Let's Talk About Fair Market Value
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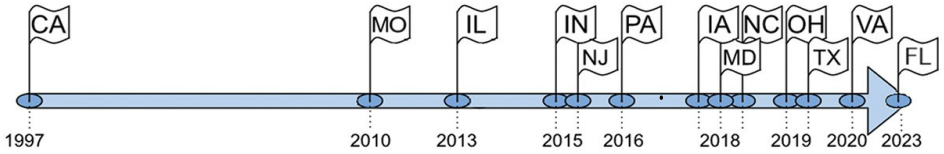
I. What Is "Fair Market Value"?

A. Thirteen states have enacted fair market value (FMV) legislation that addresses (1) **the appraised value** of municipally-owned (and, in some instances, investor-owned) water and wastewater systems, (2) **the acquisition cost (purchase price) paid for the systems** by a regulated water or wastewater public utility, and (3) **whether all or a portion of that cost is included in the acquiring public utility's rate base for ratemaking purposes**:[2]



Fair Market Value acquisition policies have been established for small, municipal, distressed, and even healthy systems. Each state that uses FMV has established its own policies for determining which systems qualify to either acquire or be acquired using FMV. States may specify that systems under a certain size (investor-owned utility or municipal system) are eligible for FMV acquisitions; may focus on systems that are "distressed"; may specify that only municipal systems are eligible for FMV acquisition; or they may require acquiring systems to be of a certain size to be eligible for the FMV method of valuation.[3] FMV legislation often requires the fair market value to be determined in compliance with the Uniform Standards of Professional Appraisal Practice employing the cost, market, and income approaches.[4]

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[1] Former Commissioner (1979-85 & 2005-15) and Chairman (2008-11) of the Pennsylvania Public Utility Commission. Comments welcome: jhcesquire@gmail.com. Full disclosure: I have spoken forcefully against Pennsylvania's 2016 FMV law (Comments of James H. Cawley, *Valuation of Acquired Municipal Water & Wastewater Systems—Act 12 of 2016 Implementation*, Pa. Pub. Util. Comm'n Docket No. M-2016-2543193 (March 22, 2024), https://www.puc.pa.gov/pcdocs/1821560.pdf; and Reply Comments of James H. Cawley in the same proceeding (April 2, 2024), https://www.puc.pa.gov/pcdocs/1823032.pdf), but have endeavored in this outline to give the pros as well as the cons of such laws.

[2] The following timeline is from T.J. McKiernan & Mildred E. Warner, *Challenges in Reintroducing Fair Market Value to US Public Water/Wastewater Systems*, 40 INTERNATIONAL JOURNAL OF WATER RESOURCES DEVELOPMENT 989, 991 (2024), https://doi.org/10.1080/07900627.2024.2400491 (hereinafter McKiernan & Warner); *see also* Thomas McKiernan, *Challenges in Reintroducing Fair Market Value to U.S. Public Drinking Water Systems* (Cornell University thesis, May 2024), https://ecommons.cornell.edu/server/api/core/bitstreams/8929ca11-419d-4237-a54f-60de5d7b6c4c/content.

[3] Kathryn Kline, *A Review of State Fair Market Value Acquisitions Policies for Water and Wastewater Systems*, National Regulatory Research Institute (September 2021) at 6 (hereinafter Kline), https://pubs.naruc.org/pub/ED8E5710-1866-DAAC-99FB-B70190F3D64A. For those interested in FMV issues, this monograph is an indispensable resource.

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

Table 2. A Comparison of State Fair Market Value Policies.

State	Year	Appraisal required?	# Appraisers	Appraiser selection	What is the rate base?
MO	2010	Yes	3	The acquiring utility and acquired utility each select one appraiser who jointly select the third.	The lesser of the purchase price and fair market value is added to the rate base.
IL	2013	Yes	3	Selected by either the acquiring or the acquired utility.	
PA	2016	Yes	2	The acquiring utility and acquired utility each select one appraiser.	
IA	2018	Yes	2	The acquired utility and the IA Utilities Board each select one appraiser.	
MD	2018	Yes	2	The acquiring utility and acquired utility each select one appraiser.	
NC	2018	Yes	3	The Commission, acquiring utility, and acquired utility each select one appraiser.	
OH	2019	Yes	3	The acquired and the acquiring utility together select three appraisers from a list maintained by the state.	
TX	2019	Yes	3	The utility commission selects the utility valuation experts.	
VA	2020	Yes	3	The commission, acquiring utility, and acquired utility each select one appraiser.	
FL	2023	Yes	3	The acquiring utility selects the appraisers from a list maintained by the commission.	
CA	1997	No	N/A	N/A	If the fair market value (sale price, by California's definition) exceeds reproduction cost, the commission may include the difference in the rate base.
NJ	2015	Yes	N/A	Either or both the acquiring and the acquired utility select the appraisers.	The value determined by the buyer and seller is included in the rate base if the system meets a predefined 'emergent condition'. Appraisals should support the final purchase price.
IN	2016	Yes	3	The municipal legislative body or municipal executive select the appraisers.	The full purchase price is added to the rate base if it is less than the appraised fair market value.

Source: Author analysis of Public Utility Codes.

Source: McKiernan & Warner at 999.

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

B. Ultimately, We're Talking About Rate Base Valuation

(*Rate Base – Accrued Depreciation*) x Rate of Return + Prudent Expenses = Revenue Requirement

C. Traditional Method vs. FMV of Valuing A System to be Acquired

1. The traditional method for determining the value of a system to be acquired is to calculate the original rate base value (original cost) less accrued depreciation (the "book value").

2. FMV values the system by appraisals of a municipal or public utility property's "exchange value," which is often (if not invariably) higher than the traditional book value, by estimating what the property would sell for after being publicly listed for sale or if sold by public auction in a vibrant marketplace of buyers and sellers of such properties. Despite being the most frequently used appraisal standard in commercial real estate and eminent domain contexts, a concrete definition of fair market value eludes expert appraisers.[5]

II. FMV Is an Aberrant, Early-Rejected Method of Valuation Promoted by American Water Works & Essential Utilities

1. Through subsidiaries, American Water Works[6] and Essential Utilities[7] provide water and wastewater services in the United States. The two companies have been the principal promoters of the FMV concept in Pennsylvania.[8]

2. Confusing "fair market value" with "fair value," McKiernan & Warner, in their otherwise excellent article, wrongly state that "Fair market value was the rate base value standard up until the early 20th century" citing the U.S. Supreme Court's decision in *Smyth v. Ames*, 169 U.S. 466 (1898).[9]

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[5] *McKiernan & Warner* at 994. The appraisals supplant original cost plant-in-service studies. See the Policy Statement referenced in footnote 29, *infra*.

[6] AWW subsidiaries operate in CA, HI, IL, IN, IA, KY, MD, MO, NJ, PA, TN, VA, and WVA.

[7] Essential Utilities (formerly Aqua America and Peoples Natural Gas, which continue to operate under their original names) subsidiary Aqua operates in IL, IN, NJ, NC, OH, PA, TX, and VA.

[8] McKiernan & Warner at 998 ("Our analysis finds the introduction of FMV is concentrated in states where investor-owned utilities already operate. American Water, the largest investor-owned water/wastewater utility in the United States, operates in all but one of the states (Ohio) where FMV bills have passed. Similarly, all eight states, including Ohio, where Essential Utilities (the second largest investor-owned water utility) provides water service, have passed FMV bills. Large investor-owned utilities and the trade associations that represent water companies (NAWC) have publicly supported, advocated or even drafted FMV law alongside legislators. American Water has demonstrated that FMV is a legislative priority and a cornerstone to their growth goals during recent investor presentations (American Water Works Association, 2023). They have been able to realize their goal of passing FMV laws in 10 of the 13 states in which they operate."

[9] McKiernan & Warner at 993. Justice Harlan defined "fair value" as: "[T]he basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And, in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. What the company

> As "fair market value" is emerging today, it emulates the older historic fair value standard [of *Smyth v. Ames*]. *It rejects the book value standard (depreciated original cost) in favour of a value approach more dependent on market forces and future revenue generation*. Of the thirteen states where fair market value has been adopted, only California, Illinois and Ohio provide clear definitions, which are nominal secondary descriptions to the more specific FMV appraisals required by state statutes. Most states defer to appraisers to determine fair market value (NC, PA, FL, MD, TX, VA, MO), thereby circumventing a definition altogether. Iowa defines fair market value as the greater of the average of two FMV appraisals, the depreciated value of capital assets or the amount necessary to retire the system's outstanding revenue and general obligation bonds. New Jersey and Indiana do not include any reference to fair market value, despite legalizing processes similar or identical to other states.[10]

3. "Three principal concepts compete for acceptance as the appropriate rate base: fair value, reproduction cost, and original cost."[11] Prof. Rose explained:

> The [U.S. Supreme] Court defined fair value as a judgment figure to be derived by the regulatory authority after giving consideration to, *inter alia*, original cost of construction, amount and market value of bonds and stock, *and the earning capacity of the property under particular rates prescribed by statute*. This concept of fair value was soon modified. In 1909 the Supreme Court held in City of Knoxville v. Knoxville Water Co., 212 U.S. 1 (1909), that accrued depreciation must be deducted from original and reproduction cost in establishing fair value. *In addition it was early realized that market value of securities and earnings could not properly served as the basis of determining earnings. The Minnesota Rate Cases, 230 U.S. 352, 461 (1913). Consequently, "fair value" has been often re-interpreted as a judgment figure predicated principally upon original and reproduction costs, both depreciated*."[12]

4. As debated and decided at the dawn of federal and state regulation of investor-owned public utilities during the first decades of the last century, "market value," "exchange value," or "fair market value" was found incompatible and improper for public utility rate base valuation. Such valuation was approved for condemnation proceedings and commercial real estate dealings.

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is entitled to ask is a fair return upon the value of that which it employs for the public convenience." 169 U.S. at 546-547.

[10] *Id.*at 994 (emphasis added). Regarding New Jersey's law, see Peggy Gallos and Dennis W. Doll, *Op-Ed: What's Fair About This Method Of Determining "Fair-Market-Value" Of Public Utilities?* (July 23, 2021), https://www.middlesexwater.com/op-ed-whats-fair-about-this-method-of-determining-fair-market-value-of-public-utilities/; Peggy Gallos, Why Ratepayers Protections Are Needed in the U.S. Water Utility Privatization Push (Oct. 21, 2021), https://www.aeanj.org/why-ratepayers-protections-are-needed-in-the-u-s-water-utility-privatization-push/.

[11] Joseph R. Rose, *Confusion in Valuation for Public Utility Rate-Making*, U. MINN. L. REV. 1, 26 (1962), https://scholarship.law.umn.edu/mlr/1700 (hereinafter Rose).

[12] *Id*. at 1 n.2 (emphasis added). Two excellent histories of public utility rate base valuation are: Lawrence P. Simpson, *Development of Public Utility Rate Valuation*, 5 ALA.L.J. (TUSCALOOSA) 195 (1929-1930); and Edward Ross Carpenter, *Fair Value or Prudent Investment as a Rate Base in Pennsylvania? A Conflict Between the Public Utility Commission and the Superior Court,* 99 U. Pa. L. Rev. 371 (1950), https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=8195&context=penn_law_review.

(a) *Eminent Domain Valuation –*

When the state appropriates private property for public use by eminent domain, the just compensation that must be paid therefor is generally defined as "market value" or "fair market value."[13] Using eminent domain terms and concepts in public utility ratemaking wrongly suggests that each act of rate-fixing under legislative authority is an act comparable to the expropriation of the utility's earning power for which compensation must be made.

This is completely untenable because no one versed in constitutional law would confuse the power to regulate a business in the public interest with the state's power to take over a business by paying the private owners just compensation for its taking. In the latter situation, the eminent domain limitation is apposite, and the government must pay the owner compensation measured by the market value of the property it expropriates. However, when the government regulates a business without assuming complete control, the power thus exercised is categorized in constitutional theory as the police power.[14] In the reasonable exercise of this police power, the state may regulate a business's services and rates.

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

> The normal test of just compensation in eminent domain cases is the market value of the property and, where the property taken is a business, evidence of earnings is relevant in determining that value. In rate-making, however, the earnings themselves are under scrutiny, and any rate base which capitalizes earnings under existing rates is totally useless; the present rates, no matter how excessive, can never be reduced. Courts and commissions have, therefore, almost universally excluded probable earning power and market value of securities from consideration in determining fair value.[15]

(b) *Commercial Valuation –*

"It was recognized that a commercial valuation predicated upon earning capacity had no place in a process of price determination whose objective was the determination of the reasonable exchange value of service produced under regulated monopolistic or semi-monopolistic conditions."[16] Thus, for example, private property selling value derived in competitive commercial real estate markets differs from the value given to public utility assets for ratemaking purposes in a non-competitive regulated environment.

Therefore, as with the determination of condemnation damages, the method for determining commercial value is inappropriate in a non-competitive, economically regulated monopoly environment where the property owner is given an exclusive franchise service

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

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

[15] Carpenter, *supra* note 11, at 372-373 (footnotes omitted).

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

territory, and the property is used to provide a service that is absolutely and irreplaceably essential to modern life. Consequently, such property is "affected with the public interest," and the service provider's business practices, rates, and terms of service may be controlled under the police power of the state for the common good.

Under such regulated circumstances, there is little or no ready market for the sale of a municipal water or wastewater system because it is unique in character, and the marketplace only consists of other municipal entities and public utilities. There are no other competitors from whom customers may get the identical service, and there is an extremely limited number of potential buyers (all of whom are either public utilities or need to become a public utility with the regulatory body's approval to serve customers with the acquired property, unless the buyer is another municipal entity).

Practically speaking, a utility buyer must (1) be financially strong enough to pay tens or even hundreds of millions of dollars to acquire municipal systems, (2) have a sufficiently large customer base across which the acquisition costs can be spread without having to raise its own rates significantly, and (3) have existing water and/or sewer facilities and a workforce in close enough proximity to the acquired system to allow its efficient and economical operation. In most (if not all) states, very few (if any) municipal entities and no more than three regulated water/wastewater public utility companies possess these qualifications.

(c) *The problem of "Circularity" –*

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

> The commercial value of an industrial property depends upon its expected net earning power. This in turn, among other factors, depends upon the prices or rates to be realized from the products or services to be sold. Thus the *commercial value* of a public utility property would depend upon the *rates charged for service*, and therefore could not be logically used as a measure for the determination of reasonable rates. As a matter of principle, it would obviously preclude either the lowering or increasing of rates. High rates would be reflected in expected earnings, and therefore in the value of the properties; hence they could not be reduced. Likewise low rates would be reflected in the consequent value, and so could not be increased.
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> Commercial value *as such* clearly is not a concept that can be applied to monopolized industries for the purpose of protecting consumers against exorbitant charges or safeguarding investors from confiscatory rate restrictions.[17]

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

> And, being a prosperous utility, the most useful item in the determination of its value would be its earning capacity. In fact, in the case of a successful plant for which there is no market value in the sense of value established by exchanges on the market, the best index to market value is the capitalization of earning capacity. Yet the central purpose of a rate proceeding is to determine what the earning

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

> capacity should be. If in such a rate proceeding a commission uses a rate base determined on the basis of value and the valuation arrived at reflects the earning capacity of the plant, the whole proceeding is stymied at the outset[,] for by hypothesis[,] the rate base chosen will be the valuation reflecting the existing rate schedule. … the Supreme Court, whenever it has had occasion to consider the question critically, has made clear that earning capacity, the very issue at stake, is not a factor to be considered in determining fair value.[18]

Finally, this from Alfred E. Kahn, the Cornell economist whose two-volume treatise, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS (1970), became the go-to reference for a generation of public utility regulators and those they regulated:[19]

> [L]argely for constitutional reasons, the traditional emphasis and focus of most of the litigation in the American regulatory experience has been on [the determination of] the "rate base." . . . "[F]air value" cannot serve as the basis for rate regulation if it is taken to mean market value, since the market value of any enterprise or of its common stock depends on its earnings or anticipated earnings, which in turn depend on the rates that are allowed it: "'fair value' is the end product of the process of rate-making not the starting point…."[20]

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

(d) *Justice Brandeis got it right in 1923 –*

U.S. Supreme Court Justice Louis D. Brandeis, in his dissenting opinion (agreeing with the majority but for different reasons) in *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 292 (1923), most prominently explained why "fair value" (and, by clear implication, "fair *market* value") as established in *Smyth v. Ames*, was inappropriate for public utility ratemaking (emphasis added):

> To give to capital embarked in public utilities the protection guaranteed by the Constitution, and to secure for the public reasonable rates, it is essential that the rate base be definite, stable, and readily ascertainable, and that the percentage to be earned on the rate base be measured by the cost, or charge, of the capital employed in the enterprise. It is consistent with the federal Constitution for this Court now to

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

[19] Followed closely by Charles F. Phillips, Jr., THE REGULATION OF PUBLIC UTILITIES (1984).

[20] 1 A.E. Kahn, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 38 (1970) (quoting *Federal Power Commission v. Hope Natural Gas Co*., 320 U.S. 591, 601 (1944); the Court continued: "The heart of the matter is that rates cannot be made to depend upon 'fair value' when the value of the going enterprise depends on earnings under whatever rates may be anticipated.").

> lay down a rule which will establish such a rate base and such a measure of the rate of return deemed fair. In my opinion, it should do so.
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> The rule of *Smyth v. Ames* sets the laborious and baffling task of finding the present value of the utility. *It is impossible to find an exchange value for a utility, since utilities, unlike merchandize or land, are not commonly bought and sold in the market. Nor can the present value of the utility be determined by capitalizing its net earnings, since the earnings are determined, in large measure, by the rate which the company will be permitted to charge, and thus the vicious circle would be encountered.*[21]

5. So the circularity problem nixes the Income Approach of appraisal. Can the appraisal produce a just and reasonable result under the remaining two approaches: Cost Approach and Market Approach?

(a) Cost Approach – This value estimate reflects the cost of reproducing or replacing the municipal (or public utility) system's assets in the current market, which resurrects the discredited Reproduction Cost method.

(b) Market Approach – This value estimate is derived by comparing the purchase price with the prices of similar previously sold systems in the same or similar market. Two possible problems: There may not be an active market, and the selection of the "barometer" group members significantly determines the outcome (as with the "comparable earnings" method of determining return on equity).

III. Arguments in Favor of Fair Market Value

1. FMV is a rate mechanism that encourages regionalization or consolidation of small, distressed, and/or municipal water and wastewater systems by valuing the system at its potential sales price rather than its historical value.[22]

2. FMV acquisitions for water and wastewater systems are designed to encourage large (healthier) systems to consolidate small, struggling, and (in some cases) municipal systems. These acquisitions can help reduce the number of struggling water and wastewater systems and improve water quality for customers.[23]

3. Fair market valuation benefits municipal owners because they receive higher purchase prices from water and wastewater public utilities than they would if book value (original cost minus accrued depreciation) were used as the ratemaking cost recovery standard.

(a) Book value is typically less than "fair market value" because many older municipal systems have substantially or completely amortized the cost of their original investments, resulting in a book value of zero. In fact, many municipal assets continue to operate for years after they are completely amortized on the balance sheet.

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[21] *See also* Rose at 26 ("Fair value must in this respect be distinguished from exchange value, which is dependent upon earnings or anticipated earnings and which thus cannot logically serve as the basis for determination of earnings.").

[22] Kline at 15.

[23] *Id*. at 3.

(b) Many municipal systems' assets have been substantially funded by "contributed capital," i.e., not with customer dollars but with state and federal grants and property contributed by real estate developers. Under the "no return on contributed property" rule applicable to regulated public utility ratemaking, little or no "depreciated original cost rate base" exists upon which a return can be earned. There is little or no value to be added to the acquiring utility's rate base, which may prevent the utility from recovering its purchase price in its future rates.

4. "Although lawmakers and FMV supporters concede that rates will rise, they argue FMV legislation creates an opportunity to invest in deteriorating infrastructure. Regulated utilities earn a return on their capital investments and thus may be more motivated to invest in their systems than government-owned water operators. System managers of government-owned water/wastewater infrastructure often defer upgrades for their aging systems due to political concerns over raising rates."[24]

5. "Municipally owned water and wastewater systems face an additional set of unique challenges due to their governance structure. Some of the reasons a municipal system would have an incentive to be acquired include tight budgets and underfunded pensions, competition for funding with other municipal services, additional property tax revenue from [the] acquiring [investor-owned utility], and high costs to comple with EPA mandates."[25]

6. "There is opportunity for low-income customers to benefit from subsidization across systems in states where investor-owned utilities possess multiple systems and are permitted to 'consolidate' tariffs (i.e., multiple systems are joined into a group with a common rate base and the same rates charged to customers). Systems acquired by a single company and included in the same tariff group can 'smooth' cost burdens of investments over a larger customer base, which has potential to benefit currently underinvested systems."[26]

7. Robert F. Powelson, *Our Water Is Becoming Privatized. That's A Good Thing* (Phila. Inq., April 4, 2022), https://nawc.org/resources/our-water-is-becoming-privatized/; Norman Kennard, *Communities Across Pennsylvania Benefit from Water Company Expertise* (Broad + Liberty, July 7, 2023), https://broadandliberty.com/2023/07/07/norman-kennard-communities-across-pennsylvania-benefit-from-water-company-expertise/#:~:text=The%20policy%20solutions%20passed%20by%20the%20state%20General,of%20their%20communities%E2%80%99%20vital%20water%20and%20wastewater%20infrastructures.

IV. Arguments Against Fair Market Value

1. Fair market valuation is incompatible with the regulation of monopoly public utilities that must charge "fair, just, and reasonable" rates. "Best price" does not necessarily equal "just and reasonable rates."

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[24] McKiernan & Warner at 1002; *see also* Kline at 12 ("Municipal water systems also face challenges with underinvestment, because local governmental entities are often reticent [hesitant] to enact the unpopular rate increases necessary to fund infrastructure maintenance. Rather than using funds for maintenance, municipalities may allocate funds earned from water systems to close gaps in a locality's budget.").

[25] Kline at 12.

[26] McKiernan & Warner at 1002-1003.

(a) Getting the highest purchase price for a municipal system may overly burden the acquired and the utility's existing customers' rates to enable recovery of the premium paid to the municipality.

(b) FMV legislation usually provides an incentive for the seller and buyer to agree upon the highest rather than a lower, competitively derived price, with the difference made up by all the utility's new and existing customers.

(c) Rate freezes and phased-in rate increases for the acquired customers are only temporary; meanwhile, the acquiring utility's existing customers may be required to subsidize the cost of service to the acquired municipal customers.

2. An "exchange value" method of valuing the acquired municipal entity's assets for inclusion in the utility's rate base is an untenable, unachievable contrivance because a vibrant competitive marketplace to achieve the lowest fair sale price is lacking. Typically, the only buyers are one or two monopolies or duopolies.

3. The public interest is served only when investor-owned water and wastewater companies are incentivized to acquire *distressed or nonviable* municipal water and wastewater systems. Conversely, providing incentives for such companies to acquire *healthy* municipal systems is not only unnecessary, but it also harms the public interest if the acquisition cost added to the acquiring utility's rate base has not been determined to be just and reasonable by the state's public utility regulatory commission.

(a) An example of the former is Section 1327 of the Pennsylvania Public Utility Code, 66 Pa.C.S. § 1327.[27] For the acquiring utility to be eligible for a "positive acquisition adjustment" for some or all of the premium paid over the municipal system's depreciated original cost, that system must serve 3,300 or fewer customer connections, be distressed, and "…not, at the time of acquisition, furnishing and maintaining adequate, efficient, safe and reasonable service and facilities…" 66 Pa.C. § 1327(a)(3). The number of customer connections could, of course, be eliminated or raised by statutory amendment.

(b) An example of the latter is Section 1329 of the Pennsylvania Public Utility Code, 66 Pa.C.S. § 1329,[28] discussed below, which has been used to acquire viable and, in most cases, very healthy municipal systems using FMV, superseding a Commission Policy Statement

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27 https://www.legis.state.pa.us/cfdocs/legis/LI/consCheck.cfm?txtType=HTM&ttl=66&div=0&chpt=13&sctn=27&subsctn=0. The Commission has promulgated several rules that effectuate this provision under the Commission's regulations. 52 Pa. Code § 69.711 (relating to acquisition incentives), https://www.pacodeandbulletin.gov/Display/pacode?file=/secure/pacode/data/052/chapter69/s69.711.html&d=. The Commission's acquisition incentives include a rate of return premium for the acquiring utility; a debt acquisition adjustment when the buyer pays more than depreciated original cost (§ 69.711(b)(ii)); the deferral of acquisition improvement costs; and a plant improvement surcharge. See 66 Pa.C.S. § 523 (relating to performance factor consideration); James H. Cawley & Norman J. Kennard, A GUIDE TO UTILITY RATEMAKING (2d ed. 2018) at 135-136, https://www.puc.pa.gov/General/publications_reports/pdf/Ratemaking_Guide2018.pdf; *but see* Mark Ellis, *Rate of Return Equals Cost of Capital: A Simple, Fair Formula to Stop Investor-Owned Utilities from Overcharging the Public* (Jan. 2025), https://www.economicliberties.us/wp-content/uploads/2025/01/20250102-aelp-ror-v5.pdf.

28 https://www.legis.state.pa.us/cfdocs/legis/LI/consCheck.cfm?txtType=HTM&ttl=66&div=0&chpt=13&sctn=29&subsctn=0. *See Implementation of Section 1329 of the Public Utility Code*, Docket No. M-2016-2543193, Final Implementation Order (Oct. 27, 2016). The Commission has a website page on § 1329 at: http://www.puc.state.pa.us/filing_resources/issues_laws_regulations/section1329_applications.aspx.

issued in 2006 that provided for Commission approval of any inclusion of acquisition assets in the rate base.[29]

(c) When a system is in poor condition, an incentive is needed to persuade an investor-owned utility to undertake the tasks of restoration. When, however, a system is healthy and requires little or no restoration efforts, no incentive is needed, especially if the system is an attractive expansion opportunity near a utility's existing service territory. In such a case, why should the entire premium over the depreciated original cost be added to the utility's rate base, resulting in higher rates for all the utility's customers to subsidize the acquisition? Should not the utility's shareholders, who profit from the perpetual stream of revenue from the larger customer base, absorb some or all of that premium?

V. Queries

1. By empowering unelected, unappointed, and unconfirmed non-governmental appraisers, or the seller and buyer by negotiation, to determine an essential element of the ratemaking process, does the FMV law unconstitutionally delegate the police power to private individuals?

(a) State constitutions provide that the legislative power of the state is vested in a General Assembly, usually consisting of a Senate and a House of Representatives, and that the General Assembly is the exclusive lawmaking body and may not delegate its power to enact laws.[30] "[I]t is axiomatic that the Legislature cannot delegate its power to make laws to any other branch of government, *or to any other body or authority*."[31] This non-delegation principle seeks to ensure that "duly authorized and politically responsible officials make all policy decisions, thereby demanding accountability,"[32] and it protects against "arbitrary exercise and uncontrolled discretionary power."[33]

(b) Thus, the General Assembly may not delegate its power to make laws or to create public mandates with the force of law to private individuals who are not politically responsible officials or to private entities (including private, investor-owned public utilities) that are not politically responsible.[34]

(c) For example, what if a law delegates a state's public utility regulatory commission's authority to value municipal property for ratemaking purposes to two private Utility Valuation Experts (one chosen by the selling municipality, the other by the public utility

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[29] 52 Pa. Code § 69.721 (relating to acquisitions of viable [and nonviable] water and wastewater system-Statement of Policy), § https://www.pacodeandbulletin.gov/Display/pacode?file=/secure/pacode/data/052/chapter69/s69.721.html&d=#.

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

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

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

[33] *Id*.

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

buyer) to conduct two independent appraisals of the selling municipal entity's property that are averaged to arrive at a fair market value, which must be added *without modification* to the acquiring utility's rate base in its next rate case if that FMV is lesser than the purchase price negotiated by the seller and buyer? Alternatively, if the purchase price is lesser than the fair market value, that amount must be added without modification to the acquiring utility's rate base in its next rate case.

(d) Under the state constitution, does either eventuality constitute an unconstitutional delegation of power to make laws or to create public mandates with the force of law to private individuals (i.e., to private appraisers, an investor-owned public utility, and to a municipality that has no authority to supplant the regulatory commission's authority to determine property valuation for ratemaking purposes)?

2. Can FMV legislation be challenged for compliance with the Fifth and Fourteenth Amendments requirement that utility rates be "just and reasonable," providing a return on used and useful property, *with rates determined through* ***balancing*** *customer and investor interests*?

(a) The "end result" holding of *Federal Power Commission v. Hope Natural Gas Co*., 320 U.S. 591 (1944), and *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989) ("Similarly, an otherwise reasonable rate is not subject to constitutional attack by questioning the theoretical consistency of the method that produced it." 488 U.S. at 314). *Hope* held that it is "the result reached and not the method employed" that is controlling in determining "just and reasonable" rates (320 U.S. at 603), but the Court made clear that the fixing of just and reasonable rates unquestionably involves "a balancing of investor and consumer interests." 320 U.S. at 604. Closing sentence of *Barasch*: "The Constitution within broad limits leaves the States free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public." 488 U.S. at 316.

(b) The legitimate concerns of consumers and investors are not of a constitutional dimension, but rather factors to be taken into account in the balancing of interests process.[35]

(c) If there is no required "balancing" of customer and investor interests in the FMV law, and instead it is entirely one-sided and solely favors the utility, e.g., by requiring that the FMV or purchase price (or the lesser of the two) be included in the utility's rate base without modification by the utility's regulator, can the resulting rates be just and reasonable?

(d) Can the "balance" be restored by offsetting the inclusion of the acquisition assets at an inflated value by lowering the return on equity? *See Permian Basin Area Rate Cases*, 390 U.S. 747, 769 (1968) ("Regulation may, consistently with the Constitution, limit stringently the [investor's] return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness." (Citation omitted.)[36]

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[35] *See*, *e.g., Pennsylvania Electric Co. v. Pa. Pub. Util. Comm'n*, 502 A.2d 130, 135 (Pa. 1985). The Pennsylvania Supreme Court also equated the constitutionally based requirement of "just and reasonable" rates, under the Fifth and Fourteenth Amendments, with the "just and reasonable" rates standard of 66 Pa.C.S. § 1301(a) (relating to rates to be just and reasonable; regulation) which provides in relevant part: "Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable, and in conformity with regulations or orders of the commission."). 502 A.2d at 132-133.

[36] *See also* John N. Drobak, *From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation*, 65 B.U. L. Rev. 65 (1985) (discussing the consumer interest factor of the *Hope* test.)

(e) If a constitutional violation is foreclosed, does failure to balance consumer and investor interests violate the *statutory* requirement of "just and reasonable" rates? No balancing = no just and reasonable rates?

(f) At a minimum, can utility regulators (who have been given complete discretion by *Hope* and *Barasch*) compensate for the mandatory inclusion of acquisition assets into the rate base by setting the overall rate of return lower in the Zone of Reasonableness?[37]

3. Can customer protective conditions be attached to the acquisition approval order,[38] or can the Commission deny the utility's acquisition application (considered in conjunction with the FMV/purchase price determination) because adding the acquisition assets to the utility's rate base at the determined value will raise customers' rates unduly (or outweigh the purported benefits of the acquisition)?[39]

VI. Possible Solutions

1. Repeal or amend. There may be redeeming qualities in the thirteen statutes listed above on page 2, but, as noted above, the very concept of "fair market value" is anathema to public utility ratemaking. The only real solution is to repeal these laws, or at least those that are blatantly pro-utility without balancing customer and investor interests. The second-best solution is to amend them to lessen the burden on the utility's customers. Neither of these solutions may be politically feasible.

(a) The most virulently pro-utility/anti-customer version of FMV legislation was Pennsylvania Act 12 of 2016 which added Section 1329 to the Pennsylvania Public Utility Code, 66 Pa.C.S. § 1329.[40] In the eight years following its enactment, there have been 23 acquisitions by Pennsylvania American, Aqua, and Violia, resulting in a combined *annual* increase in water bills of $85 million. In every instance, the *lesser* of the FMV determined by private appraisers (chosen by the seller and buyer) and the purchase price negotiated by the selling municipal entity and the utility *was the purchase price*. This strongly suggests that the

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[37] The rate in a particular case need only fall within a zone of reasonableness to satisfy the just and reasonable standard: "there is no single cost-recovering rate, but a zone of reasonableness…." *Federal Power Comm'n v. Conway*, 426 U.S. 271, 278 (1976). In theory, the zone of reasonableness has a floor below which the rate would confiscatory and a ceiling above which the rate would be exploitative.

[38] *See* 66 Pa.C.S. § 1329(d)(3)(ii) ("If the commission issues an order approving the application for acquisition, the order shall include: … (ii) additional conditions of approval as may be required by the commission.").

[39] *See Popowsky v. Pa. Pub. Util.* Comm'n, 937 A.2d 1040, 1056 (Pa. 2007) (holding that in merger proceedings rates must be considered "at least in a general fashion … or the probable general effect of the merger upon rates … as a component of a net benefits assessment," quoting *City of York v. Pa. Pub. Util. Comm'n*, 295 A.2d 825, 829 (Pa. 1972); *McCloskey v. Pa. Pub. Util. Comm'n*, 195 A.3d 1055 (Pa. Commw. 2018) (holding that excessive rates resulting from the determination of the lesser of the fair market value and the negotiated purchase price and its inclusion in the utility's rate base may outweigh the typical alleged benefits of the transaction and the commission's policy of encouraging regionalization and consolidation in the water and sewer industries); *Cicero v. Pa. Pub. Util. Comm'n*, 300 A.3d 1106 (Pa. Commw. 2023), *appeal granted*, https://www.pacourts.us/assets/opinions/Supreme/out/570MAL2023%20-%20105971576270177280.pdf?cb=1 (holding that the commission erred and abused its discretion by incorrectly applying the substantial affirmative public benefits standard to the proposed acquisition that included consideration of FMV under 66 Pa.C.S. § 1329) (oral argument before the Pennsylvania Supreme Court will be held on May 14, 2025).

[40] See footnote 28, *supra*.

FMV appraisal was intended as a lofty ceiling under which the parties' mutually pleasing "bargain" would always fall.

(b) With customer rates mounting, Pennsylvania's Consumer Advocate, Patrick M. Cicero, in testimony before a committee of the House of Representatives with oversight over legislation affecting public utilities, suggested repeal of Act 12 or at least that the law be sunsetted to expire and, before the sunset date arrived, a legislative review be undertaken concerning the law's effect on rates and "whether it has produced a substantial affirmative benefit to the public." He also supported four bills that would amend Act 12 to make its effects less onerous on customers.[41] None was enacted.

2. PaPUC allowed challenges to FMV appraisals.[42]

3. The PaPUC by order entered on July 2, 2024,[43] issued a Final Supplemental Implementation Order (FSIO) that updated existing guidelines and procedures for implementing Act 12 of 2016, Pennsylvania's FMV law (Section 1329, 66 Pa.C.S. § 1329). These updates included the introduction of mandatory in-person public hearings, enhanced rate impact notification for customers, standardization of methods used by utility valuation experts (UVEs), and new criteria for the Commission to assess the fairness of acquisition prices:

> **Revisions to the Section 1329 Valuation Process**
>
> The Commission's FSIO revised PUC procedures and guidelines related to the evaluation of Section 1329 applications to include the following:
>
> - ***Public Meeting/Hearing Requirements*** – The Commission bolstered requirements for public notice by requiring utilities to hold at least two public meetings *before* signing an asset purchase agreement. The utility must now provide proof of compliance with this requirement in its initial application.
>
> - ***Rate Impact Notices*** – Applicants are required to attest, or declare under affidavit, the following within an initial filing:
>
> o Both parties acknowledge the seller is aware of the potential impacts the transaction may have on the selling utility's rates. This would include detailing the overall dollar and percentage impact implicated from stand-alone rates from

[41] The Consumer Advocate's testimony and that of others who testified, together with links to the bills, are available at https://www.legis.state.pa.us/cfdocs/legis/CMS/ArchiveDetails.cfm?SessYear=2023&MeetingId=3374&Code=-1&Chamber=H.

[42] *See Application of Aqua Pennsylvania Wastewater, Inc. Pursuant to Sections 1102 and 1329 of the Public Utility Code for Approval of its Acquisition of the Wastewater System Assets of New Garden Township and the New Garden Township Sewer Authority*, Docket No. A-2016-2580061, Opinion and Order entered June 29, 2017, at 34-35, https://www.puc.pa.gov/pcdocs/1526799.docx ("Accordingly, we find that Section 1329 permits the Commission and the Parties to develop a record pertaining to the review and analysis of the fair market value appraisals of the UVEs.").

[43] *Valuation of Acquired Municipal Water & Wastewater Systems – Act 12 of 2016 Implementation*, Docket No. M-2016-2543193, Order entered July 2, 2024, https://www.puc.pa.gov/pcdocs/1836178.pdf. Appendix A, https://www.puc.pa.gov/pcdocs/1836179.pdf; Appendix B, https://www.puc.pa.gov/pcdocs/1836180.pdf; Appendix C, https://www.puc.pa.gov/pcdocs/1836181.pdf; and Appendix D, https://www.puc.pa.gov/pcdocs/1836182.pdf.

the transaction price.

- The selling utility has publicly communicated such implications on rates through notices issued to its existing customers.

- Both parties understand the Commission may shift rate allocations in a manner different from any commitments made in the underlying application.

- ***Default Weights for Appraisals*** – In an effort to instill consistency in the valuation process, the Commission required UVEs to weigh each valuation result evenly: one-third for cost, one-third for market, and one-third for income. Applicants may seek approval to deviate from this requirement, but are required to show good cause to do so.

- ***Reasonableness Review Ratio (RRR)*** – Publication of a reasonableness review ratio as a guidepost that the Commission can use when it analyzes and eventually makes a final determination on the overall prudency of various 1329 applications. That ratio will be based on publicly available data from investor-owned utilities and be compared against the ratio of depreciated original cost of the selling utility and the 1329 transaction price.

  The provisions of the FSIO are not retroactive. The rate impact notice, public hearings, and default appraisal weight provisions of the FSIO went into effect 30 days after the entry of the Commission's Order with respect to all acquisitions where an asset purchase agreement (APA) had not been executed.

  For acquisitions where an APA has been executed, including those for which a Section 1329 application has been filed but not finally accepted, the Commission considers the unique facts and circumstances of each acquisition and takes into account the date on which the APA was executed and the application was filed.

  The Commission published an initial RRR 30 days after entering this Order.[44]

3. As reported by NRRI's Kathryn Kline,[45] Attorney and expert witness Scott Hempling[46] provides suggestions for improving FMV outcomes by focusing on quantifying the benefits of FMV by establishing clear metrics that will allow regulators to better understand the outcome of each acquisition. Hempling also encourages competition, where possible, to ensure that purchasers acquire systems at the most economically efficient cost. Finally, Hempling suggests that commissions use benchmarking to hold acquiring systems accountable for improvements post-acquisition.[47]

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[44] https://www.puc.pa.gov/media/3113/rrr_report_2024.pdf.

[45] Kline at 19.

[46] "About" [webpage]. Scott Hempling, Attorney at Law, https://www.scotthemplinglaw.com/about.

[47] Scott Hempling, *Water Mergers: Are They Making Economic Sense?* June 2019., https://www.scotthemplinglaw.com/essays/water-mergers-are-they-making-economic-sense.

4. In the Public Interest, *Water Wars in Pennsylvania: How Corporations Play the Long Game* (July 2024), https://inthepublicinterest.org/water-wars-in-pennsylvania-how-corporations-play-the-long-game/ ("The goal of this report is to expose the political and acquisition strategies that private water companies employ so residents, advocates, and policymakers can successfully push back and keep their water safe, affordable, and under public control.").

5. Pennsylvania Municipal Authorities Association, *The Value of Authority Ownership of Public Water and Sewer Systems*, Second Edition, https://drive.google.com/file/d/19puvXiv0HeoTnVIR9Ys_Mtlf6Cr_NNWE/view.