date of the contract or agreement. The Company filed copies of the APA and all agreements being assigned or assumed by Aqua in its Application filing. Aqua also acknowledges that the municipal agreements contained as exhibits to the APA will not be become effective until after closing of the APA which is well beyond the thirty-day filing period set forth in Section 507. The municipal agreements are part of the evidentiary record and we are aware of no Party finding an issue with them or providing an objection to them being assigned or assumed by the Company. Although I&E and the OCA have raised objections to provisions of the APA, we are approving the Application, as discussed herein, as being in the public interest. There is no evidentiary basis upon which to find that the APA or the municipal agreements being assigned or assumed by Aqua fail to satisfy the Section 507 standard pertaining to reasonableness, legality or any other matter effecting the validity of the agreement.

In the Recommended Decision, the ALJ explained in his disposition of the Section 507 issue that he will direct Aqua to file the APA and all relevant municipal agreements that it is assuming under the APA with the Commission under separate “U” dockets within twenty days of entry of a final Opinion and Order in this proceeding. The ALJ indicated that this filing procedure will facilitate administrative completeness and efficiency and is similar to the process outlined in the *PAWC Scranton Order*. Indeed, the Commission directed a similar requirement in the *Aqua – New Garden Reconsideration Order*.

With regard to Aqua’s Exception No. 5, Aqua expresses concerns about a potential contingency requirement pertaining to the filing of the forms of assignment agreements. Aqua does not object to the filing of the actual municipal agreements it is assuming within twenty days of entry of the Opinion and Order and, thus, does not object to the ALJ’s disposition. However, the Company is concerned that any executed copies of assignment agreements pertaining to the assumption of the municipal agreements cannot be executed within twenty days from the issuance of a final Commission Order. Thus, if the Commission were to direct the filing of assignment agreements, Aqua requests that it be permitted to file a form of the un-executed assignment agreements within twenty days of the entry of the final Commission Order and that it subsequently be permitted to file the executed versions under separate “U” dockets after closing.

Here, it does not appear that the Parties submitted into evidence the forms of the un-executed assignment agreements.[[27]](#footnote-28) Consistent with our direction in the Aqua – New Garden proceeding, we decline to require the separate filing of assignment agreements pertaining to the assumption of the municipal agreements. Accordingly, we shall dismiss Aqua’s Exception No. 5 as being moot.

## H. Separate Cost of Service Study

**1. Aqua’s Exceptions**

In its Exception No. 6, Aqua avers that while it is not opposed to the ALJ’s recommendation that Aqua submit, at the time of its next base rate case, a cost of service study or analysis that separates the costs, capital and operating expenses of providing wastewater service to Limerick customers as a separate class, the Commission should make it clear that the study is required in the first base rate case in which Aqua will include the cost of the Limerick system. Aqua Exc. at 24-25 (citing R.D. at 47, 53).

**2. OCA’s Replies to Aqua’s Exceptions**

In its Replies to Aqua Exception No. 6, the OCA asserts that if Aqua “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.” OCA R. Exc. at 22. The OCA avers that the ALJ emphatically stated in the Recommended Decision: “[t]hat 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.” OCA R. Exc. at 22 (citing R.D. at 53) (emphasis added). Hence, the OCA believes 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 OCA also requests that the Commission decide in the instant proceeding regarding whether Aqua’s submission of a cost-of-service study will be necessary many years into the future. OCA R. Exc. at 22.

**3. Disposition**

Under the circumstances of this case, we do not believe there is any confusion in the ALJ’s recommendation that Aqua submit a cost-of-service study for Limerick in its next base rate case. We note that Section 1329 allows for the rate base of the selling utility to be incorporated into the rate base of the acquiring utility during the acquiring utility’s next rate base rate case or the initial tariff filing of an entity. *Final Implementation Order* at 15. Here, the ALJ recommended the inclusion of Limerick’s rate base value in Aqua’s rate base for ratemaking purposes, and accordingly, directed, pursuant to Section 1329 and the *Final Implementation Order*, that at the time of filing of its next base rate case, Aqua 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 40, 53. Further, we note that if Aqua’s Exception No. 6, is predicated on the Commission’s approval of the regulatory asset treatment proposal under Aqua’s Rate Stabilization Plan, we consider the Exception moot based on our decision to deny the proposal. Hence, we see no need to make a determination in this proceeding as to how many years in the future Aqua is required to submit a cost-of-service study for the Limerick acquisition. As such, Aqua’s Exception No. 6, is hereby denied.

## I. Revised DSIC Tariff and LTIIP

**1. OCA’s Exceptions**

In its Exception No. 7, the OCA disagrees with the ALJ’s determination that with regard to Section 1329(d)(4) of the Code,[[28]](#footnote-29) Aqua is not required to file its tariff changes and revised LTIIP within thirty days of entry of the Commission’s Final Order as a condition of approval of Aqua’s Application. OCA Exc. at 23 (citing R.D. at 48-50). The OCA avers that the ALJ, nonetheless, concluded that “Aqua will be expected to fully comply with the requirements set forth in the [Implementation Order].” OCA Exc. at 23 (citing R.D. at 49). The OCA advocates that the Commission should require Aqua to file its tariff changes and revised LTIIP within thirty days following entry of the Commission’s Final Order as a condition of approval for the following reasons. First, the OCA points out that the *Final 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.” OCA Exc. at 23 (citing *Final Implementation Order* at 27-28). According to the OCA, Aqua indicated that its tariff modifications in 2016 complies with the Section 1329(d)(4) tariff change requirement, and that Aqua has not filed a revised LTIIP in compliance with the *Final Implementation Order*. OCA Exc. at 23-24 (citing R.D. at 48; *Final Implementation Order* at 28). Hence, the OCA believes a thirty-day deadline is reasonable and necessary to ensure that Aqua files the revised LTIIP before charging the DSIC surcharge to Limerick customers. OCA Exc. at 24.

The OCA further notes that the Commission has previously imposed a thirty-day deadline for the filing of a revised LTIIP. For instance, according to the OCA, in *Petition of Peoples Natural Gas Co., LLC,* Docket No. P-2013-2344596, 2006 Pa. PUC LEXIS 137 (Order entered March 10, 2016)(*Peoples*) at \*43, the Commission ordered: “[t]hat within 30 days of the entry of this Order, thePeoples Natural Gas Co., LLC, shall file a new or revised LTIIP consistent with the directives of this Order.” The OCA avers, in *Peoples,* the Commission cited to Section 1352 of the Code, which provides that it shall order a revised LTIIP when a proposed plan is not sufficient to maintain safe, reliable, and reasonable service. OCA Exc. at 24 (citing *Peoples* at 40; 66 Pa. C.S. § 1352(a)(7)). The OCA argues that in *Peoples,* while not required by the statute or otherwise, the Commission imposed a deadline. OCA Exc. at 24 (citing *Peoples* at 43). The OCA argues that contrary to the ALJ’s reasoning that the *Final Implementation Order* does not include a thirty-day deadline, the Commission should impose a 30-day deadline in the instant proceeding just like it did in *Peoples*. OCA Exc. at 24 (citing 66 Pa. C.S. § 1103(a)). Thus, the OCA states that if the Commission approves the instant Application and if Limerick customers are to begin paying the DSIC surcharge prior to the effective date of rates established in Aqua’s next base rate case, the Commission should condition its approval of the Application on Aqua’s filing of the required tariff changes and revised LTIIP within thirty days following entry of the Final Order in the instant proceeding. OCA Exc. at 25.

**2. Aqua’s Replies to OCA’s Exceptions**

In reply, Aqua repeats its argument that it filed tariff modifications in Supplement No. 101 at R-2016-2576069, enabling it to apply its DSIC to Limerick customers. Aqua, however, reiterates that it will amend its LTIIP before charging DSIC to Limerick customers. Hence, Aqua does not believe the thirty-day filing requirement is necessary at this time. Therefore, Aqua requests that the Commission deny OCA Exception No. 7. Aqua R. Exc. at 18.

**3. Disposition**

Upon review, we shall deny OCA Exception No. 7. We note that Section 1329(d)(4) allows a public utility’s existing DSIC to be applied immediately to the selling utility customer’s bills. *Final Implementation Order* at 27. Furthermore, the *Final Implementation Order* states 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 DSIC tariffs to reflect language consistent with the *Act 11 Implementation Order*. In conjunction, the public utility would also need to amend its LTIIP.” *Id.* at 27-28. However, our review of the record evidence does not reveal that Aqua intends to charge the DSIC to Limerick customers immediately. Aqua has indicated that it will amend its LTIIP before charging the DSIC to Limerick customers. Aqua R. Exc. at 18. We, therefore, direct that, if in the future Aqua decides to charge the DSIC to Limerick customers, Aqua file and obtain approval of the tariff changes and the revised LTIIP from the Commission prior to charging the DSIC surcharge. Hence, we agree with the ALJ that there is no reason to impose a thirty-day deadline for Aqua to file a revised LTIIP at this time. As such, we will deny OCA Exception No. 7.

# IV. Conclusion

For the reasons discussed above, we shall deny the Exceptions of Aqua, I&E, and the OCA and adopt the Recommended Decision, consistent with the discussion in this Opinion and Order; **THEREFORE,**

**IT IS ORDERED:**

1. That the Exceptions filed by Aqua Pennsylvania Wastewater, Inc., the Commission’s Bureau of Investigation and Enforcement, and the Office of Consumer Advocate, filed on October 3, 2017, are all denied.

2. That the Recommended Decision of Administrative Law Judge Steven K. Haas, issued on September 18, 2017, is adopted.

3. That the Application of Aqua Pennsylvania Wastewater, Inc., filed on May 19, 2017, seeking approval of: 1) the acquisition of the wastewater system assets of Limerick Township, Montgomery County, Pennsylvania, (2) the right of Aqua Pennsylvania Wastewater, Inc., to begin to offer, render, furnish and supply wastewater service to the public in portions of the Limerick Township, and (3) an order approving the acquisition that includes the ratemaking rate base of the Township’s wastewater system assets pursuant to Section 1329(c)(2) of the Pennsylvania Public Utility Code (Code), 66 Pa. C.S. § 1329(c)(2), is approved.

4. That the resulting rate base addition of $64,373,378 is approved.

5. That the Commission's Secretary issue a Certificate of Public Convenience evidencing Aqua Pennsylvania Wastewater, Inc.’s right under Sections 1102(a)(1), 1102(a)(3) and 1329(c)(2) of the Pennsylvania Public Utility Code, 66 Pa. C.S. §§ 1102(a)(1), 1102(a)(3) and 1329(c)(2), to: (a) acquire, by sale, the wastewater system assets of Limerick Township, Montgomery County, Pennsylvania, (b) the right of Aqua Pennsylvania Wastewater, Inc. to begin to offer, render, furnish and supply wastewater service to the public in portions of Limerick Township, Montgomery County, Pennsylvania, and (c) allow Aqua Pennsylvania Wastewater, Inc. to incorporate the ratemaking rate base of $64,373,378 for the Limerick Township wastewater system assets in its next base rate case pursuant to 66 Pa. C.S. § 1329(c)(2).

6. That the Commission’s Secretary issue a Certificate of Filing under Section 507 of the Public Utility Code, 66 Pa. C.S. § 507, for the assignment and assumption agreements filed with the Commission on May 19, 2017, for the following municipal agreements:

* 1. The Agreement Between the Borough of Royersford, the Royersford Borough Authority, the Township of Limerick and the Limerick Township Municipal Authority Providing for Sewer Service for the Township of Limerick, dated December 4, 1967.
  2. The Extension of Agreement Between the Borough of Royersford, the Township of Limerick and the Limerick Township Municipal Authority Providing for Sewer Service for the Township of Limerick, dated November 30, 1976.

7. That the municipal agreements set forth in Ordering Paragraph No. 6 shall be filed under separate “U” docket numbers.

8. That within ten (10) days after the closing of the transaction, Aqua Pennsylvania Wastewater, Inc. shall file a compliance tariff supplement containing the existing rates of Limerick Township at the time of closing.

9. That at the time of filing its next base rate case, Aqua Pennsylvania Wastewater, Inc., 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 rate class.

10. That at the time of filing its next base rate case, Aqua Pennsylvania Wastewater, Inc., shall submit an analysis that addresses the effects of designing rates for the customers of Limerick Township rates as a separate, stand-alone rate zone.

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

12. That any directive, requirement, disposition or the like contained in the body of this Opinion and Order that is not the subject of an individual Ordering Paragraph, shall have the full force and effect as if fully contained in this part.

13. That this proceeding be marked closed.

**BY THE COMMISSION,**



Rosemary Chiavetta

Secretary

(SEAL)

ORDER ADOPTED: November 8, 2017

ORDER ENTERED: November 29, 2017

1. An “acquiring public utility” is defined as a water or wastewater public utility subject to regulation under the Code “that is acquiring a selling utility as the result of a voluntary arm’s-length transaction between the buyer and seller.” 66 Pa. C.S. § 1329(g). [↑](#footnote-ref-2)
2. On November 3, 2017, the OCA filed a Petition for Review of the *Aqua – New Garden Application Order* as subsequently upheld by the *Aqua - New Garden Reconsideration Order*. *McCloskey v. Pa. PUC*, Docket No. 1624 C.D. 2017 (Pa. Cmwlth. filed November 3, 2017). Thereafter, Aqua filed a Petition for Review (Cross Appeal to 1624 C.D. 2017) of both the *Aqua – New Garden Application Order* and the *Aqua - New Garden Reconsideration Order*. *Aqua Pennsylvania Wastewater, Inc. v. Pa. PUC*, Docket No. 1692 C.D. 2017 (Pa. Cmwlth. filed November 17, 2017). [↑](#footnote-ref-3)
3. ENR (Engineering News-Record) is a company that publishes both a Construction Cost Index (CCI) and a Building Cost index (BCI) that are widely used in the construction industry. According to its website, “[b]oth indexes have a materials and labor component. In the second issue of each month ENR publishes the CCI, BCI, materials index, skilled labor index and common labor index for 20 cities and the national average. The first issue also contains an index review of all five national indexes for the latest 14 month period.” *See* https://www.enr.com/economics. [↑](#footnote-ref-4)
4. The APA includes a three year “rate freeze,” which provides that Limerick customers will be charged the existing Limerick rates for a period of not less than three years. According to Aqua, while the APA includes a three-year rate freeze, there is no provision within the APA that provides for a limitation on rate increases. Aqua Exc. at 3 (citing Aqua Stmt. 1 at 6). [↑](#footnote-ref-5)
5. Ordering Paragraph 3 of the ALJ’s Recommended Decision states:

   That the Commission retains the authority to allocate revenues, if appropriate, to the Limerick Township customers that are in excess of the restrictions outlined in the Asset Purchase Agreement. Aqua Pennsylvania Wastewater, Inc. and its shareholders should bear all risk of a shortfall between revenues it is permitted to recover under its Asset Purchase Agreement with Limerick Township and the costs that Aqua Pennsylvania Wastewater, Inc. incurs with respect to the acquired system. To the extent that Aqua Pennsylvania Wastewater, Inc. is unwilling or unable to charge costs in excess of the limitations provided in the Asset Purchase Agreement, the excess costs should be borne by its shareholders and not spread to other ratepayers.

   R.D. at 53. [↑](#footnote-ref-6)
6. According to the OCA, based on the ratemaking rate base of $75.1 million, if Aqua files a rate 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%. OCA R. Exc. at 3 (citing OCA M.B. at 47; OCA Stmt. 1S at 6). [↑](#footnote-ref-7)
7. In the *PAWC Scranton Order*, the OCA asserted that SSA’s balance sheet as of March 31, 2015, placed the book value for the wastewater plant at approximately $74 million and that PAWC was not acquiring SSA’s entire assets. According to the OCA, the actual book value of the assets PAWC was acquiring was actually less than $74 million. *PAWC Scranton Order* at 69 n.13. [↑](#footnote-ref-8)
8. Aqua’s Exhibit D shows two calculations of the potential rate impact of the splitting of the ratemaking rate base and creation of the regulatory asset on existing customers. [↑](#footnote-ref-9)
9. Aqua avers it has regulatory assets in rate base including its FAS 109 – Unfounded Deferred Income Taxes and FAS 143 – Net Negative Salvage. Aqua Exc. at 7 (citing Aqua Stmt. 1R at 4, 17). [↑](#footnote-ref-10)
10. HRG used a discount rate of 2.5% in its analysis. The ALJ adopted a discount rate of 6.97% as the true reflection of Aqua’s total cost of capital. Aqua Exc. at 14-15. [↑](#footnote-ref-11)
11. Aqua believes the discount factor should be based on conditions that currently exist and not conditions at the time of the prior rate filing. *Id.* at 16 (citing Aqua Stmt. 4R at 16). [↑](#footnote-ref-12)
12. Aqua notes that the erosion of cash flow provision is a negative $300,000, and was a reduction in the fair market value analysis by HRG. Aqua Exc. at 17 (citing Aqua Stmt. 4R at 14). [↑](#footnote-ref-13)
13. HRG’s analysis estimated the Limerick system’s value at $100,690,000, which HRG averaged with its DCF estimate of $55,020,000 to produce an estimated fair market value income approach of $77,855,000. Aqua Exc. at 17 (citing Aqua Exh. 1, Aqua Exh. R at 10-11). [↑](#footnote-ref-14)
14. $3,416,000 - $1,410,000 - $238,000 = $1,723,000. OCA R. Exc. at 17 (citing OCA Stmt. 1 at 21). [↑](#footnote-ref-15)
15. According to the OCA, this amount is calculated from Mr. Walker’s assumptions within his DCF and Cost of Reproduction New analysis. OCA Exc. at 11 (citing OCA Stmt. 2S at 8). [↑](#footnote-ref-16)
16. Aqua argued that the model used by both Gannett and the OCA reflects the same 1.5% growth in capital expenditures and depreciation and that capital expenditures shown in the 13th year of the model almost exactly matches the depreciation displayed for the same time. According to Aqua, this means the capital investments being put back into the system are matching depreciation which keeps the system in a state of good repair. Per Aqua, using the 50-year model without a terminal value would cap the life of the business at 50 years, which ultimately understates the value indicated by the OCA’s 50-year model. OCA Exc. at 11 (citing Aqua R.B. at 26-28). [↑](#footnote-ref-17)
17. According to Aqua, HRG believes the low unit price in the asset listing is because the cost does not include the value of the mains in residual subdivisions. Aqua avers that units included in the asset listing were obtained from drawings and system maps and included contributed mains. Aqua asserts that contributed mains are part of the transaction and have value which is why HRG chose an appropriate methodology for including them in the reproduction cost approach. Aqua Exc. at 19-20 (citing Aqua Stmt. 4R at 8). [↑](#footnote-ref-18)
18. OCA points out that while the ALJ properly rejected this adder, as identified in OCA Exception No. 2, the ALJ improperly refused to remove the adder for future capital projects in HRG’s market approach. OCA avers 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. From the OCA’s point of view, while the USPAP requires consideration of such projects, there is no mandate that the market value be increased. OCA argues “where future capital projects are paid for by the buyer, there is no basis to increase the value of system for the buyer. OCA R. Exc. at 20 (citing OCA Stmt. 1 at 23; OCA Stmt. 1S at 14). [↑](#footnote-ref-19)
19. The OCA cited to the Pennsylvania Law Encyclopedia’s discussion of depreciated reproduction cost, 40 P.L.E. PUBLIC UTILITIES § 74, n.2346 (“In determining the present fair value of a public utility’s property, the reproduction cost new, a 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). OCA Exc. at 6 (also citing*,* *Application of Columbia Gas of Pa, Inc.,* Docket No. A-120700F0008, 2006 Pa. PUC LEXIS 683 (Opinion entered December 27, 2006) at \*3; and *Application of Columbia Gas of Pa, Inc.,* Docket No. A-120700F0009, 2007 Pa. PUC LEXIS 616 (Opinion entered March 1, 2007) at \*4. [↑](#footnote-ref-20)
20. Aqua avers that separate land appraisals were, however, not performed. Aqua R. Exc. at 9. [↑](#footnote-ref-21)
21. According to Aqua, per the ordinance, all future development that can be served by Limerick must connect to it or violate the Limerick Township ordinance. Aqua Exc. at 22. [↑](#footnote-ref-22)
22. The OCA emphasized that in the *PAWC Scranton Order* the purchase price was $195 million, and the consent decree committed PAWC to invest another $140 million in capital improvements over 25-years. OCA Exc. at 7-8. [↑](#footnote-ref-23)
23. The OCA does not believe Limerick should be compensated for these avoided costs through an inflation of the market value appraisal. OCA Exc. at 9. [↑](#footnote-ref-24)
24. *See, Application of Aqua Pennsylvania Wastewater, Inc. pursuant to Sections 1102 and 1329 of the Public Utility Code for Approval of its Acquisition of the Wastewater System Assets of New Garden Township and the New Garden Township Sewer Authority*, Docket No. A-2016-2580061 (Order entered February 15, 2017) (*Interlocutory Review Order*). [↑](#footnote-ref-25)
25. Aqua states that the agreements being assigned to Aqua include an Agreement between the Borough of Royersford, the Royersford Borough Authority, the Township of Limerick and the Limerick Township Municipal Authority Providing for Sewer Service for the Township of Limerick, dated December 4, 1967, and the later Extension of Agreement, dated November 30, 1976. According to Aqua, the other agreements to be assigned included with Aqua Exhibit 1, Aqua Exhibit F, are with private entities, not municipalities, and, therefore, outside any possible filing requirements under Section 507. Aqua R. Exc. at 6, n.20. [↑](#footnote-ref-26)
26. Aqua indicated that by letter dated October 11, 2016, the Borough of Royersford agreed to the assignment of the intermunicipal sewer agreement. Aqua R. Exc. at 7 (citing Aqua Exh. 1; Aqua Confidential Exh. F, Royersford Letter 10-11-2016). [↑](#footnote-ref-27)
27. This is in apparent contrast to the PAWC Scranton proceeding which involved the submission of form contracts that required execution subsequent to the issuance of the final Commission Order. [↑](#footnote-ref-28)
28. Per the OCA, pursuant to Section 1329(d)(4), from the time a tariff goes into effect until the time 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). [↑](#footnote-ref-29)