

July 21, 2021

Dale R. Folwell, CPA  
North Carolina State Treasurer

Beth A. Wood, CPA  
North Carolina State Auditor

Dear Treasurer Folwell and Auditor Wood:

On July 6, 2021, you received a nine-page response from the Bald Head Island Transportation Authority (BHITA) to questions that the LGC raised about various flaws in BHITA's proposal to acquire the BHI transportation system (System) from its current owner, Bald Head Limited (Limited), for \$47.75M, and to finance that acquisition through a \$56.1M revenue bond issue. We are writing not so much to refute BHITA's response to your questions, but, rather, to focus attention on BHITA's response to Question 10. It explains how BHITA's proposed acquisition price was arrived at, and why its revenue bond issue would prove unreasonably costly to users of the System, and unnecessarily risky to Bald Head Island, the State, and NC taxpayers. For these reasons, we continue to believe that BHITA's bond application is not in the public interest and should be rejected by the LGC.

From the inception of the Ferry Transportation Authority Act (Act) in 2017, which Limited conceived and wrote, through BHITA's submission of its bond application, this entire process has been a classic case of what economists commonly refer to as rent-seeking. **Rent-seeking denotes efforts by a business, usually a monopoly, to manipulate public policy in ways that maximize its profitability without creating any benefits for its customers or society more generally.**<sup>1</sup> Many economists believe rent-seeking is akin to theft in that, when successfully executed, it simply shifts wealth from one entity to another without creating any new wealth or value.<sup>2</sup>

This letter examines how Limited used the NC legislative process and, subsequently, the BHITA in an effort to maximize the sales price of its transportation assets. Limited went down the rent-seeking path, in part, because it has a fiduciary responsibility to its owner, the George P. Mitchell Family Estate, to maximize and monetize the value of those assets. Limited also knew that it could get nowhere near BHITA's \$47.75M offer price from another commercial operator were it to put the System, or its more profitable piece parts, up for sale on the open market.

### **1. Limited's Framework for Rent-Seeking (In Paradise)**

Limited understood from the outset that maximizing the sales price of its transportation system could best be accomplished by persuading the NC legislature to create a new state entity (i.e.,

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<sup>1</sup> See Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies and Theft," *Western Economic Journal* 5:3 (1967, June) p. 224

<sup>2</sup> See, for example, Johann Graf Lambsdorff, "Corruption and rent-seeking," *Public Choice* 113, (2002) p. 97-125.

BHITA) and authorizing it to purchase the System using debt capital raised through the issuance of revenue bonds that the State would effectively back or guarantee. Limited also understood that whatever amount of debt that BHITA would agree to borrow through a bond issue, in order to acquire Limited's transportation assets, would have to be approved by the LGC. The LGC, in turn, would very likely insist that BHITA's bond issue be investment-grade (i.e., a bond rating of BBB- or higher) in order to better protect the State and NC taxpayers from default.

In effect then, Limited's ability to maximize the sales price of its transportation system would turn on its ability to convince BHITA to borrow as much debt capital as it could through an investment-grade revenue bond issue, and use those proceeds solely to pay Limited along with various fees and reserve requirements associated with issuing the bonds. This is precisely what Limited and BHITA did, and what the LGC is now being asked to approve.

The Ferry Transportation Authority Act contained five other provisions that would prove instrumental to Limited's rent-seeking (sales price maximization) scheme. First, it stipulated that the price BHITA paid for Limited's transportation assets would have to be "at or below their appraised value." This was necessary in order to create the appearance that the Act would not give rise to excessive profiteering on Limited's part, and that the price BHITA eventually agreed to pay Limited (i.e., \$47.75M) would have at least some basis or rationale, other than how much public debt BHITA could conceivably borrow (i.e., \$56.1M) in order to pay Limited (i.e., \$47.75M)

Second, the Act would deregulate BHI ferry passenger rates immediately after BHITA acquired the transportation system from Limited. Deregulating ferry rates was key to projecting increases in the System's annual cash flows that would be required to service a substantial revenue bond issue.

Third, the Act provided no state funding that BHITA would need in order to pay various financial and engineering consultants involved in appraising Limited's transportation assets and subsequently preparing its bond application. Instead, those consultants were paid by Limited, the seller, with predictable results. While these expenses were certainly not insignificant, they paled in comparison to the added wealth that Limited, and the Mitchell Family Estate, would realize from successfully executing its rent-see (sales price maximization) scheme.

Fourth, the Act stipulated that BHITA would be governed by an eleven-person, politically-appointed Board of Trustees of which only three members were required to reside on Bald Head Island. This made it far easier for Limited to persuade BHITA's Board – which had no budget or independent professional staff of its own -- to accept an inflated appraisal of Limited's transportation assets, and to use that appraisal as a rationale for agreeing to maximize the amount of debt that it could borrow (in order to pay Limited) through its revenue bond issue.

Fifth, the Act gave BHI stakeholders absolutely no recourse to contest any BHITA decision, including rate increases or reductions in the frequency of ferry or barge runs, that might prove

unduly harmful. This was important because prospects of BHITA being sued by users of System, including the Village of Bald Head Island, would have complicated the bond rating process, very possibly to the point of raising the level of risk that investors would impute to the bonds. Higher risk would have reduced the amount of debt that BHITA would be able to borrow which, of course, would have lowered its offer price to Limited.

Once this framework was put in place with the adoption of the Ferry Transportation Authority Act in 2017, Limited used various financial consultants, that presumably worked on BHITA's behalf, but were paid by Limited, to appraise the System's assets, and subsequently determine how much public debt BHITA could potentially raise, and how much of that debt could be paid to Limited.

All of this became apparent once, but only after, BHITA released various financial documents, including the Worsley real estate appraisal and the Mercator *Bond Feasibility Study*, as part of its revenue bond application to the LGC. This did not occur until February of this year, and then only at the LGC's insistence. Had BHITA's valuation processes been more open for public review and input, as it certainly should have been, the LGC very likely would not have found itself in the position of being asked to approve a bond application that would prove unreasonably costly to BHI stakeholders, and unnecessarily risky to Bald Head Island and the State.

## **2. BHITA's Appraisal: Scheme or Scam?**

On December 3&4, 2020, BHITA and several of its consultants gave a *Credit Presentation* to the LGC staff which attempted to rationalize BHITA's \$47.75M offer price and its \$56.1M bond issue. Page 34 of the presentation, "Acquisition Due Diligence," summarizes the results of BHITA's asset appraisal which came to \$50.94M, based largely on two highly flawed real estate appraisals done by the Worsley Real Estate Company. Worsley's appraisals of Limited's Deep Point and BHI ferry terminal sites came to \$43.395M, or roughly two and a half times what the Brunswick County tax assessor estimated the properties were worth.

In its July 6 response to your questions, BHITA made no real attempt to defend the Worsley appraisals. Instead, it simply noted that it is conducting a new real estate appraisal which it hopes will address several obvious shortcomings of the Worsley appraisals that the LGC raised with BHITA. Significantly, the new appraisal is still in process and will be completed only a few weeks before BHITA apparently intends to ask the LGC to approve its \$56.1M bond application.

Page 34 of BHITA's *Credit Presentation* also notes that, in 2017, Limited hired Mercator International, in anticipation of BHITA being created by the Act, to estimate the enterprise value of the ferry transportation system which Mercator placed at \$55.8M, or nearly 20 times the System's operating income (EBITDA) in 2017.<sup>3</sup> Mercator's 2017 study is consequential for a

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<sup>3</sup> See BHITA Draft 12/14,2020, *Preliminary Official Statement Dated January \_\_, 2021*, pages 33-46. Financial operating results reported therein indicate that, in 2017, Limited's transportation system earned \$2,834,682 in total operating income (EBITDA), of which \$1,972,634 (70%) came from its unregulated parking operation,

couple of reasons. First, its \$55.8M valuation, represented Limited's opening bid in its price "negotiation" with BHITA.<sup>4</sup> Second, though never released to the public, Mercator's 2017 valuation report was made available to the BHITA Board and subsequently shared with Worsley which completed its appraisal in 2019.

One of the major shortcomings of the Worsley appraisal had to do with the fact that it purposefully excluded use of the Income Approach which is generally regarded as the most reliable method of appraising income producing properties. Worsley states at multiple points in his two appraisal reports that the Income Approach was not used on explicit instructions from BHITA's Business Valuation Consultant.<sup>5</sup> It is not clear whether Mercator International had assumed the role of BHITA's Business Valuation Consultant in 2019. In 2020, however, Mercator was contracted by BHITA to prepare its *Bond Feasibility Study* that BHITA subsequently relied on as the foundation for its \$56.1M bond issue that would be needed to finance its proposed \$47.75M acquisition of Limited's transportation assets.

### **3. Why BHITA's Proposed \$47.75M Purchase Price Represents the Highest Price BHITA Could Pay Limited and Finance with an Investment-Grade Revenue Bond Issue**

BHITA's \$50.9 appraisal was certainly germane to Limited's rent-seeking scheme but only because the figure needed to exceed what BHITA would be able to pay Limited by virtue of how much public debt BHITA could raise through its investment-grade revenue bond issue. The latter amount turned out to be \$56.1M, contingent on BHITA's willingness to immediately raise BHI ferry, barge, and parking rates by 20 percent in order to produce the added cash flow that Mercator estimated BHITA would need to cover its annual debt service costs. Again, BHITA could do so because, under the terms of the Act, once the transportation system was acquired from Limited, passenger ferry rates would no longer be regulated by the NC Utilities Commission.

All of this very likely explains why Limited hired Mercator International to value its transportation System in 2017, and why BHITA hired Mercator in 2020 to figure out how much public debt BHITA could borrow through an investment-grade bond issue, and, thus, how much it could pay Limited.

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\$780,631 (27%) from its unregulated barge operation, and \$81,417 (3%) from its regulated passenger ferry operation.

<sup>4</sup> In a January 5, 2021 letter from BHITA Board of Trustee Chair Susan Rabon to Treasurer Folwell, Ms. Rabon noted that: "The Authority (in conducting its due diligence) first requested the Sellers to provide all of the information they had developed regarding the (value of the) System, which included reports prepared by third party consultants for the seller." These reports presumably included Mercator International's enterprise valuation report.

<sup>5</sup> The preface of the Worsley real estate appraisal report for the Deep Point ferry terminal site states: **At the request of the Client's (BHITA) Business Valuation Consultant, the Cost Approach was utilized in this analysis. The Business Valuation Consultant has been retained to evaluate the Business Enterprise Value (BEV) or on-going concern. In order to ensure the opinion of value reported herein accounts only for the real property, the Sales Approach and Income Approach were not utilized. This is considered reasonable based on the special-purpose nature of the subject property and the engagement of the Business Valuation Consultant.**

In December, 2020, as part of its bond application to the LGC, BHITA submitted Draft 4 of Mercator's *Bond Feasibility Study* to the LGC. Among other things, it concluded that if BHITA raised ferry, barge and parking rates by 20 percent immediately after it acquired the transportation system, BHITA could increase the system's cash flow enough to service a \$56.1M revenue bond issue that S&P Global subsequently would rate BBB- (one notch above junk).<sup>6</sup>

As shown on page 53 of its *Credit Presentation*, "Estimated Sources and Uses of Funds," BHITA's financial consultants then determined that if BHITA issued revenue bonds in the amount of \$56.1M, it could pay Limited \$47.75M with the balance (i.e., \$8.35M) needed to cover fees and various reserve requirements associated with the \$56.1M bond issue.<sup>7</sup> Thus, its proposed \$47.75 purchase price represents the **highest** price that BHITA could pay Limited and finance through an investment-grade revenue bond issue which the LGC is now being asked to approve.

Had BHITA's offer price been higher than \$47.75M, its proposed bond issue – and the requisite rate increases needed to generate additional cash flow -- would have been larger and, therefore, riskier. S&P Global's bond rating, in turn, would very likely have been lowered below BBB- which the LGC may not have approved, out of concern that BHITA's acquisition should not be financed in its entirety with junk bonds.

Of course, had BHITA's \$50.94M appraisal come in significantly below \$47.75M, as it should have, its offer price would necessarily have declined, along with the size of its bond issue. A smaller bond issue, in turn, likely would have garnered a higher rating simply because it would carry less risk. A smaller bond issue, with a higher investment-grade rating and a lower interest rate, also would have given BHITA more flexibility to raise additional capital in the event that future capital spending requirements exceeded BHITA's current projections which, very likely, will be the case.

We know that BHITA's proposed \$47.75M purchase price, as well as its \$56.1M bond issue, are grossly inflated simply because no entity, other than BHITA, would or could borrow that much to pay Limited. **A debt load of \$56.1M, after all, is five times the ferry system's 2019 total operating revenues and roughly 15 times its 2019 operating income (EDITDA). In a normal commercial setting, a debt-to-EBITDA ratio of less than 3 is considered reasonable for privately owned businesses and their creditors.<sup>8</sup> Ratios above 3 or certainly 4 are "red flags" when it comes to judging a business' credit worthiness, but the ratio here is five times what is routinely considered reasonable or safe.**

Again, BHITA's proposed acquisition price and bond issue "work" only because under the terms of the Ferry Transportation Authority Act (that Limited conceived and wrote), BHITA would

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<sup>6</sup> See S&P Global Ratings, *Bald Head Island Transportation Authority, North Carolina*; Transit, January 13, 2021.

<sup>7</sup> See BHITA *Credit Presentation* to LGC staff, December 3&4, 2020, p.

<sup>8</sup> See, for example, Corporate Finance Institute, "Net Debt-to-EBITDA Ratio: A measure of a company's ability to pay off its liabilities," corporate finance institute.com.

have complete discretion to raise rates for the ferry, parking and barge services to whatever levels BHITA would need to service its debt. Importantly, the Act also effectively eliminates any recourse that BHI stakeholders would otherwise have to contest any BHITA decision that could unreasonably harm BHI.

Another buyer would not have this discretion. Ferry rates would remain regulated by the NC Utilities Commission. And while the system's parking and barge operations are not regulated, a potential commercial buyer (and its bankers) would need to assess the likelihood that the Village of Bald Head Island could persuade the state to regulate the entire transportation System if barge and parking rates became that much more excessive and subject to monopoly pricing abuse which they already are today.<sup>9</sup>

In summary, Limited's rent-seeking scheme is very well documented by the factual record presented in BHITA's bond application. It also is thoroughly corroborated by BHITA's rather remarkable and candid response to your "must answer" Question 10 in its July 6 letter to the LGC. Question 10 asked why BHITA dismissed concerns that its proposed purchase price was well in excess of what Limited's transportation System might actually be worth (i.e., to a buyer other than BHITA) based on its actual operating income (EBITDA). BHITA responded:

There is no standardized approach to valuation to this type of asset, as governmental acquisitions of privately held infrastructure assets are very rare. Furthermore, the Authority is operating under a statute that requires it to acquire assets rather than a business. EBITDA is a measure of profits that also takes into account variable tax rates and depreciation policies. **Because the Authority is not a for-profit entity, ... the Authority did not focus on EBITDA as a valuation tool for either (market) value or (bond) feasibility.... [S]ince the Authority will be operating as a public entity rather than a private enterprise; its financial analysis and financial projections are all based on operating cash flows .... Rather than using a simple projection of the seller's historical net income to measure financial performance (and fair market value), the Authority worked with a feasibility consultant (Mercator International) to develop cash flow models as part of its due diligence of the transaction.** In developing these models, the seller's audited financials were reviewed and analyzed to inform future projections of operating cash flow. **(Emphasis added)**

By its own admission, BHITA did exactly what Limited intended it to do in executing Limited's rent-seeking scheme for maximizing the sales price of its transportation assets. In so doing, it also placed the ball squarely in the LGC's court.

#### **4. Why BHITA's \$56.1M Revenue Bond Application Should Be Rejected**

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<sup>9</sup> In 2019, the operating income ratio (i.e., operating income/revenue) for Limited's unregulated parking and barge operations were 78% and 69% respectively; versus 8% for the regulated passenger ferry operation. See BHITA Draft 12/14,2020, *Preliminary Official Statement Dated January \_\_, 2021*, pages 33-46.

There are two principal reasons why the LGC should reject BHITA's bond application. First, for reasons detailed above, BHITA's proposed bond issue is unreasonably large and, if approved, will prove to be unreasonably costly to BHI stakeholders who have no choice but to use the transportation System. Again, the BHITA's bond issue is as large (and potentially) costly as it is clearly because it was set up to maximize how much public debt it could borrow – in order to pay Limited – through an investment grade bond issue.

No buyer, other than BHITA, would or could borrow \$56.1M to purchase Limited's transportation assets. This is simply because no other buyer would be allowed to operate within the very favorable, profit-maximizing confines that Limited created for the BHITA through the passage of the Ferry Transportation Authority Act. The BHITA Board of Trustees, or at least a majority of the Board, either did not understand that they could have acquired Limited's transportation System at a far lower price, or they simply accepted what they were being told by various financial consultants (e.g., Mercator International) that supposedly were working on BHITA's behalf but were paid by Limited, the seller.

In any event, BHITA's decision to borrow \$56.1M in order to pay Limited \$47.75M is tantamount to monetizing the transportation System's future monopoly profits and transferring that wealth from captive users of the System to Limited and, by extension, the Mitchell Family Estate. This clearly is not in the public's interest.

A second reason why the LGC should reject BHITA's bond application has to do with the fact that, if approved, the bond issue will unnecessarily subject Bald Head Island and the State to an unreasonably high degree of financial risk. Because its \$56.1M bond issue is rated BBB-, or one notch above junk, it will effectively tap-out BHITA's borrowing capacity at least until a significant amount of that debt is paid down. Why? Because the LGC presumably would not, and should not, approve a second (subordinated) BHITA bond issue that almost certainly would be rated well below investment-grade.

This could prove very problematic for Bald Head Island and the State if, in the next 3-4 years, BHITA found it necessary to spend additional capital that it could not raise in the bond market. The need to do so could easily result from damage caused by a hurricane, or if BHITA found it necessary to undertake capital improvements/maintenance that Limited has very likely neglected or minimized in the last few years in order to boost the transportation System's earnings enough to justify the inflated sales price that BHITA has agreed to pay.

Should "unanticipated" and unavoidable capital spending requirements materialize, for whatever reason, BHITA would very likely have to ask the State for an infusion of capital, or failing that, try and take out a subordinated bridge loan from a bank. Even assuming a bank loan could be arranged, it undoubtedly would come with a very high interest rate which, of course, would prompt yet another major increase in ferry, barge and parking rates. If a bank loan could not be obtained, due to the large amount of debt BHITA would already be carrying relative to its operating revenue and cashflow, it could easily be forced to default on its bond payments. In that event, the State would be compelled to step in, bail out BHITA's bond holders

and take over the transportation System until new ownership could be worked out. What might happen to the quality and frequency of BHI ferry, barge, and parking service in that instance is anybody's guess but it obviously would not be for the better.

In closing, it is clear BHITA's bond application is not in the public interest, and certainly not in the interest of BHI stakeholders. It should be rejected by the LGC. The application is a product of rent-seeking behavior on Limited's part. We do not fault Limited for carrying out its fiduciary duty to the Mitchell Family Estate by trying to maximize the sales price of its transportation assets in the manner that it did. Had Limited not over-reached by attempting to squeeze as much wealth out of its rent-seeking scheme as it possibly could, BHITA's bond application might well have been approved in February.

BHITA, on the other hand, deserves a flat F for failing to work out a reasonable deal with Limited that would have served the interests of those users that depend on the BHI ferry transportation System. Instead, BHITA simply enabled Limited's rent seeking scheme. It no doubt did so largely because it was given no funding by the State which it clearly needed to hire its own independent financial advisors.

In hind sight, BHITA's Board of Trustees should have refused to proceed in appraising Limited's transportation assets and preparing its bond application until and unless it was given the requisite state funding that it needed to conduct an independent assessment of what the transportation System might actually be worth. It also should have refused to sign the non-disclosure agreement that Limited insisted each Board member sign as a condition for seeing Limited's prior-year financial statements for its transportation System. And it most definitely should have set up its own website, and posted all documents that it relied on in course of appraising Limited's transportation assets, and developing its bond application. Had it done so, as soon as those documents were completed, public input very likely would have led to a far more reasonable bond application than what is now before the LGC.

The BHITA Board did none of this. Nor, apparently, did it understand that it was being used by Limited to transfer wealth from users of the BHI transportation System to the Mitchell Family Estate, in a manner that many economists believe is akin to theft.

Respectfully yours,

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cc: Honorable Ronald Penny, NC Secretary of Revenue  
Honorable Elaine Marshall, NC Secretary of State  
Honorable Mike Philbeck, Speaker of the House, NC State Legislature  
Mr. Joshua Bass



Ms. Viola Harris

Mr. Scott Padgett

Mr. Edward Munn

Ms. Sharon Edmundson, Deputy State Treasurer and Director NC State and Local  
Government Finance Division

Mr. Timothy Romocki, Director, Debt Management, NC Department of State Treasurer

Ms. Susan Rabon, Chair, Bald Head Island Transportation Authority

J. Andrew Sayre, Mayor, Village of Bald Head Island