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March 22, 2024

Via Email Only

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:

Please find my **corrected** Comments in the above-referenced proceeding, which are attached for electronic filing. The version filed on March 18 was corrected only for typographical errors; no substantive additions or changes were made.

I apologize to you and your staff for causing the extra work of reviewing and re-posting these comments.

Respectfully submitted,

/s/ James H. Cawley
PA Attorney I.D. # 6896

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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 JAMES H. CAWLEY[1]

By Tentative Supplemental Implementation Order entered on February 7, 2024 ("TSIO"), the Commission invited comments regarding proposed revisions to its current procedures when the selling municipal and buying public utility parties intend to proceed under Section 1329,[2] including:

- Giving notice of and holding at least two in-person public hearings before executing an asset purchase agreement;
- Requiring the selling and buying parties to verify, or declare under affidavit, in the initial application that both parties acknowledge that the municipal seller is aware of the potential rate impacts the transaction may have on its customers and has communicated such implications on rates through notices issued to its customers. Both parties must also verify or declare that they understand that the Commission may shift rate allocations differently from any commitments made in the application;
- Requiring utility valuation experts ("UVEs") to establish a fair market value of the seller's assets by weighing each valuation result evenly, one-third each for the cost, market, and

[1] Former Commissioner, (1979-85 & 2005-15) and Chairman (2008-11) of the Pennsylvania Public Utility Commission.

[2] Pennsylvania Public Utility Code Section 1329, 66 Pa.C.S. § 1329, Act of April 14, 2016, P.L. 76, No. 12 (hereinafter "Section 1329" or "Act 12"), attached hereto as **APPENDIX A**.

income approaches under the Uniform Standards of Professional Appraisal Practice dictated by Section 1329(a)(3); and

- Adopting and annually publishing a Reasonableness Review Ratio ("RRR") as a nonbinding guide for the Commission's use to analyze and determine the overall prudency of Section 1329 applications. The ratio would be the fair market value ("FMV") to the depreciated original cost ("DOC") of a barometer group of similarly situated investor-owned water utilities ("IOUs"), with the FMV equaling the enterprise value ("EV") of the IOUs as a relevant proxy and the DOC equaling the total value of the physical assets of the IOU less depreciation (i.e., the net property, plant, and equipment metric included on each company's balance sheet).

The TSIO was published in the Pennsylvania Bulletin on February 17, 2024, 54 Pa.B. 906, with comments due 30 days and reply comments 45 days after publication.

I. INTRODUCTION AND SUMMARY

The first two proposals, described above, are sensible additions to the Commission's Section 1329 application requirements. They are designed to ensure that the selling municipality's customers are fully aware of the likely rate increases resulting from selling their system to a water or sewer public utility using the Section 1329 procedure.

The other two proposals are commendable attempts to bring rationality and fairness to an irredeemably unconstitutional law designed to usurp the Commission's fundamental authority and to end-run the Commission's statutory duty to ensure that *every* public utility rate is just and

reasonable.[3] They suffer, however, from needless complexity caused by the statute's unprecedented switch from depreciated original cost valuation to fair market valuation for water companies' acquisitions of municipal water and sewer systems.

Section 1329, added by Act 12 of 2016, is a corruption of public utility ratemaking in Pennsylvania. It is completely contrary to the fair balance and public interest emphasis of the Public Utility Code and its predecessors.[4] It is the most pro-utility, anti-customer provision ever added to Pennsylvania's public utility laws. It restores pre-1913 monopoly pricing to existing and acquired water and sewer customers. It has already caused extreme rate increases for those customers, approaching $100 million *annually*, with much more to come if left unchecked.

Act 12 was misleadingly sold to the legislature as a necessary incentive for large water companies to acquire distressed and impoverished municipal water and sewer systems. As enacted, the new Section 1329 procedure has been used to acquire only healthy and well-managed municipal systems. If the sales pitch had been true, existing Section 1327(a),[5] which specifically addresses incentives to the same large water companies to acquire troubled systems, could have been amended to allow for contributed property to be included in their valuation for acquisition

[3] The first sentence of Section 1301(a), 66 Pa. C.S. § 1301(a), states: "(a) Regulation.—Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable, and in conformity with regulations or orders of the commission."

[4] The Public Service Company Law, Act of July 26, 1913, P.L. 1374, No. 854, and the Public Utility Law, Act of May 28, 1937, P.L. 1053, No. 286.

[5] Section 1327 is attached hereto as **APPENDIX B**.

purposes,[6] which would have cured the utilities' only legitimate complaint about Section 1327's provisions.

Instead, the large water companies overreached by promoting a new Section 1329 that allowed limitless purchase prices, unconstitutional marginalization of the Commission, and extraordinary windfalls for large water company investors and a handful of municipalities.

Because administrative agencies, even independent ones like the Commission, lack the authority and jurisdiction to declare their organic statute unconstitutional,[7] the Commission must do its best to interpret and apply the Public Utility Code to avoid a constitutional challenge.

As described below, the Commission reconciled Sections 1329(c)(2)[8] and 1329(g)[9] consistent with the constitutionally mandated tenor of the Code, which is to regulate public utilities in the public interest by balancing the needs of their investors and their customers. These comments urge the Commission to continue reconciling Section 1329's provisions, especially Section

[6] Act 12 added the required language to new Section 1329(d)(5): "The original source of funding for any part of the water or sewer assets of the selling [municipal] utility shall not be relevant to determine the value of said assets."

[7] Only a court of law can find that Section 1329 is facially unconstitutional or that the Commission has unconstitutionally applied it because an administrative agency is without power to determine the constitutionality of its own enabling legislation. *Borough of Green Tree v. Bd. of Property Assessment*, 328 A.2d 819 (Pa. 1974); *Schneider v. Pa. Pub. Util. Comm'n*, 479 A.2d 10 (Pa. Cmwlth. 1984); *Allegheny Ludlum Steel v. Pa. Pub. Util. Comm'n*, 447 A.2d 675 (Pa. Cmwlth. 1982), *aff'd*, 459 A.2d 1218 (Pa. 1983).

[8] "(c) Ratemaking rate base.—The following apply: … (2) The ratemaking rate base of the selling utility *shall* be the lesser of the purchase price negotiated by the acquiring public utility or entity and selling utility or the fair market value of the selling utility." (Emphasis added.)

[9] "(g) Definitions … "Ratemaking rate base." The dollar value of a selling utility which, for postacquisition ratemaking purposes, is incorporated into the rate base of the acquiring public utility or entity." A "selling utility" is defined in the same subsection as a "water or wastewater company … owned by a municipal corporation or authority."

1329(c)(1)(i)&(ii)[10] in Section 1308 rate cases to avoid violating the Pennsylvania and U.S. Constitutions and to preserve an essential purpose of the Commission's existence—ensuring that every public utility rate is just and reasonable. However, the legislature's delegation of municipal property valuation for ratemaking purposes to private persons and entities is irredeemably unconstitutional.

II. BACKGROUND

A. Public Utility Property Valuation, 1913 – 2015

In 1937, the Public Utility Law was derived, almost verbatim, from the carefully drafted provisions of the Uniform Public Utilities Act,[11] which, like Pennsylvania's Public Service Company Law of 1913, followed in fundamental respects the pattern of the pioneer 1907 legislation of this type in Wisconsin and New York. This legislation adopted the administrative method of regulation by an expert commission with continuing, statewide jurisdiction, as previously worked out for railroads in Pennsylvania in 1907.[12] Such commission jurisdiction was extended to public services previously recognized by the courts as requiring, for the protection of their customers against monopolistic oppression, appropriate regulation, and a judicially enforced duty to serve the public at reasonable rates.

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[10] "(c) Ratemaking rate base.—The following apply: (1) The ratemaking rate base of the selling utility shall be incorporated into the rate base of: (i) the acquiring public utility during the acquiring public utility's next base rate case; or (ii) the entity in its initial tariff filing."

[11] *See Report of Committee on a Uniform Public Utilities Act*, in THE ANNUAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 721, 737-68 (1927).

[12] The Pennsylvania State Railroad Commission was created by law effective on May 31, 1907. It was a commission with jurisdiction over the rates and operations of all corporations transporting freight or passengers by rail or water; pipeline companies; and express, telephone, and telegraph companies but its powers were merely of investigation and recommendation. If its recommendations was not followed, it could only refer the matter to the Attorney General and the Secretary of Internal Affairs to act as they saw fit. *See* Arthur U. Ayres, *The Pennsylvania State Railroad Commission*, 26 QUARTERLY J. OF ECONOMICS 792 (Aug. 1912), *available at* https://www.jstor.org/stable/1883807.

One may assume the legislative grant of this jurisdiction constitutional because the corresponding grant of jurisdiction in the Public Service Company Law was held constitutional as a reasonable exercise of police power by appropriate means for a legitimate end.[13]

Businesses affected with a public interest because of an authorized monopoly for the service of a public need may constitutionally be subjected to the Commission's power of regulation.[14]

From the beginning of public utility regulation in Pennsylvania in 1913, the shareholders and bondholders of Pennsylvania's investor-owned (as opposed to municipally owned) public utilities earned a return ("rate of return") on the "fair value" of the utility's property used to provide customer service (the "rate base").

The concept of "fair value" originated from the U.S. Supreme Court's dictum in *Smyth v. Ames*[15] which was based partly on earlier eminent domain cases interpreting the requirement of "just compensation" for the taking of property.[16] The Court held that a utility was entitled to just compensation for the use of its property, saying:

> We hold … that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the *fair value* of the property being used by it for the convenience of the public.[17]

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[13] *Jenkins Twp. Public Serv. Comm'n*, 65 Pa. Super. 122 (1916); *Relief Elec. Light, Heat & Power Co's Petition*, 63 Pa. Super. 1 (1916). The Public Utility Law replaced the Public Service Company Law, which was codified in 1978 in the Public Utility Code.

[14] *Hertz Drivurself v. Siggins*, 58 A.2d 464 (Pa. 1948); *Brink's Express Co. v. Public Serv. Comm'n*, 178 A. 346 (Pa. Super. 1935).

[15] *Smyth v. Ames*, 169 U.S. 466 (1898).

[16] *See Ames v. Union Pac. Ry*., 64 Fed. 165, 177 (C.C.D. Neb. 1894); *see also* Robert L. Hale, *Does the Ghost of Smyth v. Ames Still Walk?*, 55 Harv. L. Rev. 1116-1123 (1942), *available at* https://www.jstor.org/stable/1334472; 2 James C. Bonbright, THE VALUATION OF PROPERTY, 1094-1097 (1937), *available at* https://www.jstor.org/stable/1884503.

[17] *Id*. at 546 (emphasis added).

In dictum, the Court stated that to ascertain the fair value of a utility,

> the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, *the probable earning capacity of the property under particular rates prescribed by statute*, and the sum required to meet operating expenses, are all matters for consideration and are to be given such weight as may be just and right in each case.[18]

However, the U.S. Supreme Court soon rejected figures derived from earnings as measures of fair value.[19] The reason for its rejection was explained in a prominent law review article[20] as follows:

> The normal test of just compensation in eminent domain cases is the market value of the property, and where the property taken is a business, evidence of earnings is relevant in determining that value. In rate-making, however, the earnings themselves are under scrutiny, and any rate base which capitalizes earnings under existing rates is totally useless; the present rates, no matter how excessive, can never be reduced. Courts and commissions have, therefore, almost universally excluded probable earning power and market value of securities from consideration in determining fair value. To ascertain present value, they have turned to something less obviously dependent on earnings. This substitute value is cost, particularly reproduction cost, *i.e*., the cost of reproducing the present plant at the present time.

The U.S. Supreme Court remained committed to a reproduction cost rate base until 1934 when it sustained an original cost valuation of a bridge by the Pennsylvania Public Service Commission[21] and in two other cases[22] pointed out the absurdities reached by reproduction cost valuations. After the enactment of the federal Natural Gas Act of 1938, the Court declared that the

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[18] *Id*. at 546-547 (emphasis added).

[19] *Willcox v. Consolidated Gas Co*., 212 U.S. 19, 47 (1909).

[20] Edward Ross Carpenter, Note, *Fair Value or Prudent Investment as a Rate Base in Pennsylvania? A Conflict Between the Public Utility Commission and the Superior Court*, 99 U. Pa. L. Rev. 371, 372-373 (1952), *available at* https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=8195&context=penn_law_review.

[21] *Clark's Ferry Bridge Co. v. Pa. Pub. Serv. Comm'n*, 291 U.S. 227 (1934).

[22] *Lindheimer v. Illinois Bell Tel. Co*., 292 U.S. 151, 161-164 (1934); *Dayton Power & Light Co. v. Pub. Util. Comm'n*, 292 U.S. 290, 311-312 (1934).

Federal Power Commission need not consider reproduction cost. Then, the Court famously tired of reviewing public utility valuation methods and declared in *Federal Power Commission v Hope Natural Gas Company*[23] that "it is not theory but the impact of the rate order which counts."

In its early cases, the Pennsylvania Public Service Commission gave considerable weight to original cost, which it defined as "the cost of properties where first dedicated to public use,"[24] but used reproduction cost if the utility's accounting records were deficient. In 1923, the Commission, following the U.S. Supreme Court, moved towards a reproduction cost base.[25]

In 1937, the new Democratic majority of the legislature, believing that the Public Service Commission was hampered by the incorporation of the fair value rule of *Smyth v Ames* into the Public Service Company Law of 1913, and to protect consumers from excessive rates masked behind reproduction cost estimates, enacted the Public Utility Law. Inexplicably, the new law authorized the new Public Utility Commission to fix the "fair value" of a utility's property but omitted the criteria for determining fair value set forth in the earlier act. There then followed a series of clashes with the Pennsylvania Superior Court over the meaning of the words "fair value"

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[23] *Federal Power Comm'n v. Hope Natural Gas Co*., 320 U.S. 591, 605 (1944) (hereinafter *Hope*).

[24] *See*, *e.g*., *Thayer v Beaver Valley Water Co.*, 2 Pa. P.S.C. 430, 433 (1916); *Ben Avon Borough v. Ohio Valley Water Co*., 2 Pa. P.S.C. 969 (1917).

[25] As practiced in Pennsylvania, reproduction cost valuation sought to estimate the cost of reproducing the existing plant in service at current material and labor prices. It assumed that the existing property was reconstructed as a whole in a single continuous operation. An engineering inventory was made, a period of construction was estimated, and current prices were applied to the units of property. These were "spot" prices as of a given date or average prices for one, two, three, or five years. Wage rates and labor performance were also estimated. *Pittsburgh v. Public Util. Comm'n*, 82 A.2d 515 (Pa. Super. 1951). After World War II, trended original cost was largely replaced by estimates of reproduction cost. The practice first developed in the application of price indices to an estimate of a reproduction cost already in existence to avoid the expense of making another such estimate. *Scranton-Spring Brook Water Serv. Co. v. Pub. Serv. Comm'n*, 119 Pa. Super. 117, 146 (1935). Trending was then extended to original cost by constructing index numbers for labor and materials and applying them to the original cost of the property as reflected in the primary accounts. The trending was brought down to the cut-off date of the rate proceedings. *Bell Tel. Co.*, 16 P.U.R.3d 207 (Pa. Pub. Util. Comm'n 1956).

with the Court declaring that the failure to enumerate the items to be considered in fixing the fair value required a continuation of the criteria of the earlier law (which contained *Smyth v. Ames'* criteria, including consideration of the property's "probable earning capacity"), and the Commission repeatedly insisting on a variation of original cost called "prudent investment" which resembled cost when first devoted to public use but the investment must have been made "prudently."[26]

The result was preservation almost intact of the valuation standards of the 1913 act in which reproduction cost played a very large part until the late 1940s when the Superior Court finally acceded to the Commission's compromise position of giving equal weight to both depreciated original cost and depreciated reproduction cost.[27]

In the following thirty-five years, when public utilities requested an increase in rates, expert witnesses spent an inordinate amount of time in Commission hearings arguing about the appropriate fair value of the utility's rate base because precise numbers were impossible. These efforts were so wearisome and expensive that in 1975 a Pennsylvania Senate committee heard extensive testimony decrying the "delay, uncertainty and waste of regulatory resources in establishing 'fair value'," [28] even from a prominent lawyer representing utilities who testified that

> What I am suggesting is that those issues of a case which must be resolved through the hearing process be confined as far as possible and simplified. To this end, the idea of original cost rate base ought to be considered seriously and dispassionately. This heresy is advanced not as a means of keeping rates down—rate of return must be adjusted commensurately—but as a way of getting rid of the whole business of

[26] Justice Brandeis suggested the prudent investment method of valuation in his separate opinion in *Missouri ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n*, 262 U.S. 276, 289 (1923).

[27] *See*, *e.g.*, *Blue Mountain Tel. & Tel. Co. v. Pa. Pub. Util. Comm'n*, 67 A.2d 441, 443 (1949); *City of Pittsburgh v. Pa. Pub. Util. Comm'n*, 69 A.2d 844, 847 (1949).

[28] REPORT AND RECOMMENDATIONS OF THE SENATE CONSUMER AFFAIRS COMMITTEE TO REFORM THE PENNSYLVANIA PUBLIC UTILITY COMMISSION (September 1975) 62-69 (quoting testimony of Richard D. Cudahy, Chairman of the Wisconsin Public Service Commission).

> attempting to establish "fair value." The cost of a utility plant is reasonably ascertainable: Its "fair value" is not. … *At any rate, it seems to me that there is so much to be gained by eliminating the hocus-pocus of "fair value" that the effort should be made*.[29]

In place of valuing public utility property at its indefinable "fair value," the Committee, at the urging of Jack K. Busby, president of Pennsylvania Power & Light Company, and other witnesses,[30] recommended adoption of valuation at the property's "original cost less depreciation," noting that "[t]he rate of return must be raised correspondingly to adjust for the fact that the return will be calculated on the older, original cost of the investment rather than its speculatively determined present-day value."[31]

This change, however, was not adopted until the amendment of Public Utility Code Section 1311(b) (relating to valuation of and return on the property of a public utility) by Act 153 of 1984 applicable to all public utility property,[32]

B. Public Utility Property Valuation, 2016 – the Present

1. Section 1329's Design

Under Section 1329, added to the Public Utility Code by Act 12 of 2016, the municipal seller and the utility buyer, simultaneously with the utility's application for Commission approval of the overall acquisition under Public Utility Code Section 1102,[33] can elect to proceed under an

[29] *Id*. at 69 (quoting remarks made by Robert H. Griswold, Esquire, to the Public Utility Law Section of the Pennsylvania Bar Association in 1971) (emphasis added).

[30] *Id*. at 63.

[31] *Id*. at 68-69.

[32] Act of Sept. 27, 1984, P.L. 721, No. 153. A nearly identical amendment was made by the act of Dec. 21, 1984, P.L. 1265, No. 240. Section 1311(b)(1) now provides: "The value of the property of the public utility included in the rate base shall be the original cost of the property when first devoted to the public service less the applicable accrued depreciation as such depreciation is determined by the commission."

[33] This section in combination with Section 1103 requires that the Commission find that the acquisition will "affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way." *City of York v. Pa. Pub. Util. Comm'n*, 295 A.2d 825, 828 (Pa. 1972); *see also Cicero v. Pa. Pub. Util.*

unprecedented procedure that requires a selling municipal water or sewer system's assets to be valued for ratemaking purposes using "fair market value" ("FMV")[34] appraisals rather than the system's depreciated original cost, which is the required basis in water and sewer public utility ratemaking for all other existing and acquired water and sewer assets.[35] No such procedure exists for acquiring and valuing any other public utility property in Pennsylvania for ratemaking purposes.

FMV is derived from the average of two separate appraisals performed by two Commission-registered[36] "utility valuation experts" ("UVEs"), one chosen by the seller and one by the buyer,[37] "in compliance with the Uniform Standards of Professional Appraisal Practice, employing the cost, market and income approaches."[38]

Comm 'n, 300 A.3d 1106, 1120 (Pa. Cmwlth. 2023). The PUC may consider the acquisition's impact on rates as one factor (which can be outweighed by other factors) in determining whether the acquisition will result in a substantial public benefit. *McCloskey v. Pa. Pub. Util. Comm 'n*, 195 A.3d 1055, 1066-67 (Pa. Cmwlth. 2018), *appeal denied*, 207 A.3d 290 (Pa. 2019).

[34] Section 1329(a).

[35] Section 1311(b)(1) provides: "The value of the property of the public utility included in the rate base shall be the original cost of the property when first devoted to the public service less the applicable accrued depreciation as such depreciation is determined by the commission."

[36] Only ten UVEs are registered with the Commission. The registry is available at https://www.puc.pa.gov/media/2475/registry_of_uves-july2023.pdf.

[37] Section 1329(a)(1), (2), (3).

[38] Section 1329(a)(3). These standards are described by the Appraisal Foundation as follows: "The *Uniform Standards of Professional Appraisal Practice* (USPAP) is the generally recognized ethical and performance standards for the appraisal profession in the United States. USPAP was adopted by Congress in 1989, and contains standards for all types of appraisal services, including real estate, personal property, business and mass appraisal. Compliance is required for state-licensed and state-certified appraisers involved in federally-related real estate transactions." *See*

https://www.appraisalfoundation.org/imis/TAF/Standards/Appraisal_Standards/Uniform_Standards_of_Professional_Appraisal_Practice/TAF/USPAP.aspx?hkey=a6420a67-dbfa-41b3-9878-fac35923d2af.

The *lesser* of the FMV and the purchase price negotiated by the seller and buyer is the dollar value (called the "ratemaking rate base" or "RMRB") that the buying utility is authorized to include in its rate base when it next requests the Commission to approve a rate increase.[39]

The mandatory words "*shall* be incorporated into the rate base of: (i) the acquiring public utility during the acquiring public utility's next base rate case" in Section 1329(c)(l)(i) and the requirement in Section 1329(d)(3)(i) that the Commission's acquisition application approval order *shall* specify the RMRB figure as determined in Section 1329(c)(2) and defined in Section 1329(g) make clear that the legislation intends to deprive the Commission of authority to modify the RMRB as determined by Section 1329(c)(2) in its combined Sections 1102/1329 application approval order and to prohibit any challenge to the RMRB amount in the next post-acquisition rate case.

2. The Disingenuous Genesis of Section 1329

The prime sponsor of House Bill 1326 of the Regular 2015-2016 Session (which became Act 12 of 2016) circulated a co-sponsorship memorandum basing the need for the legislation on the plight of troubled and impoverished municipal water and sewer systems and on an alleged disincentive created by existing law that prevented willing public utilities from rescuing them:

> Currently, there are community owned and private water and wastewater utilities whose system infrastructure is urgently in need of repair or replacement[;] however, the system owners cannot afford to make these needed upgrades without significant investment resulting in increased costs to its customers. For many of these systems, sale to a larger water or wastewater company is a welcome opportunity as it enables system improvements and ensures the continued provision of safe, reliable service to customers at reasonable rates. However, current law relating to valuation of utility property discourages these acquisitions because the purchasing utility may not be able to recover its investment.[40]

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[39] Section 1329(c)(1) & (2).

[40] Co-sponsorship memorandum of House Bill 1326, P.N. 1787, Regular Session of 2015-2016 (*available at*

The memo then introduced a completely foreign concept to Pennsylvania public utility regulation—*fair market value as a basis for valuing utility property for ratemaking purposes:*

> To remedy this issue, I will be introducing legislation to establish a process for determining ***the fair market value*** of a water or wastewater company acquired by a water or wastewater public utility *for rate making purposes*. My bill establishes a *voluntary* process whereby the acquiring public utility and selling utility may choose to have the value of the selling utility established through independent appraisals conducted by utility valuation experts. ***The fair market value of the selling utility, for post-acquisition rate making purposes***, will be either the average of the two appraisals or the purchase price, whichever is less.
>
> The Public Utility Commission must approve all public utility acquisitions and will review the utility valuation expert appraisals and the proposed post-acquisition rates as part of this process. The PUC may reduce the established fair market value if the rates of the purchasing utility will increase by 5% or more.[41]

The memorandum was disingenuous at best for these reasons:

First, contrary to the first sentence of the memo, the legislation did not confine the new Section 1329 to distressed or non-viable municipal systems. As enacted, Act 12 of 2016 has instead been used to buy financially healthy and operationally well-managed municipal systems at excessive prices.[42]

Second, in the last sentence of the memo's first paragraph, the "current law relating to valuation" allegedly discouraging acquisitions of distressed municipal systems refers to Public Utility Code Section 1327 (relating to the acquisition of water and sewer utilities). That section

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https://www.legis.state.pa.us//cfdocs/Legis/CSM/showMemoPublic.cfm?chamber=H&SPick=20150&cosponId=18409).

[41] *Id*. (emphasis and bolding added).

[42] *See* Testimony of Patrick M. Cicero, Consumer Advocate, before the Pennsylvania House of Representatives Committee on Consumer Protection, Technology and Utilities Regarding House Bills 1862, 1863, 1864, and 1865 amending Sections 1327 and 1329 of the Public Utility Code, December 12, 2023 at 2, 14 ("In our view, none of these [twenty-one Commission approved] acquisitions [under Section 1329] have been troubled or non-viable systems….None of the acquisitions approved so far would have likely met the § 1327(a)(2) or (3) criteria because none were troubled systems….").

was added to the Code in 1990 and expanded in 1995, both at the urging of the same large investor-owned water public utilities that promoted House Bill 1326 to encourage them to acquire and remediate distressed and non-viable systems owned by public utilities and municipal corporations.[43] Section 1327 contains alternative provisions for instances where the acquisition cost (principally the purchase price) is greater or lower than the acquired system's depreciated original cost.

Section 1327(a) liberally creates a rebuttable presumption that any excess amount (over the original cost of the system's property when first devoted to public service less the accrued depreciation) in the purchase price is reasonable and includable in the acquiring utility's rate base if, among other requirements, the acquiring utility proves that the acquired system either has no more than 3,300 customers OR the system is "nonviable in the absence of the acquisition," AND its owner is not furnishing and maintaining adequate, efficient, safe and reasonable service and facilities" as evidenced by (among other things) violations of statutory or regulatory requirements of the Commission or the Department of Environmental Resources and Department of Conservation and Natural Resources; a finding by the Commission of inadequate financial, managerial, or technical ability of the acquired system; or water availability, palatability, pressure, or volume deficiencies.

The Commission must also find that the system cannot be reasonably expected to furnish and maintain adequate future service at rates equal to or less than those of the acquiring utility and that "the actual purchase price is reasonable."

Thus, if the large acquiring water companies failed to recover the purchase prices they paid for distressed or non-viable municipal systems, it was not the fault of Section 1327. Rather, the

[43] Act of April 4, 1990, P.L. 107, No. 24; act of June 1, 1995, P.L. 49, No. 7.

alleged villain was the Public Utility Commission for disallowing portions of the purchase prices as unreasonably excessive or improper for inclusion in the acquiring water companies' rate bases for ratemaking purposes.

Excessiveness or impropriety is primarily determined by assessing whether the purchase price is unreasonably greater than the system's depreciated original cost (i.e., the net book value of the system). Many municipal systems have minimal or nonexistent net book values because the plant in service is fully depreciated or because much of the plant was constructed with "contributed property"—state and federal grants and donations of land and installed plant-in-service from real estate developers, not with customer payments or tax dollars. In public utility ratemaking, investors only receive a return on the capital they have invested to create the utility's rate base property used to provide service to the public, and no return is paid on property contributed by others.

Thus, the large water companies could not always fully recover their purchase prices to acquire distressed or non-viable municipal systems. The problem was easily cured by further amending Section 1327 with the same language that they suggested in the new Section 1329(d)(5): "The original source of funding for any part of the water or sewer assets of the selling utility shall not be relevant to determine the value of said assets."

Rather than promoting this simple fix to acquire more distressed municipal systems under Section 1327, the promoters of House Bill 1326 were more likely interested in growing their customer bases by acquiring *financially healthy, well-managed municipal systems*, particularly those closest to their existing facilities and workforces. Convincing such systems to sell would require large purchase premiums over the systems' depreciated original costs even if contributed property was included. It would be very difficult for the Commission to approve the reasonableness of such pricey purchases if the systems were not distressed. So, instead of just solving the

contributed property problem, the large water companies broke traditional public utility principles by promoting a law that excluded the Commission from the process except for rubberstamping the seller's and buyer's wishes.

Third, a new Section 1329 solved all the problems by replacing the municipal system's depreciated original cost (as the basis for measuring the excess amount of the purchase price) with the "fair market value" of the municipal system.

Likely knowing that FMV was alien to public utility ratemaking, the promoters of the concept cloaked it in a patina of respectability by having independent appraisers establish the value under national appraisal standards, even though there could not be a true public auction of the municipal assets as a competitive brake on the appraisal values. As just noted, the new law eliminated the contributed property problem by providing that the appraisers could include donated property in their appraisal values. Most importantly, the new law provided that the lesser of the FMV and the negotiated purchase price would be an unchallengeable amount that must be included in the acquiring utility's rate base in its next rate case.

As the co-sponsorship memo promised, the Commission could "review" the appraisals and the proposed post-acquisition rates, but, as the memo failed to explain, it could not change the FMV determined by the appraisers and, in the acquiring utility's next rate case, it could not exclude the "ratemaking rate base" amount (the lesser of the FMV and the purchase price) from inclusion in the utility's rate base because it had already approved that amount in the Section 1102/1329 proceeding as mandated by Section 1329(c)(1)(i).

Also, as the memo described, the seller and buyer's election to proceed under the new Section 1329 is voluntary, ostensibly in the sense that they do their customers a favor by such an

election. Given the large rate increases that have resulted,[44] calling the election to proceed under Section 1329 "voluntary" is akin to Russia justifying its unprovoked invasion of Ukraine by saying that it did so voluntarily.

Lastly, the memo mentioned reducing the FMV if the acquiring utility's rates increased by five percent or more, but this was deleted from the enacted printer's number of the bill.

3. The Audacity of Section 1329 Is Revealed

Act 12 of 2016, adding a new Section 1329 to the Public Utility Code, became effective on June 13, 2016. It was first invoked when Aqua Pennsylvania Wastewater, Inc. filed with the Commission on December 15, 2016, an application under Sections 1102 and 1329 for approval to acquire the wastewater system assets of New Garden Township, Chester County, and the New Garden Township Sewer Authority (collectively, New Garden) and to allow Aqua to begin providing wastewater service in New Garden Township.[45]

The application asked the Commission for an order approving the acquisition that included the ratemaking rate base (RMRB) of the wastewater assets under Section 1329(c)(2). As required by Section 1329(d)(1), the application included the RMRB, copies of the fair market appraisal reports of two Utility Valuation Experts (UVEs), one chosen by the seller and one by the buyer, and the purchase price agreed to by Aqua and New Garden ($29.5 million).

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[44] *See* Consumer Advocate Cicero's testimony *supra* note 42, at 3 ("By our office's conservative estimate, because of these [21] acquisitions and directly due to the fair market value embedded into Section 1329, consumers are or will be required to pay in excess of $85 million more each year for water and wastewater service than they would have without Section 1329. This amount will only increase because as of the filing of this testimony [December 12, 2023], there are five more acquisitions that have started the process of Public Utility Commission (PUC) review which if approved as filed would add an additional $19.4 million in added annual costs.").

[45] *Application of Aqua Pennsylvania Wastewater, Inc. Pursuant to Sections 1102 and 1329 of the Public Utility Code for Approval of its Acquisition of the Wastewater System Assets of New Garden Township and the New Garden Sewer Authority*, Docket No. A-2016-2580061.

The wastewater assets' Fair Market Value (FMV) was $32,140,875, the average of the two UVE appraisals of $30,615,410 and $33,666,340. Because the agreed-upon purchase price of $25.5 million was less than the FMV, it became the RMRB.

After evidentiary hearings, Aqua filed its main brief for consideration by Administrative Law Judge Steven K. Haas.[46] In surely one of the most extraordinarily audacious arguments ever made to the Commission, Aqua contended that the mandatory term "shall" in Section 1329(c)(2) and the definition of "fair market value" in Section 1329(g) as "[t]he average of the two utility valuation expert appraisals conducted under subsection (a)(2)" were clear and definitive that the Commission had no role in determining the RMRB except to adopt the lesser of the FMV as determined by the UVEs' appraisals and the purchase price agreed to by Aqua and New Garden. Therefore, testimony submitted by I&E and OCA challenging the UVE appraisals and resulting RMRB were not permitted:

> Section 1329 creates a streamlined process for a municipality to obtain fair market value in a regulatory setting without the burden of expensive and time-consuming litigation. In order to protect the public interest and at the same time avoid increasing costs for the statutory advocates, the General Assembly required the use of Commission approved UVEs to represent the public interest and the use of a specific formula for the calculation of ratemaking rate base.[47]
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> * * *
>
> The development and use of the UVE is a consumer protection required by the General Assembly so that the two impartial, independent and qualified experts provide fair market value determinations. The statutory requirement that the UVEs determine fair market value in compliance with USPAP, employing the cost, market and income approaches is a further consumer protection.[48]

[46] Main Brief of Aqua Pennsylvania Wastewater, Inc., March 6, 2017, *available at* https://www.puc.pa.gov/pcdocs/1511571.pdf.

[47] *Id*. at 28.

[48] *Id*. at 33.

Nothing in the text or the legislative history of Section 1329 suggests that it was intended to avoid time-consuming litigation (it has done the opposite) or an increase in the OCA's or OSBA's costs. Absent also is any intention to void OCA's and OSBA's statutory authority to advocate for their constituencies. Most lacking is any authority for UVEs' usurpation of the Commission's duty to balance the needs of utilities and consumers to ensure just and reasonable rates. The patina of independent appraisers applying the USPAP adds nothing to bolster the discredited use of fair market value appraisals to determine the value of municipal assets for public utility ratemaking, which, as discussed below, is unconstitutional.

The idea of private appraisers, both working for two parties wishing for the highest appraisals possible, as representatives of the public interest is absurd. So is the notion that the Commission's duties can be supplanted by a formula concocted by those two private parties to further their own self-interest.

4. The Commission's Reconciliation of Sections 1329(c)(2) and 1329(g) with Sections 505 and 1103(b)

I&E and OCA objected to Aqua's baseless claims that Section 1329 was intended as a formulaic replacement of the Commission's authority to protect the public interest.[49] They argued that Code Section 505 preserves the Commission's authority to conduct an inquiry into the value of property that a public utility seeks to acquire, and Section 1103(b) affords the Commission explicit authority in proceedings involving Certificate of Public Convenience requests "to make such inquiries, physical inspections, valuations, and investigations, and may require such plans, specifications, and estimates of cost, as it may deem necessary and proper…."

[49] *See* Reply Exceptions of the Bureau of Investigation and Enforcement, May 8, 2017, at 15-19, *available at* https://www.puc.pa.gov/pcdocs/1519862.pdf, and Reply Brief of the Office Consumer Advocate, March 16, 2017, at 6-7, *available at* https://www.puc.pa.gov/pcdocs/1512772.pdf, and Reply Exceptions of the Office of Consumer Advocate, May 8, 2017, at 14-17, *available at* https://www.puc.pa.gov/pcdocs/1519915.pdf.

OCA argued that eliminating the Commission's ability to investigate the reasonableness of the appraisals and make necessary adjustments to determine the fair market value would prevent the Commission from ensuring that rates are just and reasonable.

OCA also argued that removing the Commission's authority to determine the rate base and shifting that authority to the UVEs would render the statute unconstitutional because the legislative power over prices, rates, or wages vested with the Commission cannot be delegated to a private party.

The Commission avoided the need to address the constitutional issue by holding that Section 1329, "despite being a later enacted statute, is reconcilable with Sections 505 and 1103(b). "Thus, consistent with [Pennsylvania Rule of Statutory Construction 1971(c),[50]] 1 Pa. C.S. § 1971(c), we do not believe the General Assembly intended to repeal the earlier enacted provisions under Sections 505 and 1103(b) of the Code. Accordingly, we find that Section 1329 permits the Commission and the Parties to develop a record pertaining to the review and analysis of the fair market value appraisals of the UVEs."[51]

Notably, the Commission did not base this conclusion on another, even more important OCA argument—that Section 1329 was established under Chapter 13 of the Code and must be implemented consistent with Section 1301(a)'s requirement that all rates be just and reasonable.[52] OCA was correct that eliminating the Commission's ability to investigate the reasonableness of

[50] "§ 1971 Implied repeal by later statute … (c) … a later statute shall not be construed to supply or repeal an earlier statute unless the two statutes are irreconcilable."

[51] *See* Opinion and Order entered June 29, 2017, at 34-35 (citation and footnote omitted), *available at* https://www.puc.pa.gov/pcdocs/1526799.docx.

[52] Reply Exceptions of the Office of Consumer Advocate, May 8, 2017, at 14.

the appraisals and to make necessary adjustments to determine the fair market value would prevent the Commission from ensuring that rates are just and reasonable.

The UVEs' appraisals and the resulting FMV were adjusted in the Commission's Opinion and Order. Still, as has occurred in over twenty subsequent acquisitions that closed after receiving approval by the Commission under Sections 1102 and 1329, the FMV in *New Garden* substantially exceeded the purchase price, whose reasonableness was not questioned or challenged, and it became the Commission-approved RMRB for subsequent inclusion in Aqua's rate base.

In short, the Commission properly reconciled Section 1329 by entertaining I&E's and OCA's suggested adjustments to the appraisals that determined FMV and by partially adopting those changes. However, the changes were made to unavoidably inflated valuations prepared under a constitutionally repugnant process.

III. THE IMPROPRIETY OF FAIR MARKET VALUE APPRAISAL AS A METHOD TO DETERMINE PUBLIC UTILITY RATE BASE VALUATION FOR RATEMAKING PURPOSES

A. Judicial and Scholarly Rejection of Fair Market Value

As debated and decided at the dawn of federal and state regulation of investor-owned public utilities during the first decades of the last century, "market value" or "fair market value" was found incompatible and improper for public utility rate base valuation. Eminent domain and commercial methods of valuation were found wanting and therefore rejected.

1. Eminent Domain Valuation

When the state appropriates private property for public use by eminent domain, the just compensation that must be paid therefor is generally defined as "market value," or "fair market value."[53] Using eminent domain terms and concepts in public utility ratemaking (as Act 12 does)

[53] *See* 1 James C. Bonbright, VALUATION OF PROPERTY 413 (1937).

wrongly suggests that each act of rate-fixing under legislative authority is an act comparable to the expropriation of the utility's earning power for which compensation must be made.

This is completely untenable because no one versed in constitutional law would confuse the power to regulate a business in the public interest with the state's power to take over a business by paying the private owners just compensation for its taking. In the latter situation, the eminent domain limitation is apposite, and the government must pay the owner compensation measured by the market value of the property it expropriates. However, when the government regulates a business without assuming complete control, the power thus exercised is categorized in constitutional theory as the police power.[54] In the reasonable exercise of this police power, the state may regulate a business's services and rates.

By 1950, Edward Ross Carpenter, was able to conclude:

> The normal test of just compensation in eminent domain cases is the market value of the property and, where the property taken is a business, evidence of earnings is relevant in determining that value. In rate-making, however, the earnings themselves are under scrutiny, and any rate base which capitalizes earnings under existing rates is totally useless; the present rates, no matter how excessive, can never be reduced. Courts and commissions have, therefore, almost universally excluded probable earning power and market value of securities from consideration in determining fair value.[55]

2. Commercial Valuation

"It was recognized that a commercial valuation predicated upon earning capacity had no place in a process of price determination whose objective was the determination of the reasonable exchange value of service produced under regulated monopolistic or semi-monopolistic

[54] *See Federal Power Comm'n v. Natural Gas Pipeline Co*., 315 U.S. 575, 582 (1942) (discussing the constitutional power of Congress to address the substantive issues under its police powers to set rates that were "just and reasonable.").

[55] Edward Ross Carpenter, *supra* note 20, 99 U. Pa. L. Rev. at 372-373 (footnotes omitted).

conditions."[56] Thus, for example, private property selling value derived in competitive commercial real estate markets differs from the value given to public utility assets for ratemaking purposes in a non-competitive regulated environment.

Therefore, as with the determination of condemnation damages, the method for determining commercial value is inappropriate in a non-competitive, economically regulated monopoly environment where the property owner is given an exclusive franchise service territory, and the property is used to provide a service that is absolutely and irreplaceably essential to modern life. Consequently, such property is "affected with the public interest," and the service provider's business practices, rates, and terms of service may be controlled under the police power of the state for the common good.

Under such regulated circumstances, there is no ready market for the sale property because it is unique in character, and public utilities have control of that market. There are no competitors from whom customers may get the identical service, and there are an extremely limited number of potential buyers (all of whom are either public utilities or need to become a public utility with the Commission's approval to serve customers with the acquired property). Thus, to avail itself of Act 12, a utility buyer must (1) be financially strong enough to pay tens or even hundreds of millions of dollars to acquire municipal systems, (2) have a large customer base across which the acquisition costs can be spread, and (3) have existing water and/or sewer facilities and a workforce in close enough proximity to the acquired system to allow its efficient and economical operation. In Pennsylvania, only three companies possess these qualifications.

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[56] Martin G. Glaeser, PUBLIC UTILITIES IN AMERICAN CAPITALISM 285 (1957); *see also* Martin G. Glaeser, OUTLINES OF PUBLIC UTILITY ECONOMICS 470 (1927) and Robert L. Hale, *The 'Physical Value' Fallacy in Rate Cases*, 30 Yale L. J. 710, 715 (1921) (discussing, when the reproduction cost method of valuation is used, it serves an intelligible function in arriving at market value only in the case where free competition is possible, but it can be of no economic significance in the case where monopolistic conditions prevail as in the utility field).

In addition, the use of a "market" or "fair market value" is inappropriate because of "circularity." A leading authority on public utility issues of the 1930s explained the problem this way:

> The commercial value of an industrial property depends upon its expected net earning power. This in turn, among other factors, depends upon the prices or rates to be realized from the products or services to be sold. Thus the *commercial value* of a public utility property would depend upon the *rates charged for service*, and therefore could not be logically used as a measure for the determination of reasonable rates. As a matter of principle, it would obviously preclude either the lowering or increasing of rates. High rates would be reflected in expected earnings, and therefore in the value of the properties; hence they could not be reduced. Likewise low rates would be reflected in the consequent value, and so could not be increased.
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> Commercial value *as such* clearly is not a concept that can be applied to monopolized industries for the purpose of protecting consumers against exorbitant charges or safeguarding investors from confiscatory rate restrictions.[57]

Another contemporary scholar described the circular logic of using earning capacity to determine public utility rate base valuation:

> And, being a prosperous utility, the most useful item in the determination of its value would be its earning capacity. In fact, in the case of a successful plant for which there is no market value in the sense of value established by exchanges on the market, the best index to market value is the capitalization of earning capacity. Yet the central purpose of a rate proceeding is to determine what the earning capacity should be. If in such a rate proceeding a commission uses a rate base determined on the basis of value and the valuation arrived at reflects the earning capacity of the plant, the whole proceeding is stymied at the outset for by hypothesis the rate base chosen will be the valuation reflecting the existing rate schedule. … the Supreme Court, whenever it has had occasion to consider the question critically, has made clear that earning capacity, the very issue at stake, is not a factor to be considered in determining fair value.[58]

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[57] John Bauer, *Public Policy Concept of Valuation for Purposes of Public Utility Rate Control*, 27 Geo. L. J. 403, 405 (1939).

[58] Paul G. Kauper, *Wanted: A New Definition of the Rate Base*, 37 Mich. L. Rev. 1209, 1220 (1939), citing *Simpson v. Shepard*, commonly known as the *Minnesota Rate Cases*, 230 U.S. 352, 455 (1913), and *Los Angeles Gas & Electric Co. v. Railroad Comm'n of California*, 289 U.S. 287, 305 (1933).

Thus, the Commission has always made the distinction when valuing public utility property for ratemaking purposes between "exchange value," which is determined in a competitive open marketplace of many buyers and sellers (e.g., commercial real estate sales) and dependent upon the property's earnings or anticipated earnings, and "fair value," which is derived from due consideration of original cost or a mixture of original cost and reproduction cost, neither of which depends upon earnings.

3. The Courts

As related above, the U.S. Supreme Court in *Smyth v. Ames*[59] in dictum stated that to ascertain the fair value of a utility, the probable earning capacity of the property under particular rates prescribed by statute must be considered. In 1909, however, the Court rejected figures derived from earnings as measures of fair value.[60]

As also discussed above and exhaustively detailed by Edward Ross Carpenter's article in the University of Pennsylvania Law Review, the Commission's attempt, after the passage of the Public Utility Law in 1937, to adopt original cost valuation was thwarted by the Pennsylvania Superior Court, which required fair value with an emphasis on reproduction cost. Yet, the Commission eventually prevailed by giving weight to a mixture of original cost and reproduction cost.[61] That practice continued until 1984 when depreciated original cost was statutorily required in Section 1311(b).

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[59] *See supra* note 18 and accompanying text.

[60] *Willcox v. Consolidated Gas Co*., 212 U.S. 19, 47 (1909).

[61] *See* Joseph R. Rose, *Confusion in Valuation for Public Utility Rate-Making*, 47 Minn. L. Rev. 1, 13-14 (1962), *available at* https://scholarship.law.umn.edu/mlr/1700.

For the foregoing reasons, until the enactment of Act 12 of 2016, "fair market value" was never used in Pennsylvania to value either public utility or municipal property for ratemaking purposes.

B. A Return to 1975 Hocus-Pocus Ratemaking

With the enactment of Act 12, in municipal water and sewer company acquisition cases, the Commission has been forced to return to 1975 hocus-pocus ratemaking with the same time-consuming, expensive dueling of experts that Robert H. Griswold so vigorously criticized that year before the Pennsylvania Senate committee.[62]

New Sections 1329(a)(2) & (3) require two "utility valuation experts" to "perform separate appraisals of the selling [municipal] utility for the purpose of establishing its fair market value … in compliance with the Uniform Standards of Professional Appraisal Practice, employing the cost, market and income approaches."

An examination of each approach confirms that history has once again repeated itself.

- In the *cost approach*, the value estimate reflects the cost of reproducing or replacing the municipal system's assets in the current market, with adjustments for age, wear and tear, functional deficiencies, and economic conditions. This approach is premised on the principle of "substitution," assuming a purchaser would not pay more than the cost of replacing an asset with one that is equally desirable and useful. Replacement costs are typically calculated by multiplying the original cost by an index (typically, The Handy-Whitman Index of Public

[62] For example, the Commission's analysis of extensive witness testimony, exhibits, and objections thereto for a determination of the ratemaking rate base in its final order in *Application of Aqua Pennsylvania Water, Inc. to Acquire the Wastewater System Assets of East Whiteland Township*, Docket No. A-2021-3026132, Opinion and Order entered July 29, 2022, consumed 56 pages of the 133-page order.

Utility Construction Costs) that updates the original costs of the system's assets to the current costs of replacing them.

This is "reproduction cost" revived.[63] As related above, the new Public Utility Commission attempted unsuccessfully to abandon reproduction cost in favor of "prudent investment" in *Public Utility Commission v. Solar Electric Co*., 18 Pa. P.U.C. 359 (1938), but not before the Commission pointed out the fallacy of assuming that the present plant would be reproduced identically and at one time, and criticized reproduction cast as a method of valuation because of its dependence on prices which might change overnight. In summary, the Commission said, "Reproduction cost new less accrued depreciation is at variance with the prime purpose of utility regulation, namely, to provide adequate service at just and reasonable rates, calculated to return to the investor a fair return upon the capital he has contributed to a public enterprize."[64]

Shortly thereafter, the U.S. Supreme Court in *Lindheimer* and *Dayton Power & Light Co*. pointed out the absurdities reached by reproduction cost valuations and ceased its support of them.[65] As previously noted, the Commission later compromised its differences with the Pennsylvania Superior Court by adopting a mixture of depreciated original cost and depreciated reproduction cost and, after 1984, original cost alone.

- In the *market approach*, value is estimated by comparing the purchase price negotiated by the municipality and the public utility with the price of similar previously sold systems in a similar

[63] *See supra* note 25 and accompanying text.

[64] *Pa. Pub. Util. Comm'n v. Solar Elec. Co.*, 18 Pa. P.U.C. 359, 388-389 (1938), *rev'd*, *Solar Elec. Co. v. Pa. Pub. Util. Comm'n*, 9 A.2d 447 (Pa. Super. 1939) (holding that "the cost of reproducing the property has consistently been held to be not only a relevant but also an essential element in the ascertainment of its 'fair value' for rate-making purposes" (9 A.3d at 456)).

[65] *See supra* note 22.

market. Sales of comparable properties can feasibly provide an accurate indicator of the municipal system's market value, but this is only true if there is an active market for recent sales.

In Pennsylvania, there is a limited market for well-managed, financially healthy municipal water and sewer systems like those purchased so far under Act 12, and, even then, significant adjustments are necessary to achieve comparability.

As is the case with determining a just and fair overall rate of return on the utility's rate base using comparable earnings by a barometer group of similar companies, the choice of barometer group members significantly influences the outcome. The same is true when a barometer group of similar municipal systems is chosen for comparison purposes to arrive at an individual system's "fair market value." The result can vary significantly depending on the discretionary inputs. This same drawback exists with the TSIO's fourth proposal which also relies on comparable barometer groups.

- In the *income approach*, the market value is based on the total present worth of the anticipated future income from the property. This is generally considered the best means of estimating a market value for income-producing properties, including utilities. "Direct capitalization" converts a single year's expected income by dividing the net income estimate by a multiplier (usually EBITA—Earnings Before Interest, Taxes, and Amortization).

  This is the same commercial valuation that courts, commissions, and scholars have rejected because it is incompatible with public utility ratemaking. In fact, all three approaches are the standard methods of commercial valuation and, therefore, are equally unsuitable for valuing public utility property for ratemaking purposes.

IV. SECTION 1329 IS IRREDEEMABLY UNCONSTITUTIONAL

A. Section 1329 Is Unconstitutional Because It Precludes a Commission Determination of the Justness and Reasonableness of the Ratemaking Rate Base

As previously noted, Section 1329 in a combined Section 1102/1329 proceeding excludes the Commission from any role in determining the ratemaking rate base amount (the lesser of the FMV and the purchase price) except to include the amount in its order approving the acquisition. As mandated by Section 1329(c)(1)(i), that amount is included in the utility's rate base in a subsequent separate Section 1308 proceeding. That is, the Commission is prevented from determining the justness and reasonableness of the ratemaking rate base.

Public utility regulators are obliged by law to regulate public utilities to ensure that the rates they establish are just and reasonable for both utility investors and consumers. The just and reasonable standard, while codified in the provisions of state and federal regulatory statutes, has been found by the Pennsylvania Supreme Court and the U.S. Supreme Court to satisfy the constitutional requirement precluding regulatory commissions from exercising their ratemaking authority in a manner that confiscates utility assets.[66] That is to say, rates found to be "just and reasonable" for statutory purposes do not constitute a taking under the U.S. Constitution.

Therefore, a utility's total revenues from the sale of its services pursuant to commission-established rate levels are permissible if such revenues fall within the "zone of reasonableness" bounded at the lower end by the constitutional prohibition against confiscation and at the upper end by the statutory prohibition against the exploitation of utility consumers through the exercise of monopoly pricing powers.[67]

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[66] *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968), *reh. den*. 392 U.S. 917 (1968); *Pennsylvania Elec. Co. v. Pa. Pub. Util. Comm'n*, 502 A.2d 130, 132-133 (Pa. 1985).

[67] *Id*.

The Pennsylvania Supreme Court has applied a similar test to public utility valuation for ratemaking purposes by describing the zone of reasonableness as "the outer boundaries beyond which, on the one hand, a regulator approaches an uncompensated eminent domain taking of investor property by valuing it below its original cost and, on the other hand, a regulator approaches an unlawful taxation of consumers under the guise of rate fixing by valuing the property in excess of its reproduction cost."[68]

The constitutional problem with Section 1329 is that the Commission is prevented from determining whether the RMRB is just and reasonable and, therefore, within the zone of reasonableness. The RMRB, determined by a process entirely controlled by the buyer and seller, is hardly likely to confiscate the utility's property, but instead virtually ensures that the utility's existing and acquired customers will be charged exploitative rates. The Commission is prevented from inquiring whether either result occurs.

Hope's "end result" holding,[69] that methodological infirmities are unimportant if the rate order is reasonable, does not save the section from unconstitutionality because the Section 1102/1329 proceeding is a separate, stand-alone proceeding with its own methods and end result order. The proceeding's exclusionary methods result in an unreasonable order.

Nor is the RMRB a Commission-made rate that cannot be challenged in the later Section 1308 rate case, despite the Commission's inclusion in the ordering paragraphs of each acquisition approval order a direction to the Commission's Secretary to issue a Certificate of Public

[68] *Pa. Pub. Util. Comm'n v. Pennsylvania Gas and Water Company*, 424 A.2d 1213, 1220 (Pa. 1980).

[69] 'I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry .. is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." *Hope*, 320 U.S. at 602.

Convenience allowing the acquiring public utility to incorporate the RMRB amount "in its next base rate case pursuant to 66 Pa. C.S. § 1329(c)(2)."

For starters, no unconstitutional rate can be insulated from retroactive modification by the Commission. Secondly, the rationale for the Commission-made rate doctrine—that courts should be able to rely on the Commission's findings that rates are just and reasonable until declared otherwise on a prospective basis[70]—cannot be satisfied because Section 1329 prevents the Commission from reviewing record evidence and finding that the RMRB is just and reasonable. Instead, the Commission is ordered to adopt, without inquiry or modification, the lesser of two figures determined by the buyer and seller.

The Commission's reconciliation of Section 1329 with other provisions of the Code does not make Section 1329 any less unconstitutional.

B. Section 1329 Is Unconstitutional Because the Commission Is Prevented from Balancing Customers' and Public Utility Investors' Interests

Instead of *balancing* the needs of public utility investors and customers, as Section 1301(a) of the Public Utility Code and the Pennsylvania and U. S. Constitutions require, Section 1329 prevents such balancing by dictating the municipal seller's value for ratemaking purposes and the amount that must be included in the utility buyer's rate base in its next rate case.

In stark contrast to the Commission's *comprehensive* jurisdiction over service, rates, and certificates of public convenience of conventional and monopolistic public utilities, Section 1329(c)(1)(i) mandates that the ratemaking rate base "*shall* be incorporated into the rate base of (i) the acquiring public utility during the acquiring public utility's next base rate case" and Section

[70] *Cheltenham & Abington Sewerage Co. v. Pa. Pub. Util. Comm'n*, 25 A.2d 334, 337 (Pa. 1942).

1329(d)(3)(i) requires that the Commission's acquisition application approval order *shall* specify the RMRB figure as determined in Section 1329(c)(2) and defined in Section 1329(g)**.**

These mandates make clear that the legislation intends to deprive the Commission of the authority to modify the RMRB in its combined Sections 1102/1329 application approval order and to challenge or allow modification of the RMRB amount in the next post-acquisition rate case filed under Section 1308. Although the Commission has reconciled the first mandate under a rule of statutory construction and may attempt to do so regarding the second mandate, neither mandate can be reconciled *constitutionally* with Section 1301(a)'s requirement that every rate be just and reasonable.

The United States Supreme Court's seminal decision in *Federal Power Commission v. Hope Natural Gas Co*.[71] noted that there were no applicable constitutional requirements more exacting than the requirement of "just and reasonable" rates set forth in the federal Natural Gas Act.[72] In 1968, the Court's decision in *Permian Basis Area Rate Cases* held that "the just and reasonable standard of the Natural Gas Act 'coincides' with the applicable constitutional standards … and any rate selected by the [Federal Power] Commission from the broad zone of reasonableness permitted by the Act cannot properly be attacked as confiscatory."[73]

Quoting these decisions, the Pennsylvania Supreme Court in *Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission*[74] held that the "constitutionally based requirement of

[71] *Federal Power Comm'n v. Hope Nat. Gas. Co*., 320 U.S. 591 (1944).

[72] *Hope*, 320 U.S. at 607.

[73] *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968), *reh. den*. 392 U.S. 917 (1968) (citing *FPC v. Natural Gas Pipeline Co*., 315 U.S. 575, 585-586 (1942)).

[74] *Pennsylvania Elec. Co. v. Pa. Pub. Util. Comm'n*, 502 A.2d 130 (Pa. 1985) (hereinafter *Pennsylvania Electric*); *see also Popowsky v. Pa. Pub. Util. Comm'n*, 665 A.2d 808 (Pa. 1995) (holding that, in determining just and reasonable rates, the Commission has discretion to determine the proper balance between the interests of ratepayers and utilities).

'just and reasonable' rates, under the Fifth and Fourteenth Amendments, is in effect embodied in terminology found in the Pennsylvania Public Utility Law," noting that the Court had recently stated:

> Indeed, in Pennsylvania Public Utility Commission v. Pennsylvania Gas and Water Co., 492 Pa. 326, 337, 424 A.2d 1213, 1219 (1980), cert. den. 454 U.S. 824, 102 S.Ct. 112, 70 L.Ed2d 97 (1981), we stated that the requirement of "just and reasonable" rates set forth in the Public Utility Law, 66 P.S. § 1141 (repealed 1978: reenacted at 66 Pa.C.S.A. § 1301), "confer[s] upon the regulatory body the power to make and apply policy concerning the appropriate *balance* between prices charged to utility customers and returns on capital to utility investors *consonant with constitutional protections* applicable to both."[75]

Regarding the considerations to be taken into account in applying the "just and reasonable" rates standard, the Court acknowledged *Hope's* emphasis that the focus of inquiry is properly upon the end result or "total effect" of the rate order, rather than upon the rate-setting method employed, but stressed that *Hope* still required that the rate-setting method must involve "a balancing of the investor and the consumer interests."[76]

The Court summarized the point by saying:

> In short, Hope sets forth a balancing test, like that which we described in Pennsylvania Gas, supra, for the determination of "just and reasonable" rates, to be applied with the aim of protecting consumers against exploitation at the hands of utility companies while seeking to preserve the financial integrity of utility companies.[77]

Thus, balancing of investor and customer interests forbids favoring either. Anticipating the complaint of the water company promoters of Section 1329 that they were at risk of not receiving

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[75] *Id*., *Pennsylvania Elec. Co*., 502 A.2d at 133 (emphasis original).

[76] *Id*., quoting *Hope*, 320 U.S. at 602 & 603.

[77] *Id*., 502 A.2d at 133.

full recovery of their investments in distressed municipal systems (and thus needed the certain recovery that a new Section 1329 would provide them), the Court in *Pennsylvania Electric* stated:

> We find no authority, in Hope or in other decisions, indicating that broad public interests are to yield to the interests of investors whenever the financial integrity of a utility company is imperiled.
>
> In cases where the balancing of consumer interests against the interests of investors causes rates to be set at a "just and reasonable" level which is insufficient to ensure the continued financial integrity of the utility, it may simply be said that the utility has encountered one of the risks that imperil any business enterprise, namely the risk of financial failure. The express language of the Hope decision weighs against regarding utilities as a protected class of business enterprises which are to be relieved of such normal business risks. Specifically, it was stated in Hope, 320 U.S. at 603, 64 S.Ct. at 288, 88 L.Ed. at 345, that investment returns to utility owners "should be commensurate with returns on investments in other enterprises having corresponding *risks*," (emphasis added). In addition, the Hope decision observed, "'regulation does not insure that the business shall produce net revenues.' [quoting Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 590, 62 S.Ct. 736 [745], 86 L.Ed. 1037, 1052 (1942)]." 320 U.S. at 603, 64 S.Ct. at 288, 88 L.Ed. at 345. The risks which utilities are to bear were further noted in Natural Gas Pipeline, 315 U.S. at 590, 62 S.Ct. at 745, 86 L.Ed. at 1052, where it was stated that "the hazard that the property will not earn a profit remains on the company in the case of a regulated, as well as an unregulated business." Since the risk of nonprofitability remains upon regulated utility companies, it follows that the consequence of that lack of profitability, to wit diminished financial integrity, also rests upon utility companies. Indeed, the Hope decision accorded implicit recognition to the fact that, in determining "just and reasonable" rates there may be circumstances in which investor interests in the financial integrity of the enterprise may fail to be fulfilled….[78]

The U.S. Supreme Court's last decision on the subject, *Duquesne Light Co. v. Barasch*,[79] confirmed its prior decisions. As the Court required a balancing of investor and consumer interests in *Hope*, so too the Court looked to state regulatory commissions to set the balance among the competing interests in rate regulation: "The Constitution within broad limits leaves the States free

[78] *Id*., 502 A.2d at 134-135 (emphasis original).

[79] *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

to decide what ratesetting methodology best meets their needs *in balancing the interests of the utility and the public*."[80]

Furthermore, the *Duquesne* Court, which affirmed the disallowance of utility recovery of the expended construction costs of a canceled nuclear power plant, recognized that consumers could not be burdened with prudently incurred costs of unproductive assets, just as it concluded in *Market Street Railway Co. v. Railroad Comm'n of California*[81] that economic failure could result in investor losses.

Section 1329 is unquestionably unconstitutional because it prevents balancing investors' and customers' interests by dictating the municipal seller's value for ratemaking purposes and the amount that must be included in the utility buyer's rate base in its next rate case.

Again, the Commission's reconciliation of Section 1329 with other Code sections does not lessen its unconstitutionality.

C. Section 1329 Unconstitutionally Delegates the Commission's Authority to Determine Valuation to Private Individuals and Entities Lacking Political Responsibility and Accountability

Article II, § 1 of the Pennsylvania Constitution provides that the legislative power of the Commonwealth is vested in a General Assembly consisting of a Senate and a House of Representatives. The General Assembly is the exclusive lawmaking body, and it may not delegate the power to enact laws.[82] "[I]t is axiomatic that the Legislature cannot delegate its power to make

[80] *Id*., 488 U.S. at 316 (emphasis added).

[81] *Market St. Ry. Co. v. Railroad Comm'n of California*, 324 U.S. 548 (1945) (holding that investors' interests did not protect a nearly defunct rail system in San Francisco from a rate reduction, stating that "[t]he due process clause … has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces." 324 U.S. at 567).

[82] *Belovsky v. Redevelopment Authority of City of Philadelphia*, 54 A.2d 277 (Pa. 1947).

laws to any other branch of government, *or to any other body or authority*."[83] This non-delegation principle seeks to ensure that "duly authorized and politically responsible officials make all policy decisions, thereby demanding accountability,"[84] and it protects against "arbitrary exercise and uncontrolled discretionary power."[85]

Thus, the General Assembly may not delegate its power to make laws or to create public mandates with the force of law to private individuals who are not politically responsible officials or to private entities (including private, investor-owned public utilities) that are not politically responsible.[86]

In the field of public utility regulation, the General Assembly had never done so until the enactment of Section 1329 in 2016, which delegates the Commission's authority to value municipal property for ratemaking purposes to private Utility Valuation Experts to conduct appraisals of municipal property that are averaged to arrive at a fair market value that becomes the RMRB if it is lesser than the purchase price.

Alternatively, if the purchase price is lesser than the fair market value, the unconstitutional delegation is to a private, investor-owned public utility and to a municipality that has no authority to supplant the Commission's authority to determine property valuation for ratemaking purposes.

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[83] *State Board of Chiropractic Examiners v. Life Fellowship of Pennsylvania*, 272 A.2d 478, 480 (Pa. 1971) (emphasis added).

[84] *Wm. Penn Parking Garage, Inc. v. City of Pittsburgh*, 346 A.2d 269, 291 (Pa. 1975).

[85] *Id*.

[86] *See*, *e.g.*, *A. L. A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, 537 (1935) (holding that a delegation of legislative authority to trade or industrial associations, empowering them to enact laws for the rehabilitation and expansion of their trades or industries, is utterly inconsistent with the constitutional prerogatives and duties of Congress).

As discussed above, Section 1329 forecloses any role for the Commission besides including the lesser of the FMV and the purchase price in its order approving the acquisition. Thus, neither the public utility nor the municipality is accountable for determining the RMRB and its subsequent inclusion in the utility's rate base. Individually and collectively, they may arbitrarily exercise uncontrolled discretionary power.

The Commission cannot reconcile this Section 1329 infirmity with other provisions of the Code because it has no authority to change the section's methodology. Nevertheless, the section is utterly unconstitutional.

V. RECOMMENDATIONS

Regarding the proposals in the TSIO:

1. The Commission has been saddled with implementing a blatantly unconstitutional statute that is at odds not only with the Pennsylvania and U.S. Constitutions but also with fundamental provisions of the Public Utility Code (chiefly Section 1301(a)) and the Commission's and its predecessor's historic valuation methods.

Act 12 of 2016 was a needless overreach that could have been avoided by simply amending Section 1327(a) to allow for the inclusion of contributed property in a municipal system's valuation for purposes of computing an appropriate acquisition adjustment.

If the large water companies can lobby the legislature for single tariff pricing, the Distribution System Improvement Charge, fully projected future test years, liability of water customers for sewer revenue deficiencies, enactment and amendment of Section 1327, and Act 12, *the Commission*, having been delegated the legislature's authority under the police power to

regulate public utilities, *should as the Legislature's expert agency, likewise proactively urge the legislature to repeal Act 12 and amend Section 1327 as just described*.[87]

If it remains passive and only reactive, it is complicit in the continued imposition of unconstitutional, exploitative, exorbitant rates on the customers of the Commonwealth's three largest water companies.

2. As the witnesses who testified before the Pennsylvania Senate Consumer Affairs Committee correctly noted, if depreciated original cost valuation was adopted as a replacement for "fair value" as then practiced (a mixture of depreciated original cost and depreciated reproduction cost), it would be necessary to increase the overall rate of return on rate base to reflect the effects of obsolescence, wear and tear, and inflation on much of the utility plant then in service. After depreciated original cost was adopted by an amendment to Section 1311(b) in 1984, such increases in overall rate of return presumably occurred.

As a result of over twenty Section 1329 application approvals and the inclusion of RMRB amounts in the utilities' rate bases, those rate bases contain a mixture of original cost/reproduction cost, original cost, and inflated RMRB valued property. In subsequent rate cases after Section 1329 application approvals, the Commission must reduce the overall rate of return to reflect the inflated RMRB amounts which were adopted by an inappropriate and unconstitutional "fair market value" method.

[87] Commission requests to the legislature for needed changes in the public utility laws began with the Pennsylvania State Railroad Commission's first annual report in 1908. In its annual report for 1910, the Commission asked the legislature for an amendment to its organic law that would strengthen its authority by allowing it to enforce its recommendations in the courts of law. The legislature finally responded by replacing the Commission with the Public Service Commission in the Pennsylvania Public Service Company Law of 1913. *See* Arthur U. Ayres, *The Pennsylvania State Railroad Commission*, 26 QUARTERLY J. OF ECONOMICS 792, 796 (Aug. 1912), *available at* https://www.jstor.org/stable/1883807.

3. Again, because of Section 1329's inappropriateness and unconstitutionality, the Commission must more stringently exercise its authority to deny Section 1102 acquisition applications if the accompanying Section 1329 application will produce excessive rates. After the Pennsylvania Commonwealth Court's *McCloskey* decision,[88] excessive rates resulting from the determination of RMRB and its inclusion in the utility's rate base may outweigh the typical alleged benefits of the transaction and the Commission's encouragement of regionalization and consolidation in the water and sewer industries. The resulting rate *estimates* are known and must be noticed to the affected customers, as the TSIO's second proposal recognizes.

Given the massive annual rate increases that have already occurred because of Section 1329 application approvals, with the prospect of ever-greater increases as such applications multiply, *the importance cannot be overstated of the need for the Commission to vigorously enforce its Section 1102 authority to offset its exclusion from the Section 1329 process that determines the RMRB.*

Of course, the Section 1102 proceeding is not a substitute for the Section 1308 rate proceeding that follows, when all the utility's revenues and expenses are before the Commission and subject to challenge by the Commission and interested parties. But it is an essential "first line of defense" against the effects of excessive rates caused by inflated acquisition purchase prices.

4. For the Commission and interested parties to review and challenge combined Section 1102/1329 applications adequately, the six-month period allotted by Section 1329(d)(2) must be removed or extended. It reflects the impertinent view that the Commission's only role in determining the RMRB is to rubberstamp the work product of the seller and buyer and their UVE agents. On December 12, 2023, Consumer Advocate Patrick Cicero forcefully and convincingly

[88] *McCloskey v. Pa. Pub. Util. Comm'n*, 195 A.3d 1055 (Pa. Cmwlth. 2018).

justified the removal of the time limitation in his testimony to the House Committee on Consumer Protection, Technology and Utilities.[89]

Barring such removal, the Commission may for good cause treat Section 1329(d)(2) as directory rather than mandatory because it provides no penalty for non-compliance that would render the proceeding a nullity.[90]

Respectfully submitted,

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[89] *See supra* note 42 at 9-11.

[90] *See*, *e.g.*, *JPay, Inc. v. Dep't of Corr. & Governor's Office of Admin.*, 89 A.3d 756, 763 (Pa. Cmwlth. 2014) ("While both mandatory and directory provisions of the Legislature are meant to be followed, the difference between a mandatory and directory provision is the consequence for non-compliance: a failure to strictly adhere to the requirements of a directory statute will not nullify the validity of the action involved."). Disobedience to a mandatory clause renders the action illegal and void. *Zemprelli v. Thornburgh*, 407 A.2d 102, 108 (Pa. Cmwlth. 1979).

APPENDIX A

1329. Valuation of acquired water and wastewater systems.

(a) Process to establish fair market value of selling utility.--Upon agreement by both the acquiring public utility or entity and the selling utility, the following procedure shall be used to determine the fair market value of the selling utility:

(1) The commission will maintain a list of utility valuation experts from which the acquiring public utility or entity and selling utility will choose.

(2) Two utility valuation experts shall perform two separate appraisals of the selling utility for the purpose of establishing its fair market value.

(3) Each utility valuation expert shall determine fair market value in compliance with the Uniform Standards of Professional Appraisal Practice, employing the cost, market and income approaches.

(4) The acquiring public utility or entity and selling utility shall engage the services of the same licensed engineer to conduct an assessment of the tangible assets of the selling utility. The assessment shall be incorporated into the appraisal under the cost approach required under paragraph (3).

(5) Each utility valuation expert shall provide the completed appraisal to the acquiring public utility or entity and selling utility within 90 days of execution of the service contract.

(b) Utility valuation experts.--

(1) The utility valuation experts required under subsection (a) shall be selected as follows:

(i) one shall be selected by the acquiring public utility or entity; and

(ii) one shall be selected by the selling utility.

(2) The utility valuation experts shall not:

(i) derive any material financial benefit from the sale of the selling utility other than fees for services rendered; or

(ii) be an immediate family member of a director, officer or employee of either the acquiring public utility, entity or selling utility within a 12-month period of the date of hire to perform an appraisal.

(3) Fees paid to utility valuation experts may be included in the transaction and closing costs associated with acquisition by the acquiring utility or entity. Fees eligible for inclusion may be of an amount not exceeding 5% of the fair market value of the selling utility or a fee approved by the commission.

(c) Ratemaking rate base.--The following apply:

(1) The ratemaking rate base of the selling utility shall be incorporated into the rate base of:

(i) the acquiring public utility during the acquiring public utility's next base rate case; or

(ii) the entity in its initial tariff filing.

(2) The ratemaking rate base of the selling utility shall be the lesser of the purchase price negotiated by the acquiring public utility or entity and selling utility or the fair market value of the selling utility.

(d) Acquisitions by public utility.--The following apply:

(1) If the acquiring public utility and selling utility agree to use the process outlined in subsection (a), the acquiring public utility shall include the following as an attachment to its application for commission approval of the acquisition filed pursuant to section 1102 (relating to enumeration of acts requiring certificate):

(i) Copies of the two appraisals performed by the utility valuation experts under subsection (a).

(ii) The purchase price of the selling utility as agreed to by the acquiring public utility and selling utility.

(iii) The ratemaking rate base determined pursuant to subsection (c)(2).

(iv) The transaction and closing costs incurred by the acquiring public utility that will be included in its rate base.

(v) A tariff containing a rate equal to the existing rates of the selling utility at the time of the acquisition and a rate stabilization plan, if applicable to the acquisition.

(2) The commission shall issue a final order on an application submitted under this section within six months of the filing date of an application meeting the requirements of subsection (d)(1).

(3) If the commission issues an order approving the application for acquisition, the order shall include:

(i) The ratemaking rate base of the selling utility, as determined under subsection (c)(2).

(ii) Additional conditions of approval as may be required by the commission.

(4) The tariff submitted pursuant to subsection (d)(1)(v) shall remain in effect until such time as new rates are approved for the acquiring public utility as the result of a base rate case proceeding before the commission. The acquiring public utility may collect a distribution system improvement charge during this time, as approved by the commission under this chapter.

(5) The selling utility's cost of service shall be incorporated into the revenue requirement of the acquiring

public utility as part of the acquiring utility's next base rate case proceeding. The original source of funding for any part of the water or sewer assets of the selling utility shall not be relevant to determine the value of said assets.

(e) Acquisitions by entity.--An entity shall provide all the information required by subsection (d)(1) to the commission as an attachment to its application for a certificate of public convenience filed pursuant to section 1102.

(f) Postacquisition projects.--The following apply:

(1) An acquiring public utility's postacquisition improvements that are not included in a distribution improvement charge shall accrue allowance for funds used during construction after the date the cost was incurred until the asset has been in service for a period of four years or until the asset is included in the acquiring public utility's next base rate case, whichever is earlier.

(2) Depreciation on an acquiring public utility's postacquisition improvements that have not been included in the calculation of a distribution system improvement charge shall be deferred for book and ratemaking purposes.

(g) Definitions.--The following words and phrases when used in this section shall have the meanings given to them in this section unless the context clearly indicates otherwise:

"Acquiring public utility." A water or wastewater public utility subject to regulation under this title that is acquiring a selling utility as the result of a voluntary arm's-length transaction between the buyer and seller.

"Allowance of funds used during construction." An accounting practice that recognizes the capital costs, including debt and equity funds that are used to finance the construction costs of an improvement to a selling utility's assets by an acquiring public utility.

"Entity." A person, partnership or corporation that is acquiring a selling utility and has filed or whose affiliate has filed an application with the commission seeking public utility status pursuant to section 1102.

"Fair market value." The average of the two utility valuation expert appraisals conducted under subsection (a)(2).

"Ratemaking rate base." The dollar value of a selling utility which, for postacquisition ratemaking purposes, is incorporated into the rate base of the acquiring public utility or entity.

"Rate stabilization plan." A plan that will hold rates constant or phase rates in over a period of time after the next base rate case.

"Selling utility." A water or wastewater company located in this Commonwealth, owned by a municipal corporation or authority

that is being purchased by an acquiring public utility or entity as the result of a voluntary arm's-length transaction between the buyer and seller.

"Utility valuation expert." A person hired by an acquiring public utility and selling utility for the purpose of conducting an economic valuation of the selling utility to determine its fair market value.

(Apr. 14, 2016, P.L.76, No.12, eff. 60 days)

APPENDIX B

1327. Acquisition of water and sewer utilities.

(a) Acquisition cost greater than depreciated original cost.--If a public utility acquires property from another public utility, a municipal corporation or a person at a cost which is in excess of the original cost of the property when first devoted to the public service less the applicable accrued depreciation, it shall be a rebuttable presumption that the excess is reasonable and that excess shall be included in the rate base of the acquiring public utility, provided that the acquiring public utility proves that:

(1) the property is used and useful in providing water or sewer service;

(2) the public utility acquired the property from another public utility, a municipal corporation or a person which had 3,300 or fewer customer connections or which was nonviable in the absence of the acquisition;

(3) the public utility, municipal corporation or person from which the property was acquired was not, at the time of acquisition, furnishing and maintaining adequate, efficient, safe and reasonable service and facilities, evidence of which shall include, but not be limited to, any one or more of the following:

(i) violation of statutory or regulatory requirements of the Department of Environmental Resources or the commission concerning the safety, adequacy, efficiency or reasonableness of service and facilities;

(ii) a finding by the commission of inadequate financial, managerial or technical ability of the small water or sewer utility;

(iii) a finding by the commission that there is a present deficiency concerning the availability of water, the palatability of water or the provision of water at adequate volume and pressure;

(iv) a finding by the commission that the small water or sewer utility, because of necessary improvements to its plant or distribution system, cannot reasonably be expected to furnish and maintain adequate service to its customers in the future at rates equal to or less than those of the acquiring public utility; or

(v) any other facts, as the commission may determine, that evidence the inability of the small water or sewer utility to furnish or maintain adequate, efficient, safe and reasonable service and facilities;

(4) reasonable and prudent investments will be made to assure that the customers served by the property will receive adequate, efficient, safe and reasonable service;

(5) the public utility, municipal corporation or person whose property is being acquired is in agreement with the acquisition and the negotiations which led to the acquisition were conducted at arm's length;

(6) the actual purchase price is reasonable;

(7) neither the acquiring nor the selling public utility, municipal corporation or person is an affiliated interest of the other;

(8) the rates charged by the acquiring public utility to its preacquisition customers will not increase unreasonably because of the acquisition; and

(9) the excess of the acquisition cost over the depreciated original cost will be added to the rate base to be amortized as an addition to expense over a reasonable period of time with corresponding reductions in the rate base.

(b) Procedure.--The commission, upon application by a public utility, person or corporation which has agreed to acquire property from another public utility, municipal corporation or person, may approve an inclusion in rate base in accordance with subsection (a) prior to the acquisition and prior to a proceeding under this subchapter to determine just and reasonable rates if:

(1) the applicant has provided notice of the proposed acquisition and any proposed increase in rates to the customers served by the property to be acquired, in such form and manner as the commission, by regulation, shall require;

(2) the applicant has provided notice to its customers, in such form and manner as the commission, by regulation, shall require, if the proposed acquisition would increase rates to the acquiring public utility's customers by an amount in excess of 1% of the acquiring public utility's base annual revenue;

(3) the applicant has provided notice of the application to the Director of Trial Staff and the Consumer Advocate; and

(4) in addition to any other information required by the commission, the application includes a full description of the proposed acquisition and a plan for reasonable and prudent investments to assure that the customers served by the property to be acquired will receive adequate, efficient, safe and reasonable service.

(c) Hearings.--The commission may hold such hearings on the application as it deems necessary.

(d) Forfeiture.--Notwithstanding section 1309 (relating to rates fixed on complaint; investigation of costs of production), the commission, by regulation, shall provide for the removal of

the excess costs of acquisition from its rates, or any portion thereof, found by the commission to be unreasonable and to refund any excess revenues collected as a result of this section, plus interest, which shall be the average rate of interest specified for residential mortgage lending by the Secretary of Banking in accordance with the act of January 30, 1974 (P.L.13, No.6), referred to as the Loan Interest and Protection Law, during the period or periods for which the commission orders refunds, if the commission, after notice and hearings, determines that the reasonable and prudent investments to be made in accordance with this section have not been completed within a reasonable time.

(e) Acquisition cost lower than depreciated original cost.-- If a public utility acquires property from another public utility, a municipal corporation or a person at a cost which is lower than the original cost of the property when first devoted to the public service less the applicable accrued depreciation and the property is used and useful in providing water or sewer service, that difference shall, absent matters of a substantial public interest, be amortized as an addition to income over a reasonable period of time or be passed through to the ratepayers by such other methodology as the commission may direct. Notice of the proposed treatment of an acquisition cost lower than depreciated original cost shall be given to the Director of Trial Staff and the Consumer Advocate.

(f) Reports.--The commission shall annually transmit to the Governor and to the General Assembly and shall make available to the public a report on the acquisition activity under this title. Such report shall include, but not be limited to, the number of small water or sewer public utilities, municipal corporations or persons acquired by public utilities, and the amounts of any rate increases or decreases sought and granted due to the acquisition.

(Apr. 4, 1990, P.L.107, No.24, eff. 60 days; June 1, 1995, P.L.49, No.7, eff. 60 days; Feb. 14, 2012, P.L.72, No.11, eff. 60 days)

2012 Amendment. Act 11 amended subsec. (b) intro. par.

References in Text. The Department of Environmental Resources, referred to in subsec. (a), was abolished by Act 18 of 1995. Its functions were transferred to the Department of Conservation and Natural Resources and the Department of Environmental Protection.