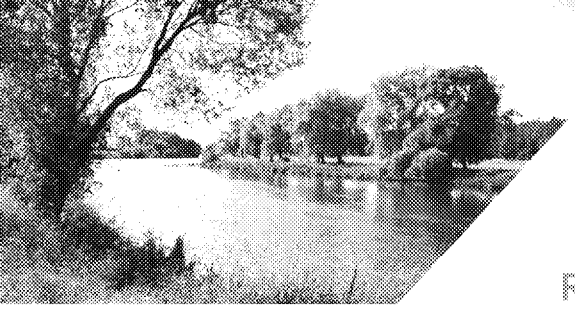

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RURAL INFRASTRUCTURE BRIEFINGS

October 2017

When Rural Water Systems Combine

Consolidation may offer benefits for the nation's rural water industry, but it's also triggered debate on its rationale, approaches and community impact

These briefings showcase different facets of the rural infrastructure industries: power, energy, and utilities; water utilities; and communications.

Inside this Issue...

Is consolidation in your water system's future? Who should determine whether it's the right or wrong move for your utility – or even for your community? And how should a potential consolidation unfold?

These questions are at the heart of a growing discussion across the nation's rural water industry. As water utilities wrestle with increasing regulatory compliance and costly infrastructure needs, many are considering whether consolidation, also referred to as regionalization or partnering, could help them meet their challenges. Proponents say consolidation can help rural water systems leverage economies of scale and available expertise to make better use of resources and opportunities.

But not everyone agrees on the rationale or approach to consolidation. Many worry that consolidation will strip local control from a community or customer base. Others refute the idea that small water systems can't take care of their own business or run quality operations on their own. Others caution about proceeding without careful thought of unintended consequences.

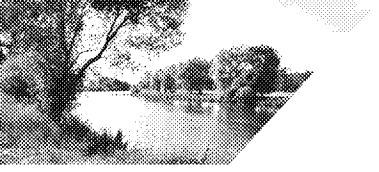
Differing points of view have increased controversy about consolidation and led to tension among industry leaders.

Rural America's consolidation trend

Consolidation, of course, is not a new trend. It's been occurring among U.S. businesses for decades, whether in the form of unifications, mergers or acquisitions. But in rural America, the consolidation pace has picked up significantly in recent years. Farm supply companies, dairy and grain cooperatives, Farm Credit Associations and other agricultural businesses are merging at a high rate of consolidation not seen since the late 1990s and early 2000s, according to Chuck Conner, president and CEO of the National Council of Farmer Cooperatives.

In fact, the rural water industry itself also has been consolidating. In Kentucky alone, the number of water systems has fallen from 2,000 in 1979 to 400 today, largely due to consolidation. Many of the Midwest's regional water systems are the result of mergers and alliances.

Regardless of the industry, these consolidations all share a need for more: more economies of scale, more capital to acquire assets and sophisticated technology, more resources and ability to better serve their members.



Consolidation benefits

For rural water systems, consolidation can help spread debt service as well as administrative and operational costs over a larger customer base, says Jim LaPlant, CEO and engineer for Iowa Regional Utilities Association (IRUA). Based in Newton, Iowa, the not-for-profit regional water and wastewater system serves more than 60 small communities.

> *"It can make sense to partner with a neighboring system. But it's essential that communities agree that it's for the good of the residents.*

Among the other pros of consolidation, adds LaPlant, is its ability to allow regional water systems to take advantage of bulk purchasing opportunities. It also gives them the ability to afford and attract highly specialized employees who can provide value with in-house engineering, technical consulting, accounting, public relations and other functions. Consolidation also enables regional water systems to develop multiple alternate sources of supply, "which provides added versatility in operations and service reliability," he says.

Moreover, systems that have consolidated into regional utilities have enhanced economic development by providing services to rural subdivisions, business parks, and ethanol and biodiesel plants. Regional systems can also budget and implement positive public relations programs that can raise the image and acceptance of the drinking water industry, LaPlant notes.

"We are seeing strong interest in consolidation in small communities and unincorporated areas that have older well-water supplies and distribution systems," he says. "In many instances, these small systems are governed by an older council or board, and usually have an older operator who is ready to retire. In many instances, younger generations are not interested in the time and dedication it takes to keep these systems viable."

Consolidation caution

Consolidation, however, has its downside. "Regional systems are a lot of hard work," LaPlant says.

He should know. IRUA has undertaken an aggressive and determined effort to grow and partner since the late 1970s. Through regionalization, it has expanded well beyond its original 950 miles of pipeline and 2,000 customers. Today, it serves 15,500 customers, including 1,000 for sewer services. Spread out over 18 counties in central and northeast Iowa, it now counts 5,000 miles of distribution pipeline. IRUA purchases water from four municipal water sources and owns a 3 million-gallon-per-day membrane treatment plant. It has taken commitment by IRUA's board and staff "to meet all the challenges in expanding our services," notes LaPlant.

But consolidation brings other concerns, and some industry leaders have been calling for caution when it's touted as the answer to the rural water industry's challenges. Among them is Matt Holmes, deputy CEO of the National Rural Water Association (NRWA), the nation's largest community-based drinking water utility organization. Based in Duncan, Oklahoma, NRWA's 49 affiliated state rural water associations represent 31,000 utility-system members across the country.

"We understand there will be consolidation in the rural water industry," Holmes acknowledges. "It can make sense to partner with a neighboring system. But it's essential that communities agree that it's for the good of the residents, that it's not a top-down push. It should be a local decision.

"Water is about control," he adds. "It's about the economic vitality of a community and the public health of its citizens. It's important for people to have a say in how it's handled. They have to understand that checks and balances must be put into place so that their water resource continues to be managed in the best interests of the community."

Holmes is also concerned about repeated assertions that smaller water systems need to consolidate because they can't meet regulatory requirements. "There's no compelling data that smaller systems have a larger number of violations," he says. "People say smaller systems represent the majority of violations, but that's

because they represent some 90 percent of the nation's water systems. They are the majority of systems."

Steve Fletcher, manager of Illinois-based Washington County Water Company, also contradicts claims that smaller water companies can't continue to operate themselves today and so must depend on a union with another system. Washington County Water serves 5,600 customers and three towns.

"Just because a system is small doesn't mean it can't take care of its own business," says Fletcher, who is also president of NRWA. "There are avenues for small towns to get help."

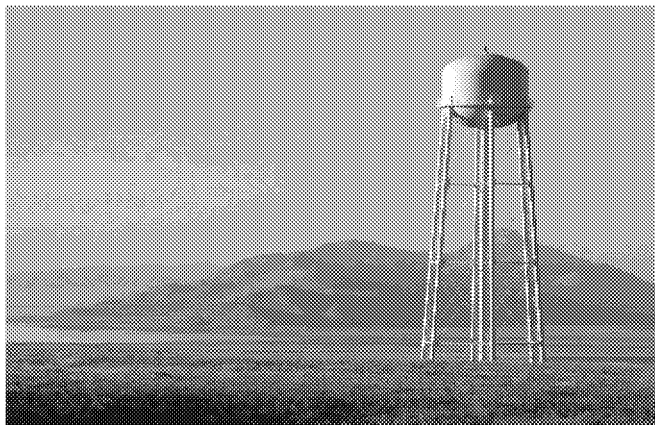
NRWA, he notes, has proposed a provision for the 2018 farm bill that provides financial incentives to communities that lack the capacity to provide services to their immediate residents. "This would allow contiguous neighbors and utilities outside the underserved area to receive a direct subsidized loan to provide service to that community," Fletcher says.

He further believes small towns derive their identity in part from local businesses. For many communities, the local water utility belongs to the constellation of businesses that helps form a town's character. Its role is all the more valued because it provides one of the life's most essential resources. When a consolidation swallows up a local business pillar, some fear a community's cultural values and local control begin to erode.

"Many towns don't want to lose their identity," Fletcher says. "Many have already lost their local school and other businesses. They don't want to lose anything else."

NRWA's Holmes also emphasizes that rural water systems often underestimate consolidation's cost and complexity. For example, water utilities must be aware of the hurdles of moving water over broader areas. "Water is extremely heavy and costly to move," Holmes says. That intensifies the challenges of engineering, digging lines underground, pumping, elevation changes, treatment and regulatory issues that must be addressed when water systems consolidate or regionalize.

Holmes also notes that among regional systems that distribute water over long distances, water often stays in pipelines longer. "Disinfection agents can react with



natural organic matter and produce harmful disinfection byproducts," he says.

"I encourage any water system that's considering consolidation or partnering with another water system to engage a third party to help them navigate that decision," says Holmes. "You're making a decision that will last for years. It behooves you to get professional advice."

Such professional help could come from attorneys, CPAs, engineering firms and consultants – especially those without a financial interest in the project. The University of North Carolina Environmental Finance Center provides information for small water-system management. Industry organizations such as NRWA and the Association of Regional Water Organizations (ARWO) also can help small water systems navigate consolidation decisions.

Unique challenges of the rural water industry

The rural water industry struggles with unique challenges that can complicate the question of consolidation.

For starters, there are the sheer number and geography of rural water systems: some 50,000 in the U.S., spread out across all 50 states. Ninety-two percent of them serve small communities of 10,000 or less. Many are seeing declining populations and aging workforces. At the same time, they're also facing increasing capital costs to maintain and replace infrastructure and provide necessary services. Rural water systems often rely on federal funding, whether through grants or loans, to meet those needs.

But that federal assistance may be in jeopardy. In its proposed 2018 budget, the Trump Administration has recommended cutting farm bill programs by $231 billion. This includes substantial reductions in USDA's Rural Development agency, limiting aid to rural water systems and eliminating a program that funds rural water and wastewater infrastructure. Those proposed cuts have left many wondering if small water systems, many of which are already struggling financially, can remain independent. NRWA, with the backing of several U.S. senators, has voiced its concern over these proposed cuts.

Another challenge is that too few rural water utilities charge their customers the full cost of supplying safe drinking water. That often results in neglected repairs and upgrades to their water systems.

"Many local officials keep rates low so they will get re-elected," says Bill Teichmiller, CEO of EJ Water Cooperative in Dieterich, Illinois. "But that sets up the town to not have enough money for future repairs and maintenance."

Randy Van Dyke, CEO of Iowa Lakes Regional Water (ILRW), agrees. "Sometimes those actual costs could amount to $100 per month per home, compared to the current $10," he says. "Most water systems don't want to see rate adjustments, so they kick the can down the road."

The industry also struggles with three key issues that may lead water systems to consider consolidation, says IRUA's LaPlant.

"One is a lack of planning to adequately provide capacity for unserved or underserved rural areas," LaPlant says. "The second is the loss of skills and institutional knowledge due to the retirement of a generation of funding specialists who looked for partnerships and regional solutions when water projects were being considered. The third is the lack of a meaningful or value engineering process that confirms the best water project is being considered from a life-cycle cost standpoint."

Many small water systems don't have the human resources, whether it's the board or staff, to meet the challenge of owning and operating complex water treatment and distribution systems, he adds. Consolidation or partnerships can be the answer.

> *"Most water systems don't want to see rate adjustments, so they kick the can down the road.*

LaPlant serves on the board of ARWO, a not-for-profit group formed in 2016 to represent regional water and wastewater systems and advance their means for knowledge exchange.

"National drinking water organizations such as ARWO are sending the message to Congress and regulatory agencies, such as EPA, that regional water systems have the capacity and track record of success to be considered first when projects are evaluated," LaPlant says.

He also points out that a regional utility is a team effort "but there isn't a game without adequate, affordable funding."

Federal focus on water system partnerships

Those who advocate for consolidation and industry partnerships have found a proponent in the Trump Administration. In January 2017, the Environmental Protection Agency (EPA) hosted a daylong meeting in Washington, D.C. on "Water System Partnerships." The meeting, which included LaPlant, Teichmiller and Van Dyke, focused on efforts to bolster partnership activities, when it makes sense, for the nation's drinking water industry.

"This Administration is asking people to embrace long-term resiliency and sustainability," says ILRW's Van Dyke. "Consolidation is going to continue because costs in the 21st century, for both water and wastewater systems, are becoming more significant. Regional water systems are equipped to provide a number of solutions for a community."

Some rural water leaders worry that government agencies can force consolidation. A Safe Drinking Water Act (SDWA) violation may even dictate the timing of a consolidation. Certainly, the drinking water industry has come under the spotlight in the wake of the lead-tainted water crisis in Flint, Michigan, which surfaced in 2015. One outcome

of that focus is congressional bill H.R. 3387, introduced in July 2017 to amend the SDWA to improve public water systems and enhance compliance. Among its provisions is an allowance for states to force consolidation if a water system cannot comply with regulations.

Nevertheless, the federal government also recognizes that small rural water systems need help with regulatory compliance. In July 2017, the U.S. EPA reestablished a policy to provide on-site assistance to the country's small drinking-water utilities to help them comply with federal environmental regulations. EPA's decision directs the agency to fund technical assistance through the Grassroots Rural and Small Community Water Systems Assistance Act, enacted in December 2015. It marked an important change in EPA policy, since full-time, on-site technicians were eliminated in 2012 when Congress gave EPA discretion over the operation of the program. EPA's move drew praise from NRWA.

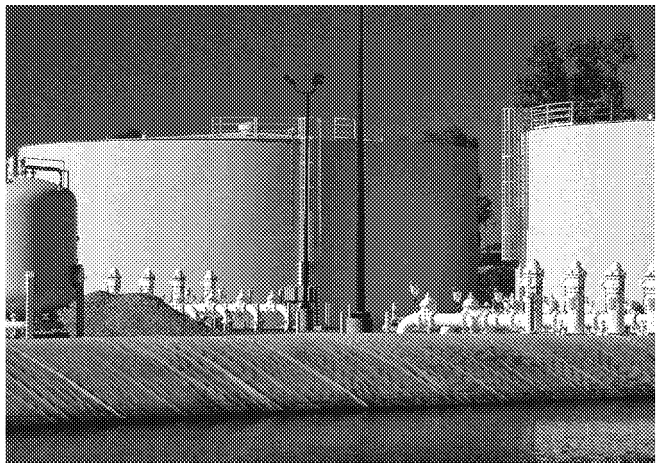
Consolidation's many forms

Consolidation in the rural water industry can encompass a wide range of options, from simple to complex. It can reflect the formation of a new water association by several neighboring systems. It can refer to the merger of a single rural utility with another water company or even with a neighboring municipality.

One consolidation scenario could involve one water system taking over all responsibility and costs for operating another water utility. That could include providing a whole new water source for customers in a neighboring community and building a new distribution system to deliver the water to that area.

Another example might consist of one water system providing another with infrastructure renovation, such as treatment plant backwash improvements, water tower maintenance and reducing distribution system water loss.

Consolidation can also mean partnering with another water system simply to provide services. For example, a water system continues to operate and maintain its distribution system but contracts with another utility for regulatory compliance, billing, meter reading or other services. Likewise, partnering may only involve assisting with emergency preparedness.



Among rural water systems that have grown through consolidation is Arkansas-based Conway County Regional Water Distribution District (CCRWDD). Formed in 1977, the nonprofit later purchased a neighboring water system. It also built out the water infrastructure for the city of Conway. In 1986, when three nearby county water systems asked CCRWDD to supply them with water and services, it did.

"That consolidation of services not only eased their burden of regulatory compliance," says CCRWDD operations manager Steve Wear. "It also was more cost-effective for them to purchase water from us than build their own water treatment facility."

Those consolidation moves increased CCRWDD's base from 1,100 to 25,000 customers, raising the company's revenues. "Because we added so many customers, we haven't had a residential rate increase since 1986," he says.

Wear believes a rural water system may be ready to consider partnering or consolidating with another system if it's having repeated issues with its board of directors, facilities, water quality or supply. Such issues can go on for years because government agencies often "throw money at the problems of a water system," he says. "Five years later, the water system is back asking for more money because the facility or equipment hasn't been maintained."

Partnering with a municipality

Another rural water system with considerable experience with consolidation is Iowa Lakes Regional Water (ILRW), where Van Dyke is CEO. Based in Spencer, Iowa, the water utility formed in the early 1980s as a not-for-profit rural water system, serving just 926 farms and rural homes. Today, ILRW partners with about 30 small towns, spread over 10,000 square miles of northwest Iowa and southwest Minnesota. It serves more than 5,200 water and wastewater customers, representing a population of 15,000 people.

In some cases, ILRW supplies water to partnering towns. In other cases, it simply provides services such as billing and revenue collections, meter reading, regulatory compliance and emergency management. One of its newer partners is Ayrshire, Iowa.

In late 2015, Ayrshire's city leaders reached out to ILRW for help in resolving several problems. The year before, Ayrshire had received notice from the Iowa Department of Natural Resources that the city had violated the federal Clean Water Act with its water treatment plant backwash discharge into a nearby creek. The city hired an engineering firm to review the problem and find a solution. That study revealed costs of as much as $80,000 to bring the city into compliance. In addition, water tower maintenance would cost an additional $60,000. Moreover, the city's water distribution system had a water loss of more than 60 percent, which also would require significant expenditures to resolve. On top of that, the city's only water plant operator was about to retire.

In response to the city's call for help, ILRW presented three options. Ultimately, the city chose the most complete option: ILRW would provide Ayrshire with a new water source and distribution system with full fire protection, and it would restore and upgrade the city's water tower in perpetuity, all at no cost to the city. In turn, ILRW would consider all residents of the city of Ayrshire as rural water members who would share the same rates as all other ILRW members.

"This was a successful merger and consolidation effort," says Van Dyke, ILRW's CEO since 1980.

"When two entities look at consolidation, the first thing people get anxious about is giving up control," he adds. "They may also be looking at a big jump in costs. Many times, decision-makers resist because they haven't been given enough information to see the big picture. They may not see what's coming down the road, such as the impact of a newly regulated contaminant or a multi-year drought. Most of the time, communities are slow to be forward-thinking about the real life-cycle of their facilities and equipment, and the costs to maintain or upgrade them."

It can take years to cultivate a partnership, he adds. A minimum of eight to 12 months is needed to sit down with a community, evaluate its water system and determine how the entities can work together.

"Consolidation has to be what's best for people at the grassroots level," says Van Dyke. "It can never be regulated or mandated."

EJ Water's Teichmiller also believes consolidation can benefit rural water systems. It's a trend already taking place among private water companies, where large tracts of acquisitions are underway. He agrees that consolidation must be decided at the local level. "It's critical to hold town hall meetings to walk through the pros and cons of consolidation so the community can make an informed decision," he says.

But to help make those decisions, he believes local leaders must be educated, not just about the complexity of consolidation but also about economic development and leadership. They need to plan for their communities 10, 20 or 30 years ahead. That educational push is underway both at EJ Water and at the new ARWO, where Teichmiller serves as president.

"Customer expectations are dramatically increasing," Teichmiller says. "We've called it the Amazon affect. Customers are expecting social media engagement. How will small towns engage with this new tool when most are operating with part-time staffs in the office? Many towns are struggling to meet tomorrow's expectations. It's grown harder to stay sustainable and viable if you're a small town. It's a national epidemic."

Kentucky's consolidation lessons

If any state knows about regionalization in the water industry, it's Kentucky.

"Kentucky has a number of regionalization efforts that have been successful," says Gary Larimore, executive director of the Kentucky Rural Water Association.

Several systems there are interconnected to purchase wholesale water as well as for emergencies. Other systems share common offices, management and operational personnel but have separate boards. The state has six regional water commissions formed to provide wholesale water to utilities.

"The Logan-Todd County Regional Water Commission is an excellent example of strong leadership, public involvement, good communication and patience," Larimore says. "This successful effort took over 10 years from start to finish."

Kentucky's few forced regionalization efforts continue to struggle with board, management and operational issues. "These were all the issues that the consolidations and mergers were supposed to resolve," notes Larimore. "There continues to be mistrust among the local elected officials, water system board members and staff. The system continues to struggle with regulatory compliance. The customers of the systems have lost all confidence in the abilities of the local water system leaders to provide them with safe drinking water."

The forced mergers were an attempt by regulatory agencies and local county officials to achieve better efficiency and regulatory compliance, he says. Unfortunately, the local leaders never communicated with or convinced the public that the merger would resolve the problems. "Public buy-in is essential to the success of any regionalization effort," Larimore says. "In reality, the problems remained the same. Merging the systems only merged the problems."

Ultimately, Kentucky has learned that rural water systems need a very good reason to regionalize. Will the community or public be better served by the new system? What are the added benefits a community will receive from this new entity?

"We should not be regionalizing simply because we think it is a good idea," notes Larimore. "There must be an obvious and overriding reason or need to consolidate. Every situation should be viewed independently, and decisions should be based on what is best for the customers. Simply merging or consolidating systems will not necessarily give you a better system. It may only give you one large, bad system." ■

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