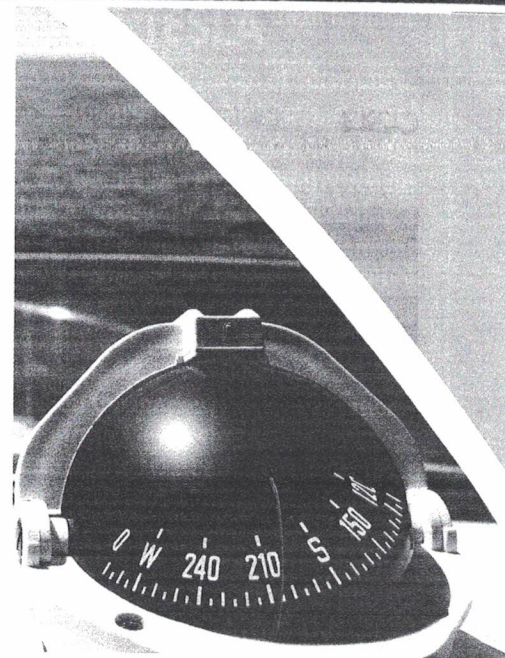


CASE 29

TESLA MOTORS, 2015

In 2015, Tesla Motors was a \$3.2-billion company on track to set history. It had created two cars that most people agreed were remarkable. *Consumer Reports* had rated Tesla's Model S the best car it had ever reviewed. Though it was not yet posting profits (see Figures 1 and 2), sales were growing rapidly and analysts were hopeful that profits would soon follow. It had repaid its government loans ahead of the major auto conglomerates. Most importantly, it looked like it might *survive*—perhaps even thrive. This was astonishing, because there had been no other successful auto manufacturing start-up in the United States since the 1920s.

The road leading up to Tesla's position in 2015 had not always been smooth, and many doubts still lingered. Tesla had benefited from the enthusiasm of the "eco-wealthy"—a rather narrow portion of the market. How would Tesla fare when it was in direct competition with General Motors, Ford, and Nissan for the mass market? Would it be able to turn a sustainable profit on its auto-making operations? Furthermore, some questioned whether Tesla's goals to sell to the mass market even made sense. In the niche market, it had a privileged position with customers who were relatively price insensitive and seeking a stylish, high-performance car that made an environmental statement. To compete for the mass market, the car would have to provide good value for the money (involving trade-offs that might conflict with Chairman Elon Musk's ideals), and the obstacles to charging would have to be overcome.



HISTORY OF TESLA

In 2003, an engineer named Martin Eberhard was looking for his next big project. A tall, slim man with a mop of gray hair, Eberhard was a serial entrepreneur who had launched a number of start-ups, including a company called NuvoMedia, which he sold to Gemstar in a \$187-million deal. Eberhard was also looking for a sports car that would be environmentally friendly—he had concerns about global warming and U.S. dependence on the Middle East for oil. When he didn't find the car of his dreams on the market, he began contemplating building one himself, even though he had zero experience in the auto industry. Eberhard noticed that many of the driveways that had a Toyota Prius hybrid electric vehicle (or "dorkmobile" as he called it) also had expensive sports cars in them, making him speculate that there could be a market for a high-performance, environmentally friendly car. As Eberhard explained: "It was clear that people weren't buying a Prius to save money on gas. Gas was selling close to inflation-adjusted all-time lows. They were buying them to make a statement about the environment."¹

Eberhard began to consider a range of alternative fuel options for his car: hydrogen fuel cells, natural gas, diesel. However, he soon concluded that the highest efficiency and performance would come from an entirely electric vehicle. Luckily for Eberhard, Al Cocconi (founder of AC Propulsion and one of the original engineers for GM's ill-fated EV-1) had concluded

Figure 1 Tesla Income Statement, in \$US Thousands

	2014	2013	2012
Revenues			
Automotive sales	\$3,192,723	\$1,997,786	\$385,699
Development services	5,633	15,710	27,557
Total revenues	3,198,356	2,013,496	413,256
Cost of revenues			
Automotive sales	2,310,011	1,543,878	371,658
Development services	6,674	13,356	11,531
Total cost of revenues	2,316,685	1,557,234	383,189
Gross profit	881,671	456,262	30,067
Operating expenses			
Research and development	464,700	231,976	273,978
Selling, general and administrative	603,660	285,569	150,372
Total operating expenses	1,068,360	517,545	424,350
Loss from operations	(186,689)	(61,283)	(394,283)
Interest income	1,126	189	288
Interest expense	(100,886)	(32,934)	(254)
Other income (expense), net	1,813	22,602	(1,828)
Loss before income taxes	(284,636)	(71,426)	(396,077)
Provision for income taxes	9,404	2,588	136
Net loss	(294,040)	(74,014)	(396,213)

Figure 2 Tesla Balance Sheet, in \$US Thousands

	2014	2013
Assets		
Current assets		
Cash and cash equivalents	\$1,905,713	\$ 845,889

	2014	2013
Restricted cash and marketable securities	17,947	3,012
Accounts receivable	226,604	49,109
Inventory	953,675	340,355
Prepaid expenses and other current assets	94,718	27,574
Total current assets	3,198,657	1,265,939
Operating lease vehicles, net	766,744	382,425
Property, plant and equipment, net	1,829,267	738,494
Restricted cash	11,374	6,435
Other assets	43,209	23,637
Total assets	\$5,849,251	\$2,416,930
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	\$ 777,946	\$303,969
Accrued liabilities	268,884	108,252
Deferred revenue	191,651	91,882
Capital lease obligations, current portion	9,532	7,722
Customer deposits	257,587	163,153
Convertible senior notes	601,566	182
Total current liabilities	2,107,166	675,160
Capital lease obligations, less current portion	12,267	12,855
Deferred revenue, less current portion	292,271	181,180
Convertible senior notes, less current portion	1,806,518	586,119
Resale value guarantee	487,879	236,299
Other long-term liabilities	173,244	58,197
Total liabilities	4,879,345	1,749,810

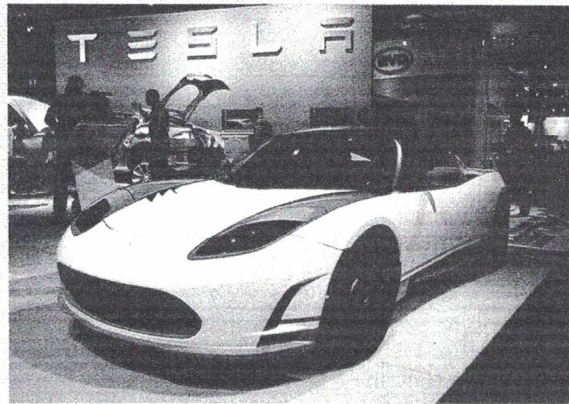
the same thing and produced a car called the tzero. The tzero could go from zero to 60 miles per hour in 4.1 seconds, but it was powered with extremely heavy lead-acid batteries, limiting its range to about 60 miles between charges. Eberhard approached Cocconi with the idea of using lighter, lithium ion batteries, which offered six times more energy per pound. Cocconi was eager to try out the idea (he had, in fact, been experimenting with lithium ion batteries), and the resulting lithium ion-powered tzero accelerated to 60 miles per hour in 3.6 seconds and could travel more than 300 miles. Eberhard licensed the electric-drive-train technology from AC Propulsion, and founded his company, Tesla Motors (named after Nikola Tesla, an early 20th-century inventor who developed, among other things, the AC electrical systems used in the United States today).²

Another entrepreneur—one with much deeper pockets—was also interested in developing electric vehicles based on the tzero: Elon Musk. In 2002, Musk was a 31-year-old South African living in California, who had founded a company that ultimately became PayPal. After selling PayPal to eBay in 2002 for \$1.5 billion, he started a company called SpaceX with the ambitious goal of developing cheap, consumer space travel. (SpaceX's Dragon spacecraft ultimately made history in May 2012 by becoming the first commercial vehicle to launch and dock at the International Space Station.³) Musk was also the chairman of a high-profile, clean-tech venture in Northern California, Solar City. Musk's assertive style and astonishing record of high-tech entrepreneurship made him one of the inspirations for the Tony Stark character in Jon Favreau's *Iron Man* movies.

Like Eberhard, Musk thought electric cars were the key to the U.S. achieving energy independence, and he approached Cocconi about buying the tzero. Tom Gage, who was then AC Propulsion's CEO, suggested that Musk collaborate with Eberhard. After a 2-hour meeting in February 2004, Musk agreed to fund Eberhard's plan with \$6.3 million. He would be the company's chairman; Eberhard would serve as CEO.

The first Tesla prototype, the Roadster, was based on the \$45,000 Lotus Elise, a fast, light sports car that seemed perfect for the creation of Eberhard and Musk's grand idea (see Figure 3a). The car would have 400 volts of electric potential, liquid-cooled, lithium ion batteries, and a series of silicon transistors that would give the car acceleration so powerful the driver

Figure 3a Tesla Roadster



would be pressed back against the seat.⁴ It would be nearly as fast as a Porsche 911 Turbo, would not create a single emission, and would get about 220 miles on a single charge from the kind of outlet you would use to power a washing machine.⁵

While the men at first worked well together, personality clashes soon emerged. Both were technically savvy and vigorously addressed problems within the company. As described by Laurie Yoler, Eberhard was "just brilliant, and he has this tenacity that is unbelievable ... He is the guy you want around in those early days when you have naysayers all around." However, Eberhard could also be abrasive and critical. Musk, in turn, was not content to just financially back the company. He began to get intimately involved in decisions about the car's design and the operation of the company. Soon Musk and Eberhard were at odds over decision making. Eberhard preferred to stick with the fiberglass body panels used in the original Elise; Musk wanted to use the lighter, stronger—and more expensive—carbon fiber. Eberhard had approved the hiring of PR professionals to build publicity for the car before its launch; Musk fired them, believing his own involvement and the car itself would generate enough publicity. Eberhard wanted to reap the cost savings of sticking with the Elise's original crash-tested, off-the-rack chassis; Musk wanted to lower the doorsills by two inches to make the car easier to enter and exit. Musk also wanted to redesign the headlights and door latches, and replace the Elise's seats with more comfortable—and again, more expensive—custom seats.⁶

In each case, Musk prevailed. He insisted that “you can’t sell a \$100,000 car that looks like crap.” Musk’s views were hard to ignore given that, by 2007, he had put \$55 million of his own money into the company and had also raised money from wealthy friends, including eBay’s second employee, Jeff Skoll, and Google founders Sergey Brin and Larry Page.

Musk’s insistence on the best materials and parts, however, combined with Eberhard’s inexperience as the manager of a major firm, resulted in delays and runaway costs. At a staff meeting in June 2007, Tom Colson, head of manufacturing, revealed a cost analysis suggesting that the average cost of the cars would be over \$100,000 for the first 50, and would decline only slightly with increased volume. Eberhard could not answer the financial questions of the venture capitalists on Tesla’s board, and their confidence in him was eroded even further by his defense: “In any other company it’s the CFO that provides those numbers ... I’m an engineer, not a finance guy.” In August 2007, the board removed him as CEO and demoted him to president of technology. Then, in October 2007, Musk arranged for Eberhard to be ousted from the company entirely. Furious, Eberhard started a blog detailing what he called the “Stealth Bloodbath” going on at Tesla, and he would later sue Musk for libel, slander, and breach of contract.⁷

Meanwhile, Eberhard’s temporary replacement was Michael Marks, former CEO of Flextronics. Marks immediately created a priority list that identified items with potential to delay the car. He mothballed any plans for side projects and focused the entire business on streamlining costs and launching the Roadster. Despite his efforts, the Roadster missed its deadline for beginning production at the Lotus facility, triggering a penalty built into the manufacturing contract Eberhard had signed with Lotus: a \$4-million fee.

By the beginning of 2008, morale was at an all-time low. In March, however, production began on the Roadster, and by July 2008, most of the production problems had been forgotten as the first seven Roadsters (the “Founder’s Series”) hit the road. Enthusiasm for the cars was astonishing—an all-star list of celebrities made reservations to buy one, and everywhere a Roadster appeared, people (albeit mostly men) stopped to stare.⁸

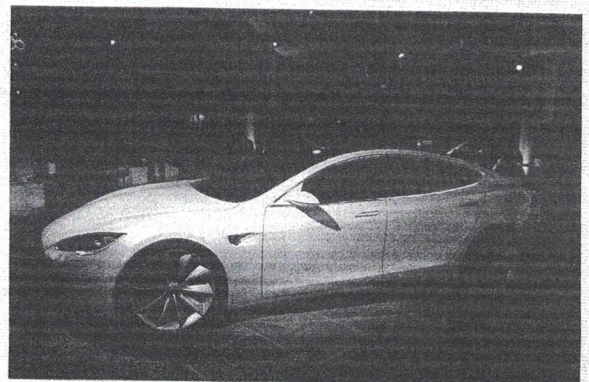
Musk’s ambitions did not stop at a niche high-end car, however. He wanted to build a major U.S. auto company—a feat that had not been successfully

accomplished since the 1920s. To do so, he knew he needed to introduce a less expensive car that could attract a higher volume of sales, if not quite the mass market. In June 2008, Tesla announced the Model S, a high-performance, all-electric sedan that would sell for a price ranging from \$57,400 to \$77,400 and compete against cars like the BMW 5-series (see Figure 3b). The car would have an all-aluminum body and a range of up to 300 miles per charge.⁹ The Model S cost \$500 million to develop; however, offsetting that cost was a \$465-million loan Tesla received from the U.S. government to build the car, part of the U.S. government’s initiative to promote the development of technologies that would help the United States achieve energy independence.

By May 2012, Tesla reported that it already had 10,000 reservations for customers hoping to buy the Model S, and Musk confidently claimed the company would soon be producing and selling 20,000 Model S cars per year. Musk also noted that after ramping up production, he expected to see “at least 10,000 units a year from demand in Europe and at least 5,000 in Asia.”¹⁰ The production of the Model S went more smoothly than that of the Roadster and, by June 2012, the first Model S cars rolled off the factory floor. The very first went to Jeff Skoll, eBay’s first president, and a major investor in Tesla. On the day of the launch, Skoll talked with Musk about whether it was harder to build a rocket or a car (referring to Musk’s SpaceX company): “We decided it was a car. There isn’t a lot of competition in space.”¹¹

To build the car, Tesla bought a recently closed automobile factory in Fremont, California, that had

Figure 3b Tesla Model S



been used for the New United Motor Manufacturing Inc. (NUMMI) venture between Toyota and General Motors. The factory, which was capable of producing 1,000 cars a week, was far bigger than Tesla's immediate needs and would give the company room to grow. Furthermore, though the plant and the land it was on had been appraised at around \$1 billion before NUMMI was shut down, Tesla was able to snap up the idled factory for \$42 million.¹² Tesla also used the factory to produce battery packs for Toyota's RAV4 and a charger for a subcompact Daimler AG electric vehicle. These projects would supplement Tesla's income while also helping it build scale and learning-curve efficiencies in its technologies.

In the first quarter of 2013, Tesla announced its first quarterly profit. The company had taken in \$562 million in revenues and reported an \$11.2-million profit. Then more good news came: The Model S had earned *Consumer Reports'* highest rating and had outsold similarly priced BMW and Mercedes models in the first quarter.¹³ In May 2013, the company raised \$1 billion by issuing new shares, and then surprised investors by announcing that it had paid back its government loan. After repaying the loan, Tesla had some \$679 million in cash. Musk had announced confidently that he felt it was his obligation to pay back taxpayer money as soon as possible, and that the company had sufficient funds now to develop its next generation of automobiles without the loan and without issuing further shares.¹⁴

By 2015, Tesla Motors was also in the process of developing a sport utility vehicle that seats seven, the Model X (see Figure 3c), which cost \$250 million to

develop and would be available in 2016.¹⁵ This SUV was part of Musk's longer-term ambition to tap a more mainstream market for the cars.

OBSTACLES TO THE ADOPTION OF ELECTRIC VEHICLES

A number of obstacles slowed the adoption of electric vehicles. The first was the price: Electric vehicles were, typically, significantly more expensive than comparable internal-combustion models. Complicating matters further, most consumers had a very difficult time estimating the cost of ownership of an electric car. How much would they pay to charge at home? How much would they pay to charge away from home? What would the maintenance and repairs of an electric vehicle cost? How long would the battery and/or car last? Would it have resale value? To lessen these concerns, Elon Musk set out to make the cost of owning a Tesla as certain as possible. First, he created a "Supercharger" network that Model S owners could use for free, for the life of the car. As noted by Musk, "The clearest way to convey the message that electric cars are actually better than gasoline cars is to say charging is free."¹⁶ The hitch was that a user had to be within range of a Supercharger station. Second, Musk announced an unprecedented price-protection guarantee that permitted a Model S owner to trade in their car for a designated residual value anytime within the first 3 years of the car's life. Musk also announced plans to offer free repairs, and a free replacement car while a customer's car was being repaired. Needless to say, analysts scratched their heads at the potential costs of these guarantees.

The second major obstacle to the adoption of electric vehicles was their limited range and associated "range anxiety" (concerns about driving in places where owners were not sure they would be able to charge their cars). These concerns were not so much of an issue for the Tesla cars due to their exceptionally long range. Other "mass-market" electric vehicles faced tougher hurdles. For example, though a Nissan Leaf could be charged at an ordinary, 110-volt household outlet, a full charge by this method could take 8 hours. Level 2 charging with a

Figure 3c Tesla Model X



Darren Brode/Shutterstock.com

220-volt outlet could shorten that time to 4 hours, but this was still completely impractical for recharging during a trip. DC Fast Chargers and Tesla's "Superchargers" promised to fully charge a vehicle in 30 minutes or less. While this is still significantly longer than the typical 6-minute gasoline fill-up, it meant that charging could be feasible if it were co-located with other services that drivers might appreciate, such as restaurants or coffee shops. DC Fast Chargers and Tesla's Supercharging stations were expensive to purchase and install—up to \$250,000 depending on the location—and they had to be close to heavy-duty electricity transformers. By May 2015, there were 425 Tesla Supercharger stations worldwide, with a total of 2,338 Superchargers.¹⁷

COMPETITION IN THE ELECTRIC VEHICLE MARKET

Hybrid electric vehicles (HEVs) such as the Toyota Prius made their appearance in the U.S. auto market in 2000. These vehicles were readily adopted by consumers because they require no change in typical consumer usage habits; they use gasoline and automatically switch between electric miles and gasoline miles. Most HEVs, however, have extremely limited electric range. For many, 10 miles of electric driving before switching over to gas is the norm. This limits their ability to reduce carbon emissions or influence energy usage. All-electric vehicles, also called plug-in electric vehicles, known alternatively as AEV or PEV, get all of their energy from electricity. They are thus considered true zero-emission vehicles. Plug-in hybrid electric vehicles (PHEVs) such as the Chevy Volt plug in to charge but can also use gas.

By 2015, a number of automakers were producing electric vehicles, in large part due to California's standards mandating that, for automobiles to be sold in California, a certain portion of an automaker's fleet had to be emission free. As a result, some automakers were willing to produce all-electric vehicles at a loss in order to also sell more lucrative internal-combustion models. These zero-emission mandates spurred a flurry of introductions of electric vehicles in the early

1990s. The subsequent downscaling of California's zero-emission mandate in the late 1990s led GM, Toyota, Honda, and Ford to shut down their loss-making EV programs, including most notoriously GM's EV-1s, which were literally torn from their owners and crushed, as shown in the film *Who Killed the Electric Car?* Other automakers opted to buy zero-emission credits from those companies that sold more than their required proportion of zero-emission vehicles. Other states had adopted similar programs, and at the federal level firms could earn greenhouse gas (GHG) emission credits by exceeding the U.S. Environmental Protection Agency's greenhouse gas standards. Tesla was one such automaker who had surplus credits (since it produced no internal combustion vehicles), and as a result Tesla earned \$40.1 million in 2012, \$194.4 million in 2013, and \$216.3 million in 2014 selling its surplus credits to other automakers.¹⁸

Several companies had attempted to enter the all-electric vehicle market, but had run out of cash and ceased operations. These included Fisker, Coda, Azure Dynamics, Bright Automotive, and others. The more serious competition was coming from established automakers that had deeper pockets to withstand the losses of building the electric vehicle market. Among these, there were a few competing cars that had sold significant (though still small) numbers of cars into the market. The Nissan Leaf, for example, retailed for about \$35,000, and had a range of about 90 to 100 miles per charge. By the end of 2014, it had sold 72,322 units in the United States and over 140,000 worldwide. The Chevy Volt was a plug-in hybrid that could travel about 40 all-electric miles per charge, and an additional 340 miles on gasoline (making it a good solution for individuals who primarily made short commutes but also wanted to drive the car long distances without "range anxiety"). It also retailed for about \$35,000, and, including its rebadged "Ampera" versions, it had sold over 88,000 of the cars worldwide by the end of 2014.

TESLA'S STRATEGIES

Automated Manufacturing

In 2015, nearly all of Tesla's manufacturing was done at its plant in Fremont, California, though

it had plans to build a manufacturing center in Tilburg, the Netherlands, where it had an assembly facility.¹⁹ Tesla's manufacturing process was highly automated, with extensive use of 8- to 10-foot-tall red robots, reminiscent of Iron Man. Each robot had a single, multijointed arm. While typical auto factory robots perform only one function, Tesla's robots perform up to four tasks: welding, riveting, bonding, and installing a component. Eight robots might work on a single car at each station of the assembling line in a choreographed pattern, like ballet. The robots produce up to 83 cars a day and can be reprogrammed to produce the Model X on the same assembly line.²⁰

Distribution

Musk saw the franchise-dealership arrangements that U.S. car companies use to sell cars as an expensive, margin-killing model. Furthermore, selling an electric vehicle is more complicated than selling an internal combustion vehicle. Because consumers are less familiar with electric vehicles, they required more explanation about the electricity costs, service issues, potential resale value issues, and more. Musk thus chose to sell direct to consumers with boutique-like stores in upscale shopping malls where salespeople could provide high-touch service and answer customer questions without using high-pressure sales tactics. The company also sold direct to consumers on the Internet.

Musk's decision to own and operate Tesla dealerships himself was a controversial move that provoked the ire of dealership networks. In the 1950s, regulation had been passed in the United States to protect dealers from exploitation by what were then very powerful auto manufacturers. This regulation prohibited auto manufacturers from competing with their own dealers by directly selling cars to consumers. The industry, however, had become increasingly competitive due to globalization, thereby lowering the power of auto manufacturers. Though most economic analysis suggested that the industry would be more efficient if the dealership restrictions were removed, the regulation remained largely unchallenged until Tesla's entry.²¹ Tesla was chipping away at them one by one. In 2015, there were still 28 states that banned direct sales, making it extremely difficult for Tesla to enter.

Marketing

Tesla spends no money on advertising, nor does it have any plans to hire advertising agencies or run ads in the future. Its in-house marketing team has only seven people on staff, and an internal team runs the website. Nissan, by contrast, spent \$25 million advertising the Leaf in 2012. According to Tesla spokesperson Alexis Georgeson, "Right now, the stores are our advertising. We're very confident we can sell 20,000-plus cars a year without paid advertising ... It may be something we'll do years down the road. But it's certainly not something we feel is crucial for sales right now."²²

LOOKING TO THE FUTURE

In 2014, Tesla announced it would be opening a "gigafactory"—a giant, lithium-ion battery factory—with its partner Panasonic. The factory, located in Nevada after the state offered \$1.1 billion in abatements, was slated to produce 500,000 lithium-ion battery packs per year by 2020.²³ That number exceeded total global production of lithium-ion batteries in 2014. Musk believed he could drive battery production costs down by as much as 30% at the factory, but many industry observers were puzzled by the move. If there were a major innovation in battery technology—advances in aluminum air batteries for example—the massive technological investment could be rendered obsolete.

In 2015, Tesla also introduced the "Powerwall"—a home energy-storage battery that would store electricity generated by solar panels during the day to then be used whenever needed by the consumer. Within a week of announcing the Powerwall, the company had orders for all of its production through 2016—roughly \$800 million worth of revenues.²⁴

Tesla's moves have been bold and risky, and its success thus far is inspiring. The company had survived its infancy, appeared to be solvent, and was meeting its sales objectives even though serious obstacles remained for electric vehicles. It was also competing against companies with far greater scale. As noted by O'Dell, a senior editor at auto information sites

Edmunds.com, on Tesla's success, "A lot of people have been very, very skeptical ... when you want to be an automaker, you are competing with multibillion-dollar conglomerates ... It's entrepreneurship on steroids ... They had a huge learning curve but they've powered through it." Theo O'Neill, an analyst at Wunderlich Securities, adds that "It's going to prove everybody in Detroit wrong ... They all say what Tesla is doing isn't possible."²⁵

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