May 31, 2023

Via Electronic Filing

Shonta Dunston
Chief Clerk
North Carolina Utilities Commission
4325 Mail Service Center
Raleigh, North Carolina. 27699-4300

Re: **Docket A-41, Sub 22** -- ***In the Matter of Joint Application of Bald Head Island Transportation, Inc., and Bald Head Island Ferry Transportation, LLC, for Approval of Transfer of Common Carrier Certificate to Bald Head Island Ferry Transportation, LLC, and Permission to Pledge Assets***

Dear Ms. Dunston:

Attached is a *Consumer Statement of Position* in Docket A-41 Sub 22. Should you have any questions, please do not hesitate to contact us.

Respectfully yours,

Robert T. Blau
5 Starrush Trail
Bald Head Island, NC 28461

J. Paul Carey
611 Currituck Way
Bald Head Island, NC 28461

Attachment

May 31, 2023

Consumer Statement of Position
Re: Docket A-41 Sub 22

On May 10, 2022, the Public Staff filed a proposed settlement agreement for resolving this proceeding. The agreement was negotiated by the Staff and the Applicants, Bald Head Island Limited (BHIL) and SharpVue Capital (SV), apparently without knowledge of or input from other intervenors who represent users of the Bald Head Island transportation system (System). The Public Staff is the urging the Commission to adopt the agreement without change.

This Statement explains why approval of the proposed agreement would have the practical effect of nullifying much needed ratepayer protections that the Commission established in its December 30, 2022 Order in Docket A-41 Sub 21. The proposed agreement should be rejected, and any further settlement discussions should include all parties that have intervened in Docket A-41 Sub 22.

Q. Could you briefly summarize your Statement?

Under the terms of the Public Staff's recommended settlement, SV investors would pay BHIL a purchase price of $56M and agree to operate the System subject to various regulatory conditions outlined in the Public Staff's May 10 filing. Under those conditions, the System operator would be permitted to increase user rates for ferry, parking and barge service annually by percentage amounts equivalent to annual increases in the consumer price index for urban areas (CPI-U). Rates would go up regardless of changes in the actual cost of operating the System. Also, as long as the System's operating costs increased at a slower rate than the CPI-U, its profit margins and overall earnings would continue to increase at a much higher pace given that the volume of ferry, parking and barge traffic should continue to grow. Importantly, the proposed settlement further contemplates that the System's real property would be "spun off" and placed in an unregulated affiliate (Pelican Real Property). The regulated entity (BHIFT), in turn, would lease that land from its unregulated affiliate under terms that the Commission would be asked to approve.

In our view, all of this would play out very much to the detriment of System users and the community of Bald Head Island over time. Ferry, parking and barge rates would continue to increase to levels far higher than they need to be, or would be if the System were regulated effectively. Also, by allowing SV investors to spin off the System's real estate into an unregulated affiliate, the proposed settlement agreement represents an open invitation for SV, or its successor, to break the System up in an effort to make it more difficult and costly to regulate, thereby enhancing its market value to subsequent buyers.

Further, based on limited information underlying BHIL's transfer application that has been made public thus far, we question whether ownership of the System is really being transferred from the Mitchell Family Estate (Estate), which owns BHIL, to an independent group of SV investors. It is surprising that SV did not insist on working out a significantly lower purchase price following the Commission's December 30, 2022 Order in Docket A-41 Sub 21. SV's failure to do so is not consistent with efforts one might reasonably expect from an independent buyer. Nor is SV acting in the best interest of System users who will be asked to pay whatever price SV might agree to in order to acquire the System.

One possible explanation for this is that SV's ability to pay BHIL $56M may be predicated on the Mitchell Estate providing much or most of the investment capital needed to close the deal. If that is the case, then the Estate, for all practical purposes, would be selling the System to itself. While there may be various financial and regulatory reasons for doing this, benefiting System users is obviously not one of them.

At this point in the process, the Commission should know exactly where or from whom the $56M that SV would need to acquire the System from BHIL will come from. Because this information has an important bearing on how much ferry, parking and barge rates will be allowed to increase going forward, it should be disclosed and subjected to public comment.

Q. Why do you believe BHIL and SV agreed on a $56M purchase price, and why do you believe $56M is excessive?

In an acquisition such as this, the buyer typically is incented to negotiate the lowest possible purchase price that the seller will accept. In this instance, it is not at all clear that SV's $56M offer resulted from a meaningful, arms-length negotiation with BHIL, the seller. A brief review of where the $56M valuation originated suggests otherwise.

In 2017, BHIL hired a consulting firm, Mercator International, to conduct an enterprise valuation of the System. BHIL did so in anticipation of using Mercator's analysis to help negotiate an acceptable purchase price for the System with the Bald Head Island Transportation Authority (BHITA) which the NC legislature also created in 2017 for that purpose, at BHIL's urging. As was noted in the course of the Commission's proceeding in Docket A-41 Sub 21, Mercator estimated the System's enterprise value at $56M, as well as the value of its three components: the BHI passenger ferry ($3.6M), the Deep Point parking facility ($38.2M) and the barge operation ($14M).

Mercator's valuation also was based on the following projected EBITDA margins for each of the three components and for the System as a whole.

EBITDA Margins (Earnings Before Interest, Taxes, and Depreciation/Amortization as a % of Revenues)

	Year								
Component	2016	2017	2018	2019	2020	2025	2030	2035	2040
Ferry	**-3.1%**	**5.6%**	**10.3%**	**12.1%**	**11.8%**	**15.0%**	**12.4%**	**12.6%**	**12.3%**
Parking	**70.1%**	**71.7%**	**82.3%**	**83.0%**	**83.1%**	**84.0%**	**84.8%**	**85.5%**	**86.1%**
Barge	71.8%	71.3%	74.8%	76.5%	76.9%	78.9%	80.5%	82.0%	83.2%
Consolidated	25.6%	31.4%	43.2%	45.0%	45.2%	47.6%	48.0%	49.3%	50.3%

Source: Mercator International *Bald Head Island Sellers Due Diligence,* January 2018, Tables 13-16, pp. 66-71.

Projected EBITDA margins for the parking and barge operations were substantially higher than those for the passenger ferry primarily because, unlike the passenger ferry, BHIL's parking and barge monopolies, at the time, were not subject to rate-of-return regulation.

As it turned out, and for reasons detailed in our March 6, 2023 Consumer Statement in this proceeding, BHITA and BHIL subsequently whittled the System's purchase price down from Mercator's $56M enterprise valuation to $47.75M. This, however, was based on S&P Global estimates that BHITA could borrow up to $56M (but no more) and maintain an investment grade bond rating (i.e., BBB- or better) – provided that BHITA increased ferry, parking and barge rates by 20 percent in order to cover debt service costs associated with its $56M bond issue**.** Based on a 2021 *Bond Feasibility Study* that Mercator International also conducted for BHITA (but paid for by BHIL), S&P Global subsequently gave BHITA's proposed $56M bond issue a tentative rating of BBB-, or one notch above junk.

In early 2022, the NC Local Government Commission (LGC) did not approve BHITA's bond application out of concern that BHITA's appraisal of the System's market value was deeply flawed and its proposed $56M bond issue was excessive and would have subjected System users and the state to too much default risk. On May 30, 2022, BHIL and SV, announced they had reached a deal for SV to acquire the System for $56M and that the same BHIL personnel who currently manage the System would continue to do so after it was acquired by SV.

Importantly, following the Commission's December 30, 2022 Order in Docket A-41 Sub 21, SV apparently made no effort to negotiate any reduction in the $56M purchase price even though once a new rate case is filed for the System as a whole, the Commission would likely not permit the parking and barge operations to generate excessively high EBITDA margins on which Mercator's initial $56M valuation was based. SV and BHIL made no changes in the purchase price. Instead, they appealed the Commission's Order in Docket A-41 Sub 21 and apparently focused on persuading the Public Staff to agree to a set of regulatory conditions for approving the transfer application in this proceeding that presumably would enable the System to generate enough earnings to compensate SV's investors for putting up the $56M.

Q. Would the Public Staff's proposed settlement agreement allow SV investors to recoup their $56M investment in the System without annually raising rates more than the CPI-U?

Since virtually all financial information underlying the transfer application has been deemed confidential, it is difficult for anyone who did not intervene in Docket A-41 Sub 22 to address this issue. However, drawing on the extensive financial record developed by the BHITA, including Mercator's 2017 enterprise valuation, we can say with a reasonable degree of certainty that if SV investors were to recoup an initial $56M investment in the System, plus a reasonable risk adjusted annual return on that investment, the System's EBITDA margins – particularly for the parking and barge operations – would need to remain at or near Mercator's 2017 projections. We also believe that EBITDA margins ranging from 80-85 percent of revenues (see the table above) for a mature business with relatively modest capital spending requirements are patently excessive and indicative of monopoly pricing abuse which the Commission's December 30 2022 Order was intended to address.

Conversely, if it turned out that SV investors were unable to earn a return on their initial $56M outlay that they expected, for regulatory or other reasons, they may be unwilling to invest additional capital needed to keep the System in good working order. Therein lies the rub for System users, and the primary reason the Commission should reject the Public Staff's recommended settlement agreement. The $56M acquisition price is simply far too high, as is the risk that would-be investors may not be allowed to earn returns they expect on an initial $56M investment assuming the System remains regulated in its entirety. For System users, the scenario is that they will face annual rate increases and poorer service – a lose, lose proposition.

Q. Do you agree with the Public Staff Brief that was filed in this proceeding on May 22, 2023?

We agree with assertions in the Brief that the System's rate base should reflect the net book value of capital plant currently in service (i.e., original cost less accumulated depreciation) and that it not include an acquisition premium. We also believe the Commission needs to clarify how the System's rate base will be calculated and what it will and will not include before the Commission authorizes any transfer of ownership at any given purchase price. Failure to do so will only add to the risk that a would-be buyer, like SV, will over-pay for the System, potentially under-earn on its inflated investment (e.g., due to regulatory constraints), and subsequently starve the System of needed capital spending going forward.

We do not agree with assertions discussed in the Public Staff's May 22 brief, that "it would be difficult if not impossible to establish the System's rate base at this time." To the contrary, BHIL has detailed itemized records of all capital spent on the System going back more than 30 years. Those records also contain accumulated depreciation expenses for

individual capital expenditures based on straight line depreciation schedules. Given these data, the Commission could easily calculate the System's current net book value as well as make any adjustments to that value that the Commission might deem appropriate for ratemaking purposes. Thus, there would be absolutely no need for the Commission to rely on "long term ground leases (e.g., between SV's proposed regulated and unregulated affiliates) for Parking and Barge operations [that] would serve as a sufficient basis for establishing cost of service rate base." [1]

Q. Why would allowing SV to put the System's real property into a separate unregulated affiliate adversely effect System users as long as the Commission oversees long term ground leases that the regulated operations are permitted to enter into?

In theory, if Pelican Real Property (Pelican) were permitted by the Commission to operate as an unregulated affiliate of SV's regulated entity (BHIFT), and Pelican attempted to hike lease rates for the using the System's land (because it could), the Commission could simply preclude BHIFT from passing those cost increases through to System users. That threat, in turn, could be enough to keep Pelican's (unregulated) monopoly pricing power in check.

In practice, however, things may not prove to be that simple or straight forward. Indeed, it is highly likely that placing the System's real estate in an unregulated affiliate would eventually result in the System's regulated operations (BHIFT) being sold to a separate owner (e.g., another private equity investor, or BHITA, which BHIL continues to fund). Why?

As Mercator's enterprise valuation indicates, most of the System's market value lies in its parking operation. This is simply because parking not only generates the lion's share of earnings, but also carries substantially less operating risk than the passenger ferry and barge. Unlike the ferry or the barge, the parking lot obviously can't run aground on a sandbar, catch fire and sink, or even sustain that much damage in a hurricane. If allowed to operate as an unregulated monopoly, however, it can generate a good deal more cash flow than either the ferry or the barge, or both combined.

As such, SV may believe that the System's overall market value could be increased by selling the regulated (BHIFT) or unregulated (Pelican) entities to different owners. Suppose, for instance that the System's land is moved into an unregulated affiliate (Pelican) which SV subsequently sells to another private equity company on expectation that the new owner could raise lease rates charged to BHIFT, or use the land for some other purpose such as a hotel. Would the Commission insist that Pelican work out very long-term leases (e.g., 99 years) with BHIFT at the outset in order to protect System users from this type of scenario playing out?

[1] See *Public Staff Brief in Docket No. A-41 Sub 22*, May 22, 2023, p. 3.

Alternatively, let's assume SV acquired the System and subsequently sold BHIFT to the BHITA who, in turn, would rent the System's land from Pelican, or its successor. In that instance, adoption of the Public Staff's proposed settlement could result in entire System being deregulated since, under North Carolina law, the Commission would have no authority over BHITA. Should that scenario materialize, and SV, or its successor, decided to hike lease rates for the land (because it could), would BHITA push back or simply pass any cost increase through to System users? We can't say for sure, but since BHITA proposed to borrow $56M to acquire the System in 2022, we have our doubts that push back would win the day.

We are not lawyers, but since the entire System is currently regulated by the Commission, per its December 30, 2022 Order in Docket A-41 Sub 21, we presume that SV would not be allowed to put the System's land into an unregulated affiliate without expressed Commission approval. In our view, doing so would be a very much at odds with the interests of System user. In addition to encouraging the type of regulatory "end run" highlighted above, anytime an unregulated affiliate is introduced into an otherwise regulated corporate structure, common costs (as well as operating risk) between the two have to be allocated for regulated ratemaking purposes. As the Commission is no doubt aware, that process can be time consuming, highly contentious and costly to all parties involved. This situation would be no different, and very likely would cause rates for all three services – parking, ferry and barge – to go up unnecessarily and considerably more than if the System were not broken up and regulated as a single commercially owned monopoly which it currently is.

Q. What difference would it make to System users if the Mitchell Family Estate proved to be SV's leading individual investor?

From the standpoint of System users, having the same party on both sides of a deal such as this can obviously remove or mitigate the buyer's incentive to get the purchase price down, not up! A buyer who is acquiring a business typically wants to pay as little as possible since that subsequently lowers the buyer's operating costs and enhances the profitability of the business it acquires going forward. If the buyer turns out to be the seller, things can obviously get more complicated and costly, at least for the business' customers.

In a competitive market, if the buyer of a business fails to negotiate a favorable purchase price which causes costs and retail prices to go up too much after the deal is closed, customers would always have the option of turning to another, more efficient provider. In a monopoly situation like this, however, they clearly would not have that option and, thus, would have no choice but to pay the piper.

Q. Is there a potential settlement agreement that would resolve this proceeding without subjecting System users and the community of BHI to an unreasonable amount of unnecessary cost and financial risk?

We continue to believe that a settlement agreement in this proceeding could be worked out that would benefit the Applicants, System users, the community of BHI, and even the Commission itself. This could be accomplished fairly easily if the Commission were to clarify what SV, or another commercial operator, would be allowed to include in its rate base for the entire System, including its real property. The Commission should then ask the Applicants and the intervenors to negotiate an acceptable annual revenue requirement for the System based on: 1) that rate base, 2) an allowed rate of return that would be sufficiently high to fairly compensate the System's owner as well as attract new investment for much needed System improvements, and 3) annual operating costs, including depreciation expenses. If those negotiations proved successful, the Commission's role could be limited to reviewing the terms of the agreement, and judging their reasonableness.

Alternatively, if the Applicants and the intervenors could not successfully negotiate an annual revenue requirement for the System, the owner/operator or one or more of the intervenors could initiate a new rate case in which case the Commission would resolve the matter. Hopefully, the time and expense that has resulted from litigating Docket A-41 Sub 21 and Sub 22 would be enough to motivate all parties to work out a mutually agreeable revenue requirement for the System as a whole. Once that is done, the process could be repeated every year or two, or three, and the System would effectively regulate itself while remaining subject to the Commission's jurisdiction and oversight.

Q. What specific actions do you believe the Commission should take at this juncture in this proceeding?

We believe that the interests of System users would best be served if the Commission did the following. First, it should reject the Public Staff's proposed settlement agreement on the grounds that any settlement must be negotiated between the Applicants and the intervenors in this proceeding. Second, the Commission should clarify how the System's rate base, including its real property, will be calculated for ratemaking purposes. Third, the Commission should then invite the Applicants, the intervenors, and the Public Staff to submit a revised proposed settlement agreement based on a negotiated annual revenue requirement as described above.

Q. Are there other points that should be brought to the Commission's attention?

We believe it was entirely inappropriate for the Public Staff to have excluded the Village of BHI, the BHI Club, and the Bald Head Association from any and all discussions that the Staff had with the Applicants in this proceeding about a settlement agreement. In most Federal regulatory proceedings, this would not have occurred due to *ex parte* communications rules that were put in place for very good reasons. We would urge the Commission to urge the

Public Staff to keep any further discussion it has with either the Applicants or the intervenors inclusive and preferably held around the same table at the same time.

In our view, the need to do so is all the more apparent given that so much information underlying the transfer application in this proceeding has been deemed confidential, and hidden from public view. As we have discussed in previous Consumer Statements filed in Docket A-41 Sub 21 and Sub 22, as well as letters written to the LGC regarding BHITA's failed bond application, a greater degree transparency usually produces better decision-making simply because it allows decision makers to be better informed. Well informed decisions usually work to the benefit of all concerned.

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