

Utility Strengthening Through Consolidation: Guiding Principles for the Water Sector

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The water sector is at a crossroads. Many converging forces pose significant problems for water utilities as they seek to maintain and expand the high-quality water service that the nation expects. Key challenges to securing our water future include aging infrastructure, soaring operating expenses, affordability for lower-income customers, shifting population and demographic changes, and how to make systems more resilient in the face of a more uncertain climate. Substantial fragmentation in the water sector makes the complicated issues facing communities even more challenging.

*For purposes of this document, consolidation is defined in the following manner: water sector utility consolidation occurs when two or more distinct legal entities become a single legal entity operating under the same governance, management, and financial functions. Consolidation may or may not include physical interconnection of assets depending on geographic proximity and system hydraulics. When physical interconnection is not feasible, consolidation can still take place on a regional basis with fully merged governance, operations, and finances supporting the geographically disparate physical assets. Consolidation can involve merging several entities that provide the same utility service (e.g., drinking water) into one entity. It can also involve combining entities providing different water utility services (e.g., drinking water and wastewater) within a region into a single entity. The term consolidation has also been applied to situations in which a subset of governance, management, operations, and financial functions are consolidated without resulting in a single legal entity.

In June 2018, the US Water Alliance convened a leadership dialogue, *Utility Strengthening Through Consolidation*.^{*} This forum brought together water executives, community leaders, and policymakers in a cross-sector discussion focused on the role of utility consolidation in advancing sustainable water management in the United States. The dialogue explored the role consolidation can play in helping water sector utilities, and the communities they serve, address existing and anticipated challenges; the benefits consolidation can provide; and the barriers hindering the rate and scope of consolidation in the US water sector.

Dialogue participants—acting in their individual capacities as informed experts—agreed that further consolidation in the water sector is desirable and feasible. There is collective realization that consolidation is one important strategy to address current and emerging water sector challenges. Consolidation can enable utilities to address unfunded investment gaps; achieve predictable, consistent revenue; address affordability and environmental justice; provide a stronger basis for local economic growth; support better operational resilience; provide the capacity to meet modern treatment standards; and leverage innovation opportunities in the water sector more readily.

Despite being an important tool for sustainable water management, utility consolidation is one of the most difficult topics to discuss in the sector. Communities considering options to better meet their water service needs struggle to find comprehensive, fact-based ways to do so.

Participants in the US Water Alliance's leadership dialogue, *Utility Strengthening Through Consolidation*, call on all water sector partners to reduce barriers to consolidation and promote the use of this important tool.

Towards that end, together, we offer the following principles to guide future efforts:

1. **Focus on proactive, community-driven, and locally-determined approaches to consolidation.**

Consolidation is best undertaken proactively. Community leaders and stakeholders should tailor the process for evaluating options and determine appropriate institutional arrangements at the local level. Consolidation will work best when utilities voluntarily explore consolidation options before a substantial deterioration in operations and assets takes place. An optimal time is when a fundamentally sound system undertakes an opportunity assessment and identifies infrastructure replacement needs, new regulatory requirements, or other significant cost drivers, and decides merging with another utility is the best option for customer service and affordability. Consolidation is also a complex undertaking. It intersects with the local history of how communities have governed drinking water and wastewater, and will depend on watershed and socio-political conditions. Consolidation efforts must be sensitive to local control of land use and water services and the community benefits they provide, whether they are economic, social, cultural, public health, or environmental health related.

2. **Build in backstops to address significant public health or environmental risks and threats.**

While voluntary consolidation is the best approach, some communities and their water systems face challenges that place public health or the environment at significant risk. State governments play an important role in these cases.

Communities facing economic, demographic, or other challenges can experience an erosion of their rate base, which places substantial pressure on the technical, financial, and managerial capacity of their water systems. These conditions can place public and environmental health at risk and require coordinated intervention. Consolidation, technical assistance, funding, and other support—individually or combined—all need to be on the table to ensure communities are provided with reliable

access to clean and safe water services. If communities are in this challenged context but encounter resistance or reluctance to solve the challenge, state authority to require consolidation becomes a critical option, and may ensure sustainable local water services, protection of public health, and environmental well-being.

3. **Define, and be guided by, the community value proposition.**

Present consolidation in the context of the value it can provide the community. Clearly articulate the potential costs and the potential benefits a community can anticipate from consolidating utilities. Consolidation must balance up-front requirements, costs, and any true loss of community decision-making with the mid-to-longer-term benefits consolidation can provide. Consolidation transactions are complex, and the benefits from consolidation must be sufficiently compelling to justify and drive the transaction forward. A continuum exists relative to current system operating contexts and the incentives and enabling environment that support consolidation. This continuum runs from high technical/financial/managerial (TFM) capacity systems operating in economically stable communities to low TFM capacity systems operating in economically vulnerable communities. Each end of this continuum represents unique cases where either the benefits of consolidation will be insufficient or the barriers to consolidation will be too high to support consolidation taking place. The local value proposition for consolidation will vary along this continuum, and communities should evaluate their value proposition and make a locally-driven business decision on whether they will pursue consolidation. To help communities make informed, well-balanced decisions, water sector partners need to better characterize and communicate the costs and benefits of consolidation and promote rigorous, but streamlined, opportunity assessments.

4.

A range of consolidation models can work; communities must have balanced, factual information to make informed choices.

Communities need balanced information on the full range of governance models under which consolidation can take place. A range of governance models and institutional arrangements exist to support consolidation. These include: general purpose government (e.g., municipal water departments); special purpose government utility (e.g., authority service district); privately owned utilities; and cooperative, nonprofit organizations (e.g., membership cooperatives). Each of these models offers communities a different combination of governance structures, access to capital, and jurisdictional and geographic considerations. Any of the available institutional governance models can be an effective approach to utility consolidation, with advantages in some community contexts and disadvantages in others. The historical backdrop and the unique design elements of a governance model determine effectiveness, *not* the structure of the model itself. Models can also be customized through interlocal agreements in which different aspects of governance, decision making, and operational responsibility are delegated or shared regionally. The water sector best serves communities by providing clear, balanced information on the range of models, key considerations, and design elements to make them effective.

5.

Develop a cohesive authorizing environment at the state level.

Given that consolidation is an important tool to accelerate movement towards a One Water future in the United States, state governments should adopt a complete and cohesive authorizing environment to streamline consolidation transactions, lower up-front transaction costs, and provide balanced, factual information on consolidation options. No state has a comprehensive and cohesive package of legislation and regulation that enables a clear, low-transaction cost path to consolidation. This complicates consolidation transactions, and at times, actually prohibits certain forms of transactions. Some state governments have policy or regulation that unfairly favors certain institutional approaches to consolidation. Others have implemented policy to better motivate and enable water systems consolidation.

State governments should outline the assistance options and the technical assistance programs available to support for systems interested in exploring consolidation. The water sector can support state governments in adopting the needed statutes and regulations, as well as lower the significant barrier to consolidation activity by cataloging and characterizing these options.

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