

May 2, 2021

Honorable Beth A. Wood, CPA
North Carolina State Auditor
20601 Mail Service Center
Raleigh, NC 27669-0600

Dear Auditor Wood:

We are writing in response to an April 30 letter sent to you by Ms. Susan Rabon, Chair of the Bald Head Island Transportation Authority (BHITA). Her letter concerns the Local Government Commission's (LGC) consideration of BHITA's \$56M revenue bond application. These bonds would be used to finance the purchase of the Bald Head Island (BHI) transportation system (System) from its owner, Bald Head Limited (Limited) for \$47.75M. It is our understanding that the LGC will consider BHITA's bond application at its scheduled May 4, 2021 meeting.

We strongly oppose the bond application for reasons discussed in our April 26, 2021 letter to you requesting an independent financial audit of BHITA's valuation of Limited's transportation assets. We believe Ms. Rabon's April 30 letter underscores the need to conduct such an audit. Nothing in her letter refutes fundamental problems we identified in our prior letter: (1) BHITA's valuation and bond application for the transportation System are excessive; (2) the proposed acquisition will unreasonably benefit Limited, at the expense of people who ride the BHI ferry; and (3) it will subject the state and NC taxpayers to unnecessary financial risk and costs should BHITA default on its revenue bonds due, for instance, to unanticipated damage caused by an unusually strong hurricane.

Nothing in Ms. Rabon's letter lessens our concerns. All three of the aforementioned problems stem from the fact that Limited, the seller, paid various consultants that BHITA relied on to value Limited's transportation assets, and subsequently develop its revenue bond application that is now before the LGC. This created and continues to create an inherent conflict of interest. By putting itself in the position of paying all BHITA consultants, Limited also appears to have used its control of BHITA's valuation process to maximize the sales price of Limited's transportation System. How do we know this?

By its own admission, BHITA apparently reached a tentative agreement with Limited on an acquisition price, or possible price range, in 2019 following real estate appraisals that were done for BHITA by the Worsley Real Estate Company and paid for by Limited. We do not know what the initial negotiated price or price range turned out to be because none of this information was disclosed the time, and is still being kept under wraps.

Importantly, however, the "negotiated" acquisition price was constrained by the amount of debt that BHITA would need to issue, in order to pay Limited. This amount could not exceed what the LGC would subsequently approve. And since it is highly unlikely that the LGC would approve a bond issue rated below investment grade, a BBB- bond rating effectively became the lowest that BHITA's prospective bond issue could receive from the bond rating agencies and still get LGC approval.

In 2020, the Mercator consulting group was hired to estimate what BHITA would need to do with the transportation System's rates for ferry, parking and barge use going forward in to order to pay for a revenue bond issue large enough to finance the acquisition price, while maintaining an investment grade bond rating. After going through several iterations of its "forward looking" financial model,

Mercator concluded that BHITA could service a \$56M bond issue needed to finance the \$47.75M acquisition price it would agree to pay Limited -- provided BHITA increased ferry, barge and parking rates by roughly 20 percent, immediately after acquiring the System. BHITA's bond consultants, also paid by Limited, then determined, based on Mercator's cashflow projections, that BHITA's proposed revenue bond issue would tentatively be rated BBB- or one notch above junk, and, thus, acceptable to the LGC.

All of this no doubt involved a balancing act of sorts which would explain why Mercator went through several iterations of its model. Had BHITA and Limited agreed to a higher purchase price, the size of the bond issue also would have increased, along with projected rate increases needed to boost the System's cashflow enough to handle the added debt. A larger debt issue, however, would have made it more difficult to maintain an investment grade BBB- bond rating since adding debt would raise the risk of default, *ceteris paribus*. Conversely, had BHITA insisted on a lower price, the bond issue would have been smaller which, in turn, would have resulted in a higher bond rating. The fact that the \$56M bond issue was tentatively rated BBB- by BHITA's bond consultants, or one notch above junk, is prima facie evidence that Limited succeeded in persuading BHITA to accept the highest possible purchase price that it could get while maintaining an investment grade bond rating.

Even so, as explained in our April 26 letter to you, had BHITA released Limited's prior-year financial operating results for its transportation System, as it should have, the availability of these data would have made it virtually impossible to justify a \$47.75M purchase price or anything approaching that price. The reason is that Limited's transportation System is a local monopoly, currently regulated by the NC Utilities Commission. As such, in the absence of the legislation, the Utilities Commission very likely would not have allowed BHI ferry rates to increase at all, much less by the 20 percent or so that would be needed to service BHITA's proposed \$56M bond issue.

In view of all of this, it was especially unfortunate that the Worsley Real Estate Company was expressly precluded by BHITA's Business Valuation consultant (no less) from using Limited's prior-year financial statements to appraise the market value of the transportation System. Again, as we explained in our prior letter, had Worsley appraised the System using the standard Income Approach, he would have been required to use these prior-year financial data which, in turn, would have led to a significantly lower appraisal of the value of the ferry terminal sites at Deep Point (in Southport) and on BHI. The appraisal would have been lower simply because it would have been based on the System's recent financial performance which, unlike the Mercator study, would not have included or reflected BHITA's planned 20 percent rate hikes once it acquired the System from Limited and ferry rates were deregulated.

In her April 30 letter to you, Ms. Rabon noted that:

Worsley was expressly directed not to use the income approach, as that value could not be determined separate from the operation of the ferry and barge operations. *See Worsley Report (Deep Point):* "in order to insure the opinion of value herein accounts only for the real property, the Sales Comparison and Income Approach is not utilized."

In our opinion, excluding the use of prior-year financial data from BHITA's appraisals on this basis makes no sense precisely because BHITA is proposing to purchase the entire transportation system which includes the ferry, barge and parking operation. If Worsley was not qualified to appraise the System as a

whole, not just the real property attributed to various piece parts, the BHITA Board should have at least insisted that Limited hire a business valuation consultant that was qualified and further insist that the appraisal include and explicitly reflect the System's prior-year financial performance. Had it done so, the appraised value of the transportation System that BHITA used to settle on an acceptable purchase price with Limited would have been much lower.

Are there legitimate business reasons why Limited should have been allowed to shield its prior-year financial data for the transportation System from public review and, more importantly, from being used in BHITA's appraisals? Not to our knowledge. Because the transportation System is a local monopoly, it is regulated by the Utilities Commission and operates under a certificate of public convenience and necessity that is granted by the Commission. While businesses that are not regulated are often permitted to withhold competitively sensitive financial information from public review, that rationale doesn't apply here because Limited's transportation System has no competitors.

In our view, exclusion of the prior-year financial data, coupled with serious conflicts of interest issues that resulted from various consultants who were supposedly working on BHITA's behalf, but paid by Limited, also represents ample cause for your office to conduct an independent financial audit of BHITA's entire valuation process. We do not make this request lightly. However, because the terms of the legislation that created BHITA gives BHI stakeholders no recourse to contest decisions made by BHITA that will unduly harm BHI, we feel we have no choice. Thank you for considering our request.

Respectfully yours,

Robert T. Blau, CFA
5 Starrush Trail, Bald Head Island

J. Paul Carey
611 Currituck Way, Bald Head Island

cc: Honorable Dale R. Folwell, CPA, NC State Treasurer and Chair, Local Government Commission
Timothy Romocki, Director, Debt Management, NC Department of State Treasurer
Susan Rabon, Chair, Bald Head Island Transportation Authority
J. Andrew Sayer, Mayor, Village of Bald Head Island