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August 29, 2012

Mr. Garret H. Strathearn
City of Allentown
435 W. Hamilton Street
Allentown, PA 18101

RE: City of Allentown Water and Sewer
Business Enterprise Valuations

Dear Mr. Strathearn;

In response to your request, the following discussion regarding the valuation approaches and considerations should be responsive to the recent comments and questions relative to the valuations studies referenced above.

Valuation Approaches

There are three (3) industry accepted and recognized approaches utilized to determine the present value of a utility system as follows:

- Cost Approach,
- Income Approach, and
- Market Approach.

Cost Approach

The cost approach considers the surviving fixed capital assets utilized in providing service to the customers. The depreciated original cost value of those assets are an indication of the book value of those assets as of a certain study date. The

condition of the assets and future capital requirements to maintain or replace existing assets provides indicators as to the life expectancies of those assets. However, the fixed capital assets of a well maintained system would rarely sell for the net book value. A purchase price premium in excess of book value would be expected; otherwise, the incentives to sell those assets are diminished. The City of Allentown's water and sewer assets are well maintained with minimal near term capital improvements required to maintain the quality of service to the customers. AUS Consultants compiles market to book ratios of publically traded utility companies. This information was utilized in the cost approach.

Income Approach

The income approach considers the present value of the utility systems future income streams by utilizing a discounted cash flow method ("DCF"). The DCF model considers the future annual profitability of the utility system and the amount of net income available for capitalization.

General considerations reflected in the model would include, but not limited to, the following:

- Future Rate Increases,
- Future Rates of Inflation,
- Future Major Capital Improvements,
- Annual Capital Renewals & Replacements,
- Economies of Scale / Operating Synergies, and
- Weighted Average Cost of Debt.

Investors look to maximize operating efficiencies and to maximize income streams. They also consider the present and future cost savings through long-term debt instruments. Thus, making the City's water and sewer systems very attractive to investors looking to create regional systems or enter into markets previously controlled by publically owned entities.

Market Approach

The Market approach considers comparable sales of similar utility systems. The major problem with the market approach is that no two utility systems are exactly the



same. Therefore, judgment is required in analyzing utility sales. AUS Consultants, through its Royalty Source® division has the capabilities to generate utility acquisitions / sales information. We have utilized our knowledge of the industry, experience and judgment in applying the market approach to the Allentown project.

Real World Application

In the “ideal world” the results from each of the valuation approaches would render similar or exact results. In the “real world” many factors influence the valuation results and those factors can produce varying ranges of values. Therefore, a weighting of the approaches, based upon the judgment of the valuation expert, will provide a reasonable range of values.

Market Conditions

No valuation study can predict the market conditions at the time of offering. Many factors not related to the indicated value of the fixed capital assets of the utility system can affect the offers to purchase.

For example, during the 2008/2009 time period, few utility acquisitions were completed due to the borrowing capabilities of interested investors. The debt markets were essentially closed for business. Few utility transactions were completed due to market conditions that had no relationship to the utility values.

City of Allentown Valuations

The results of the value ranges developed for the water and sewer operations are based upon the City’s sound historical financial data. The ranges of values are considered conservative and reflect recent industry experience. It is important to note that a valuation of a utility system is entirely different from a “real estate appraisal” and the process is unique to the utility industry.

Closure

I trust that this brief explanation will be sufficient for a response to the water and sewer customers. Be assured that the approaches taken to arrive at the values of the water and sewer systems follow industry accepted guidelines and the proposers will



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likely try to replicate portions of the models in their completing their financial due diligence.

Respectfully Submitted,
AUS Consultants

A handwritten signature in black ink, reading "Gary D. Shambaugh". The signature is written in a cursive style with a large, looping initial "G".

By: Gary D. Shambaugh

