TILSON

September 1, 2016

Subject: Range of Likely Sale Prices - BIPCO

Introduction

Tilson was hired by the Town of New Shoreham (Town) to provide a high level estimated range of likely sale prices for the Block Island Power Company (BIPCO). For this exercise, Tilson took into account the uniquely regulated nature of electric utilities, and based its estimate on BIPCO's rate base and its allowed return on capital (profit) by the Rhode Island Public Utilities Commission. Tilson also took into account the value of BIPCO's assets not currently used to generate and distribute electricity. For estimating the value for these non-electrical assets, Tilson made assumptions on their regulatory treatment based on past PUC and Federal Energy Regulatory Commission (FERC) filings.

This is not a Fairness Opinion, but rather a high level estimation of potential BIPCO sale prices based on available information. As noted below, Tilson did not perform due diligence on the potential negative valuation effect associated with realized costs of environmental and fire remediation that is not recoverable from rate payers.

Electric Utility Regulatory Context

In most states, including Rhode Island, electric utilities' rates (prices) are set by a public utility commission. The rationale for this regulation is that the utilities that distribute electricity to homes and businesses serve as a de-facto monopoly. In return for being granted permission to operate as a monopoly, utilities accept rate-making decisions from public utilities commissions, typically staffed by political appointees.

Utility ratemaking protects the consumer from overcharging by a monopoly. It can also promote policy goals, such as promoting energy efficiency; encouraging use of renewable energy; and promoting certain social goals. Rates set appropriately dis-allow excess operating costs, and attract enough capital investment to serve customers well without incentivizing over building and charging consumers for a level of service they don't need.

Most rate setting bodies, including the Rhode Island PUC (PUC), back into a utilities' rates by setting a utility's revenue requirement. The utility's revenue requirement is the annual revenue needed to cover a utility's approved operating expenses (salaries, supplies, maintenance, taxes), plus a reasonable return on the utility's rate base, which is the capital investment, net of depreciation, that is utilized in the delivery of the service. In BIPCO's case, the rate base includes diesel generators, utility poles, bucket trucks, land and structures. It also includes assets like cash for working capital and fuel inventory.

Once a rate is set, the utility may either exceed or not meet their revenue requirement and reasonable profit. For example, if a utility sells more electricity than projected or achieves operating efficiencies, it will exceed both its revenue requirement or target profit. If a utility sells less electricity or has higher costs than expected, it will not meet its revenue requirement or its targeted profit. Once a rate is set, a utility's profit is a function of measures both within and out of its control. If a utility's costs change significantly over what was represented in the rate case, (for example if they require a large capital investment), the utility will file for a new rate and recover that cost from its customers.[1]

BIPCO's Most Recent Rate Filing

The last rate filing that BIPCO made before the PUC for an electricity rate change was in 2008. In the 2008 rate setting process and subsequent order,[2] the PUC followed the standard process by setting BIPCO's revenue requirement to cover allowable operating expenses (it disallowed some miscellaneous expenses), and to provide for a reasonable return on capital (i.e. profit). The allowed return on capital, or profit, is intended to pay the interest on the debt and pay the owners a return on their investment. The allowed return was formulated to pay the owners a profit of 10.5% on their qualifying equity after having serviced the debt of the company.

There were a couple of notable non-standard portions of the rate setting process that have implications for BIPCO's value to future owners, and thus its estimated sale price: The first is that the PUC gave special regulatory treatment to an approximate $800,000 gain on the sale of BIPCO land. The PUC let the BIPCO owners keep ½ of the gain, and insisted that the other ½ of the gain be retained as equity by BIPCO, but was not eligible for an annual 10.5% return on capital. This is notable for two reasons: future owners may be able to monetize land owned by BIPCO and keep some portion of it for themselves, rather than invest it back into the company. Also, ½ of the gain, $392,944, is effectively stranded equity and the new owners of BIPCO will likely not be allowed to earn a return on this equity in a future rate case.[3]

The second notable portion is that the PUC allowed the owners to pay themselves salaries and benefits as employees of BIPCO as part of the operating expense that is recovered in the rate base. While it is common for owners of small companies to have joint roles as employees, it is less common in regulated rate of return utilities. The PUC ruling allowed the owners to realize compensation of their annual salaries, benefits, and a 10.5% return on capital (and keep ½ of the 2006 land sale).[4] The PUC found

[1] In BIPCO's case there is an exception to this principle: the diesel fuel costs are passed through directly to the consumer, thus eliminating any fuel price volatility risk to BIPCO.
[2] State of Rhode Island and Providence Plantations Public Utilities Commission, Block Island Power Company General Rate Filing, Docket No. 3900, November 24, 2008.
[3] This valuation assumes that subsequent land sales will have a similar ½ sale price treatment, and that the PUC will continue to insist that the ½ of all past and future land sales will be reinvested in the company without earning a return for the owners.
[4] Owners were not required to document their duties at BIPCO

that their combined salaries of $168,000 was reasonable. This is relevant because a new owner may ascribe value beyond the target 10.5% return on equity (currently $75,999 per year) if he or she plans to employ him or herself at BIPCO.[5]

Estimation Approach

Tilson's approach to estimating a range of sale price was to value the company on a stand-alone basis. Tilson will address the value of potential synergies and control in a separate analysis. Given the unique nature of electric utility regulation, Tilson based its estimation on today's rate base and the target return on capital set by regulators. Tilson also estimated the value of additional sources of income that an owner may be able to derive outside of the regulated return. The potential additional sources of income include: land sale, separating the telecommunications tower from the utility operations, and self-employment for the owners and its associated benefits.

In order to do this analysis, Tilson had access to a limited scope of documents, and did not have access to BIPCO personnel, PUC personnel, or any of the third party BIPCO providers of accounting, legal or regulatory resources. Tilson relied on the following documentation:

- 2008 BIPCO rate case, RI PUC docket 3900
- BIPCO Audited Financials from 2013-2015
- Unaudited BIPCO Balance Sheet and Income Statement as of May 2016
- 2007, 2014 and 2015 FERC Form 1
- A packet of information on rental revenue and salary expenses provided by BIPCO
- Aerial photographs of BIPCO land
- Assessed value of BIPCO land from the Town database

Current Rate Base Assumptions

In the 2008 rate case, BIPCO was allowed to earn a return on a rate base of $3.96M, this was 78% of the assets on their balance sheet, which were $5.12M at the time. Tilson assumed that going forward, BIPCO's rate base would also be equal to 78% of the assets on its unaudited 2016 balance sheet of $4.9M.

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[5] By 2015, the total compensation before benefits paid to the three BIPCO owners was $192,745 in salary, $39,000 in management bonus, and $39,000 in dividends. This compares to total salaries of all other employees of $531,833 (Source: BIPCO BUDGET FY 2107 documents). Per the 2008 rate case, other benefits paid to the owners included medical benefits, free electricity, boat storage, and use of company vehicles.

Rate Base as a Percentage of Total Balance Sheet Assets

	2008 Case	Unaudited 2016
Balance Sheet Total Assets	5,112,830	4,938,451
Rate Base	3,967,137	
Imputed Rate Base		*3,831,833*

Return on Rate Base

In the 2008 rate case, the PUC allowed a return on the rate base proportional to the debt and equity structure. A key finding of Tilson's analysis was that the PUC disallowed any return on $392,944 of equity, which was ½ of the net proceeds of the 2006 land sale. This had the net effect of depressing the total return on equity for BIPCO shareholders to 7.4%.

Return on Equity Worksheet, 2008 Rate Case

Equity Return Worksheet	Amount	Return	% of Total Equity	Weighted Factor
Common Stock	191,515	10.5%	14%	0.02
Zero Cost Captial (Land Sale)	392,944	0%	30%	-
Retained Earnings	741,311	10.5%	56%	0.06
Total Return on Equity				**7.4%**

In 2008, this yielded a revenue requirement (and therefore new electricity rates), that would give BIPCO the following profit profile, with an annual target profit of *$75,999 accruing to company owners:*

2008 Rate Case Returns			
2008 Rate Base	3,967,137		
Debt	74%	Weighted Cost Debt	5.3%
Equity	26%	Weighted Cost Equity	7.4%
Rate Case Return (Profit) on Rate Base			
Return on Debt	155,159		
Return on Equity	75,999		
Total Profit	**231,158**		

Tilson learned[6] that there was a recent sale of land to National Grid, whose net proceeds are entered into the unaudited BIPCO 2016 balance sheet as "CASH-RUS ACCT" for $487,209. This land sale is not unlike the land sale in 2006, in that the land was in the rate base, and the BIPCO ratepayers were paying for its taxes and maintenance. Therefore, Tilson assumed that PUC would treat ½ of the net earnings

[6] Per Everett Shorey, New Shoreham Energy Utility Task Force member.

from the National Grid sale similarly to the Zero Cost Capital of the land sale in 2006. The other portion would remain on the balance sheet as retained earnings. The worksheet below uses the total equity in the May 2016 unaudited financials to estimate the equity eligible for a return on capital, after reserving ½ of the recent $487,209 in a Zero Cost Capital account:

Return on Equity Worksheet, Estimate with Current Financials (and 1/2 land sale zero return on capital)				
Est. Based on Balance Sheet	Amount	Return	% of Total Equity	Weighted Factor
Common Stock	200,000	10.5%	14%	0.01
Zero Cost Captial (2006 Land Sale)	392,944	0%	27%	-
Est. Zero Cost Capital (1/2 2015 Land Sa	243,500	0%	17%	-
Est. Retained Earnings	618,439	10.5%	43%	0.04
Total Return on Equity	1,454,883		100%	5.9%

Therefore, following this assumption through, in a new rate case, BIPCO would have the following target profit profile[7] with an annual profit of about $66,679 accruing to owners. The reason the profit is lower is because there is less equity on the 2016 work sheet using the PUC methodology that is eligible for a 10.5% return on capital.

Projection Based on May 2016 Balance Sheet			
Imputed Rate Base	3,831,833		
Debt	71%	Weighted Cost Debt	5.3%
Equity	29%	Weighted Cost Equity	5.9%
Projected Return (Profit) on Rate Base			
Return on Debt	142,724		
Return on Equity	66,679		
Total Profit	**209,404**		

Additional Sources of Value

As mentioned earlier, there are additional potential sources of value in parts of BIPCO assets and operation as a stand-alone entity. For the purpose of this estimate, those potential sources are: land not directly utilized in providing electrical service; the existing communication tower; and the opportunity for a new owner to self-employ and enjoy the benefits associated with owning a utility.

The ability of a new owner of BIPCO to monetize and capitalize on these sources of value is unclear. The RUS, BIPCO's main creditor, has a lien on BIPCO's assets.[8] Therefore, where possible, Tilson assumed regulatory treatment for land sales consistent with the 2008 rate case, and developed two scenarios for the ability of a new owner to realize the commercial value of the telecommunications tower outside of BIPCO regulated electricity operations.

[7] Tilson assumed the same cost of debt as the 2008 rate case.

[8] Per Everett Shorey, and per the 2008 rate case in discussing the 2006 land sale

Land

In 2006, the RUS released the lien on Plat 17, lot 38, which BIPCO sold for $912,000. It is unclear whether the RUS and the PUC would allow BIPCO's owners to keep any of the proceeds of the National Grid Sale as retained earnings, However for purposes of this estimate, Tilson is assuming that net proceeds of the National Grid sale and all future land sales will be split between retained earnings eligible for a 10.5% return or dividend payout and zero cost capital that will remain ineligible for a return. Per a high level review of BIPCO land, Tilson believes it's possible for BIPCO to revise the property lines between lots 36 and 35 to carve out the sub-station and BIPCO office, and sell the majority of lot 35 on the open market. For purposes of this estimate, Tilson will assume net proceeds of the revised (and smaller) lot 25 of $300,960, which is equal to its current assessed value.

Monetizeable Land Value	**Amount**
1/2 of Lot 35 Assessed Value	150,451
Total Additional Value to Company	**150,451**

For the purposes of this estimate, Tilson assumed that the land is sold 1 year after the rate case, and that the ½ of proceeds are added to a zero cost capital account, and the other ½ are paid out as dividends or added to retained earnings.

Telecommunication Tower

BIPCO currently owns a telecommunication tower that is located on its land. This is likely the most valuable asset that is not directly utilized in providing electricity service. According to an unnamed document provided to the Town by BIPCO, there are four tenants currently on the tower that collectively pay $16,062 per month in rent ($192,774 per year).[9]

However, whether the RUS has a lien on the tower, and the exact nature of the tower's regulatory status is unclear. In its review of documents, Tilson found evidence to support both the inclusion and exclusion of the tower in BIPCO's rate base and revenue requirement. For example, two sources of evidence support the exclusion of the tower: on the FERC Form 1 as a non-utility asset; and the tower was fully depreciated on May 2016, and its removal would have no effect on the rate base.[10] However, the tower and its revenues (some as deferred credits) were factored into BIPCO's rate case in 2008.

Tilson believes that it is possible for a future owner of BIPCO to sell the tower, or to successfully remove both the tower revenues and costs from the utility rate making process, and run the towers as a stand-alone business.[11] As such, it is an important potential driver of BIPCO value and sale price. Below is a high level estimate of the annual income from the tower:

[9] Numbers provided to Tilson, via a packet prepared by BIPCO and given to the town

[10] Per 2008 rate case documentation

[11] A clearer understanding of whether the RUS has a lien on the tower, and the likely PUC treatment requires further due diligence that was outside the scope of this analysis.

Annual Value of Radio Tower	
Radio Tower Lease Revenue	192,744
Radio Tower Maintenance Expense (est)	5000
Radio Tower Property Tax Expense (est)	1500
Annual Profit Radio Tower Est.	**186,244**

Premium Associated with Self Employment at a Utility

It is not uncommon for the prices of types of businesses that are viewed as attractive to own to be higher than other businesses with a similar profit profile. In the case of BIPCO, the owners, two of whom work part time, are currently paying themselves $192,745 plus benefits before a management bonus. These costs are sanctioned by the PUC and being borne by rate payers, although it is questionable whether a business in a competitive market could sustain this addition to its overhead.

Any “above market” benefits that the owners are currently getting would likely be valued and incorporated into the sale price by a buyer(s) considering the total benefits of ownership. The current benefits (after a return on equity investment paid as dividends) being drawn by the owners include salary, medical benefits (for two of the three owners per 2008 rate case), free electricity (for two owners with houses on the island), boat parking, and use of company cars. The 2008 rate case stated that two of the owners worked at BIPCO part time, and that BIPCO didn’t pay FICA on the salaries because they weren’t employees. Tilson took these facts into consideration when making the assumptions on the annual above market benefits associated with owning BIPCO, below.

Annual Above Market Benefit Est.	**Amount**
Salaries (1/2 2016 amount)	99,000
Management Bonus (50% 2015 amount)	19,500
Free Electricity	3,000
Medical Benefits (0%)	-
Boat Storage	1,500
Use of Company Cars	4,000
Annual Above Market Benefit Est.	**127,000**

Synergies

Potential for-profit buyers of BIPCO would look to see whether there are any synergies associated with their existing business. Tilson did not assume any synergies for this analysis.

Tilson will examine the synergies with Town ownership and control of BIPCO in a separate document.

Liabilities

Tilson understands that BIPCO has several potential liabilities, and that there is no guarantee that the RI PUC will allow BIPCO to recover those costs from rate payers.

The first liability is a potential environmental liability. Tilson understands that the EPA is requiring BIPCO to replace leaking underground fuel storage tanks, and that the cost is in excess of $1 million dollars. Tilson also understands that the Town expects the PUC to allow BIPCO to recover those costs from ratepayers in the future.

The second potential liability is the damage caused by the generator fire. Tilson understands that three generators, two bucket trucks and a building were damaged in the recent generator fire at BIPCO. Tilson also understands from SGC's report that some of the generators did not receive the maintenance at the recommended intervals. Therefore, if the insurance company makes a claim of negligence, the financial settlement will be delayed, and may not make BIPCO whole on its costs. The monthly charge for the temporary generators and transformers is $103,000, according to the Town.

Tilson did not take any of these potential liabilities into account for this analysis, and would expect a buyer of BIPCO to perform due diligence in this area.

Estimated Sale Price Range

Based on the analysis above, plus some additional assumptions which will be detailed below, the estimated sale price ranges from $1.2M-$2.2M. The assumptions in these numbers include:

- A 10 year projection of flat cash-flows
- A discount rate of 10.5%
- A terminal value of return on equity of 9.5x (10.5% return in perpetuity)
- A terminal value of tower revenue and a self-employment premium of 5x (these are less secure sources of value beyond 10 years)
- Lot 35 is sold in year 2
- The purchaser extracts the allowable return on equity as dividends every year
- Assumed purchase by a private-for-profit entity or person or people
- An effective tax rate for the owner(s) of 25%

The lower end of the estimate assumes that the tower revenue stays in the rate base and revenue requirement. The profit associated with owning and operating the tower would be factored into BIPCO's revenue requirement and have the effect of pushing down electric rates.

The higher end of the estimate assumes that the new owner removes the tower from the rate base and revenue requirement in year 2. The new owner of BIPCO keeps this profit, and it does not factor into part of the revenue requirement (and therefore the benefit of the tower accrues directly to BIPCO's owner, and not the ratepayers).

The spreadsheet with the valuation is included in Appendix A.

Appendix A

High Level Valuation Using Discounted Cashflow Model: Without Tower Monetization

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Term. Value
Target Return on Equity	66,679	66,679	66,679	66,679	66,679	66,679	66,679	66,679	66,679	66,679	635,042
Tower Net Benefit	-	-	-	-	-	-	-	-	-	-	-
Land Sale		150,451									-
Self Employment/Utility Premium	127,000	127,000	127,000	127,000	127,000	127,000	127,000	127,000	127,000	127,000	635,000
Total Annual Cashflow	193,679	344,130	193,679	193,679	193,679	193,679	193,679	193,679	193,679	193,679	1,270,042
Taxes (25% effective rate)	(48,420)	(86,033)	(48,420)	(48,420)	(48,420)	(48,420)	(48,420)	(48,420)	(48,420)	(48,420)	(317,510)
Net Cashflow	145,260	258,098	145,260	145,260	145,260	145,260	145,260	145,260	145,260	145,260	952,531
NPV @10.5%	$1,283,726										

High Level Valuation Using Discounted Cashflow Model: With Tower Monetization

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Term. Value
Target Return on Equity	66,679	66,679	66,679	66,679	66,679	66,679	66,679	66,679	66,679	66,679	635,042
Tower Net Benefit		186,244	186,244	186,244	186,244	186,244	186,244	186,244	186,244	186,244	931,220
Land Sale		150,451									-
Self Employment/Utility Premium	127,000	127,000	127,000	127,000	127,000	127,000	127,000	127,000	127,000	127,000	635,000
Total Annual Cashflow	193,679	530,374	379,923	379,923	379,923	379,923	379,923	379,923	379,923	379,923	2,201,262
Taxes (25% effective rate)	(48,420)	(132,594)	(94,981)	(94,981)	(94,981)	(94,981)	(94,981)	(94,981)	(94,981)	(94,981)	(550,315)
Net Cashflow	145,260	397,781	284,943	284,943	284,943	284,943	284,943	284,943	284,943	284,943	1,650,946
NPV @10.5%	$2,230,355										