Burton Water Cooperative: White Paper Executive Summary

The Burton community has a rare opportunity to acquire the assets of the Burton Water Company (BWC) and manage it through a community-governed Cooperative (Co-op). ***Considering the Co-op's thorough analysis, combined with the unique nature of the system and the rare opportunity to gain local control over our water supply, the Co-op's Board of Directors recommends purchase of the company at the seller's asking price of $1.2 million yet is asking for strong community concurrence before moving forward at that price.***

Background and Timeline.

The current BWC owners are looking to sell the company and indicated they would be open to selling it to a community-controlled entity formed by current customers. BWC's assets are of particular value to this community. The water comes from shallow groundwater that is filtered by the sands beneath the Misty Isles property and is distributed through a system of pipes that are largely gravity fed. The assets have been well-maintained over the years.

A group of current BWC customers came together in the fall of 2021 to explore the feasibility of the proposed acquisition. The effort has involved four primary working committees (Governance, Finance, Membership, and Operations), plus a Coordinating Committee, with over 30 members of the Burton community participating. In early spring 2022, the Membership Committee selected seven committee members to serve as a Feasibility (i.e., interim) Board to guide the Co-op into incorporation as a Washington non-profit organization and coordinate Co-op activities until the acquisition is finalized and the Co-op transitions into an Operating Phase (or until the project proves unfeasible).

Since that time, the goals of the Board's work has been to establish: *1) the condition of the water system infrastructure; (2) a fair market value for the assets; (3) an achievable financing plan; and 4) the feasibility of an operating Co-op going forward.*

In May 2022, the Board began price discussions with the owners, who stated that they had received offers up to $1.5 million. The Co-op's Finance Committee conducted an independent analysis of the value of BWC based on its financial records, past financial performance, and comparable transactions using multiple valuation methodologies. After an initial round of discussions with the Board, the Sellers reduced the price to $1.2 million. Based on its own analyses, the Co-op Board authorized an offer to the owners of $900,000. The owners, in response, stated that the $1.2 million price was firm.

Community Input.

Considering all the factors – including significant intangible value to the community of keeping the water system locally owned by the community – the Board recommends moving forward with the transaction assuming broad community support. The Board therefore seeks concurrence from the community – via a straw poll – before advancing a $1.2 million offer. The attached 'white paper' offers a comprehensive analysis of the Finance Committee's valuation to help community members adequately assess this decision for themselves.

Community Decision Process.

The 'white paper,' along with a straw poll (online and hard copy) to gauge community support, is being distributed to all BWC customers. ***The Board will host a community meeting on July 20 (7 pm via Zoom) to present the 'white paper', take community questions, and allow for comment.*** More details about the poll and how it will be collected and tallied are included in the 'white paper'.

BURTON WATER COOPERATIVE
WHITE PAPER
July 6, 2022

Background

The Burton community has a rare opportunity to form a cooperative to acquire the assets of the Burton Water Company (BWC). BWC is an investor-owned utility regulated by the Washington Utilities and Transportation Commission. The current owners are two long-term residents of the island. They are looking to sell the company and they have been entertaining unsolicited offers for their company for several years, including offers from two large out-of-state companies.

In the fall of 2021, they indicated to the members of the community that they would be open to a proposal from a community-controlled entity formed by the current customers. This is the first time the company has been offered for sale in decades. It is also the first time that BWC's customers have been afforded an opportunity to create a community-owned (i.e., cooperative) water system.

The assets of BWC are special and of particular value to the roughly 400 connections in our community served by BWC. The water comes from shallow groundwater that is filtered by the sands beneath the Misty Isles property and emerges from the ground on a small parcel on the south side of 232nd Avenue. The water is clean and pure and is distributed through a system of pipes that are largely gravity fed, providing water service to the small community in Burton, the Burton Peninsula, and the West shore of Quartermaster Harbor up to between 107th and 115th Aves. Many parts of BWC's service territory have few alternatives for sourcing water supply, particularly on the Burton Peninsula due to the intrusion of seawater. The assets have been well-maintained by the owners over the years.

Feasibility Efforts and Timeline

A group of current BWC customers came together in late 2021 to form working groups and explore the feasibility of the proposed transaction. The effort to explore the feasibility of Co-op purchase and management of the system has consisted of four primary working committees: Governance, Finance, Membership, and Operations. In addition, a Coordinating Committee was formed to coordinate efforts and assumptions between the four primary committees.

The Co-op was formally established in March 2022 as a non-profit Washington corporation organized as a cooperative. The Membership Committee selected a slate of seven volunteers from the committees to serve as the Board of Directors (Board) during the feasibility phase until a financing and management plan as well as operating phase bylaws were finalized and approved by the members of the Co-op or until the project proved unfeasible. Assuming terms for the transaction could be agreed upon, the Co-op would hold an election of the membership to approve the acquisition of the assets of BWC, establish operating bylaws, and seat its first elected board.

The owners initially gave the community until May to complete a transaction. They made their books and records available for review and provided information about current operations.

The Board has worked with the committees to examine BWC's books/records and explore financing with various lenders, interviewed management and board members of other water cooperatives and mutual associations to determine best practices, and commissioned an engineering study of the physical plant condition and capital needs. **The goal of this work was to establish: *1) the condition of the water system infrastructure, (2) a fair market value for the assets; (3) an achievable financing plan; and (4) the feasibility of the Co-op going forward.*** In addition, a regular communication system with stakeholders through newsletters and community meetings was established to begin to build Co-op membership.

Based on the progress made by the Co-op Board and committees, the BWC owners have been willing to extend their time deadline, which has afforded us the ability to continue to work through and complete a thorough feasibility study.

Price Discussions

In May, informed by the prior months' feasibility work, the Board began to discuss price with the owners. The owners had communicated consistently that they had received several offers from reputable investor-owned water companies in Oregon and California to purchase the company, and that the offered prices ranged from $1.2 million to $1.5 million. The owners, after a series of discussions with members of the Board, reduced their price to $1.2 million.

The Board, with the assistance of the Finance Committee, completed an independent analysis of the value of BWC based on its financial records, past financial performance, and comparable transactions. The analysis also looked specifically at how regulated water companies are valued and the impact that state regulation of the company's prices has on that value. The committee's goal was to verify the reasonableness of the competing offers so that the Board could confidently move forward with offering fair market value for the assets on behalf of the Co-op.

Based on our analyses, plus representations made by the owners that some investments they had made were not yet reflected on BWC's books, the Co-op Board authorized a non-binding offer to the owners of $900,000, subject to verification of said subsequent investments, plus a provision to hire the owners back on a consulting basis for a transitional period at a to-be-negotiated hourly rate. The Board felt this was a fair and reasonable offer. The owners rejected this offer, stating that their already reduced $1.2 million price was firm. In response to our offer, the sellers stated that if the Co-op could not meet their price, they would run the company for some time and then sell to the highest bidder.

Key Question for the Community

The Co-op Board needs feedback from the BWC's current customers to confidently move forward at $1.2 million. Based on evaluating the numbers alone, our analysis does not support $1.2 million as the fair market value of the system. We have reviewed the third-party $1.2 million offer and noted it is not binding and is contingent on due diligence. Regardless, there is a good chance that the owners will walk away from our deal without a $1.2 million offer from the Co-op.

Importantly, beyond "the numbers", the Board also acknowledges there is significant intangible value to the community that should be considered. A Burton Water Cooperative would:

- Secure senior water rights and our water supply in perpetuity
- Provide community control through a local, member-elected board
- Set stable water rates based on the cost of service, without a profit

- Have strong environmental stewardship
- Utilize local knowledge and relationships
- Build upon a successful ownership and management model utilized elsewhere on Vashon
- Be more likely (than an off-island for-profit owner) to retain the current skilled and experienced on-island system operator and therefore have higher resiliency in case of disaster
- Enable neighbors to work together on a critical community resource.

A few important things to note regarding our interactions with the owners: They have received a number of unsolicited offers. To their credit, they did not jump at the first offer. With the pause, they created an opportunity for us to come together to make a community purchase happen. During this community feasibility period they have been fully cooperative, freely shared all requested financial information, consulted on system conditions, and opened the site for tours. In addition, they have worked with us in good faith which meant we didn't need to spend money on attorney costs for document negotiation, they have not required earnest money, they have been flexible on the timeline, and they have not required money for time extensions. These are all real financial benefits to us.

In addition, based on the information available to us at this time, the Board finds that the acquisition of the assets at the owners' requested price is feasible with:

- modest rate increases over the years (based on actual costs, not on maximizing rate of return)
- federal financing (through USDA) at below market interest rates and long term; and
- a projected member equity contribution of around $1,000 to $3,000 per member (based on one property and one connection) with the option to pay this over time in installments.

Considering <u>all</u> these factors, the Co-op Board recommends moving forward with the transaction assuming broad community support. The Board therefore seeks concurrence from the community (via a straw poll, described below) before advancing a $1.2 million offer. With a community mandate, we will pursue a $1.2 million purchase price based on the unique nature of the system and the rare opportunity to gain local control over our water supply.

<u>Analysis</u>

There is no single, definitive "correct" way to value a business or utility. Instead, there are several accepted methods, all of which help to hone in on fair market value: what a willing buyer and a willing seller would agree is a reasonable price. With publicly traded companies, parties usually agree on a price that includes a premium over the current share price after consulting the extensive financial data available to the public. Private companies, because there is no market for their stock, require a bit more analysis to establish value.

Here are the approaches the Finance Committee considered for establishing the value of BWC:

- Discounted cash flow – standard valuation based on future profits
- Book value – starting point for valuing retail utilities regulated by a commission
- Multiples of cash flow – standard valuation based on cash flow (after deducting debt)
- Competing offers – especially if firm (no further negotiation)
- Comparable sales – as in real estate.

All these methods can add to the picture of value, but some are more helpful than others.

Discounted Cash Flow (or DCF) is one of the principal ways to establish the value of a business. It simply discounts the forecasted future profits of a business to their present value using as a discount rate the cost of capital of that enterprise. DCF is one of the most useful and accepted ways to calculate value. Its usefulness in determining value depends largely on the accuracy of the forecasted profits. It works well for infrastructure companies, like water distributors, because the expenses and profits of such businesses tend to be stable over time.

Book value, the total investment in the enterprise minus depreciation (an accounting allowance for wear and tear), is rarely used to value most businesses, simply because historical cost of a business rarely impacts the value that business has to a current willing buyer. But book value means a lot in regulated businesses, because it is how state regulatory commissions calculate the profit that a company may include in its rates. The US Supreme Court ruled more than 100 years ago that regulated utilities have a constitutional right to earn a reasonable return on their invested capital. As a result, regulatory commissions are required to calculate this return and include that profit in the rates they approve. Commissions, however, are not required to provide utilities with a margin on their other, non-capital costs and expenses, and so they don't. Since the future profits are estimated by multiplying the cost of invested capital[1] times book value, the book value tends to be considered "the value" of the utility[2].

Multiples of cash flow is another useful way to get to value for most businesses, but particularly those that are capital intensive. It looks at the price paid for similar companies and divides that by the cash flow of those other companies to calculate a representative ratio. That representative ratio is then applied to the cash flow of the business being valued and yields a value for that company. For example, if a business has a cash flow of $50,000, and similar businesses have sold for 8 times their cash flow, then this business would be worth $400,000. Its rigor lies in the fact that the variable is cash flow, so it compares companies based on its true economic value. The typical multiple for infrastructure companies tends toward 7, although it can be as high as 10.

Competing offers can be strong indicators of fair market value, but only if they are fully negotiated offers. A negotiated binding offer actually meets the definition of fair market value, because it is an arm's length transaction between a willing buyer and a willing seller. A letter of intent subject to due diligence provides some limited information on value, but it is not reliable as the basis for determining fair market value. Depending on what is learned and subsequent market conditions the price could go up or down.

Comparable sales, like multiples of cash flow, uses historical transactions to approximate fair market value. This method is particularly useful in real estate, where value is often subjective. Using comparable sales in theory captures the market for such properties, particularly where

[1] "Cost of invested capital" means the cost, expressed as a rate, paid to lenders as interest or to shareholders as dividends and appreciation. It is usually expressed as the Weighted Average Cost of Capital, which produces a weighted average of the rate of return paid to borrowers and shareholders. In other words, the average of the two rates take into account how much of each that the company has (debt and equity).

[2] Book value is not the end of the analysis. Current assets, such as cash and receivables, should be added to the value, and of course, a premium (discussed below).

there is a large population of prior sales to analyze. It is less useful in illiquid markets where a single outlier can skew the results.

Regardless of the methodology, acquisitions usually involve adding a premium to the calculated value. Premiums are a reality of the business of acquisitions, because sellers often need an inducement to sell rather than continuing business as usual. In unregulated businesses, these premiums are sometimes large. But utilities, because they have less potential for profit (due to regulation), usually receive a 15-20% premium.

Findings

The table below summarizes the Co-op Board's findings:

Method	BWC Value	+15% premium
Discounted cash flow	(646,000)[3]	743,000
Book value	646,000	743,000
Multiples of cash flow	755,000	869,000
Comparable Offers	None fully negotiated	-
Competing Letter of Intent (assets plus consulting contract for 3 years)	$1,200,000	Not applicable
Comparable Sales	Limited data	-

Book value for BWC is complicated by several factors. Utilities have their own system of accounts, different in some respects from normal businesses, due to the effects of regulation. BWC is an unusually small company run by two individuals, not a large corporation, and they use local island accountants to do their filings in Olympia. But the biggest complication is BWC's use of a commission-approved mechanism called Contributions in Aid of Construction (or "CIAC").

In essence, CIAC is capital that BWC raised from customers through a surcharge on top of regular approved rates, and which it used for capital projects (together with the owner's cash). About 40% of the existing capital investment in the system was provided by customers' added surcharge contributions separate from the owners' investments. The use of CIAC in this way is legal and unique to water utilities, and it is used to help small companies that don't have access to the financial markets. However, companies using CIAC cannot include the CIAC-funded capital in the book value for purposes of calculating rates[4]. Since they are not allowed to earn a return on those funds (i.e., can't charge rates based on them), then the amount of CIAC also cannot be used for estimating the value of the enterprise. Said another way, CIAC does not generate profits for the owners, and so should not be used to value the enterprise.

[3] Discounted cash flow, in this case, has limited value beyond the book value method because the calculation is circular. The company's cost of capital is used to calculate future profits. Discounting those future profits uses that same cost of capital rate, and so the result equals the book value, which was the starting point. The actual calculation is complicated, and so was not performed.

[4] WAC 480-110-455

Total anticipated transaction costs

The total cost of the proposed Co-op endeavor is more than the purchase price alone. In addition to the purchase price, the Co-op will need to pay due diligence/feasibility expenses, transaction costs, one-time startup costs, capitalization of reserves, and some initial immediate capital improvements. The Co-op also needs sources of funding to offset these costs. Currently, the plan envisioned would use a combination of a loan and equity in the form of funds from members. Key to this is special financing available to community based co-ops from the USDA at extremely favorable rates.

Assuming a purchase price of $1.2 million and 415 connections, the projected costs (anticipated at this time) and likely sources of funds to pay those costs are:

Costs	
Purchase of BWC assets (1)	$1,200,000
Feasibility Costs (2)	$ 102,000
Start Up Expenses (3)	$ 20,000
Initial Capital Improvements (4)	$ 380,000
Capitalizing Operating Reserve (5)	$ 100,000
Funding Capital Reserve (6)	$ 349,800
Closing Costs(7)	$ 65,000
Total	$2,216,800

Sources	
Member Capital (8)	$ 449,800
USDA Loan (9)	$1,741,000
State Grant (10)	$ 26,000
Total	$2,216,800

Supporting notes for the table above:

(1) Owner's stated firm price
(2) Estimated due diligence and feasibility expenses for required elements (capital needs assessment, legal, financing, required third party reports) with being as cost conscious as possible
(3) One-time start-up costs such as accounting, computer system, office costs, etc.
(4) Replacement of a critical piece of the water distribution system (e.g., portions of the main distribution line)
(5) Reserve for unplanned loss of revenue or extraordinary expense
(6) Reserves for future capital improvements not paid for through regular revenues
(7) Cost of related financing and approval costs.
(8) Assumes each co-op member pays a one-time Membership Fee of $5 plus an Ownership Assessment Charge of $995 per connection (i.e., $1,000 total for one membership and one connection). This could be paid in a single lump sum or on an installment plan over several years. These funds capitalize the Operating and Capital Reserve. The scenario here assumes maximizing the amount of the USDA loan which keeps the member equity contribution low (current estimate $1,000/connection). Alternatively, a "no debt" scenario would cost about $5,340/connection. A third scenario could be somewhere in between (e.g., $3,000).
(9) USDA loan with a 40-year term and current interest rate of 2.64% (this rate is expected to rise over the coming months). The loan covers all the costs except funding the stated reserves.
(10) Current commitment from State Dept. of Commerce

Listed below are a few key observations from the cost information above.

- Cost per connection of acquisition alone: $2,890. This is how the $1.2 million breaks out if spread across all BWC connections. It does not include the cost of financing (e.g., feasibility studies and other transaction costs) but is provided here to give a sense of the economic impact of the required purchase price on a per-connection basis.
- Cost per connection of acquisition alone using anticipated USDA financing: $14/month for 40 years
- Cost per connection to Co-op members for the total transaction cost with no debt (i.e., no USDA loan): $5,340
- Cooperative water rates would increase a projected 3 to 5% every 3 years (less than 2% annually).

In thinking about the overall transaction, the Co-op Board has been using the following criteria to evaluate feasibility and reasonableness.

- The assumptions for projecting annual operating revenues and expenses are solid and well supported
- The financing for the transaction (member equity, debt, grants, other) can be obtained and is stable over time
- The plan has a predictable and reasonable impact on water rates
- The cost for someone to join the co-op and obtain water service is reasonable, and if a financial burden, can be paid over several years
- There is cash available to cover reasonably projected capital needs over time (first 20 years).

Straw Poll of Community

Beginning on July 10 and running until July 31, the Board will conduct a straw poll to gauge community support for moving forward. The straw poll is included as a questionnaire with this white paper. All current BWC customers (including those with active connections and those who the BWC has committed in writing to serve) will be provided the opportunity to participate in the straw poll[5]. People can participate by paper poll or electronically. One poll response per person/family/entity regardless of number of properties or connections held (similar to how membership/voting ultimately will occur under the Co-op structure). In order to facilitate maximum participation, people may respond electronically or by paper. People responding to the poll by paper may return it to the secure box at the Burton Store (like when you pay your bill) or by mail to the Burton Water Cooperative mailing address (20211 Vashon Hwy SW, #29; Vashon, WA 98070). People responding electronically will do so via Google Forms (see the Co-op website: www.burtonwater.org) or by scanning and emailing their completed questionnaire to info@burtonwater.org. The Membership Committee will confirm the eligibility of each respondent and record the results.

[5] This straw poll, which is different from a vote of the Co-op membership, will be open for participation to all BWC customers (i.e., all potential Co-op members) for the purposes of gathering widespread input. Future votes - including a vote later in 2022 whether to formally approve the transaction and Co-op bylaws - will be open to those who choose to become members.

Participation from the community is crucial. In order to justify the considerable time and continued expense involved in this endeavor, the Board is looking for at least 60% participation from eligible participants and an affirmative response of 60% of those responding to move forward at the stated purchase price. A result above that mandate level will indicate to the Board to continue to move forward with the transaction at the stated sale price. A result below that mandate level may lead the Board to exit negotiations and may result in the owners looking elsewhere for another buyer. For reference, the election to establish the Hospital District on Vashon had an about 38% participation rate from eligible voters with a 50% plus 1 approval required. Also, for reference: the Board's 60% approval threshold reflects the percentage of yes votes required to approve a school bond.

The Board will host a community meeting (via Zoom, with the link to be available on the Co-op's website and here) on July 20 to discuss the Board's findings and this white paper, to answer questions from the community regarding the feasibility study, and to allow for public comment on the proposed acquisition. **Questions at any time may be directed to info@burtonwater.org.**

Conclusion

The community Co-op purchase of the BWC assets appears feasible and presents a unique opportunity to keep ownership and management of our water supply local. The current BWC owners' required purchase price is $1.2 million. Low-interest long-term financing is available from USDA to help with the purchase price and related transaction costs. Some member equity (on the order of $1,000 or more) will be required in order to keep the up-front financing manageable and to establish capital reserves. **Considering all the factors, the Co-op Board recommends moving forward with the transaction assuming broad community support.** The Board is asking for that input via a straw poll questionnaire referenced above that will run until July 31. Submitting your straw poll response is crucial for the Board to make a decision about how to move forward. A predominantly 'Yes' result will indicate to the Board to move forward with the acquisition at the Seller's price. Anything less than a 60% approval rate will likely result in the Board concluding that the transaction is not feasible due to lack of community support.