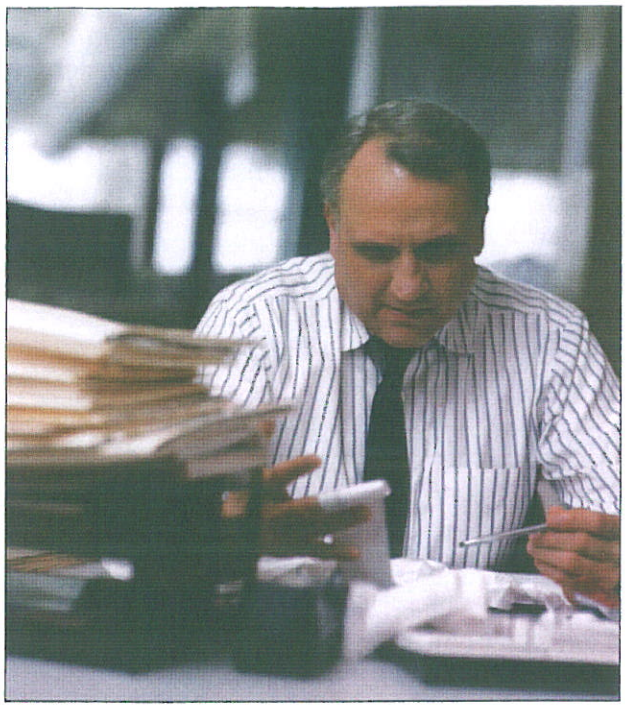

## $H_2O$ to Go

# Sustainability Options for Small Water Utilities

by Tim Bradley and Bob Kelly

Water utilities are unique among their nonliquid siblings — gas, electric, and telecommunications providers. As fundamentally local businesses, water utilities serve limited, well-delineated geographic areas and provide a highly regulated service. Most have the right of eminent domain.

Perhaps foremost, water utilities are monopolies, and their rates are regulated by either a state public utility commission or a local oversight body such as a city council, board, or commission. This regulation has considerable effect on their valuation. And, because water utilities are perhaps the most capital-intensive of all regulated utilities, the valuation process must account for a water utility's special characteristics.

The most persistent misconception about regulated water utilities — all utilities for that matter — is that their rates of return and hence their profits are guaranteed. In fact, only the price per unit is guaranteed. This mechanism for setting a level of profit is still no assurance the entity will reach a profit. For publicly owned water utilities, profit is not a consideration; meeting annual revenue requirements for sustainability and complying with debt covenants, though, are the "rate drivers" for such utilities.

Over time, some water utilities — particularly small systems — become incapable of maintaining financial, technical, or managerial capacity, or they receive cripplingly low levels of rate relief from regulatory agencies. Policymakers consider these utilities to be unsustainable, a subjective category referring to water systems in the direst circumstances. No reliable statistics appear to exist on the number of unsustainable utilities. Though they are probably small in number, these utilities still represent a thorny problem for the US Environmental Protection Agency and states, as implications of service abandonment loom large.

Accordingly, in 2000, the National Drinking Water Small Systems Implementation Working Group reported to USEPA that states are in the best position to evaluate water systems in their jurisdictions for sustainability. States should consider all possible long-term solutions, including incentives, tax relief, a utility emergency fund, subsidies, and, possibly, takeover.

### Receivership Option

For exceptionally troubled systems, states should have a procedure for using receivership as a temporary or transitional strategy for returning a utility to its true operating capacity or readying it for acquisition. Receivership is not an independent solution, but only a provisional remedy used in very limited conditions en route to other relief by final judgment.

A receiver is generally appointed by a court to take charge of and manage a distressed utility to assure continuity of service while arranging for its ultimate disposition, e.g., sale, merger, or privatization. The receiver is entitled to the same fees, commissions, and expenses as, for example, receivers in mortgage foreclosures would be entitled to collect. Receivers must secure the funding to cover a utility's costs of operation, their own fees, and any legal or consultant costs. Depending on jurisdiction, the courts, receivers, or commissions may establish rates during a

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receivership — up, down, or the same, according to local regulation.

### Selling Considerations

When evaluating a range of prospective buyers, the seller should consider other water utilities in the unregulated sector, as well as regulated investor-owned utility buyers. In many jurisdictions, municipal or government buyers may not be nearly as limited in their rate-setting practices as are their investor-owned brethren. Remember, also, that nonregulated buyers are not subject to federal income taxes or property taxes and can frequently find financing at a lower cost, using tax-exempt bonds and grants. These differences may allow a nonregulated buyer to pay a substantially higher purchase price than a regulated buyer.

The policies of regulators can have a profound impact on selling price, as well as whether an entity can be sold at all. Some regulators have policies that require sharing gains on the sale of a utility with customers. Most have policies on acquisition adjustments (recovery through rates of a premium paid by the purchaser). Before moving forward, buyers should become intimately familiar with the details of their local regulator's policies about gain on sale and acquisition adjustments.

Further, state utility commissions typically require that acquisitions boost the water system's reliability, improve its ability to comply with health and safety regulations, make possible new efficiencies and economies of scale, and have a fair and reasonable effect on existing customers.

On the other hand, to encourage voluntary acquisitions, states might offer substantial tax relief for utilities that assume responsibility for unsustainable systems. They could offer financing opportunities for acquiring water utilities. Pennsylvania's PennVest program is a good example. Some commissions provide economic incentives for acquiring troubled utilities, offering a menu of options, which include allowing positive acquisition adjustments, not requiring negative acquisition adjustments on systems purchased below cost, premium rates of return, allowances for system-wide cost recovery, consolidated rate structures (which are often known as single-tariff pricing), rate increase phase-ins, and industrial development rates.

### Examining the Records

To get a true picture of a utility, the buyer-to-be must look at it under the microscope of due diligence, which means an exhaustive and often exhausting review of a utility's records, including deeds, easements, water rights, union contracts, leases, environmental correspondence, any citations for regulatory

*continued on page 18*


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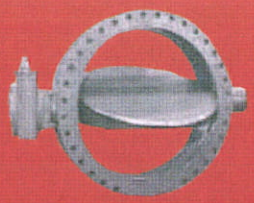

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## Recent Water Utility Sales in California

| Date of Sale | Seller | Buyer | Price | Price Per Connection | Rate Base Multiple |
|---|---|---|---|---|---|
| 3/16/01 | Yuba Investment Company* | Browns Valley Irrigation District | ($50,000) | ($2,778) | N/A |
| 8/2/02 | Mineral City Water System | Mineral City Water District | $50,000 | $278 | 0.35 |
| 10/17/02 | Central Valley Water Company | City of Dinuba | $1 | $0 | N/A |
| 2/2/03 | Los Trancos Water District | California Water Service | $125,000 | $455 | 0.04 |
| 3/27/03 | Watertek, Inc. | Grand View Water Co., East Plano Water Co., Metropolitan Water Co. | $50,000 | $342 | 1.0 |
| 5/30/03 | Grenada Water Company | Grenada Sanitary District | $4,650 | $47 | 0.10 |
| 5/29/03 | Montara Water System (California-American) | Montara Sanitation District | $11,097,000 | $6,936 | N/A |
| 7/1/04 | Walnut Ranch Water Company | Del Oro Water Company | $43,050 | $545 | 1.00 |

* YIC agreed to reimburse BVID for $50,000 in repairs and annexation costs.

**Examples of how much water utilities are really being sold for (in California): Yuba Investment Company "sale" in which the owner had to pay $50,000 to have a nearby sanitation district take the utility off its hands. Central Valley Water Company had to sell its system for one dollar. Grenada Water Company was sold for 10% of rate base, Los Trancos Water District for 4%.**

## $H_2O$ to Go (from page 17)

noncompliance, and details of any intangible assets, such as goodwill. (Goodwill is generally accepted as a combination of amorphous favorable characteristics to which a dollar value can be attached, such as name, reputation, location, customer loyalty, and the like.)

As a component of an appraisal or valuation study, any prospective purchaser should conduct a thorough review of a utility's historical financial statements. A prerequisite to a meaningful and thorough valuation, this historical analysis involves ratio analysis and benchmarking with industry data. The balance sheet is particularly helpful in determining the original cost of the system. Benchmarking to financial statements of other water utilities of similar size and supply source (groundwater versus surface water) can prove useful.

Financial statements, though, even if audited, often need adjustment to be truly meaningful. For example, such statements often fail to list facilities contributed by real estate developers who may be required by planning commissions to provide proof of an adequate water supply before being allowed to build. This could be because the developers did not provide the utility with documentation of the facilities' construction costs. Even when the financials do list costs, developers' misallocation of costs between utility and land development may heavily distort the numbers. Another reason contributed facilities might not appear in financials is that they are usually excluded when setting a utility's rates.

Nevertheless, contributions are highly relevant in valuation and purchasers should consider them. Contributed assets can have value when a utility is either wholly or partially condemned or if it is sold to a municipality. Ignoring contributed assets can mean the purchaser could receive an unwarranted windfall in later years if the system is condemned or sold.

## Major Providers of Financial Assistance to Drinking Water Systems

| Name of Program | Contact Information |
|---|---|
| Drinking Water State Revolving Fund | <www.epa.gov/safewater/dwsrf/contacts.html> 1-800-426-4791 (Safe Drinking Water Hotline) |
| State-specific loan/grant programs | Contact your state drinking water agency |
| Rural Utilities Service (RUS) Water and Waste Disposal Loan and Grant Program | <www.usda.gov/rus/water/states/usamap.htm> (202) 720-0962 |
| Community Development Block Grants | <www.hud.gov/offices/cpd/communitydevelopment/programs/stateadmin/stateadmincontact.cfm> (202) 708-1112 |
| National Bank for Cooperatives Loan Program (CoBank) | <www.cobank.com> (202) 542-8072 |
| Small Business Administration | <www.sba.gov> (800) U-ASK-SBA |
| Environmental Finance Centers (EFCs) | <www.epa.gov/efinpage/efcreg.htm> (202) 564-4994 |