



# TILSON

September 1, 2016

**Subject: Synergies and Benefits Associated with Ownership of BIPCO**

## Introduction

Tilson was hired by the Town of New Shoreham (Town) to provide an analysis of the potential synergies and benefits of Town ownership of BIPCO. For this analysis, Tilson drew on the documentation used for the sale price estimation, conversations with Everett Shorey and Nancy Dodge, its existing knowledge of municipal broadband networks, and the financial model being used in its current broadband consulting engagement with the Town.

## Overview

When valuing a potential acquisition, purchasers take into account potential synergies and the benefits of controlling the target company. In a corporate Mergers and Acquisitions context, these synergies might include operating efficiencies, lower costs of capital, quality control, negotiating leverage, access to talent, tax efficiencies etc. These synergies are typically built into a purchaser's willingness to pay. In a competitive bidding process, the purchaser with the most synergies pays the highest price and wins the bid.

This document contemplates the quantifiable benefits to the Town and its electricity ratepayers, plus additional benefits that are more difficult to quantify. Because there is significant overlap between the Town's property tax payers, the Town's residents, and the Town's electricity rate payers, the term "Town" shall be used interchangeably to refer to all three sets of constituents, unless otherwise specified.

## Lower Electricity Rates

As described in Tilson's price estimation document, most rate setting bodies, including the Rhode Island PUC (PUC), back into a utilities' electricity rates by setting a revenue requirement that covers a utility's eligible costs and provides a profit to the owner(s). 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. For BIPCO, the owner's profit is targeted as a 10.5% annual return on equity used in the rate base.

Town ownership of BIPCO would lower the approved operating expenses, and eliminate the need to provide a 10.5% annual profit. These lower costs would feed back into the revenue requirement, lower the revenue requirement, and thus lower electricity rates. (It should be noted that if the Town buys



BIPCO, it will have paid for the future profit stream. So, while aggregate rates will be lower for ratepayers by the amount of 10.5% annual profit, taxpayers will have “bought down” these lower rates by buying BIPCO.)

BIPCO will need to file a new tariff within 6 months of interconnecting to the grid. These estimations of lower electricity rates are based on what rates would otherwise be under private sector ownership (current owners or similar new owner). Tilson has not examined the effect that the near term costs of interconnecting to the grid will have on current versus future rates.

**Forecasted Annual BIPCO Savings to be Factored into Revenue Requirement**

Annual Management Compensation Savings ("Annual Above Market Benefit Estimate" from Sale Price Estimation)	127,000
Return on Equity @ 10.5%	66,679
RI Gross Receipt Tax (tax efficiency/shift to RI taxpayers)	108,500
Loss of Town Property Tax Revenue	(15,238)
<b>Total Annual Difference</b>	<b>286,941</b>

In 2015, BIPCO collected \$2,462,239 in electricity charges (excluding the fuel surcharge). The annual expense difference represents 12% of those costs. It should be emphasized the source of the first two line items of savings were items would likely be previously paid out to owners and captured in the purchase price. Therefore, the two sources of savings would have been “bought down” by the purchase price, and are not new sources of value. The new sources of value, not already captured in the purchase price estimate, are derived from tax shifting,<sup>1</sup> and are outlined below:

**Forecasted Annual BIPCO Savings - New Sources of Value/Synergies**

Annual Management Compensation Savings ("Annual Above Market Benefit Estimate" from Sale Price Estimation)	-
Return on Equity @ 10.5%	-
RI Gross Receipt Tax (tax efficiency/shift to RI taxpayers)	108,500
Loss of Town Property Tax Revenue	(15,238)
<b>Total Annual Difference</b>	<b>93,262</b>

**The net present value of these tax differences**, discounted at 10.5%, is **\$857,112**. This is the number that should be considered as the best estimate of the synergies of the Town owning BIPCO.

<sup>1</sup> In 2015, BIPCO paid a RI Gross Receipt tax of \$108,500. According to Everett Shorey, the Town would not have to pay the tax. Tilson did not independently verify this. Property taxes are taxes paid by BIPCO to the Town. Because the Town would presumably make up the loss in property taxes elsewhere in its budget, this line item could be viewed as having zero value. It is being left in as a conservative measure.



It should be noted that Tilson has not made a separate entry for the tower revenue, since it is not known what a private owner would be able to do with the tower revenue, and it is not a new source of value. However, it is assumed that if the Town owned BIPCO, it would either use the tower revenue to offset electricity rates, or to off-set property taxes.

## Municipal Broadband Benefits

Many of today's municipal broadband success stories come from communities with municipally owned utilities. Chattanooga, TN; Cedar Falls, IA and Leverett MA are all good examples. The reason for this is that there are significant operational synergies with joint provision of electric and broadband services. Electrical utilities own the poles that broadband wires hang on; and they can leverage their maintenance and customer service infrastructure for broadband service.

The regulated nature of electrical utilities requires good accounting practices to separately account for joint provision of a non-regulated service. When providing these joint services, a utility needs to account for the costs and revenues associated with providing this service separately. Nonetheless, it costs the utility less on an incremental basis to provide these services than it would cost a newly formed broadband provider to do so. This is particularly true on an island, where a municipal broadband provider would otherwise need to provide its own bucket truck and maintenance staff, but would be unlikely to fully utilize them.

The Town of New Shoreham has initiated an RFI for a municipal FTTH broadband network. As contemplated now by the respondents, the Internet Service Provider would handle billing, collections, and customer support for \$20/month per customer. Therefore, no synergy for joint billing has been factored into this estimate. However, the arrangement with any potential future service provider may change and potentially yield additional sources of operating efficiencies.

Tilson estimates that there will be about \$104,000 of recurring operating efficiencies of joint provision of electrical and broadband services. This represents 43% of the fixed operating cost of maintaining the fiber network (i.e. fiber hanging on poles without provision of service) in Tilson's latest financial model for a Town municipal network.



Broadband Synergy		Assumptions
<b>One Time</b>		
Bucket truck purchase (one time)	100,000	Broadband would not have to buy a bucket truck. Could pay for use of BIPCO truck. Shared truck likely adequate.
<b>Recurring</b>		
Shared bucket rental payments to BIPCO	(9,600)	\$800/month for shared use of a bucket truck.
Savings on bucket truck maintenance, insurance, taxes	4,200	Spare bucket truck capacity. BIPCO charges out 1/2 truck. Truck would have been parked on town land, though.
Field Technicians	100,000	Two contracted field technicians @\$200k vs payment of \$100k for sharing two technicians.
Pole attachment revenue	10,122	Town/BIPCO would receive 1/2 of forecasted \$20,244 pole attachment rent. Other 1/2 of pole attachment costs paid to Verizon.
Recurring sub-total	104,722	

The net present value of these synergies, discounted at 10.5% is **\$720,377**, and outlined in Appendix A.

## Alignment of Interests

Historically BIPCO has been owned by individuals, and run as a for-profit company. In a perfectly competitive business environment, a firm owner’s interests are closely aligned with their customers. If firm owners do not serve their customers well, their customers will patronize a competing firm that does. Electrical utilities however, are regulated monopolies without the same competitive pressures that keep customers’ interests at the forefront. The system of state regulation of our electric utilities does an adequate job of ensuring that utilities serve customers by providing a reliable service without overcharging customers for ownership or management excess. However, the current system cannot align interests between owners and ratepayers to the same extent that healthy market competition does. Perhaps the largest and most difficult to define benefit of Town ownership is the alignment of owner and rate payer interests.

In BIPCO’s case, concrete examples of instances where owners and rate payers interests are not aligned were made in Tilson’s sale price estimation in the section entitled “Premium Associated with Self Employment at a Utility,” where it appears that owners were paying themselves benefits that they might not do if they were operating a business in a perfectly competitive market.”<sup>2</sup> In the regulated environment, costs borne by the utility (and benefits paid out to management) are also borne by the ratepayer. After electrical rates are set in a rate-case, it may be in the interest of management to cut costs. It may be that the observations made in SCG’s High Level Engineering Review – inadequate regularly scheduled maintenance and excessive tree growth around the poles<sup>3</sup> – were due to cost cutting by management.

<sup>2</sup> These included payment of generous part time salaries, bonuses and benefits plus free electricity

<sup>3</sup> According to BIPCO’s BUDGET FY 2017 document, in the 5 1/2 years between 2011 and May 2016, BIPCO has paid for tree trimming in only three of those years. If there have been outages due to inadequate tree trimming, this would likely be an example of mis-alignment of interests.



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The biggest potential for alignment of interests may be yet to come. In the near future, whatever entity owns BIPCO will have some very large and important initiatives to implement. It will be perhaps an unprecedented flurry of activity in the company's history. These initiatives include:

- fire damage remediation;
- negotiation of an insurance settlement;
- recommended substation repair and maintenance;
- interconnection with National Grid;
- membership to ISO New England;
- a rate case filing; and
- mandatory fuel tank removal and potential replacement.

Lastly, the Town has spent about \$125,000 to hire a regulatory consultant to advocate for ratepayers in the 2008 rate case. This consultant successfully argued several issues that saved BIPCO ratepayers money, including the exclusion of a payment of a pension to a former owner and consultant of BIPCO, and the exclusion of \$392,000 from the equity entitled to a 10.5% annual return. If the Town owned BIPCO, it would likely save **\$125,000** by not hiring this consultant in the upcoming rate case.<sup>4</sup>

## Control Over Policy Initiatives

If the Town owned BIPCO, it would implement various initiatives that could help implement environmental and social policy goals. For example, two initiatives that the Town could undertake only by controlling BIPCO are: net metering to encourage the use of solar power; and time of use pricing to help consumers save money by shifting the time of their energy use.

## More Town Land

The Town owns a maintenance facility next to BIPCO land on Ocean Avenue (Plat 17, lot 39). If the Town owned the adjacent lots 35, 37 and 39 as part of BIPCO, it would have more space and flexibility with which to conduct its operations in this area.

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<sup>4</sup> The costs for BIPCO to file a rate case are recovered from ratepayers.



## Summary

There are three sources of potential quantifiable synergies to Town ownership of BIPCO, which are estimated to have a net present value of \$1.7M. This is a high level estimate, and Tilson recommends in particular conducting more research on whether the Town would indeed be saving the RI Gross Earnings Tax pre-and post- grid interconnection.

### Total of Estimated Quantifiable Benefits of Town Ownership

Synergy	NPV	Beneficiary
Tax Efficiencies	\$ 857,112	Electric rate payers
Municipal Broadband Benefit	\$ 720,377	Tax payers and/or broadband users
Upcoming Rate Case Advocacy	\$ 125,000	Taxpayers
Total	\$ 1,702,489	

In addition to certain quantifiable synergies, the Town can expect to have other benefits that cannot be quantified, including the alignment of interests; control over policy initiatives; and owning more land.

Whoever owns BIPCO will have multiple simultaneous strategic initiatives to manage. A question that would be helpful for the Town to answer is how well it can manage these initiatives to its own benefit and how that compares to a different owner managing BIPCO to their benefit.



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## Appendix A

<b>Broadband Synergy</b>	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	<b>Assumptions</b>
Bucket truck purchase (one time)	100,000										Broadband would not have to buy a bucket truck. Could pay for use of BIPCO truck. Shared truck likely adequate.
Shared bucket rental payments to BIPCO	(9,600)	(9,600)	(9,600)	(9,600)	(9,600)	(9,600)	(9,600)	(9,600)	(9,600)	(9,600)	\$800/month for shared use of a bucket truck. Spare bucket truck capacity. BIPCO charges out 1/2 truck. Truck would have been parked on town land, though.
Savings on bucket truck maintenance, insurance, taxes	4,200	4,200	4,200	4,200	4,200	4,200	4,200	4,200	4,200	4,200	Two contracted field technicians @ \$200k vs payment of \$100k for sharing two technicians.
Field Technicians	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	Town/BIPCO would receive 1/2 of forecasted \$20,244 pole attachment rent. Other 1/2 of pole attachment costs paid to Verizon.
Pole attachment revenue	10,122	10,122	10,122	10,122	10,122	10,122	10,122	10,122	10,122	10,122	
sum	204,722	104,722	104,722	104,722	104,722	104,722	104,722	104,722	104,722	104,722	
Discount rate	10.5%										
NPV	<b>720,377</b>										

### Additional Assumptions:

- 10 year life with no terminal value;
- Flat costs.