

COMMONWEALTH OF PENNSYLVANIA



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October 8, 2021

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

Re: Application of Aqua Pennsylvania Wastewater, Inc.  
pursuant to Sections 507, 1102 and 1329 of the Public  
Utility Code for Approval of its Acquisition of the  
Wastewater System Assets of Lower Makefield  
Township  
Docket No. A-2021-3024267

Dear Secretary Chiavetta:

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

Copies have been served per the attached Certificate of Service.

Respectfully submitted,

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cc: The Honorable Jeffrey A. Watson (**email only**)  
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Certificate of Service

\*318423

CERTIFICATE OF SERVICE

Re: Application of Aqua Pennsylvania Wastewater, :  
Inc. pursuant to Sections 507, 1102 and 1329 :  
of the Public Utility Code for Approval of its : Docket No. A-2021-3024267  
Acquisition of the Wastewater System Assets :  
of Lower Makefield Township :

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

Dated this 8<sup>th</sup> day of October 2021.

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Dated: October 8, 2021  
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BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

In re: Application of Aqua Pennsylvania  
Wastewater Inc. pursuant to Sections 507,  
1102 and 1329 of the Public Utility Code for  
Approval of its Acquisition of the  
Wastewater System Assets of Lower  
Makefield Township

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Docket No. A-2021-3024267

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MAIN BRIEF  
OF THE  
OFFICE OF CONSUMER ADVOCATE

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## I. STATEMENT OF THE CASE

### A. Procedural History

On March 14, 2021, Aqua Pennsylvania Wastewater, Inc. (Aqua or Company) filed an Application under Sections 507, 1102, and 1329 of the Public Utility Code requesting that the Public Utility Commission (Commission): (1) approve the acquisition of the wastewater system assets of Lower Makefield Township (LMT), Bucks County; (2) approve the right of Aqua to provide wastewater service in the requested territory; and (3) include, in its Order approving the acquisition, the ratemaking rate base of the Assets as determined under Section 1329(c)(2) of the Public Utility Code. Application at ¶ 3. Aqua also requested approval of the Asset Purchase Agreement (APA) dated September 17, 2020 as well as other municipal agreements, pursuant to Section 507 of the Public Utility Code, and requested that the Commission issue an Order and Certificate of Public Convenience approving and addressing the items requested in this Application. Application at ¶ 5. LMT owns a sanitary wastewater collection system operated by the Municipal Sewer Authority of the Township of Lower Makefield, which provides direct wastewater service to 11,151 customers in Lower Makefield Township. Application at ¶ 8; Aqua St. 2 at 10. LMT does not own a wastewater treatment plant. Wastewater treatment is mainly provided by the Municipal Authority of the Borough of Morrisville and also by Yardley Borough Sewer Authority. Application at ¶ 15. All of LMT's ratepayers are charged either a metered rate or a flat rate (for customers not metered for water consumption, i.e. on private wells). Application at ¶ 34.

On June 9, 2021, the Office of Small Business Advocate filed a Notice of Intervention and Public Statement. On June 16, 2021, the Commission's Bureau of Investigation and Enforcement filed a Notice of Appearance. On June 29, 2021, Lower Makefield Township filed a Petition to

Intervene. The OCA filed a Protest and Public Statement on July 2, 2021. Additionally, five protests were filed by pro se individuals

On June 30, 2021, Aqua filed a letter, with an attached verification, stating that it had complied with the notice requirements contained in the June 25, 2021 Secretarial Letter. By Secretarial Letter dated August 4, 2021, the Commission informed Aqua that it had accepted the Application for filing. A Prehearing Conference Order was issued on August 11, 2021.

A prehearing conference was held on September 9, 2021, in which the Company, Lower Makefield, OCA, I&E, OSBA, Barry Summers, and Peter LaChance participated. On September 10, 2021, the OCA served the direct testimony of Ralph Smith.<sup>1</sup> I&E, OSBA, Barry Summers, and Peter LaChance also served direct testimony on September 10, 2021. The Applicant served rebuttal testimony on September 17, 2021. On September 23, 2021, a Public Input Hearing was held, at which time portions of Mr. Summer's Direct Testimony was admitted into the record. On September 24, 2021, the ALJ issued an order striking the testimony of Peter A. LaChance. The OCA, I&E, OSBA, and Barry Summers served surrebuttal testimony on September 24, 2021. An evidentiary hearing was held on September 29, 2021, where the Applicants' witnesses provided oral rejoinder testimony and the OCA submitted its testimony into the record.

Pursuant to the schedule, the OCA files this Main Brief in support of its position. The OCA submits that the average appraisal amount is overstated. If the Application is approved, the OCA recommends that the Commission should adopt the OCA's proposed adjustments to the appraisals and a recommended rate base of \$51.236 million rather than \$53 million as requested

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<sup>1</sup> Ralph Smith is a Senior Regulatory Consultant at Larkin & Associates, PLLC, an accounting and regulatory consulting firm. The firm performs independent regulatory consulting primarily for public service/utility commission staffs and consumer interest groups. Larkin & Associates has extensive experience in the utility regulatory field as expert witnesses in over 400 regulatory proceedings including numerous telephone, water and sewer, gas, and electric matters. Mr. Smith is both a licensed CPA as well as member of the Michigan Bar. Mr. Smith's extensive education and experience has been summarized and attached to his Direct Testimony (OCA St. 1) as Attachment A.



by Aqua. In addition, the OCA's position is that Aqua should record the impact of the tax savings resulting from claimed repairs deductions in a regulatory liability account.

**B. Overview of the Proposed Transaction**

LMT owns a sanitary wastewater collection system operated by the Municipal Sewer Authority of the Township of Lower Makefield, which provides direct wastewater service to 11,151 customers in Lower Makefield Township. Application at ¶ 8; Aqua St. 2 at 10. LMT does not own a wastewater treatment plant. Wastewater treatment is mainly provided by the Municipal Authority of the Borough of Morrisville and also by Yardley Borough Sewer Authority. Application at ¶ 15.

Aqua proposes to acquire Lower Makefield's sewer assets for \$53,000,000. Aqua elected to file its Application under Section 1329 in addition to Sections 1102 and 507 of the Public Utility Code. Aqua requests that the purchase price of \$53,000,000 be approved for ratemaking purposes as it is lower than the average of the two appraisals provided with its Application. See 66 Pa. C.S. § 1329(c)(2). In addition, Aqua seeks approval of the APA with Lower Makefield. Application Exh. B. The APA requires Aqua to implement rates that are no higher than Lower Makefield's rates in effect at closing. Application Exh. B at Section 7.04. The APA also provides that Aqua intends to bill customers on a monthly basis instead of an annual basis. Id. Moreover, in accordance with Section 1102 of the Public Utility Code, Aqua is requesting a Certificate of Public Convenience in order to provide wastewater services to the Lower Makefield customers. Application at ¶ 5. Separate customer notices were sent to the Lower Makefield customers and current Aqua customers informing them of the proposed transaction and the potential rate impact.

**II. BURDEN OF PROOF**

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

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

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

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

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

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

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

### III. STATEMENT OF QUESTIONS INVOLVED

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

Suggested Answer: No.

Q. Whether the impact on income tax expense from repairs deductions claimed by Aqua for LMT wastewater utility system assets should be recorded in a regulatory liability account and addressed in Aqua's first base rate case in which rates for the acquired LMT wastewater utility customers are addressed?

Suggested Answer: Yes.

#### IV. SUMMARY OF ARGUMENT

The proposed transfer of the Lower Makefield wastewater system to Aqua was filed under Sections 507, 1102, and 1329 of the Public Utility Code. 66 Pa. C.S. §§ 507, 1102, 1329. As it pertains to Section 1329, it should be emphasized that the statutory appraisal process is not a simple formulaic mathematical exercise. Review of the appraisals provided by Aqua and Lower Makefield show that there are judgments made in each type of analysis as well as in how much weight is given to each approach. The appraisals submitted by Aqua for the Seller and Buyer must be revised to reflect a number of flaws identified by the OCA. As a result of these corrections, the average of the two appraisals is less than the purchase price of \$53,000,000. The appropriate amount for ratemaking purposes should be \$51.236 million. OCA Table I, Col. G, Ln. 15.

In addition to the necessary adjustments to ratemaking rate base under Section 1329, the OCA recommends that Aqua be required to account for the impact of the tax savings resulting from claimed repairs deductions in a regulatory liability account that would be addressed in Aqua's next base rate case that includes the acquired LMT system. OCA St. 1-SR at 7. This condition is particularly important because Aqua witness Packer estimated a \$10,038,836 annual revenue requirement to support the Lower Makefield system if the \$53,000,000 rate base is approved. Aqua St. 1 at App. A. The deferred amounts could provide some relief to help offset the customer rate increases that would be caused by the change in ownership of the LMT wastewater utility. For all of these reasons and as discussed further herein, the OCA recommends that, if the

Commission approves the Application, certain adjustments are necessary to protect the public interest.

## V. ARGUMENT

### A. Section 1329

#### 1. Introduction

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

In this proceeding, the two appraisal values were \$55,505,000 (Gannett Fleming) and \$54,430,591 (AUS Consultants). The average of the two appraisals is \$54,967,796. OCA Table I at Col. C, Ln. 13; OCA St. 1-SR at 21. Aqua has proposed a rate base of \$53,000,000 (the purchase price) for the Lower Makefield assets it will acquire because the purchase price is lower than the average of the two appraisals. Using an engineering assessment performed by Ebert Engineering, Inc., Gannett Fleming shows the original cost of Lower Makefield's wastewater

system and land to be \$32,003,924, with accumulated depreciation of \$12,195,650 and a net book value of \$19,808,274.<sup>2</sup> OCA St. 1 at 21-22.

As discussed below, the OCA submits that Aqua's proposed rate base is overstated due to errors and flaws in the appraisals, and the correct ratemaking rate base amount is \$51,236,259 under Section 1329. OCA Table I at Col. G, Ln. 15.

## 2. Section 1329 - Legal Principles

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

The Applicant must provide to the Commission copies of the appraisals, the purchase price, the ratemaking rate base, the closing costs, and, if applicable, a tariff and rate stabilization plan. 66 Pa. C.S. § 1329(d)(1). Regardless of whether the Applicant meets the requirements of Section 1329, the Applicant still has the burden of proving that it satisfies the requirements of Sections 1102 and Section 1103 of the Public Utility Code as specified above. See McCloskey v. Pa. PUC, 195 A.3d 1055, 1064 (Pa. Commw. 2018); 66 Pa. C.S. §§ 1102, 1103. Moreover, the Commission has determined that UVEs are required to apply jurisdictional exceptions under the valuation approaches, in order to establish appropriate guidelines and consistent assumptions for Section 1329 Fair Market Value appraisals, to comply with Commission precedent, and to reduce variances

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<sup>2</sup> Under Section 1329, the net book value does not reflect an adjustment to remove customer contributions or Pennvest grant funds and thus is higher than it would be under original cost ratemaking calculations. See Aqua Exh. Q at 18-19.

in the appraisals for the same property. Application of Aqua Pennsylvania Wastewater, Inc., A-2019-3008491, Order at 6-7 (Nov. 5, 2019) (Cheltenham).

3. Aqua’s Application

The appraisals contained in Aqua’s Application were prepared by Gannett Fleming for Aqua and AUS for LMT.

Gannett Fleming’s appraisal determined as follows:

Appraisal Approach	Value Indicator	Weight	Weighted Value
Cost Approach	\$ 54,531,935	33.3300%	\$ 18,175,494
Income Approach	\$ 53,741,785	33.3300%	\$ 17,912,137
Market Approach	\$ 58,239,781	33.3400%	\$ 19,417,143
Total		100.0000%	\$ 55,504,774
Conclusion			\$ 55,505,000

OCA St. 1 at 28.

AUS’ appraisal is summarized as follows:

Appraisal Approach	Value Indicator	Weight	Weighted Value
Cost Approach	\$ 51,414,555	50.0000%	\$ 25,707,278
Income Approach	\$ 57,872,959	40.0000%	\$ 23,149,184
Market Approach	\$ 55,741,285	10.0000%	\$ 5,574,129
Total		100.0000%	\$ 54,430,590
Conclusion			\$ 54,431,000

OCA St. 1 at 35.

AUS gives different weight to each approach while Gannett Fleming gives equal weight to the Cost, Income, and Market approaches. OCA Table I. The indicated value under each approach vary from approximately \$51,414,455 to \$58,239,781. Id. Even before reviewing the specifics of each consultant’s analyses, it is clear that judgment is involved in the inputs used, the weighting given to each approach and the determinations. That is why two UVEs have reached different Fair Market Value (FMV) results for the Lower Makefield system. See 66 Pa. C.S. §§ 1329(a)(2)-(3).

As such, the OCA submits that the Commission must carefully consider the flaws in the appraisal results identified in the OCA's testimony. OCA witness Smith calculated that the adjusted Gannett Fleming appraisal result would be \$48,309,516, and the adjusted AUS appraisal result would be \$54,163,000, in order to properly reflect financial and ratemaking principles. OCA Table I at Col. G, Ln. 5, 10. The recalculated average of the two appraisal results is \$51,236,259, which is the amount Mr. Smith recommends be used by the Commission for establishing rate base under Section 1329 rather than the \$53,000,000 proposed by Aqua. OCA Table I at Col. G, Ln. 13.

#### 4. Challenges to UVE Appraisals

The issue of whether parties can challenge Utility Valuation Expert (UVE) appraisals has already been decided in the New Garden proceeding. The Commission determined as follows:

Accordingly, we find 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.

Application of Aqua Pennsylvania Wastewater, Inc., Docket No. A-2016-2580061, Order at 69 (June 29, 2017) (New Garden) (internal citations omitted). The ratemaking approvals of Section 1329 have to be reconciled with the requirement of Section 1301 of the Public Utility Code, 66 Pa. C.S. § 1301, requiring each rate to be just and reasonable and the requirements of Section 1102 that acquisitions provide substantial affirmative benefits.

In a subsequent Section 1329 proceeding, the Commission reiterated that Section 1329 contains no prohibitions on the ability of parties to review the UVE appraisals as to their reasonableness and stated as follows:

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.

Application of Aqua Pennsylvania Wastewater, Inc., Docket No. A-2017-2605434, Order at 36 (Nov. 29, 2017) (Limerick). The OCA submits that it would be inconsistent with the requirements

of the Public Utility Code and prior Commission orders to permit Aqua to simply present a rate base number, show that the appraisers chose numbers to fill in all the blanks in the formulas, and not permit any review or challenges of those inputs. As explained above, the Commission has already made the determination that challenges to appraisals are permissible.

a. Cost Approach

Cost Approach is defined as, “A procedure to estimate the current costs to reproduce or create a property with another of comparable use and marketability.” See OCA St. 1 at 28<sup>3</sup>. OCA Witness Smith recommended adjustments to AUS’ Cost Approach valuation.

i. AUS Service Lives

In the AUS appraisal, Mr. Weinert used an 80-year service life for calculating the valuation of LMT’s Account 361 – Gravity collection Mains. OCA St. 1 at 35. At \$22.142 million, Account 361 is the largest single account, by far, in the LMT sewer system. Id. at 22. Mr. Weinert’s 80-year service life for Account 361 is 15 years longer than the 65 year service life utilized by Gannett Fleming for the same account. OCA St. 1 at 35. OCA witness Smith explained that under the Cost Approach, having a 15-year discrepancy in the estimated service life for the largest account in the LMT sewer system could lead to misstated results. Id. at 35-36.

The Ebert Engineering report stated that documentation was missing for the age, size and material of the gravity collection mains in the LMT system, however, estimates were made as follows:

Sanitary sewer pipes with missing original documents had their age, size, and material estimated with the help of the Township staff’s institutional knowledge. Specifically, the sanitary gravity pipe material was assumed to be vitrified clay if the pipe was constructed before 1980. After 1980, the sanitary gravity pipe material was assumed to be SDR-35.

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<sup>3</sup> The American Society of Appraisers “Approaches to Value” accessed Jan. 27, 2017, <http://www.appraisers.org/Disciplines/Personal-Property/pp-appraiser-resources/approaches-to-value>.



OCA St. 1 at 22 *citing* Aqua Exh. D at 2. As noted by Mr. Smith, Vitrified Clay Pipe (VCP) is pipe that was manufactured using clay and shale as raw materials and historically was widely used in gravity sanitary sewer collection mains. OCA St. 1 at 22. There are some disadvantages to using vitrified clay pipes which can become brittle, allowing cracks to form. OCA St. 1 at 22.

Aquas has not met its burden of proof to support an 80-year service life for the account at issue. Given that there is missing documentation concerning the type and age of the pipe and the susceptibility of old VCP to cracking, for valuation purposes, OCA witness Smith recommended adjusting the 80-year service life used in AUS' appraisal to match the 65-year service life for this same account utilized by Gannett Fleming. OCA St. 1 at 23, 36.

In a previous case involving Aqua and Mr. Weinert as Aqua's UVE, a similar issue regarding the Cost Approach and service lives for VCP was addressed and the OCA's adjustment was adopted. The Commission determined as follows:

#### Disposition

Upon review of the record, the ALJ's Recommended Decision and the Parties' Exceptions, we find that the ALJ properly considered and rejected Aqua's arguments regarding the use of a 90-year service life for VCP mains, laterals, and manholes in the AUS' cost approach. Aqua did not meet its burden of proof on this issue. It presented no testimony to support its arguments that "[t]he AUS extended service lives are also supported by the Engineer's Assessment and the AUS detailed cost approach calculations" and that using relining techniques extends the life expectancy of the mains. Aqua Exc. at 7. Mr. Weinert, AUS' UVE, in testimony did not address the relining of mains, so it is not clear whether AUS considered the relining of a very small portion of the collection mains to be relevant to the service life of the collection mains.

We find it compelling that, Mr. Walker, Aqua's UVE, based his appraisal on the same Engineer's Assessment and concluded that a 75-year service life for these same-lined VCP mains was appropriate. OCA R. Exc. at 4 (citing OCA St. 1 at 11). In addition, Aqua's own testimony indicates that the average age of the pipe in the system is approximately 75 years old. Aqua St. No. 2 at 8. Moreover, with Aqua's budgeted \$54.8 million for implementing corrective actions needed under the DEP Corrective Action Plan to address the system's chronic I&I, and the focus of the Corrective

Action Plan on lines, manholes and laterals that may be sources of I&I, the service life of 90 years used by AUS is not reasonable. See Aqua St. No. 2 at 7. Accordingly, for all of the foregoing reasons stated above, we deny Aqua Exception No. 2.

We agree with the OCA that the use of a 75-year service life for VCP mains, laterals and manholes is both reasonable and consistent with Gannett Fleming's depreciation analysis under the cost approach in this proceeding. We also agree with the OCA that the correct adjustment amount to the AUS cost approach to reflect the adjustment from a 90-year to a 75-year service life for VCP mains, laterals and manholes is \$12,339,645 to the AUS cost approach (correcting the typographical error shown in the R.D. of \$12,319,645, see R.D. at 41). We shall grant OCA Exception No. 1. This produces an adjusted AUS cost approach result of \$37,544,813.

OCA St. 1 at 36-37 citing Cheltenham at 44-45. Moreover, at the evidentiary hearing in this proceeding, Mr. Weinert acknowledged that he relied on Gannett Fleming's depreciation studies in formulating his Cost Approach. Tr. at 77.

In Mr. Weinert's previous appraisals, he has typically used between 65 and 75 years as the service life for gravity collection systems. Moreover, Mr. Weinert's previous appraisals indicate his use of a 75-year service life for VCP. As noted above, in Cheltenham Mr. Weinert utilized a 75-year service life for VCP mains, laterals, and manholes, consistent with Gannett Fleming's depreciation analysis in that proceeding. See Cheltenham at 44-45.

In Limerick, when an appraisal did not reasonably present a sufficient basis for Aqua's conclusion regarding collection main, the Commission determined as follows:

We agree that Aqua failed to provide any reasonable basis or any convincing evidence as to why the collection mains should be treated differently or as a special circumstance in HRG's valuation under the reproduction cost approach.

Limerick at 56. Similarly, here, Mr. Weinert fails to provide any reasonable basis to conclude that the 80-year service life that he uses for collection mains is more appropriate than the 65-year service life for the same collections mains that was used by Gannett Fleming in this proceeding.

As such, OCA witness Smith recommended an adjustment of \$4,714,148 to the AUS appraisal to match the 65-year service life utilized by Gannett Fleming. OCA Table I at Col. D, Ln. 2. The OCA submits that Mr. Smith's adjustment to the Cost Approach should be accepted.

b. Income Approach

i. Introduction

Mr. Smith recommended several adjustments to the Income Approach analyses as discussed in OCA Statements 1 and 1SR. Mr. Smith's adjustments to Mr. Weinert's Income Approach analysis are \$48,462,957 (\$19,385,183 weighted result). OCA Table I at Ln. 2. Mr. Smith's adjustments to Mr. Walker's Income Approach analysis are \$49,717,098 (\$16,570,709 weighted result). OCA Table I at Ln. 7. As set forth below, Mr. Smith's adjustments are reasonable and consistent with public utility principles and should be adopted.

The theory behind Income Approach valuation is that the value of a business is the future economic benefit that ownership will provide. OCA St. 1 at 29-30. The Income approach is defined as:

A procedure to conclude an opinion of present value by calculating the anticipated monetary benefits (such as a stream of income) for an income-producing property.

Id.<sup>4</sup> OCA witness Smith described the Income Approach models utilized by the UVEs in this proceeding as follows:

The income approach models utilized by both the buyer and seller employ a discounted cash flow model wherein annual cash flows are projected based upon forecasted levels of revenues, cash O&M expenses, income taxes, capital expenditures and changes in working capital. These annual cash flows are modeled for a set number of years into the future and then a terminal value is added to the previous discounted annual cash flows as a measure of the expected cash flows in perpetuity.

OCA St. 1 at 30-31.

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<sup>4</sup> Citing "Approaches to Value." The American Society of Appraisers accessed March 5, 2020.

The fundamental flaw in both UVE models is the calculation of terminal values for the LMT system. OCA St. 1 at 31. OCA witness Smith notes that, in calculating terminal values, both UVEs utilized a “capitalization rate” to project future cash flows in perpetuity. OCA witness Smith testified as follows:

In calculating the terminal value, both UVEs utilized what is known as a “capitalization rate” to project future cash flows in perpetuity. In simple terms, each UVE calculated a terminal value (in nominal terms) by applying the projected cash flow in the last year of the model to a capitalization rate. Specifically, the last model year’s annual cash flow is multiplied by 1, and then divided by the calculated capitalization rate. Mathematically, this approach escalates annual cash flows at a constant annual growth rate (percent) in perpetuity. **It essentially assumes that net cash flows would grow at a constant annual growth rate to infinity.** A capitalization rate is defined as a firm’s total cost of capital (k) minus its expected future annual constant rate of growth (g).

OCA St. 1 at 31 (emphasis added).

While the use of capitalization rates may be appropriate for evaluating project feasibilities and for valuing unregulated business enterprises, Mr. Smith explained that there are limitations to capitalization rates in valuing regulated public utilities. OCA St. 1 at 31-32. Regulated public utilities’ revenues, income streams, and cash flows are directly based on the capital investments required to operate as a utility and rates are set using this rate base/rate of return method of ratemaking. Id. This is commonly referred to as the rate base/rate of return method of ratemaking.

OCA St. 1 at 30. For a regulated utility, Mr. Smith explained:

A utility’s allowable revenue requirement is equal to its cash operating expenses plus depreciation plus a return on its net investment (rate base) plus income taxes on the return. Therefore, the resulting annual net cash flow is equal to depreciation plus the after-tax return on the net investment. As such, the higher the assumed level of investment, the higher the periodic cash flows and the higher the ultimate valuation.

OCA St. 1 at 30.

The theory underlying the use of capitalization rates is that a firm’s net cash flow will grow at a constant rate in perpetuity without significant reinvestment greater than historical depreciation.

OCA St. 1 at 31. However, this is not the case for regulated utilities. A regulated utility's net cash flow is a direct function of its plant in service. OCA St. 1 at 32. A utility's net cash flow can, and will, only grow with increases to its plant investment and rate base. Id. In recent years, the LMT wastewater net plant balance/amount has been declining; however, over a sufficiently long period of time, it is expected that the LMT wastewater utility plant investment will grow as aging plant is replaced. OCA St. 1 at 32.

It is important to understand that, for a regulated utility, the valuation is a direct function of, and is exactly equal to, the selected investment. OCA St. 1 at 31. The utility recoups these additional investments over time through future depreciation rates. Id. at 32. Unlike the private sector, for rate regulated utilities, spending on plant additions is a use of cash and depreciation expense is a source of cash. OCA St. 1 at 32. This is the circularity issue identified by Mr. Smith that is present when using capitalization rates to value public utilities under rate base/rate of return regulation. Id. This limitation to capitalization rates in relation to valuing regulated public utilities has not been recognized by the Gannett Fleming and AUS UVEs but should be considered when reviewing the assumptions used by each UVE in conducting the analyses.

The OCA submits that the failure to consider the source and use of cash in the valuation estimates that have been submitted on behalf of the buyer and the seller results in a significant overstatement of the terminal value. As Mr. Smith stated, a regulated utility's net cash flow "is a direct function of its plant in service in that a utility's net cash flow can, and will, only grow with increases to its plant investment (rate base)." OCA St. 1 at 30. He noted that, for discounted cash flow valuation purposes, "capital expenditures (that give rise to plant additions) are treated as a negative cash outflow during the year in which the expenditure is made and the utility recoups these additional investments over time through future depreciation rates (cash inflow)." OCA St. 1 at 32.

The fatal flaw in both the buyer and seller UVEs' estimation of a "terminal" value is that the capital expenditures in the last year of the model are much less than the depreciation expense on existing plant during that year. OCA St. 1 at 32. That would mean that according to the assumptions and modeling done by both UVEs, LMT would be depreciating and using up its plant faster, and to a higher degree, than it is making investments to replace that plant. OCA St. 1 at 32. Clearly, this practice cannot not be sustained. Id. The impact of those unfounded assumptions and modeling is to severely overstate the Income Approach valuation.

Mr. Smith adjusted the income approach of Gannett Fleming's and AUS' UVEs to recalculate the terminal value using the amount of Net Plant less Accumulated Deferred Income Taxes (ADIT) projected to be remaining at the end of 2044 and 2049, respectively. OCA St. 1 at 33, 38. The terminal value approach used by Aqua and LMT unrealistically overstates the valuation and would result in excessive valuation and return and should not be adopted. Mr. Smith's approach ensures that investors will earn a fair rate of return over the life of the plant in service and will recoup their initial investment through depreciation. Mr. Smith's approach does not increase rates to provide excessive returns over the life of the plant. Further, Mr. Smith's approach is consistent with the most fundamental principles of ratemaking.

ii. AUS Income Approach Adjustment

On behalf of LMT, Jerome Weinert with AUS developed an Income Approach resulting in an estimated fair market value of \$57,872,959. OCA St. 1 at 35. AUS allocated 40% weight to the Income Approach which gave it a weighted value of \$23,149,184. Id.

As discussed above, Mr. Smith recommended an adjustment to the terminal value used in the AUS income approach. Specifically, Mr. Smith recalculated the valuation of the terminal value using the amount of Net Plant less ADIT projected to be remaining at the end of 2049. See OCA Exhibit RCS-4. Mr. Smith's adjustment to terminal value results in an Income Approach valuation

of \$48,462,957. OCA Table I. This adjustment reduces the AUS Income Approach amount by approximately \$9.41 million. OCA St. 1 at 38.

iii. Gannett Fleming Income Approach Adjustment

On behalf of Aqua, Harold Walker of Gannett Fleming, developed a valuation under the Income Approach resulting in an estimated fair market value of \$53,741,785. OCA St. 1 at 28, 33. Mr. Walker allocated 33.33% weight to that approach which gave it a weighted value of \$17,912,137. OCA St. 1 at 28.

In response to Mr. Smith's explanation that, under the UVE's assumptions, LMT would be depreciating and using up its plant faster than it is making investments to replace that plant, Aqua witness Walker claimed in rebuttal testimony that that "it would take 1,564 years to use up existing plant." OCA St. 1-SR at 15; Aqua St. 4-R at 8. LMT's existing plant would be expected to be "used up" over the expected remaining life of that plant, however. A review of the depreciation rates being used for the existing LMT plant confirms that there is no utility plant at LMT which has an expected useful life of anywhere near to 1,564 years. OCA St. 1-SR at 15. As such, OCA witness Smith adjusted Gannett Fleming's Income Approach by recalculating the valuation of the terminal value using the amount of Net Plant less Accumulated Deferred Income Taxes (ADIT) remaining at the end of Year 24. See Exhibit RCS-2-SR, page 2.

The adjusted Income Approach value of \$48,462,957 is \$5,278,828 lower than Mr. Walker's proposed amount of \$53,741,785 See OCA Table I.

c. Market Approach

In reaching his Market Approach valuation for the LMT system, Mr. Weinert included the Delaware County Regional Water Quality Authority (DELCORA) in his comparison group and indicated a final purchase price of \$276,500,000. OCA St. 1 at 38-39; Aqua Exh. R at 10. The Aqua-DELCORA acquisition, however, is an ongoing matter as the transaction has not closed. To

be clear, the \$276,500,000 purchase price and ratemaking rate base proposed by Aqua in the DELCORA proceeding has not been finalized and, further, in March 2021, the Commission issued an Order to vacate the Recommended Decision, reopen the record, and remand the proceeding, which has since been stayed.<sup>5</sup> As such, including the DELCORA acquisition and indicating \$276,500,000 as the “final purchase price” for the DELCORA system is inaccurate and potentially misleading.

The FSIO states as follows regarding the jurisdictional exceptions under the Market Approach:

3. Speculative growth adjustments will not be used.

...

6. Comparable sales used to establish the valuation should use the current customers.

FSIO at 87-88 (emphasis in original).

As the DELCORA system has not been purchased for \$276,500,000, and as there is no final purchase price for the system, Mr. Smith recommended that the LMT acquisition be removed from AUS’ comparison group. See OCA St. 1 at 39. Including the DELCORA system in the proxy group under the Market Approach and indicating a “final purchase price” for the DELCORA system is misleading and is purely speculative. Additionally, the DELCORA customers are not the currently customers of Aqua. The OCA notes that based on how the AUS Market Approach was derived, eliminating the DELCORA acquisition from the comparison group did not impact the final resulting valuation under the AUS Market Approach. OCA St. 1 at 39. The OCA submits, however, that removing the DELCORA acquisition AUS’ proxy group for the LMT acquisition is reasonable, given the circumstances surrounding the pending Aqua-DELCORA acquisition.

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<sup>5</sup> Application of Aqua Pennsylvania Wastewater, Inc., A-2017-2606103, ALJ Order Staying Proceeding (Apr. 16, 2021).



i. Conclusion

OCA witness Smith calculated that, in order to properly reflect financial and ratemaking principles under Pennsylvania law, the adjusted Gannett Fleming appraisal result would be \$48,309,516, and the adjusted AUS appraisal result would be \$54,163,000, in order to properly reflect financial and ratemaking principles. OCA Table I at Col. G, Ln. 5, 10. The recalculated average of the two appraisal results is \$51,236,259, which is what Mr. Smith recommends be used by the Commission for establishing rate base under Section 1329 rather than the \$53,000,000 proposed by Aqua. OCA Table I at Col. G, Ln. 13. The OCA submits that Mr. Smith's recommended adjustments are reasonable, consistent with Public Utility Code and precedent, and should be adopted by the Commission in this proceeding.

B. Income Tax Savings on Repairs Deductions

OCA witness Smith recommended that, if the Commission approves the transaction, the impact on income tax expense from repairs deductions claimed by Aqua for LMT wastewater utility system assets should be recorded in a regulatory liability account and addressed in Aqua's first base rate case in which rates for the acquired LMT wastewater utility customers are addressed. OCA St. 1 at 41.

As a result of the proposed transaction, Aqua is expected to have federal income tax deductions for repairs for the acquired LMT wastewater system. OCA St. 1 at 40. As such, Aqua can avail itself of tax deductions for repairs even where the accounting treatment results in the repairs costs being capitalized for book purposes. The repairs deductions can be substantial and result in reducing income tax expense. Id. Mr. Smith noted that Aqua has treated federal income tax deductions for repairs for regulatory purposes by applying flow-through accounting for the impact of those deductions. OCA St. 1 at 40. Mr. Smith anticipated in direct testimony that Aqua would attempt to utilize flow-through accounting for the impact of repair deductions related to the

assets of LMT after completing a full assessment of the property relative to the IRS Tangible property regulation. OCA St. 1 at 40.

In rebuttal, Aqua witness Packer agreed with Mr. Smith's characterization of Aqua's ability to avail itself of tax deductions for repairs completed on the LMT system after closing and that Aqua has applied flow-through accounting for the impact of those deductions. OCA St. 1-SR; Aqua St. 1-R at 9. Aqua witness Packer, however, claims that the likelihood of repair deductions being realized by the Company is remote in the first five years, which are the years prior to the first rate case that the LMT system would be included. OCA St. 1-SR at 5; Aqua St. 1-R at 9. In other words, Aqua witness Packer is essentially asking that Aqua be allowed to retain any benefits from repairs deductions on the acquired LMT system as an offset to the revenue deficiency that he claims exists for LMT's existing rates. OCA St. 1-SR at 21. OCA witness Smith summarized Mr. Packer's reasoning as follows:

In essence, his response is that (1) federal income tax repairs deductions claimed by Aqua for the acquired LMT wastewater utility system are likely to be small, and (2) Aqua should be allowed to keep the benefits of those repairs deductions through the date of establishing new rates for the LMT wastewater utility because Aqua claims that the LMT system has a revenue deficiency that would not be addressed until Aqua's next base rate case in which the LMT system were to be included.

OCA St. 1-SR at 5.

To be clear, the size of those repairs deductions is not currently known. OCA St. 1-SR at 6. The OCA submits that the fact that Aqua expects the repairs deductions to be relatively small in the early years of Aqua's ownership of the LMT wastewater utility is not a valid reason against the deferred accounting recommendation. The federal income tax repairs deductions for the acquired LMT system are related to Aqua's ownership of the LMT wastewater utility and represent a potential benefit to Aqua's ratepayers that could be significant and that could help offset the estimated rate increases that Aqua has projected as a result of its acquisition of LMT. OCA St. 1-SR at 6. Conversely, not requiring such deferred accounting would essentially allow Aqua to keep

for its investors all of the income tax savings from repairs deductions for the LMT wastewater utility system from the date of acquisition through the timing of Aqua's next base rate case in which the LMT utility would be included. OCA St. 1-SR at 6.

Accordingly, OCA witness Smith recommended that Aqua should be required to account for the impact of the tax savings resulting from claimed repairs deductions in a regulatory liability account that would be addressed in Aqua's next base rate case that includes the acquired LMT system. OCA St. 1-SR at 7. Mandating the deferred accounting in a regulatory liability account of Aqua's repairs deductions for the acquired LMT system from the date of the acquisition through the test year being used in Aqua's next base rate case will preserve the issue so that it can be addressed in Aqua's next rate case. If Aqua believes that the amounts accumulated in the regulatory liability account for the LMT wastewater utility repairs deductions should not be used to offset rate increases in that case, Aqua would have the opportunity to present its reasoning in that future rate case.

Given the size of the proposed transaction and the potential benefits of utilizing tax repairs, the OCA submits that Mr. Smith's recommendation to account for the impact of the tax savings resulting from claimed repairs deductions in a regulatory liability account that would be addressed in Aqua's next base rate case that includes the acquired LMT system is reasonable and should be adopted. As such, the OCA respectfully requests that the Commission include OCA witness Smith's recommended condition regarding the treatment of tax repairs deductions as part of its Order in this proceeding.

## VI. CONCLUSION WITH REQUESTED RELIEF

For the reasons stated above the Office of Consumer Advocate's proposed recommendations should be adopted, including the OCA's proposed adjustments to the appraisals resulting in an overall ratemaking rate base of \$51,236,269. In addition, the impact on income tax expense from repairs deductions claimed by Aqua for LMT wastewater utility system assets should be recorded in a regulatory liability account and addressed in Aqua's first base rate case in which rates for the acquired LMT wastewater utility customers are addressed.

Respectfully submitted,

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