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Effective Regulation of Public Utilities

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Peter F. Drucker, *The Effective Executive*

- HOME
- ABOUT
- SERVICES AND CLIENTS
- PAPERS
- EXPERT TESTIMONY
- MONTHLY ESSAYS
- RECENT PROJECTS
- SEMINARS

- HOME
- MONTHLY ESSAYS
- WATER MERGERS: ARE THEY MAKING ...



WATER MERGERS: ARE THEY MAKING ECONOMIC SENSE?

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Mergers and acquisitions have come to the water industry. The targets are small companies—some private, some municipally owned, each a monopoly. Some are merging with each other; others are being acquired by large investor-owned companies. As infrastructure ages, environmental costs rise, and population grows, economies of scale may justify larger service territories. But as with all M&A activity in monopoly markets, these transactions display tension between the parties’ strategic objectives and the public’s long-term interests.

Price prevailing over performance

Here’s what’s happening in State X: State law lets investor-owned acquirers and municipal system owners negotiate their own prices, subject to deferential state commission review. But deference is problematic because each side has an incentive to inflate the purchase price. The municipal seller can use the extra proceeds to build soccer fields or fix pension deficits. The acquirer can put the acquisition cost into rate base; so, oddly, the more it pays the more it profits. (Try explaining that one to a neighbor uninfected by a career in utility regulation.) And the acquirer can spread its purchase cost among its multiple water subsidiaries—so small, gradual rate increases tend to go unnoticed. Assume, further, that the state regulator approves these rising acquisition prices, as long as they don’t exceed some standard borrowed from the real estate industry—a standard like “reproduction cost new”—that that has no relevance to the acquired system’s real value.

Worsening the situation: Acquirer 1’s willingness to pay high acquisition prices is contagious. So rivalry among acquirers drives up the acquisition prices beyond the already wrong prices. The result? A race to the bottom, with municipal sellers choosing acquirers based on price instead of performance—ironically so, since the reason to encourage water mergers, we are told, is to lower cost and improve performance.

This picture fails the public because it lacks discipline. It lacks competitive discipline because each negotiator is a monopolist. It lacks regulatory discipline because the cap on the purchase price—reproduction cost new—has no relation to a water system’s actual cost or value. And the municipal seller’s priority? Today’s proceeds rather than tomorrow’s performance. A real trifecta—failures of competition, regulation, and politics. How do we fix it?

Solutions: Start by studying economies of scale

For a century, utilities’ monopoly status has been justified by “economies of scale.” Is it not odd that no one actually studies economies of scale? Before approving more mergers, some skilled, objective, apolitical regulatory body—not local but statewide—should determine the economies of scale for providing water service in different parts of the state. (For newcomers: Economies of scale refers to the cost function of a particular service. A particular service has economies of scale if the per-unit cost of providing that service declines as the number of customers served or units sold grows.)

With this economies of scale information, the commission could pencil in economically sized service territory boundaries, rationally rather than opportunistically. The commission then could guide mergers and acquisitions toward these economic outcomes, rejecting or approving acquisitions depending on their consistency with the draft map. Caution: Economics need not be the sole criterion; values like local control and ownership type (investor-owned vs. municipally-owned vs. cooperatively-owned) matter too. But starting from the economic optimum allows decisionmakers to know the cost of varying from it to advance other values.

I’ve been warned that “political” conditions disfavor “bureaucrats” deciding what companies should serve within which boundaries. But where else did the historic

MONTHLY ESSAYS BY TOPIC

- Attributes of Effective Regulators
- Actions of Effective Regulators
- Political Pressures
- Regulatory Courage
- Jurisdiction: Power Is a Means, Not an End
- Practice and Procedure
- Regulatory Organizations
- Mergers and Regulated Utilities
- Aspiration and Thanksgiving

MONTHLY ESSAYS BY YEAR

- 2019
- 2018
- 2017
- 2016
- 2015
- 2014
- 2013
- 2012
- 2011
- 2010
- 2009
- 2008
- 2007

boundaries come from? And the current approach merely replaces “bureaucrats” with “monopolists.” Feeling better? (As for that term “bureaucrats”—a tagline with the intellectual value of a kindergarten spat—some of the finest, sharpest thinkers I know are state and federal regulatory staff who spend their working lives protecting us from ourselves. That means you, DD, RR and JG—thanks for the help.)

Then, can we get the acquisition price right?

Studying economies of scale can get us the right service territory sizes, but what about those inflated acquisition prices? Given the lack of arms-length bargaining (recall that both sides are monopolists and both want the price high), we need some kind of cap.

“Reproduction cost new” has no relation to real-world water company value, because (a) regulated water prices (which give a system its value) are based on book value, not reproduction cost; and (b) the acquirers are acquiring existing systems, not creating new systems.

The logical solution? *Limit the acquisition premium (the excess of purchase price over book value) to the cost savings promised by the consolidation.* A premium that exceeds the savings is economically irrational: It’s like giving the bank a \$20 bill and getting back \$15; you walk away worse off. So require prospective acquirers to identify, pre-acquisition, the savings that consolidation will bring, and make them commit to those savings. As long as the premium falls below that amount, the acquisition will leave us no worse off.

Then what? No-worse-off is for losers. Winners want to be best off. Limiting the premium to the expected savings avoids harm, but it does not get us the best result. We get that result by creating a *competition among acquirers*, subject to the cap, to see who can promise the most savings. The more savings, the higher the economic gain. And gain can be shared between buyer and seller. The buyer is better off to the extent it keeps any of the savings it creates. So by capping the premium at savings, we change the acquirer’s incentive from inflating the rate base to maximizing savings. And since the seller also benefits from getting a share of the savings, its incentive is to pick the acquirer that can create the most savings. Now who wins the acquisition contest? Not the one with the most cash available to pay the highest price. Not the one with the most captive customers among whom it can spread that highest price. *The winner of the acquisition contest is the acquirer that can create the most savings.* That was the point of consolidation to begin with, yes?

One last idea: The commissions overseeing water mergers should establish objective metrics for performance. Otherwise, the incentive to create savings will lead to short-term cost cuts that cause long-term problems.

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So we have a four-part solution: (a) Create a statewide plan that identifies potential territory sizes based on true economies of scale; (b) limit the acquisition premium to savings attributable to the consolidation; (c) establish clear metrics for performance; and (d) let system sellers host competitions based on savings. Competitions designed by regulators to achieve the public interest—a better solution than leaving consolidation decisions to monopolists.