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RRA Water Advisory

Consolidation of Municipal Systems Accelerates with use of Fair Market Valuation

During the past two years, the investor-owned water utility sector has experienced an acceleration in water and wastewater acquisitions, which points to a broader consolidation trend. Acquisition announcements have spanned the country and included a variety of acquirers. The appetite for transactions has remained robust despite the current economic slowdown and global health pandemic.

The water utility sector has been ripe for consolidation for decades, due in large part to the market's highly fractured dynamic. Fair market value legislation has been of great interest to investors, as it is meant to facilitate the acquisition of municipal systems, by valuing a potential acquired systems on market value rather than on original cost basis.

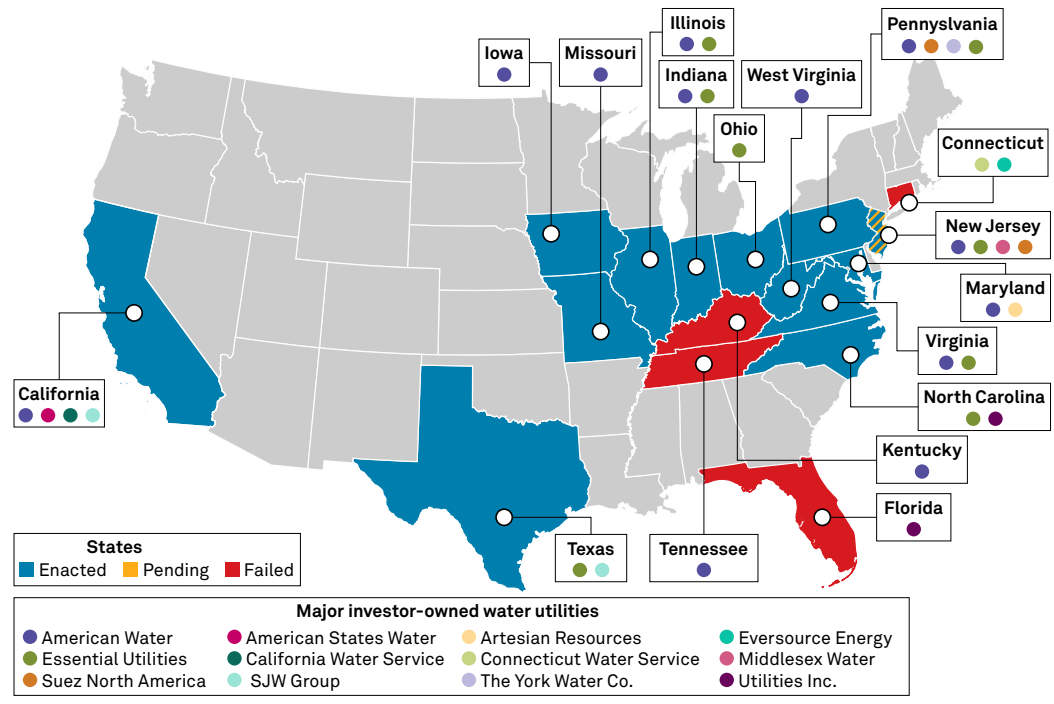
Regulatory Research Associates, a group within S&P Global Market Intelligence, expects investor-owned water utilities to concentrate their corporate development resources on identifying and acquiring systems in states that utilize this legislation and other regulatory policies favorable to acquisitions. With the National Association of Water Companies focused on expanding its presence with state house and government officials to implement constructive legislative changes, RRA expects to see further adoption of fair value statutes in additional states.

Heike Doerr
Principal Research Analyst

Sales & subscriptions
Sales_NorthAm@spglobal.com

Enquiries
support.mi@spglobal.com

Fair market legislation for water utilities



As of Sept. 28, 2020.
Source: S&P Global Market Intelligence

Fair market valuation is an alternative approach to valuing assets of a water or wastewater system that is being acquired that is not tied to the traditional original cost method. Through such a methodology, two or three independent valuation experts appraise the assets and determine the value of the system being acquired. The rate base of the system is determined by the lower of the purchase price or the average of the appraisals. Transaction and closing costs incurred by the acquiring utility are also included in rate base.

On Essential Utilities Inc.'s Aug. 6 conference call, Matthew Rhodes, executive vice president of strategy & corporate development, stated that the company "continue[s] to see a strong pipeline of municipal acquisitions, especially given the passage of fair market value legislation. And now with economic pressures, as the COVID-19 crisis continues, we are anticipating more municipalities will be looking for solutions to financial constraints."

Over 50,000 water utility systems exist nationwide, and approximately 85% are municipally owned, while the remaining 15% are investor-owned or privately held. The municipal infrastructure consists of large urban systems with varying degrees of competence and economic health, an array of mid-sized and smaller cities, and even smaller community systems, which make up over 56% of all systems. Amid the fragmentation, many municipalities face high capital spending needs and financing pressures. The sector has been overdue for significant consolidation.

Financially, municipal systems are challenged by limited available government funding, competing financial needs for other municipal services, such as fire and rescue, and the general unwillingness of elected officials to raise taxes. Operationally, smaller systems lack the expertise to keep up with increasingly stringent water quality standards. The emergence of COVID-19 has further highlighted the technical expertise and benefits of economies of scale that the large investor-owned utilities possess.

Walter Lynch, president and CEO of American Water, identified the company's opportunity to investors on Aug. 6, "We now have about 800,000 customer opportunities in our pipeline as many communities are seeking solutions to increase challenges, which include regulatory, financial and those posed by COVID-19 in managing water and wastewater systems."

WATER UTILITY INDUSTRY GROWTH DRIVERS

The industry is highly fragmented. The U.S. Environmental Protection Agency estimates that municipal systems represent 84% of the 52,000 community water systems and 98% of the 16,000 wastewater systems in the U.S. The municipals range in size from large, municipally owned systems to small systems where a few customers share a common well. Investor-owned and privately held utilities represent the remaining 16% of the water and 2% of the wastewater market.

Infrastructure investment needs are rising. The EPA's most recent drinking water "Needs Survey," published in 2013, estimated that $384 billion, in 2011 dollars, will be needed through 2030 to upgrade U.S. water systems, both public and private, to meet environmental standards. Others have estimated the funding requirements at as much as $1 trillion.

Acquisitions fuel customer growth. Water utilities have achieved sales growth through a combination of organic customer growth and system acquisitions. Consolidation has been a slow, but continuous, process. Since 1992, Aqua America has completed over 300 acquisitions. Of those, only 25, or roughly 8%, were municipal systems.

Wastewater acquisitions are a relatively new focus. Municipal officials tend to be less attached to their sewer systems than their water systems. Water utilities interested in expanding into wastewater are approaching local officials in communities where they already provide water service.

Improving regulatory practices. The need for substantial new capital has captured the attention of many state regulators. While still trailing the electric and gas utility sectors in the number of mechanisms available to them, water utilities are seeing more constructive frameworks emerge in an effort to encourage investment to maintain or improve water service quality.

Understanding the Impact of Contributions In Aid of Construction

Historically, there has been a disconnect between the value a municipality placed on its assets and the amount acquirers of the municipal water utilities were required to pay; this difference has largely been a result of municipalities' expectation regarding contributions in aid of construction, or CIAC. In many instances, in order to connect to the municipal systems, large-volume/multiple-connection new customers, such as large housing developments, were required to pay for the associated build-out of the distribution system; the amounts paid are considered CIAC.

Municipalities have included these assets in the market value of the systems to be acquired and, by extension, in the purchase price. Investor-owned utilities are unwilling to acquire assets at these levels when the goodwill created by the difference between the purchase price and the book value cannot be included in rate base.

Traditionally, when an investor-owned utility acquires a system, that system's assets are reflected in rates at a value equal to original cost less accumulated depreciation. To the extent the purchase price exceeds this value, the difference is considered goodwill, which is generally excluded from rate base.

Fair value legislation is designed to alleviate this situation.

Contributions in aid of construction: In order to connect to a municipal system, large-volume/multiple connection new customers, were required to pay for the associated build-out of the distribution system; the amounts paid are considered CIAC. Under generally accepted accounting principles, assets funded by CIAC are not considered part of the book value of the system, and would not be included in the traditional valuation used to reflect the acquired assets in a utility's rate base.

Transactions fuel capex expansion

Hundreds of billions of dollars are needed to repair the aging infrastructure of the water utility sector, which has been on the brink of a massive capital spending undertaking for decades. The relatively small private sector, serving just 15% of the U.S. population, has been making these investments at an accelerated pace; however, the much larger municipal sector has continually delayed such projects. With these large capital spending projects looming, municipal owners have been more agreeable to considering divesting water and wastewater systems.

Fair valuation laws, details by state

State	Legislation	Legislation enacted	Qualifying system
California	Senate Bill 1268	1997	Water only
Illinois	Public Act 098-0213	08/09/13	Water or wastewater
	Public Act 100-0751	08/10/18	Water or wastewater
Indiana	Senate Bill 257	03/22/16	Water or wastewater
Iowa	House File 2307	03/21/18	Electric, gas, water, sanitary sewage, or stormwater, or any combination thereof
Maryland	House Bill 156/ Senate Bill 845	04/24/18	Water or wastewater
Missouri	House Bill 142	08/28/14	Water or wastewater
New Jersey	Assembly Bill 3628	02/05/15	Water only
North Carolina	House Bill 351/ Senate Bill 339	06/25/18	Water or wastewater
Ohio	House Bill 422	01/04/19	Water or wastewater
Pennsylvania	Act 12	04/14/16	Water or wastewater
Texas	House Bill 3542	06/10/19	Water or wastewater
Virginia	House Bill 835	03/31/20	Water or wastewater
West Virginia	Senate Bill 551	03/25/20	Water or wastewater

As of Sept. 28, 2020.
Source: S&P Global Market Intelligence

Acquisitions continue to drive an expansion of capital expenditure programs across the water industry, fueling earnings growth. As an example, Essential Utilities anticipates investing approximately $16 million over the next 10 years on the distribution system of East Norriton Township, Pa., that it recently acquired.

The table above provides an overview of fair value legislation currently in place. Not all legislation is created equal, and the benefits in some states have been limited by the associated rules, which this report will discuss in additional detail.

Comparing Legislative Policy

Not all legislation is created equal, and the benefits in some states have been limited by the associated rules or criteria used for determining eligible systems. RRA would expect to see acquisition activity accelerate the most in jurisdictions with parameters most conducive to facilitating transactions.

Pennsylvania's legislation is considered one of the most constructive. Act 12, enacted in 2016, broadened the scope of the valuation treatment to include wastewater systems and removed system-qualifying limitations. Previous regulations had applied only to the acquisition of a "distressed utility," a water utility that had failed to furnish or maintain adequate, efficient, safe and reasonable service, and served no more than 3,000 customers.

Selected Pennsylvania fair market value transactions

Acquisition completion date	Selling municipality	water utiilty buyer	System type	Transaction value ($M)	Customer additions
PENDING	Lower Makefield Township	Essential Utilities	Wastewater	53.0	11,000
PENDING	Upper Pottsgrove Twsp	American Water	Wastewater	13.8	1,600
PENDING	Royersford Borough	American Water	Wastewater	13.0	1,600
PENDING	Valley Township	American Water	Water/ WW	21.3	4,800
PENDING	Borough of Kane Authority	American Water	Wastewater	17.5	2,100
PENDING	Delaware County Regional Water Quality Control Authority	Essential Utilities	Wastewater	276.5	165,000
PENDING	New Garden Township	Essential Utilities	Wastewater	29.5	10,500
06/22/20	East Norriton Township	Essential Utilities	Wastewater	21.0	4,950
04/09/20	Felton Borough	The York Water Co.	Wastewater	0.9	130
12/19/19	Cheltenham Township	Essential Utilities	Wastewater	50.3	10,200
12/06/19	Borough of Phoenixville	Essential Utilities	Water	3.5	536
10/24/19	Exeter Township	American Water	Wastewater	93.5	9,000
10/09/19	Steelton	American Water	Water	21.8	2,400
08/29/19	Jacobus Borough	The York Water Co.	Wastewater	2.1	700
07/24/19	Borough of Turbotville	American Water	Water/ WW	1.0	610
04/03/19	Mahoning Township	SUEZ Water	Water/ WW	9.5	1,200
03/07/19	Sadsbury Township	American Water	Wastewater	8.6	1,000
12/12/18	East Bradford Township	Essential Utilities	Water	5.0	1,250
07/25/18	Limmerick, PA	Essential Utilities	Wastewater	75.0	5,400
12/18/17	McKeesport, PA	American Water	Wastewater	159.0	31,000

As of Sept. 28, 2020.
WW = wastewater.
Source: S&P Global Market Intelligence

The largest transaction is Essential Utilities' planned acquisition of the Delaware County Regional Water Quality Control Authority, or DELCORA, in southeast Pennsylvania. DELCORA faced almost $1.2 billion in new and ongoing capital costs to meet new EPA regulations and anticipates that customer bills would be kept lower under private ownership. The $276.5 million wastewater acquisition was announced in September 2019 and is expected to close in early 2021, pending approval from the Pennsylvania Public Utilities Commission.

In **New Jersey**, the legislation limits potential acquisition targets to systems that have an "emergent condition," which are defined in the table below. While this legislation does limit the systems available to be acquired, the legislation removed a hurdle in completing acquisitions. Previously, a public entity needed to put a potential sale directly to the public in the form of a referendum. Not only did this requirement slow the process, but also advocates opposed to the privatization of water systems used referendums to generate public opposition to transactions. The Water Infrastructure Protection Act, which became law in 2015, removed the public vote requirement to sell water systems throughout the state under emergency conditions.

Definition of New Jersey emergent conditions

Emergent conditions shall exist if at least one of the following conditions is met:
(1) The system is located in an area designated by the Dept. of Environmental Protection as an area of Critical Water Supply Concern
(2) The owner is a significant non-complier, has been the subject of a formal enforcement action initiated by DEP, or is substantially out of compliance with an administrative consent order
(3) There is a present deficiency or violation of maximum contaminant levels established persuant to the Safe Drinking Water Act, concerns regarding potability of water, adequate water pressure, or treatment of wastewater
(4) There is a demonstrated lack of historical investment, repair, or sustainable maintenance to the infrastructure of the system
(5) The system owner lacks the financial, technical, or managerial capacity to operate the system

Source: New Jersey state statute

Recent legislative developments

On March 31, **Virginia** Gov. Ralph Northam signed legislation which requires the Virginia State Corporation Commission to establish "rules governing petitions by an acquiring public utility that has elected to seek use of the fair market value of a municipal or other governmental selling utility's water or sewer assets to determine the initial rate base for the purpose of post-acquisition rate recovery."

West Virginia Gov. Jim Justice signed The Water and Wastewater Investment and Infrastructure Improvement Act on March 25, which states that utilities may use depreciated original cost "or other industry standard utility asset valuation methods, excluding the use of fair market appraisal valuation methods." The Act states that the Public Service Commission of West Virginia will "permit acquiring and selling parties to negotiate a value for those assets, permit the acquiring party to include the negotiated sale price of the assets in post-acquisition rate base for rate-making purposes." While it may seem as if fair market valuation is explicitly disallowed, the act does not disallow fair market valuation to be utilized in negotiating a sales price. The Act also stipulates the use of sale proceeds by the municipality and allows for the combination of water and wastewater revenue requirements to moderate the rate impact of wastewater system customers.

On Sept. 17, West Virginia American Water announced its first acquisition in the state, which relies on this legislation. The company's acquisition of the Page-Kincaid Public Service District's water system has been filed with the West Virginia PSC for regulatory approval. According to American Water, "the community's water system needs substantial infrastructure upgrades, primarily associated with water quality concerns and service reliability."

In **New Jersey**, companion bills Assembly Bill 1710/Senate Bill 2207 were introduced March 16. The bill would allow a municipality selling a sewerage system to use a fair market value of the system to determine the transaction price and rate base. The legislation is being proposed to "enhance the ability of a municipality to sell a sewerage system, thereby allowing municipalities to turn a future liability into a current asset." Additionally, the measure would eliminate the existing voter referendum before a transaction can be completed.

Additional legislation supportive of consolidation

Legislation enacted in **Indiana** and **New Jersey** imposes testing, reporting and infrastructure investment requirements on water systems. These measures are meant to hold public water systems accountable for making infrastructure improvements and conducting regular inspections and could improve municipal acquisition opportunities for the investor-owned utilities, as some systems may not be able to comply with the new legislation.

Unsuccessful attempts at passing legislation

In **Connecticut** fair market valuation legislation failed to make much progress in 2018 or 2019.

In 2018, legislation was tabled when it did not receive the support of the Public Utilities Regulatory Authority, or PURA. In a March 2018 Connecticut Energy and Technology Committee public hearing, PURA Vice Chairman John W. Betkoski and Elin Swanson Katz, then from the Office of Consumer Counsel, or OCC, voiced opposition of the measure. "PURA and OCC oppose the bill as it could potentially lead to the acquiring water company overpaying for the purchase of a municipal water system. This would likely result in existing customers subsidizing the costs of the purchase of the municipal system as well supporting the necessary future capital improvements to bring the system up to the quality of service level being provided by the acquiring company. The fair market value approach contained in the proposed bill is contrary to longstanding and well-established regulatory precedents in Connecticut and most states nationally."

In **Florida**, House Bill 207 was "indefinitely postponed and withdrawn from consideration" on March 14, 2020. Similar legislation, Senate Bill 1484, made little progress in 2019. Both bills applied to acquiring utilities that provide water and wastewater to more than 10,000 customers and did not specifically stipulate the ownership of the acquired utility system. The fair market value of the acquired utility would be established as the average of two separate valuations, one hired by the selling utility and the other representing the acquiring utility.

In **Kentucky**, Senate Bill 163 was recommitted to the Senate Committee on Natural Resources and Energy on March 28, 2019, but did not make it out of committee. The legislation would have allowed the acquiring utility to include the entire value of acquired assets, as measured by the fair market value or purchase price paid, in the company's next base rate case. The fair market value of the acquiring system would be established by the average of three appraisals. The bill did not include any stipulations regarding the size or condition of the acquired system. Similar legislation did not make it out of the committee for Natural Resources and Energy during 2018.

In **Tennessee**, companion bills Senate Bill 532/House Bill 604 would have allowed a utility purchasing a water or wastewater utility to request that the Tennessee Public Utility Commission use a fair market value of the selling utility based on two appraisals of the acquired system. Senate Bill 532 had advanced in the Senate and was sent to the Senate Commerce and Labor Committee April 9, 2020; however, House Bill 604 seems to have stalled in the House, and was returned to the Clerk's desk March 26. Similar bills did not make it out of the committee in 2019.

Additional Regulatory Enablers

In addition to fair value legislation and infrastructure surcharges, commissions have employed a variety of regulatory policies to facilitate the consolidation of water systems. Examples of these policies are summarized in the following chart. Please note that this chart is not intended to be comprehensive, but rather focuses on activity in the 25 rate jurisdictions currently evaluated by RRA which have the largest presence among the investor-owned and largest privately held water utilities.

Regulatory mechanisms enabling consolidation

Mechanism	States	Description
Rate consolidation	AZ, CA, FL, IA, ID, IL, IN, KY, MA, MD, MO, NC, NH, NJ, NY, OH, PA, SC, VA, WV	Consolidation of rate tariffs into regional districts or state-wide
ROE Premium	CT, PA	A premium to ROE granted in recognition of non-viable or small water systems purchased by a water utility
Acquisition premium	AZ, PA, TX	Allowance that provides for the difference between depreciated original cost and purchase price.
Acquisition adjustment	CT, IA, IN, KY, PA	Reasonable costs of the acquition may be recovered in rates

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Source: S&P Global Market Intelligence

Rate consolidation has been the most widely accepted regulatory mechanism that encourages the acquisition of smaller systems by the utilities. This mechanism has a variety of purposes including minimizing the number of rate tariffs that must be filed and reviewed during rate proceedings and enabling a utility to spread the cost of infrastructure projects across a larger customer base. This allows system upgrades to occur without a massive increase to the bills of the customers of the acquired smaller systems.

ROE premiums have been employed occasionally. Small troubled systems are typically a headache for both commissions and state environmental regulators. In Connecticut, the PURA may award a premium rate of return to a water company that has acquired nonviable systems when it is demonstrated that such acquisition would benefit customers by enhancing system viability, avoiding capital costs or savings in operating costs, or as otherwise determined by PURA. In a 2013 rate case decision, the PURA awarded Aquarion Water a 50-basis-point acquisition premium in recognition of Aquarion's purchase of 11 troubled systems between 2011 and 2013.

The specifics of ROE premiums in Pennsylvania are less clear, as the commission routinely relies on black-box settlements which do not disclose ratemaking specifics such as authorized ROE. In addition to ROE premiums and recovery of acquisitions premiums, the Pennsylvania PUC has also considered deferral of acquisition improvement costs and plant improvement surcharges for acquirers that have worked with the Department of Environmental Protection to encourage the consolidation of small troubled systems.