at 24 (citing Aqua M.B. at 74-75). Aqua explains that it updated its insurance claim to reflect actual general liability expense information for the Year 2022 that became available after the case had been filed. Aqua Exc. at 24 (citing Aqua M.B. at 75). Aqua further submits that it then used I&E's proposed three-year average percentage increase to this expense to adjust the final quarter of the FPFTY. Aqua Exc. at 24 (citing Aqua M.B. at 75-76; Aqua St. 4-R at 6-7).

Aqua provides that although the ALJ concluded that the Company improperly mixed calculation elements, there is nothing unusual or improper in updating the claim to reflect known, actual information for FY 2022, or in developing the FPFTY claim using three quarters of that actual data and one quarter of projected data using the same adjustment factor (4.38%) proposed by both the OCA and I&E. According to Aqua, there is no evidence of record to support I&E's concerns regarding the reliability of this information. Aqua Exc. at 24 (citing Aqua R.B. at 30).

Aqua avers that the Recommended Decision inconsistently accepts I&E's calculation as credible but rejects Aqua's calculation which uses the same method updated with the most recent data available. Aqua Exc. at 25.

In its reply to Aqua Exception No. 5, I&E notes that after reviewing the record evidence presented by all parties, the ALJ correctly concluded that Aqua failed to provide adequate documentation in support of its treatment of insurance expense and the mixing of calculation elements is not justified for the purposes of projecting expense increases. I&E R. Exc. at 8-9 (citing R.D. at 59).

4. Disposition

I&E notes that the Company has recorded its calendar year 2022 insurance expense for accounting purposes, similarly updating the claim for ratemaking purposes, and on a consolidated basis the accrual produces a year-over-year increase of 8.49% between calendar year 2021 and 2022 based on premiums the Company will pay in 2022. I&E St. 1-SR at 14 (citing Aqua St. 4-R at 6). I&E explains that the Company has updated its entire FTY claim for insurance and the first nine months of the FPFTY (April 1, 2022 through December 31, 2022) based on the recently determined accruals. I&E explains further that the final three months of the FPFTY (January 1, 2023 through March 31, 2023) were inflated using a 4.38% increase to the FTY result. *Id.*

I&E provided the updated expense portion of the insurance claims, noting that the revised claims for all the wastewater revenue requirements have decreased from direct testimony to rebuttal testimony with no explanation for the directional change. I&E St. 1-SR at 15. We agree with I&E, that Aqua has not provided an explanation for these updated insurance claims and provided no documentation for the recent 2022 accruals to support the changes in rebuttal testimony.

Therefore, we shall deny Aqua's Exception No. 5, and adopt the ALJ's recommendation that Aqua's claim for insurance expense should be decreased by $340,945, or from $4,915,277 to $4,574,332 for water and increased by $29,967, or from $39,853 to $69,820 for wastewater. The wastewater adjustments are comprised of: (1) an increase for Wastewater Base of $18,640, or from $16,327 to $34,967; (2) an increase for Limerick of $3,533, or from $5,613 to $9,146; (3) an increase for East Bradford of $789, or from $1,232 to $2,021; (4) an increase for Cheltenham of $6,299, or from $9,814 to $16,113; (5) an increase for East Norriton of $1,382, or from $4,915 to $6,297; and (6) a decrease for New Garden of $676, or from $1,952 to $1,276. R.D. at 59; I&E St. 1-SR at 16. These adjustments are outlined in Table II-Adjustments in each of the groups of rate tables in the Commission Tables Calculating Allowed Revenue Increase, attached to this Opinion and Order.

C. Payroll

1. Positions of the Parties

Both I&E and the OCA proposed adjustments to Aqua's claim for payroll expense. I&E proposed a vacancy rate of 6.83%. The OCA proposed a vacancy rate of 2.88%, rather than the Company's 2.50%. Aqua opposed I&E's vacancy rate but accepted the OCA's 2.88% full time vacancy rate. Aqua M.B. at 66. Aqua's witness, Ms. Erin M. Feeney, explained that I&E's adjustment double counts the adjustment already built into the Company's claim as a part of the gross payroll amounts. Aqua M.B. at 66 (citing Aqua St. 2-R at 37; Aqua St. 2 at 11). Subsequently, I&E withdrew its adjustment for payroll expense. Aqua M.B. at 66 (citing I&E St. 1-SR at 25).

The OCA calculated its vacancy rate of 2.88% based on information provided in response to I&E-RE-22-D. According to the OCA, the 2.88% vacancy rate is based on the difference between actual regular hours and authorized regular hours during the HTY, and more accurately reflects Aqua's expense. OCA M.B. at 33-34 (citing OCA St. 1 at 41-42). The OCA proposed an adjustment decreasing payroll expense by $119,358 for the Company's water operations and $6,855 for wastewater operations. The OCA provided that in aggregate, this calculation decreases payroll expense by $126,213. OCA M.B. at 34 (citing OCA St. 1 at 44-45; OCA Exh. LA-2, Sch. C-11 at 2).

The OCA proposed an additional adjustment to payroll expense by reducing the number of seasonal positions included in the Company's claim to reflect the level of seasonal employees as of June 30, 2021. Aqua M.B. at 67 (citing OCA St. 1 at 43-44).

2. Recommended Decision

The ALJ recommended that the Company's payroll expense as updated with the OCA's 2.88% vacancy rate should be accepted. R.D. at 60 (citing Aqua Exh. 1-A(a) and 1-B(b) through 1-G(g)). The ALJ reasoned that Aqua had supported its projection for seasonal positions with the testimony of Ms. Feeney. Specifically, the ALJ stated that the 2020 and 2021 number of seasonal positions filled were impacted by the COVID-19 pandemic and should be considered outliers. The ALJ noted that Aqua anticipates filling all thirty-three seasonal positions during the FPFTY. R.D. at 60 (citing Aqua St. 2-R at 39).

3. OCA Exception No. 5 and Replies

In its Exception No. 5, the OCA disagrees with the ALJ's finding that Aqua has adequately supported its claim for thirty-three seasonal employees. The OCA submits that while Aqua may believe that it will fill all thirty-three of its budgeted-for seasonal positions in the FPFTY, the Company has failed to provide evidence that this is likely. According to the OCA, the record indicates that Aqua has not consistently filled all of its seasonal positions even before the COVID-19 pandemic began. OCA Exc. at 6-7 (citing OCA M.B. at 34-35). The OCA provides that in 2019, Aqua filled only thirty-one of the budgeted thirty-three positions. During the pandemic, the OCA continues, Aqua filled only eleven out of thirty-three budgeted positions. OCA Exc. at 7 (citing OCA St. 1SR at 32-33). The OCA avers that it is not reasonable to assume that Aqua's hiring will be more robust than before the pandemic. The OCA recommends an adjustment of $286,373 to remove payroll expense for twenty-two of the authorized seasonal positions. OCA Exc. at 7.

In its reply to OCA Exception No. 5, Aqua argues that the ALJ correctly reasons that the payroll expense claim, including the seasonal positions, is "based upon anticipated normal operating conditions" during the FPFTY. Aqua R. Exc. at 5 (citing R.D. at 61). Aqua contends that the seasonal employee counts for 2020 and 2019 were impacted by the COVID-19 pandemic and are not reflective of normal operating conditions. Aqua R. Exc. at 5.

4. Disposition

The seasonal employment period runs from mid-May to mid-September. I&E Exh. 1, Sch. 5 at 2. The OCA contends that the seasonal employee count should reflect the level as of June 30, 2021 when eleven positions were filled. We disagree with the OCA's recommendation. The record does not clearly indicate that the number of seasonal employee positions as of June 30, 2021 reflects the total number employed through the seasonal employment period for 2021, or going forward. The Company filled thirty-one seasonal positions in 2019. The Company has noted that it expects to return to more normal operations. We agree with the ALJ that the Company's assertion that it will be able to fill thirty-three seasonal positions going forward in the FPFTY is reasonable. The OCA Exception No. 5 is denied.

D. Stock-based Incentive Compensation

1. Positions of the Parties

Aqua has included expenses related to its stock-based incentive compensation program. Aqua maintained that this is an important part of its overall compensation program. R.D. at 61. Aqua averred that it is entitled to recover, in rates, all expenses reasonably necessary to provide service to customers. According to Aqua, the OCA has not claimed that the total stock reward expenses were unreasonable, imprudent, or excessive. Aqua noted that the OCA objected to the expenses on the basis that shareholders benefit from increases in stock prices, without consideration for the customer benefits derived from achievement of the customer performance metrics applied to stock rewards. Aqua M.B. at 69.

Aqua stated that the Commission has established a bright line test for incentive compensation expense. According to Aqua, if the incentive compensation programs of the utility are reasonable and provide a benefit to ratepayers, then they may be recovered in their entirety. Aqua M.B. at 69 (citing *2012 PPL Order* at 26). Aqua noted that the Commission recently applied this standard in approving the recovery of stock-based incentive compensation in *Pa. PUC v. UGI Utilities, Inc. – Electric Division*, Docket No. R-2017-2640058 (Order entered October 25, 2018) (*UGI Electric*).

Aqua averred that it demonstrated that its stock reward plans include both financial and operating metrics and goals. Aqua provided that it further demonstrated that its incentive compensation package is reasonable, prudently incurred and not excessive in amount. Aqua's witness, Mr. William C. Packer, explained:

> [A] key component of the incentive compensation plan is employee objectives that provide benefits to customers. Many of the employee objectives focus on cost containment, quality service, productivity enhancements and compliance initiatives to ensure reasonable cost and high-quality service to our customers.

Aqua M.B. at 70 (citing Aqua St. 1-R at 17-18).

I&E did not object to the Company's proposed incentive compensation plan expense.

The OCA acknowledged that where an incentive compensation plan is reasonable, prudently incurred, not excessive, and there is a benefit to ratepayers, a company may recover the expense of that program. The OCA noted that the Commission has approved recovery for incentive compensation programs when they are focused on improving operational effectiveness. OCA M.B. at 36 (citing *2012 PPL Order*).

The OCA averred that Aqua's stock-based compensation program provides Aqua and Essential Utilities executives with compensation based on the performance of the Company's or parent company's stock price. According to the OCA, absent a clear tie to ratepayer benefit or operational effectiveness, it is unreasonable to burden ratepayers with the costs of the stock compensation program. OCA M.B. at 37.

2. Recommended Decision

The ALJ accepted Aqua's position that the stock-based compensation program benefits ratepayers. The ALJ explained that the Company described how the purpose of the plan is to tie compensation to employees accomplishing the Company's main objectives, which benefits consumers. R.D. at 62 (citing Aqua St. 1-R at 15-16). The ALJ further explained that Aqua stated that compensation from the program is both "competitive" and "appropriate." The ALJ noted that the Company has been using the program since 1999,[47] and thus claims that the program is a key element of its overall payment package in attracting and keeping a skilled workforce. R.D. at 62 (citing Aqua St. 1-R at 17). The ALJ reasoned that the OCA's argument that the program also benefits stockholders is not sufficient to demonstrate that the program is unreasonable or excessive. R.D. at 63.

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[47] We note that the Company states that the Incentive Compensation Plan was started in 1990. Aqua St. 1-R at 16.

3. OCA Exception No. 4 and Replies

In its Exception No. 4, the OCA disagrees with the ALJ's findings regarding Aqua's stock-based incentive compensation program. The OCA recommends an adjustment of $846,493 to remove these costs. OCA Exc. at 4-5 (citing OCA M.B. at 36-39; OCA Table II (Water); Table II (Wastewater)). According to the OCA, the ALJ noted that since the purpose of the plan is to tie compensation to employees accomplishing the Company's objectives, the program must ultimately benefit consumers. OCA Exc. at 5 (citing R.D. at 62). The OCA contends that Aqua has failed to demonstrate that the key component of the program is to establish employee eligibility based on performance duties and metrics that are "*directly related to the provision of service*." OCA Exc. at 5 (citing *Pa. PUC v. Pennsylvania American Water Co.*, 2021 Pa. PUC LEXIS 55 (*PAWC 2021*) at *59-60).

The OCA provides that although, in theory, a payment program which benefits stockholders might also benefit consumers, in this case, the payment program has no clear relationship to ratepayer benefits or operational effectiveness. OCA Exc. at 5 (citing OCA St. 1 at 48). The OCA avers that the stock-based incentive compensation program appears to have the primary purpose of benefitting executives and high-level managers. However, the OCA argues that no evidence has been provided to show the benefits of the payment program to ratepayers. OCA Exc. at 5 (citing OCA St. 1SR at 36).

The OCA highlights the ALJ's statement that Aqua has established that compensation from the program is both "competitive" and "appropriate." OCA Exc. at 5 (citing R.D. at 62). While this may be true, the OCA argues, it is irrelevant to whether the program is benefitting ratepayers and whether it should be funded by ratepayers. OCA Exc. at 5.

The OCA avers that Aqua's incentive compensation program is not reasonable or prudently incurred. In addition, the OCA insists that there is no evidence that it provides any benefit to ratepayers and, accordingly, Aqua should not be able to recover the plan expenses from ratepayers. The OCA remains of the opinion that its $846,493 adjustment to remove these costs for ratemaking should be adopted. OCA Exc. at 6 (citing OCA M.B. at 36-39; OCA Table II (Water) and (Wastewater)).

In its reply to the OCA Exception No. 5, Aqua avers that the incentive compensation has been paid each year since 1990, demonstrating that the plan is successful in encouraging the accomplishment of Aqua's key objectives and the ongoing control over operating costs. Aqua R. Exc. at 4 (citing Aqua St. 1-R at 16-17).

I&E did not offer a reply to OCA Exception No. 5.

4. Disposition

We find that Aqua has provided evidence linking the stock-based incentive compensation program with benefits to customers and improved operational efficiency. Aqua's witness Mr. Packer explained that with the implementation of the Incentive Compensation Plan in 1990, a portion of an employee's total cash compensation was placed "at risk" pending the achievement of key performance objectives. The employee's progress toward these performance objectives was used to determine the employee's resulting percentage of a target bonus. Aqua St. 1-R at 15.

Mr. Packer explained further the rationale of the Company's incentive compensation plan as follows:

> The purpose of the Plan is to tie employee compensation to the accomplishment of the Company's key operating objectives, thereby ensuring that the entire workforce is

> working toward the same end. Customers benefit from the participant's individual objectives being met, as improvements in performance are accomplished by controlling costs, improving efficiencies and enhancing customer service. As a result, the need for rate relief is mitigated.

Aqua St. 1-R at 15-16.

Mr. Packer stated that "[m]any of the employee objectives focus on cost containment, quality service, productivity enhancements and compliance initiatives to ensure reasonable cost and high-quality service to our customers." Aqua St. 1-R at 17-18. Mr. Packer provided that "[s]tock compensation is an equally important form of compensation at risk, promotes retention, and emphasizes an investment interest in the business at the employee level that promotes efforts to provide safe, adequate, and reliable utility service." Aqua St. 1-R at 19.

We agree with the ALJ that the stock-based compensation benefits ratepayers. We find that the stock-based compensation is linked to performance objectives that benefit consumers, including controlling costs and compliance initiatives. Accordingly, the OCA Exception No. 5 is denied.

E. Supplemental Executive Retirement Plan (SERP)

1. Positions of the Parties

Aqua explained that the SERP is a legacy retirement program for highly compensated individuals who did not qualify under the Company's former pension plan due to Internal Revenue Service (IRS) limitations. Aqua M.B. at 72 (citing Aqua St. 1-SR at 11-12). In April 2003, the Company closed both the pension plan and its SERP to employees hired after that date. Aqua averred that the SERP provides replacement retirement benefits for a limited number of past and present employees and their spouses who are not eligible for the Company's former pension plan. Aqua M.B. at 72 (footnote omitted).

The OCA provided that the Company's claim unreasonably imposes an expense for SERP for Essential Utilities and Aqua top executives on consumers when that expense is not affiliated with the provision of public utility service. The OCA noted that the SERP provides retirement benefits for select highly compensated executives that goes beyond what employees with qualified pension plans receive and beyond IRS limitations for qualified plans. The OCA explained that without the expense of SERP, the Company's executives would still receive retirement benefits available to any other Aqua employee. According to the OCA, an expense that exists for the purpose of providing additional compensation to executives that are already the highest paid in the Company is both excessive and unnecessary to the provision of water service. OCA M.B. at 49 (citing *Pa. PUC v. Pennsylvania American Water Co.*, 1993 Pa. PUC LEXIS 79 (*PAWC 1993*) at *121-123, 136-139 (holding that unnecessary expenditures that do not relate to the provision of utility service should not be borne by ratepayers)). The OCA argued that while the Company is free to provide these additional retirement benefits to its executives, it should do so at the expense of shareholders rather than ratepayers. The OCA recommended removing the requested FPFTY expenses of $695,612 for the water utility and $57,050 for the wastewater utility. OCA M.B. at 49 (citing OCA St. 1 at 62; OCA Exh. LA-2, Sch. C-18; Table II (Water); Table II (Wastewater Base)).

2. Recommended Decision

The ALJ noted that the SERP is not associated with retaining or recruiting executive talent. R.D. at 63. The ALJ provided that Aqua did not demonstrate that the SERP is connected to employee performance metrics that relate to the provision of utility service. The ALJ recommended the SERP expenses be excluded and that $695,612 for the water utility and $57,050 for the wastewater utility be removed from the requested FPFTY expenses. For wastewater, the ALJ recommended that the $57,050 adjustment be allocated to each rate zone based on the relative percentage of management fees assigned to each rate zone per Aqua Exhibits 1-B to 1-G at Sch. C-1. The ALJ recommendations are as follows:

> The wastewater adjustments are comprised of decreases for Wastewater Base, Limerick, East Bradford, Cheltenham, East Norriton, and New Garden of $23,373; $8,035; $1,763; $14,049; $7,036; and $2,794; respectively. These adjustments are reflected in each rate case under [Recommended Decision, Appendix] Table II, row "Supp. Exec. Retire Program." As noted in [Recommended Decision, Appendix] Table VI for each rate zone, the cash working capital resulting from this SERP adjustment is recommended to be assigned to the management fee expense account for each rate zone.

R.D. at 63-64.

3. Aqua Exception No. 6 and Replies

In its Exception No. 6, Aqua avers that the Recommended Decision improperly applies incentive compensation recovery criteria to a post-employment retirement benefit to reach an incorrect recommendation. Aqua explains that the SERP is a legacy retirement program, similar to the Company's pension plan but limited to certain senior level employees who did not qualify under the Company's former pension plan due to Internal Revenue Code limitations. Aqua Exc. at 25 (citing R.D. at 63). Aqua notes that the SERP provides replacement retirement benefits for the limited number of present and retired employees and their spouses who are not eligible for the Company's qualified pension plan. Aqua Exc. at 25.

Aqua maintains that eligibility for benefits each year under the SERP is not based upon performance criteria, but upon employment. When the program closed to new employees after April 2003, the pre-April 2003 employees continued to receive their promised benefits upon retirement. Aqua replaced the SERP and the pension plan with a defined contribution 401(k) program to control costs. Aqua Exc. at 26, n.15. Aqua notes that like the pension plan, the Company continues to incur costs under this legacy plan. Aqua expects the cost of the program to decline over time. Aqua Exc. at 25-26.

Aqua avers that as a post-employment benefit, recovery of the costs of the program in rates should not be measured by whether it serves as a current recruiting tool, or whether the recipient retirees have met an incentive target. Aqua Exc. at 26.

In its reply to Aqua Exc. No. 6, the OCA submits that the Company acknowledges that the SERP has no connection to the provision of utility service, to customer service, or to attracting and retaining new employees. OCA R. Exc. at 3 (citing OCA M.B. at 47-50; OCA R.B. at 23-24).

The OCA disagrees with Aqua's argument that the SERP should be included in rate recovery because excluding the program would "disincentivize utilities from changing or eliminating post-employment benefits, if the ongoing costs of a discontinued program may no longer be recoverable." OCA R. Exc. at 3 (citing Aqua Exc. at 26). The OCA contends that Aqua's argument has no basis in Commission precedent because it ignores that compensation programs wholly disconnected from utility service should never be funded, whether those programs are discontinued or current. OCA R. Exc. at 3 (citing OCA M.B. at 47-48; OCA R.B. at 23-24).

4. Disposition

We agree with the OCA, that not all costs incurred by Aqua are recoverable. While Aqua continues to incur costs from the SERP, Aqua's customers who receive no benefit from and have no ties to the SERP, should not be required to fund these costs. We agree with the ALJ's recommendation to remove the Company's FPFTY expenses of $695,612 for water and $57,050 for wastewater, in the manner outlined by the ALJ, *supra*. Accordingly, Aqua Exception No. 6 is denied.

F. Non-Rate Case Legal Expense

1. Positions of the Parties

Aqua proposed a three-year average of non-rate case legal expenses to reflect the costs incurred in a normal year, including the costs of union contract negotiations that occur on a two-year or more interval. Aqua M.B. at 80-81. Aqua's claim includes a request to recover $644,4475 in non-rate case legal expense. Aqua M.B. at 80.

The OCA recommended a reduction of $24,981 in Aqua's non-rate case legal expense to more accurately reflect the average amounts recorded by Aqua for the twelve month periods ending March 31, 2020 and March 31, 2021. OCA R.B. at 22 (citing OCA M.B. at 47). The OCA provided that its suggested two-year time frame excludes the 2019 year because the expense that year was unusual and is not representative of current or future levels of non-rate case legal expense. *Id.*

2. Recommended Decision

The ALJ reasoned that the use of a two-year average, as the OCA recommended, would fail to include expenses that occur on a two-year or more interval, such as union negotiations. The ALJ noted that according to Aqua, its proposal is consistent with its claim in prior rate cases and other expense categories that exhibit similar ebbs and flows as in this case. The ALJ found Aqua's claim based on a three-year average of non-rate case legal expenses to be reasonable. R.D. at 64-65 (citing Aqua St. 3-R at 10).

3. OCA Exception No. 3 and Replies

In its Exception No. 3, the OCA contends that the ALJ erred by accepting Aqua's claim for $644,475 for non-rate case legal expense. OCA Exc. at 3 (citing R.D. at 65). The OCA avers that this amount of non-rate case legal expense was derived from a three-year average of non-rate case legal expense. The OCA notes that it proposed averaging two years of non-rate case legal expense instead of three, to exclude the year ending March 31, 2019, in which Aqua had unusually high legal expenses. OCA Exc. at 3 (citing OCA M.B. at 47). The OCA avers that Aqua's non-rate case legal expense in the year ending March 31, 2019 was unusually high and it does not provide an accurate representation of what that expense will be in the future. OCA Exc. at 4 (citing OCA M.B. at 47). According to the OCA, Aqua's non-rate case legal expense has decreased in each of the two years following 2019. OCA Exc. at 4 (citing OCA St. 1 at 58). Additionally, the OCA contends that Aqua has failed to establish that any expenses from the 2019 year are recurring. The OCA argues that Aqua's non-rate case legal expense should be reduced by $24,981 to more closely reflect what the Company's expenses will be in the future. OCA Exc. at 4 (citing OCA M.B. at 47; OCA Exh. LA-2, Sch. C-17 at 2, Table II (Water)).

In its reply to the OCA Exception No. 3, Aqua provides that a three-year average for non-rate case legal expense accounts for the fluctuation of this expense that occurs in the normal course of business. In addition, the Company claims, that the two-year average proposed by the OCA may not capture regular cyclical legal expenses such as union contract negotiations. Aqua R. Exc. at 3 (citing Aqua M.B. at 81).

4. Disposition

We agree with the ALJ that a three-year average for non rate case legal expense is reasonable. In our view, a three-year average is more appropriate to include costs that a two-year average would not capture. Aqua's union contract negotiations are scheduled to occur during the FTY. Aqua St. 3-R at 10. As Aqua pointed out, the Company has used a three-year average for this expense in its prior rate case. Aqua M.B. at 81.[48] The OCA Exception No. 3 is denied.

G. Purchased Water Expense

1. Positions of the Parties

Aqua has included a claim for $4,135,311 for Purchased Water Expense during the FPFTY. Aqua M.B. at 81 (citing Aqua Exh. 1-A, Sch. C-7.1). The amount includes $297,839 of purchased water from Aqua Ohio. Aqua M.B. at 82 (citing Aqua Exh. 1-A, Sch. C-7.1.i, Line1).

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[48] We note that Aqua used a three-year average to calculate its Legal Expense Claim in the *Aqua 2018 Rate Case*. *Aqua 2018 Rate Case*, Aqua Exh. 1-A(a), Sched. C-9.1. This claim was included within the Settlement approved by the Commission in the *Aqua 2018 Rate Case.*

I&E proposed a decrease of $166,975, reflecting water purchases from Aqua Ohio at $0.3449 per hundred gallons. I&E St. 1-SR at 19 (citing I&E St. 1 at 19). I&E argued that the cost of purchased water (Aqua Ohio Struthers Division) should be the same as the rate Aqua Pennsylvania receives when it sells water to that same affiliate (Aqua Ohio Masury Division) for ratemaking purposes so that Pennsylvania customers are not harmed. According to I&E, the Ohio rate is not guaranteed full recovery when that tariff rate is being claimed by a Pennsylvania affiliate in a Pennsylvania rate filing. I&E M.B. at 34-35 (citing St. 1-SR at 20).

Aqua's witness, Ms. Feeney, explained that I&E's recommendation ignores the fact that Aqua's sales to the Masury Division and Aqua's purchases from the Struthers Division of Aqua Ohio are not comparable. R.D. at 66 (citing Aqua St. 2-R at 33). Aqua explained further that these sales and purchases take place in different geographic locations. Additionally, Aqua highlighted that the Masury and Struthers Divisions of Aqua Ohio are separate – each division has a separately determined cost of service, separate tariffs, and different rates. *Id.*

2. Recommended Decision

The ALJ recommended that I&E's proposed adjustment be rejected. The ALJ reasoned that there is no evidence that the purchase of water from Aqua Ohio Struthers Division at tariffed rates is imprudent or excessive. The ALJ noted that in considering the Masury contract, the Commission will determine whether the sale of water to Masury at discounted rates is appropriate. The ALJ stated that as the purchase of water from Aqua Ohio Struthers division is made pursuant to tariff rates that have been approved by the applicable authorities with jurisdiction to regulate those utility rates, Aqua's claimed purchased water expense should not be adjusted. The ALJ further reasoned this rate is unaffected by the rate to be charged by Aqua to the Masury Division, which Aqua based upon a contract rate established in relation to the cost of a competitive alternative available to the Masury Division. R.D. at 66.

3. Disposition

No Party filed Exceptions on this issue. Finding the ALJ's recommendation to be reasonable, we adopt it without further comment.

H. Dredging Expense

1. Positions of the Parties

Aqua proposed to change its dredging process and to accrue a reserve exclusively for dredging costs at a rate of $400,000 per year and charge actual costs against that reserve as they are incurred. Aqua M.B. at 85 (citing Aqua St. 3 at 5). Aqua proposed that the reserve be recorded as a regulatory liability. Aqua stated that this proposed adjustment would reduce dredging expense by approximately $300,000 over three years. Aqua would change its past practice of mobilizing and demobilizing equipment (with fixed costs of approximately $150,000 per occurrence) three times over a three-year span, to only one time over a three-year span. *Id.*

I&E recommended no adjustment to the claimed dollar amount, but recommended that Aqua's dredging expense be normalized and that the Company's proposed use of a reserve account and regulatory liability be rejected. I&E M.B. at 36 (citing I&E St. 1 at 21; I&E St. 1-SR at 21). I&E argued that dredging is a routine expense and should be normalized for ratemaking purposes. *Id.*

2. Recommended Decision

The ALJ recommended that the dredging expense be normalized and that the requested approval for deferred accounting treatment should be rejected. The ALJ reasoned that while the claimed expense may be substantial, it is not extraordinary, non-recurring, or within the scope of the type of items that the Commission has allowed as an exception to the general rule against retroactive recovery. R.D. at 67.

3. Disposition

No Party filed Exceptions on this issue. Finding the ALJ's recommendation to be reasonable, we adopt it without further comment.

I. Advertising

1. Positions of the Parties

Included in Aqua's claim for advertising expense is $75,000 for water operations and $7,500 for wastewater operations related to the advertising for the Company's proposed Universal Service Program (USP). Aqua M.B. at 86 (citing Aqua St. 2-R at 34-35; OCA Exh. LA-3, 17-18).

The OCA recommended that the Company only be permitted to recover $25,000 for water operations and $2,500 for wastewater operations for this category of advertising. Aqua M.B. at 86 (citing OCA St. 1 at 40). The OCA considered this a new expense, since it was not incurred in the HTY and FTY. The OCA proposed to normalize the FPFTY amounts claimed by Aqua for this expense over three years. Aqua M.B. at 86 (citing OCA St. 1 at 41).

Aqua provided that the program was not in effect in the HTY and will not be in effect during the FTY. Aqua proposed the new program to be in effect in the FPFTY and averred that to normalize this expense with prior years when the program did not exist is unfair. Aqua M.B. at 87.

2. Recommended Decision

The ALJ recommended that Aqua's claimed expense to advertise the proposed new USP should be accepted. The ALJ reasoned that the program is proposed to be in effect during the FPFTY and, therefore, Aqua's advertising expense reasonably projects the new amounts associated with ensuring customers are informed about the new program. R.D. at 69 (citing 66 Pa. C.S. § 1316).[49]

3. OCA Exception No. 2 and Replies

The OCA avers that normalizing this cost for customer outreach for the new USP over three years is consistent with an understanding that advertising priorities change over time. The OCA provides that normalization of a new expense being introduced for the first time in the FPFTY that may fluctuate in future rate cases is required under Commission precedent. OCA Exc. at 3 (citing *Pa. PUC v. Pennsylvania American Water Co.*, Docket Nos. R-00038304, *et al.*, 2003 Pa. PUC LEXIS 498 (Recommended Decision issued December 2, 2003) (*PAWC 2003*) at *101-102, *adopted as modified*, Order entered January 29, 2004).

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[49] *See* 66 Pa. C.S. § 1316 (permitting utilities to recover advertising expenses that "(4) Provides important information to the public regarding safety, rate changes, means of reducing usage or bills, load management or energy conservation" or "(5) Provides a direct benefit to ratepayers.").

The OCA argues that normalization would reduce the impact for rate payers, and that Aqua has failed to explain why doing so prevents it from accomplishing its goal of customer outreach. OCA Exc. at 3 (citing OCA M.B. at 32).

In its reply to the OCA Exception No. 2, Aqua contends that the ALJ correctly concluded that Aqua is permitted to recover the expense under 66 Pa. C.S. § 1316 and that to require Aqua to normalize an expense to be incurred in the FPFTY for a program to be implemented in the FPFTY is unfair. Aqua R. Exc. at 2-3 (citing R.D. at 68-69; Aqua M.B. at 86-87). Aqua avers that, as the ALJ noted, the OCA proposed increased outreach efforts for the proposed USP. Aqua R. Exc. at 3 (citing R.D. at 69). Aqua argues that the OCA offered no evidence to indicate Aqua's existing level of advertising expense, exclusive of the new CAP spending, is excessive. Aqua contends that the OCA is relying on an inapposite case that dealt with the specific variability of uncollectibles expense and not a new expense associated with a new program. Aqua R. Exc. at 3 (citing Aqua R.B. at 35; *PAWC 2003* at *101-102).

4. Disposition

We find the advertising expense for the proposed USP to be reasonable. We agree with the ALJ that to normalize the expense over three years is not fair. We do not agree with the OCA's argument that Commission precedent requires the normalization. The *PAWC 2003* citation is related to an expense that varied over three years, not an expense for a new program occurring for the first time in the FPFTY. Accordingly, the OCA Exception No. 2 is denied.

J. General Price Level Adjustment

1. Positions of the Parties

Aqua provides that its "General Price Level Adjustment" reflects the anticipated effect of inflation on operating expenses that were not specifically adjusted. Aqua M.B. at 59 (citing Aqua St. 3 at 2, Aqua Exhs. 1-A; 1-B through 1-G; Sch. C-4.1). Aqua explains that it derived its inflation factors based on the quarterly Consumer Price Index (CPI) percentage change from the same quarter in the prior year set forth in the October 10, 2020, Blue Chip Economic Indicators. Aqua explains further that "[s]ince the forecast is not available for the quarters in the FPFTY, the Company uses the last available forecasted quarterly percentage change and uses that as the annual rate to multiply inflation eligible expenses." Aqua M.B. at 59 (citing Aqua St. 3 at 3).

The OCA argued that the adjustment is a blanket inflation adjustment which does not utilize a targeted approach. Aqua M.B. at 60 (citing OCA St. 1 at 34-35). The OCA provided that Aqua's adjustments for estimated blanket inflation are inconsistent with the law and should be removed, reducing FPFTY expenses by $1.07 million. OCA M.B. at 28 (citing OCA St. 1 at 34-25; OCA Exh. LA-2, Sch. C-5; Table II (Water, Wastewater Base, Limerick, East Bradford, Cheltenham, East Norriton, New Garden)). The OCA stated that Aqua did not adequately justify the purpose behind its inflation adjustments. The OCA argued that Aqua is speculating regarding what increase, if any, is appropriate for those expenses. OCA M.B. at 28-29.

2. Recommended Decision

The ALJ agreed with the OCA that Aqua has not justified the use of a general price level adjustment to expenses. The ALJ noted that according to Aqua's witness, Mr. Christopher E. Manning, the general inflation factor would be applied to

22% of Aqua's total operating expenses. R.D. at 70 (citing Aqua St. 3-R at 3). The ALJ reasoned that while it may be simpler for Aqua to use a general inflation factor for a block of expenses, its simplicity belies the fact that Commission precedent requires specificity if an inflation factor is utilized. The ALJ explained that to permit a large, sophisticated utility like Aqua to use a general inflation factor on a group of expenses as proposed here would incentivize less accurate tracking of expenses and would disincentivize Aqua from controlling its costs. In the ALJ's view, Aqua has not demonstrated that tracking the changes in these expenses individually is unduly burdensome. R.D. at 70.

The ALJ recommended that the Company's full inflation adjustment should be removed as it is not supported by record evidence and contradicts precedent to approve inflation adjustments only when the proposed adjustments are specific and not too general. The ALJ recommended an adjustment of $864,335 for water operations and $205,560 for wastewater operations. The wastewater adjustments are comprised of decreases for Wastewater Base, Limerick, East Bradford, Cheltenham, East Norriton, and New Garden of $145,368, $23,275, $6,828, $8,719, $8,665, and $12,705, respectively. These adjustments are reflected in each rate case table under Table II, Row "General Inflation" of the Recommended Decision Appendix. As noted in Table VI of the Recommended Decision Appendix for each rate zone, the cash working capital adjustment resulting from this general inflation adjustment is recommended to be assigned to a general expense account for each rate zone that uses a number of lag days that is equal to the weighted average O&M Expense lag days for each rate zone after all other adjustments are applied. R.D. at 70-71, R.D. Appendix, Table II, Table VI.

3. Aqua Exception No. 7 and Replies

In its Exception No. 7, Aqua provides that the Commission has repeatedly held that general price adjustment factors may be applied to expenses not separately adjusted, where the utility has demonstrated the adjustments are adequately supported and relatively conservative. Aqua Exc. at 27 (citing Aqua M.B. at 61-62). Aqua states that the Commission "has consistently accepted inflation adjustments where supported by historic data demonstrating that the utility has experienced cost increases that exceed the claimed inflation increases." Aqua Exc. at 27 (citing Aqua M.B. at 62 (quoting *Pa. PUC v. Philadelphia Suburban Water Company*, Docket Nos. R-00016750, 2002 Pa. PUC LEXIS 55 (Order entered July 8, 2002) (*Philadelphia Suburban Water 2002*) at *55).

Aqua avers that the ALJ incorrectly stated that the adjustment lacked specificity. Aqua Exc. at 27 (citing R.D. at 70). Aqua notes that its Main Brief provided details on the proposed adjustment and demonstrated that it uses an inflation factor well below the historical cost increases the Company has faced. Aqua Exc. at 28 (citing Aqua M.B. at 63).

In its reply to Aqua Exc. No. 7, the OCA contends that the ALJ correctly disallowed the Company's proposed general price level adjustment. The OCA avers that Aqua's argument that the Commission has approved similar inflation adjustments by the Company ignores that the Commission has historically required utilities to provide greater specificity about these adjustments. OCA R. Exc. at 4 (citing OCA M.B. at 28-30; OCA R.B. at 14).

According to the OCA, Aqua's claim that the ALJ "ignores" precedent by disallowing this general inflation adjustment is incorrect. OCA R. Exc. at 4 (citing Aqua Exc. at 27). The OCA provides that the Commission has historically disallowed speculative inflation factors. OCA R. Exc. at 4 (citing *Pa. PUC v. Philadelphia Elec. Co.*, 58 Pa. P.U.C. 7 (1983) (*PECO 1983*); *National Fuel Gas Dist. Corp. v. Pa. PUC*, 677 A.2d 861 (Pa. Cmwlth. 1986) (*NFG 1986*)). The OCA notes that Aqua provided only three examples of expenses that have grown at rates which exceed the Company's proposed inflation factor. OCA R. Exc. at 4 (citing Aqua St. 3 R at 3-4). The OCA argues that the proposed inflation adjustment should not be approved because Aqua has provided no evidence about the other operating expenses to which the inflation factor would be applied. OCA R. Exc. at 4 (citing R.D. at 70; OCA M.B. at 30; OCA R.B. at 15).

The OCA finds ALJ Long's concern about setting a precedent which would allow large utilities such as Aqua to apply a general inflation factor to unspecified expenses is well-founded. OCA R. Exc. at 4 (citing R.D. at 70). The OCA agrees with the ALJ that if the Commission were to approve Aqua's entire proposed inflation adjustment based solely on three expense examples provided by Aqua, it would open the door for other large utilities to propose unjustified blanket inflation expense adjustments in future rate cases. The OCA concludes that ALJ Long correctly disallowed Aqua's proposed inflation adjustment, reducing FPFTY expenses by $1.07 million. OCA R. Exc. at 4 (citing R.D. at 70-71; OCA M.B. at 28-30; OCA R.B. at 15; OCA Table II (Water, Wastewater Base, Limerick, East Bradford, Cheltenham, East Norriton, New Garden)).

4. Disposition

Aqua's proposed General Price Adjustment applies to approximately 22% of Aqua's O&M expenses. The OCA acknowledged that in our recent decision in *Pa. PUC v. PECO Energy Co. – Gas Division*, Docket No. R-2020-3018929, Order entered June 22, 2021 (*PECO Gas 2021*), we approved an inflation adjustment. However, as the OCA correctly notes, the company in that proceeding used a more targeted approach to an inflation adjustment than Aqua proposed. OCA St. 1 at 35. More specifically, the Commission approved an inflation adjustment for regulatory Commission expenses but denied an inflation adjustment in that same case that the Commission found less specific. *See PECO Gas 2021* at 88, 95-96.

The Commission recently denied a blanket increase by Wellsboro Electric Company[50] of 3% inflation applied to FTY expenses to estimate FPFTY expenses.

In *Wellsboro 2020* the Commission stated:

> [T]he Company did not demonstrate that making this blanket adjustment to each expense claim directly relates to the actual costs expected to be incurred in each expense account in the FPFTY.

Wellsboro 2020 at 40.

In both its briefs and its Exceptions, Aqua also cited to *Philadelphia Suburban Water 2002*, to justify the use of an inflation factor for 22% of expenses. *See* Aqua M.B. at 62; Aqua Exc. at 27. However, we note in that case, the inflation adjustment was more closely targeted to the inflation adjustment and "was applied only to those miscellaneous employee expenses not otherwise specifically adjusted." *Philadelphia Suburban 2002* at *51 (citing R.D. at 37-38). We agree with the ALJ that Aqua has not justified the use of a general price level adjustment to expenses "not specifically adjusted in this case or not subject to inflation." R.D. at 70. We also agree that allowing Aqua to apply a general inflation adjustment to a block of expenses could incentivize less accurate tracking of expenses and a less rigorous approach to controlling costs for those expenses. The application of a General Price Adjustment to 22% of expenses is neither targeted nor specific. We find the ALJ's recommendation to deny Aqua's use of a General Price Adjustment to be reasonable. Therefore, we shall adopt the ALJ's recommendation to remove the Company's entire claimed amount of $864,335 for water operations and $205,560 for wastewater operations. As noted by the ALJ, the wastewater adjustments are comprised of decreases for Wastewater Base, Limerick, East

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[50] *Pa. PUC, OCA, OSBA v. Wellsboro Electric Company*, Docket No. R-2019-3008208 (Order entered April 29, 2020) (*Wellsboro 2020*).

Bradford, Cheltenham, East Norriton, and New Garden of $145,368, $23,275, $6,828, $8,719, $8,665, and $12,705, respectively. These are outlined in Table II-Adjustments in each of the rate tables that are attached to Commission Tables Calculating Allowed Revenue Increase at the end of this Opinion and Order.

Based on the above discussion, Aqua Exception No. 7 is denied.

K. Chemicals and Purchased Power (Water) Expenses

1. Positions of the Parties

The OCA proposed to increase the Company's claimed Chemicals Expense for water operations by $66,787. R.D. at 71 (citing OCA St. 1 at 38). This adjustment is based on the OCA's proposed adjustment to Metered Residential Water sales, which estimates the Company's progress towards the return to pre-pandemic residential usage levels as slower than the Company predicts.

The OCA recommended a related negative adjustment of $96,312 to the Purchased Power expense. OCA M.B. at 30 (citing OCA St. 1 at 38; OCA Exh. LA-2, Sch. C-7; Table II (Water)).

I&E did not recommend adjustments to gas and electric O&M expenses. I&E M.B. at 39.

2. Recommended Decision

The ALJ did not recommend any adjustments to Aqua's claim for chemicals expense consistent with the ALJ's recommendations related to Metered Residential Water Sales revenue. R.D. at 71.

3. OCA Exception No. 1

In its Exception No. 1, the OCA recommends an increase to residential revenues of $2.757 million based on a slower return of residential revenues than Aqua predicted. Associated with that more gradual revenue increase, the OCA recommends a negative adjustment of $66,787 to the Chemicals Expense for water operations and a negative adjustment to Purchased Power expense of $96,312. OCA Exc. at 1-2 (citing OCA M.B. at 30; OCA Table II (Water)). The OCA also recommends that the Company's CWC be adjusted to reflect this revenue adjustment and based on the expense adjustments it recommended. OCA Exc. at 2 (citing OCA M.B. at 22; OCA Table II (Water), OCA Table II (Wastewater)).

4. Disposition

As provided in our disposition of the OCA's Exception No. 1 in Section VII. D. of this Opinion and Order, *supra*, we denied the OCA Exception No. 1. Therefore, we shall also decline to make the OCA's requested adjustments to the Chemicals Expense and the Purchased Power Expense for water operations.

L. Depreciation - Amortization Expense Adjustment – Water – Phoenixville Acquisition

1. Positions of the Parties

Aqua has requested a positive acquisition adjustment of $2,315,440 to its rate base for the Phoenixville water system as of the end of the FPFTY. Aqua M.B. at 19 (citing Aqua Exh. 1-A, Sch. G-3). Aqua has provided a claim of $121,865 for amortization expense associated with the positive acquisition adjustment to rate base. Aqua M.B. at 58.

Both I&E and the OCA contended that the amortization expense associated with the Phoenixville acquisition should be disallowed. Aqua M.B. at 58 (citing I&E St. 3 at 11, OCA St. 1 at 30). I&E recommended that the Phoenixville acquisition adjustment be denied, which reduces rate base by $2,315,440 and also reduces the annual amortization expense by $121,865, which is expressed as a depreciation expense. I&E M.B. At 20 (citing I&E St. 3 at 10-11; I&E St. 3-SR at 7). I&E recommended that the Company's total annual amortization expense be reduced by $121,865. I&E M.B. at 21 (citing I&S St. 3-SR at 3-7).

2. Recommended Decision

The ALJ recommended that $2,437,305 be removed from Aqua's rate base, and the concomitant adjustments should be made to the accrued depreciation reserve and annual amortization expense which is expressed as a depreciation expense. R.D. at 44 (citing Aqua M.B. at 18). *See* also R.D. at 44, n. 27.

3. Aqua Exception No. 2

In its Exception No. 2, Aqua avers that the ALJ erred by disallowing Aqua's water rate base claim related to the acquisition of the Phoenixville Water system. Aqua Exc. at 15-18.

4. Disposition

As provided in our disposition of Aqua's Exception No. 2 in Section VI.B., *supra*, we denied the Company's Exception No. 2 and found the ALJ's recommended negative adjustment to rate base of $2,437,305 to be reasonable. Accordingly, we find that the concomitant adjustments as recommended by the ALJ should be made to the accrued depreciation reserve and the annual amortization expense, which is expressed as a depreciation expense in this filing. The adjustments are reflected in our Commission Tables Calculating Allowed Revenue Increase, attached to this Opinion and Order at Table II-Water, Rows "Acquis. Adj. – Phoenixville" and "Amort. Phoenixville Acquis. Adj."

M. Cash Working Capital

1. Positions of the Parties

Aqua explained that CWC is the capital requirement arising from the difference between: (1) the lag in the receipt of revenue for rendering service; and (2) the lag in the payment of cash expenses incurred to provide that service. Aqua explained further that its CWC claims for water and wastewater operations include the necessary working capital associated with O&M expense, taxes, and interest. Aqua M.B. at 32 (citing Aqua Exh. 1-A(a), Sch. G-5; Aqua Exh. 1-B(b), Sch. G-5). For water operations, its CWC amount claimed is $1,736,000. Aqua M.B. at 32 (citing Aqua Exh. 1-A(a), Sch. G-5). For wastewater base operations, its CWC amount claimed is $550,000. Aqua M.B. at 31 (citing Aqua Exh. 1-B(b), Sch. G-5).

Aqua stated that no parties challenged the Company's lead/lag study or its calculation of: (a) the average lag days in payment of expenses, taxes or interest, (b) the average lag day in receipt of revenues, or (c) the average lag days between payment of expenses and receipt of revenue. Aqua M.B. at 31 (citing Aqua St. 1 at 27 (describing the results of the lead/lag study)).

I&E provided that it agrees with the Company's use of a lead/lag study to measure how many days exist on average between the midpoint of the service period and the date the payment is received. I&E M.B. at 38 (citing I&E St. 1 at 30). Based on I&E's recommended expense adjustments, I&E recommended a cash working capital allowance for Water of $1,679,000 or a reduction of $57,000 from the Company's claimed $1,736,000. I&E did not recommend an adjustment for cash working capital for Wastewater Base or the other wastewater acquisitions. I&E M.B. at 38 (citing I&E St. 1-SR at 31).

The OCA averred that there should be a negative adjustment of $9.433 million for Interest for Water Operations, and the proposed rate base amount for CWC should be reduced by $0.718 million. OCA M.B. at 22 (citing OCA St. 1 at 24). The OCA explained that this adjustment is based on negative adjustments to Long Term Debt-Interest and Pennvest Interest. OCA M.B. at 22 (citing OCA St. 1 at 24; OCA Exh. LA-2, Sch. B-3). The OCA stated that, excluding the Section 1329 acquisitions by the Company, there should be an approximate negative $440,000 adjustment for Interest for Aqua's wastewater rate base and recommended a CWC requirement that is $28,000 lower than Aqua's proposed CWC allowance for Wastewater base operations. The OCA stated that this adjustment is made based on a negative adjustment to Long Term Debt-Interest, and both adjustments are made at the recommendation of the OCA's witness, Mr. Smith. OCA M.B. a 22 (citing OCA St. 1 at 25; OCA Exh. LA-2, Sch. B-3).

The OCA also recommended an adjustment to CWC based on its recommended adjustment to residential water sales revenue. OCA Exc. at 2.

2. Recommended Decision

The ALJ recommended adjustments to CWC related to the General Price Level Adjustment made as detailed in that discussion *supra*. R.D. at 71.

Overall, the ALJ noted that Aqua's claims for CWC have been adjusted based on the recommended adjustments to rate base, O&M expenses and taxes in the tables attached as appendices to the Recommended Decision. R.D. at 45.

3. OCA Exception No. 1 and Replies

In its Exception No. 1, the OCA insists that CWC should be adjusted to reflect the OCA's recommended residential revenue adjustment and its expense adjustments. OCA Exc. at 2 (citing OCA M.B. at 22; OCA Table II (Water); OCA Table II (Wastewater)).

In its reply to the OCA Exception No. 1, Aqua contends that OCA's recommended residential revenue adjustment was correctly rejected by the ALJ. Aqua R. Exc. at 1-2.

4. Disposition

As provided in our disposition for OCA Exception No. 1 in Section VII.E., *supra,* we denied OCA Exception No. 1. We decline to make the OCA's related requested adjustments to CWC. Accordingly, we shall also decline to make the OCA's requested changes to CWC related to Long Term Debt-Interest and Pennvest Interest.

Based on the above discussion of the adjustments to Aqua's individual expense claims, we have approved a total downward adjustment to the Company's water

O&M expenses of $1,900,892.[51] The cash working capital components related to interest and dividends, taxes, and O&M expense result in a net overall increase of $199,948 to the Company's water CWC.[52]

Additionally, we have approved a total downward adjustment to the Company's wastewater O&M expenses of $232,643. The cash working capital components related to interest and dividends, taxes, and O&M expense result in a net overall increase of $362,667 to the Company's wastewater CWC. As stated in Section VI.C, *supra,* this is broken down as follows: (1) a net increase to the CWC component for Wastewater-Base of $216,340,[53] which reflects, in part our downward adjustment to O&M expenses of $150,101; (2) a net increase to the CWC component for Wastewater-Limerick of $76,673,[54] which reflects, in part our downward adjustment to

[51] As set forth in Table II-Water in the Commission Tables Calculating Allowed Revenue Increase, attached to this Opinion and Order, our net total reduction to the Company's water expenses claim is $1,894,043. This figure includes a total reduction of $1,900,892 related to our downward adjustments to the Company's water expense claims for general liability insurance expense, general price level adjustment, and SERP expense, as discussed in this Expenses section. This is netted against a total increase to expenses of $5,849 related to water contract revenues and concomitant forfeited discounts, as discussed in Section VII of this Opinion and Order, *supra.* [(-$1,900,892+$5,849=$-$1,895,043]. It is our $1,900,892 reduction to the Company's expenses that flows to our downward adjustment to Cash Working Capital – O&M Expense that is described in the next footnote.

[52] As set forth in Table II-Water, the $275,473 addition is the net of: (1) an increase of $4,950 to Cash Working Capital – Interest and Dividends; (2) an increase of $431,945 to Cash Working Capital – Taxes; and (3) a decrease of $161,422 to Cash Working Capital – O&M Expense. [($4,950 + $431,945 - $161,422) = $275,473].

[53] As set forth in Table II-Wastewater-Base, the $216,340 addition is the net of: (1) a decrease of $945 to Cash Working Capital – Interest and Dividends; (2) an increase of $226,646 to Cash Working Capital – Taxes; and (3) a decrease of $9,361 to Cash Working Capital – O&M Expense. [(-$945 + $226,646 - $9,361) = $216,340].

[54] As set forth in Table II-Wastewater-Limerick, the $76,673 addition is the net of: (1) a decrease of $389 to Cash Working Capital – Interest and Dividends; (2) an increase of $78,550 to Cash Working Capital – Taxes; and (3) a decrease of $1,488 to Cash Working Capital – O&M Expense. [(-$389 + $78,550 - $1488) = $76,673].

O&M expenses of $27,778; (3) a net increase to the CWC component for Wastewater-East Bradford of $9,669,[55] which reflects, in part our downward adjustment to O&M expenses of $7,802; (4) a net increase to the CWC component for Wastewater-Cheltenham of $54,249,[56] which reflects, in part, our downward adjustment to O&M expenses of $16,469; (5) a net increase to the CWC component for Wastewater-East Norriton of $24,706,[57] which reflects, in part our downward adjustment to O&M expenses of $14,318; and (6) a reduction to the CWC component for Wastewater-New Garden of $18,970,[58] which reflects, in part our downward adjustment to O&M expenses of $16,175.

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[55] As set forth in Table II-Wastewater-East Bradford, the $9,669 addition is the net of: (1) an increase of $250 to Cash Working Capital – Interest and Dividends; (2) an increase of $9,729 to Cash Working Capital – Taxes; and (3) a decrease of $310 to Cash Working Capital – O&M Expense. [($250 + $9,729 - $310) = $9,536].

[56] As set forth in Table II-Wastewater-Cheltenham, the $54,249 addition is the net of: (1) a decrease of $431 to Cash Working Capital – Interest and Dividends; (2) an increase of $56,325 to Cash Working Capital – Taxes; and (3) a decrease of $1,645 to Cash Working Capital – O&M Expense. [(-$431 + $56,325 - $1,645) = $54,249].

[57] As set forth in Table II-Wastewater-East Norriton, the $24,706 addition is the net of: (1) a decrease of $369 to Cash Working Capital – Interest and Dividends; (2) an increase of $25,827 to Cash Working Capital – Taxes; and (3) a decrease of $752 to Cash Working Capital – O&M Expense. [(-$369 + $25,827 - $752) = $24,706].

[58] As set forth in Table II-Wastewater-New Garden, the $18,970 reduction consists of: (1) a decrease of $378 to Cash Working Capital – Interest and Dividends; (2) a decrease of $18,230 to Cash Working Capital – Taxes; and (3) a decrease of $362 to Cash Working Capital – O&M Expense. [(-$378 - $18,230 - $362) = – $18,535].

IX. Taxes

A. Payroll Tax Expense

1. Positions of the Parties

Aqua's initial payroll tax claim included a payroll tax expense of $3,163,655, based on its vacancy rate of 2.50%. Aqua Exh. 1-A, Sch. D-2.5. The OCA submitted that a more accurate vacancy rate would be 2.88%. OCA M.B. at 33. Aqua and I&E accepted the OCA recommended 2.88% vacancy rate. Aqua M.B. at 88, I&E M.B. at 37. Accordingly, the Company updated its claim for payroll tax expense to $3,151,838. Aqua Exh. 1-A(a), Sch. D-2.5.

2. Recommended Decision

The ALJ remarked that Aqua's payroll tax claim was updated in rebuttal testimony to reflect the Company's acceptance of a revised vacancy rate of 2.88%. As a result, it was not necessary for the ALJ to make further adjustments to the payroll taxes. R.D. at 71-72.

3. Disposition

No Exceptions were filed objecting to the ALJ's recommendation on this issue. We find that the ALJ's recommendation is supported by ample record evidence and is just and reasonable. Therefore, we shall adopt Aqua's payroll tax claim based on a 2.88% vacancy rate.

B. Income Taxes

1. Positions of the Parties

Aqua stated its interest expense deduction claimed for ratemaking purposes was calculated using the interest synchronization method, which multiplies the weighted cost of debt in the Company's capital structure by the Company's rate base. Aqua Exh. 1-A, Sch. E-1 at 1. The OCA calculated Aqua's interest synchronization using the OCA's recommended hypothetical capital structure, *infra*. OCA R.B. at 39. As Aqua disagrees with the OCA's proposed hypothetical capital structure, it also opposes the OCA's proposed adjustment to the interest expense deduction. Aqua R.B. at 36.

2. Recommended Decision

As will be discussed more fully in Section X.B, *infra,* the ALJ rejected the OCA's use of a hypothetical capital structure for Aqua. Thus, the ALJ denied the OCA's claim regarding interest synchronization as it relates to income taxes. R.D. at 71-72.

3. Disposition

No Exceptions were filed objecting to the ALJ's recommendation on this issue. We find that the ALJ's recommendation is supported by ample record evidence and is just and reasonable. Therefore, we shall adopt the ALJ's recommendation that Aqua's interest synchronization method be employed, using the Company's capital structure, to calculate its interest expense deduction.

C. Tax Repair Deduction

1. Positions of the Parties

Aqua has proposed to carve-out $4 million per year for its repair deductions, in the calculation of income tax expense, on the basis that it has identified a portion of its annual repair deductions as being uncertain of passing an IRS audit. To account for the "uncertain" repair deductions, Aqua has established a reserve to reduce rate base. Aqua M.B. at 90-92. Any IRS disallowance would be offset against the reserve. Aqua explained that FIN 48 is related to the Company's practice of claiming the greatest tax-repair deductions it believes are reasonable, it recognizes that the IRS may ultimately disallow certain claims. Aqua M.B. at 91; Aqua St. 8-R at 6. Aqua's witness, Ms. Christine L. Saball, noted the IRS has yet to issue guidance regarding what capital additions will qualify as repairs, and thus there is uncertainty regarding the actual tax repair deductions that will be allowed. *Id.*

The OCA contended that Aqua's "flow through" treatment for its tax repair deductions is "unusual" and can result in large amounts of excess earnings between rate cases. OCA M.B. at 77; OCA R.B. at 37. The OCA also proposed to eliminate the Company's $4 million adjustment for FIN 48 uncertain tax positions. According to the OCA, Aqua's FIN 48 adjustment for uncertain tax positions should reflect the amount expected to be deducted for repairs without any offset for uncertain tax positions, relying on guidance provided by the Federal Energy Regulatory Commission (FERC) for energy utilities. OCA M.B. at 81; OCA St. 1 at 34-35.

2. Recommended Decision

The ALJ was not convinced that removal of the FIN 48 adjustment from the tax repair deduction is required. R.D. at 73. The ALJ noted that the OCA contended that this treatment of the tax repair deduction "may" result in excess earnings. However, the ALJ was persuaded by Aqua's explanation that "including the FIN 48 adjustment protects customers because they will not be required to return to the Company disallowed deductions, because those deductions will not have been reflected in rates." R.D. at 74 (citing Aqua St. 8-R at 7). The ALJ was also persuaded by how the Company handles the FIN 48 exclusion with regard to its rate base. In this regard, the ALJ noted the Company's statement that "[t]o compensate customers for the time value of money benefits of the FIN 48 exclusion, the Company deducts from rate base the reserve balance established for all years in which the challenged deductions are claimed." *Id.*

The ALJ was further persuaded to recommend that the Company's tax repair deduction be approved, based on the following Company arguments that: (1) shareholders will not receive income for the tax effect of the FIN 48 adjustment, and the rate base deduction ensures that customers receive the time value of money benefit related to the deferral of the uncertain tax position; (2) if, in the future, the IRS allows the full tax repair deduction, then the reserve balance will be returned to customers in rates; (3) if the full deduction is disallowed, as the Company assesses is likely, the reserve will be debited for the disallowed amount; and (4) customers will receive the benefit of the reserve balance amortized as a deduction to tax expense in future rate cases. R.D. at 74 (citing Aqua St. 8-R at 6-7).

Thus, the ALJ recommended that the Commission permit Aqua to continue utilizing the flow-through treatment of tax repair deductions which were approved in the settlement of Aqua's 2018 base rate case. Similarly, the ALJ recommended the Commission reject the OCA's objection to Aqua's "collar mechanism."[59] The ALJ

[59] The ALJ noted that the OCA did not address its witness' argument in surrebuttal testimony opposing the collar mechanism in its Main Brief. R.D. at 74, n.120.

concluded that there is no convincing evidence that this tax treatment has resulted in excess earnings or has otherwise harmed ratepayers. R.D. at 74.

3. OCA Exception No. 10 and Replies

In its Exception No. 10, the OCA excepts to the ALJ's recommendation and states that the tax repair deduction should only include those repairs that Aqua expects to claim for tax purposes and that the proposed carve-out is inappropriate for ratemaking purposes. The OCA also states that it does not take issue with the "collar mechanism" recommended by the ALJ. However, the OCA opines that if any "collar" amount around the repairs deduction amount that is used to compute income tax expense were to be used going-forward, the "collar" should be no wider than $4 million per year. OCA Exc. at 14-15.

In its Replies, the Company asserts that the ALJ correctly concluded the FIN 48 adjustment appropriately accounts for a portion of Aqua's claimed repairs expense deduction that will likely be disallowed by the IRS. Aqua notes the "collar" was established to address concerns that the claimed deduction could substantially vary from the actual deduction. Aqua R. Exc. at 8-9.

4. Disposition

We find that the ALJ's recommendation allowing Aqua to implement the FIN 48 adjustment as well as the "collar" up to $4 million, is supported by ample record evidence and is just and reasonable. Accordingly, we shall adopt the ALJ's recommendation on this issue and deny the OCA's Exception No. 10.

X. Rate of Return

Rate of Return is one of the components of the utility's Revenue Requirement formula, outlined, *supra.* Specifically, a utility's rate of return is the amount of revenue an investment generates in the form of net income and is usually expressed as a percentage of the amount of capital invested over a given period of time. A fair and reasonable overall rate of return is one that will allow the utility an opportunity to recover those costs prudently incurred by all classes of capital used to finance the rate base during the prospective period in which its rates will be in effect. I&E M.B. at 42.

A. Proxy Groups

To estimate a utility's cost of equity,[60] or return on equity, a proxy group of similar companies is used. This group of companies acts as a benchmark to satisfy the long-established guideline of utility regulation that seeks to provide the subject utility the opportunity to earn a return similar to that of enterprises with corresponding risks and uncertainties. A proxy group is generally preferred over the use of data exclusively from any one company, because it has the effect of smoothing out potential anomalies associated with a similar company and, therefore, is a more reliable measure. I&E St. 2 at 7.

1. Description of the Parties' Proxy Groups

Aqua used a proxy group of eight companies, which it referred to as the "Water Group." In arriving at its Water Group, the Company applied the following criteria:

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[60] The Parties' positions regarding the cost of common equity will be discussed in more detail in Section X.D of this Opinion and Order, *infra.*

1. Each company was listed in the "Water Utility Industry" section (basic and expanded) of The Value Line Investment Survey (*Value Line*); and

2. The company's stock was publicly traded.

Aqua submitted that its size and financial risk are similar to the companies in its Water Group and, therefore, the Water Group provides a reasonable basis for measuring the Company's cost of equity. Aqua St. 7 at 13, 18.

I&E's proxy group consisted of seven companies. In selecting a proxy group of companies that are similar to Aqua, I&E applied the following criteria to *Value Line*'s "Water Utility" Company group:

1. Fifty percent or more of the company's revenue were generated from the water utility industry;

2. The company's stock was publicly traded;

3. Investment information for the company was available from more than one source, including *Value Line*;

4. The company must not be currently involved in an announced merger or the target of an announced acquisition; and

5. The company must have four consecutive years of historic earnings data.

I&E St. 2 at 8-9.

I&E explained that Aqua's Water Group contains all seven companies in its own proxy group. However, I&E excluded Artesian Resources Corporation from its own proxy group because it violates I&E's third proxy group criterion, *supra.* In this regard, I&E explained that Artesian Resources Corporation does not have a *Value Line* report, and therefore, does not have projected dividends per share or projected earnings growth rate information. I&E St. 2 at 10-11; I&E St. 2-SR at 2-3.

The OCA chose to use the same proxy group as selected by the Company. According to the OCA, while different arguments could be raised for the inclusion or exclusion of a particular utility within the proxy group, by using the same proxy group as the Company, the OCA has removed the selection of the proxy group as a variable in analyzing the appropriate rate of return. In the OCA's view, utilizing the Company's proxy group is valuable in focusing on the primary factors driving the cost of equity estimate and in demonstrating why Aqua's conclusions regarding its proposed rate of return are unreasonable. OCA M.B. at 60-61.

Aqua claimed that I&E's decision to exclude Artesian Resources Corporation from its proxy group was erroneous. Aqua submitted that the composition of a proxy group should not be dependent upon whether relevant data is available from a specific source. Rather, Aqua argued, there is other source data available for Artesian Resources Corporation, as set forth in Aqua Exhibit 4-A, such that it should be included in the proxy group used in this proceeding. Aqua M.B. at 110.

Table 3, below, provides a summary of the companies each party proposed to be used in their respective water proxy groups:

Aqua	OCA	I&E
American States Water	American States Water	American States Water
American Water Works Company	American Water Works Company	American Water Works Company
Artesian Resources Corporation	Artesian Resources Corporation	California Water Serv. Group
California Water Serv. Group	California Water Serv. Group	Essential Utilities, Inc.
Essential Utilities, Inc.	Essential Utilities, Inc.	Middlesex Water Company
Middlesex Water Company	Middlesex Water Company	SJW Corporation
SJW Corporation	SJW Corporation	York Water Company
York Water Company	York Water Company	

Table 3: Summary of the Proposed Water Proxy Groups in this Proceeding

Aqua St. 1 at 13; I&E St. 2 at 9; OCA St. 3 at 17.

As discussed below, the ALJ recommended that the Commission adopt the proposals set forth by I&E in setting a cost of equity for Aqua in this proceeding, including the use of I&E's proxy group. R.D. at 77-81. No Party specifically challenged the use of I&E's proxy group in the Exceptions phase of this proceeding. Finding I&E's proxy group criteria to be reasonable, and finding the companies contained therein to be representative of Aqua, we shall adopt I&E's proposed proxy group.

B. Capital Structure Ratios

A utility's capital structure represents how the utility has financed its rate base with different sources of funds. Determining the appropriate capital structure is crucial in developing the weighted cost of capital, which, in turn, determines the overall rate of return in the revenue requirement equation, *supra*. The primary funding sources for the utility are long-term debt and common equity. Additionally, a capital structure may include preferred stock and/or short-term debt. However, the Company is financed only with long-term debt and common equity. I&E St. 2 at 11.

1. Positions of the Parties

Aqua proposed a capital structure of 53.95% common equity and 46.05% long-term debt, which represents its projected capital structure as of the end of the FPFTY ending March 31, 2023. Aqua explained that it based its FPFTY capital structure upon its actual capital structure at the HTY ended March 31, 2021 and made adjustments to reflect events that will occur during the FTY and FPFTY. Aqua continued that these changes are to finance the Company's net rate base additions of approximately $557 million in the FTY and FPFTY. Specifically, Aqua included additional debt of $190 million to be issued in the FPFTY. In addition, Aqua projected the retention of approximately $269.7 million in earnings over the period, and the infusion of an additional $100 million in equity. Aqua M.B. at 102.

Aqua argued that the Commission has determined in previous proceedings that a utility's actual capital structure should be utilized unless there is a finding that it is atypical or too heavily weighted to either the debt or equity side. Aqua M.B. at 103-04 (citing *2012 PPL Order*). According to Aqua, this policy was recently affirmed in *Columbia Gas*. Aqua insisted that its common equity ratio falls within the ranges of the common equity ratios in its Water Group and in the proxy groups employed by both the OCA and I&E, and cannot be deemed "atypical." Accordingly, Aqua submitted that it is appropriate to use the Company's actual capital structure for ratemaking purposes. Aqua M.B. at 102, 103-07; Aqua R.B. at 42-45.

I&E recommended that the Commission adopt Aqua's proposed capital structure. According to I&E, the Company's claimed capital structure falls within the range of the 2020 capital structures for the companies in I&E's proxy group. I&E explained that the 2020 capital structures represented the most recent information available at the time of I&E's analysis. I&E further noted that the most recent five-year average range contains individual company capital structure ratios ranging from 39.93%

to 56.33% debt and 43.67% to 59.54% common equity, with an overall five-year average of 46.88% debt and 53.05% common equity. According to I&E, this five-year average capital structure is almost identical to the Company's claimed capital structure. I&E M.B. at 44; I&E St. 2 at 12.

In contrast, the OCA submitted that the Commission has the discretion to employ a hypothetical capital structure if the utility's actual capital structure is unreasonable or uneconomical. OCA M.B. at 57 (citing *Big Run Tel. Co. v. Pa. PUC*, 449 A.2d 86, 89 (Pa. Cmwlth. 1982) (*Big Run*)). Applying this to the instant proceeding, the OCA explained that it opposed the Company's proposed capital structure because the common equity ratio of nearly 54% that Aqua seeks to employ is significantly higher than the average of the eight regulated water utilities in its Water Group. According to the OCA, because this results in an unreasonably high cost of capital estimate, the Commission must impose a capital structure upon the Company that will not unfairly penalize its ratepayers and that is more reflective of one that might exist in a competitive environment. In the OCA's view, the use of a hypothetical capital structure will reduce costs to ratepayers, as opposed to increasing costs. OCA M.B. at 56, 58-59.

Specifically, the OCA sought to use a hypothetical capital structure of 50% common equity and 50% long-term debt to set rates for Aqua. The OCA explained that such a capital structure is reflective of the average capital structures of the companies in the Water Group used by Aqua. In addition, the OCA pointed out that the average debt ratio of the Company's Water Group is 50%, based on 2020 data. OCA R.B. at 28-29; OCA St. 3-SR at 3-4.

2. Recommended Decision

The ALJ recommended that Aqua's proposed capital structure of 53.95% common equity and 46.05% long-term debt be adopted. The ALJ acknowledged the

OCA's observation that the Commission has the discretion to employ a hypothetical capital structure where a company's actual capital structure is unreasonable or uneconomical. However, the ALJ concurred with Aqua that the legal standard in Pennsylvania for deciding whether to use a hypothetical capital structure is not whether the utility's capital structure deviates from the "average" capital structure of the proxy group, but whether the capital structure is outside the range of the capital structures of the companies in the proxy group. The ALJ echoed I&E that Aqua's claimed capital structure is within the range of the capital structures in I&E's proxy group and is, therefore, reasonable. R.D. at 77.

3. OCA Exception No. 8 and Replies

In its Exception No. 8, the OCA remains of the opinion that a hypothetical capital structure consisting of 50% common equity and 50% long-term debt should be utilized in setting just and reasonable rates for Aqua. The OCA reasons that Aqua's proposed capital structure is inappropriate because the equity component is 400 basis points (*i.e.,* 4.00%) higher than the average of the companies in Aqua's Water Group. Thus, the OCA submits that if the Commission were to adopt the ALJ's recommendation, then this would result in a return on equity and a revenue requirement that are too favorable to Aqua's investors because they would impose an unfair cost burden to the Company's ratepayers. The OCA reiterates its argument that the Commission has exercised its discretion to direct a utility to use a hypothetical capital structure where the utility's management adopts an actual capital structure that imposes an unfair cost burden on ratepayers. As such, the OCA claims that the Commission should reverse the recommendation of the ALJ and exercise its discretion in this current proceeding. The OCA insists that its proposed hypothetical capital structure will adequately balance the interests of both the Company's ratepayers and investors and will reflect a capital structure that might exist in a competitive environment. OCA Exc. at 10-11.

In its Replies to Exceptions, Aqua rebuts that the ALJ correctly recommended that the OCA's proposed hypothetical capital structure should be rejected. Aqua submits that the OCA's position disregards long-established Commission precedent for deciding whether to use a hypothetical capital structure in setting rates. Namely, Aqua restates its position that the Commission has consistently held that if a utility's actual capital structure is within the range of a similarly situated proxy group of companies, then rates are set based on the utility's actual capital structure. Aqua maintains that its capital structure falls within the range of the companies in its Water Group and should be adopted. Aqua R. Exc. at 7.

In its Replies to Exceptions, I&E declines to offer a specific reply to the OCA's Exception No. 8. Rather, I&E simply reinforces its position that the Company's claimed capital structure should be adopted. I&E R. Exc. at 15.

4. Disposition

We shall deny the OCA's Exception No. 8 and adopt the ALJ's recommendation to use Aqua's actual capital structure, consistent with the following discussion.

Like the ALJ, we note the veracity of the OCA's statement that the Commission has the discretion to employ a hypothetical capital structure where a company's actual capital structure is unreasonable or uneconomical. However, because we find no merit in the OCA's arguments that the Company's actual capital structure is either unreasonable or uneconomical, we shall decline to exercise this discretion in the instant proceeding.

The use of an actual capital structure represents the Company's decision, in which it has full discretion, on how to capitalize its rate base. This actual capitalization forms the basis upon which Aqua attracts capital. *See 2012 PPL Order* at 68; *Columbia Gas* at 116; *PECO Gas* at 144. For example, Aqua's long-term debt cost rate of 4.00%, discussed, *infra,* which all Parties have accepted for ratemaking purposes, fully reflects the capitalization determined by the Company to be appropriate.

In both *Columbia Gas* and *PECO Gas,* we reaffirmed the legal standard in Pennsylvania for deciding whether to use a party's proposed hypothetical capital structure in setting rates, *i.e.*, we stated that if a utility's actual capital structure is within the range of a similarly situated proxy group of companies, rates are set based on the utility's actual capital structure. *Columbia Gas* at 116; *PECO Gas* at 144. More specifically, we reaffirmed this standard, which we articulated in the *2012 PPL Order,* as follows:

> Absent a finding by the Commission that a utility's actual capital structure is atypical or too heavily weighted on either the debt or equity side, we would not normally exercise our discretion with regard to implementing a hypothetical capital structure.

Columbia Gas at 116-17; *PECO Gas* at 144-45 (citing *2012 PPL Order* at 68).

We find that the record developed in this proceeding lends support to the same conclusion that we reached in the *2012 PPL Order*, *Columbia Gas*, and *PECO Gas*. First, we note the testimony of I&E that Aqua's claimed capital structure falls within the range of the 2020 capital structures for the companies in I&E's proxy group, which we have determined to be the companies that are most representative of Aqua. The 2020 range consists of long-term debt ratios ranging from 39.93% to 56.33% and equity ratios ranging from 43.67% to 59.54%, with a five-year average of 46.88% for long-term debt and 53.05% for common equity. As I&E observed, the five-year average capital structure of the proxy group is nearly identical to the Company's claimed capital structure. *See* I&E St. 2 at 12.

Next, we note that using I&E's proposed proxy group, Aqua's witness, Mr. Paul R. Moul, provided the below chart in his rebuttal testimony, which we have set forth in Table 4. Namely, this chart details the forecasted common equity ratios for 2024 through 2026 for each of the companies in I&E's proposed proxy group, as outlined in *Value Line* as of October 8, 2021.

Company	Projected Common Equity Ratio for 2024-2026
American States Water	46.50%
American Water Works	39.00%
California Water Serv. Group	59.00%
Essential Utilities, Inc.	45.00%
Middlesex Water Company	60.00%
SJW Corporation	62.00%
York Water Company	62.50%
Average	**53.43%**

Table 4: Forecasted Common Equity Ratios for 2024 through 2026 for I&E's Water Proxy Group Companies

Aqua St. 7-R at 9-10. In comparing the Company's proposed common equity ratio to the forecasted common equity ratios of I&E's proxy group, we find that the above table lends support to Aqua's argument that its proposed actual common equity ratio falls well within the range of the forecasted common equity ratios of similarly situated water companies. In this regard, the data in this table demonstrates that Aqua's proposed common equity ratio of 53.95% is very close to the forecasted average common equity ratio for the entire proxy group of 53.43%. Furthermore, Aqua's proposed common equity ratio is below four of the companies in the I&E proxy group (*i.e.*, California Water Serv. Group, Middlesex Water Company, SJW Corporation, and York Water Company), whose forecasted common equity ratios range from 59.00% to 62.50%.

Based on the forgoing, we find that the record underscores that Aqua's proposed actual capital structure is not atypical and is within the range of reasonableness.

Therefore, we find no basis upon which to impose the OCA's hypothetical capital structure on the Company. Therefore, we shall deny the OCA's Exception No. 8 and adopt the ALJ's recommendation to use Aqua's proposed actual capital structure of 53.95% common equity and 46.05% long-term debt in this proceeding.

C. Cost of Debt

1. Positions of the Parties

Aqua proposed a cost of long-term debt of 4.00%. Aqua submitted that because no Party has challenged this debt cost rate, it should be adopted in the context of Aqua's actual capital structure ratios for debt, *infra*. Aqua M.B. at 107.

I&E noted that given Aqua's proposed capital structure ratios, *supra,* Aqua's proposal results in a weighted cost of debt of 1.84%. I&E submitted that Aqua's claimed cost rate of long-term debt is reasonable because it is representative of the industry, and it falls within I&E's proxy group's implied long-term debt cost range of 2.69% to 5.67% with an average implied long-term debt cost of 4.04%. I&E M.B. at 44-45.

2. Recommended Decision

The ALJ observed that no Party disagreed with Aqua's proposal to use its actual cost of long-term debt of 4.00%. Therefore, the ALJ recommended that the Company's proposal be adopted. R.D. at 77.

3. Disposition

No Party filed Exceptions on this issue with regard to the ALJ's recommendation. Finding the ALJ's recommendation to be reasonable, we shall adopt it without further comment. Accordingly, we shall approve a long-term debt cost rate of 4.00% for Aqua in this proceeding.

D. Cost of Common Equity

In the instant proceeding, Aqua, I&E, and the OCA presented a position on a reasonable ROE. The Parties' positions were generally developed through comparison groups' market data, costing models, reflection or rejection of risk and leverage adjustments, and a management performance adjustment, as will be further addressed, *infra*. Table 5, below, summarizes the cost of common equity claims made and the methodologies[61] used by the Parties in this proceeding:

Party	DCF	CAPM	RP	CE	ROE
Aqua	11.78%	13.40%	10.50%	12.80%	10.75%
I&E	8.90%	9.89%			8.90%
OCA	8.00%	6.40%			8.00%

Table 5: Summary of Each Party's proposed ROE

[61] As will be discussed below, in the following chart, DCF refers to the Discounted Cash Flow Method, CAPM refers to the Capital Asset Pricing Model, RP refers to the Risk Premium Method, and CE refers to the Comparable Earnings Method.

1. Methods for Determining the Cost of Common Equity

a. Discounted Cash Flow Method (DCF)

The DCF method applied to a proxy group of similar utilities, has historically been the primary determinant utilized by the Commission in determining the cost of common equity. *Pa. PUC v. City of Lancaster Bureau of Water*, Docket No. R-2010-2179103 (Order entered July 14, 2011) at 56; *Pa. PUC v. PPL Electric Utilities Corp.*, Docket No. R-00049255 (Order entered December 22, 2004) (*2004 PPL Order*) at 59. The DCF model assumes that the market price of a stock is the present value of the future benefits of holding that stock. These benefits are the future cash flows of holding the stock, *i.e.*, the dividends paid and the proceeds from the ultimate sale of the stock. Because dollars received in the future are worth less than dollars received today, the cash flow must be "discounted" back to the present value at the investor's rate of return.

(1) Positions of the Parties

Aqua's DCF model consists of a dividend yield plus a growth rate plus a leverage adjustment. The Company's DCF cost of common equity is 11.78%, which is calculated as follows:

	Dividend +	Growth +	Leverage =	DCF Cost Rate
Aqua DCF	1.94%	7.50%	2.34%	**11.78%**

Aqua's dividend yield calculation used six-month average dividend yields for the Water Group resulting in a dividend yield of 1.87%. The Company then adjusted this dividend yield for expected growth in dividends to produce a final dividend yield of 1.94%. Aqua St. 7 at 24.

Aqua principally relied upon five-year forecasts of earnings per share growth, as earnings growth appropriately measures the growth in price over time. The Company used three separate sources of projected earnings growth: IBES/First Call, Zacks, and *Value Line*. From this data, and applying judgment, the Company recommended a growth rate of 7.50%. Aqua St. 7 at 30.

As will be discussed in more detail below, in Section X.D.2, Aqua also argued that a leverage adjustment should be added to its DCF cost rate. The Company explained that a leverage adjustment is designed to adjust the DCF cost rate for the different percentage of debt in the capital structure calculated at market values of equity and long-term debt (the values used by investors) as compared to the percentage of debt in the capital structure at book value (the values used in the ratemaking process) to account for the greater financial risk created by a higher debt ratio when that cost rate is applied to a book value capitalization in utility proceedings. The Company argued that an unadjusted DCF greatly understates the cost of common equity because the proportion of market value common equity in the Water Group's capitalization was significantly higher than its proportion measure at book value. Aqua calculated an 11.78% return on equity using market value weighting. The Company calculated its leverage adjustment by subtracting the DCF return of 9.44% from the market value cost of equity of 11.78%. Accordingly, Aqua proposed to add a leverage adjustment of 234 basis points (*i.e.*, 2.34%) to its DCF cost of common equity calculation. Aqua St. 7 at 30-34, Sch. 10.

At the outset, I&E claimed the DCF method is in accordance with the Commission's historical use of the DCF as the primary methodology to determine a utility's cost of equity. I&E noted its recommendation is consistent with the methodology historically used by the Commission in base rate proceedings, most recently acknowledged in *Columbia Gas*. In I&E's view, it is now well settled that the Commission prefers the use of the DCF as the primary methodology in setting a utility's ROE in a rate case. Through the methodologies outlined in its testimony, I&E calculated that the DCF methodology produces a cost of common equity of 8.90%. I&E M.B. at 45-46.

I&E employed the standard DCF model, $k = D_1/P_0 + g$, where k is the cost of common equity, D_1 is the dividend expected during the year, P_0 is the current price of the stock, and g is the expected growth rate of dividends. I&E argued that a representative dividend yield must be calculated over a time frame that avoids problems of both short-term anomalies and stale data. I&E's dividend yield calculation placed equal emphasis on the most recent spot and the 52-week average dividend yields, resulting in an average dividend yield of 1.75%. I&E St. 2 at 21-22.

I&E used earnings growth forecasts to calculate its expected growth rate. I&E's earnings forecasts are developed from projected growth rates using five-year estimates from established forecasting entities for its proxy group of companies, yielding an average five-year growth forecast of 7.15%. I&E St. 2 at 23.

I&E submitted that Aqua's proposed leverage adjustment should be rejected because investors base their decisions on book value debt and equity ratios for regulated utilities, and not on market values, rendering any adjustment unnecessary. I&E also submitted that recent Commission precedent supports rejecting a utility's request for a leverage adjustment. I&E St. 2 at 42-44.

The OCA proposed an 8.00% DCF cost of equity. The OCA utilized a Quarterly Approximation DCF model that accounts for quarterly growth of dividends, instead of annual growth. OCA St. 3 at 25; OCA Exh. DJG-6. To obtain the stock price (P_0), the OCA selected a 30-day average for each company in the proxy group. OCA St. 3 at 27. The dividend term used by the OCA in the Quarterly Approximation DCF Model is the current quarterly dividend per share (d_0). The OCA states the model assumes that each quarterly dividend is greater than the previous one by $(1 + g)^{0.25}$. OCA St. 3 at 28.

Like I&E, the OCA submitted that Aqua's proposed leverage adjustment should be rejected. The OCA reasoned that Aqua based the leverage adjustment on its inaccurate and incorrect use of the Hamada formula. OCA St. 3 at 35-37.

b. Capital Asset Pricing Model (CAPM)

The CAPM uses the yield on a risk-free interest-bearing obligation (such as those issued by the U.S. Treasury) plus a rate of return premium that is proportional to the systematic risk of an investment. To compute the cost of equity with the CAPM, three components are necessary: a risk-free rate of return (Rf), the beta measure of systematic risk (β), and the market risk premium (Rm-Rf) derived from the total return on the market of equities reduced by the risk-free rate of return. The CAPM specifically accounts for differences in systematic risk (*i.e.*, market risk as measured by the beta) between an individual firm or group of firms and the entire market of equities.

Aqua, I&E, and the OCA each used the following standard CAPM formula:

$$\mathbf{k} = R_f + \beta(R_m - R_f)$$

Where: k = the cost of equity and the remaining terms are as defined above.

(1) Positions of the Parties

Aqua determined the CAPM cost of equity as follows:

	R_f +	β x	$(R_m - R_f)$+	Size =	CAPM Cost Rate
Aqua CAPM	2.75%	1.07	9.00%	1.02%	**13.40%**

Aqua determined the risk-free rate to be 2.75% based on current and forecasted long-term Treasury Bond yields. Aqua also calculated a 9.00% premium for the risk/market premium component of the CAPM analysis, based upon the average historical data and forecasted returns. The Company used a leverage adjusted beta of 1.07, to reflect the financial risk associated with the rate setting capital structure that is measured at book value. Additionally, Aqua included a 1.02% size adjustment to its CAPM analysis. Therefore, Aqua calculated a CAPM cost of common equity of 13.40% for its Water Group. Aqua St. 7 at 41-43.

In calculating the CAPM cost of common equity, I&E chose the risk-free rate of return (Rf) of 1.98% from the projected yield on ten-year Treasury bonds as the most stable risk-free measure. I&E explained that its decision to use ten-year Treasury bonds balanced out issues related to the use of thirty-year long-term bonds and short-term T-Bills. I&E used the average of its proxy group betas from *Value Line* of 0.78. To arrive at a representative expected return on the overall stock market, I&E stated that it reviewed *Value Line*'s 1700 stocks and the S&P 500. I&E explained that the result of the overall stock market returns based on its CAPM analysis is 12.14%, which yields a cost of equity result of 9.89%. I&E St. 2 at 24-27. According to I&E, the 9.89% cost of equity from its CAPM should only be used as a point of comparison to its 8.90% DCF cost of capital. I&E St. 2 at 28.

In response to Aqua's CAPM analysis, I&E submitted that the Company used the same leverage adjustment for inflating its CAPM betas from 0.78 to 1.07 that was used for its DCF calculation. I&E asserted that such enhancements are unwarranted for beta in a CAPM analysis for the same reasons that enhancements are unwarranted for DCF results. In addition, I&E disagreed with Aqua's 102-basis point size adjustment applied to its CAPM analysis. I&E St. 2 at 47-49.

In its CAPM analyses, the OCA used a thirty-day average of thirty-year Treasury Bond yields to calculate a risk-free rate of 2.02%. OCA St. 3 at 40. The OCA found an average beta of 0.79 for its proxy group. OCA Exh. DJG-8. To find the equity risk premium, the OCA relied on expert surveys and an implied equity risk premium. The OCA calculated the implied equity risk premium by subtracting the risk-free rate from an implied expected market return. Using this data, the OCA concluded the proper CAPM return on equity is 6.4%. OCA St. 3 at 44-48.

c. Risk Premium (RP) Model and Comparable Earnings (CE) Model

Under the Risk Premium approach, the cost of equity capital is determined by corporate bond yields plus a premium to account for the fact that common equity is exposed to greater investment risk than debt capital. The RP method determines the cost of equity by summing the expected public utility bond yield and the return of equities over bond returns (*i.e.*, the "equity premium") over a historical period, as adjusted to reflect lower risk of utilities compared to the common equity of all corporations. Aqua M.B. at 117-118; Aqua St. 7 at 35-36.

The CE method estimates a fair return on equity by comparing returns realized by non-regulated companies to the returns that a public utility with similar risk characteristics would need to realize in order to compete for capital. According to Aqua, because regulation is a substitute for competitively determined prices, the returns realized by non-regulated firms with comparable risks to a public utility provide useful insight into investor expectations for public utility returns. The firms selected for the CE method should be companies whose prices are not subject to cost-based price ceilings (*i.e.*, non-regulated firms) so that circularity is avoided. The CE method utilizes the concept of opportunity cost, wherein investors will likely dedicate their capital to the investment offering the highest return with similar risk to alternative investments. Aqua M.B. at 121; Aqua St. 7 at 43-44.

(1) Positions of the Parties

The Company determined the RP cost of common equity to be 10.50% as follows:

	Interest Rate +	Risk Premium =	RP Cost Rate
Aqua RP	3.75%	6.75%	**10.50%**

Aqua explained that the interest rate in its calculation is an estimated interest rate for A-rated public utility bonds, while the risk premium in its calculation is the average of historical risk premiums of long-term corporate bonds.

Aqua also performed a comparable earnings analysis based on the principle set forth by the United States Supreme Court that a utility should be afforded an opportunity to earn a return on its property equal to that being earned on investments in other businesses with corresponding risks and uncertainties. *See Bluefield, supra.* The Company's analysis identified non-regulated companies with comparable risk and produced a cost rate of 12.80%. Aqua M.B. at 121; Aqua St. 7 at 46.

I&E submitted that neither the RP method nor the CE method should be used in determining an appropriate cost of equity in a base rate proceeding. I&E pointed out that the RP method is a simplified version of the CAPM model. However, I&E noted that while the CAPM directly measures the systematic risk of the company through the use of beta, the RP method does not measure the specific risk of the company. As to the CE method, I&E charged that it is not market-based and relies upon historic accounting data. Further, I&E contended that under the CE method, the most problematic issue is determining what constitutes comparable companies. I&E St. 2 at 15, 19-20.

The OCA claimed that the Commission should disregard Aqua's RP and CE analyses. The OCA argued that Aqua's RP and CE analyses are flawed by the Company's choice of inputs and inclusion of adjustments. OCA M.B. at 73-75.

Therefore, I&E and the OCA recommended using the DCF method as the primary method to determine the cost of common equity and using the CAPM method as a comparison to the DCF results. Both I&E and the OCA pointed out that the DCF method has historically been the Commission's preferred method of setting common equity cost rates. I&E M.B. at 45; OCA M.B. at 59-60.

d. Recommended Decision

The ALJ agreed with I&E's proposal to calculate the recommended return on equity pursuant to the DCF methodology, using the CAPM as an alternate means to verify the reasonableness of the return on equity. The ALJ recommended the Commission approve the use of the DCF method as the primary method to determine the cost of common equity, consistent with the methodology commonly endorsed by the Commission in base rate proceedings. R.D. at 77-78.

e. Aqua Exception Nos. 1.1 and 1.4; OCA Exception No. 9 and Replies

In its Exception No. 1.1, Aqua contends that the ALJ erred by not analyzing the dividend yield and growth rate components of I&E's DCF methodology. Aqua claims I&E's use of spot prices, which were near the 52-week high of the proxy group, lowered its dividend yield. Aqua states that using only I&E's 52-week average dividend yield of 1.87% is very close to its own six-month average dividend yield of 1.94%. According to Aqua, I&E's growth rate is unreasonable because it improperly includes an extremely low growth rate of 3.6% for Middlesex Water. Citing *Columbia Gas*, Aqua notes that I&E excluded a high data point from its growth rate calculation on the basis that it was outside the norm and distorted the DCF results. If high growth rates can be excluded, as I&E has done in the past, then Aqua argues that low growth rates must also be excluded from I&E's DCF calculation. Aqua determines that removing the 3.6% growth rate for Middlesex Water from I&E's growth rate calculation results in a 7.74% growth rate. By adopting Aqua's dividend yield and calculating I&E's growth rate without Middlesex Water, the Company claims a DCF result of 9.68%. Aqua Exc. at 5-7.

In its Exception No. 1.4, Aqua maintains the ALJ inaccurately asserts that I&E used the DCF method and the CAPM method to arrive at its recommended ROE of 8.9%. Although I&E did prepare a CAPM analysis, Aqua states I&E ignored its 9.89% CAPM return on equity result. Aqua insists the Commission also recognizes the importance of informed judgment and information provided by other models. For example, Aqua submits that in the *2012 PPL Order*, the Commission considered the CAPM and RP methods instead of DCF-only results. Aqua claims one of the flaws of the DCF in a rising interest rate environment is that it lags in responding to interest rate changes. Therefore, Aqua proposes the CAPM and RP methods are necessary to consider in a time of rising interest rates because both methods directly reflect forecasts of interest rates and bond yields. In conclusion, Aqua argues that the ALJ's reliance upon I&E's DCF result should be rejected and the Commission should consider and reflect in its ROE determination the results of other methods more attuned to rising interest rates. Aqua Exc. at 10-12.

In its Replies to Aqua's Exceptions, I&E asserts that the ALJ correctly recognized that Commission precedent favors the use of the DCF methodology, as applied by I&E, and that Aqua's DCF calculation included the use of an inflated growth rate and an unnecessary leverage adjustment. According to I&E, Aqua has erroneously argued that I&E ignored its CAPM result in deriving the I&E ROE recommendation. I&E expresses that it uses the DCF method as the primary methodology to calculate its recommended return on equity while also using the CAPM as a check on the reasonableness of its DCF results. I&E R. Exc. at 2-4.

In its Replies to Aqua's Exceptions, the OCA submits that contrary to Aqua's assertion, the DCF growth rate recommended by the ALJ is not understated. The OCA avers Aqua's argument for increasing the Growth Rate to 7.5% based on excluding the Middlesex Water IBES/First Call growth rate should be denied. OCA R. Exc. at 5-10.

In its Exception No. 9, the OCA claims the ALJ erred by adopting I&E's DCF model. The OCA maintains its Quarterly Approximation DCF model is more reasonable than Aqua's and I&E's DCF calculations because it accounts for quarterly growth of dividends rather than annual growth. Additionally, the OCA argues its Quarterly Approximation DCF model produces higher cost of equity estimates compared with the other DCF Model variations because dividends are compounded quarterly. In estimating the growth rate, the OCA insists it is prudent for U.S. GDP to be a limiting factor for the long-term growth rate input of the DCF model. OCA Exc. at 12-14.

In its reply to the OCA's Exception No. 9, Aqua maintains the ALJ correctly rejected the OCA's DCF method. Aqua insists the OCA uses an arbitrary growth rate and its DCF method should be rejected. Aqua R. Exc. at 8.

In its reply to the OCA's Exception No. 9, I&E supports the ALJ's adoption of its methodology, resulting in an 8.90% ROE. I&E R. Exc. at 15.

f. Disposition

Upon our consideration of the record evidence, we agree with the ALJ's determination that Commission precedent prefers the DCF methodology as applied by I&E. We also are persuaded by the arguments of Aqua that the Commission recognizes the importance of informed judgment and information provided by other ROE models. Therefore, we shall deny Aqua's Exception No. 1.1 and the OCA's Exception No. 9, and grant Aqua's Exception No. 1.4, consistent with the following discussion.

Aqua suggests I&E's use of spot stock prices skewed its dividend yield lower, thus reducing the DCF ROE. However, the record does not include any testimony specifying how I&E may have erred by including spot stock prices when calculating the proxy group dividend yield. The Commission affirmed I&E's DCF methodology in *Columbia Gas* and *PECO Gas*, thereby verifying I&E's use of spot stock prices. We find that I&E's DCF proxy group dividend yield calculation appropriately includes spot stock prices.

Next, Aqua claims I&E's growth rate is low because it includes an unreasonable growth rate for Middlesex Water. Aqua submits that I&E excluded an unreasonable growth rate from a proxy group it used in *Columbia Gas* and should do the same in the instant case. As the OCA points out, the growth rate excluded in *Columbia Gas* was 26.5%, 3.5 times greater than I&E's *Columbia Gas* proxy group average growth rate. OCA R. Exc. 5-6. In the instant case, Middlesex Water's growth rate is 3.6% compared to I&E's proxy group average of 7.15%, less than half of the proxy group average. We do not find Middlesex Water's growth rate to be unreasonably low and, as such, it was appropriately included in I&E's DCF growth rate calculation.

The OCA claims the ALJ erred by not adopting its Quarterly Approximation DCF model. Like Aqua, we find the OCA's Quarterly Approximation DCF methodology to be unconventional and that it includes flaws with both its dividend yield and growth rate calculations. Aqua M.B. 126-128. Additionally, we find the OCA's Quarterly Approximation DCF methodology to be inconsistent with the DCF methodology affirmed in both *Columbia Gas* and *PECO Gas*. Therefore, we find the ALJ did not err by rejecting the OCA's Quarterly Approximation DCF methodology.

We are persuaded by the arguments of Aqua that the ALJ erred by concluding I&E used its DCF *and* CAPM results to determine Aqua's ROE. In this regard, we note that although I&E did use its CAPM as a comparison to its DCF result, it made no CAPM based adjustment to its final ROE recommendation. I&E M.B. at 47. As Aqua points out, *infra*, the U.S. economy is currently in a period of high inflation. To help control rising inflation, the Federal Open Market Committee has signaled that it is ending its policies designed to maintain low interest rates. Aqua Exc. at 9. Because the DCF model does not directly account for interest rates, consequently, it is slow to respond to interest rate changes. However, I&E's CAPM model uses forecasted yields on ten-year Treasury bonds, and accordingly, its methodology captures forward looking changes in interest rates.

Therefore, our methodology for determining Aqua's ROE shall utilize both I&E's DCF and CAPM methodologies. As noted above, the Commission recognizes the importance of informed judgment and information provided by other ROE models. In the *2012 PPL Order*, the Commission considered PPL's CAPM and RP methods, tempered by informed judgment, instead of DCF-only results. We conclude that methodologies other than the DCF can be used as a check upon the reasonableness of the DCF derived ROE calculation. Historically, we have relied primarily upon the DCF methodology in arriving at ROE determinations and have utilized the results of the CAPM as a check upon the reasonableness of the DCF derived equity return. As such, where evidence based on other methods suggests that the DCF-only results may understate the utility's ROE, we will consider those other methods, to some degree, in determining the appropriate range of reasonableness for our equity return determination. In light of the above, we shall determine an appropriate ROE for Aqua using informed judgement based on I&E's DCF and CAPM methodologies.

Accordingly, we shall deny Aqua's Exception No. 1.1 and the OCA's Exception No. 9, and shall grant Aqua's Exception No. 1.4

2. Leverage Adjustment and Management Performance

a. Positions of the Parties

As previously noted, Aqua argued that a leverage adjustment should be added to its DCF cost rate. In addition, Aqua proposed to add a management effectiveness adjustment to its ROE claim. Both I&E and the OCA opposed the addition of a leverage adjustment or any allowance for management effectiveness.

As noted above, Aqua claimed that a utility that has a stock price above its book value and has an embedded cost of debt that is different from its marginal cost of debt has a market value or capitalization of its equity that is greater than the book value of its equity. Thus, Aqua explained, when an investor purchases equity at the market price (*i.e.,* the price used in the DCF model), the percentage of equity in the market capitalization is greater than the percentage of equity at book value. According to the

Company, under such circumstances, the DCF cost rate based on market prices must be adjusted upward to reflect the greater financial risk created by a higher debt ratio when that cost rate is applied to a book value capitalization in utility rate proceedings. Aqua M.B. at 113.

Aqua noted that the Commission has applied a leverage adjustment in cases in which it believes market conditions have resulted in an understated DCF cost rate. In support of this argument, Aqua cited to several previous rate cases before the Commission, including the *2004 PPL Order*, in which the Commission applied a leverage adjustment of forty-five basis points. Aqua M.B. at 112-13. Aqua further claimed that the Commonwealth Court has held that the decision of whether to adopt a leverage adjustment is within the Commission's discretion. *Id.* (citing *Popowsky v. Pa. PUC*, 868 A.2d 606, 612-13 (Pa. Cmwlth. 2004) (*2004 PA American*)).

According to Aqua, the market conditions that were present in the above rate cases also exist in this current proceeding. Aqua pointed to, *inter alia*, the high inflation rate that is currently present in the economy. Aqua reasoned that higher inflation expectations point to higher interest rates, which will contribute to higher capital costs prospectively, given that higher inflation results in greater risk of recovery of operating costs and greater volatility of earnings. In turn, Aqua insisted that the resulting increased capital costs warrant its requested leverage adjustment of 234 basis points. Aqua M.B. at 111, 117; Aqua St. 7 at 35.

As noted above, the Company also proffered that it demonstrated strong performance in the area of management effectiveness, such that it should be recognized by the Commission. Thus, Aqua sought an upward adjustment to its cost of equity for management effectiveness. Although the Company did not quantify what it believes to be an appropriate level of additional basis points for management performance,[62] it nonetheless claimed that in accordance with Section 523 of the Code, 66 Pa. C.S. § 523, the Commission is required to consider management effectiveness in setting a utility's rates. According to Aqua, nothing in Section 523 of the Code requires a finding that a utility must outperform all other utilities in the Commonwealth or that a utility's programs not be funded by customers before it is eligible for an increment to the rate of return for management performance. Aqua M.B. at 121, 128-29.

Aqua argued that it is committed to providing safe and reasonable service for the benefit of its communities and the environment. Aqua stated that it continues to assist the Commonwealth in dealing with the problems created by small, troubled, or non-viable water and wastewater systems. Aqua submitted that it provides high quality service and has implemented numerous programs designed to enhance the service it provides to customers. In support of these claims, Aqua highlighted that: (1) it maintains a strong, constant focus on water quality by providing filtration for all surface water sources and disinfection for all ground water sources, and by maintaining a central water quality laboratory in which it regularly takes water samples from its systems and responds promptly to water quality issues; (2) has acquired various water and wastewater systems that are in need of substantial improvement, has made larger scale plant upgrades that were beyond the capability of prior owners and/or operators, and has agreed to be a receiver for other troubled water systems under the provisions of Section 529 of the Code, 66 Pa. C.S. § 529; (3) has taken proactive measures to achieve its goal of providing twenty-four hour per day uninterrupted service to customers including undertaking extraordinary remediation and reconstruction efforts of the systems it has undertaken as a

[62] While Aqua did not quantify what it believes to be an appropriate amount of additional basis points for management effectiveness, it did highlight that the Commission awarded the Company an upward adjustment of twenty-two basis points for management effectiveness in *Pa. PUC v. Aqua Pa., Inc.*, Docket No. R-00072711 (Order entered July 31, 2008) (*2008 Aqua Order*). Aqua M.B. at 115.

receiver; (4) seeks to contain operating costs by reviewing staffing needs and operating procedures to reduce operating expenses and by proactively taking advantage of refinancing opportunities and lowered interest rates on long-term debt; (5) has leveraged its size and operational abilities to develop rates that are just and reasonable, while also prudently investing in needed capital in the utility infrastructure serving its customers; (6) has successfully provided its water and wastewater services during the COVID-19 pandemic without any interruption, while furnishing a safe workplace for its essential employees; (7) has proactively implemented changes to its low-income program, and policies to help customers who have been impacted by the pandemic, including providing credits to its low-income customers; (8) has assisted other water and wastewater systems during the pandemic; (9) has provided its customers with a high level of customer service, including rolling out technology designed to improve customers' ability to be advised of, and track service disruptions; (10) has maintained its "A Helping Hand" low-income customer assistance program to help facilitate the payment of water bills by its low-income residential customers; (11) continues to embark on substantial capital programs intended to ensure long-term viability by rehabilitating its underground piping infrastructure; (12) has taken advantage of key tax programs to ensure the lowest possible cost of service for its customers; and (13) has taken environmental initiatives, including seeking to minimize its purchased power costs and to improve its carbon footprint to ensure that it is being a good steward of the environment. Aqua M.B. at 129-37.

In contrast, I&E recommended that the Commission reject both the Company's request for a leverage adjustment and its request for a management performance adjustment. With regard to the Company's proposed leverage adjustment, I&E took the position that the Company's proposal was inappropriate for several reasons. First, I&E claimed that the Company's proposal is not supported by academic journals, textbooks, or other literature, and that rating agencies assess financial risk based upon a company's financial statements, and not its market capital structure. Second, I&E cited to several recent rate cases to illustrate that Commission precedent favors rejecting a utility's request for a leverage adjustment. Third, I&E posited that a leverage adjustment would unduly burden the Company's ratepayers. In this regard, I&E claimed that awarding the Company a leverage adjustment of 234 basis points would cause Aqua's ratepayers to fund an additional amount of $68,578,855 annually to cover the increase of an inflated rate of return along with the associated impact resulting from increases to income taxes, gross receipts tax, uncollectibles, and assessments. I&E M.B. at 51-54.

As to the Company's request for an upward adjustment in recognition of management effectiveness, I&E likewise contended that no such adjustment is warranted. In this regard, I&E provided that the true measure of whether a utility has exhibited strong management performance is whether the utility earns a higher return through the efficient use of resources and cost cutting measures. I&E continued that the increased income resulting from cost savings and true efficiency in management and operations is to be passed on to shareholders. I&E opined that the initiatives the Company cited to in support of its request for a management effectiveness adjustment demonstrate nothing more than the Company meeting the requirements outlined in Section 1501 of the Code, 66 Pa. C.S. § 1501, that it must provide adequate, efficient, safe, and reasonable service. In I&E's view, neither Aqua, nor any other utility should be awarded additional basis points to their ROE for simply meeting the requirements set forth in Section 1501. I&E M.B. at 47-48.

I&E also submitted that if the Company is as effective at controlling operating and maintenance costs as it argues, those savings should flow through to its ratepayers and/or investors. At the same time, I&E contended that Aqua's claimed savings to its ratepayers would likely be offset by the addition of basis points for management performance, as ratepayers would have to fund the additional costs. I&E reasoned that this would defeat the purpose of cutting expenses to benefit ratepayers. I&E M.B. at 49-50. Further, I&E cited to *Columbia Gas* wherein the Commission upheld the finding of ALJ Katrina L. Dunderdale that Columbia's management performance adjustment should be denied in light of the ongoing COVID-19 pandemic, noting that Columbia's proposal would defeat the purpose of cutting expenses to benefit ratepayers, particularly during a period in which many ratepayers have experienced reduced income from job loss or reduction in hours. *Id.* at 50 (citing *Columbia Gas* at 134). I&E posits that the Commission should reach a similar conclusion in this current proceeding. I&E M.B. at 50.

The OCA echoed the position of I&E that neither the Company's proposed leverage adjustment nor its proposed management effectiveness adjustment should be granted. The OCA acknowledged Aqua's statement that, as set forth in the Commonwealth Court's decision in *2004 PA American*, the decision of whether to adopt a leverage adjustment is within the Commission's discretion and is made on a case-by-case basis. OCA M.B. at 66. However, the OCA averred, *inter alia,* that the Commission typically only applies a leverage adjustment in cases in which market conditions have resulted in a DCF cost rate that is understated. *Id.* (citing *2012 PPL Order* at 120). The OCA opined that the opposite conditions exist in this current proceeding such that any leverage adjustment would be unnecessary and would be contrary to the public interest. OCA M.B. at 66-67.

According to the OCA, the primary reason for Aqua's inclusion of a leverage adjustment is that it seeks a higher return on equity than what the record supports. The OCA submits that although the Company cited the prospect of risks to investors, the Company failed to note that as a public utility operating in a monopoly environment, it faces less risk than the average company, which operates in a competitive marketplace. In addition, the OCA argued that in citing the potential risks to its investors, Aqua failed to acknowledge the additional risks that would be imposed on its ratepayers if it were awarded a leverage adjustment. Thus, the OCA claimed that the Company's request should be disregarded by the Commission. OCA M.B. at 67-68; OCA R.B. at 31-33.

Likewise, the OCA argued that the Company's request for an upward adjustment to its ROE for management performance is wholly unsupported. According to the OCA, Aqua has not conducted any comparative analyses to determine if the Company's management performance is superior to that of other regulated utilities, including those in its proxy group. To the contrary, the OCA claimed that the record thoroughly demonstrates that Aqua's management has not performed effectively in a variety of metrics, including but not limited to water quality, wastewater treatment compliance, system reliability, cost containment, rates, COVID-19 response, customer service, low-income customer assistance programs, infrastructure rehabilitation, tax programs, and environmental initiatives. As such, the OCA claimed that there is no basis for awarding a rate of return higher than Aqua's estimated cost of equity. OCA M.B. at 75-76; OCA R.B. at 34-35.

b. Recommended Decision

The ALJ concluded that Aqua has failed to justify that the addition of a leverage adjustment to its DCF cost calculation would be appropriate. Thus, the ALJ recommended that the Company's proposed leverage adjustment of 234 basis points be denied. R.D. at 78-79.

The ALJ also concurred with the positions of I&E and the OCA that Aqua should not be awarded any upward adjustment for strong management performance. First, the ALJ found that although it is true that the Company has been a strong partner with the Commission in acquiring troubled water systems, it has also acquired water and wastewater systems that were not troubled and has asked its existing customer base to help finance the costs to serve its newly acquired customers through base rates, reconcilable surcharge mechanisms, and/or its Distribution System Improvement Charge (DSIC). Thus, the ALJ concluded that the Company's claimed savings to ratepayers would likely be offset by the addition of basis points for management performance, as ratepayers would need to fund the additional costs. In the ALJ's view, this would defeat the purpose of cutting expenses to benefit ratepayers. R.D. at 79-80.

Next, the ALJ concluded that although the Commission has rejected the notion that no rate increases are appropriate during the COVID-19 pandemic, it is also not appropriate to demand more from ratepayers than necessary to meet the utility's basic needs. The ALJ pointed out that at the public input hearings many of Aqua's customers described the additional economic burdens caused by job loss, elevated family care responsibilities and other hardships resulting from the ongoing effects of the pandemic. According to the ALJ, to permit the Company to seek an additional premium from ratepayers during a pandemic would be inequitable and "tone deaf" given the high level of unemployment experienced by residential customers and the detrimental effect the pandemic has had on small businesses. Thus, the ALJ concurred with I&E that the Commission should apply the same reasoning set forth in *Columbia Gas, supra,* and should deny the Company's request to add basis points to its ROE for strong management performance. R.D. at 80-81.

c. Aqua Exception Nos. 1.2 and 1.6 and Replies

In its Exception No. 1.2, Aqua finds fault with the ALJ's recommendation that the Company's proposed leverage adjustment should be rejected. The Company contends that the ALJ has failed to consider that the Commission has included an adjustment for leverage in instances where the DCF understates the cost of common equity. Aqua insists that such conditions are present in this instant proceeding. Aqua restates its arguments, *supra,* that a leverage adjustment is designed to adjust the DCF cost rate for the different percentage of debt in the capital structure calculated at market values of equity and long-term debt, as compared to the percentage of debt in the capital structure at book value, and to align those risks. Aqua Exc. at 7.

Next, Aqua acknowledges that the Commission has been selective in awarding a leverage adjustment to the DCF cost calculation in rate cases. However, Aqua submits that what is most apparent from the decisions in which the Commission has not adopted a leverage adjustment is that the Commission has concluded that the unadjusted DCF results in such cases do not underestimate the cost of common equity. According to the Company, there is substantial evidence in this instant proceeding to demonstrate that the unadjusted DCF results understate the cost of common equity in the current environment. Thus, Aqua submits that the Commission should reverse the ALJ's recommendation and should award the company a leverage adjustment of 234 basis points, or 2.34%. Aqua Exc. at 7-8.

In its Exception No. 1.6, Aqua claims that in recommending that the Commission reject the Company's request for an upward adjustment to its ROE for strong management performance, the ALJ has disregarded the requirements of Section 523 of the Code, 66 Pa. C.S § 523. Aqua notes that Section 523 directs the Commission to consider the efficiency, effectiveness, and adequacy of service of each utility when determining just and reasonable rates. Aqua argues that while the ALJ concluded that providing additional basis points for effective management may offset cost savings such that it would defeat the purpose of cutting expenses to benefit ratepayers, the Commission has rejected contentions that utilities should not be provided additional basis points for quality utility service in light of Section 523. Aqua insists that the Commission should similarly reject such contentions in this proceeding. Aqua Exc. at 13-14.

Aqua also objects to the ALJ's finding that while the Company has been a strong partner with the Commission in acquiring troubled water systems, it has also acquired systems that were not troubled and has asked existing customers to pay for those acquisitions. Aqua claims that such acquisitions are mutually exclusive. The Company avers that it includes in rate base only those amounts permitted by law. In addition, Aqua insists that cost savings for its ratepayers have been realized through economies of scale associated with its acquisitions. Thus, Aqua submits that incentives to encourage acquisitions and regionalization to reduce the number of troubled water systems in the Commonwealth should not be denied simply because the Company also undertakes acquisitions of some entities that may not be classified as "troubled." Aqua Exc. at 14.

In its Replies to the Exceptions, I&E counters that the ALJ correctly rejected Aqua's proposed leverage adjustment. I&E maintains that Aqua has erroneously argued that there is substantial evidence to demonstrate that the unadjusted DCF results understate the cost of common equity in the current economic environment and that the ALJ appropriately rejected these arguments. I&E R. Exc. at 2.

In a similar fashion, I&E submits that the ALJ properly denied the Company's request for an upward adjustment to its ROE for strong management performance. I&E refutes Aqua's contention that the ALJ disregarded the requirements of Section 523 of the Code. To the contrary, I&E asserts that the ALJ properly considered the record evidence and the arguments presented by all of the Parties and then concluded that awarding the Company a management effectiveness adjustment is not warranted in this proceeding. I&E remains of the opinion that the Commission should reject the Company's request, consistent with its reasoning for rejecting a management performance adjustment in *Columbia Gas*. I&E R. Exc. at 5-6.

The OCA's arguments in its Replies to Exceptions mirror those of I&E with regard to both the leverage adjustment and the management performance adjustment. As to the leverage adjustment, the OCA also adds that the unadjusted DCF results of Aqua, I&E, and the OCA all fall between 8% and 9.07%, indicating a relatively small range resulting from the application of DCF models employed by the Parties' respective expert witnesses. Thus, the OCA submits that the Company's 234 basis point adjustment is unreasonable and creates substantial burdens for consumer ratepayers as subsidizers of investors. In addition, the OCA claims that the Company incorrectly posited that the market-derived cost of equity needs to be adjusted to compensate for the difference in financial risk. The OCA restates its argument that because Aqua is a regulated public utility, it does not have greater financial risk when compared to the average company in the competitive marketplace. OCA R. Exc. at 6-8.

Furthermore, the OCA highlights that the Commission has routinely denied proposed leverage adjustments in rate case proceedings. In the OCA's view, the record evidence in this current proceeding does not support Aqua's request for a leverage adjustment and the ALJ appropriately rejected the Company's request. OCA R. Exc. at 7-8.

As to the Company's Exception No. 1.6, the OCA restates its position that Aqua has been *deficient* in many areas of management performance.[63] The OCA submits that even absent these deficiencies, the provision of safe, adequate, and reliable water and wastewater service is required under Section 1501 of the Code, 66 Pa. C.S. § 1501. As a result, the OCA asseverates that simply meeting these required standards does not constitute exemplary management performance. Otherwise, the OCA reasons, the Commission would be awarding unwarranted additional basis points for management effectiveness to nearly every utility under its jurisdiction. OCA R. Exc. at 8-9.

The OCA also refutes the Company's claim that its acquisition of small, troubled, or non-viable wastewater systems warrants consideration for additional basis points for strong management performance. The OCA points to the ALJ's finding that

[63] As discussed in Section XII.A, *infra,* the OCA, in its Exception No. 23, argues that Aqua's customer satisfaction survey, which indicates that only seventy-three percent of its customers rated their satisfaction as "excellent" or "very good" lends further support for rejecting the Company's request for a management effectiveness adjustment. *See* OCA Exc. at 34-35.

the costs of rehabilitating these systems is passed along to the Company's other ratepayers. According to the OCA, even if the Company's reference to economies of scale proves true, this is not an indicator of effective management performance. Instead, the OCA maintains that such economies are a function of the Company's system. Thus, the OCA asserts that the ALJ properly rejected the Company's request for an upward adjustment to its ROE for management performance. OCA R. Exc. at 9-10.

d. Disposition

As Aqua correctly notes in its Exception No 1.2, the Commission has been selective in adding a leverage adjustment to the DCF cost calculation in rate cases. We reinforced this in *UGI Electric*, stating that "the fact that we have granted leverage adjustments in a few select cases in the past does not mean that such adjustments are warranted in all cases. Rather, the award of such an adjustment is not precedential but discretionary with the Commission." *UGI Electric* at 93; *see also 2012 PPL Order* at 91.

In examining the record in this proceeding, we are not persuaded by Aqua's arguments that we should reach a different conclusion from that reached in *UGI Electric* and other recent base rate proceedings and award the Company an artificial leverage adjustment to its ROE. In its briefs, Aqua cited to the high inflation rate that is currently present in the economy in support of its argument for a leverage adjustment. Aqua M.B. at 117. However, the crux of the Company's request for a leverage adjustment to its ROE centers on its belief that the difference between its book value capital structure and its market value capital structure poses a financial risk. Thus, the Company seeks a leverage adjustment to account for applying the market value cost rate of equity to the book value of its equity.

We find I&E's arguments in opposition to the Company's position to be persuasive. For example, as I&E observed, credit rating agencies assess financial risk based upon a company's booked debt obligations and the ability of its cash flow to cover the interest payments on those obligations. The agencies use a company's financial statements, and not the company's market capital structure, in conducting their analysis. It is a company's financial statements that affect the market value of the stock, and, therefore, the financial statements and the book value capital structure are relied upon in an analysis such as that done by rating agencies. I&E St. 2 at 40; I&E St. 2-SR at 10. Accordingly, we find that the record in this proceeding supports rejecting the Company's requested leverage adjustment.

Additionally, we note that PPL, in its 2012 rate case, sought a leverage adjustment in the range of 70 to 118 basis points based upon similar arguments regarding a perceived risk related to its market to book ratio. Likewise, UGI Electric, in its 2018 rate case, sought a leverage adjustment on this same basis. We found no merit in these arguments. *2012 PPL Order* at 91; *UGI Electric* at 93. We likewise find no merit in Aqua's arguments in which it seeks to support a leverage adjustment that is more than 100 basis points higher than that requested by either PPL or UGI Electric. Rather, we find, as we did in those base rate proceedings, that awarding the Company a leverage adjustment would run contrary to the public interest. Therefore, we shall deny the Company's Exception No. 1.2.

As to the Company's requested management performance adjustment, we note that pursuant to the Code, the Commission may reward utilities through rates for their performance. In pertinent part, Section 523 of the Code, 66 Pa. C.S. § 523, provides:

> **§ 523. Performance factor consideration.**
>
> (a) **Considerations.** – The Commission shall consider, in addition to all other relevant evidence of record, the efficiency, effectiveness and adequacy of service of each utility when determining just and reasonable rates under this

> title. On the basis of the commission's consideration of such evidence, it shall give effect to this section by making such adjustments to specific components of the utility's claimed cost of service as it may determine to be proper and appropriate. Any adjustment made under this section shall be made on the basis of specific findings upon evidence of record, which findings shall be set forth explicitly, together with their underlying rationale, in the final order of the commission.
>
> (b) **Fixed utilities.** – As part of its duties pursuant to subsection (a), the commission shall set forth criteria by which it will evaluate future fixed utility performance and in assessing the performance of a fixed utility pursuant to subsection (a), the commission shall consider specifically the following:
>
> (1) Management effectiveness and operating efficiency as measured by an audit pursuant to Section 516 (relating to audits of certain utilities) to the extent that the audit or portions of the audit have been properly introduced by a party into the record of the proceeding in accordance with applicable rules of evidence and procedure.
>
> * * *
>
> (4) Action or failure to act to encourage development of cost-effective energy supply alternatives such as conservation or load management, cogeneration or small power production for electric and gas utilities.
>
> * * *
>
> (7) Any other relevant and material evidence of efficiency, effectiveness and adequacy of service.

On consideration of the record evidence in this proceeding, we shall award Aqua an upward adjustment of twenty-five basis points to its ROE for management effectiveness, consistent with the following discussion.

We specifically recognize Aqua's efforts and willingness to quickly provide emergency aid to various water and wastewater systems that needed substantial improvement. Aqua has often provided this emergency aid on short notice and at the request of the Commission or other parties to protect the public from egregious health and safety threats and to protect the Commonwealth's drinking water resources from catastrophic damage. The competence and reliability of Aqua's management effectiveness in this regard is unparalleled. Aqua's management has earned this reputation by consistently and successfully working to protect the public and the environment under emergency situations presenting highly difficult operational, financial, and legal issues over many years. For example, we note the aid rendered by Aqua in Emlenton, Pennsylvania where the Commission fielded approximately ninety-three simultaneously filed formal complaints against the Emlenton Water Company alleging unsafe and inadequate water service and water-born illness. *See Bradley Louise, et al. v. Emlenton Water Company*, Docket No. C-2008-2058411 (Complaint filed July 24, 2008); *Joint Application of Aqua Pennsylvania, Inc. and Emlenton Water Company*, Docket No. A-2008-2074746 (Order entered December 29, 2008).

Aqua's management performance in recent emergency situations reinforces that the Company has been, and continues to be, a trusted and reliable corporate citizen on which the public can rely. Specifically, Aqua is currently operating three troubled utility systems under emergency receiverships throughout the Commonwealth, including one wastewater and two water systems. These respectively include North Heidelberg Sewer Company (NHSC), Twin Lakes Utilities, Inc. (Twin Lakes), and James Black Water Service Company (James Black). *See* Aqua St. 1 at 40; Aqua M.B. at 133-34.

Regarding NHSC, on March 21, 2017, I&E requested that the Commission issue an *Ex Parte* Emergency Order to avoid "a tidal wave of adverse consequences, including the potential discharge of untreated wastewater into the Commonwealth's waterways, which could result in irreparable harm to the environment, the health of NHSC's customers, and the safety of the public at large." *See Pa. PUC v. Metropolitan Edison Company and North Heidelberg Sewer Company*, Docket No. P-2017-2594688, (Petition for *Ex Parte* Emergency Order filed March 21, 2017) at 11.[64] At that time, NHSC served approximately 273 residential and one commercial wastewater customer. *May 2017 Order* at 5. I&E added that should NHSC fail to immediately take corrective action, the Commission should appoint a receiver pursuant to 66 Pa. C.S. § 529 because it appeared that NHSC was "consciously and intentionally placing in jeopardy its ability to provide safe, reliable and reasonable wastewater service to its customers." Petition for *Ex Parte* Emergency Order at 12. In the *Ex Parte* Order, Chairman Dutrieuille directed Aqua to assume this receiver role, which Aqua immediately and willingly did.

This past autumn, Hurricane Ida substantially destroyed NHSC's wastewater treatment plant and Aqua immediately responded to avert what could have been yet another disaster to the environment and to downstream drinking water supplies. Aqua M.B. at 131. Aqua's reconstruction efforts have gone beyond the normal expectations of a receiver. *Id.* On May 2, 2022, Aqua filed its 17th quarterly status report regarding its successful and ongoing five-year effort to rehabilitate the NHSC system, both operationally and financially, for the safety and benefit of the families served by that system and all Commonwealth residents downstream of its wastewater discharge. In our view, Aqua's reconstruction efforts have gone beyond the normal expectations of a receiver.

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64 On March 22, 2017, Chairman Gladys Brown Dutrieuille signed an *Ex Parte* Emergency Order (*Ex Parte* Order) granting the Petition for *Ex Parte* Emergency Order as modified to ensure continued wastewater service from NHSC to its customers, subject to ratification by the full Commission. On April 6, 2017, the Commission issued a Ratification Order of the *Ex Parte* Order. Subsequently, the Commission modified the *Ex Parte* Emergency Order. *Pa. PUC v. Metropolitan Edison Company and North Heidelberg Sewer Company*, Docket No. P-2017-2594688 (Order entered May 4, 2017) (*May 2017 Order*).

Regarding Twin Lakes, on October 23, 2018, Twin Lakes petitioned the Commission to approve an abandonment of water service to its approximately 114 residential customers no later than March 31, 2019. *Twin Lakes Utilities, Inc. Application to Abandon Service to its customers in Sagamore Estates in Shohola Township, Pike County Pennsylvania*, Docket No. A-2018-3005590 (filed October 23, 2018). Twin Lakes claimed it could no longer provide service to its customers because of significant quality of service and financial issues. *Id.*; *see also*, *Office of Consumer Advocate's Answer in Support of the Petition of Twin Lakes Utilities*, Docket No. P-2020-3020914 (filed August 5, 2020) (also containing a reiteration of the history and issues behind the Twin Lakes Section 529 forced acquisition petition supported by the OCA).

On June 10, 2020, Twin Lakes provided notice to the Commission that on September 1, 2020, it would cease providing water service to its customers. *Twin Lakes Utilities, Inc. – Notice of Termination of Service Agreement Between Middlesex Water Company and Twin Lakes Utilities, Inc.*, Docket No. M-2020-3020390 (served June 10, 2020). The practical effect of such abandonment would be the loss of potable water service and, for many customers, the loss of water for in-home sanitation as well. On July 13, 2020, the Commission directed that Twin Lakes "shall not abandon or surrender water service to its customers, in whole or in part, without Commission authorization." *Twin Lakes Utilities, Inc. – Notice of Termination of Service Agreement Between Middlesex Water Company and Twin Lakes Utilities, Inc.*, Docket No. M-2020-3020390 (*Secretarial Letter* issued July 13, 2020.)

Nevertheless, on August 3, 2020, Twin Lakes provided public notice to its customers that "to protect the public health, Twin Lakes will cease water service at 12:01 am on September 1, 2020." *Twin Lakes Utilities, Inc. Section 529 Petition*, Docket No. P-2020-3020914 (filed August 3, 2020.) Shortly thereafter, the OCA petitioned the

Commission stating that the "OCA respectfully requests the Commission direct Aqua Pennsylvania to act as a receiver to operate Twin Lakes until the resolution of the Section 529 proceeding." *Office of Consumer Advocate Petition for Issuance of an Interim Emergency Order on an Expedited Basis*, Docket No. P-2020-3020914 (filed August 18, 2020) at ¶ 18. The OCA opined that "Aqua Pennsylvania appears to be financially, managerially, and technically capable to serve Twin Lakes' customers. It is a capable PUC jurisdictional water utility and a proximate public utility as required under Section 529." *Id.* at ¶ 17 (*citations omitted*). We note that Aqua willingly took on this request and the Company continues to make significant investments into the Twin Lakes system to ensure its customers receive safe water service.

Simultaneous with its work with NHSC and Twin Lakes, Aqua is also serving as a receiver to James Black, a typical small, troubled water system with approximately nineteen customers. *See In re James Black Water Service Company*, Docket No. M-2019-3012563 (*Ex Parte* Emergency Order issued September 3, 2019; Order ratified September 19, 2019). We include a description of this typical small troubled water system only to provide perspective on the difference in scale required to rehabilitate NHSC and Twin Lakes, and to comment on the depth of resources, expertise, and employee commitment required to simultaneously manage all these emergency efforts, as the Company has done.

In view of the above, it is clear that Aqua has answered the call to provide emergency assistance at the request of the public, public advocates, and government agencies. Given the nature and frequency of these emergencies, we are of the opinion that the Company should be recognized for its efforts to serve as a ready and willing ally in water and wastewater emergencies. In our view, affording Aqua a modest upward adjustment to its ROE to recognize its exemplary emergency service is a just, reasonable, and affordable approach to addressing its ongoing emergency aid efforts. It would be inequitable to proceed otherwise, as there is no provision of the Code that demands utilities exhaust employees or financial resources because of emergencies occasioned by others.

Section 523 of Code, *supra,* permits the Commission to award a management performance adjustment based on "[a]ny other relevant and material evidence of efficiency, effectiveness and adequacy of service." 66 Pa. C.S. § 523(b)(7). Aqua's consistent willingness to answer calls for aid to other water and wastewater providers shows it is doing more than required under Section 1501 of the Code. The examples discussed above indicate that Aqua carries a roster of large and complex emergency aid matters unlike any other Pennsylvania utility. As stated in its direct testimony, operating troubled systems requires significant time, commitment, and involvement from many departments within Aqua. Aqua St. 1 at 20. As such, Aqua management is exceeding the expectations placed upon it not only by its existing customers, but also the Commonwealth. For this reason, we find that Aqua should receive a management efficiency award commensurate with the emergency service described herein. Therefore, to reflect the extraordinary effort exhibited by Aqua to aid and protect Pennsylvania water and wastewater customers and the environment, we shall award Aqua an additional twenty-five basis points to its ROE for management performance. As discussed in Section X.D.3, *infra,* this will result in a total ROE for the Company of 10.00%.[65] Accordingly, we shall grant Aqua's Exception No. 1.6.

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[65] As previously noted, in the *2008 Aqua Order,* the Commission awarded Aqua a management performance adjustment of twenty-two basis points for a total ROE of 11.00%.

3. Rate of Return on Common Equity

a. Positions of the Parties

As noted above, four methods of determining the cost of equity were presented for inclusion in the record in this proceeding: (1) DCF; (2) CAPM; (3) RP; and (4) CE. Aqua relied on each of these methodologies in presenting its recommended rate of return on common equity of 10.75%. Aqua St. 7 at 7.

As previously discussed, both I&E and the OCA took issue with the Company's analysis in arriving at the proposed cost of equity and argued that equal weight should not be given to the four different methodologies as Aqua did in its evaluation. Additionally, both I&E and the OCA submitted that the Commission has indicated a preference for using the DCF method to establish reasonable common equity costs.

As a result of its DCF analysis, I&E recommended a cost of common equity of 8.90%. St. 2 at 21.

The OCA recommended a cost of common equity of 8.00% based on its DCF model. OCA St. 3 at 3.

b. Recommended Decision

The ALJ rejected Aqua's proposed rate of return on common equity of 10.75%. Namely, the ALJ agreed with I&E's proposal to calculate the recommended cost of equity pursuant to the DCF methodology and using the CAPM to verify the reasonableness of the DCF ROE. According to the ALJ, I&E's analysis is consistent with the methodology commonly endorsed by the Commission and most recently accepted in *Columbia Gas*. Therefore, the ALJ recommended that the Commission adopt the 8.90% cost of equity as determined by I&E. R.D. at 78.

c. Exceptions and Replies

(1) Aqua Exc. Nos. 1.3, 1.5, and 1.7 and Replies

In its Exception Nos. 1.3 and 1.7, Aqua disagrees with the ALJ's cost of equity recommendation of 8.90%, based on I&E's methodology recently approved in *Columbia Gas*. Aqua takes the position that

> "[i]f adopted, this ROE will represent a watershed moment for the end of the Commission's longstanding commitment to supporting infrastructure investment, made doubly worse in a period of rising capital costs. The RD ROE would signal to the utilities and the credit rating agencies that Pennsylvania regulation has ceased to support investment in the state at a time of critical capital investment needs."

Aqua claims the ALJ erred by using a formulaic application of I&E's DCF method. In selecting I&E's recommended ROE, Aqua asserts the ALJ is implicitly endorsing an approach that rejects the application of informed judgment. In further support of its position, Aqua argues that the ALJ completely failed to address the substantial increases to the rate of inflation that have been experienced subsequent to the preparation of rate of return recommendations by the Parties. Aqua highlights that the inflation rate reported in December of 2021 was a thirty-nine year high of 6.8%. Aqua adds this current period of significant inflation "shows no signs of abating." Aqua Exc. at 2-4, 9-10, 13.

In its Exception No. 1.5, Aqua stresses that the ALJ's recommendation of an 8.90% ROE is below recent Commission determinations of a 9.86% ROE for

Columbia Gas, and a 10.24% ROE for *PECO*. In addition, Aqua argues that the allowed DSIC ROE of 9.80% is further evidence that the ALJ's recommended 8.90% ROE is deficient and will not provide Aqua with the opportunity to earn its investor-required cost of capital for the FPFTY. Aqua reinforces its position that the Commission should not be reducing a utility's ROE when there is a continuing, compelling need for capital investment to rehabilitate aging infrastructure. Aqua Exc. at 12-13.

In its reply to Aqua's Exceptions, I&E disputes Aqua's argument that the ALJ's rate of return recommendation in this proceeding should have been based on the allowable DSIC rate of return and the rate of return awarded to other dissimilar public utilities in other base rate proceedings. Rather, I&E avers that the ALJ correctly considered the substantial record evidence presented by all Parties in this base rate proceeding and properly recommended the Commission adopt the I&E recommended 8.90% ROE. Aqua R. Exc. at 11-12.

In its reply to Aqua's Exceptions, the OCA submits that the ALJ correctly rejected Aqua's cost of equity recommendation of 10.75%. The OCA avers Aqua's proposed 10.75% ROE relies on flawed empirical analyses and unsupported upward adjustments. OCA R. Exc. at 5.

(2) OCA Exception No. 9 and Replies

In its Exception No. 9., the OCA claims the ALJ erred by adopting I&E's proposed ROE of 8.90%. The OCA believes that adoption of I&E's cost of equity recommendation, albeit more reasonable than Aqua's ROE calculation, still overstates the cost of common equity. The OCA remains of the opinion that a ROE of 8.0% should be awarded to the Company, based on its Quarterly Approximation DCF model. OCA Exc. at 12.

In its reply to the OCA's Exception No. 9, Aqua submits the OCA's proposed ROE should be rejected because it would signal to Pennsylvania utilities and the investment community that Pennsylvania regulation no longer is supportive of capital investment, made doubly bad given the clear rise in inflation and capital costs that are occurring. Aqua R. Exc. at 7-8.

In its reply to the OCA's Exception No. 9, I&E supports the ALJ's recommendation to adopt the methodology employed by I&E, which resulted in an 8.90% ROE, as the most reasonable. I&E R. Exc. at 15.

d. Disposition

As determined in our disposition of Sections X.D.1 and X.D.2, *supra*, we will rely upon I&E's DCF and CAPM methodology and informed judgment, in addition to awarding an upward adjustment of twenty-five basis points for management effectiveness, in arriving at our determination of the proper ROE to award to Aqua in this proceeding. In particular, we note that the evidence presented in this case based on I&E's CAPM methodology produced a ROE higher than the results produced by its DCF. This suggests that, while properly computed in the abstract, I&E's DCF results understate the current cost of equity for Aqua and that consideration should be given to the CAPM in determining the appropriate range of reasonableness.

We agree with Aqua that the setting of the proper return on equity is necessary in this environment of increasing inflation, leading to an increase in interest rates and capital costs. Aqua Exc. at 2-4, 9-10, 13. However, we disagree with Aqua benchmarking recent Commission ROE determinations for *Columbia Gas* and *PECO Gas*, in addition to the most recent DSIC ROE, as further evidence that the ALJ's recommended 8.90% ROE is deficient. We agree with I&E that *Columbia Gas* and *PECO Gas* are dissimilar public utilities to Aqua, and each had a company specific ROE determined by evidence presented at the time of its individual base rate case. Further, we note the DSIC ROE is unlike a ROE set in a base rate proceeding. The DSIC ROE is determined by the Commission on a quarterly basis and is set per industry. As such, it is not company specific. Therefore, we shall grant Aqua Exception Nos. 1.3 and 1.7 and deny Aqua Exception No. 1.5.

As also explained in our disposition of Section X.D.1, we found the ALJ did not err by rejecting the OCA's Quarterly Approximation DCF methodology. Consequently, we do not agree with the OCA's resultant 8.0% ROE for Aqua. Consistent with these determinations, we shall deny OCA Exception No. 9.

We have previously determined, above, that we shall utilize I&E's DCF and CAPM methodologies. I&E's DCF and CAPM produce a range of reasonableness for the ROE in this proceeding from 8.90% to 9.89%. Based upon our informed judgment, which includes consideration of a variety of factors, including increasing inflation leading to increases in interest rates and capital costs since the rate filing, we determine that a base ROE of 9.75% is reasonable and appropriate for Aqua. When combined with our upward adjustment of 25 basis points to the Company's ROE for management effectiveness, this will produce a final authorized ROE for Aqua of 10.00% (*i.e.*, 9.75% + 0.25% = 10.00%). Accordingly, we shall modify the ALJ's ruling as to the ROE to award Aqua in this proceeding.

E. Overall Rate of Return

1. Positions of the Parties

In this proceeding, Aqua claimed that it should be permitted to earn an overall rate of return of 7.64%. Aqua's proposed overall rate of return is comprised of a weighted average of a 4.00% rate of return on long-term debt, and a 10.75% rate of return on common equity, inclusive of an upward adjustment for management effectiveness. This is, in turn, based on a capital structure of 53.95% common equity and 46.05% long-term debt. Aqua Exh. 4-A at 1, Sch. 1.

I&E recommended that Aqua should be afforded the opportunity to earn an overall rate of return of 6.64%. This recommended overall rate of return is comprised of a weighted average of a 4.00% rate of return on long-term debt and an 8.90% rate of return on common equity and is based off of the Company's proposed capital structure. I&E M.B. at 42.

The OCA proffered that the Commission should allow Aqua the opportunity to earn a 6.00% overall rate of return on its rate base. The OCA's recommendation is comprised of a weighted average of a 4.00% rate of return on long-term debt and an 8.00% rate of return on equity and is based on a hypothetical capital structure of 50% common equity and 50% long-term debt. OCA M.B. at 53.

Although CAUSE-PA did not propose a specific rate of return for the Company in this proceeding, it stated that it supported and adopted the position of the OCA. CAUSE-PA M.B. at 12.

2. Recommended Decision

The ALJ recommended that the Commission adopt I&E's proposed overall rate of return of 6.64%. This is based upon the ALJ's recommendations, *supra*,: (1) approving the Company's proposed capital structure of 53.95% common equity and 46.05% long-term debt; (2) approving the Company's claimed cost rate of 4.00% for long-term debt; (3) utilizing I&E's methodology for determining a rate of return on common equity; and (4) denying the Company's claimed 234-basis point leverage adjustment and its upward adjustment for superior management performance. The ALJ's recommended rate of return is outlined in Table 6, as follows:

Type of Capital	Ratio	Cost Rate	Weighted Cost
Long-Term Debt	46.05%	4.00%	1.84%
Common Equity	53.95%	8.90%	4.80%
Total	100.00%		6.64%

Table 6: The ALJ's Recommended Capital Structure and Overall Rate of Return for Aqua

The ALJ applied this rate of return to Table IA of each of the rate tables set forth in the Appendix to the Recommended Decision. According to the ALJ, an overall rate of return of approximately 6.64% fairly balances the requirement that a utility be permitted an opportunity to recover those costs prudently incurred by all classes of capital used to finance the rate base during the prospective period in which its rates will be in effect, while also mitigating the revenue increases that will impact ratepayers who continue to struggle in the aftermath of the COVID-19 pandemic. R.D. at 81, Appendix Tables IA.

3. Exceptions and Replies

Only Aqua and the OCA filed exceptions to the ALJ's recommendations on a fair rate of return for the Company. Aqua and the OCA's Exceptions and Replies to Exceptions on the overall rate of return are based on their respective Exceptions and Replies to Exceptions regarding the ALJ's recommended capital structure, proxy group, and the cost of common equity, *supra*.

4. Disposition

For the reasons discussed above, we have adopted the ALJ's recommendation as to the appropriate capital structure and cost of debt for Aqua.

Additionally, based on the use of informed judgment and the addition of an upward adjustment for management effectiveness, we have modified the ALJ's recommendation as to the appropriate cost of common equity for the Company. This will, in turn, modify the ALJ's recommended overall rate of return. The table below summarizes our final determinations regarding Aqua's capital structure, cost of debt, and cost of common equity, as well as the resulting weighted costs. As Table 7 indicates, we shall set an authorized overall rate of return for Aqua at 7.24%.[66] We shall apply this rate of return, as set forth in Table IA to each of the rate tables that are attached to the Commission Tables Calculating Allowed Revenue Increase at the end of this Opinion and Order.

Type of Capital	Ratio	Cost Rate	Weighted Cost
Long-Term Debt	46.05%	4.00%	1.84%
Common Equity	53.95%	10.00%	5.40%
Total	100.00%		7.24%

Table 7: Aqua Capital Structure – Authorized Overall Rate of Return

XI. Rate Structure

A. Cost of Service

1. Positions of the Parties

Cost allocation studies are used to allocate the total water and wastewater cost of service to the various customer classifications based on established principles of cost-causation with the fundamental purpose of aiding in the accurate and reasonable design of rates. *See* R.D. at 82.

[66] We note that there are additional rate issues pertaining to the elements in the proposed base rate increase addressed later in this Opinion and Order and not included here simply because the Order follows the structure of the Recommended Decision for ease of reference by the reader.

In this proceeding, none of the Parties disputed the method used by Aqua to calculate the cost of service for its water operations and its wastewater operations. In each of the studies prepared, the total costs of service are allocated to the various customer classifications in accordance with generally accepted cost of service principles and procedures. Aqua St. 5 at 3, 19.

Aqua's cost allocation study for its water operations is included in Aqua Exh. 5-A, Part I. The method used for the allocation water cost of service was based on the Base-Extra Capacity Method for allocating costs to customer classifications. This method is described in the 2017 and prior editions of the *Water Rates Manual*, published by the American Water Works Association (AWWA). Aqua Exh. 5-A, Part I at 3. The four basic categories of cost responsibility that are considered using this method are base, extra capacity, customer, and fire protection costs. *Id.*

Aqua's cost allocation study for its wastewater operations is included in Aqua Exh. 5-B, Part I. The method used for the allocation of wastewater cost of service incorporates the functional cost allocation methodology described in the text "Financing and Charges for Wastewater Systems," Manual of Practice No. 27, published by the Water Environment Federation. Aqua Exh. 5-B, Part I at 2-3. This method is recognized for allocating the cost of providing wastewater service to customer classifications in proportion to the classifications' use of the commodity, facilities, and services. *Id.* Aqua prepared separate cost allocation studies for its wastewater Base Operations and the separate operating divisions for Limerick, East Bradford, Cheltenham, East Norriton and New Garden. *See* Aqua St. 5 at 18-19. The separate operating cost allocation studies from the Base Operations are wastewater systems acquired since the *Aqua 2018 Rate Case*. Aqua St. 1 at 7.

2. Recommended Decision

The ALJ recommended that the cost of service study methods used by Aqua for its water and wastewater operation be approved because they are reasonable and consistent with past practice. R.D. at 83.

3. Disposition

No Party filed Exceptions on this issue. Finding the ALJ's recommendation to be reasonable, we adopt it without further comment.

B. Cost of Service – Wastewater

1. Positions of the Parties

Both I&E and the OCA recommended that Aqua be required to prepare ongoing cost allocation studies for the wastewater systems acquired by the Company under Section 1329 of the Code, 66 Pa. C.S. § 1329, in future base rate cases. Additionally, I&E and the OCA argued that the Company should be required to file two separate revenue requirements going forward. These recommendations would require Aqua to prepare a cost of service study (COSS) and revenue requirement for (a) combined Wastewater Zones 1 through 6 (consisting of the Company's legacy systems), (b) combined Wastewater Zones 7-11 (representing the systems acquired under Section 1329 of the Code prior to this base rate proceeding),[67] and (c) each additional

[67] Specifically, these Wastewater Zones are as follows: Zone 7-Limerick, Zone 8-East Bradford, Zone 9-Cheltenham, Zone 10-East Norriton, and Zone 11-New Garden. *See* Aqua Volume 5, Exh. 5-B, Part II, Schs. LMK, EB, CH, EN and NG.

system acquired after this proceeding under Section 1329. I&E M.B. at 65-66; OCA M.B. at 84-86.

I&E argued that combining Wastewater Zones 7 through 11 into one COSS in Aqua's next base rate case is important because these zones include systems acquired under Section 1329 and represent a unique group of zones and cost recovery requirements. Therefore, I&E recommended that these zones should continue to be grouped into one COSS in future cases. I&E also reasoned that it is important to distinguish the difference between these systems and systems not acquired under Section 1329 because of the generally higher cost of providing service to customers in these systems acquired under Section 1329. I&E M.B. at 65-66 (citing I&E St. 5 at 66).

The Company opposed the recommendations of I&E and the OCA stating that the decision to require separate cost allocation studies for future wastewater acquisitions should not be pre-determined but should be evaluated in such future proceedings. Aqua further noted that it has never been required to carve out water and wastewater acquisitions in this manner, after the initial rate case post-acquisition. Additionally, the Company asserted that because the acquired systems are similarly operated as the legacy systems, no advantage could be gained on a cost of service basis by separating these systems. Aqua also contended that the Commission should not dictate how the Company will file its next base rate proceeding absent its agreement, citing the general principle that the Commission should refrain from acting as a super board of directors. Moreover, Aqua argued, the recommendations frustrate the goal of single tariff pricing and consolidation of rate zones. Aqua M.B. at 219-20; Aqua R.B. at 93.

2. Recommended Decision

The ALJ recommended that the Commission adopt the positions advanced by I&E and the OCA that Aqua be required to prepare separate COSS and revenue requirements in its next base rate proceeding. R.D. at 82-83.

The ALJ reasoned that this base rate filing emphasizes the importance of tracking the implications of the acquisition of water and wastewater systems and the effect of those acquisitions on rates and cost of service. In acknowledging that consolidating rate zones is important, the ALJ emphasized the importance of appropriately tracking the cost to serve the acquired systems – and the steps taken to move rates in these systems closer to the cost of service – while ensuring that other ratepayers are not subsidizing service to these customers indefinitely. The ALJ considered the proposals to be reasonable and sensible and well within the Commission's mandate to ensure that a utility's rates are just and reasonable and meet the public interest. *Id.* at 83.

3. Exceptions and Replies

In its Exception No. 8, Aqua argues that the ALJ erred by ordering the Company to prepare a separate COSS for each system acquired under Section 1329 of the Code that is included in the next base rate proceeding following such acquisition. Aqua Exc. at 29-31.

Initially, Aqua contends that the Recommended Decision ignores applicable appellate precedent, citing *City of Pittsburgh v. Pa. PUC*, 526 A.2d 1243 (Pa. Cmwlth. 1987), *appeal denied*, 517 Pa. 628, 538 A.2d 880 (1988) (*City of Pittsburgh*). The Company asserts that in *City of Pittsburgh* the Commonwealth Court specifically affirmed a prior Commission order that declined to condition a water utility's proposed consolidation of rate districts upon the maintenance of separate records for each district. Aqua argues that, consistent with this case, it should not be required to maintain and prepare separate studies and revenue requirements in its next base rate proceeding. Aqua Exc. at 30.

The Company further contends that the Recommended Decision disregards the impacts of imposing this requirement on Aqua relative to other water and wastewater utilities in Pennsylvania. According to Aqua, this requirement will result in significant accounting, tracking, operational and rate impacts that would also frustrate the Commission's policy supporting single tariff pricing and consolidation. Likewise, Aqua continues, the increased costs and complications associated with preparing separate cost allocation studies would likely put the Company at a competitive disadvantage from other bidders in future acquisition opportunities. *Id.* (citing Aqua M.B. at 219).

Furthermore, Aqua submits that, for new acquisitions, the recommended requirements should be analyzed in the context of future Section 1329 acquisition proceedings, and not in this base rate case. The Company submits that the Commission should not require Aqua to indefinitely prepare separate costs of service and revenue requirements for future acquired systems, where it is not known whether and when further systems will be acquired. Aqua Exc. at 30-31.

In its reply, I&E argues that the ALJ properly recommended that the Commission adopt its recommendations regarding recently acquired Section 1329 systems and those acquired subsequent to this base rate proceeding. I&E asserts that the ALJ correctly emphasized the importance of tracking the implications of the acquisitions under Section 1329 and the effect of those acquisitions on rates and cost of service. I&E adds that the ALJ noted the importance of consolidating rate zones. However, I&E asserts, the ALJ correctly determined the need to appropriately track the cost to serve Section 1329 acquired systems and the steps to move rates in these systems closer to the cost of service while ensuring that other ratepayers are not subsidizing service indefinitely. I&E R. Exc. at 9-10.

In its reply, the OCA asserts that the ALJ's recommendation is reasonable given the significant impact that Section 1329 acquisitions had on rates for wastewater and water customers in this proceeding. OCA R. Exc. at 12-14.

The OCA argues that Aqua's objections to the recommendations on the basis that it would place an extra burden on Aqua relative to other water and wastewater utilities are misplaced. If other utilities are acquiring systems under Section 1329, the OCA submits, then they will be in the same situation that Aqua was in the current base rate case where it provided one COSS for legacy systems and individual COSSs for the systems acquired prior to the base rate case. According to the OCA, an individual COSS has been adopted by the Commission for every Section 1329 acquisition approved to date and it is reasonable to assume the Commission will continue to apply it uniformly to Aqua's competitors. OCA R. Exc. at 12.

The OCA contends that the main distinction in this proceeding is that Aqua would be preparing only one additional COSS for the combined Section 1329 systems included in this case. Regarding Aqua's concerns of increased costs and complications of preparing one additional COSS for those systems, the OCA asserts that the Company does not quantify such costs. Instead, the OCA cites to the rate case expense claim in the current proceeding – $400,000 on "Engineering, Cost Allocation and Depreciation"– and compares it with the purchase price of the five systems Aqua already acquired under Section 1329, which ranged from $5 million to $75 million, or an average of $34.4 million. OCA R. Exc. at 12-13 (citing Aqua Exh. 1-C, Sch. C-4.4). The OCA argues that even if COSSs and cost allocation represented the entire $400,000 in this case, ignoring that 91.51% of rate case expense is allocated to water operations, the cost would represent only 1% of the average purchase price of the Section 1329 systems in this case. The OCA submits that this cost to Aqua cannot reasonably be considered a meaningful competitive disadvantage. OCA R. Exc. at 13.

The OCA also criticizes Aqua's concerns about imposing future requirements indefinitely in this base rate case because it is not known whether and when further systems will be acquired. Citing to Aqua's three pending Section 1329 applications, the OCA submits that establishing a requirement for a separate COSS for Section 1329 acquisitions in this case would avoid the need for the Parties and the Commission to address it in every Section 1329 proceeding.[68] The OCA proffers that the continuing need for this requirement could be evaluated in the next base rate proceeding. *Id.*

The OCA further objects to Aqua's contention that preparing a separate COSS would frustrate the policy of single tariff pricing. Regarding the citation to *City of Pittsburgh*, which upheld the Commission's decision to not require a water utility to maintain separate records for rate districts after they were consolidated, the OCA contends the Commonwealth Court's decision is distinguishable. Here, the OCA asserts, Aqua has not reached the point of consolidating Section 1329 systems with its legacy systems. Rather, the OCA emphasizes that Aqua has proposed to reduce its legacy rate zones from six to five and for each Section 1329 system to stay in its own, separate rate zone. OCA R. Exc. at 13-14 (citing Aqua St. 5-R at 21; Tariff Sewer No. 3).

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[68] The OCA notes there are three pending Section 1329 proceedings: *Application of Aqua Pa. Wastewater, Inc.*, Docket No. A-2019-3015173 (Delaware County Regional Water Quality Control Authority Wastewater System Assets); *Application of Aqua Pa. Wastewater, Inc.*, Docket No. A-2021-3026132 (East Whiteland Township Wastewater System Assets); and *Application of Aqua Pa. Wastewater, Inc.*, Docket No. A-2021-3027268 (Williston Township Wastewater System Assets). The OCA also references the recent acquisition approval in the *Application of Aqua Pa. Wastewater, Inc.*, Docket No. A-2021-3024267 (Order entered January 13, 2022) (Lower Makefield Township Wastewater System Assets). OCA R. Exc. at 13, n.8.

Additionally, the OCA argues that in this case Aqua proposes a one-third recovery of its wastewater revenue requirement from water customers, which moves all customers further from paying rates that reflect their indicated cost of service. OCA R. Exc. at 14 (citing OCA St. 4 at 4 (Table I); Aqua Exhs. 5-A, Part I, 5-B, Part I). The OCA submits that the ALJ correctly addressed the concerns about subsidies between water and wastewater and between the legacy and acquired wastewater systems in the Recommended Decision and appropriately adopted the proposal of I&E and the OCA. OCA R. Exc. at 14 (citing R.D. at 83).

4. Disposition

We begin by addressing the contention that an individual COSS has been adopted by the Commission for every Section 1329 acquisition approved to date. *See* OCA R. Exc. at 12. In the recent Section 1329 application by Pennsylvania-American Water Company (PAWC) to acquire the water and wastewater system assets of Valley Township, the parties to that proceeding filed a Joint Petition for Approval of Unanimous Settlement of All Issues (PAWC Settlement) which the Commission approved without modification. *Application of Pennsylvania-American Water Company*, Docket Nos. A-2020-3019859 and A-2020-3020178 (Order entered October 28, 2021) (*PAWC – Valley Township Order*). The PAWC Settlement did not require separate COSSs related to the Valley Township acquisitions in PAWC's next base rate case nor did the Commission modify the Settlement to impose such a requirement. *Id.*

Our decision in the *PAWC Valley Township Order* is illustrative of the importance of analyzing the necessity of COSSs within the context of individual Section 1329 acquisition proceedings. Although there is a benefit to having COSS data pertaining to Section 1329 acquisitions available in a base rate proceeding subsequent to an application approval, it is apparent from the PAWC Settlement – which included the statutory advocates as signatories – that it need not be mandated within all Section 1329 proceedings. We decline here to pre-judge the issue in all future Section 1329 proceedings when the facts and circumstances of that individual proceeding may not necessarily require a cost of service analysis. Moreover, we shall not impose such a blanket mandate requiring COSSs on all future Section 1329 proceedings involving Aqua when the Commission did not impose such a requirement in an individual application proceeding involving another regulated service provider. However, our decision herein shall not be deemed to limit the authority of the Commission to require the preparation of cost allocation studies for systems acquired in individual Section 1329 proceedings as the circumstances may warrant.

Regarding the proposal to maintain ongoing, separate COSSs for those systems acquired under Section 1329 of the Code prior to this base rate proceeding, we note that the Commission first directed the filing of a cost of service analysis as a condition of approval in Aqua's Section 1329 acquisition of the wastewater system assets of New Garden Township and the New Garden Township Sewer Authority. *Application of Aqua Pennsylvania Wastewater, Inc.*, Docket No. A-2016-2580061 (Order entered June 29, 2017) (*New Garden*).

The intention of the conditions in the *New Garden* proceeding and similar directives in other Section 1329 proceedings was, in part, to inform the Parties and the Commission of the overall rate impact that the acquisition will have on customers within the context of the *next* base rate proceeding. *See New Garden* at 69-70. It was not to impose ongoing conditions indefinitely in all subsequent rate cases.

Thus, we shall grant Aqua Exception No. 8 and modify the Recommended Decision accordingly.

C. Revenue Allocation

1. Positions of the Parties

Aqua noted that under *Lloyd v. Pa. PUC*, 904 A.2d 1010, 1020 (Pa. Cmwlth. 2006) (*Lloyd*), cost of service is the "polestar" of utility rates, and a proposed revenue allocation will only be found to be reasonable where it moves distribution rates for each class closer to the full cost of providing service. Aqua provided that its proposed revenue allocation for both water and wastewater involves a determination of: (1) the allocated cost responsibilities and the percentage of revenue under existing rates; and (2) the percentage of cost responsibilities and percentage of *pro forma* revenues under proposed rates for each customer classification. Aqua M.B. at 211-12 (citing *Lloyd* at 1020). Aqua submitted that, upon making such determinations, the Company: (1) proposed allocating revenues to each customer class that would be required to move that class toward the cost of service; and (2) determined an amount of wastewater revenues to be recovered in water rates, pursuant to Section 1311(c) of the Code (commonly referred to as Act 11).[69] Aqua M.B. at 212 (citing Aqua St. 5 at 10, 21;

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[69] Section 1311(c) of the Code:

> When any public utility furnishes more than one of the different types of utility service, the commission shall segregate the property used and useful in furnishing each type of such service, and shall not consider the property of such public utility as a unit in determining the value of the rate base of such public utility for the purpose of fixing base rates. A utility that provides water and wastewater service shall be exempt from this subsection upon petition of a utility to combine water and wastewater revenue requirements. The commission, when setting base rates, after notice and an opportunity to be heard, may allocate a portion of the wastewater revenue requirement to the combined water and wastewater customer base if in the public interest.