COMMONWEALTH OF PENNSYLVANIA

March 19, 2024

E-FILED

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

Re: Valuation of Acquired Municipal Water & Wastewater Systems – Act 12 of 2016 Implementation / Docket No. M-2016-2543193

Dear Secretary Chiavetta:

Enclosed please find Comments in response to the Tentative Supplemental Implementation Order dated February 7, 2024, on behalf of the Office of Small Business Advocate ("OSBA"), in the above-captioned proceeding.

If you have any questions, please do not hesitate to contact me.

Sincerely,

/s/ Steven C. Gray

Steven C. Gray
Assistant Small Business Advocate
Attorney ID No. 77538

Enclosures
cc: Kevin Higgins

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Valuation of Acquired Municipal Water & Wastewater Systems – Act 12 of 2016 Implementation	**:**	**Docket No. M-2016-2543193**

COMMENTS
OF THE OFFICE OF SMALL BUSINESS ADVOCATE
IN RESPONSE TO THE TENTATIVE SUPPLEMENTAL IMPLEMENTATION ORDER

The Office of Small Business Advocate ("OSBA") appreciates and supports the Commission's effort to amend its procedures and guidelines to address a number of important concerns regarding Section 1329 applications.

A particular concern of the OSBA is the size of the premiums above depreciated original cost that have been incorporated into the acquisition price of municipal wastewater systems in certain instances. The OSBA recognizes that some premium above depreciated original cost may be necessary to effectuate the transfer of under-capitalized and under-performing municipal utility systems to investor-owned water and wastewater utilities that are better equipped to provide the necessary management and capital to deliver safe and reliable service. A critical question in these cases is whether the size of the premium is reasonable.

Because utilities that are acquiring other utility systems expect customers ultimately to pay for the acquisition costs through customer rates, the size of any premiums above depreciated original cost is a matter of the public interest. All things being equal, the amount of acquisition cost above depreciated original cost increases rate base and customer rates – either for the customers of the acquired utility, the customers of the acquiring utility, or both – before any new

investment in needed facilities is made. For a municipal utility in need of major new infrastructure, the inclusion of a large acquisition premium above depreciated original cost in rate base compounds the challenge of improving service to the customers in the acquired service area in a cost-effective manner.

The current acquisition process is fraught with perverse incentives that are contrary to the public interest. Normally, in a pricing negotiation, the economic incentives for each party to the transaction are opposite one another: the seller is incentivized to attain the highest price possible, whereas the buyer has an incentive to attain the lowest price possible. A price resulting from negotiations between sophisticated and informed parties conducted under such conditions may be presumed to represent a fair and genuine compromise.

However, contrary to this fundamental economic logic, parties to Section 1329 transactions can have similar, if not identical, incentives, which is to attain as *high* a "negotiated" price as possible, so long as the full acquisition price is approved for inclusion in rate base. A negotiated price arranged between parties that each have an incentive for the price to be as high as possible does not represent a fair and genuine compromise in a normal economic sense. Rather, the result of such an arrangement can be expected to be biased towards the upper end of plausible prices.

From the perspective of a municipal utility that is being acquired, its natural economic incentive is to obtain as high a price as possible, although we would expect that to be tempered somewhat by a municipality's concern about the impacts on its customers. The perverse incentive to attain a high acquisition price occurs with the acquiring utility, which can be rewarded with an increase in rate base equal to the acquisition price, so long as it does not exceed the fair market value of the assets as established by the appraisals. Since the basic building block for a public utility to earn profits is the size of its rate base, an acquiring utility is

incentivized to attain as high an acquisition price as possible within this constraint. Simply put, the absence of the normal economic incentive for the buyer to negotiate as low a price as possible for the asset means that the Commission cannot rely upon the "negotiated price" as a guide to ensuring just and reasonable rates in a Section 1329 acquisition transaction.

Against this backdrop, the OSBA welcomes the Commission's proposal to provide a benchmark for evaluating the sale price of a municipal water system other than the appraisals submitted by the utilities. In OSBA's view, the Reasonableness Review Ratio ("RRR") proposed by the Commission is a positive step and should be adopted as a metric for evaluating the reasonableness of the acquisition cost in Section 1329 transactions, subject to the caveat that the RRR should not be presumed to be the *floor* on the acquisition cost, but rather a benchmark for evaluating it.

Conceptually, the RRR (enterprise value over net property, plant and equipment) represents the premium that *shareholders* place on the value of Commonwealth water utilities relative to their net book values. That is, the RRR captures (on average) what *investors* are willing to pay for utility shares. It does not necessarily follow that it represents a premium that customers should *reimburse* utility shareholders for paying. Rather, it is a useful metric for evaluating how any premium above depreciated original cost should be apportioned between customers and shareholders in the ratemaking process. The OSBA suggests that it may be reasonable to consider that 50% of the RRR in excess of 1.0 could be borne by customers in rates and any premium in excess of that borne by shareholders. So, for example, if the RRR is 1.68, an acquisition premium of 34%[1] above depreciated original cost could be deemed to be in the range of reasonableness for inclusion in rate base.

[1] (1.68 – 1.00) x .5 = .34

The OSBA encourages the Commission to adopt the RRR as a valuation metric as a starting point for determining the share of an acquisition premium that should be paid by customers through rates and the share that is appropriately allocable to shareholders. The OSBA believes that the use of the RRR in the manner described above can support normal economic incentives in the Section 1329 acquisition process and better balance the interest of customers and shareholders.

Respectfully submitted,

/s/ Steven C. Gray
Steven C. Gray
Assistant Small Business Advocate
Office of Small Business Advocate

For:

NazAarah Sabree
Small Business Advocate

DATE: March 19, 2024