Mergers and Acquisitions in the Water Industry: Legal Issues

Scott Hempling[1]

Introduction

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 within a state; others are being acquired by large investor-owned, nationwide holding company systems. As infrastructure ages, environmental costs rise, and population grows, economies of scale may justify larger service territories. But making water companies larger to exploit economies of scale is different from making a single water company a minority member of a national holding company holding dozens of water companies.

As with all M&A activity involving monopoly utility markets, these transactions display tensions between the transacting parties' strategic objectives and the public's long-term interests.

[1] Presentation to the National Association of State Utility Consumer Advocates, November 2026. cott Hempling is an attorney, teacher, and expert witness. He has advised and testified before numerous state utility commissions, and appeared frequently before U.S. congressional and state legislative committees. He has addressed audiences throughout the United States and in Australia, Belgium, Canada, Central America, England, Germany, India, Italy, Jamaica, Mexico, New Zealand, Nigeria, Norway, Peru, and Vanuatu. He has authored *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* (American Bar Association 2d ed. 2021); *Regulating Mergers and Acquisitions of U.S. Electric Utilities: Industry Concentration and Corporate Complication* (Edward Elgar Publishing 2020); and *Preside or Lead? The Attributes and Actions of Effective Regulators* (2d ed. 2013).

An adjunct professor at Georgetown University Law Center, Hempling is a former Executive Director of the U.S. National Regulatory Research Institute, and a former Administrative Law Judge at the U.S. Federal Energy Regulatory Commission. He received a B.A. *cum laude* from Yale University in (1) Economics and Political Science and (2) Music, and a J.D. *magna cum laude* from Georgetown University Law Center. He can be reached at shempling@scotthemplinglaw.com, or 301-754-3869. His website is www.scotthemplinglaw.com.

This presentation focuses on legal principles to apply in encouraging, discouraging, and assessing water-utility transactions. It has the following parts:

1. All regulation is based on an assumption of conflict between private interest and public interest.

2. In mergers and acquisitions of utilities, the typical transactional purpose embodies a private-public conflict because the purpose is to monetize for private gain the utility's publicly-granted franchise.

3. Because M&A transactions involving monopoly utilities are not disciplined by effective competition, they require active, nondeferential regulation.

4. Approving a holding company's acquisition of one utility is effectively approval of all of the holding company's future acquisitions.

5. If in agreeing to an acquisition, a jurisdictional utility transfers control of its decisions to a nonjurisdictional entity, the utility violates basic utility law.

6. The control premium paid by the acquirer to the target utility belongs largely to the utility's customers, not to the target utility.

7. Solutions: Commission-run, merit-based competitions for the franchise, elimination of the control premium, and limits on the acquisition premium.

Most of the principles discussed, and some of the substance, are detailed in my book *Regulating Mergers and Acquisitions of U.S. Electric Utilities: Industry Concentration and Corporate Complication* (Edward Elgar Publishing 2020). The book is now available from the publisher for free download under the Open Access protocol.[2]

[2] At https://www.e-elgar.com/shop/usd/regulating-mergers-and-acquisitions-of-u-s-electric-utilities-industry-concentration-and-corporate-complication-9781839109454.html?srsltid=AU7gw4WAw7t00QvygpEfFkYlsjTBheVD18bcDDtklcGboi8vPzKgPOt_.

I. All regulation is based on an assumption of conflict between private interest and public interest

A. The premise of regulation is that absent regulation, one or more actors will have opportunity and incentive to act for their private interest, in ways that harm the public interest.

B. For any industry context, effective regulatory law therefore takes three steps:

1. Identify the conflicts between private and public interests.
2. Identify the conduct that will harm the public interest.
3. Modify that private conduct so that it aligns with the public interest.

That is why we have speed limits, restaurant food-safety rules, and utility statutes.

C. In acquisitions of utilities, the presence or absence of conflict is revealed in the transaction's true purpose, discussed next.

II. In mergers and acquisitions of utilities, the typical transactional purpose embodies a private-public conflict because the purpose is to monetize for private gain the utility's publicly-granted franchise

A. The acquirer and target together treat the target's monopoly franchise as a private asset to be sold and purchased for private gain. The target is selling control of the franchise for gain. The acquirer is buying control of that government-granted privilege to balance its portfolio and to increase its earnings.

B. Under the just-and-reasonable standard, every utility has a duty to provide service at the highest cost-effective quality, and at a price no higher than necessary. If customer benefit were the true reason for these transactions, the target utility would not be insisting on a premium. The premium forces the acquirer to spend money that could otherwise go to system improvements. A target that insists on a premium risks causing meritorious potential acquirers to walk away. We are so used to seeing the premium that we fail to call it what it is: a self-interested violation of the target's duty to serve.

C. Worsening the situation: The repeated insistences on premia, and the repeated regulatory tolerances of them, are contagious. Rivalry among acquirers to buy each new earnings opportunity drives up the acquisition prices beyond the already wrong prices. The result? A race to the bottom, with target utilities choosing acquirers based on price instead of performance.

III. Because M&A transactions involving monopoly utilities are not disciplined by effective competition, they require active, nondeferential regulation

A. In markets characterized by effective competition, competitive success depends largely on merit. When negotiating an M&A transaction, the target's desire for a high price is disciplined by the acquirer's need to retain the target's customers.

- Consider the sale of an apartment building, in a city with plenty of apartment vacancies—and therefore effective competition among building owners. The building seller will demand the highest possible price, but the buyer will resist paying a price above what she predicts she can recover in rent as she competes for tenants. So the building buyer will pay a premium no greater than the new economic value she believes she can create as the new owner.

- The new owner can create new value by increasing quality, allowing her to raise the rent; or by lowering costs, allowing her to increase earnings. That new economic value is a customer benefit.

- Competitive pressures thus discipline the acquisition price. The interests of building seller, building buyer, and current and future tenants are all aligned.

B. Contrast an M&A transaction involving a utility monopoly. The utility's retail sales are not subject to competition; so there is no competitive discipline on the seller's price offer. The only discipline can come from regulators. And commissions have no clear policy on the acquisition premium—accept mostly to allow target utilities to demand it and to allow acquirers to pay it.

C. In the absence of regulatory discipline, we get regulatory deference. That deference leads to customer abuse, because at least for municipal water systems, 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 some or all of the acquisition cost into rate base; so, oddly, the more it pays, the more it profits. And the acquirer can spread its purchase cost among its multiple water subsidiaries—so small, gradual rate increases tend to go unnoticed.

D. Remember that the target's very act of insisting on a premium is a violation of the franchise. The solution is simple: Commissions should prohibit or limit the premium. Some fine-tuning of this idea appears later in this presentation.

IV. Approving a holding company's acquisition of one utility is effectively approval of all of the holding company's future acquisitions

A. The acquiring holding company usually intends additional acquisitions. But the acquiring holding company is not subject to the target's commission's jurisdiction. What are the implications?

1. After acquiring the local utility, the acquirer then can buy other companies—and not just utility companies—of any type, industry, location, amount, or risk, all without the commission's permission or even knowledge. The reason is that the acquirer is not subject to the commission's jurisdiction—a large flaw in current utility law. So by approving the acquisition of the local utility, the commission is effectively approving of all those future acquisitions, regardless of their risk. The local utility becomes a smaller and smaller part of the acquiring holding company's system.

2. It is legally impossible to view that outcome as a public-interest result.

3. Here's a way to understand the situation. Suppose your utility's current holding company asks your commission for blanket permission to acquire anything anywhere, at any time, with no notice to the commission and no review by the commission—regardless of location, size, financial leveraging, or business risk. The commission would reject such an audacious request. But that is exactly what happens when a commission approves the holding company's acquisition of your utility. The only difference is that the second request is not explicit.

B. The acquirer's "speculation" defense

1. In prior acquisition cases, applicants have labeled concerns about post-acquisition business risk "speculative." It is the applicants who speculate.

   a. The geographic reach and type-of-business scope of the acquirer's future acquisitions have no legal limit. That is not speculation; it is a fact.

   b. The commission does not know, and will have no power to control, how small the local utility will become relative to the holding company's total size. The commission does not know the future complexity, or the regulatory resources necessary to protect the local utility from that complexity. Those are not speculations; those are facts.

c. If the holding company's future risk-taking leaves insufficient equity to provide to the local utility and to all the holding company's other subsidiaries, the commission has no enforceable guarantee that the local utility will be the top priority. That is not speculation; it is a fact.

2. The attack of "speculation" is actually a misuse of the term. A projection is not "speculative" if it is plausible. Any credible regulatory professional knows that (a) adverse outcomes in one place in a corporate system can raise costs for other places in the corporate system; and (b) there is no agreed-on, fixed methodology by which a regulator can, with certainty, zero out the effect of nonutility risk on the utility's authorized cost of capital. So the possibility of harm to the local utility is well above plausible. What is not plausible is the acquirer's insistence, or its implicit view, that there is no possibility of harm to the local utility ever occurring.

3. The cost of a risk is the dollar damage caused by an adverse event multiplied by the probability of that event. The response to quantification uncertainty is not to assign a damage value of zero. That is the "speculation" argument's error.

V. If in agreeing to an acquisition, a jurisdictional utility transfers control of its decisions to a nonjurisdictional entity, the utility violates basic utility law

A. The control premium is the excess of purchase price over the target's market value the day before the acquisition is announced. The acquirer is paying the control premium to get control. Otherwise the acquirer would be paying only the market value. If the acquirer is getting control, that means that the target is transferring control—control over all aspects of running and financing the utility company:

1. budgets, including limits on the target's spending;

2. performance standards, including tradeoffs between quality and cost;

3. rate increase strategy;

4. capital expenditures;

5. debt and equity issuances;

6. dividend payments; and

7. employment and retention of executives, managers, and employees—and their compensation.

B. But a utility cannot lawfully transfer control of its service obligations to anyone—especially to an entity over which the state commission has no jurisdiction. Consider these precedents:

- A utility contracted to its affiliate "the power to control (1) the prices at which [Penn Water] may sell its product; (2) the extent to which [Penn Water] may extend its plant; (3) the territory in which [Penn Water] may sell its product; and (4) the amount of back feed energy which [Penn Water] must purchase from Consolidated."[3]

- A utility agreed with its competitor to forgo installing more gas pipe. The Supreme Court held that "a corporation cannot disable itself by contract from performing the public duties which it has undertaken, and by agreement compel itself to make public accommodation or convenience subservient to its private interests."[4]

- A franchised railroad company leased to another entity "its roads, buildings and rolling stock," giving that company control of all the assets necessary to provide the railroad company's franchised service.[5]

VI. The control premium paid by the acquirer to the target utility belongs largely to the utility's customers, not to the target utility

A. What is the control premium, and why does the acquirer pay it?

1. The control premium is the excess of the purchase price over the unaffected market price of the target's stock. The acquirer pays that amount to get control of the target's franchise monopoly privilege. The acquirer expects that with that control, it can increase its earnings by more than the premium that it paid.

---

[3] *Pa. Water & Power Co. v. Consol. Gas, Elec. Light & Power Co. of Baltimore*, 184 F.2d 552, 567 (4th Cir. 1950).

[4] *Gibbs v. Baltimore Gas Co*., 130 U.S. 396, 410 (1889).

[5] *Thomas v. R.R. Co.,* 101 U.S. 71, 83 (1879).

2. Compare an ordinary purchaser of stock. She tells her broker, "Buy me some shares at the market price," because she has no reason to pay more than the market price. She controls only her stock, which entitles her to a sliver of the company's future earnings and value. She is a passive owner.

3. The acquirer of all the stock, in contrast, pays more than the market price because it is buying more than merely stock; it is buying control.

4. For acquisitions in competitive markets (i.e., acquisitions not involving a franchised monopoly utility), the acquirer might project that it can use its control to increase the quality of the products or lower the cost, so as to, with increased quality, generate more sales or the same sales at a higher price; or, with lower cost, earn more profit-per-sale.

5. For acquisitions of monopoly utilities, those motivations don't exist, because those actions don't increase earnings, other than earnings between rate cases (which regulators can get for the customers by reducing the lag between rate cases, or by conditioning approval on the acquirer reflecting the savings immediately in rates).

6. The acquirer also might see an opportunity to charge rates that produce (a) actual returns exceeding the utility's "required" return and (b) actual returns exceeding the utility's commission-authorized return.

B. The proceeds from the premium: Who deserves them?

1. In a competitive market as in a utility monopoly market, the acquirer pays a control premium to get control of the target's market position. The fundamental difference between a competitive market target and a utility monopoly market target lies in how the target gets its market position. In an effectively competitive market, the target company has earned its market position through performance merit—by taking investment risks and displaying managerial skill. (Luck can also play a role.) So it makes complete sense for the target to demand and keep the premium.

2. In the utility monopoly context, the utility gets its market position not from performance merit but from the government—many decades ago for reasons no one can remember. The target is selling control of the franchise privilege. The value of that privilege comes largely from the state government's decision to grant the utility a monopoly. So there is no objective rationale for allowing the target to keep the premium.

3. There is a larger point. In competitive markets there is an unobjectionable expectation: that executives who create earnings opportunities, and

shareholders who take risks in anticipation of those earnings opportunities, will be rewarded for making their company more attractive to prospective acquirers. In the acquisition context, that reward includes the control premium.

4. But the acquisition of a government-protected monopoly water utility does not occur in a competitive water market. The earnings opportunities that the acquirer hopes to exploit exist not because the target's executives and shareholders did anything special, but because the state government granted the utility a monopoly position, one whose economic value depends in large part on the captivity of the utility's customers.

C. Possible utility arguments against sharing the premium with customers

1. The target utility is likely to argue that its shareholders deserve the full control premium, because the utility is their company to sell, just like any company is its shareholders' to sell. This argument misapplies competitive market practice to a regulated monopoly market context. The necessary explanation has four parts:

    a. The target's valuable market position derives from its government-granted franchise.

    b. The state-created franchise is a public privilege, not a private asset.

    c. Because commission-set rates are the utility shareholders' appropriate compensation, gain from selling control of the franchise is overcompensation.

    d. Mere legal ownership of the target's stock does not entitle the stock owner to the control premium.

2. The target utility's arguments are valid, up to the market-trading price of the shareholders' stock. But the arguments are not valid for the control premium, because the control premium is being paid for control of the government-granted franchise.

3. The franchise is not a private asset that can be sold and resold, like a McDonald's franchise or a New York City taxi medallion. It is not like corporate stock, or buildings, or trucks, or power plants. The franchise privilege is not a commodity, to be sold to the highest bidder. The franchise is not bought and sold by anyone. It remains with the government, to be granted conditionally to whichever company the government chooses.

4. Given these facts, allowing the target utility to keep 100% of the control premium has no basis in logic or law.

D. Longstanding regulatory principles require that the target's shareholders and customers share the control premium based on each group's contribution to its value

1. A well-known use of this principle occurs when commissions allocate the gain from a utility's sale of an asset previously used for utility service. If that asset had been in the utility's rate base (which means that the cost was borne by the customers), and if the utility then sells that asset for a price exceeding the asset's net book value, the gain typically goes to the customers. The customers bore the cost, so they get the gain. If the asset had not been in rate base, the gain normally goes to shareholders because they bore the economic burden. Benefit goes to the burden-bearer.

2. To support this reasoning, the frequently cited precedent is *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission.* The D.C. Circuit there stated:

> It is well settled that utility investors are entitled to recoup from consumers the full amount of their investment in depreciable assets devoted to public service. This entitlement extends, not only to reductions in investment attributable to physical wear and tear (ordinary depreciation) but also to those occasioned by functional deterioration (obsolescence) and by exhaustion (depletion). . . .[Since customers] have shouldered these burdens, . . . it is eminently just that consumers, whose payments for service reimburse investors for the ravages of wear and waste occurring in service, should benefit in instances where gain eventuates—to the full extent of the gain.[6]

[6] 485 F.2d 786, 808-11, 822 (D.C. Cir. 1973) (footnotes omitted). *See also id.* at 808 ("[I]f the land no longer useful in utility operations is sold at a profit, those who shouldered the risk of loss are entitled to benefit from the gain."). *See also Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, 2 FCC Rcd. 6283, 6295 ¶¶ 113-14 (Sept. 17, 1987) (order on reconsideration) (observing that "[t]he equitable principles identified in [Democratic Central Committee] have direct application to a transfer of assets out of regulation that produces gains to be distributed, and requiring that customers receive the gains on assets when the market value of the assets exceeds net book cost"); *N.Y. Water Serv. Corp. v. Pub. Serv. Comm'n of N.Y.*, 12 A.D.2d 122, 129 (N.Y. App. Div. 1960) (allocating gain on sale to customers when customers bore the risk of a loss in value of the assets); *N.Y. State Elec. &*

VII. Solutions: Commission-run, merit-based competitions for the franchise, elimination of the control premium, and limits on the acquisition premium

A. M&A transactions must align with the public interest and with the just-and-reasonable standard

1. In terms of the public interest, the rationales that can justify a merger or acquisition are these: economies of scale (at one or more levels of the planning, financing, and operating process), suboptimal performance, and financial troubles. Transactions that do not have one or more of these purposes as their central purpose are likely to involve private-public conflict.

2. The rates that result from an M&A transaction must satisfy the just-and-reasonable standard. That standard requires maximum customer benefits, not "no harm." Consider these precedents:

    - A utility must operate with "all reasonable economies."[7]
    - A utility must use "all available cost savings opportunities...as well as general economies of management."[8]
    - A utility has an obligation to serve at "lowest feasible cost."[9]

Gas, Case No. 96-M-0375, 1996 N.Y. PUC LEXIS 671, at *8 (N.Y. Pub. Serv. Comm'n Nov. 19, 1996) (memorandum opinion) (reserving the net gains on the sale of land for customers is equitable and reasonable); *N.Y. Tel. Co. v. N.Y. Pub. Serv. Comm'n*, 530 N.E.2d 843 (N.Y. 1988) (customers entitled to benefits on sale of yellow pages advertisements).

[7] *El Paso Natural Gas Co. v. Federal Power Commission*, 281 F.2d 567, 573 (5th Cir. 1960).

[8] *Midwestern Gas Transmission Co. v. E. Tenn. Natural Gas Co.*, 36 FPC 61 (1966), *aff'd sub nom. Midwestern Gas Transmission Co. v. Federal Power Commission*, 388 F.2d 444 (7th Cir. 1968).

[9] *Potomac Elec. Power Co. v. Pub. Serv. Comm'n of D.C.*, 661 A.2d 131, 137 (D.C. 1995).

3. *Immediate task for commissions:* Prepare studies on all of the rationales based on the transactions to date.

   a. 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 and national—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.)

   b. With this economies-of-scale information, the commission could pencil in economically sized service territory boundaries. The commission then could guide mergers and acquisitions toward these economic outcomes, rejecting or approving acquisitions depending on their consistency with the draft map.

   c. 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.

B. Statutory language that defines the "public interest"

Here is an example of possible statutory language that is less rigorous and precise than I would make it if I had a sure legislative majority, but that is more rigorous and precise than any state statute I know of.

A transfer of control must promote the public interest. It promotes the public interest only if its negotiated purpose is to improve service and if it—

(i) will cause no harm, and no risk of harm, to customers' right to cost-effective, reliable service at just-and-reasonable rates;

(ii) will not reduce the level of competition, enable anticompetitive conduct, or vest in the post-transaction entity any unearned competitive advantage; and

(iii) is economically efficient, taking into account all alternatives, in the provision of service to customers, including by achieving real cost reductions and service improvement in the provision of reliable, affordable, utility service.

C. Getting the right acquisition price

1. There is no logical rationale for allowing a purchase price that includes a control premium (excess of purchase price over market price), for all the reasons discussed above. The target should not even be insisting on a control premium.

2. So then the purchase price would be at the pre-announcement market price (because I don't think the commission can lawfully require a utility's shareholders to sell their shares at below market price). But when this price exceeds the book value used for ratemaking, what if any portion of the purchase price goes into rates? Specifically, the portion of the purchase price that exceeds the book value of the assets?

   I used to think it correct to allow in rates that amount, up to the level of the guaranteed cost savings arising from the transaction (or alternatively the value to customers of the improved service). The rationale is that if we want transactions that produce savings or improve service, and because we cannot force a potential acquirer to make the acquisition, we have to make them whole for the purchase price—as long as customers are not made worse off by the purchase price.

3. We need to polish this "recovery of the premium up to the amount of savings" approach so that customers are actually better off. Allowing the price-less-book-value amount to equal the savings gets us an acquisition with no customer benefits, because the cost of the premium completely offsets the savings. So probably the savings need to exceed the recovered amount by a percentage comparable to the utility's authorized ROE, because customers' spending on the premium has an opportunity cost that, for starters, we can assume to equal the utility's authorized ROE.

4. If we truly want only acquisitions whose central purpose is customer benefits, then we need to make acquisitions competitive, where we design the competition to benefit the customers. This is where every commission is lacking. All commissions leave decisions about whether-to-acquire to a marketplace that is not competitive. A better example of regulatory abdication escapes me. A desire for an acquisition should come from the commission, not the acquirer. And if it comes from the commission, then

the commission needs to find the best acquirer, just like it needs to find the best general counsel and the best chief engineer.

5. In short: 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 to see who can promise the most customer-benefitting combination of cost reductions and service improvements. The more savings, the higher the economic gain. 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 nationally among whom it can spread that highest price. The winner of the acquisition contest is the acquirer guaranteeing the largest improvement in cost performance and operational performance.

6. Necessarily: 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.

D. The divestiture solution

The consequence of noncompliance with a condition must be disaffiliation of the utility from its acquirer. That is the only logical result. Commissions cannot impose conditions arbitrarily. Therefore a condition is lawful only if, absent the condition, the transaction would not be lawful. From that premise follows this conclusion: *A failure to comply with a condition makes that condition inoperable. A transaction without the condition is unlawful. So the transaction must unwind.*

Let's ask ourselves: Why don't commission approval orders say that much—or in fact say anything about penalties for noncompliance?