

The Acquisition of Challenged Water Systems in Illinois

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NARUC Summer Meeting - Committee on Water

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The Acquisition of Challenged Water Systems: Background

- The ICC regulated 150 water and wastewater utilities in the 1970's. Through acquisitions and mergers, that number was cut in half by the mid 1990's.
- Today, the ICC regulates 12 water and wastewater utilities in Illinois that provide water service to approximately 8% of the state.
- Three large water and sewer utilities:
 - Aqua Illinois, Inc. *(72,225 customers)*
 - Illinois American Water Co. *(313,058 customers)*
 - Utilities Services of Illinois, Inc. *(19,024 customers)*
- Nine smaller water and sewer companies *(ranging from 24 to 1,990 customers)*
 - Typically serving a single subdivision in a remote area
 - In need of utility plant replacements to meet stringent environmental regulations

The Acquisition of Challenged Water Systems:

Section 9-210.5 - Valuation of Water and Sewer Utilities

- Enacted on August 9, 2013
- Implemented to encourage acquisition of smaller utilities and non-investor owned systems with hardships:
 - Poor maintenance
 - Lack of ongoing system investment due to inadequate financial capital
 - Inability to meet increasing health and environmental regulatory requirements
- Only applies to communities with 7,500 customer connections or less.
- Larger utilities are financially able to make needed improvements and are typically well staffed with competent, professionally-trained individuals.
- Sunset provision: June 1, 2018

The Acquisition of Challenged Water Systems: Large Investor-Owned Utility Incentives

- Higher Rate Base Valuation
 - Rate base is measured based on original cost in Illinois (the cost when the utility plant assets were first put into utility service).
 - Amount may be difficult to determine due to lack of records or a full depreciation at the time of acquisition.
 - 9-210.5 allows the rate base to be based on the lesser of (i) the purchase price or (ii) the fair market value determined by the average of 3 appraisals of the system.
- Extended Use of Allowance for Funds Used During Construction (AFUDC)
 - Allowed to accrue a cost of financing the improvement based on the AFUDC until the sooner of the investment has been in service for 4 years or the time rates are implemented in the utility's next rate case.
 - This allows for a higher rate base due to additional financing costs allowed thru AFUDC.
- Delayed Depreciation
 - Allowed to not reflect depreciation for ratemaking purposes until the sooner of the date the investment has been in service for 4 years or the time rates are implemented in the utility's next rate case.
 - This allows for a greater net plant and thus higher return on rate base in rates.

The Acquisition of Challenged Water Systems: Results Post Section 9-210.5 Implementation

- Prior to 2013, the Commission averaged less than two water or sewer acquisition cases per year.
- Post implantation, five cases were initiated in 2013; three cases in 2014; and six cases in 2015.
 - Since June 2016, one case has been filed and another potential acquisition was blocked by an unfavorable vote within the municipality.
- The largest two investor-owned utilities, Aqua and Illinois American Water, are involved in most of the recent acquisitions.
- The recently acquired utilities are a mixture of investor-owned utilities, municipal-owned utilities, and water/sewer districts.

The Acquisition of Challenged Water Systems: Customer Benefits and Rate Impact

- The acquiring utility has ability to improve and maintain infrastructure and provide better quality of service.
 - In four acquisitions representing about 8,225 customers, the acquiring utilities proposed a total of nearly \$19 million in capital spending within the first seven years of operation.
- Section 9-210.5 mandates that the acquiring utility charge its new customers the then-existing rates of the district of which the small utility becomes a part after the acquisition.
 - One provision reduces this rate if it would result in an amount that exceeds 1.5% of the area's median household income.
- In 2/3 of the completed acquisition cases customers experienced a rate decrease or no change in rates.
- In 1/3 of the completed acquisition cases, customers experienced substantial rate increases.
 - Involved the acquisition of an investor-owned utility.

Questions?



Small Water Utility Acquisitions

Regulatory Challenges and Opportunities



Arizona Water Utility Challenges

- 400 Individual Water Companies Owned by 350 Different Companies
- Only Seven Water Companies with Revenues in Excess of \$10M /Year
- Over 250 Water Companies with Revenues < \$2.5M /Year
- Over 200 water companies with < 2500 connections
- Small water systems lack access to affordable capital and/or have low revenues and/or cash flows
- Small systems have difficulty properly funding maintenance or recent water quality mandates
- Many are "mom & pop" companies that lack proper staff for operations and maintenance or ability to implement recent water quality mandates



Arizona Water Utility Challenges

- Many small water systems are isolated or are in geographically remote rural areas and some aquifers have significant levels of arsenic, nitrates or other contaminants
- Many small water systems are approaching the end of their useful life and need significant upgrades in plant
- The regulatory process can be complex, expensive and burdensome for small water utilities creating a disincentive for filing a rate case
- Small water companies that don't come in for rate cases after an extended period may be significantly under earning resulting in revenue and cash flow issues
- Small water systems may repeatedly defer required maintenance issues due to revenue or cash flow issues
- Small water system management may not have the experience or expertise to tackle complex regulatory and water quality compliance issues.



Arizona Water Utility Challenges



What happens if a storage tank ruptures and can't be repaired?

What happens if a well casing collapses? What if a well pump fails?

What if a major contaminate is found in the water?



How can we possibly address all these challenges?



Arizona Water Utility Reforms

- Reduce the regulatory burden for small water companies
- Creation of a Staff Ombudsman to assist small water companies
- Establishment a more streamlined Emergency Rate Case process
- Establishment of an Emergency Water Fund for small water companies
- Develop an Acquisition and Consolidation policy for small water companies
- Define and publish a clear and concise set of Commission Water Policy Directives



Reducing the Regulatory Burden

- Streamlined rate case process including short form filings
- Establish standards of materiality when reviewing operating expenses
- Streamline audits when specific line items being evaluated are not material to rates
- Establish rate design guidelines to assist staff and water utilities and ensure greater consistency in rate cases for small water companies
- Establish guidelines for "cost of capital" rates and minimum operating margins based on financial and risk profile to reduce rate case expenses and insure revenue adequacy
- Provide for waivers under Arizona Administrative Code regarding filing requirements for mergers and acquisitions when appropriate.



Emergency Water Reforms

- Established an updated and streamlined Emergency Rate Case process
- Achieve a significant reduction in processing times on Emergency Rate Cases
- Establishment of an Emergency Water Fund for small water companies
- Defined a streamlined and time efficient process for EWF applications and funds disbursements
- Established a multi-agency Water Emergency Team consisting of representatives from Commission Staff, Department of Water Resources, Department of Environmental Quality and others as needed.



Small Water Utility Reforms

- Implement rate design guidelines to increase fixed cost recovery and stabilize rates
- Establish rates using "operating margin" or "free cash flow" in situations with zero or negative rate base
- Allow jointly owned small water companies to adopt a single rate design or merge into a single entity without regard for interconnection or geographic proximity issues
- Allow "purchase power adjusters" or "conservation adjusters" for small water companies
- Reforms may take multiple rate case cycles to fully implement to avoid rate shock



Small Water Utility Acquisition and Consolidation Reforms

- Consider providing acquisition premiums for large firms that acquire small troubled water companies using one or more methods
 - Premium return on equity
 - Acquisition adjustments
 - Deferral of improvement costs
 - Surcharges for recovery of cost of system improvements
- Acquisitions must be in the public interest, cannot affect viability of acquiring utility, will not unreasonably increase rates and must be conducted in an fair and transparent "arm's length" transaction.



Where do we go from here?

- Establish standards for acquisition of viable small water companies based on track record of acquisitions of troubled water companies and their successful integration
- Establish standards for cost of capital and rates of return for large and small water companies that are appropriate for their size, access to capital and level of risk.
- Consider using future test years when significant near term investment in infrastructure is anticipated to reduce regulatory lag
- Consider establishing infrastructure surcharges and reserve accounts when significant infrastructure improvements are anticipated
- Investigate public / private partnerships or creation of water districts with geographically appropriate public systems when indicated

The background of the slide is a photograph of a water treatment facility. In the foreground, there is a large, circular, tan-colored storage tank. Two workers in blue shirts and white hard hats are standing on a walkway next to the tank, near a yellow access hatch. In the background, there are several industrial buildings, a white truck, and a red trailer. The sky is clear and blue. The bottom half of the slide is covered by a blue gradient overlay where the text is located.

NARUC Summer Meetings

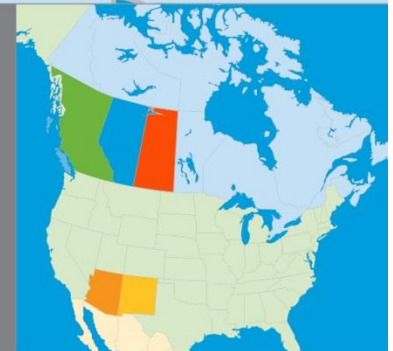
To Acquire or Not to Acquire? That is the Question



EPCOR OPERATIONS

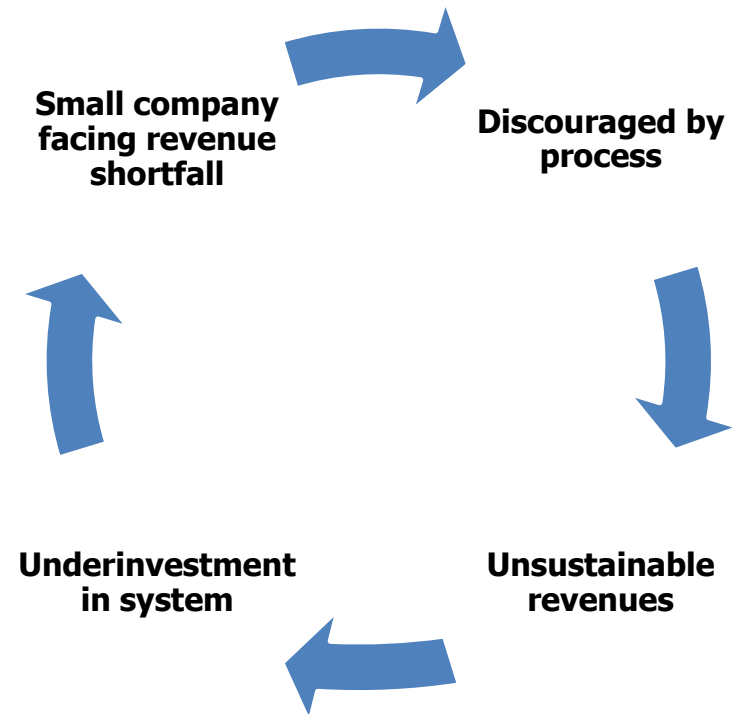
- Electricity Distribution & Transmission
- Water Facilities

- Wastewater Facilities
- Water/Wastewater Facilities
- Industrial Wastewater Facilities

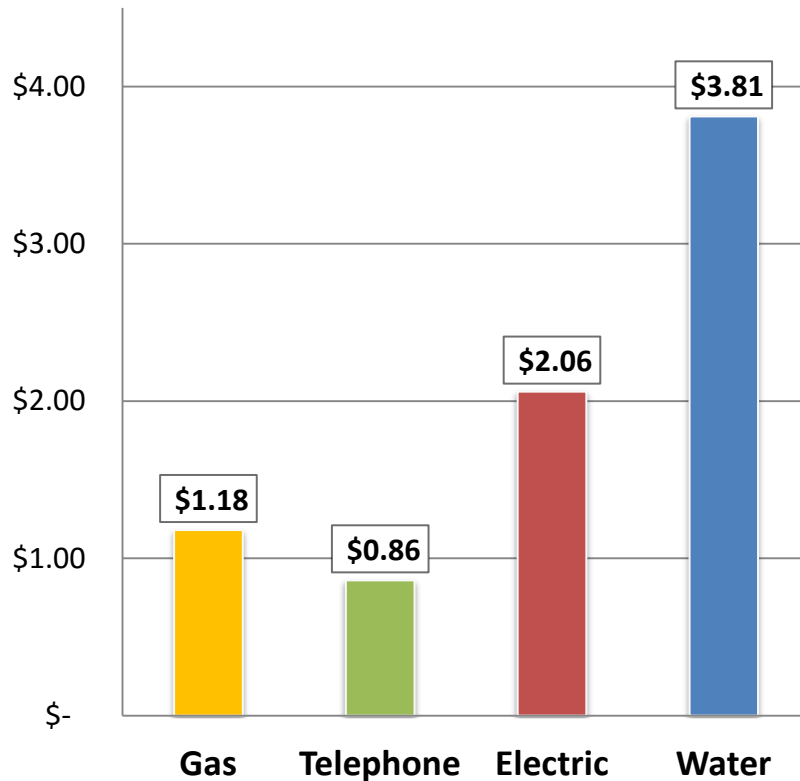


Regulatory Challenges for Small Systems

- Rate applications
 - Expensive
 - Complicated
 - Time-consuming
- Limits timely filings
- Risks missing necessary revenue increases
- Large % of CIAC reduces rate base
- Capital not readily available for emergencies
- Increasing compliance standards



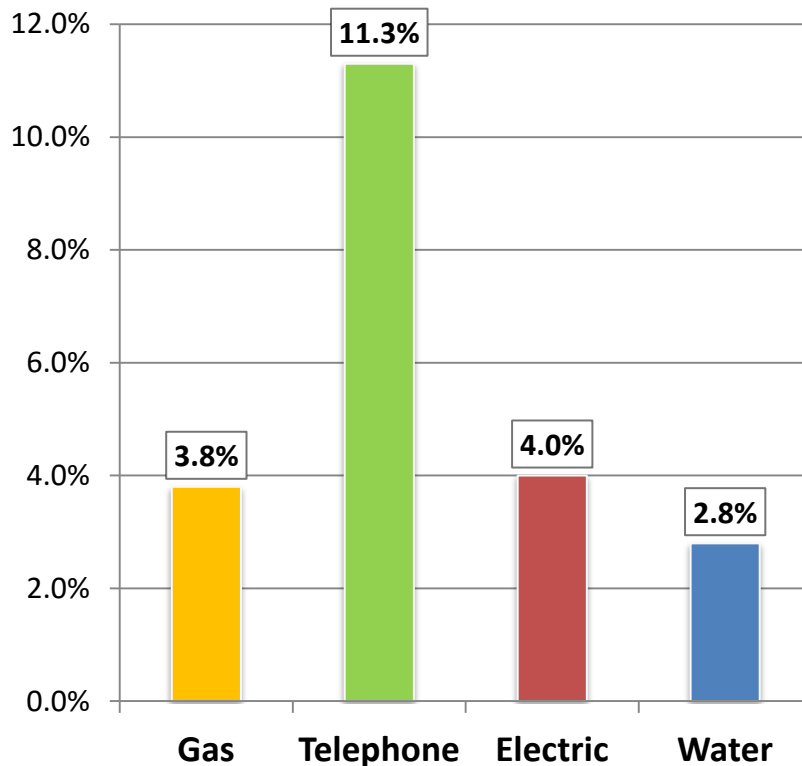
Capital Invested per \$1 of Revenue



Source: 2009 AUS Utility Reports

- EPA rules = large investment in treatment
- Substantial investment to distribute
- More capital per revenue than other utilities
- Burdensome for small utilities

Depreciation Rates



Source: 2009 AUS Utility Report

- Water has lowest depreciation rates
- Long recovery period
- Impacts ability to attract capital
- Viewed negatively

Small Systems & the Regulatory Process

- Need for regulatory change discussed for the past three decades
- Some commissions have implemented regulatory practices
 - Matching scale of the regulatory effort to revenue request
 - Some states have innovative practices for small systems that are not used effectively
- NARUC passes resolution for best practices for small systems in 2013

Effective regulatory practices

- Can break cycle of underinvestment
- Address noncompliant systems
- Consolidation is key
- Support for acquiring system is critical to manage risk
 - Reputational
 - Financial
 - Operational
- Consolidation policies should...
 - Address all systems both **non-viable and viable**
 - Promote sustainability and **serve the public interest**
 - Protect and incent the investor

How?

- Best practices include:
 - Tied to system improvements
 - Acquisition adjustments
 - Independent valuation or appraisal
 - Return on equity premiums
 - Rate consolidation
- Leaders include Pennsylvania, Missouri, and Illinois with Arizona on its way.....



Rate Consolidation

- Small system
 - \$1M in revenue
 - 1,600 customers
 - 28% water loss
 - Challenging water resources
 - Capital investment need \$1.5M+
- Unavoidable costs = large rate impact
- Consolidated rates can minimize impact

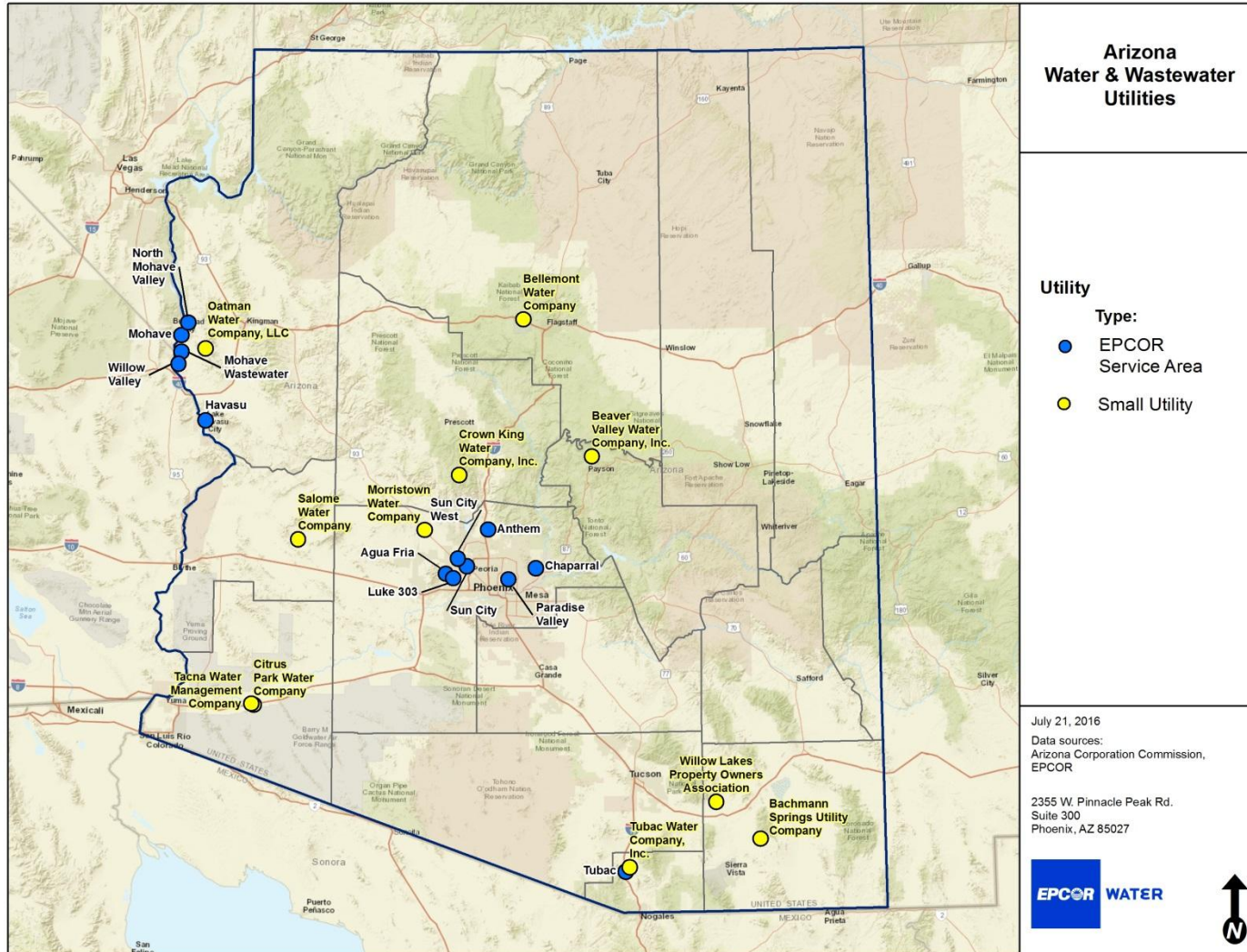


Rate Consolidation

- Large system
 - \$40M in revenue
 - 44,000 customers
 - Capital investment \$20M+
- Additional investment = minimal impact
- Consolidated rates applied to all customers



Regional Hubs



Thank You

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