

Growth by Acquisition or Merger – Does It Make Sense for You?

by David W. Findlay, CPA, CMC

It's fairly safe to say that the most common way that municipal water and/or sewer utilities grow their customer base is from new development and higher density redevelopment and in-fill. This is true throughout the United States and certainly true in our western states. However, over the last twenty years, city and county utilities, special utility districts, and public utility districts have also been growing their customer bases by merging or consolidating their organizations with other utilities or through friendly or hostile acquisition processes. When you consider the number of public water systems currently in operation, it only seems logical. According to the Department of Health (DOH), Office of Drinking Water (ODW), **there are 16,900 public water systems in the state of Washington responsible for serving water to more than 4.9 million Washington residents.** That's just water systems and just in one state!

Even accounting for the fact that the majority of these systems (approximately 12,400) are classified as Group B systems - small, private systems operated by 501 (c) not-for-profit homeowner associations, mutual corporations, and private investor-owners serving 2 to 14 connections or about 150,000 residents, that still leaves an estimated 4,300 Group A systems serving close to 5 million residents. Furthermore, the Group A systems (15 or more connections) frequently operate side-by-side or even within overlapping service area boundaries. For example, the City of Bothell has 4 water and sewer utilities operating within the city limits and designated urban growth boundaries. Likewise over the past 29 years, the City of Bellevue has acquired 9 water and/or sewer systems or portions of systems that had been operating within the City limits.

It's obvious from the DOH information that there is an abundant supply of small to medium sized water systems that could benefit from some form of consolidation with another utility, and I believe that the number of water system owners who are willing to divest ownership is growing. Quite simply, the cost of operation, maintenance, comprehensive planning, periodic replacement and continued need for capital improvement and upgrades created by the impact of ever increasing environmental and regulatory demands is making it cost prohibitive in the long run for smaller utilities to remain in operation and financially viable. Further, there appears to be no end in sight. The rules and regulations and the associated demands being placed on water systems is continuing to escalate at both federal and state levels; just a few recent examples include the "Public Health Security and Bioterrorism Preparedness and Response Act of 2002", "GASB 34", and Washington State's "Water Use Efficiency Rule". Fortunately, there is also a corresponding increase in the demand by small to medium sized financially viable water utilities to acquire those systems. I believe that this demand is fostered by a basic business premise and common sense that suggests that increasing the number of customer connections along with an established infrastructure can provide the owner with the opportunity to spread its relatively fixed costs of operations, maintenance and

capital investments over a larger customer base, leading to better overall financial performance and cost control.

Hopefully, this discussion will lead the reader to contemplate a basic question: Does growth by acquisition or merger make sense for you? Does it make sense to expand your customer base by consolidating your operations with other utility systems, especially if there is little or no growth opportunities to be realized from new development or redevelopment within your service area? At present there is a growing interest and involvement by the private sector in acquiring closely held private and publicly owned water systems, with less interest in sewer systems. Recent acquired utilities I have reviewed have ranged in size from 50 to 2,500 connections. In some western Washington locales, selected municipal corporations, mostly county public utility districts (PUDs) have been extremely active in acquiring small water systems of all sizes, some virtually bankrupt and in very poor physical condition or non-compliant with regulatory requirements. Water systems have also been acquired by financially viable water utilities through State Department of Health initiated receivership processes and municipal condemnation (eminent domain) actions.

If PUDs and private sector operations see value in acquiring connections and growing their utility assets and customer bases by purchasing small to medium sized rural and urban water systems, why wouldn't those same opportunities provide similar if not increased benefits to municipal corporations that are not fettered with Washington Utility Transportation Commission (WUTC) regulatory controls over how rates and charges are set and charged including how return on capital and net income is allowed? Cities, special utility districts, and some counties that are already in the water and/or sewer utility business can also directly benefit from growth in customer base, especially if the actual number of service connections is less than 10,000, regardless of how small. For Group B water systems and very small Group A water systems, municipal utilities can also provide lower cost of capital for funding capital improvements, upgrades and asset replacements. Sometimes these municipal utilities can also obtain funding assistance through grants for qualified utility capital projects and even acquisitions that the private sector cannot avail itself. **But just as important, growing the customer connection base can lead to financial relief for all affected ratepayers.**

The following very simple hypothetical example of two similarly sized water systems illustrates how cost economies of scale might be realized through acquisition or merger. This example assumes that both systems have the same average age of infrastructure and both are in fairly good condition. Each system needs to and does employ five similar positions. Both utilities employ trained field personnel with the required certifications, along with a manager/operation and two administrative positions. Both utilities have similar operating budgets. However, the UTILITY 1 only serves 2,500 customer connections and UTILITY 2 serves 5,000 customer connections. This means that UTILITY 1 employs one person per 500 customer connections, while UTILITY 2 employs one per 1,000 customer connections. Clearly UTILITY 2 has the opportunity to provide similar service to its customer as UTILITY 1, but at a lower average cost per customer, thus positioning it to implement lower water service rates.

It is possible that if these two utilities were to simply merge, or if UTILITY 2 were to purchase UTILITY 1, then the new larger UTILITY 2 could serve all customer connection with perhaps 7 FTEs (assuming the eliminating of 1 manager, 1 administrative FTE, and 1 field employee). All customers could then benefit by the improved operating ratio of one employee to 1,071 customer connections as well as less overhead, administrative, and facilities costs per connection.

I have been directly involved with almost 60 water and/or sewer utility appraisals, mergers and acquisitions. The majority of the transactions were negotiated sales of privately owned water systems to municipal corporations. Some of the transactions were executed by way of abandonment and eminent domain proceedings requiring that the courts determine a fair price e.g., just compensation. I have also assisted clients in negotiating the merger of two municipal organizations into one, where one entity ceased to exist, and the remaining corporation took on all the responsibilities of the organization. The process sometimes requires substantial due diligence analysis and evaluation especially to plan for the transition into the new organization. In many cases, the work was primarily the appraisal of the potential acquisition candidate's assets using a combination of standard valuation methods – the Income Approach, the Market Approach, and the Cost Approach, and helping the clients to negotiate an affordable but fair purchase price. The bottom line for almost every transaction has been that even with the need to pay for the water systems, the overall average cost of service per customer usually decreased substantially, or the acquiring agency was able to mitigate planned rate increases or even reduce rates as a result.

In conclusion, if you have an interest in growing your utility, take the time to evaluate your potential to add more customers through an acquisition or merger strategy. Evaluate neighboring utilities; get to know their management and operations personnel. Take the time to see if there are cost reduction initiatives that might be triggered by a consolidation of organization, administration, management, and field personnel, and the joint use of light and heavy equipment and shop facilities. Take a barometer test of what the reaction to a friendly acquisition or merger might be. If now is not the best time to expand by acquisition or merger, when might the "weather" be more favorable? Perhaps there will be a planned event such as a retirement of a key manager or operating person that will open up an opportunity to merge organizations with less internal resistance. Prudent management practices suggest that we owe it to the customer ratepayers to evaluate options to control costs, increase or improve level and reliability of water and/or sewer service and to improve the long-term viability of system assets. Growth by acquisition or merger is one way to better achieve these management objectives.

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For more information on this subject, send an email to: davidf1@fcsgroup.com.

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