

What Reaves Sees in America's Water

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America's water utility infrastructure is in sorry shape and has been so for many years. Lately the American Society of Civil Engineers, which periodically grades the nation's infrastructure, gave the network below-average ratings for drinking water (D) and waste water (D+), concluding that \$271 billion was needed in fresh investment to bring the systems back up to grade and meet expanding demand over the next 25 years. Others estimate a full \$1 trillion in investment to meet drinking water needs over the same span.¹ This represents a major investment opportunity provided conditions are right.

Already, state governments are paving the way becoming pioneers in progressive ratemaking. Pennsylvania, New Jersey, Indiana, and Illinois to name a few have established infrastructure surcharge mechanisms to encourage quicker water pipeline replacement. These surcharges have also become adopted in gas and electric utilities regulation. These programs, plus the absolute amount of investment needed, means water utilities should be able to grow earnings and dividends in the mid-to-high single-digit range for many years.

One promising area of opportunity comes in the recent push to produce more mergers. The U.S. water system is hopelessly fragmented with 50,000 municipal water systems, many of which cannot afford to bring their systems up to grade. The solution, as some see it, would be to encourage publicly-traded, well-funded water companies like American Water Works and Aqua America to buy these flagging municipal systems. The idea: Broad ownership by public utilities results in lower financing costs and expenses that can be spread across all its customers in that state. Spreading the tax burden makes the bite less harsh. For municipalities, always themselves strapped for cash, mergers represent windfalls; proceeds can fund education and emergency services.

Many municipalities so far have resisted selling. First, they face perceived public resistance as the result of rate hikes because water is often heavily subsidized. Politically many folks view access as to water as a right, and resist selling that right to a private, profiteering company. Finally, outcomes are unpredictable because the decisions are often made in referendums.

According to Robert Powelson, president of the National Association of Water Companies, properly maintained rate structures are vital for ensuring the long range health of any municipal water or wastewater system. Far too often we see examples of municipal systems keeping rates artificially low. In the end these communities are left with a water system that lacks proper investment, jeopardizing the health of the residents it serves."² For many communities the best solution means working with a water company.

Trenton Water Works (TWW) shows just how politically charged a troubled water system can become. Back in 2010 a grassroots campaign successfully derailed a planned sale of TWW suburban assets to American Water Works defeating a well-financed marketing campaign by a margin of 4:1.³

Persistent problems have led to trouble with the New Jersey Department of Environmental Protection, which last year described the situation in a City-ordered report by Mott Macdonald. The report criticized Trenton Water Works for underservicing its customers operating with a \$12 million surplus with only one-third the necessary staff.⁴ “The significant vacancy rate across (water works) raises significant concerns regarding its ability to reliably supply drinking water to its customers on a continuous basis without,” said the report.

Trenton’s newly-elected Mayor Reed Guscoria is already enmeshed in discussions with the New Jersey Environmental Protection Agency appointing Dr. Shing-Fu Hsueh, a water quality expert as temporary overseer, while vowing in his swearing-in speech to make the public water system fully functional. “There will be no privatization of our water supply,” the Mayor reportedly declared. “The special interests who are watching our every move, they can look elsewhere.”⁵

States have enacted new mechanisms to speed the deal flow. First, in New Jersey, legislators now require municipalities with failing water infrastructure to sell—essentially forcing the issue. Several states have also implemented procedures for valuing assets, ensuring both the acquiring utility and the municipality receive a fair deal.

So there you have it. Billions of investments, states encouraging acquisitions at fair prices and consolidation on a massive scale. No wonder we believe the outlook is good. Valuations are high right now, because of the excitement over the prospects, but there is no denying this engine for long-term growth.

Jay Rhame is a portfolio manager at Reaves Asset Management. He has more than 10 years of experience as a utilities analyst.

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Reaves Asset Management advisory clients own American Water Works and Aqua America.

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All investments involve risk and loss of principal.

¹ American Society of Civil Engineers, 2017 Infrastructure Report Cards: [Drinking Water](#) and [Waste Water](#).

² Quote supplied by National Association of Water Companies, August 3, 2018.

³ “Trenton Voters Sink Water Deal,” Meir Rinde, *The Trenton Times*, June 16, 2010

⁴ “Trenton Water Works has only one-third staff to operate its system,” Kevin Moriarty blog p 7204, December 1, 2017.

⁵ Sulaiman Abdur-Rahman, *The Trentonian*, July 5, 2018