

To Sell or Not to Sell – That is the Question?

According to a recent article in *USA Today*, American Water, which operates in 35 states, is discussing deals with 75 municipalities and other entities – the most in at least four years – to purchase their water and wastewater systems. Aqua America, which operates in 14 states, sent letters to thousands of cities in the past year and is negotiating with approximately 40 of them. Aqua America expects to acquire about 20 public water systems this year. This should be no surprise. Privatization of water and wastewater systems has occurred with large-scale systems for many years. In the past several years, large cities like Milwaukee and Atlanta both have entered into agreements with private companies to sell and or operate their water and wastewater systems. However, the trend is now for smaller towns and rural water districts to sell off their systems, to enter into long-term management agreements or to lease their systems. Several cities in Kansas have been involved.

As we all know, small towns and rural water and wastewater systems are often the hardest hit by rising costs and unfunded government mandates concerning water quality standards. Often, these utilities are poor at raising rates and setting aside funds for emergencies. And as I have discussed in earlier articles, unless the governing bodies of small systems are extremely proactive, they may face a crisis that

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can cause the administrative or physical collapse of the system. This can range from losing key personnel to a catastrophic infrastructure failure. So it is no surprise that tight budgets, falling revenues and increased government regulation are driving more and more small towns and rural systems to consider selling their water and wastewater systems to private companies. Is this good? Well it all depends. But having an understanding of the differences between non-profit systems and for-profit private systems and also knowing the alternatives to a sale are important steps to making this decision. Now in order to make it clear, Aqua America and American Water do not currently own or operate any systems in Kansas. They do operate in states all around Kansas as do other smaller, investor-owned utilities. In fact, according to the Kansas Corporation Commission, there are only four investor-owned (private)

water utilities in Kansas and they are all small systems ranging from between 100 to 1,000 connections. So Kansas is not in danger of being taken over by private water companies! In fact, large private water companies often purchase these small private systems themselves. That is what happened in Pekin, Illinois, in 1982. I understand that the city of Caldwell, Kansas in extreme south-central part of the state is in negotiations to purchase the assets of Caldwell Utilities, which provides water to the city of Caldwell.

But before we get into the story of Pekin, Illinois, it is important to understand the terminology that gets tossed around and can be quite confusing. The following statement must be clearly understood. While a rural water district or a municipal system is a public system and also a non-profit system, it should still make money. Now, what does that mean? It is a public system because it is owned by the public – that is, by all the users. The users elect a city council or a water district board to govern the system. If this sounds like a 7th Grade civics lesson – well it kind of is! When people do not understand these basics, it becomes impossible to make a clear decision on selling a system. Public systems provide representative democracy where all the people within a legally designated area, such as the city limits or the water district boundaries, have the right to elect a

board/council. This means that the users of the system do not have a direct “one person one vote system” for managing every day activities. The elected board handles these decisions or delegates them to hired employees.

For some large decisions, such as selling the system, issuing bonds, adding land to the legal boundaries, or dissolving the system, by law all the users do retain their right to vote individually. Now this is where it gets confusing. These public or municipal systems are also non-profit systems. This means that they are not taxed on the income they make, like a private corporation or you and me. This does NOT mean that they cannot make money. This is one of the biggest misconceptions that small utility boards have. I can't tell you the number of times that I have heard boards and city councils state that they are not in business to make money and then refuse to raise rates. This is WRONG! Public utilities can and should make money. If they don't make money by raising rates and

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running the utility just like a for-profit private company, then they will face financial disaster when they are unable to make long-term infrastructure improvements, hire necessary staff and meet regulatory standards. The best way is to think of each system user as a shareholder, and imagine making as much money as you can for the shareholders. The difference is that unlike a for-profit, private company, no dividends will ever be paid. The “profit” that a public utility makes is just another name for reserve funds, capital improvement funds or

emergency funds. The profit is the amount of money that is left after all the ordinary operations and maintenance costs are covered and either held in reserve or used to make system improvements. Public utilities owe it to their users to operate in the black and set money aside – i.e., to make a profit. This is the fiduciary responsibility that an elected board/council owes to its customers.

This is the single largest difference between a public, non-profit utility and a private, for-profit utility like American Water or Aqua America. Both of them should operate in the black and make a “profit”. The question is – who gets the profit? Another name for these private utilities is “investor-owned” and this is a big clue as to who gets the profit. These companies have shareholders who DO expect to be paid dividends which is another name for the profit. And, an investor-owned utility cannot pay dividends unless it makes a profit on top of what it charges its customers for service. So an investor-owned utility will have to charge enough to cover all the operations and maintenance just like a public utility, plus set aside the money for funding the same reserve accounts and making improvements just like a public utility, PLUS pay dividends to its shareholders. The customers of an investor owned utility DO NOT get to vote on any aspect of the utility operations. But the investors, also known as the shareholders, DO! They vote at an annual meeting to elect the board of directors of the investor-owned utility and in turn, the board hires a president and all the other staff to operate the utility. If this makes you wonder whom the board answers to, it should be clear by now. The board of an investor-owned utility answers to its shareholders – the people who “invested” in the company when they bought stock in it. The board does not answer to the actual utility users and the utility users do not have any say in how the utility is run. They do not get to vote directly on electing the board the way customers do in a rural water



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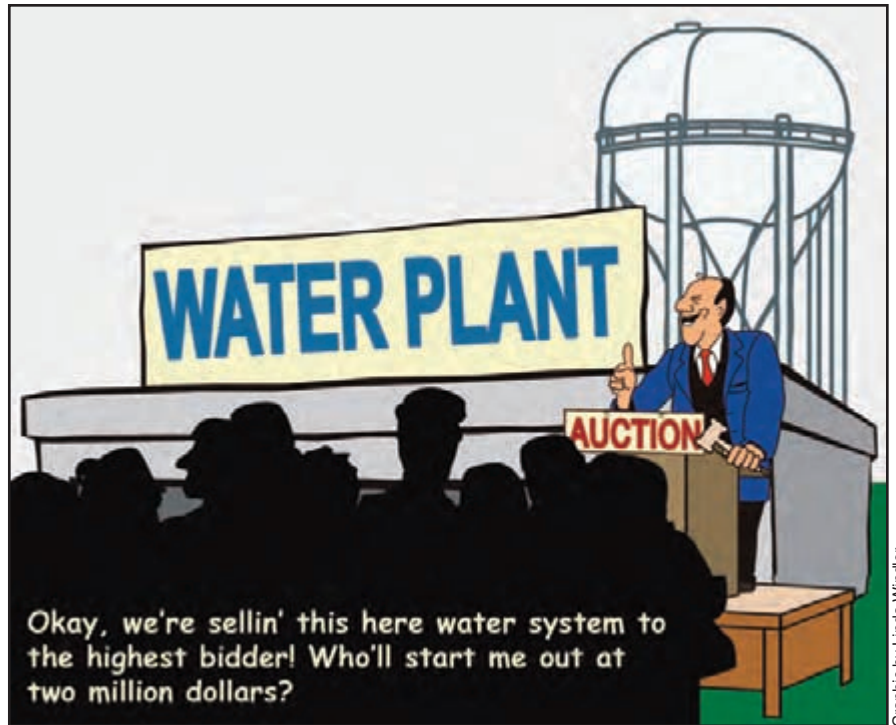
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district or municipal system. This lack of ability to vote means that the customers of an investor-owned utility are technically called “disenfranchised”.

Investor-owned utilities are not automatically “bad”. They just have a different priority than public utilities, which are directly answerable to their customers, as anyone who has attended a board or council meeting during a rate increase review knows. The priority of an investor-owned utility is to push for higher rates and maximize the profit. Because customers in investor-owned utilities do not have a “vote”, each state is responsible for protecting the interests of the customers. States do this by regulating the investor-owned utilities. The state public service commission or some similar state agency in each state regulates the geographic area in which an investor-owned utility can serve as well as the rates that can be charged. In Kansas, private water companies must file rate changes with the Kansas Corporation Commission (KCC). The KCC or similar agencies in other states, have a formula, which varies from state to state, that determines how much profit the utility is allowed to make, on top of the amount the utility gets to charge for operations and maintenance and reserve accounts. On average nationwide, an investor-owned utility will be entitled to make a return on its investment (on the money it invests in the utility) of around 10%. This is in addition to the portion of the rates that cover daily operations.

As long as a public utility understands these concepts, then it can make a good decision on whether or not selling to an investor-owned utility is a good thing or a bad thing. Unfortunately, many boards and town councils do not always understand these concepts and in addition to that, may have failed to properly raise rates and keep enough reserves to run the utility. When that happens, the utility might be on the edge of collapse or require large amounts of infrastructure investment from the community, but be a potential profit opportunity to an



investor-owned utility. Why would an investor-owned utility want to buy a struggling public utility? Because it has an established and guaranteed client base, that's why. Municipal systems are also often attracted to the prospect of not having to deal with regulatory

compliance or staffing issues. In some cases, when investor-owned utilities contract for the operations, or purchase a system outright, they simply retain all the present staff and assume management. However, the existing staff are almost always required to



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become employees of the investor-owned utility as a condition of keeping their jobs.

This gives them the ability to offer to buy a cash-strapped public utility, and make money off of that customer base.

This trend towards "privatization", where community water/wastewater systems are owned by private companies, is on the rise. Right now, municipal systems are the low-hanging fruit, because small towns have to provide multiple services, and for some of them, selling their utility makes sense. Not as many rural water and wastewater systems are owned or leased by investor-owned utilities, but nationally, that trend is also changing.

There are arguments to be made both ways. In 1982, Pekin, Illinois, population 34,000 with about 15,000 connections, had the chance to buy its water system from a small investor-owned utility but decided not to do so. Along came Illinois American Water and snapped up the utility and rates started to rise. Another recent article in *USA Today* cited Pekin as a case study for a community that is unhappy with

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privatization. There were two referendums held between 1982 and 2002, and both times, the voters rejected the idea of buying the water utility back. When the voters did finally vote to repurchase the water system, the state vetoed the sale due to regulatory problems that the city was having with its wastewater treatment plant. So why is Pekin unhappy? According to the city manager, rates for 6,000 gallons per month increased 204% between 1982 and 2002. And if the city still owned the water system, rates would be lower and extending

water lines to an expansion of Pekin's industrial park and along a new bypass would be less complicated.

According to *Illinois American*, Pekin's rates rose 2.9% in 2003, 21.2% in 2008 and will go up 18.6% in 2010. The company has invested about \$10.5 million in Pekin in the past seven years, and these types of rate increases are the means by which investor-owned utilities make money on those investments. The tension between cities and investor-owned utilities is illustrated in *Illinois American's* recent request for statewide rate increases. The Illinois Commerce Commission, which is the agency that regulates investor-owned utilities in Illinois, cut more than \$19.6 million from *Illinois American's* request for \$61 million in rate increases statewide. *USA Today* quoted Acting Commerce Commission Chairman Manuel Flores as saying the company can't "view Illinois ratepayers as an open checkbook." *Illinois American* President Karla Olson Teasley was quoted as saying that the request reflected "the true cost of providing water and wastewater service," including maintenance.

That is the argument in a nutshell. Investor-owned utilities need to make money and they have the upfront money to spend on public systems. Local communities and rural water systems may not have the money to fix ailing systems or they may, in the case of cities, have other key items to spend money on.

Again, according to *USA Today*, cities react differently to the offers to purchase their utilities. In Temple, GA, population around 4,500, the city council voted unanimously to reject an offer from a private company to lease its water and sewer systems for 30 years for \$2 million. The reason? The city didn't want to give up control over its destiny. In White Haven, PA, population around 6,000, the city sold its system in 2002 and ended up with \$2.5 million in the bank. Rates were frozen for five years and have risen five to ten percent a year since. In Marion, SC., population around

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33,000, a deal in May 2010 netted the city \$2.6 million for the sale of its water and wastewater systems.

Hazleton, PA, population around 30,000, is trying to avoid laying off half of the town's 100 employees by selling its water system. This is an excellent example of the two sides of this issue. A deal on the table could bring the city \$40 million, pay off \$2 million in debt and erase a \$1 million shortfall. The mayor has stated that he would put the money in a trust and use interest to help build a solar plant that could sell excess power to generate revenue for the city. One side argues that with the money the town would be financially secure for decades to come. But other citizens are circulating petitions opposing the sale, primarily based on a fear of increased rates and an inability to control future growth. If a town does decide to sell its system, the long-term implications of the deal need to be seriously studied. Are there guaranteed staggered rate increases? Are there guaranteed improvements to be made? How will future growth and system expansion be handled? Will the town have any input in this process?

The reality for rural systems is slightly different. Rural water systems do not have the same power as a town to sell assets without a big first step. Under most state laws, the customers of the rural water system have to vote to disband the system before it can be sold to an investor-owned utility. Once that happens, the utility becomes regulated by the state utility agency, just like any other utility. However, I have worked with rural water boards were basically sold out the back door because they entered into long-term operating agreements with investor-owned utilities, where the investor-owned utility was hired as a full contract operator. This is the trend that is significant, because the investor-owned utility does NOT fall under the state agency in this case. In these situations, the rural water district continued to exist legally but the board had little if any power. The contract

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operator usually replaced all the district employees with its own employees, so that even if a new board wanted to terminate the agreement, there were no employees to run the system, no one knew how to handle billing and there was no certified operator for the system! And I have seen operating agreements where the board had to agree to make the rate increase recommended by the contract operator. This can be a tragic situation for the customers if the goal is to maintain autonomy, but it can be argued that at least they are getting good drinking water.

If no one cares enough to step up and serve on the board, or if the current board is unwilling to raise rates and "make money" for the district, then contract operations may be the only option. Each case will have different facts, but in this tough economy, rural water systems face tougher challenges than many small towns, because they have only one source of revenue. And this makes rural water systems more vulnerable to poor management and more likely to be the target of future takeovers by investor-owned utilities through these back door contract operations agreements. Make sure that any such proposals are thoroughly considered before signing and also, engage in discussions with your professionals and member associations.

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