

STATE LEGISLATION

# Investor-owned utilities benefit as fair value legislation incentivises system sales

The adoption of fair market value legislation in a growing number of US states bodes well for investor-owned utilities looking to acquire distressed municipal water and wastewater systems.

A small but growing number of states in the US have adopted legislation that allows investor-owned utilities to recover through rates an independently appraised fair market value for acquired municipal water and wastewater systems.

This seeks to address the wide gap between what municipalities have traditionally looked to sell their systems for, and what prospective buyers have been willing to pay, and industry insiders agree that more transactions are expected to emerge as a result.

The most recent state to have adopted fair value legislation is Pennsylvania, which passed Act 12 in April of this year. While implementation of the appraisal process is still being ironed out, the legislation has already spawned tangible interest.

“It has contributed to a number of additional discussions we’ve had with municipal leaders, because they know that they can now get fair market value when they monetise their assets,” American Water’s president of regulated operations, Walter Lynch, told GWI this month. He added that the company’s pending \$156 million acquisition

of a sewer system in McKeesport, PA was motivated by the passing of Act 12.

When purchasing a municipal system, investor-owned utilities (IoUs) have historically had to take as their rate base the original cost of the assets, less depreciation. Significantly, this has excluded contributed property: many water and wastewater systems consist of distribution and collection assets which have been paid for and installed by private developers before being transferred into public utility ownership. “[This contributed property] may be worth many millions of dollars, and may have cost many millions of dollars, but it comes onto the books as zero,” Michael Klein, an attorney with Cozen O’Connor, told GWI.

The result is that many municipalities with significant contributed property have been disincentivised to sell under the original ‘cost less depreciation’ model, which could considerably undervalue their asset base. Likewise, IoUs cautious of generating goodwill have been unwilling to pay above book value, recognising that any premium is unlikely to be recovered through rates.

Fair market value legislation changes

this by allowing municipalities and potential buyers to agree on a third-party appraisal of the value of the assets, including contributed property. This appraised value is then taken as the buyer’s rate base, unless the purchase price is lower.

Ryan Wobbrock, a senior analyst at Moody’s, explained that this change is credit-positive for publicly traded IoUs looking to acquire municipal systems. “What is most important from a credit perspective is clarity surrounding the recoverability of the investment, and this legislation definitely helps provide that,” he told GWI.

The adoption of fair market value legislation highlights the fact that the regulatory environment in many states is becoming increasingly supportive of privatisation.

“If you look at the success we’ve had with the legislation that has come out in the last three years, you can see that there is much more support for IoUs,” Lynch observed. “The need to invest in our infrastructure is recognised by the commissions and the legislators, and they are providing options for municipalities looking to sell.”

David Stanton, utilities president at Suez North America, explained that fair market value dovetails with legislation allowing single-tariff districts, and facilitates Suez’s regulated strategy, which is focused on tuck-in acquisitions. “We’re in the process of trying to design a consolidation model which is built around large single-tariff districts and growing rate bases, so that we can merge in these troubled systems and share the collective burden across a bigger rate base,” Stanton told GWI.

Aqua America CEO Chris Franklin, meanwhile, continues to observe promising activity which he attributes to “dramatic” changes in the sector over the past two years. Alongside strained municipal budgets and political pressure on the efficacy of water systems, the increasingly supportive regulatory environment in the states in which Aqua operates is creating unprecedented opportunities.

“I’ve been in the business for 23 years, and I have never seen the level of activity in the municipal sector like there is today,” Franklin observed to GWI. ■

