

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**Application of Pennsylvania- :
American Water Company- :
Wastewater under Section 1329 of the :
Public Utility Code for Approval of : Docket No. A-2017-2606103
the use for ratemaking purposes of :
the lesser of the fair market value or :
the negotiated purchase price of The :
Municipal Authority of the City of :
McKeesport's assets related to its :
wastewater collection and treatment :
system and other related transactions :
:**

**MAIN BRIEF
OF THE
BUREAU OF INVESTIGATION AND ENFORCEMENT**

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I. INTRODUCTION

A. Procedural History

On May 24, 2017, the Pennsylvania-American Water Company, Inc. (“PAWC”) filed its Application, inter alia, requesting approval to (a) acquire substantially all of the Municipal Authority of the City of McKeesport's (“MACM”) assets, properties and rights related to MACM's wastewater collection and treatment system assets pursuant to 66 Pa. C.S. § 1102 (“Section 1102”); (b) obtain the Certificates of Public Convenience necessary for it to begin to offer, render, furnish and supply offer, wastewater service to the public in the areas served by MACM in the City of McKeesport (“City”), the City of Duquesne, Port Vue Borough, the Borough of Dravosburg, a portion of West Mifflin Borough, Allegheny County, Pennsylvania and to three bulk service interconnection points located in Liberty Borough, White Oak Borough, and North Versailles Borough, Allegheny County, Pennsylvania (“Service Area”); and (c) to use, for ratemaking purposes, the lesser of the fair market value or the negotiated purchase price of MACM’s assets to establish MACM’s ratemaking rate base in this proceeding pursuant to 66 Pa. C.S. § 1329 (“Section 1329”). By Secretarial Letter dated June 14, 2017, the Pennsylvania Public Utility Commission (“Commission”) acknowledged receipt of PAWC’s Application.

On June 21, 2017, the Bureau of Investigation and Enforcement (“I&E”) filed a Notice of Appearance in this proceeding. I&E serves as the Commission’s prosecutory bureau for the purposes of representing the public interest in ratemaking and service

matters, and enforcing compliance with the Pennsylvania Public Utility Code (“Code”).¹ I&E’s participation in this proceeding is warranted because its outcome will produce a direct and immediate ratemaking determination and because key components of the Code support an investigation into matters of property valuation, which are at issue in this case.

On the same date that I&E entered its appearance, the Office of Consumer Advocate (“OCA”) filed a Protest in this proceeding. On June 28, 2017, counsel for MACM and the City filed a Petition to Intervene in the instant proceeding.

On June 27, 2017, PAWC, I&E, and OCA entered into a Stipulation of the Parties Regarding Objections and Preservation of Issues (“Stipulation”), which memorialized an agreement to withhold objections and arguments regarding the proper scope of Section 1329 proceedings, including the proper scope of discovery and the Commission's scope and standard of review in such proceedings.² Instead, the parties agreed, by way of the Stipulation, to reassert their positions as represented in the first Section 1329 proceeding,³ which was filed by Aqua Pennsylvania Wastewater, Inc. (“Aqua”) to acquire the New Garden Township (“New Garden”) wastewater system. For purposes of clarity, in the Aqua/New Garden Section 1329 proceeding, which is currently pending reconsideration on the merits on unrelated issues, PAWC opined that in order for the Commission to inquire into the fair market value determinations in Section 1329 proceedings, there must

¹ 66 Pa. C.S. §§ 101 *et seq.*, and Commission regulations, 52 Pa. Code §§ 1.1 *et seq.* See *Implementation of Act 129 of 2008; Organization of Bureaus and Offices*, Docket No. M-2008-2071852 (Order entered August 11, 2011).

² Stipulation, ¶3-4.

³ *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*, Docket No. A-2016-2580061 (“Aqua/New Garden Section 1329 Proceeding”).

be clear evidence that fraud, illegality, or bad faith has undermined the appraisal.

Conversely, I&E and OCA argued that the Commission has clear authority to review and analyze the fair market value appraisals, which is ultimately the position that the Commission adopted.⁴

A Prehearing Conference was held on July 13, 2017, with Deputy Chief Administrative Law Judge Mark A. Hoyer (“ALJ Hoyer”) and Administrative Law Judge Mary D. Long (“ALJ Long”) presiding. A litigation schedule was developed that provided for the filing of testimony, hearings and briefs as follows:

Other Parties’ Direct Testimony	July 17, 2017
Rebuttal Testimony	July 26, 2017 by 2:00 p.m.
Surrebuttal	August 2, 2017 by noon
Evidentiary Hearing	August 3-4, 2017
Main Briefs	August 22, 2017
Reply Briefs	September 1, 2017

Pursuant to the litigation schedule, ALJ Hoyer and ALJ Long conducted an evidentiary hearing on August 3, 2017. At the hearing, testimony and exhibits were entered into the record and cross examination was conducted. I&E entered the following statements and exhibits into the evidentiary record: I&E Statement No. 1, I&E Exhibit No. 1, I&E Statement No. 1-SR, I&E Statement 2, I&E Exhibit No. 2, and I&E Statement 2-SR. Pursuant to the procedural schedule and in accordance with Commission regulations at Section § 5.501, I&E submits this Main Brief.

⁴ Aqua/New Garden Section 1329 Proceeding, Docket No. A-2016-2580061, pp. 29-35 (Order entered June 29, 2017).

B. Overview of the Proposed Transaction

PAWC's Application requests that the Commission grant approval for four acquisition-related requests. At the outset, under Section 1102, PAWC's Application requests permission for it to acquire substantially all MACM's assets, properties and rights related to MACM's wastewater collection and treatment system and to obtain the Certificates of Public Convenience necessary for it to begin to offer wastewater service to the public in the Service Area. The MACM assets consist of, inter alia, a combined wastewater collection system and three wastewater treatment plants which collect and treat wastewater from the City, the City of Duquesne, the Borough of Dravosburg, and the Borough of Port Vue.⁵ MACM's system also provides wastewater service through bulk service connections to White Oak Borough, Liberty Borough, East McKeesport Borough, Glassport Borough, Versailles Borough, Elizabeth Township, which PAWC seeks to continue.⁶ In total, through this acquisition, PAWC is seeking to provide service to MACM's approximately 22,000 wastewater customers.⁷

In its second request, pursuant to Section 1329, PAWC seeks to utilize the fair market value process to establish the ratemaking rate base of MACM's assets at \$162 million. In accordance with Section 1329, the \$162 million amount represents the lower of PAWC and MACM's negotiated purchase price, \$162 million, and the average of two fair market value appraisals completed by each of these parties' utility valuation experts ("UVEs"). At the start of this case, the average of the UVEs appraisals was

⁵ PAWC Application, Appendix A-14, St. No. 3, p. 3.

⁶ PAWC Application, Appendix A-14, St. No. 2, p. 7; PAWC Application, pp. 2-5.

⁷ PAWC Application, Appendix A-14, St. No. 2, p. 7.

\$184,176,500.⁸ The average was calculated using the value assigned by PAWC's UVE, Associated Utility Services, Inc. ("AUS"), who valued the MACM assets at \$161,343,000,⁹ and MACM's UVE, Herbert, Rowland & Grubic, Inc. ("HRG") who valued the assets at \$207,010,000.¹⁰ During the course of this proceeding, HRG appraiser Adrienne Vicari lowered HRG's valuation of the MACM assets to \$190,840,000, reflecting a decreased value of \$16,170,000.¹¹ Taking into account the adjustment, the average of the UVEs' fair market value appraisals is \$176,091,500,¹² which is still higher than PAWC's \$162 million purchase price.

PAWC's third request, also made pursuant to Section 1329, seeks permission to collect a distribution system improvement charge ("DSIC") for the Service Area. Additionally, PAWC seeks permission for the accrual of Allowance for Funds Used During Construction ("AFUDC") for post-acquisition improvements not recovered through its DSIC for book and ratemaking purposes. Finally, PAWC is requesting to defer depreciation related to post-acquisition improvements not recovered through the DSIC for book and ratemaking purposes.¹³

In its final request, pursuant to 66 Pa. C.S. § 507 ("Section 507"), PAWC is seeking approval to enter into an Asset Purchase Agreement ("APA") with the City and MACM to acquire the MACM system and to assume certain municipal contracts that are

⁸ PAWC Application, Appendix A-14, St. No. 1, p. 12.

⁹ PAWC Application, Appendix A-14, St. No. 7, p. 22.

¹⁰ MACM St. No. 1, p. 12.

¹¹ MACM St. No. 1-R, pp. 4-5.

¹² This amount was calculated by adding PAWC's valuation of \$161,343,000 with HRG's revised valuation of \$190,840,000 and dividing by two ($(161,343,000 + 190,840,000) / 2 = \$176,091,500$).

¹³ PAWC Application, ¶2; PAWC Statement No. 1, p. 4.

currently held by MACM.¹⁴ PAWC proposes to enter into an Assignment of Contracts Agreement with MACM to facilitate the assignment of these contracts, which include nine Municipal Service Agreements and nine related Corrective Action Agreements: (1) Lincoln Borough and Municipal Authority; (2) Elizabeth Township Sanitary Authority; (3) Liberty Borough, Municipal Authority of Westmoreland County, (4) North Versailles Township; (5) North Versailles Township Sanitary Authority; (6) East McKeesport Borough; (7) the Borough of Versailles; (8) the Borough of Glassport; (9) and Port Vue Borough.

II. STATEMENT OF QUESTIONS PRESENTED

Question #1: Should PAWC's Application be approved only upon the Condition that it be required to perform the cost of service study recommended by I&E?

Suggested Answer # 1: Yes. As filed, PAWC's Application may expose it existing customers to an undetermined, but potentially substantial rate impact without preserving the Commission's ability to review and, if appropriate, mitigate that impact in a future base rate case. To ensure that this transaction is in the public interest, the Commission should condition its approval on PAWC undertaking a cost of service study that (1) separates capital expenses and operating costs for MACM's sanitary and storm water functions and (2) separately identifies the plant in service costs at the time that the Port Vue system was purchased, the cost of any Port-Vue plant retirements, and the cost of any Port Vue plant investment.

¹⁴ PAWC Application, pp. 2-5.

III. LEGAL STANDARDS

A. Burden of Proof

PAWC, as the proponent of the Application, bears the burden of proof to establish that it is entitled to receive the approvals being sought in the Application.¹⁵ In a case such as this one, pending before an administrative tribunal, Courts have held that a “litigant's burden of proof is satisfied by establishing a preponderance of evidence which is substantial and legally credible.”¹⁶ In order to meet its burden of proof, PAWC must “present evidence more convincing, by even the smallest amount, than that presented by any opposing party.”¹⁷ To satisfy its burden, PAWC must demonstrate, by a preponderance of the evidence, that its proposed transaction complies with Pennsylvania law and should be approved.¹⁸ Specific to this case, PAWC has the burden of proving that the proposed transaction is in compliance with Sections 507, 1102, 1103, 1329 of the Code.

B. Legal Standard for Section 1102 Approval

The Code requires that the Commission issue a Certificate of Public Convenience as a prerequisite to offering service, abandoning service and certain property transfers by public utilities or their affiliated interests.¹⁹ The standards for the issuance of a Certificate of Public Convenience are set forth in Sections 1102 and 1103²⁰ of the Code.

¹⁵ 66 Pa. C.S. § 332(a).

¹⁶ *Samuel J. Lansberry, Inc. v. Pa. PUC*, 578 A.2d 600, 602 (Pa. Cmwlth. 1990).

¹⁷ *Se-Ling Hosiery v. Margulies*, 70 A.2d 854 (Pa. 1950).

¹⁸ *Samuel J. Lansberry, Inc. v. Pa. PUC*, 578 A.2d 600, 602 (Pa. Commw. 1990).

¹⁹ 66 Pa. C.S. § 1102(a).

²⁰ 66 Pa. C.S. § 1103.

A Certificate of Public Convenience shall be granted “only 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.”²¹ These provisions have been interpreted by the Pennsylvania Supreme Court in the *City of York v. Pennsylvania Public Utility Commission* for the proposition that to establish that a proposed transaction benefits the public, it must be shown to affirmatively promote the service, accommodation, convenience or safety of the public in some substantial way.²² Additionally, pursuant to Section 1103, PAWC must show that it is technically, legally, and financially fit to own and operate the assets it will acquire from MACM.²³ In addition to assessing fitness, the Commission should consider the benefits and detriments of the transaction “with respect to the impact on all affected parties”²⁴ including existing customers. To ensure that a transaction is in the public interest, the Commission may impose conditions on granting a certificate of public convenience as it may deem to be just and reasonable.²⁵

C. Legal Standard for Section 1329 Approval

Section 1329 of the Public Utility Code is a newly enacted statute which prescribes the process used to determine the fair market value of a municipal utility that is the subject of an acquisition. Section 1329 provides a framework for valuing, for

²¹ 66 Pa. C.S. § 1103(a).

²² *City of York v. Pa. PUC*, 449 Pa. 136, 295 A.2d 825, 828 (1972).

²³ *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).

²⁴ *Middletown Twp. v. Pa. P.U.C.*, 482 A.2d 674, 682 (Pa. Commw. 1984).

²⁵ 66 Pa. C.S. § 1103(a).

ratemaking purposes, water and wastewater systems that are owned by a municipal corporation or authority that are to be acquired by an investor-owned water or wastewater utility under the Commission's jurisdiction. It 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 as established by the two independent appraisals conducted by two utility valuation experts. Notably, a Commission Order approving a transaction under Section 1329 is permitted to include "[a]dditional conditions of approval."²⁶

D. Legal Standard for Section 507 Approval

PAWC's request to assume enumerated municipal contracts currently held by MACM is subject to review under Section 507 of the Code. Under Section 507, other than contracts to furnish service at tariffed rates, any contract between a public utility and a municipal corporation must be filed with the Commission at least 30 days prior to its effective date to be valid. Upon receipt of the filing, and prior to the effective date of the contracts, the Commission may institute proceedings to determine whether there are any issues with the reasonableness, legality, or any other matter affecting the validity of the contract. If this Commission decides to institute such proceedings, the contracts at issue will not become effective until the Commission grants its approval.

²⁶ 66 Pa. C.S. § 1329 (d)(3)(ii); Aqua/New Garden Section 1329 Case, Docket No. A-2016-2580061, p. 69 (Order entered June 29, 2017).

IV. SUMMARY OF THE ARGUMENT

Through Section 1102 of its Application, PAWC is seeking to acquire the MACM system, to obtain Certificates of Public Convenience necessary to offer service to the MACM service area, and to utilize the Section 1329 fair market valuation process to establish the ratemaking rate base of MACM's assets at \$162 million. As filed, PAWC's Application is not in the public interest because it would expose PAWC's existing customers to an undetermined, but potentially substantial rate impact without preserving the Commission's ability to review and, if appropriate, mitigate that impact in a future base rate case. To ensure that this transaction is in the public interest, I&E recommends that the Commission condition its approval on PAWC undertaking a cost of service study that (1) separates capital expenses and operating costs for MACM's sanitary and storm water functions and (2) separately identifies the plant in service costs at the time that the Port Vue system was purchased, the cost of any Port-Vue plant retirements, and the cost of any Port Vue plant investment.

As I&E will explain in more detail, the evidence in this proceeding supports the need for the cost of service study condition to be imposed upon the acquisition for several reasons. First, the rate impact that PAWC's customers will face under the acquisition cannot possibly be determined at this juncture. Additionally, because MACM is a combined sewer overflow ("CSO") system, the costs associated with operating the MACM system are higher than and substantially different than the costs built into the rates of traditional sanitary sewer customers. Furthermore, requiring a separate cost of service study for both CSOs and for systems acquired under Section 1329 is consistent

with recent Commission precedent. Finally, segregating Port Vue plant in service costs is necessary because of both the manner in which MACM acquired Port Vue and the substantial environmental remediation and improvements that Port Vue requires.

Additionally, although I&E does not oppose PAWC's proposed value of the ratemaking rate base, I&E avers that MACM's fair market value appraisal performed by HRG was fundamentally flawed. More specifically, HRG employed a selective and unsupported going value adjustment to its analysis, which artificially inflated the value of the MACM assets. Additionally, HRG's entire appraisal was based on an outdated edition of the Uniform Standards of Professional Appraisal Practice. Furthermore, HRG's cost approach relied upon information contained in a non-UVE's incorrect and uncertified appraisal, and its market approach relied completely upon a mathematical calculation based entirely on unsupported assumptions. I&E believes that the HRG fair market valuation offered in this case presents the Commission with an opportunity to address certain HRG appraisal practices which artificially inflated the value of MACM's assets.

V. ARGUMENT

A. Section 1102 Approvals

1. Fitness

As previously mentioned, as a condition of obtaining its requested Certificates of Public Convenience, under Section 1103, PAWC must show that it is technically, legally,

and financially fit to own and operate the assets it will acquire from MACM.²⁷ Because PAWC is a certificated public utility, there is a rebuttable presumption that it possesses the requisite fitness.²⁸ In this case, I&E has not challenged PAWC's technical, legal, and financial fitness to own and operate the assets that it seeks to acquire. To that end, neither I&E, nor any party to this proceeding, has presented evidence to challenge PAWC's fitness on these bases. Accordingly, I&E concedes that PAWC has established that it possesses the requisite fitness.

2. Public Benefits

Because the Commission must consider the benefits and detriments of the transaction "with respect to the impact on all affected parties,"²⁹ including existing customers, I&E avers that the Commission should not approve PAWC's Application without imposing certain conditions to protect PAWC's existing customers. In its current form, while PAWC's Application provides substantial public benefits for MACM customers, it provides only tentative benefits for existing PAWC customers, while exposing them to an undetermined rate impact. The vast disparity between the many quantified public benefits that MACM customers will enjoy and the tentative benefits that PAWC's existing customers may receive warrants that protective measures be imposed. For this reason, and as more thoroughly explained below, I&E recommends that the Commission approve PAWC's Application conditionally.

²⁷ *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).

²⁸ *South Hills Movers, Inc. v. Pa. PUC*, 601 A.2d 1308, 1310 (Pa. Cmwlth. 1992).

²⁹ *Middletown Twp. v. Pa. P.U.C.*, 482 A.2d 674, 682 (Pa. Commw. 1984).

a. Substantial Benefits to Customers in the MACM Service Area

The record in this case cites numerous benefits that the MACM service area and its customers would enjoy as a result of the acquisition. More specifically, PAWC witness Cherepko, the Mayor of the City, indicates that the proceeds of the transaction are crucial to the financial stability of the MACM service area.³⁰ Mayor Cherepko also indicated that the acquisition would positively impact the City's short-term and long-term financial health, improve MACM's operations and customer service, grant MACM access to better and more varied sources of capital, and provide additional revenue to the City in the form of sale proceeds and tax revenue.³¹ PAWC witness Grundusky indicates that under the acquisition, MACM customers will benefit from PAWC's additional bill payment options, extended customer service and call center hours, enhanced customer information and education programs, and access to customer assistance program.³²

Additionally, as I&E witness Cline explained, PAWC has committed to undertaking numerous projects necessary to facilitate environmental compliance measures in the MACM system, and the estimated costs of those projects is \$37,066,723.³³ According to PAWC, its range of engineering and operational experience, and its financial resources make it better equipped to address the "environmental compliance challenges of the [MACM] System."³⁴ I&E submits that

³⁰ Tr. at 72.

³¹ PAWC Application, Appendix A-14, St. No. 6, p. 8.

³² PAWC Application, Appendix A-14, St. No. 1, p. 16.

³³ I&E St. No. 2, p. 12.

³⁴ PAWC Application, Appendix A-14, St. No. 3, p. 16.

rectifying the environmental compliance issues that exist within the MACM system³⁵ is an important benefit, as PAWC has committed to addressing these deficiencies, including the numerous deficiencies in the Dravosburg, Duquesne, and Port Vue system.³⁶ Overall, PAWC has committed to making \$62,730,000 in post-acquisition improvements to the MACM system.³⁷ Accordingly, considering the financial benefit to the Service Area, and the many benefits for MACM customers and improvements to the MACM's system, it is clear that the acquisition will substantially benefit MACM's customers.

b. Tentative Benefits for PAWC's Existing Customers

In contrast to the numerous, measurable, and quantified benefits that MACM customers can expect to receive under the acquisition, the benefits for PAWC's existing customers are either not actual benefits or they are tentative and generalized benefits.

For example, PAWC indicated that one of the benefits for existing customers is that the acquisition will not impose an immediate rate impact on PAWC's customers.³⁸

As I&E witness Cline pointed out, the lack of an immediate rate impact is not a substantial benefit:

[T]his simply indicates that the impact of the Transaction for PAWC's existing customers will be delayed for a short period of time. At the very least, this claim is neutral as the immediate rate impact of the Transaction is the same regardless of whether the Transaction is approved or denied because existing PAWC customer rates will not be affected until the MACM system is included in PAWC's next base rate case. To be clear, the Company is proposing that the ratemaking rate base of MACM's system be established at

³⁵ I&E Ex. No. 2, Sch. 2, pp. 4-13.

³⁶ PAWC Application, Appendix A-14, St. No. 3, pp. 12-15.

³⁷ PAWC Application, Appendix A-14, St. No. 3, p. 14.

³⁸ PAWC Application, Appendix A-14, St. No. 1, p. 16.

\$162,000,000, some or all of which will be paid for by PAWC's customers. Therefore, PAWC's purported benefit of no *immediate* rate impact will likely be short lived as the Company may soon seek to recover some or all of the \$162,000,000 from its customers if this Transaction is approved.³⁹

Accordingly, the lack of an immediate rate impact upon existing customers cannot be considered an affirmative public benefit.

On the other hand, PAWC has identified potential benefits that its existing customers might enjoy in the future. As an example, PAWC anticipates that the transaction will further regionalization of wastewater systems to provide greater environmental and economic benefits to PAWC's customers.⁴⁰ Additionally, PAWC expects that the acquisition will mitigate of the level of net plant investment per customer by adding more customers to share future infrastructure investment costs.⁴¹ PAWC also expects that the acquisition will eventually help PAWC maintain reasonable rates for all of its customers in the future because of the expansion of its customers base.⁴²

To the extent that the identified benefits materialize, I&E does not dispute their value to existing customers. In fact, I&E notes that they are substantially similar, if not more numerous, than the public benefits that the Commission sanctioned in the first Section 1329 proceeding filed by Aqua to acquire New Garden.⁴³ Yet, the fact remains that PAWC cannot quantify when alleged operational efficiencies will benefit PAWC

³⁹ I&E St. No. 2, p. 7.

⁴⁰ PAWC Application, Appendix A-14, St. No. 1, p. 16.

⁴¹ Id. at pp. 17-18.

⁴² PAWC Application, Appendix A-14, PAWC St. No. 1, pp. 17-18.; PAWC St. No. 4, pp. 8-9.

⁴³ Aqua/New Garden Section 1329 Case, pp. 66-67 (Order entered June 29, 2017).

customers.⁴⁴ Instead, PAWC simply opines that “[i]n the long-term, the acquisition of the System will help PAWC keep rates reasonable for all its customers...”⁴⁵ but it has failed to provide even an estimation of when this potential benefit will materialize. Thus, I&E agrees with OCA witness Everette that PAWC has not supported its claims that the acquisition will provide cost savings for existing customers.⁴⁶ Therefore, as I&E witness Cline explained, and as discussed further below, the long-term benefit of an expanded customer base cannot be viewed as a benefit for its existing customers unless PAWC undertakes a MACM system cost of service study for use in its next base rate case.⁴⁷

3. Cost of Service Studies

To protect ratepayers, I&E recommends that PAWC provide a separate cost of service study for the MACM system that separates capital expenses and operating costs for sanitary and storm water functions.⁴⁸ Additionally, I&E recommends that Port Vue-specific plant in service costs of the MACM system be identified separately within the overall MACM cost of service study.⁴⁹ The evidence in this proceeding supports the need for these conditions to be imposed upon the acquisition for several reasons. First, the rate impact that PAWC’s customers will face under the acquisition cannot possibly be determined at this juncture. Additionally, because MACM is a CSO, the costs associated with operating the MACM system are higher than and substantially different that the

⁴⁴ PAWC Application, Appendix A-14, St. No. 4, p. 8.

⁴⁵ Id. at 9.

⁴⁶ OCA St. No. 1, p. 18.

⁴⁷ I&E St. No. 2-SR, p. 4.

⁴⁸ I&E St. No. 2, p. 20.

⁴⁹ Id. at 2.

costs built into the rates of traditional sanitary sewer customers. Furthermore, requiring a separate cost of service study for both CSOs and for systems acquired under Section 1329 is consistent with prior Commission precedent. Finally, requiring segregation of Port Vue-specific plant in service costs is necessary because of the manner in which MACM acquired Port Vue combined with the substantial environmental remediation that Port Vue requires.

a. The Uncertain Rate Impact of the Acquisition

As I&E witness Cline testified, the ratemaking impact of the acquisition is relevant to this proceeding. More specifically, in the Order approving Aqua's acquisition of the wastewater system assets of New Garden Township, the Commission indicated that "it was appropriate for the ALJ to examine the ratemaking issues in the evaluation of the public benefit factors."⁵⁰ It is therefore appropriate to analyze PAWC's proposed post-acquisition rate structure in this case. In this case, PAWC is requesting a fair market value rate base level of \$162 million and committing to making \$62,730,000 in post-acquisition improvement costs.⁵¹ In total, I&E witness Cline calculates that the impact of the requested rate base level is \$224,730,000, and that the resulting change to net plant investment per customer is an increase of \$785 per customer.⁵² If PAWC's Application is approved, PAWC's existing customers will bear the rate impact.

⁵⁰ Aqua/New Garden Section 1329 Case, Docket No. A-2016-2580061, p. 60 (Order entered June 29, 2017).

⁵¹ PAWC Application, Appendix A-14, St. No. 3, p. 14.

⁵² I&E St. No. 2, pp. 10-11.

However, both PAWC and I&E agree that the acquisition's impact on existing PAWC water and wastewater customers cannot accurately be predicted and that these issues need to be decided in future base rate cases.⁵³ Our agreement on this basis is important, because without a cost of service study, the Commission's ability to evaluate the rate impact of the acquisition upon existing PAWC customers and its options of addressing that impact to provide any appropriate relief to existing customers, could be compromised.⁵⁴ As PAWC witness Nevirauskas has indicated, when assessing the rate impact of this transaction, PAWC will look at the cost of service for the McKeesport system to determine if the rates are adequate to support the system.⁵⁵ In this case, a cost of service study for the MACM system that separates capital expenses and operating costs for sanitary and storm water functions would help the Commission determine MACM's revenue requirement to provide service to its different customer classes, and extend rate making options that may not exist without such a study.⁵⁶

As witness Cline explained, requiring PAWC to provide this cost of service study would ensure that in a future rate case, the Commission is provided with a tool to determine the cost to operate the MACM system separately and to calculate the costs of the MACM's different services. Additionally, the cost of service study would preserve future ratemaking options by separating the costs between PAWC's different customer classes and jurisdictions, attributing costs to PAWC's different customer classes and

⁵³ PAWC Application, Appendix A-14, St. No. 4, p. 3; I&E St. No. 2-SR, p. 5.

⁵⁴ I&E St. No. 2-SR, p. 4.

⁵⁵ Tr. at 63.

⁵⁶ I&E St. No. 2, p. 21.

jurisdictions; and, importantly, enabling the determination of how costs will be recovered from the utility's different customer classes and jurisdictions.⁵⁷ Finally, as witness Cline pointed out, the cost of service study becomes essential when rate subsidization is at issue:

a COSS [cost of service study] can establish the existence and extent of subsidization (inter and intra-class) and assist in determining the appropriate amount of revenue requirement to be shifted from the wastewater customers to the water customers, which PAWC has utilized in past base rate cases. Therefore, without the cost of service study that includes segregated storm water costs, the appropriate ratemaking recommendations for those costs cannot be proposed or implemented.⁵⁸

Here, subsidization is likely to be an issue in PAWC's next rate case, as PAWC witness Nevirauskas indicated that PAWC has access to Act 11 under which it "may allocate a portion of the wastewater requirement to the combined water and wastewater customer base if in the public interest."⁵⁹ Mr. Nevirauskas further concluded that in PAWC's next base rate case, PAWC may spread a portion of the costs associated with the MACM system to its water customers.⁶⁰ Absent the cost of service study that I&E recommends, the Commission's ability to evaluate any cost spreading from the perspective of cost causation will be compromised.

I&E rejects PAWC's arguments that the recommended cost of service study should not be performed because it is burdensome for the Company, expensive, increases rate

⁵⁷

Id.

⁵⁸

Id. at 21-22.

⁵⁹

PAWC St. No. 4-R, p. 4.

⁶⁰

Id.

case expense for ratepayers, and is inconsistent with the Commission's policy of favoring single tariff pricing. First, cost of service studies are not necessarily burdensome and costly to produce compared to the overall cost of operating a utility. While PAWC estimated the cost of an average cost of service study to be \$75,000, that amount is far less than the \$1.11 - \$1.31 million of transaction and closing costs that PAWC anticipates will result from this transaction.⁶¹ Even assuming, *arguendo*, that the cost of service study costs \$75,000 to produce, the benefit to ratepayers from the cost of service study to ensure that ratemaking options are preserved in future rate cases is far greater than the high transaction and closing costs that do not appear to have any benefit to ratepayers.⁶²

Additionally, a cost of service study is not inconsistent with single tariff pricing. On the contrary, cost of service studies are compatible with single tariff pricing because they allow the parties and the Commission to make an informed decision of when single tariff pricing is appropriate. The studies simply serve as guides to help ensure that certain customers and customer classes are not allocated an excessive level of costs while ensuring that rates are not merged into single tariff pricing too quickly. Accordingly, the Commission should condition any approval of PAWC's Application upon the requirement that PAWC provide a separate cost of service study for the MACM system that separates capital expenses and operating costs for sanitary and storm water functions.

⁶¹ PAWC St. No. 4-R, pp. 11-12.

⁶² I&E St. No. 2-SR, p. 15.

b. The Unique Nature and Costs of CSOs

MACM's status as a CSO implicates the need for PAWC to undertake a cost of service study that separates capital expenses and operating costs for MACM's sanitary and storm water functions. By way of further explanation, a system's classification as a CSO means that its ratepayers have additional costs built into their rates that traditional sanitary sewer customers do not. Examples of these additional costs include capital plant costs for storm water catch basins, storm sewer mains prior to the combination with sanitary sewers, and overflows for when the volumes exceed the capacity of the treatment facility. Further related costs include maintenance expenses for cleaning the catch basins, repairing mains, and additional chemical expenses for the higher volumes that are treated during storm events.⁶³ Without having a cost of service study that identifies and separates these costs, there will be no way for the Commission to properly review and, as appropriate, assign these costs in PAWC's next base rate case. Importantly, the Commission has already recognized that, "[a]s with all rate design issues, the basis of rate setting is a cost of service study."⁶⁴ Therefore, it is clear that depriving the Commission of that tool in PAWC's next base rate case would make the ratemaking process impracticable.

Additionally, as PAWC has indicated that it anticipates using Act 11 to spread costs, it is imperative that PAWC develop a separate cost of service study to isolate

⁶³ I&E St. No. 2, p. 18.

⁶⁴ *Joint Application of Pennsylvania-American Water Company and the Sewer Authority of the City of Scranton*, Docket No. A-2016-2537209, p. 86 (Order entered October 19, 2016) ("Scranton acquisition case").

MACM's storm water costs so that the Commission can determine whether and how it is in the public interest to spread these costs. It is important to note that I&E's position on the need to separate the storm water costs is in no way predicated on the argument that storm water is not wastewater. Instead, I&E acknowledges that Act 154 of 2016, which took effect on November 4, 2016, amended the Code's definition of 'wastewater' to include "storm water which is or will become mixed with waters... within a combined sewer system."⁶⁵ However, neither Act 154 nor any subsequent legislation in any way establishes a basis for how storm water costs should be allocated or recovered from ratepayers. Because storm water cost allocation still has not been addressed, and PAWC may seek to spread MACM storm water-specific costs to its other wastewater and water customers,⁶⁶ the recommended cost of service study must be included as part of PAWC's next base rate filing. Without this cost of service study, the information may not be available at all or available in the form necessary to enable the Commission to properly allocate costs and determine just and reasonable rates.

c. Prior Commission Precedent

Two recent Commission proceedings support I&E's recommendation that PAWC be required to undertake a MACM cost of service system that separates capital expenses and operating costs for MACM's sanitary and storm water functions. Specifically, the 2016 case in which PAWC acquired the Sewer Authority of the City of Scranton ("SSA")⁶⁷ and the 2016 Aqua/New Garden Section 1329 proceeding represent instances

⁶⁵ 66 Pa. C.S. § 102.

⁶⁶ Tr. at 63-64.

⁶⁷ Scranton Acquisition Case, Docket No. A-2016-2537209 (Order entered October 19, 2016).

in which the Commission conditioned acquisition approvals upon the utility's performance of a cost of service study. Although I&E avers that each of these cases provides ample support for requiring PAWC to undertake a separate cost of service study, the combined weight of this authority makes it clear that the cost of service study is necessary and that PAWC's Application should not be approved without requiring that the cost of service study be performed.

PAWC acquired its first CSO during the Scranton acquisition case.⁶⁸ Although the Scranton acquisition case was not filed under Section 1329 of the Code, that distinction makes no difference in the cost of service context. In that proceeding, PAWC sought to acquire SSA and to begin to provide combined wastewater and storm water service to SSA's customers, which presented an issue of first impression for the Commission. Similar to this proceeding, I&E recommended that if PAWC's application to acquire the SSA was approved, PAWC should be required to provide cost of services studies that separate sanitary sewer and storm water flows, capital expenses, and operating costs in its next base rate proceeding.⁶⁹ Ultimately, the Commission ordered PAWC to perform two cost of service studies: (1) a cost of service study that fully separates the costs of providing storm water services in the SSA service area; and (2) a cost of service study that removes all costs and revenues associated with the SSA operations (both wastewater and storm water) and, using the same rate design

⁶⁸ Id.

⁶⁹ Scranton Acquisition Case, Docket No. A-2016-2537209, I&E Main Brief, p. 1.

methodology it proposes be adopted in the case, develop rates that exclude the impact of the SSA acquisition included in the base rate filing.⁷⁰

In explaining the rationale behind its requirement for these costs of service studies, the Commission noted the somewhat novel and complex nature of storm water cost recovery, the need to preserve ratemaking options in PAWC's next base rate proceeding and the assistance that the studies would provide the Commission in evaluating the rate impacts of the acquisition upon PAWC's existing customers.

The Commission has some experience with stormwater cost recovery, (citation omitted) but not of the magnitude involved here. (citation omitted). As with all rate design issues, the basis of rate setting is a cost of service study. The absence of a study designed with specific direction to address recovery of stormwater costs as a separate class would be an impediment to the full development of this issue in PAWC's next base rate proceeding. As noted by I&E, "[a] separate cost of service study would provide ratemaking solutions to this stormwater issue by potentially charging SSA customers or the City for these stormwater costs." I&E M.B. at 12.

Accordingly, we shall direct PAWC to develop and file cost of service studies in its next base rate case, pursuant to Section 53 of our Regulations, 52 Pa. Code § 53.53, Exhibit D, Section VIII, to allow both the rate limitation and stormwater costs allocation issues to be fully vetted within the nine-month time constraint of a fully litigated base rate case. First, we shall direct that PAWC include a cost of service study that fully separates the costs of providing stormwater services in the SSA service area. Moreover, PAWC shall address the pros and cons of designing stormwater rates on this separated basis.

Second, PAWC shall file a cost of service study that removes all costs and revenues associated with the SSA operations (both wastewater and stormwater) and, using the same rate

⁷⁰ Scranton Acquisition Case, Docket No. A-2016-2537209, pp. 86-87 (Order entered October 19, 2016.)

design methodology it proposes be adopted in the case, develop rates that exclude the impact of the SSA acquisition included in the base rate filing. These studies will enable the parties in the next base rate case and this Commission to better evaluate the rate impacts of this transaction on PAWC's existing customers. Both studies shall be submitted at the time of filing the next base rate case. The requirement of filing these two items is not intended to limit or affect what PAWC may propose as rates or the positions that it or any party, including the Commission, may take.⁷¹

I&E submits that the same rationale that the Commission applied in ordering PAWC to provide the cost of service studies in the Scranton acquisition case translate to this proceeding. Specifically, storm water cost recovery remains a novel and complex issue, as the repercussions of the Scranton acquisition case are now being considered in PAWC's pending base rate case and remain uncertain. Beyond the Scranton acquisition case, storm water continues to be a novel issue, and no guidance regarding storm water cost recovery exists. Additionally, as I&E previously explained, parties and the Commission need the cost of service study to preserve ratemaking options in PAWC's next base rate proceeding. Finally, the assistance that the cost of service studies would provide the Commission in evaluating the rate impacts of the Scranton acquisition will provide the same benefit to the Commission in the context of this case. Accordingly, as a condition of approval for its Application, PAWC should be required to undertake a MACM cost of service study that separates capital expenses and operating costs for MACM's sanitary and storm water functions.

⁷¹ Scranton Acquisition Case, Docket No. A-2016-2537209, pp. 86-87 (Order entered October 19, 2016.)

Additionally, in the first Section 1329 case, which was the Aqua/New Garden proceeding, the Commission ordered Aqua to prepare a cost of service study for use in its next base rate case to separate the costs, capital, and operating expenses of providing wastewater service to the newly-acquired New Garden customers.⁷² Although New Garden was not a CSO, and therefore storm water costs were not at issue, the Commission nonetheless indicated its concern with potential future cross-subsidization of New Garden customers by current Aqua customers as a result of the acquisition.⁷³ The Commission also noted that the Section 1329 record in Aqua/New Garden proceeding was not at all developed on this issue of rates, as such development was not required in that proceeding. To remedy the uncertainty and to provide an avenue for redress, if necessary, the Commission included a cost of service study condition of approval upon Aqua's Application:

A Commission Order approving the transaction is permitted to include “[a]dditional conditions of approval.” 66 Pa. C.S. § 1329 (d)(3)(ii). Accordingly, as a condition to approval of this acquisition, we direct Aqua to file a cost-of-service analysis in its next base rate proceeding, similar to the outcome we directed in *PAWC Scranton Order*. Specifically, Aqua shall develop and file a cost-of-service study in its next rate case pursuant to our Regulations (citation omitted) that separates the costs, capital, and operating expenses of providing wastewater service to the New Garden customers as a stand-alone rate group. Moreover, we shall also direct Aqua to address the pros and cons of designing New Garden rates as a separate rate group. **These conditions will ensure that all Parties and the Commission will be informed of**

⁷² Aqua/New Garden Section 1329 Case, Docket No. A-2016-2580061, , p. 73 (Order entered June 29, 2017).

⁷³ Id. at 69.

the overall rate impact that the acquisition will have on Aqua customers and, alternatively, the result of establishing New Garden as a separate rate zone. These requirements are not intended to limit what Aqua may file or the positions that it or any party may take in that rate case.⁷⁴

I&E asserts that a goal identified in the Commission's imposition of the cost of service study requirement in the Aqua/New Garden case, informing parties and the Commission of the overall rate impact of the acquisition upon customers, is operative in this case as well. Accordingly, as a condition of approval for its Application, PAWC should be required to undertake a MACM cost of service study that separates capital expenses and operating costs for MACM's sanitary and storm water functions.

d. The Port Vue System

I&E's recommendation that the plant in service costs of the Port Vue system be identified separately within the overall MACM cost of service study exists for two reasons. First, I&E has substantial concerns regarding the timing and manner in which MACM acquired the Port Vue Borough system that it now seeks to convey to PAWC through this proceeding. As I&E witness Spadaccio explained, MACM acquired Port Vue on April 29, 2016,⁷⁵ which is significant for several reasons. First, Mayor Cherepko indicated that the City had been pursuing the long-term lease or sale of the MACM since July 2015,⁷⁶ almost one year before MACM acquired the Port Vue system. Like the City, MACM also contemplated a sale of its assets before it purchased the Port Vue

⁷⁴ Aqua/New Garden Section 1329 Case, Docket No. A-2016-2580061, pp. 69-70 (Order entered June 29, 2017).

⁷⁵ I&E Exhibit No. 1, Schedule 1, p. 1 of 2.

⁷⁶ PAWC Application, Appendix A-14, St. No. 6, p. 9.

system, as evidenced by the fact that on February 26, 2016, MACM issued a Request for Bids for an asset purchase of its system or for a concession lease agreement.⁷⁷ Notably, when PAWC submitted an asset purchase bid on July 29, 2016, MACM had only owned the Port Vue system for three months.⁷⁸ When combined, these facts cast significant doubt upon about whether MACM ever intended to retain the Port Vue System.

Instead, it appears that MACM may have strategically purchased the Port Vue System in order to increase the plant value for its pending acquisition.⁷⁹ To be sure, MACM purchased the Port Vue system for \$1,400,000,⁸⁰ but within one year's time, AUS calculated the Port Vue replacement cost new less depreciation of \$4,942,794,⁸¹ and although HRG did not break out a replacement cost new less depreciation, it provided a reproduction cost analysis valuing the Port Vue System at \$18,929,210.⁸² As a result of these valuations, an exponentially higher amount than the system was originally purchased for by MACM will potentially be put into PAWC's rate base if this Section 1329 application is approved. Also, it cannot be ignored that MACM acquired the Port Vue system not only after seeking bids for a lease or sale of its entire system, but within fifteen days of Section 1329 being enacted.⁸³ As I&E witness Spadaccio opined, it is important for the Commission to be aware of the facts of MACM's purchase of the Port

⁷⁷ PAWC Application, Appendix A-14, St. No. 1, p. 8.

⁷⁸ PAWC Application, Appendix A-14, St. No. 1, p. 8.

⁷⁹ I&E St. No. 1, pp. 5-6.

⁸⁰ I&E Exhibit No. 1, Schedule 1, p. 1 of 2.

⁸¹ PAWC Application, A-5, AUS, Fair Market Value Appraisal, p. 6.

⁸² PAWC Application, A-5, HRG, Fair Market Valuation of the MACM Sanitary Sewer System, p. 27.

⁸³ Section 1329 was enacted on April 14, 2016 and effective on June 13, 2016.

Vue system since that purchase may now operate as a benefit for MACM at the detriment of PAWC's ratepayers:

[I]t is important to scrutinize the circumstances, timing and related impact of MACM's purchase of the Port Vue System because the repercussions of that strategic purchase will reward the City of McKeesport and MACM at the expense of PAWC's ratepayers. I believe that this type of purchase illustrates the harm that can occur when municipalities manipulate the Section 1329 process and I believe that the Commission should be aware of this issue.⁸⁴

Mr. Spadaccio's concerns are underscored by the fact that PAWC will incur significant costs to repair the Port Vue System and to bring it into compliance with the Pennsylvania Department of Environmental Protection's ("PA DEP") regulations.

Additionally, because of existing environmental compliance issues in the Port Vue portion of the MACM system, PAWC must undertake substantial remediation and capital improvement measures that could prove to be very costly for PAWC's ratepayers. More specifically, the Port Vue system requires a Long Term Control Plan ("LTCP"), has "numerous significant deficiencies" that have been identified in the collection system and pump station, as well as a Nine Minimum Controls Plan ("NMCP").⁸⁵ The Company indicates that the cost to remedy these concerns is estimated to include \$100,000 to prepare the Port Vue LTCP and \$14,976,275 for the collection system and pump station.⁸⁶ PAWC has also indicated there are anticipated costs associated with the NMCP.⁸⁷

⁸⁴ I&E St. No. 1-SR, p. 6.

⁸⁵ I&E Ex. No. 2, Sch. 2.

⁸⁶ I&E St. No. 2, p. 12; I&E Ex. No. 2, Sch. 2.

⁸⁷ I&E Ex. No. 2, Sch. 2.

Considering both the known and unknown costs of addressing Port Vue’s environmental compliance issues, I&E opines that the plant in service costs of the Port Vue system should be identified separately within the overall MACM cost of service study that I&E is recommending in his proceeding. More specifically, the plant in service costs at the time Port Vue was purchased, the cost of any plant retirements, and the cost of any plant investment should be reported separately for the Port Vue system in PAWC’s next base rate case. As I&E witness Cline indicated, separating the Port Vue plant in service costs is paramount because PAWC’s estimated costs for remediation of the Port Vue system are already very high and PAWC has indicated that it is still in the process of identifying the improvements necessary to address the existing deficiencies.⁸⁸ Isolating these costs is necessary to ensure that the Commission has an avenue to address them in PAWC’s next base rate case, where the true extent of the costs and the reality of their rate impact will be known. Therefore, as explained more fully below, it is important for PAWC to identify the Port Vue-specific plant in service costs so that all ratemaking options are available to the Commission.

4. Section 1329 Approvals

1. Ratemaking rate base

By invoking Section 1329, PAWC’s Application asks the Commission to issue an Order establishing the ratemaking rate base of the MACM assets at \$162 million.⁸⁹ To establish the proposed ratemaking rate base amount, PAWC complied with the Section

⁸⁸ I&E St. No. 2-SR, p. 11.

⁸⁹ PAWC Application, ¶2; PAWC Application, Appendix A-14, St. No. 1, pp. 11-12.

1329 process. Section 1329 allows investor owned water and wastewater utilities to use fair market valuation in the acquisition of water and wastewater systems that are owned by a municipal corporation or authority. Section 1329's fair market valuation approach dictates that once the buyer and the seller agree to its use, they must engage the services of a licensed engineer to assess the tangible assets of the seller. The licensed engineer assessment is then presented to two UVEs, one to represent the buyer and one to represent the seller, to conduct independent analyses based on the Uniform Standards of Professional Appraisal Practice ("USPAP"), employing the cost, market and income approaches. The results of the UVEs' analyses are then incorporated into the Section 1102 of the Code application submitted to the Commission for approval. For ratemaking purposes, the valuation will be the lesser of the fair market value or the negotiated purchase price.

In this case, pursuant to Section 1329, the \$162 million amount PAWC proposes represents the lower of PAWC and MACM's negotiated purchase price, \$162 million, and the average of two fair market value appraisals completed by each of these parties' UVEs. As explained more fully below, I&E does not oppose the proposed value of the ratemaking rate base; however, MACM's fair market value appraisal performed by HRG was fundamentally flawed. I&E believes that the flawed appraisal process in this case presents the Commission with an opportunity to address certain HRG appraisal practices which either relied upon incorrect information and unsupported assumptions or artificially inflated the value of MACM's assets.

By way of further context, PAWC's UVE performed a fair market value appraisal, resulting in an appraised value of \$161,343,000,⁹⁰ while MACM's UVE, HRG's fair market value appraisal valued the assets at \$207,010,000.⁹¹ The \$45,667,000 difference between these UVEs' appraisals is substantial and concerning. While I&E does not contest AUS' valuation, I&E submits that that the vast difference between the AUS and HRG fair market valuation appraisals implicates the following issues that underlie HRG's appraisal.

a. HRG's Selective and Unsupported Going Value Adjustment

HRG indicates that it added a "going value"⁹² of \$17.3 million to the results of both its both cost and income approaches of fair market valuation.⁹³ According to HRG, the additional \$17.3 million of going concern value is appropriate here for the following reasons:

It is readily apparent that an established enterprise has an incremental value in excess of the cost value of the physical facilities. A wastewater system requires a substantial investment in collection, treatment and disposal plant, a component of the value. In addition, an entity must acquire a customer base, hire employees, develop an accounting and record keeping process and develop operating and management policies and procedures. This process takes time and the entity will incur losses during initial years. As a component of the value of an enterprise, the cumulative losses should be considered in addition to the cost of the facilities for acquisition purposes. A calculation of an estimate of the going value to reflect the cumulative losses is presented in Schedule O of the Appendix.⁹⁴

⁹⁰ PAWC Application, Appendix A-14, St. No. 7, p. 22.

⁹¹ MACM St. No. 1, p. 12.

⁹² HRG uses the terms "going value" and "going concern" interchangeably.

⁹³ Tr. at 118, PAWC Application, Appendix A-5, HRG Appraisal, pp. 12-13; Schedule O.

⁹⁴ PAWC Application, Appendix A-5, HRG Appraisal, pp. 12.

I&E fundamentally rejects HRG's addition of a \$17.3 million premium for going value in this case. First, to the extent that MACM's wastewater system required a substantial investment in collection, PAWC is already paying MACM \$162 million, which is well beyond the \$74,340,000 depreciated original cost⁹⁵ that HRG calculated for the MACM assets. Considering that MACM will be receiving purchase proceeds that are exponentially higher than the depreciated original cost of its assets, it is clear that MACM is being adequately compensated for its initial investment. Notably, HRG's appraiser, Ms. Vicari, conceded that she was not sure whether PAWC was already paying MACM for its going value as part of the purchase price of the transaction.⁹⁶

Additionally, I&E rejects the notion that, outside of the four corners of the cost and income approaches,⁹⁷ MACM should receive separate and additional compensation for its customer base, employees, accounting and record keeping process and operating and management policies and procedures. First, it is clear from Mayor Cherepko's testimony that MACM is relying upon PAWC's resources and expertise to ensure job protection for its employees, improve existing customer service with better and more accessible customer service,⁹⁸ and thus PAWC is not benefitting from MACM in these regards. Additionally, I&E reiterates the same position regarding MAMC's record

⁹⁵ PAWC Application, A-5, HRG, Fair Market Valuation of the MACM Sanitary Sewer System, p. 6.

⁹⁶ Tr. at 120.

⁹⁷ Although AUS indicates that it considered a "going concern" value as an element of its income and market approaches, AUS did not assign a specific, separate value for going value to be added to the results of its cost and income evaluations (PAWC St. No. 7-R, pp. 10-11).

⁹⁸ PAWC Application, Appendix A-14, St. No. 6, p. 3.

keeping processes and operating procedures, noting that Ms. Vicari's appraisal indicates that MACM failed to maintain records of its utility plant costs.⁹⁹

Finally, and of most concern, is the selective manner in which Ms. Vicari employs her going value adjustments only in Section 1329 proceedings before the Commission. The record in this case bears out the fact that Ms. Vicari has only broken out a separate quotient for going value in 3 out of the 5 or 6 Pennsylvania utility appraisals that she has performed in her professional career.¹⁰⁰ During the evidentiary hearing, Ms. Vicari reluctantly admitted that of the Pennsylvania utility appraisals that she completed, she has only ever employed the going value addition for Section 1329 cases.¹⁰¹ I&E notes that there is nothing in Section 1329 that contemplates a going value adjustment or premium; therefore, it appears that Ms. Vicari relies upon the adjustment to increase the fair market value of the assets that she appraises in Section 1329 proceedings. For this reason, and for the reasons explained above, I&E submits that HRG's going value adjustment should be rejected. UVEs should not be permitted to manipulate fair market value at the expense of ratepayers.

b. Reliance Upon Another Party's Unverified Appraisal in HRG's Cost Approach

The record in this case reveals that HRG's cost approach relied upon a 2015 Industrial Appraisal Company's report to develop MACM's costs of utility plant.¹⁰² HRG used the IAC ("IAC") appraisal to compute MACM's cost of treatment, pumping and

⁹⁹ PAWC Application, Appendix A-5, HRG Appraisal, p. 4.

¹⁰⁰ Tr. at 121.

¹⁰¹ Tr. at 123.

¹⁰² PAWC Application, Appendix A-5, HRG Appraisal, p. 4.

disposal facilities to a current price level of December 31, 2016.¹⁰³ According to HRG, IAC certified that its appraisal was performed in accordance with the USPAP.¹⁰⁴ However, HRG's reliance upon the IAC appraisal proved to be detrimental, as HRG relied upon the IAC appraisal's single line item for the MACM collection system lines of \$30,000,000, with a 2008 year of installation and a 50 year life.¹⁰⁵ As this proceeding developed, HRG witness Ms. Vicari acknowledged that many of the mains in service were actually acquired between 1959-1960 and, as a result, she increased the service life from 50 to 85 years.¹⁰⁶ The impact of this adjustment is substantial, as this correction led HRG to reduce its net depreciated original cost, which in turn lowered its appraised value of the MACM assets by \$16,170,000, from \$207,010,000 to \$190,000,000.¹⁰⁷

Although Ms. Vicari indicates that she since eliminated any values included in the IAC appraisal, HRG's initial reliance upon the IAC appraisal is concerning in light of the fact that Ms. Vicari has indicated that she is unable to certify that the IAC was conducted in conformance with USPAP.¹⁰⁸ I&E notes that HRG did not discover and correct its error until after PAWC filed its Application, meaning that when PAWC and MACM negotiated the purchase price of the MACM assets, those negotiations were premised upon incorrect information. It is impossible to know whether the \$16,170,000 concession in HRG's fair market valuation would have led to a material change in the parties'

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Id.

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Id.

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MACM St. No. 1-SR, p. 2.

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MACM St. No. 1, pp. 7-8.

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MACM St. No. 1, pp. 6-7.

¹⁰⁸

Tr. at 13.

negotiations, and, ultimately, the impact upon PAWC's ratepayers if a lower purchase price had been negotiated. However, I&E submits that HRG's underlying reliance upon the appraisal of a non-UVE in this proceeding operated to the detriment of all parties and operates as an example of why UVEs should not be permitted to rely on outside appraisals in established fair market value for the purposes of Section 1329.

c. HRG's Failure to Use the Most Recent Uniform Standards of Professional Appraisal

Section 1329 makes it clear that UVEs appraisals must be conducted in compliance with the USPAP.¹⁰⁹ In this case, AUS's appraiser, Jerome C. Weinert certified that he conducted his appraisal of the MACM assets in conformance with the most recent standards, the 2016-2017 USPAP.¹¹⁰ Conversely, while the author of HRG's appraisal,¹¹¹ Adrienne M. Vicari certified that she determined the fair market value of the MACM assets in accordance with USPAP,¹¹² her certification did not indicate the version of the USPAP standards upon which her appraisal relied.

While HRG's appraisal did not identify the version of the USPAP standards that Ms. Vicari relied upon, Ms. Vicari's surrebuttal testimony relied upon the 2014-2015 edition of USPAP for support.¹¹³ Noting that the 2014-2015 version is two editions older than the 2016-2017 version that AUS appraiser Weinert used, at the evidentiary hearing in this matter, I&E attempted to rectify this disparity. When asked which publication of

¹⁰⁹ 66 Pa. C.S. § 1329(a)(3).

¹¹⁰ PAWC Application, Appendix A-14, St. No. 7, p. 14; PAWC Application, Appendix A-5, AUS appraisal, p. 37, Compliance with Uniform Standards of Professional Appraisal Practice (USPAP) 2016-2017.

¹¹¹ Tr. at 108.

¹¹² PAWC Application, Appendix A-7.

¹¹³ MACM Ex. AMV No. I through AMV No. IV.

the USPAP standards the HRG appraisal she relied upon, Ms. Vicari indicated that it relied upon the 2014-2015 edition.¹¹⁴ Of even greater concern, Ms. Vicari indicated that she was unsure of whether a 2016-2017 edition of USPAP exists that is more current than the version that underlies the HRG appraisal.¹¹⁵

I&E submits that HRG's use of an outdated version of the USPAP raises questions about the accuracy of its resultant appraisal. First, it is concerning that a Commission-approved UVE who is charged with assigning a fair market value in accordance with the USPAP in this proceeding is unaware of which standards of the USPAP are the most current. This concern is amplified by the fact that the value that HRG assigns to the MACM assets has a direct impact on PAWC's ratepayers, since it is a factor in the equation that PAWC is relying upon to establish the ratemaking rate base of MACM's assets. At a bare minimum, I&E would expect, and the Commission should require that any UVE offering a fair market value appraisal in a Section 1329 proceeding apply the most recent USPAP standards.

Additionally, it is unclear how the USPAP have evolved between the two editions that separate Mr. Weinert's use of 2016-2017 standards and Ms. Vicari's use of the 2014-2015 standards. In the intervening time period between these two USPAP editions, the USPAP may have eliminated certain practices, added practices, required additional processes, or any combination of these factors and more. Put another way, it is now unclear whether Mr. Weinert and Ms. Vicari were operating under the same set of rules

¹¹⁴ Tr. at 111.

¹¹⁵ Tr. at 111.

when each of them submitted their respective fair market value appraisals in this case. I&E avers that Ms. Vicari’s use of outdated USPAP standards raises serious issues about the accuracy of the HRG appraisal. Unfortunately, Ms. Vicari’s reliance upon the outdated USPAP came to light only very late in this proceeding, through her surrebuttal testimony and her responses to cross-examination, which made it clear that he was unfamiliar with even the existence of more recent standards. For this reason, the impact of HRG’s use of the outdated USPAP could not be determined. Accordingly, I&E respectfully requests that the Commission make it clear that UVEs must conduct their fair market valuation appraisals in accordance the most recently published version of the USPAP.

d. Unsupported Assumptions Made in HRG’s Market Approach

In HRG’s market approach, HRG defines market value as “the value established in a public market by exchanges between willing sellers and willing buyers not under duress.”¹¹⁶ According to HRG, in utility acquisitions, treatment facilities, ages, service areas, and physical condition are relevant considerations for potential purchasers.¹¹⁷ For example, a system that requires substantial repairs and upgrades would be less attractive and a buyer “would seek a substantial discounted purchase price for such a system.”¹¹⁸ Yet, despite these acknowledgements, HRG used a market analysis that calculated MACM’s average cost per customer using a sample of recent municipal wastewater

¹¹⁶ PAWC Application, Appendix A-5, HRG Appraisal, p. 7.

¹¹⁷ PAWC Application, Appendix A-5, HRG Appraisal, p. 48

¹¹⁸ PAWC Application, Appendix A-5, HRG Appraisal, p. 8.

acquisitions without any regard to the condition of those wastewater systems or even a basic understanding of the condition of the MACM system.

More specifically, HRG reviewed the total purchase prices and the total number of customers for five wastewater system acquisitions: Aqua PA's acquisitions of Penn Township and New Garden Sewer Authority, and PAWC's acquisitions of Fairview Township, New Cumberland Borough, and the SSA.¹¹⁹ Using the average of its calculated market value for all five prior acquisitions, \$8,661, HRG simply multiplied the number of MACM customers it calculated, 21,953, by \$8,661 to arrive at an estimated market value of \$190,130,000.¹²⁰ Unfortunately, this mathematical calculation fails to account for purchase price considerations that HRG has indicated will impact the market value. HRG's failure to consider the condition of the systems of the five "comparable" sales it relied upon is evident in that its appraiser, Ms. Vicari, has never physically inspected the five systems offered as comparable other than an unidentified portion of New Cumberland Borough system.¹²¹ Ms. Vicari has also not inspected the MACM system.¹²² Ms. Vicari was also uncertain of whether any of the five referenced systems has an environmental compliance issues.¹²³ Taking this information into account, as Ms. Vicari admits, she cannot compare the condition of the five previously acquired system to the MACM system. Accordingly, it is unclear upon what bases the

¹¹⁹ PAWC Application, Appendix A-5, HRG Appraisal, p. 33, Sch. J.

¹²⁰ Id.; Tr. at 115.

¹²¹ Tr. at 116.

¹²² Tr. at 108.

¹²³ Tr. at 117.

prior acquisition and the MACM transaction are comparable and premising MACM's market value upon the average of these acquisition results in an unsupported valuation.

Aside from the lack of support, HRG's market value analysis is flawed because it fails to consider the environmental compliance issues and substantial capital improvements that PAWC must make to remedy those issues. Though HRG opines that a utility system that requires substantial repairs and upgrades would be less attractive and buyers would seek substantial discounts for those systems, HRG's appraisal does not appear to contemplate such a discount for PAWC, which must spend approximately \$37,066,723 to bring the MACM system into EPA and DEP compliance.¹²⁴ I&E submits that a \$37 million environmental compliance obligation operates as a material repair or upgrade that warrants the "substantial discounts" that HRG's opines that buyers typically demand. Instead of assigning a discount, HRG has violated its own standard; accordingly, I&E submits that HRG's market value analysis is overinflated and fundamentally flawed.

2. DSIC, AFUDC, deferred depreciation, and transaction costs

As previously explained, pursuant to Section 1329, PAWC is seeking confirmation of its right to collect a DSIC for the service area. Additionally, PAWC seeks permission for the accrual of Allowance for Funds Used During Construction for post-acquisition improvements not recovered through its DSIC for book and ratemaking purposes. Finally, PAWC is requesting to defer depreciation related to post-acquisition improvements not recovered through the DSIC for book and ratemaking purposes.¹²⁵

¹²⁴ I&E St. No. 2, p. 12; I&E Ex. No. 2, Sch. 2.

¹²⁵ PAWC Application, ¶2; PAWC Statement No. 1, p. 4.

I&E has taken no position in these requests in this proceeding, as they appear to simply memorialize PAWC's intention to employ certain provisions of Section 1329. However, I&E reserves the right to address these issues in future proceedings, including base rate and distribution system improvement charge proceedings, when additional information and facts are available and when these issues are ripe for review.

As PAWC correctly acknowledges, the Commission's *Final Implementation Order* at Docket No. M-2016-2543193 makes it clear that the reasonableness and recovery transaction and closing costs are not properly reviewed and cannot be approved in Section 1329 proceedings.¹²⁶ Instead, these costs are properly reviewed in the Applicant's next base rate case that follows the acquisition, and they will be subject to the preponderance of evidence standard in that review.¹²⁷ Transaction and closing costs include the UVE's appraisal fee, and the buyer's closing costs, including reasonable attorney fees.¹²⁸ While PAWC admits that the amount of the transaction and closing costs cannot be known at this time, PAWC witness Nevirauskas estimates that the costs are anticipated to range from \$1,110,000 to \$1,310,000.¹²⁹ Consistent with the forum identified by the Commission, I&E will address these costs in PAWC's next base rate case when they are subject to review. Because it is not procedurally appropriate for I&E to argue the reasonableness of the transaction costs in this case, PAWC should not

¹²⁶ Id. at p. 3; *Final Implementation Order*, M-2016-2543193, pp. 14-15 (Order entered October 27, 2016).

¹²⁷ *Final Implementation Order*, M-2016-2543193, pp. 14-15 (Order entered October 27, 2016).

¹²⁸ *Id.*

¹²⁹ PAWC Application, Appendix A-14, St. No. 4, p. 3

interpret the lack of argument here to operate as I&E's concession that the identified transactions costs are reasonable or that they should be recovered from ratepayers.

3. Rate Freeze

Pursuant to Section 1329, an applicant may propose a rate stabilization plan.¹³⁰ A rate stabilization plan is defined as a plan that will hold rates constant or phase rates in over a period of time after the next base rate case.¹³¹ While PAWC has not proposed a rate stabilization plan in this case, under the APA, it has committed to maintaining MACM's current base rates until after the one year anniversary of the closing date of the Transaction.¹³² Although the one-year commitment is of a limited duration, PAWC still reserves the right to seek permission from the Commission to approve a MACM rate increase during that time.¹³³ I&E's review of this term ended in the conclusion that the term is not material. I&E's conclusion is based upon the fact that PAWC is currently involved in an active base rate case, and the MACM acquisition is not and could not part of that filing.¹³⁴ Considering the base rate case timeline, I&E witness Cline also estimated that PAWC is not likely to seek an increase in MACM rates until 2020 or later.¹³⁵ With this in mind, and considering the Commission's unimpacted ratemaking authority, I&E does not oppose this term.

¹³⁰ 66 Pa. C.S. § 1329(d)(1)(5).

¹³¹ 66 Pa. C.S. § 1329(g).

¹³² PAWC Application, Appendix A-14, St. No. 4, pp. 6-7.

¹³³ *Id.*, p. 7.

¹³⁴ I&E St. No. 2, pp. 16-17.

¹³⁵ *Id.*

4. Revised *pro forma* tariff supplement¹³⁶

Although I&E supports only the conditional approval of PAWC's Application, I&E does not oppose the *pro forma* tariff supplement. PAWC's Application contains a *pro forma* tariff supplement under which MACM's current rates would be initially adopted. The *pro forma* tariff supplement reflects the fees associated with the industrial pretreatment plan that PAWC plans to implement for the MACM service area, including fees for permits, fees for industrial loadings, and fees imposed for non-compliance.¹³⁷ The *pro forma* tariff supplement also includes both quarterly and monthly rates for Port Vue-area customers to extend additional billing options to those customers, and reflects MACM's existing rates for acceptance of hauled sludge.¹³⁸ Finally, through rebuttal testimony, PAWC indicated that it will also add a *pro forma* tariff provision stating that, if a municipality's wastewater volumes exceeds 350% of the aggregate quantity of water used by the municipality's water users during any billing period, the municipality must pay MACM's prevailing rates and charges for handling such excess in addition to the typical sewage charges.¹³⁹

5. Section 507 Approvals

As previously explained, PAWC is seeking approval under Section 507 of the Code to enter into an APA with the City and MACM to purchase the MACM system for \$162,000,000. Additionally, PAWC is seeking approval to enter into an Assignment of

¹³⁶ PAWC Application, Appendix A-13; PAWC Exhibit RPN-1.

¹³⁷ PAWC Application, Appendix A-14, St. No. 4, pp. 4-5.

¹³⁸ PAWC Application, Appendix A-14, St. No. 4, pp. 19-20.

¹³⁹ PAWC Exhibit RPN-1; PAWC. St. No. 4-R, p. 7.

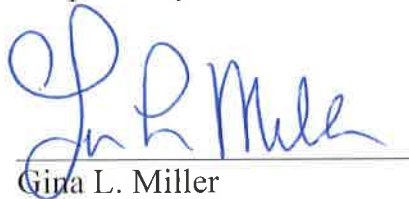
Contracts Agreement with MACM to facilitate the assignment of these contracts, which include nine Municipal Service Agreements and nine related Corrective Action Agreements.¹⁴⁰ I&E does not oppose approvals of these contracts under Section 507, as I&E opposes PAWC's Application, as filed, including the underlying APA, only on the basis of Section 1102 of the Code. However, as indicated, I&E would support the conditional approval of PAWC's Application, but the conditions are not contingent upon or relevant to Section 507 of the Code.

¹⁴⁰ PAWC Application, Appendix A-14, St. No. 2, p. 7; PAWC Application, pp. 2-5.

VI. CONCLUSION

The proposed transaction, as filed, will not affirmatively promote the public interest in a substantial way. Conditions must be imposed prior to granting the requested certificates of public convenience to protect the interests of PAWC's existing customers. Accordingly, if the transaction is approved, I&E respectfully requests that the Administrative Law Judges recommend that the Commission condition its approval on PAWC undertaking a cost of service study that (1) separates capital expenses and operating costs for MACM's sanitary and storm water functions and (2) that separately identifies the plant in service costs at the time that the Port Vue system was purchased, the cost of any Port-Vue plant retirements, and the cost of any Port Vue plant investment.

Respectfully submitted,



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Appendix A: Proposed Findings of Fact

1. Parties
 - a. I&E serves as the Commission's prosecutory bureau for the purposes of representing the public interest in ratemaking and service matters, and enforcing compliance with the Pennsylvania Public Utility Code. 66 Pa. C.S. §§ 101 *et seq.*, and Commission regulations, 52 Pa. Code §§ 1.1 *et seq.* See *Implementation of Act 129 of 2008; Organization of Bureaus and Offices*, Docket No. M-2008-2071852 (Order entered August 11, 2011).
 - b. The I&E analysis in the proceeding is based on its responsibility to represent the public interest. This responsibility requires balancing the interest of ratepayers, the utility company, and the regulated community as a whole. I&E St. No. 1, p. 1; I&E St. No. 2, p. 1.
 - c. PAWC is the Commonwealth's largest investor-owned provider of water and wastewater services. PAWC Stmt. No. 3, p. 16.
 - d. PAWC furnishes wastewater services to 54,691 customers in Pennsylvania. PAWC Stmt. No. 1, p. 15.
 - e. MACM owns and operates a combined wastewater collection system and three wastewater treatment plants which collect and treat wastewater from the City, the City of Duquesne, the Borough of Dravosburg, and the Borough of Port Vue. PAWC Application, Appendix A-14, St. No. 3, p. 3. MACM's system also provides wastewater service through bulk service connections to White Oak Borough, Liberty Borough, East McKeesport Borough, Glassport Borough, Versailles Borough, Elizabeth Township. PAWC Application, Appendix A-14, St. No. 2, p. 7; PAWC Application, pp. 2-5.

2. The MACM System

- a. MACM owns and operates a combined wastewater collection system and three wastewater treatment plants which collect and treat wastewater from the City, the City of Duquesne, the Borough of Dravosburg, and the Borough of Port Vue. MACM's system also provides wastewater service through bulk service connections to White Oak Borough, Liberty Borough, East McKeesport Borough, Glassport Borough, Versailles Borough, Elizabeth Township. PAWC Application, Appendix A-14, St. No. 2, p. 7; PAWC Application, pp. 2-5.
- b. MACM's classification as a combined sewer overflow system means that ratepayers have additional costs built into their rates that traditional sanitary sewer customers do not. Examples of these additional costs include capital plant costs for storm water catch basins, storm sewer mains prior to the combination with sanitary sewers, and overflows for when the volumes exceed the capacity of the treatment facility. Further related costs include maintenance expenses for cleaning the catch basins, repairing mains, and additional chemical expenses for the higher volumes that are treated during storm events. I&E St. No. 2, p. 18.

3. The Asset Purchase Agreement and the First Amendment to the Asset Purchase Agreement

- a. The negotiated purchase price for the acquired assets is \$162,000,000. PAWC Stmt. No. 4, p. 3.
- b. PAWC is requesting a fair market value rate base level of \$162 million and committing to making \$62,730,000 in post-acquisition improvement costs. PAWC Application, Appendix A-14, St. No. 3, p. 14.

4. The Application and the UVE's Appraisals

- a. PAWC's application is seeking to utilize the process set forth in Section 1329 to determine the fair market value of the MACM system assets and the ratemaking rate base of those assets. PAWC Stmt. No. 1, p. 4.

- b. PAWC selected AUS Consultants, Inc. (“AUS”) to perform an appraisal of the MACM system. PAWC Stmt. No. 1, p. 7.
- c. MACM selected Herbert, Rowland and Grubic, Inc. (“HRG”) to perform an appraisal of the MACM system. MACM Stmt. No. 1, p. 2.
- d. AUS was approved by the Commission for placement on the Commission’s Utility Valuation Expert (“UVE”) Registry. PAWC Stmt. No. 7, p. 7.
- e. HRG was approved by the Commission for placement on the Commission’s UVE Registry. MACM Stmt. No. 1, p. 2.
- f. AUS determined that the fair market value of the MACM system assets is \$161,343,000. PAWC Stmt. No. 7, p.22.
- g. HRG originally determined that the fair market value of the MACM system assets is \$207,010,000. HRG Appraisal p. 13.
- h. HRG later adjusted the fair market value of the MACM system assets to \$190,840,000. MACM Stmt. No. 1, p. 12.
- i. Adrienne M. Vicari, P.E. authored the HRG’s UVE appraisal. Transcript at 108.
- j. Ms. Vicari had never personally observed the conditions of MACM. Tr. p. 108.
- k. HRG’s appraisal did not consider environmental compliance with federal and state standards. Tr. p. 109.
- l. Ms. Vicari used the 2014-2015 edition of the Uniform Standards of Professional Appraisal Practice (“USPAP”) while performing her appraisal of MACM. Tr. p. 111.

- m. AUS's appraiser, Jerome C. Weinert certified that he conducted his appraisal of the MACM assets in conformance with the most recent standards, the 2016-2017 USPAP. PAWC Application, Appendix A-14, St. No. 7, p. 14; PAWC Application, Appendix A-5, AUS appraisal, p. 37, Compliance with Uniform Standards of Professional Appraisal Practice (USPAP) 2016-2017.
- n. Ms. Vicari indicated that she was unsure of whether a 2016-2017 edition of USPAP exists that is more current than the version that underlies the HRG appraisal. Tr. at 111.
- o. HRG added a "going value" of \$17.3 million to the cost approach and income approach in its Fair Market Valuation of MACM. Tr. p. 118; PAWC Application, Appendix A-5, HRG Appraisal, pp. 12-13; Schedule O.
- p. The purpose of adding "going value" to an appraisal is to compensate the City of McKeesport for assembling the system and for expenses incurred to get the system up and going. Tr. p. 119-120.
- q. Ms. Vicari is unaware of whether PAWC is already paying for "going value" as part of the price of the transaction. Tr. p. 120.
- r. Ms. Vicari has only broken out a separate quotient for going value in 3 out of the 5 or 6 Pennsylvania utility appraisals that she has performed in her professional career. Tr. at 121.
- s. Only Ms. Vicari's valuations for Section 1329 proceedings before the Commission have broken out and added a separate quotient for "going value". Tr. p. 123.
- t. AUS did not separate out a quotient for "going value" on top of the figure they arrived at in their Fair Market Valuation of the MACM. Tr. p. 121.
- u. HRG used the IAC ("IAC") appraisal to compute MACM's cost of treatment, pumping and disposal facilities to a current price level of December 31, 2016. PAWC Application, Appendix A-5, HRG Appraisal, p. 4.

- v. Ms. Vicari has indicated that she is unable to certify that the IAC was conducted in conformance with USPAP. Tr. at 13.
- w. HRG relied upon the IAC appraisal's single line item for the MACM collection system lines of \$30,000,000, with a 2008 year of installation and a 50 year life. MACM St. No. 1-SR, p. 2.
- x. As this proceeding developed, HRG witness Ms. Vicari acknowledged that many of the mains in service were actually acquired between 1959-1960 and, as a result, she increased the service life from 50 to 85 years. MACM St. No. 1, pp. 7-8.
- y. The impact of this adjustment is substantial, as this correction led HRG to reduce its net depreciated original cost, which in turn lowered its appraised value of the MACM assets by \$16,170,000, from \$207,010,000 to \$190,000,000. MACM St. No. 1, pp. 6-7.
- z. According to HRG, in utility acquisitions, treatment facilities, ages, service areas, and physical condition are relevant considerations for potential purchasers. PAWC Application, Appendix A-5, HRG Appraisal, p. 7.
- aa. A system that requires substantial repairs and upgrades would be less attractive and a buyer "would seek a substantial discounted purchase price for such a system. PAWC Application, Appendix A-5, HRG Appraisal, p. 8.
- bb. HRG used a market analysis that calculated MACM's average cost per customer using a sample of recent municipal wastewater acquisitions without any regard to the condition of those wastewater systems or even a basic understanding of the condition of the MACM system. PAWC Application, Appendix A-5, HRG Appraisal, p. 33, Sch. J; Tr. 115-117.
- cc. HRG's appraisal does not appear to contemplate a discount for PAWC, which must spend approximately \$37,066,723 to bring the MACM system into EPA and DEP compliance. TR. at 109-110; I&E St. No. 2, p. 12; I&E Ex. No. 2, Sch. 2.

5. Witness Qualifications

- a. Witness Spadaccio is a Fixed Utility Financial Analyst employed by the Commission's Bureau of Investigation and Enforcement. Mr. Spadaccio has submitted testimony or provided assistance in twenty prior Commission proceedings, which are outlined in Appendix A of I&E Statement No. 1. Appendix A addresses his utility specific training, and his formal educational background. Mr. Spadaccio is a credible witness.
- b. Witness Cline is a Fixed Utility Valuation Engineer employed by the Commission's Bureau of Investigation and Enforcement. Mr. Cline has testified or submitted testimony in fifty prior Commission proceedings, which are outlined in Appendix A of I&E Statement No. 2. Appendix A addresses his utility specific training, and his formal educational background. Mr. Cline is a credible witness.

6. PAWC's Financial Fitness

- a. No party to this proceeding challenged PAWC's financial fitness to own and operated the MACM system.
- c. PAWC will initially fund the transaction with short-term debt and will later replace it with a combination of long-term debt and equity capital. PAWC Stmt. No. 5, p. 5.
- d. In 2015, PAWC had operating income of approximately \$307 million, net income of approximately \$143 million, and cash flows from operations of approximately \$308 million. PAWC Stmt. No. 5, p. 4.
- e. PAWC carries a corporate credit rating of "A3" from Moody's Investors Services and an "A" rating from Standard and Poor's Rating Services. PAWC Stmt. No. 5, p. 4.

7. PAWC's Technical Fitness

- a. No party to this proceeding challenged PAWC's technical fitness to own and operated the MACM system.

- b. PAWC has extensive experience in the operation of wastewater collection and treatment systems. PAWC Stmt. No. 1, p. 15-16.
 - c. PAWC has the expertise to provide safe and reliable sewer services to the residents of the MACM and surrounding areas. PAWC Stmt. No. 1, p. 14.
8. PAWC's Legal Fitness
- a. No party to this proceeding challenged PAWC's legal fitness to own and operated the MACM system.
 - b. There are currently no pending legal proceedings challenging PAWC's ability to provide service to customers on MACM's system. PAWC Stmt. No. 1, p. 17.
9. Affirmative Public Benefits of a Substantial Nature
- a. PAWC witness Cherepko, the Mayor of the City, indicates that the proceeds of the transaction are crucial to the financial stability of the MACM service area. Tr. at 72.
 - b. The acquisition would positively impact the City's short-term and long-term financial health, improve MACM's operations and customer service, grant MACM access to better and more varied sources of capital, and provide additional revenue to the City in the form of sale proceeds and tax revenue. PAWC Application, Appendix A-14, St. No. 6, p. 8.
 - d. PAWC witness Grundusky indicates that under the acquisition, MACM customers will benefit from PAWC's additional bill payment options, extended customer service and call center hours, enhanced customer information and education programs, and access to customer assistance program. PAWC Application, Appendix A-14, St. No. 1, p. 16.
 - e. PAWC has committed to undertaking numerous projects necessary to facilitate environmental compliance measures in the MACM system, and the estimated costs of those projects is \$37,066,723. I&E St. No. 2, p. 12.

- f. PAWC's range of engineering and operational experience, and its financial resources make it better equipped to address the environmental compliance challenges of the MACM System. PAWC Application, Appendix A-14, St. No. 3, p. 16.
- g. Rectifying the environmental compliance issues that exist within the MACM system¹⁴¹ is an important benefit, as PAWC has committed to addressing these deficiencies, including the numerous deficiencies in the Dravosburg, Duquesne, and Port Vue system. PAWC Application, Appendix A-14, St. No. 3, pp. 12-15.
- h. The lack of an immediate rate impact upon existing customers under the acquisition is not a substantial benefit to these customers. I&E St. No. 2, p. 7.
- i. PAWC cannot quantify when alleged operational efficiencies will benefit PAWC customers. PAWC Application, Appendix A-14, St. No. 4, p. 8.
- j. PAWC has not supported its claims that the acquisition will provide cost savings for existing customers. OCA St. No. 1, p. 18.
- k. It is appropriate for the ALJs to examine the ratemaking issues in the evaluation of the public benefit factors. Aqua/New Garden Section 1329 Case, Docket No. A-2016-2580061, p. 60 (Order entered June 29, 2017).
- l. The acquisition's impact on existing PAWC water and wastewater customers cannot accurately be predicted and that these issues need to be decided in future base rate cases. PAWC Application, Appendix A-14, St. No. 4, p. 3; I&E St. No. 2-SR, p. 5.

10. Cost of Service Studies

- a. Without a cost of service study, the Commission's ability to evaluate the rate impact of the acquisition upon existing PAWC customers and its options of addressing that impact to provide any appropriate relief to existing customers, could be compromised. I&E St. No. 2-SR, p. 4.

¹⁴¹ I&E Ex. No. 2, Sch. 2, pp. 4-13.

- b. A cost of service study for the MACM system that separates capital expenses and operating costs for sanitary and storm water functions would help the Commission determine MACM's revenue requirement to provide service to its different customer classes, and extend rate making options that may not exist without such a study. I&E St. No. 2, p. 21.
- c. The goal of a cost of service study is to determine a utility's revenue requirement to provide service to its different customer classes. I&E Stmt. No. 2, p. 21.
- d. A cost of service study can establish the existence and extent of subsidization and assist in determining the appropriate amount of revenue requirement to be shifted from the wastewater customers to water customers. I&E Stmt. No. 2, p. 21.
- e. Without a cost of service study that includes segregated storm water costs, the appropriate ratemaking recommendations for those costs cannot be proposed or implemented. I&E Stmt. No. 2, p. 21.
- f. Even assuming, arguendo, that the cost of service study costs \$75,000 to produce, the benefit to ratepayers from the cost of service study to ensure that ratemaking options are preserved in future rate cases is far greater than the high transaction and closing costs that do not appear to have any benefit to ratepayers. I&E St. No. 2-SR, p. 15.
- g. Cost of service studies are compatible with single tariff pricing because they allow the parties and the Commission to make an informed decision of when single tariff pricing is appropriate. I&E St. No. 2-SR, p. 16.
- h. The need for a cost of service study should be assessed on a case-by-case basis. I&E St. No. 2-SR, p. 16.
- i. Two recent Commission proceedings support I&E's recommendation that PAWC be required to undertake a MACM cost of service system that separates capital expenses and operating costs for MACM's sanitary and storm water functions. Specifically, the 2016 case in which PAWC acquired the Sewer Authority of the City of Scranton ("SSA") and the 2016 Aqua/New Garden Section 1329 proceeding represent instances

in which the Commission conditioned acquisition approvals upon the utility's performance of a cost of service study. Scranton Acquisition Case, Docket No. A-2016-2537209 (Order entered October 19, 2016); Aqua/New Garden Section 1329 Case, Docket No. A-2016-2580061, p. 73 (Order entered June 29, 2017).

- j. The City of McKeesport had been pursuing the long-term lease or sale of the MACM since July 2015, almost one year before MACM acquired the Port Vue system. PAWC Application, Appendix A-14, St. No. 6, p. 9.
- k. MACM also contemplated a sale of its assets before it purchased the Port Vue system, as evidenced by the fact that on February 26, 2016, MACM issued a Request for Bids for an asset purchase of its system or for a concession lease agreement. PAWC Application, Appendix A-14, St. No. 1, p. 8.
- l. When PAWC submitted an asset purchase bid on July 29, 2016, MACM had only owned the Port Vue system for three months. PAWC Application, Appendix A-14, St. No. 1, p. 8.
- m. MACM purchased the Port Vue system for \$1,400,000,¹⁴² but within one year's time, AUS calculated the Port Vue replacement cost new less depreciation of \$4,942,794, and although HRG did not break out a replacement cost new less depreciation, it provided a reproduction cost analysis valuing the Port Vue System at \$18,929,210. As a result of these valuations, an exponentially higher amount than the system was originally purchased for by MACM will potentially be put into PAWC's rate base if this Section 1329 application is approved. PAWC Application, A-5, AUS, Fair Market Value Appraisal, p. 6; PAWC Application, A-5, HRG, Fair Market Valuation of the MACM Sanitary Sewer System, p. 27.
- n. It is important to scrutinize the circumstances, timing and related impact of MACM's purchase of the Port Vue System because the repercussions of that strategic purchase will reward the City of McKeesport and MACM at the expense of PAWC's ratepayers. I&E St. No. 1-SR, p. 6.

¹⁴² I&E Exhibit No. 1, Schedule 1, p. 1 of 2.

- o. The Port Vue system requires a Long Term Control Plan, has “numerous significant deficiencies” that have been identified in the collection system and pump station, as well as a Nine Minimum Controls Plan. I&E Ex. No. 2, Sch. 2.
- p. The estimated costs to remedy Port Vue’s environmental compliance issues is estimated to include \$100,000 to prepare the Port Vue Long Term Control Plan, and \$14,976,275 for the collection system and pump station. However, there may be other costs associated with the Nine Minimum Controls Plan. I&E St. No. 2, p. 12; I&E Ex. No. 2, Sch. 2.
- q. PAWC has indicated that it is still in the process of identifying the improvements necessary to address the existing deficiencies within the Port Vue system. I&E St. No. 2-SR, p. 11.
- r. PAWC must be required to provide a separate cost of service study for storm water and Port Vue so that the parties can analyze and propose the appropriate ratemaking treatment for each. I&E Stmt. No. 2, p. 23.

11. Ratemaking Rate Base

- a. The impact of the requested rate base level and is \$224,730,000, and the resulting change to net plant investment per customer is an increase of \$785 per customer. I&E St. No. 2, pp. 10-11.

12. Rate Stabilization Plan

- a. PAWC has not proposed a rate stabilization plan in this case, under the APA, it has committed to maintaining MACM’s current base rates until after the one year anniversary of the closing date of the Transaction. 66 Pa. C.S. § 1329(g).; PAWC Application, Appendix A-14, St. No. 4, pp. 6-7.
- b. Considering the base rate case timeline, I&E witness Cline estimated that PAWC is not likely to seek an increase in MACM rates until 2020 or later. I&E St. No. 2, pp. 16-17

13. DSIC, AFUDC and deferred depreciation
 - a. Pursuant to Section 1329, PAWC seeks permission to collect a distribution system improvement charge for the Service Area. PAWC Application, ¶2; PAWC Statement No. 1, p. 4.
 - b. PAWC seeks permission for the accrual of Allowance for Funds Used During Construction for post-acquisition improvements not recovered through its DSIC for book and ratemaking purposes. Finally, PAWC is requesting to defer depreciation related to post-acquisition improvements not recovered through the DSIC for book and ratemaking purposes. PAWC Application, ¶2; PAWC Statement No. 1, p. 4.
 - c. PAWC is requesting to defer depreciation related to post-acquisition improvements not recovered through the DSIC for book and ratemaking purposes. PAWC Application, ¶2; PAWC Statement No. 1, p. 4.
 - d. Transaction and closing costs are not properly reviewed and cannot be approved in Section 1329 proceedings. *Final Implementation Order*, M-2016-2543193, pp. 14-15 (Order entered October 27, 2016).
14. Rates
 - a. It is appropriate for the ALJs to examine the ratemaking issues in the evaluation of the public benefit factors. Aqua/New Garden Section 1329 Case, Docket No. A-2016-2580061, p. 60 (Order entered June 29, 2017).
 - b. The acquisition's impact on existing PAWC water and wastewater customers cannot accurately be predicted and that these issues need to be decided in future base rate cases. PAWC Application, Appendix A-14, St. No. 4, p. 3; I&E St. No. 2-SR, p. 5.

Appendix B: Proposed Conclusions of Law

1. Commission Jurisdiction

- a. The Commission has jurisdiction over the subject matter of this proceeding. 66 Pa.C.S. §§ 507, 102, 1103, 1329.
- b. I&E serves as the Commission's prosecutory bureau for the purposes of representing the public interest in ratemaking and service matters, and enforcing compliance with the Pennsylvania Public Utility Code. 66 Pa. C.S. §§ 101 *et seq.*, and Commission regulations, 52 Pa. Code §§ 1.1 *et seq.* See *Implementation of Act 129 of 2008; Organization of Bureaus and Offices*, Docket No. M-2008-2071852 (Order entered August 11, 2011).

b. Burden of Proof

- a. PAWC, as the proponent of the Application, bears the burden of proof to establish that it is entitled to receive the approvals being sought in the Application. 66 Pa. C.S. § 332(a).
- b. In a case such as this one, pending before an administrative tribunal, Courts have held that a "litigant's burden of proof is satisfied by establishing a preponderance of evidence which is substantial and legally credible. *Samuel J. Lansberry, Inc. v. Pa. PUC*, 578 A.2d 600, 602 (Pa. Cmwlth. 1990).
- c. To satisfy its burden, PAWC must demonstrate, by a preponderance of the evidence, that its proposed transaction complies with Pennsylvania law and should be approved.
- d. *Samuel J. Lansberry, Inc. v. Pennsylvania Public Utility Commission*, 578 A.2d 600, 602 (Pa. Cmwlth. 1990).
- e. PAWC has the burden of proving that the proposed transaction is in compliance with Sections 507, 1102, 1103, 1329 of the Code.

c. Legal Standards

- a. The Commission must issue a certificate of public convenience as prerequisite to offering service, abandoning service and certain property transfers by public utilities or their affiliated interests. 66 Pa. C.S. § 1102.
- b. The standards for the issuance of a Certificate of Public Convenience are set forth in Sections 1102 and 1103 of the Code. Under these Sections, a Certificate of Public Convenience shall be granted “only 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.” 66 Pa. C.S. §§ 1102-1103.
- c. These provisions have been interpreted by the Pennsylvania Supreme Court in the *City of York v. Pennsylvania Public Utility Commission* for the proposition that to establish that a proposed transaction benefits the public, it must be shown to affirmatively promote the service, accommodation, convenience or safety of the public in some substantial way. *City of York v. Pa. PUC*, 449 Pa. 136, 295 A.2d 825, 828 (1972).
- d. Under Section 1103, PAWC must show that it is technically, legally, and financially fit to own and operate the assets it will acquire from MACM. *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).
- e. In assessing PAWC’s Application, the Commission should consider the benefits and detriments of the transaction “with respect to the impact on all affected parties” including existing customers. *Middletown Twp. v. Pa. P.U.C.*, 482 A.2d 674, 682 (Pa. Commw. 1984).

- f. To ensure that a transaction is in the public interest, the Commission may impose conditions on granting a certificate of public convenience as it may deem to be just and reasonable. 66 Pa. C.S. § 1103(a).
- g. Section 1329 provides a framework for valuing, for ratemaking purposes, water and wastewater systems that are owned by a municipal corporation or authority that are to be acquired by an investor-owned water or wastewater utility under the Commission's jurisdiction. It 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 as established by the two independent appraisals conducted by two utility valuation experts. 66 Pa. C.S. § 1329.
- h. Section 1329's fair market valuation approach dictates that once the buyer and the seller agree to its use, they must engage the services of a licensed engineer to assess the tangible assets of the seller. The licensed engineer assessment is then presented to two UVEs, one to represent the buyer and one to represent the seller, to conduct independent analyses based on the Uniform Standards of Professional Appraisal Practice, employing the cost, market and income approaches. For ratemaking purposes, the valuation will be the lesser of the fair market value or the negotiated purchase price. 66 Pa. C.S. § 1329.

- i. PAWC's request to assume enumerated municipal contracts currently held by MACM is subject to review under Section 507 of the Code. Under Section 507, other than contracts to furnish service at tariffed rates, any contract between a public utility and a municipal corporation must be filed with the Commission at least 30 days prior to its effective date to be valid. Upon receipt of the filing, and prior to the effective date of the contracts, the Commission may institute proceedings to determine whether there are any issues with the reasonableness, legality, or any other matter affecting the validity of the contract. If this Commission decides to institute such proceedings, the contracts at issue will not become effective until the Commission grants its approval. 66 Pa. C.S. §507.

Appendix C: Proposed Ordering Paragraphs

IT IS ORDERED THAT:

1. Pennsylvania American Water Company's Application under Section 1102(a) of the Pennsylvania Public Utility Code, 66Pa C.S. § 1102(a), for approval of (1) the transfer, by sale, of substantially all of The Municipal Authority of the City of McKeesport's assets, properties and rights related to its wastewater collection and treatment system to Pennsylvania American Water Company, and (2) the rights of Pennsylvania American Water Company to begin to offer or furnish wastewater service to the public in the City of McKeesport, the City of Duquesne, Port Vue Borough, the Borough of Dravosburg, and a portion of West Mifflin Borough, Allegheny County, Pennsylvania and to three bulk service interconnection points located in Liberty Borough, White Oak Borough, and North Versailles Borough, Allegheny County, Pennsylvania and under § 1329, for approval of the use for ratemaking purposes of the lesser of the fair

market value or the negotiated purchase price of The Municipal Authority of the City of McKeesport's assets related to its wastewater collection and treatment system and other related transactions does not affirmatively promote the service, accommodation, convenience or safety of the public in some substantial way.

2. The Application is hereby approved subject to the following condition that will affirmatively promote the service, accommodation, convenience or safety of the public in some substantial way:

- a. PAWC shall undertake a cost of service study that (1) separates capital expenses and operating costs for MACM's sanitary and storm water functions and (2) that separately identifies the plant in service costs at the time that the Port Vue system was purchased, the cost of any Port-Vue plant retirements, and the cost of any Port Vue plant investment.

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Application of Pennsylvania-American
Water Company - Wastewater under Section
1329 of the Pennsylvania Public Utility
Code, 66 Pa. C.S. §1329, for approval of the
use for ratemaking purposes of the lesser of
the fair market value or the negotiated
purchase price of The Municipal Authority of
the City of McKeesport's assets related to its
wastewater collection and treatment system
and other related transactions;

Docket No. A-2017-2606103

CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing **Main Brief** dated August 22, 2017, in the manner and upon the persons listed below, in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a party):

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