A Financial Evaluation of the Acquisition of the Apple Valley Ranchos Water Company by The Town of Apple Valley Blue Ribbon Water Committee

Dated

December 12, 2011

By

The Finance Committee of the

Town of Apple Valley Blue Ribbon Water Committee

Committee Members

Ronald J. Barbieri, Ph.D., CPA, Chairman

Lawrence McCarthy

Joseph Tartaglini

Rob Turner

Table of Contents

A Financial Evaluation of the Acquisition of the Apple Valley Ranchos Water Company by

The Town of Apple Valley Blue Ribbon Water Committee

Executive Summary

Acquisition of the Water Company

The Finance Committee recommends that the Town not attempt to purchase Apple Valley Ranchos Water Company (AVR) through condemnation for the following reasons (in no particular order of importance):

1. The value of AVR set by the Court may be substantially more than the Town could fund through bond financing. In the present economic climate, The Town may not be able to raise $50 million or more through a General Obligation Bond or Specialty Tax Bond. The Bond Rating of the Town of Apple Valley along with many cities in California was reduced from A- to BBB+ in 2011.

2. The value established by the Court in a condemnation proceeding could greatly exceed AVR's real market value. The Town should not substantially overpay for AVR in any acquisition.

3. The value established by the Court could exceed a purchase price that would make economic sense to the ratepayers of AVR.

    A. AVR water rates could increase from present levels by an estimated 46% between now and 2019. This would add $206 to the average annual water bill of $448. Therefore, the increases in property taxes due to bond financing for the purchase of AVR should not exceed the expected 46% increase in the average water bill over the next 8 years. The BRWC thought it would be in the interest of the ratepayers to incur this level of higher property taxes in order to avoid any future increases in water rates.

    B. Given this limitation, (property tax increases should not exceed a 46% increase in the average water bill over 8 years): The maximum purchase price that could be funded by General Obligation Bonds is $90 million. The Maximum amount that could be funded by Specialty Tax Bonds is $60 million because of higher interest rates. This assumes the interest rates the Bartle Wells Report estimated (the financial markets would require for each financing option) proves to be accurate. The BRWC is concerned that the interest

rates would be substantially higher should the Town attempt such a large bond issue.

4. Both bond financing options would require a 2/3 vote of approval by the voters of the Town of Apple Valley. It would be extremely difficult to get 2/3 of the voters to approve the Town's acquisition of AVR, because other than the likelihood of substantial increases in water rates, there are no serious deficiencies in the delivery of water to the AVR ratepayers.

5. Certificates of Participation (COPs), a form of Revenue Financing, do not require voter approval in a general election, and do not count as indebtedness under the California constitutional debt limitations. Unfortunately, the Town would not be able to issue COPs to finance the purchase of AVR, because the Town-owned water company is expected to generate only approximately $554,000 of Cash Flow in 2012 provided the water rates are not increased from 2011 levels. For example, an $80 million COPs would require approximately $9.9 million per year to service the debt.

   The Bartle Wells Report concluded that there would be $6 million of Net Revenue available per year to service the bond debt. This is not correct. The Cash Flow that would be available to make the bond payments would be $5.5 million less than the Bartle Wells Report indicated.

6. If the Town of Apple Valley was not able to purchase the water company, either because it did not obtain voter approval, or because it could not obtain the bond financing, AVR and its owner, which would likely be the Carlyle Group, would sue the Town for damages. This could lead to a substantial award against the Town.

7. It would not be prudent for the Town in this economic environment to incur $5 million or more in legal and consulting fees for a hostile condemnation proceeding, when the Town's annual budget for 2011-2012 is only $25 million.

Ongoing Monitoring of AVR

The BRWC's fundamental concern is that the Carlyle Group through its Infrastructure Fund will purchase Park Water Company, and over time, place a substantial amount of debt either directly or indirectly on AVR for the following reasons (in no particular order of importance):

1. To the extent that the Carlyle Group over leverages the water company and pays the shareholders excessive returns, would result in substantially higher water bills compared to the present, and relative to adjacent city-owned water companies.

2. Moreover, it would likely lead to a lack of investment in system upgrades, thus inhibiting the responsible growth of the Town of Apple Valley relative to neighboring cities.

3. Accordingly, the Finance Committee recommended that the Town convince the CPUC to stipulate 12 conditions for its approval of the merger of Park Water Company and the Carlyle Group for two reasons: (1) to prevent AVR being over leveraged and (2) to require AVR to provide the Town with adequate financial information so that it can determine what AVR is doing.

   The Finance Committee recommends that the Town actively monitor the activities of AVR and its interactions with the CPUC to be aware of AVR's intentions relative to rate and fee increases. This would enable the Town to take steps to minimize the extent of AVR's Water Rate and Connection Fee increases. This would benefit the ratepayers after 2014 and curtail the increase in the market value of AVR.

Future Purchase of the Water Company

Later when the Town of Apple Valley is experiencing a sustained population growth and economic expansion, it could be advantageous for the Town to Purchase AVR for the following reasons (in no particular order of importance):

1. The Town would not have to pay Federal and State Income Taxes or Property Taxes to the County.

2. The Town should be able to reduce Senior Management and CPUC Expenses by an estimated $1 million per year.

3. The Town-owned water company would be able to charge Connection Fees, which could be used to fund the extension of the water system and investment in new pipes and equipment. This would reduce the ongoing pressure to increase water rates.

4. After 2019, if the Town were to own the water company, the average annual water bill, plus the average additional Property Tax Assessment, could be less than the typical water bill if AVR is owned by the Carlyle Group. In the years immediately after the acquisition by the Town, the typical ratepayer would pay more, because of the additional debt service on the bonds used to fund the acquisition.

5. The Section 5 of BRWC's Report on Public vs. Private ownership describes in detail the advantages and disadvantages of a Town owned water company.

6. The Carlyle Group has publicly indicated that it intends to sell AVR after 7 years. However, the CPUC specifies ownership will dissolve no later than September 28, 2021. The BRWC recommends that the Town consider purchasing AVR when it is available for sale. The BRWC further recommends negotiating a purchase price for AVR-- rather than taking over AVR by hostile condemnation proceedings. This would enable the Town to know the purchase price before it decides to proceed with the acquisition. The BRWC recommended that the CPUC include in its approval of the merger of Carlyle Group and the Park Water Company a condition that The Town be given a first right of refusal when the Carlyle Groups sells AVR in the future, however the CPUC declined.

Abstract of the Report

The following Abstract is intended to act as a bridge between the Executive Summary and the detailed Finance Committee Report in this BRWC Final Report (Addendum 10).

1. The Bartle Wells Report projected there would be $6,016,000 of Net Revenue generated by AVR in 2012 if it were purchased and managed by the Town of Apple Valley. The Finance Committee's analysis estimates the expected Cash Flow that would be realized in the first year after the acquisition to be closer to $554,000. There are several reasons why the Cash Flow of the Town-owned water company would be substantially less than estimated in the Bartle Wells Report.

    A. Actual billed Revenue is projected to be 22% or $4,286,000 less than the budgeted Revenue of $19,463,000 used in the Bartle Wells Report. This is because actual water usage by AVR ratepayers is projected to be 30% less than budgeted volumes. This negative impact on Cash Flow is partially offset by a $2,015,000 reduction in projected Operating Expenses due to the delivery of less water in 2012. Hence, the Town-owned water company is expected to realize a Net Income of only $2,580,000 compared to $5,316,000 estimated in the Bartle Wells Report.

    B. In 2012, AVR estimates that it would invest $3,700,000 for Plant and Equipment, because all of these types of investments are added to the rate base. The Bartle Wells Study assumed a capital investment program of only $2,000,000. The additional capital expenditures AVR projects would reduce the water company's annual Cash Flow by $1,700,000; however, this shortfall will be paid back to AVR in future rate increases.

    C. In 2012, AVR will be required to repay approximately $795,000 in Advances, which will also negatively impact the Water Company's Cash Flow. This could be partially offset by the collection of Supplemental Water Acquisition Fees and Facilities Supply Fees.

    D. The Town of Apple Valley would most likely be reimbursed by the Town-owned water company each year for the loss of $186,319 in Franchise Fees and $457,000 in Property Tax Revenue currently paid by AVR to the Town. To the extent the Town was not reimbursed, its General Fund Revenue would be reduced.

    E. Given these and a few other minor adjustments, The Town-owned water company would realize $554,000 in Cash Flow in its first year of operation.

2. AVR has generated Cash Flow through the collection of Supply Facilities Fees and the Supplemental Water Acquisition Fee. Part of the Supply Facilities Fee recovers the proportional cost of both existing and future capital assets such as water main extensions and the installation of new wells, required to serve the new connection. The second fee is called the Supplemental Water Acquisition Fee. It was established to fund AVR's pre-purchase of Replacement Water from MWA or to acquire water rights should such water rights become available.

    A. Since their inception, AVR collected $2,700,000 in a combination of Supply Facilities Fees and Supplemental Water Acquisition Fees. It purchased $2,650,000 in pre-purchase of Replacement Water from the Mojave Water Agency or water rights.

    B. In the current Rate Case AVR had proposed an increase in the Supply Facilities Fee from $800 to $900 per residential unit and an increase in the Supplemental Water Acquisition Fee from $3,500 to $5,000 per residential unit or residential equivalent unit. As of October 2011, the California Public Utilities Commission (CPUC) has not approved such increases.

    C. If in the second half of this decade the level of residential, commercial, and industrial construction approached half of the average annual volumes experienced in 2004 through 2006, AVR could collect $3,000,000 a year in such fees if the proposed higher AVR unit rates were approved by the CPUC.

3. If the Town of Apple Valley were to purchase AVR it could generate Additional Cash Flow through Connection of Fees from water company customers associated with new development projects.

    A. We strongly recommend the Town not rely upon Connection Fees to fund ongoing Operating Expenses or the debt service on bonds used to purchase AVR or any other water company. The amount of cash collected from Connection Fees depends upon the level of new construction. Hence, Cash Flow of the water company will fluctuate as new construction increases or decreases. During the years 2004 through 2006, developers on average pulled permits for approximately 1,000 single-family residential units in the Town. From 2010 through the first eight months of 2011, approximately 50 housing units were permitted each year.

    B. We think it is unlikely the construction of new housing units will increase in any meaningful number before 2016. Consequently, such fees will not be a significant source of funds from 2012

through 2015. Connection Fees are best used to fund capital expenditures for a water system when construction levels are high.

4. If the Town of Apple Valley were to purchase AVR, it would likely not have to raise water rates, because it is expected to experience a positive Cash Flow of $553,732 in 2012. There would however, have to be an increase in Property Taxes due to the issuance of General Obligation bonds, or Mello-Roos Bonds, in order to fund the purchase.

5. If the Park Water Company or the Infrastructure Fund of the Carlyle Group were to own AVR, it would likely receive rate increases over the next few years because of three factors.

    A. The first factor is the requirement to increase After Tax Net Income in order to compensate for increases in the AVR's Operating Costs and increases in AVR's Rate Base.

        i. In 2012, AVR's total Rate Base is projected to be approximately $40,500,000. The Deferred Debit Accounts are not included in the Rate Base, because they are not included in Plant and Equipment. In 2010, the CPUC determined the After Tax Annual Rate of Return that AVR must realize in 2012 through 2014 on its Rate Base would be 9.42%. Given a marginal Federal and State tax rate of approximately 40%, this is equivalent to a pre-tax Rate of Return of 15.70%.

        ii. As of October 21, 2011, 10-Year T-Bills are earning a pre-tax return of approximately 3.0%. The interest rate on a 30-year mortgage on a single family home is 4.2%. Again, this is a pre-tax return to the investor. The CPUC only allows AVR to earn an interest rate equal to the 90 day commercial paper rate on the balance in its the Deferred Debit Accounts. That rate was approximately 1% in November of 2004.

        iii. While a pre-tax rate of return of 15.7% would be extremely high if all the assets in the Rate Base were valued at current replacement cost; however a significant portion of the assets in AVR's plant and equipment were installed years ago. Their depreciated value is substantially below replacement costs. It is difficult to draw any conclusions regarding whether or not the Rate of Return is too high unless we have a reliable estimate of today's depreciated replacement costs. The fact that AVR's 2012 Cash Flow including Surcharges is about breakeven suggests the Rate of Return is not too high.

iv. A 15.7% Pre-Tax Rate of Return gives AVR an incentive to install new plant and equipment on which they can realize a high return for a low level of risk. This can benefit the Town of Apple Valley in that AVR has a built in economic incentive to invest in the extension of the Water System. On the other hand, the Town has to monitor AVR's investment program to ensure that they do not over invest and therefore raise the water rates more than is necessary.

v. The actual projected increase in Revenue due to increases over present water rates is 11.13% for the DRA recommended program and 14.49% for AVR's proposal in the Settlement Agreement. The CPUC approved rate will most likely be somewhere between the two.

B. The second factor that would generate pressure for high water rates would be the downward adjustment in projected water usage if the Town's actual water usage remains near current levels rather than rebounding to more "normal" levels. If the ratepayers' level of water usage remained approximately 22% below pro-forma levels, and AVR and DRA agreed to base the water rates on actual water usage, the water rates would have to increase by approximately 17%. It is highly unlikely there would be any increase in the water rates before 2015 due to lower assumptions as to water usage.

i. The combined rate increase for 2012, due to increases in Operating Costs and AVR's Rate Base, and the increase required to eliminate under-billing, would be approximately 30%.

ii. Representatives of Park Water Company would argue that the increase in rates to compensate for actual water usage being less than budgeted would be less, because the level of water usage is going to increase; so the shortfall will be less. Notwithstanding AVR's good intentions, we believe the combined water rate increase over present levels due to both factors would likely be in the order of 30%.

C. The third factor that contributes to an effective increase in water rates relates to the recapture of under-billed Revenue through Surcharges. The latter does not actually increase the water rates; but it does increase the amount billed to the ratepayers. From the ratepayers' perspective, Surcharges represent a temporary (30-month) rate increase.

i. An annual Surcharge to the AVR ratepayers is currently approximately about $2,100,000. It would be equivalent to an effective water rate increase of 13.51%. When the increase due to the Surcharge is combined with the regular water rate increases and the estimated increase in water rates required to compensate for the lower level of water usage, the estimated increase in the typical ratepayers water bill above 2011 levels would be about 43%.

ii. These preliminary estimates of the potential water rate increases do not include the usual cost-of-living increases of 2.5% per year that will also be incorporated into the water rates in 2013 and 2014.

iii. Surcharges are expected to begin to diminish within two and a half years after either water usage and/or water rates increase sufficiently to eliminate any under under-billing of Revenue. There is not likely to be any substantial reduction in the Surcharges billed to the ratepayers until after 2015.

iv. From the ratepayers prospective the best possible scenario after 2015 is that reductions in the Surcharges offset some of the increase in the actual water rates. While this may occur, for planning purposes the AVR ratepayers should anticipate a 40% to 50% increase from current rates after 2014.

6. Another significant source of Cash Flow to the water company is the collection of Supplemental Water Acquisition Fees and, to a lesser extent, the collection of Supply Facilities Fees. The collection of such fees is a nontaxable event.

A. After 2015, AVR could experience $3,000,000 in additional Cash Flow less the amount used to purchase water rights and/or to pre-purchase Replacement Water; or the amount invested in Plant and Equipment. Such Fees would add 19.30% to the average water bill; but it would only be borne by new construction. Existing ratepayers would not experience any increase in their water bill.

B. Towards the end of this decade, construction levels could reach 1,000 residential units per year. If the Supplemental Water Acquisition Fee were to remain at $5,000 per unit, it would generate an additional $3,000,000 in Cash Receipts.

C. It is also possible that, by the end of this decade, Supplemental Water Acquisition Fees could equal $10,000 per unit. If this were

the case, another $6,000,000 would be added to the annual Cash Receipts of the water company.

D. The Supplemental Water Acquisition Fees and to a lesser extent the Supply Facilities Fees could substantially increase the Cash Flow of AVR without increasing its Net Income, because these fees flow through the Balance Sheet rather than the Income Statement. It is critical for the Town to review AVR's current and future request for increases in such fees to monitor the amount of funds collected and AVR's use of these funds.

E. We are not suggesting that this would actually occur. What we are requesting is that procedures be put in place by the CPUC to preclude this from occurring unless there is a real economic need other than excessive returns desired by the owners of AVR.

F. In addition, the Town of Apple Valley should be given sufficient financial information by AVR each year so that the Town can ascertain that AVR is properly investing the funds derived from the Supplement Water Acquisition Fees and the Supply Facilities Fees and to ensure that such fees will not become excessive.

7. The BRWC's fundamental concern is that the Carlyle Group through its infrastructure Fund will purchase Park Water Company; and over time place a substantial amount of debt either directly or indirectly on AVR. To the extent, the Carlyle Group over-leverages the water company and pays the shareholders excessive returns it would result in substantially higher water bills as compared to the present and relative to adjacent cities that own water companies. Moreover, it would likely lead to a lack of investment in system upgrades, thus inhibiting the responsible growth of the Town of Apple Valley relative to neighboring cities. Accordingly, this report recommends a list of stipulations, aimed at preventing such a situation from arising, be incorporated into the resolution of the CPUC that approves the merger between the Park Water Company and the Carlyle Group's Infrastructure Investment Fund.

   A. One of the recommended stipulations is that AVR shall provide to the Town of Apple Valley a complete set of financial statements similar to the financial statements required of publicly owned industrial companies registered with the SEC. Such Financial Statements shall include a Balance Sheet, Income Statement, Source, and Use of Funds Statement in addition to supporting statements to the level of detail that would enable the Town of Apple Valley to verify that AVR is adhering to the recommended stipulations. Such financial statements shall be provided to the Town within 60 days after the end of AVR's fiscal year. This

financial information should also include a forecast for the current fiscal year.

B. Since the adoption of Proposition 218 by the voters of the State of California, it is now extremely difficult for a city to obtain approval from two thirds of the voters to purchase a water company. AVR has a monopoly to supply water. If the ratepayers and the Town were not satisfied, it would be almost impossible for the Town to purchase AVR. In this new world of post Proposition 218, it is more critical for the CPUC to protect the ratepayers and the Town who are stakeholders in the water company without any effective recourse to purchase the water company. For this reason, it is imperative that the CPUC require AVR to provide the Town with sufficient information so that it can monitor the activities of AVR.

8. The value that the court would place on AVR in an eminent domain (condemnation) proceeding could vary widely. Chris Schilling has indicated that the Park Water Company's attorneys will argue the assets of AVR are worth substantially more than $200 million dollars. Although this Finance Committee expresses no opinion regarding whether this approximately $200 million figure cited by Mr. Schilling is accurate, the Finance Committee has incorporated this figure throughout the remainder of this analysis in order to provide a worst-case scenario analysis. The Town's attorneys and experts would likely make the case that the assets of AVR are worth less than that sum. However, to be conservative, the Town should be prepared to accept a potential condemnation price of greater than $200 million even though an objective assessment of value might be much less.

9. In the Bartle Wells Study, the use of $121 million as the highest probable acquisition cost to the Town of Apple Valley and $48 million as the lowest probable acquisition cost is acceptable even though the actual award by the court could be higher or lower. Both values are only used to estimate the service debt associated with the various types of financing. This is a reasonable range for purposes of the feasibility study and adequate for the purposes of the Finance Committee.

10. The Finance Committee has not been able to reconcile the fact that AVR, which has experienced substantial negative Cash Flows since 2008 and will likely not generate a positive Cash Flow before Surcharges in 2012, could have a market value of $121 million or even $48 million. Such market values can only be justified if the buyer believes that it will be able to raise water rates, Supplemental Water Acquisition Fees, and Supply Facilities Fees Substantially in future years. If it is not able to convince the CPUC to approve such rates, the Carlyle Investment Group will not achieve its investment goals over the next several years.

11. The value that the court would place on AVR in an eminent domain (condemnation) proceeding could vary widely.

    A. Chris Schilling has indicated that the Park Water Company's attorneys will argue that the assets of AVR are worth several hundred million dollars. The Town's attorneys and experts would likely make the case that the assets of AVR are worth far less.

    B. To be conservative, the Town should be prepared to accept a condemnation price of greater than the $200 million figure cited by Mr. Schilling even though an objective assessment of value may be only a fraction of this figure.

    C. If the Town is not able to purchase AVR at the condemnation price, Park Water Company has said they would sue the Town for damages.

12. The Finance Committee is also concerned that The Town could end up substantially overpaying for the water company if it purchased the water company through the condemnation process. If the court set the value of AVR at the $200 million figure cited by Mr. Schilling the Town would be substantially over paying for the water company.

13. The transaction costs that are relevant are those associated with the acquisition of AVR through condemnation. The Park Water Company have made it clear that the Town will have to acquire AVR through a condemnation proceeding.

    A. Within the condemnation, proceedings there would most likely be two trials. The first trial would determine whether the Town had the "right to take" AVR from the Park Water Company. The Town would have to demonstrate to the court that there is a real benefit to the Town or the ratepayers to be able to condemn the water company. The court may not agree that the Town has the right to take AVR and the condemnation procedure would be terminated. Ultimately, the Town is likely to be able to establish that the acquisition of AVR's system is in the public benefit. However, there is always some risk that the Town may incur substantial cost preparing for the first trial and not be able to purchase AVR.

    B. If the court determines the Town has a right to take AVR from the Park Water Company or the Carlyle Group's Infrastructure Fund there would be a second trial to determine the purchase price.

C. The Bartle Wells Report estimated that the total transaction costs would be $4,248,000. This includes a cost allowance of $1,000,000 for fees paid to the Condemnation attorney and trial costs. Litigation costs usually exceed initial budgets. For planning purposes, the Finance Committee assumed the costs would be $2,000,000. Hence, the total transaction costs associated with the purchase of AVR would be budgeted at $5,248,000.

14. Bartle Wells Associates evaluated four major financing options that are available to the Town of Apple Valley for acquiring the AVR system. Financing would include funding the purchase of water facilities and land and the funding of transaction costs. The four methods of financing that Bartle Wells Associates investigated include:

- General Obligation Bonds
- Mello-Roos Community Facilities District (Special Tax) Bonds
- Assessment Bonds
- Revenue-Supported Borrowing

15. The following Table summarizes the annual estimated Debt Service payment required for each of the four financing options given the four assumed purchase prices for AVR that ranged from $48 million to $200 million. The General Obligation Bonds would require the lowest level of Debt Service. Special Tax Bonds are second. Certificates of Participations actually rank third. Their Debt Service payments appear to be less than Special Tax Bonds; however, it does not include the $10 million in additional reserves that were factored into the other financing options. The lease desirable from a cost prospective is Assessment Bonds. The annual debt service range from a low of $4.6 million for a General Obligation Bond associated with a $48 million purchase price, to high of $21 million for the use of Assessment Bonds to finance a $200 million acquisition. The Finance Committee has no opinion regarding whether the $200 million figure cited by Mr. Schilling is accurate, but the Finance Committee has used that number to provide a worst-case scenario and assure that this report's conclusions are conservative.

APPLE VALLEY RANCHOS WATER COMPANY
SUMMARY OF ANNUAL DEBT SERVICE BY FINANCING OPTION
November 14, 2011

	Stock Price Lower Est.	Medium Price Estimate	RCNLD High Estimate	Very High Price Estimate
AVR Purchase Price	$ 48,000,000	$ 80,000,000	$ 121,000,000	$ 200,000,000
Annual Debt Service - General Obligation Bonds	$ 4,622,160	$ 6,949,861	$ 9,932,228	$ 15,678,739
Annual Debt Service - Special Tax Bonds	$ 5,790,721	$ 8,672,275	$ 12,362,570	$ 19,467,840
Annual Debt Service - Assessment Bonds	$ 6,269,243	$ 9,374,388	$ 13,354,929	$ 21,023,545
Annual Debt Service - Certificates of Participation	$ 4,961,743	$ 7,927,145	$ 11,723,448	$ 19,038,386

16. The only two viable financing options that could be used to purchase AVR: General Obligation Bonds and Special Tax Bonds. The use of any form of Revenue financing such as COPs would necessitate a 37% increase in water rates (if the purchase price were $48 million) to 153% (in the case of a $200 million acquisition price). The substantial increase in water rates would be counter to the primary goal, which is eliminating increases in water rates.

17. Dividing the projected level of Billed Revenue in 2012 at current rates, estimated to be $15,540,237, by the number of Equivalent Meters, the average annual Revenue per meter would be $448 or $74.67 per meter every two months. This is close to AVR's Average bimonthly water bill of $71.05 that was presented to the BRWC.

    A. Water rates are expected to increase by approximately 18% by 2014 from present levels. This would increase the average household annual water bill by $81. In 2015, water rates will be increased by an additional 13% or $58 to adjust for the fact that actual water usage will continue to remain below budged levels over the next three years. The combined annual increase for probable increase would be $139.

    B. Our review of the economics of AVR also suggests water rates would increase an additional 15% during the period 2016 through 2019. This would add another $67 to the annual average water bill. By 2019, the average water bill is likely to increase by $206 or 46% from 2011 levels.

18. It may be in the economic interest of the ratepayers for the Town to purchase AVR if the price was less than $90 million. At that price, the annual debt service per Equivalent Meter would be less than the expected increase in the average ratepayer's water bill. A higher price may possibly be justified if consideration was given to the potential reduction in the water rates after 2020 due the collection of Connection Fees.

19. The use of a General Obligation Bond would result in all the property owners in the Town sharing in the cost to purchase AVR and fund any reserves that are included in the bond issue. As a consequence, the owners of vacant land within the incorporated area of the Town of Apple Valley would bear a portion of the cost for improving the water utility company. This is justified because it would increase the value of their land.

20. If Special Tax Bonds are used to finance the purchase, the annual debt service per equivalent meter ranged from $167 if the purchase price for

AVR was $48 million to $562 for a $200 million purchase price.

A. This suggests that the acquisition of AVR using the Special Tax Bond option would benefit a typical ratepayer so long as the purchase price did not exceed $60 million. If the purchase price exceeded that level, the average annual debt service per household would exceed the expected increase of $206 in the average water bill by 2019.

B. Again, a higher price may possibly be justified if consideration was given to the potential reduction in the water rates after 2020 due the collection of Connection Fees.

21. The use of a Special Tax Bond (e.g., Mello Roos) could require all the current landowners, not just the ratepayers, within the boundaries of AVR to bear the cost to purchase AVR. Additionally, the issuance of these bonds will require reserves for capital improvements for water infrastructure. Presently, the current owners of vacant land within the boundaries of AVR do not pay for any of the various costs to improve or maintain the water utility company. This gives those owners of vacant land a free ride until the property is developed.

Purpose

The purpose of this report is to summarize the findings and conclusions of the Finance Committee of the Town of Apple Valley Blue Ribbon Water Committee (BRWC). The Finance Committee reviewed and analyzed the Bartle Wells Report, financial information provided by AVR to the CPUC, financial information published every five years by AVR and Information contained in the September 2011 Settlement Agreement between the DRA of the CPUC and AVR. Committee members also had several conversations with Chris Schilling, the Co-CEO of the Park Water Company, the parent company of AVR as well as other members of the Water Company and Town Staff.

The primary question the Finance Committee had to address was whether the Town of Apple Valley should acquire the Apple Valley Ranchos Water Company. In the process the Finance Committee estimated the Net Cash Flow that would be generated by the Water Company in 2012 if were to be purchased by the Town of Apple Valley; in order to determine if Revenue based financing could be used to fund the purchase AVR. It also indicated the extent to which Water Rates would be expected to increase or decrease because of the Town of Apple Valley's acquisition of the AVR. An effort was also made to estimate probable and potential increases in Water Rates and specific types of Connection Fees that AVR is likely to get the CPUC to approve between now and 2019 if the Carlyle Group were to own AVR.

The findings of the Finance Committee were summarized above in the Executive Summary and the Abstract of the Report. The Report below contains a detailed discussion of the analyses that were used to arrive at the conclusions of the Finance Committee.

Organization

The Report begins with an analysis of the Revenue and Expenses of AVR in order to estimate the Cash Flow of the water company in 2012 if it were owned by the Town of Apple Valley. The analysis then estimates the probable and potential increase in the Water Rates over the next 8 years if the Town Owned the Water Company and if the Carlyle Group owned the Apple Valley Ranchos Water Company (AVR). This section of the report also explores the impact the recent decline in water usage would have on Water Rates, as well as the use of Connection type Fees to generate additional Cash Flow for AVR.

The first half of the Report concludes with a discussion of the general concerns of the Blue Ribbon Water Committee related to the acquisition of AVR by the Carlyle Group. This section also enumerates the Stipulated Conditions that the Finance Committee recommends be included the CPUC's resolution approving the merger of Park Water Company and the Carlyle Group's Infrastructure Fund.

The second half of the report investigates the facts and issues that determine whether the Town should attempt to purchase AVR through condemnation. It begins by discussing the range of values that may be awarded by the Court in a condemnation trial, followed by a description of the legal and consulting fees that are likely to be incurred by the Town in the acquisition of AVR. This is followed by a description of the four types of financing that could be used to fund the acquisition of the water company.

The Report then estimates the cost of financing associated with each of the four financing options given four possible acquisition prices. The estimated annual debt service cost for each financing option was then used to estimate the average annual increase in Property Taxes per household in the Town of Apple Valley. This increase was compared to the anticipated increase in AVR's Water Rates between 2011 and 2019. This was used to determine the maximum price the Town would be able pay for AVR given the assumption that the increase in Property Taxes could not exceed the expected increase in the Water Rates by 2019. The report concludes with a discussion of the various issues, which support the recommended courses of action.

Limitations of the Study

One limitations of this analysis is caused by the fact the BRWC and the Finance Committee never received a complete set of financial statements for AVR similar to what would have been submitted by a publically registered company with the SEC. In particular, the BRWC never received a Source and Use of Funds Statement for the last five years even though this was requested several times from AVR. In addition, there were no supporting schedules for any of the Balance Sheet Accounts including accounts such as Deferred Debits and Deferred Credits. The Finance Committee had to estimate the billed Revenue and actual Operating Expenses of the water company as well as the Cash Flow of the company based on the disjointed and incomplete information that was provided. In addition, the financial information that was provided was unaudited. The fact that the Department of Ratepayers Advocates' reviewed and partially tested the information provided by AVR to the CPUC provided some comfort as to its accuracy; however it is not the same as working with a complete set of audited financial statements. Nevertheless, the Finance Committee believes the estimates of AVR's Revenue, Operating Expenses and Cash Flow were accurate enough to support its conclusion.

Projected Cash Flow of the Water Company

Overview

In order to evaluate whether or not the Town of Apple Valley should acquire the Apple Valley Ranchos Water Company it is necessary to estimate the Net Cash Flow that would be generated by the water company, hereafter referred to as

AVR, if were to be purchased by the Town of Apple Valley. This is the necessary beginning point because it will determine if Revenue Bonds could be used to fund the purchase and the extent to which Water Rates would be expected to increase or decrease because of the Town of Apple Valley's acquisition of the AVR.

The Bartle Wells Associates submitted a final report to the Town of Apple Valley entitled "Update of Feasibility Analysis of Acquisition of the Apple Valley AVR System" in July 2011. It is included as Addendum 1. This report, which shall be referred to as the Bartle Wells Report, projected that there would be approximately $6,016,000 of Net Revenue generate by AVR in 2012 if it were purchased and managed by the Town of Apple Valley (The Town). An independent analysis and investigation by members of the Town of Apple Valley Blue Ribbon Water Committee (The BRWC) revealed that the actual Cash Flow expected to be realized in the first few years after the acquisition would be substantially less than the Net Revenue Figure projected in the Bartle Wells Report. The reasons for this are discussed in the following section of this report of the BRWC.

Operation of AVR under Town Ownership

If the Town were to successfully acquire AVR it would begin operation of a water enterprise. As noted in the Bartle Wells Report, an enterprise fund of The Town must be self-sufficient. It must cover all expenses including the cost of operations, debt service and capital expenditures with the Revenue it generates. It is the understanding of the BRWC that while this would be the case if Revenue-Supported Borrowing such as Public Enterprise Revenue Bonds or Financing Leases and Certificates of Participations were used to acquire the water company, it would not apply if General Obligation Bonds, Mello-Roos Community Facilities District Bonds or Assessment Bonds were employed in the acquisition of AVR. The debt service associated with the latter would be funded by direct assessment of all or some of the property owners in the Town of Apple Valley. The following section reviews both the sources of Revenue if the Town was to purchase AVR as well as projected expenses of operating the enterprise as a public rather than a private utility.

Sources of Revenue and Other Cash Receipts

If the Town owned AVR Bartle Wells Associates estimated there would be three sources of Cash Receipts for the water company: (1) Water Rates and Charges, (2) Connection Fees, (3) Advances and Property Tax Revenue. Each is discussed in the following sub-section of this Report.

Water Rates and Charges

The primary means of generating Revenue will continue to be through Water Rates and charges. AVR currently levies fixed plus variable rate Water Rates. All customers pay a fixed monthly charge for access to the system and then a unit charge for each hundred cubic feet (ccf) of water consumed. For the variable charge, AVR switched to an inclining block rate structure with three tiers of increasing Water Rates. This was approved in AVR's last General Rate Case that was reviewed by the CPUC in 2008.

There are two parts to the typical AVR bill, the Meter Service Charge and the Usage Charge. The Meter Service Charge recovers in part the fixed cost to the water company, including meter reading and billing expenses, that does not vary regardless of the level of the customer's water usage. The Bartle Wells Report anticipated that the Town of Apple Valley would continue with the three-tiered structure of AVR that utilized increasing Block rates in order to promote conservation. The Town could also incorporate other elements into its rate design, such as standby service or drought pricing. AVR also has a low-income affordability program. While the Town would have to determine whether or not to maintain this program if it acquired AVR, the adoption of the existing Meter Service Charge and Usage Charge is a reasonable assumption for purposes of the Feasibility Study. Consequently, the BRWC adopted the same assumption in its analysis of alternative courses of action.

For the 2012 year, Bartle Wells Associates forecasted a Reported Revenue of $19,483,000 for the AVR Company if it were purchased by the Town of Apple Valley. This represents a 5.1% increase over the actual Revenue booked by AVR in 2010. It appears the Bartle Wells Report assumed the budgeted volume of water consumed by the rate payers in the Town of Apple Valley would remain the same but the effect rate would increase by 5.1%, which is the rate increase initially recommend by the Division of Rate Payers Advocates of the California Public Utilities Commission (DRA-CPUC).

RANCHOS WATER COMPANY IF PURCHASED BY TOWN OF APPLE VALLEY
PROJECTED INCOME STATEMENT FOR YEAR 2012
November 5, 2011

		Bartle Wells 2012	DRA-Total at Present Rates 2012	Adjustments to Bartle Wells 2012	Adjusted Bartle Wells 2012
Revenue					
Total Operating Revenues (Book Basis)		$ 19,483,000	$ 19,923,381	$ -	$ 19,483,000
Less Additions to Deferred Debits	22%	0	(4,383,144)	(4,286,260)	(4,286,260)
Operating Revenues (Cash Basis)		$ 19,483,000	$ 15,540,237	$ (4,286,260)	$ 15,196,740

While this is not an unreasonable Revenue assumption, it does not take into consideration the fact that the $19,483,000 does not reflect the Revenue actually received from the customers of AVR. Rather it represents a budgeted amount

based on a normalized volume of water that the California Public Utility Commission (CPUC) adopts for the Rate Case and the approved Water Rates. Unfortunately, actual water usage in the last couple of years by the customers of AVR was approximately 70% of the normalized volume of water assumed by the CPUC. This was the case for fiscal year ending in 2010 and it has been the case for the first seven months of fiscal year 2011. Representatives of AVR have recently said that recent water usage is approximately 74% of the 2011 budgeted levels.

For the last few years, the ratepayers have been using substantially less water to compensate for rapidly increasing Water Rates and the economic decline in the High Desert. While some individuals and organizations, including the CPUC, believe the decline in water usage is temporary and expect the usage will rebound to the prerecession levels of 2007. Other believes there has been a paradigm shift in customers' attitudes about water consumption. Individuals in the latter camp think an increasing percentage of AVR's customers will continue to remove lawns, trees, and plants in order to reduce their water bills. For planning purposes the BRWC assumed the per household level of water consumption would continue to decrease in response to higher Water Rates; and the total volume of water delivered by AVR would remain at current levels for the next five years even though there may be some population growth in the Town of Apple Valley during that period.

The 30% decline in water consumptions has three major implications for this analysis. First, a 30% decrease in the volume delivered compared to the budgeted amount results is an estimated 22% decrease in the Revenue actually received by AVR. The decline in Revenue Receipts is less than the decline in water usage because a portion of the Revenue is fixed and does not vary with the volume of usage. According to representatives of AVR, the fixed monthly charge on average accounts for approximately 30% of the Total water bill while the variable charges constitute 70% of the total billings. This information was provided by Chris Shilling the Co-CEO of Park Water Company the parent of Apple Valley AVR Company. He has indicated on more than one occasion that over the last few years the Cash Receipts of the water company have been substantially less than the booked Revenue. For example, in fiscal year 2010 $18,546,000 was booked by AVR; but the BRWC estimated only $14,466,000 was actually received from the customers of AVR Company. The shortfall in Revenue was debited to Regulatory Accounts-Long Term or Short Term. The offsetting credit was to the Revenue account. This shortfall in Revenue is partially offset by a reduction in operating expenses due to delivery of less water. This is discussed later in this report. This reduction in actual expenses is credited to the Deferred Debit Accounts of AVR, which are also referred to as the WRAM/MCBA accounts.

As of November 30, 2010, the Regulatory Accounts-Long Term had a debit balance of $6,642,839 and the Regulatory Accounts-Short Term had a debit

balance of $1, 855,695. The combined balance in the two Deferred Debit accounts totaled $8,498,534. This is the cumulative amount of under-billed Revenue that has not been billed to the customers of AVR, because they have consumed less water over the last few years than was budgeted to be delivered by the CPUC. This balance in this account is reduced by the difference between budgeted and actual Operating Expenses because of the delivery of less water and the recapture of under-billed Revenue from prior years through Surcharges. This is the source of the three Surcharges that appear on the more recent AVR billing invoices.

Over time, the cumulative uncollected Revenue net of savings in operating costs recorded in the Deferred Debit accounts along with accrued interest will be billed to the customers of AVR. Surcharges are recaptured in the three years following the incurrence of a shortfall. The CPUC allows for 25% to be recaptured in months 7 through 12 after the year in which the shortfall occurred. Then 50% of the shortfall is recaptured in months 13 through 24 and the remaining 25% is captured in months 25 through 30. The CPUC allows AVR to accrue interest on the balances in the Deferred Debit Accounts at the same rate that is earned on 90 days commercial paper. In October of 2011, this interest rate was approximately 1%. AVR will recoup their under-billed Revenue within 30 months after the year in which a shortfall occurs; however, in the short and intermediate term AVR did not have the Cash Flow adequately to fund capital investments in infrastructure.

In 2012, Bartle Wells Associates estimated approximately $500,000 will be billed back to the customers of AVR. Discussions with Chris Schilling, Co-CEO of the Park Water Company revealed that AVR is recapturing the under-billed Revenue net of any savings in operating expenses at the rate of approximately $2,000,000 per years. A review of a couple of water bills revealed that the Surcharges were approximately 14% of the amount billed. When this percentage is multiplied by the estimated $15,000,000 of billed Revenue, it results in $2,100,000 of Surcharges currently being billed by the water company. This tends to confirm the level of Surcharges currently being billed by AVR.

If the actual water usage were to continue at 30% below budgeted volumes, the projected Revenue in 2012 actually received by AVR would only be $15,196,740. If the Town of Apple Valley did not purchase AVR, Park Water Company would receive $4,286,260 less Cash Revenue than projected for 2012 by Bartle Wells Associates. The amount recovered through Surcharges should be added to Cash Flow of the Water Company, but not to the Revenue because it has already been booked as Revenue. When surcharges are billed to the ratepayers, the Deferred Debit accounts are credited and Accounts Receivable Accounts are debited.

The second implication relates to the value of the assets of AVR in condemnation proceedings should the Town of Apple Valley attempt to acquire the water

company. Chris Schilling has made the point that should the Town of Apple Valley attempt to acquire AVR through Condemnation, Park Water Company would argue that it should be reimbursed for the balance in the two Deferred Debit Accounts, because they represent costs already incurred that the company is entitled to recover. By the end of 2012, the balance in the Deferred Debit accounts are expected to range between $8,000,000 and $10,000,000. This preliminary estimate is based on the sum of the $8,500,000 balance in the two Deferred Debit accounts and a $4,250,000 Revenue shortfall in both 2011 and 2012 offset by cost savings of approximately $2,000,000 per year and Surcharges of $2,000,000 in 2011. While the Town of Apple Valley's attorneys would certainly argue to the contrary in any condemnation litigation proceedings; and perhaps would prevail, The BRWC adopted the conservative position that the court may in fact increase the purchase price of Rancho Water by the amount of the Deferred Debit Account balances. Hence, the BRWC added $9,000,000 to the various condemnation prices for AVR in the Bartle Wells Associate feasibility study.

The third implication relates to the acquisition of AVR by the Town. If the Town owned the water company and the average level of water usage remained near the current level, then the Town of Apple Valley would have to substantially increase the Water Rates in order to receive Cash Receipts from Revenue of $19,483,000 in 2012 as projected by Bartle Wells Associates in its feasibility study. The significant of this will be discussed after the discussion on expenses and Cash Flow.

Connection Fees

Contrary to what the BRWC has been led to believe, AVR has generated Cash Flow through the equivalent of connection fee charges to new water company customers associated with new development projects. The first is the Supply Facilities Fees, which has two components. Part of the fee is calculated to reimburse the utility for the actual cost of the new connection, including the meter, as well as the cost required to connect the customer to the system and set up the customer account. The other portion of the fee recovers the proportional cost of both existing and future capital assets required to serve the new connection. This would include water main extensions and the installation of new wells. The second fee is called the Supplemental Water Acquisition Fee. It was established to fund AVR's pre-purchase of replacement water from MWA or to acquire water rights should such water rights become available. The CPUC viewed both Fees as appropriate modifications to Rule 15 – Main Extensions.

Both Fees were designed to replace a number of existing procedures acceptable to the CPUC that had been used to fund such AVR expenditures. The Supplemental Water Acquisition Fee was set at $3,000 per unit when the Resolution was adopted. Addendum 1I contains a copy of Resolution W-4655, the CPUC Resolution adopting the Supplemental Water Acquisition Fees; and

Memorandum of Understanding between AVR and Division of Ratepayer Advocates.

In the current Rate Case AVR had proposed an increase in the Supply Facilities Fee from $800 to $900 per residential unit and an increase in the Supplemental Water Acquisition Fee from $3,500 to $5,000 per residential unit or residential equivalent unit. As noted in Paragraph 11.02.3 of the Settlement Agreement dated September 15, 2011 the DRA has rejected both proposed increases. The Supply Facility Fee and the Supplemental Water Acquisition Fee increases are based on the increase in well construction and water acquisition costs respectively. The BRWC finds this disconcerting in that it appears to provide AVR with funds to acquire water rights and backbone level equipment without any obligation by AVR to actually, either purchase water rights or invest in such infrastructure equipment. Presently, AVR appears to be leasing all their supplemental water requirements on an annual basis, the cost of which is included in the determination of the Water Rates. Without the actual obligation to purchase water rights, the Supplemental Water Acquisition Fee could function as a connection fee, thereby generating additional Cash Receipts that are not classified as Revenue for AVR. Additionally there is no transparent accounting of yearly fees generated, either rights purchased or other independent AVR infrastructure investments on a yearly or cumulative basis since the inception of the Supplemental Water Acquisition Fees.

The Supplemental Water Acquisition Fees and to a lesser extent the Supply Facilities Fees could substantially increase the "Net" Cash Flow of the water company without increasing the "Net" Income of AVR because these fees flow through either the Advances for Construction Account or more likely the Advance Fees Account on the Balance Sheet.

At first, it was our understanding that AVR had been authorized to charge all new customers a Supplemental Water Acquisition Fee since 2004, which at a rate of $3,500 per unit would have resulted in between $10,000,000 to $14,000,000 being collected. Also at the time, we could not find any indication that AVR used the funds for Supplemental Water Acquisition Fees to purchase significant water rights or to invest in plant and equipment that was not treated as an addition to the Rate Base of AVR. Recent discussions with Chris Schilling and other representatives of AVR revealed that they actually collected $2,700,000 in a combination of Supply Facilities Fees and Supplemental Water Acquisition Fees and they purchased $2,650,000 in pre-purchase of replacement water from the Mojave Water Agency (MWA) or water rights. The BRWC has independently confirmed the purchase of $880,000 in water rights. The BRWC has no evidence that the balance of the $2,650,000 was not used to pre-purchase replacement water from the MWA. In fact, the BRWC has determined that the MWA has purchased Replacement Water from the MWA.

Representatives of AVR recently provided an explanation as to why substantially less was collected than we originally estimated. For one, the resolution authorizing the collection of Supplemental Water Acquisition Fee was adopted by the CPUC on August 23, 2007. Nevertheless, some advances were collected prior to the summer of 2007 under previous programs approved by the CPUC. This was after building boom, which actually occurred from 2003 through the first half of 2007. In fact at the time the resolution was adopted AVR had approximately $1,500,000 in unspent funds. The second reason is that the Supplement Water Acquisition Fees and the Supply Facilities Fees do not apply to all new construction. For example, homes in Jess Ranch do not apply and infill homes are not subject to such fees.

The Town's use of Water Connection Fees

The Bartle Wells Report indicates that if The Town of Apple Valley were to purchase AVR it could also generate Revenue through Connection of Fees for new water company customers associated with new development projects. As is the case for the previously discussed Supply Facilities Fees and Supplemental Water Acquisition Fees, such Connection Fees have two components. Part of the fee is calculated to reimburse the utility for the actual cost of the new connection, including the meter, as well as the cost required to connect the customer to the system and set up the customer account. The other portion of the fee recovers the proportional cost of both existing and future capital assets required to serve the new connection. In the Bartle Wells Report, it was noted that as a Private Water Utility Company, AVR is precluded by the California Public Utility Commission from charging Connection Fees. Therefore, AVR must fund capital improvements, such as the replacement of old water mains or the installation of the backbone water system either through income from operations or through Advances, which are described below. In the Opinion of Bartle Wells, the latter restriction puts a private water company such as RVA at significant disadvantage compared to a government owned Water Company when it comes to making capital investments in new infrastructure.

Connection Fees charged to new customers can be substantial. For example, the water connection fee is $6,687 for a new single family home in the City of Hesperia. In the City of Victorville, the water connection fee is $11,311. Currently, the Town of Apple Valley does not have any water connection fees; but AVR does charge an $800 Supply Facility Fee plus a $3,500 Supplemental Water Acquisition Fee. These water charges for new residential construction total $4,300, which AVR refunds to the builder at the rate of 2.5% per year without interest.

If the Town of Apple Valley were to acquire AVR and established a connection fee of $10,000 per unit, and a long-term average of 500 housing units were built each year, the total Revenue from such connection fees would be $5,000,000. It

would also be reasonable to charge proportional connection fees for commercial developments and industrial projects.

The BRWC strongly recommends that the Town not rely upon construction fees to fund ongoing operating expenses or the debt service on bonds to purchase AVR or any other water company. The amount of Revenue derived from connection fees depends upon the level of new construction. Hence, Revenue will fluctuate as new construction increases or decreases. While connection fees can be used to fund the installation of infrastructure, it does have some drawbacks. As a minimum it increases the cost to deliver housing units and therefore the price of new single family and multi-family residential units. Higher prices would also tend to reduce the level of construction in the Town of Apple Valley, which is already stagnant. However, the Town does not have to acquire AVR to have a means of generating Revenue from the development of real property. Another way would be for the Town to increase its Development Impact Fees to generate Revenue to fund water distribution infrastructure.

However, higher Development Impact Fees would also reduce the value of raw land in the Town of Apple Valley. It should also be noted that the Town could increase its Development Impact Fees to generate Revenue to fund infrastructure related to water distribution. The Town does not have to acquire the water company to have a means of generating Revenue from the development of real property. It should be noted that higher Development Impact Fees have to be funded through higher home prices for residential units, which would have the same drawbacks as Connection Fees. Higher water Connection Fees and Development Impact Fees would also tend to reduce the value of raw land in the Town of Apple Valley, because of lower land residual values and land absorption rates.

We strongly recommend that the Town not rely upon connection fees to fund ongoing operating expenses or the debt service on bonds used to purchase AVR or any other water company. The amount of Revenue derived from connection fees depends upon the level of new construction. Hence, Revenue will fluctuate as new construction increases or decreases. During 2005 and 2006, developers pulled permits for approximately 1,000 single-family residential units in the Town.

From 2010 through the first eight months of 2011, less than five (5) housing units were permitted each year. We think it is prudent to assume the construction of new housing units will not increase in any meaningful number before 2015 or even 2020. Construction fees are best used to fund capital expenditures for a water system when construction levels are high.

Advances

Bartle Wells Associates describes how advances are another method that a utility can use to recover the costs associated with building new capital facilities

and infrastructure to extend new services to additional customers. Developers advance the utility the funds necessary to build new facilities such as distribution mains and the utility repays those advances over a period of up to forty years. No interest is earned on the developer's advance. If the advance were for forty years, the annual repayment amount would be 2.5% of the amount advances. The discounted value of such a payment stream is typically between 20% and 25% of the amount of the advance, which is the reason developers are reluctant to advance large amounts to the value of their project.

According to the Bartle Wells Report AVR would repay $795,000 on those advances in 2012. That amount represent a cash disbursement that should be deducted from the projected 2012 Net Revenue estimated by Bartle Wells Associates in order to determine the Net Cash Flow of the water company if it were acquired by the Town. Advances cannot be used to fund negative Cash Flows from operations nor can they be used to fund debt payments. In addition, Advances are not included in the Rate Base of the utility until they are repaid. Hence, the Rate Base of AVR will be increased in 2012 by the amount of the Advances that are repaid in that year.

Contributions

The utility can also generate Revenue through in-kind contributions of infrastructure. In this arrangement, a developer will typically agree to build the necessary water facilities to connect a new development to existing facilities at his own expense. Unlike an advance, contributions are not repaid. As of November 30, 2010, AVR had a balance of $2,080,407 in its Contributions in Aid of Construction account. Contributions are not included in the Rate Base of the utility. Contributions cannot be used to fund shortfalls in operations or to service bond debt associated with the acquisition of AVR.

Taxes

Under public ownership, the water utility would be eligible to receive tax Revenue to support its activities. Should the Town choose to finance this acquisition with General Obligation or Mello-Roos special tax bonds, it could also generate Revenues to meet debt service from a Property Tax or a Special Tax.

Revenue and Expenses

The Table Below contains three projected Income Statements for AVR. One reflects the Revenue and Expenses projected in the Bartle Wells Report. The second set of Revenue and Expenses reflects the DRA's and AVR is agreed to levels of expenditures in the September 13, 2011 Settlement Agreement submitted to California Public Utilities Commission (CPUC). In the few situations where they do not agree the Division of Ratepayers Advocates' (DRA's) recommended level of expenditures was used because it was typically the lesser

amount. In the Settle Agreement the total expenditures recommended by the DRA is approximately $560,000 less than the total expenditures requested by AVR. The Total Expenditures recommended by the DRA was approximately $13,762,000. The third set of Revenue and Expenditure projections is titled: "Adjusted Bartle Wells 2012". It reflects the BRWC's estimate of what Revenue and Expenses would be for AVR in 2012 if it were purchased by the Town of Apple Valley.

The Bartle Wells Revenue Projections of $19,483,000 for 2012 is the actual booked Revenue for AVR in fiscal year 2010 increased by 5.1%, which was the DRA's preliminary recommend increase to the Water Rates for 2012. This projection assumes that the level of water usage would remain the same across all categories of ratepayers. The DRA Total Project Revenue for 2011 at present Water Rates is $19,923,381. It is the same as the Revenue estimate agreed to by AVR in the Settlement Agreement. Presumably, this reflects the rate increase previously approved by the CPUC for 2011 and the mutually agreed to level of water usage in the Settlement Agreement. AVR have been making the case that the expected water usage for the years 2012, 2013 and 2014 should be substantially lower than the level estimated by the DRA. Chris Shilling, the Co-CEO of Park Water Company has indicated that water usage in fiscal year 2010 and the first seven months of fiscal year volume is down approximately 30% from 2008 and sales Revenue is running approximately 22% below pre-recession levels. It is likely that the actual level of water usage will be substantially less than what has been agreed to in the Settlement Agreement. Hence, actual Revenue on a cash basis will be substantially less than the pro forma recorded Revenue in AVR's financial statements. We are assuming that approximately 22% of the recorded Revenue will be debited to the Deferred Debits Accounts. Consequently, the projected Revenue on a cash basis was reduced by 22%.

This is reflected in the Table below.

The following Table depicts the projected Revenue for 2012 based on the DRA's proposed rate increase of 11.44% to be $22,140,000. If the CPUC approves the 14.83% rate increase proposed by AVR then the projected booked Revenue would be $22,810,000. It appears the CPUC will approve a rate increase between 11.44% and 14.83%.

For purposes of this analysis, it was assumed that Bartle Wells' recorded Revenue was the best estimate. It was also assumed that 22% of that projected Revenue would not be billed to customers because the actual level of water usage would be 30% less than projected for 2012. As a result, the projected Cash Receipts from Revenue would only be $15,196,740. The difference of $4,286,260 would be debited to a Deferred Debit Account and billed to the ratepayers in the subsequent three years.

RANCHOS WATER COMPANY IF PURCHASED BY TOWN OF APPLE VALLEY
PROJECTED INCOME STATEMENT FOR YEAR 2012
November 5, 2011

		Bartle Wells 2012	DRA-Total at Present Rates 2012	Adjustments to Bartle Wells 2012	Adjusted Bartle Wells 2012
Revenue					
Total Operating Revenues (Book Basis)		$ 19,483,000	$ 19,923,381	$ -	$ 19,483,000
Less Additions to Deferred Debits	22%	0	(4,383,144)	(4,286,260)	(4,286,260)
Operating Revenues (Cash Basis)		$ 19,483,000	$ 15,540,237	$ (4,286,260)	$ 15,196,740
Expenses					
Operating Expenses-AVR System					
Operations		$ 726,000	$ 919,362	$ 193,362	$ 919,362
Production					
Purchased Power		1,042,000	1,015,214	(26,786)	1,015,214
Replenishment Charges		234,000	233,401	(599)	233,401
Leased Water Rights		1,664,000	1,621,006	(42,994)	1,621,006
Chemicals		27,000	27,312	312	27,312
Customer Accounts		1,033,000	882,993	(150,007)	882,993
Uncollectables		65,000	66,872	1,872	66,872
Maintenance		1,185,000	1,106,871	(78,129)	1,106,871
Clearings		399,000	661,309	262,309	661,309
Total Operating Expenses-AVR		$ 6,375,000	$ 6,534,340	$ 159,340	$ 6,534,340
General and Admin. Expenses					
Payroll and Office Expenses		$ 1,434,000	$ 1,537,199	$ 103,199	$ 1,537,199
Insurance, Injuries and Damages		785,000	743,295	(41,705)	743,295
Employee Benefits		1,480,000	1,276,632	(203,368)	1,276,632
Regulatory Expenses		93,000	98,468	5,468	98,468
Outside Services		274,000	264,872	(9,128)	264,872
Rents		17,000	17,564	564	17,564
Franchise Requirements			186,319	0	0
A&G Other			269,826	0	0
General Office Allocation (Park Water Co.)			2,008,202	0	0
AVR Allocation			0	0	0
Property Taxes		0	357,770	0	0
Payroll Taxes		0	337,591	337,591	337,591
Town Overhead (General Fund Transfer)		1,009,000		0	1,009,000
Total General and Admin. Expenses		$ 5,092,000	$ 7,227,328	$ 192,621	$ 5,284,621
Total Operating Expenses per Budget		$ 11,467,000	$ 13,761,668	$ 351,961	$ 11,818,961
Less: Reduction in Operating Expenses Due to Under-Billed Revenue (47% of 22% Reduction in Revenue)			$ (2,060,078)	(2,014,542)	$ (2,014,542)
Total Operating Expenses Actual		$ 11,467,000	$ 11,701,590	(1,662,581)	$ 9,804,419
Net Operating Income Before Depreciation and Income Taxes		$ 8,016,000	$ 3,838,647	(2,623,679)	$ 5,392,321
Less: Depreciation		(2,700,000)	(2,812,527)	(112,527)	(2,812,527)
Net Income Before Income Taxes		5,316,000	1,026,120	(2,736,206)	2,579,794
Less: Income Taxes					
CA Income Tax		0	(176,618)	0	0
Federal Income Taxes		0	(529,258)	0	0
Net Income After Taxes		$ 5,316,000	$ 220,244	$ (2,736,206)	$ 2,579,794

Costs and Other Expenditures under Public Ownership

The operating cost for a publicly owned utility will differ from those incurred by a private utility. The publicly owned water utility would not pay income taxes or property taxes; nor would it be required to generate a profit. On the other hand, the expenses for operations and maintenance as well as administrative and general expenses would be similar. This section described each of the operating expenses and capital expenditures associated with a publically owned water company with the goal of determining a budget for the expenditures of AVR if it were acquired by the Town of Apple Valley.

Personnel

The Bartle Wells Report assumed the Town owned water utility company would continue to employ all employees from AVR that work in the Apple Valley facilities with the exception of Mr. Wheeler. The employees would staff the necessary administrative, billing, and operations positions within the Town owned utility. Some members on the BRWC were of the opinion that additional savings could be achieved through the implementation of more efficient procedures and salary and wage reductions. Other members were concerned that as governmental employees their compensation would increase from current levels. For purposes of this analysis, the Bartle Wells personnel assumptions were adopted as a reasonable estimate of such costs in 2012.

Operations and Maintenance

The Town's water utility would incur expenses related to the operation and maintenance of the water system. Major expenses in this category include funding for payroll, repairs of equipment, and maintenance of infrastructure. The utility would also incur expenses for purchasing power to run pumps, and leasing water to meet demand in excess of its free pumping allowance. To the extent that prices for commodities like power and water vary each year, the utility could face significant uncertainty in these expenses. Bartle Wells Associates assumed that under public ownership, the operations and maintenance costs would be reduced by $259,147, which is the portion of Mr. Wheeler's salary that is booked as a utility expense; but all other O&M expenses would be similar to what AVR now incurs.

The Bartle Wells Report estimated the 2012 expenses for Operations and Maintenance would total $6,375,000. This was based on the preliminary CPUC-DRA's cost estimates. In the September 15, 2011 Settlement Agreement, the DRA estimates the 2012 operating expenses for 2012 would be $6,534,340. It is our understanding that this does not include an allowance for Mr. Wheeler's salary. The Park Water Company estimates that AVR's Operational and Maintenance expenses would be $6,645,975 at current Water Rates. For purposes of this analysis, the BRWC assumed the Operational and Maintenance

costs would be $6,534,340 in 2012, which is the latest estimate by the CPUC-DRA.

Administrative and General

The Town's water enterprise would also face expenses to cover administrative and general expenses of the utility, such as costs associated with rent for office space, the cost of office supplies, and periodic use of outside services such as accountants and engineers. Bartle Wells Associates assumed that payroll, office expenses, and employee benefits would be the same under public ownership with the exception of Mr. Wheeler's salary. Bartle Wells assumed that under public ownership, payroll would be reduced by $297,665, which is the portion of Mr. Wheeler's salary that is booked as a nonutility expense.

Bartle Wells estimated the General and Administrative Expenses if the Town owned Water Company to be $5,092,000. This is reflected in the Table above. While under public ownership there would not be any corporate overhead, there would be Town overhead. Bartle Wells Associates believes a certain portion of the Town's general overhead would likely be allocated as a cost to the utility.

This would cover the proportion of the Town's facilities and personnel that support the utility. This would include the time spent by the Town Manager and Town Counsel in support of the utility, in addition to any general support provided by other members of the Town staff. This analysis assumes the Town of Apple Valley would allocate $1,009,000 of the Town's Overhead to the water utility company in 2012, which is the amount estimated by Bartle Wells Associates. This is approximately half of the General Office Allocation from Park Water Company to AVR in the DRA's preliminary cost estimate.

In the Settlement Agreement, the DRA is willing to accept General and Administrative expenses of $7,227,328 for AVR. The Park Water Company estimates the General and Administrative expenses will be $7,719,630 in 2012. Several of the Expenses included in the DRA and Park Water Company estimates would not be applicable if the water company was owned by the Town of Apple Valley. Specifically the Water Company would not pay any Franchise Fees to the Town of Apple Valley. The A & G Other expenses would be reduced to zero. The $2,038,292 General Office Allocation from Park Water Company would be replaced by a $1,009,000 allocation of the Town's overhead. There would be no property taxes. When these adjustments are factored in, the estimated General and Administrative Expenses for the Town's water company would be $5,284,621. This is $192,621 higher than the estimate by Bartle Wells Associates in their feasibility study. The BRWC estimated the Total Operating Expenses of AVR if it were owned by the Water Company for the year 2012 would be $11,818,961. This is $351,961 higher than the $11,567,000 estimated by Bartle Wells.

Adjustment for Difference Between Budgeted and Actual Water Usage

Recent discussions with Chris Shillings and other senior representatives of AVR revealed that the firms Operating Expenses would decline with the decrease in the level of water usage. They reported that the decline in water usage compared to budgeted volumes would result in a reduction of operating costs equal to approximately 47% of the amount of under-billed Revenue. In the case of the Adjusted Bartle Wells 2012 scenario, the under-billed Revenue was estimated to be $4,286,260. Multiplying this amount by 47% resulted in a reduction of total operating costs by $2,014,542 to account for a 30% in the difference in the volume of water expected to be delivered to the ratepayers of AVR and the budgeted Levels. When this amount is deducted from the Total Operating Expenses projected if the total budgeted volume of water were delivered, it results in actual operating expenses of $9,804,419. This reduction in Operating Expenses compared to budgeted levels will partially offset the amount of under-billed Revenue that is expected to be added the Deferred Debit accounts. As a result the Deferred Debit Accounts are only expected to increase by $2,271,718 in 2012. This would be further reduced by any Surcharges that are billed.

Net Income After Depreciation and Taxes

In that study, Bartle Wells projected the Net Operating Income before Depreciation and Income Taxes to be $8,016,000, which is $2,623,679 more than the BRWC's estimate of $5,392,321. Most of the difference is due to the fact the actual cash Revenue that is expected to be billed is $4,286,260 less than the budgeted Revenue because the level of water actually delivered to the customers is expected to be 30% less than level approved by the CPUC-DRA. This is partially offset by the related savings in operating expenses. The Bartle Wells Report assumed the depreciation expense for AVR would be $2,700,000. The BRWC used the DRA's depreciation estimate in the Settlement Agreement, which was $2,812,527. When this amount is deducted from the Net Operating Income before Depreciation and Income Taxes, it results in a Net Income before Taxes of $2,579,794. Because there would not be any State or Federal Income taxes if the Town of Apple Valley owned the water company, the Net Income after Taxes on a cash basis would also be the same. This compares to the Bartle Wells Estimate of $5,316,000. The latter reflects a pro-forma Revenue rather than the amount actually billed to the Rate Payers.

Cash Flow of the Water Company

The financial analysis performed by the BRWC focused on estimating the Cash Flow that would be generated by the Town owned Water Company in 2012 in order to determine the amount of cash that would be available in 2012 to service the debt if Revenue supported borrowing options are employed by the Town to purchase AVR. The Bartle Wells Report estimated there would be $6,016,000 of

Net Revenue generated by AVR if it was owned by the Town. This was arrived at by adding the depreciation expense of $2,700,000 to the After Tax Income of $5,316,000 and deducting $2,000,000 in Capital Expenditures for the maintenance of the plant and equipment. The BRWC believes a Town owned Water Company would actually have a positive Cash Flow of ($1,692,321). This was derived by adding back the depreciation expense of $2,812,527 to the previously estimated After Tax Income of $2,579,794 and deducting $3,700,000 in Capital Expenditures for Plant and Equipment, which is the level of expenditures that was recommended by the DRA of the CPUC. The BRWC believes actual capital expenditures could equal or exceed the DRA's recommended level.

RANCHOS WATER COMPANY IF PURCHASED BY TOWN OF APPLE VALLEY
PROJECTED CASH FLOW FOR YEAR 2012
November 5, 2011

	Bartle Wells 2012	DRA-Total at Present Rates 2012	Adjustments to Bartle Wells 2012	Adjusted Bartle Wells 2012
After Tax Income	$ 5,316,000	$ 220,244	$ (2,736,206)	$ 2,579,794
Add: Depreciation Expense	2,700,000	2,812,527	112,527	2,812,527
Less: Capital Expenditures	(2,000,000)	(3,697,851)	(1,700,000)	(3,700,000)
Net Revenue (Bartle Wells Definition)	$ 6,016,000	$ (665,080)	$ (4,323,679)	$ 1,592,321
After Tax Cash Flow before Other Cash Flow Adjustments (Defined by Bartle Wells as "Net Revenue"	$ 6,016,000	$ (665,080)	$ (4,323,679)	$ 1,592,321
Other Cash Flow Adjustments				
Repayment of Advances	0	(795,000)	(795,000)	(795,000)
Cash Flow from Supplemental Water Acquistion Fees and Supply Facilities Fees				300,000
Additional Revenue from Recovery of Unbilled Revenue in Accrued Debits		2,100,000	0	0
Net Cash Flow of Water Company	$ 6,016,000	$ 639,920	$ (4,818,679)	$ 1,197,321
Less: Loss of Franchise Fees to Town	(192,000)	(186,319)	5,581	(186,319)
Less: Loss Property Tax Revenue	(425,000)	(457,270)	(32,270)	(457,270)
Net Cash Flow to the Town of Apple Valley Before Debt Service	$ 5,399,000	$ (3,569)	$ (4,845,268)	$ 553,732

There are other items that have to be taken into consideration in order to determine the annual Cash Flow of the Town owned Water Company. The Bartle Wells Report mentions that, in 2012, AVR will have to reimburse third parties for previously received Advanced Fees and Other Deferred Credits in the amount of $795,000. This would be a cash disbursement that is not reflected in the estimated Operating Expenses; so it must be deducted from the Cash Flow of the Water Company. This is a required payment on the equivalent of a non-interest bearing loan.

The collection of Supply Facilities Fees and Supplement Water Acquisition Fees would add an estimated $300,000 to the Cash Flow of the Water Company in 2012. This assumes that the Town of Apple Valley would continue to charge the same fees as the amount currently approved by the CPUC. This would not represent a very large addition to the Cash Flow of the Water Company in 2012,

because there will be little in the way of new construction in that year. However, as previously noted in this report this could become a significant addition to Cash Flow towards the end of this decade.

Finally, AVR has been authorized by the CPUC-DRA to invoice the ratepayers at an estimated $2,100,000 for under-collected Revenue net of Operating Expense savings in Years 2008 through 2010. This will be billed as a surcharge to the individual ratepayers. There is a question as to whether or not the Town of Apple Valley would actually attempt to recover such unbilled Revenue of the AVR ratepayers. For purposes of determining the Cash Flow that would be available to service the debt associated with the purchase of AVR it was assumed that the Town would not proceed to bill such Surcharges, because to do so would only increase the water bill to the ratepayers.

When the above adjustment are made the 2012 Net Revenue of the Town owned Water Company, the projected Cash Flow is $1,197,321. The Bartle Wells Report estimated Net Revenue, which it treated as cash available to service debt, to be $6,016,000.

In 2012, the Town of Apple Valley is expected to collect $186,319 from AVR in the form of Franchise Fees, and $457,270 in Property Taxes. This is based on the DRA estimate negotiated in the Settlement Agreement. The amounts are similar to Bartle Wells estimates in its feasibility study. If the Town were to purchase AVR, it will forgo approximately $644,000 in Revenue. Should the Town decide to recoup this lost Revenue by an additional charge to the water company it would further reduce the Cash Flow of the Town Owned Water Company. Under this scenario, the Town owned Water Company would experience a Cash Flow of only $553,732 in 2012, which is $4,845,268 less than the $5,399,000 Cash Flow under the Bartle Wells projections.

Cash Flow of AVR in 2012 at Present Water Rates

The projected After Tax Income of AVR in 2012 based on present Water Rates is only $220,244; and the After Tax Cash Flow of AVR when the $2,100,000 Surcharges are included is slightly negative at ($3,669). This is consistent with statements made by the management of AVR. The water company needs a substantial increase in Water Rates in order to generate the mandated return of 9.42% on the water company's Rate Base and realize a Cash Flow consistent with its investment. This is discussed below.

Conclusions Regarding AVR's Expected Revenue and Cash Flow

Bartle Wells Report, projected there would be approximately $6,016,000 of Net Revenue generate by AVR in 2012 if it were purchased and managed by the Town of Apple Valley. This analysis estimates the expected Cash Flow that would be realized in the first year after the acquisition to be closer to $554,000.

There are several reasons why the Cash Flow of the Water Company would be substantially less than estimated in the Bartle Wells Report. The first reason is that actual billed Revenue is projected to be approximately 22% or $4,286,000 less than the budgeted Revenue of $19,463,000 used in the by Bartle Wells Report. This reduction in projected Revenue is caused by the fact that actual water usage by the AVR ratepayers is projected to be 30% less than budgeted volumes. This negative impact on Cash Flow is partially offset by a $2,015,000 reduction in projected Operating Expenses due to the delivery of less water in 2012. As a result, the Town-owned Water Company is expected to realize a Net Income of $2,580,000 compared to $5,316,000 estimated in the Bartle Wells Report.

The second reason for the lower Cash Flow is that $3,700,000 would be invested by the Town in Plant and Equipment. The Bartle Wells Study assumed a capital investment program in 2012 of only $2,000,000. This would further reduce Water Company's annual Cash Flow by $1,700,000. The third reason is that the Town would be required to repay approximately $795,000 in Advances, which would also negatively impact the Water Company's Cash Flow. This would be partially mitigated by an estimated $300,000 in Supplemental Water Acquisition Fees.

Finally, the Town of Apple Valley would have to be reimbursed each year for the loss of $186,319 in Franchise Fees and $457,000 in Property Tax Revenue paid by AVR to the Town. Given these adjustments, the Town-owned Water Company would realize $554,000 in Cash Flow in its first year of operation.

AVR has generated Cash Flow through the Supply Facilities Fees and the Supplemental Water Acquisition Fee. Part of the Supply Facilities Fee recovers the proportional cost of both existing and future capital assets such as water main extensions and the installation of new wells, required to serve the new connection. The second fee is called the Supplemental Water Acquisition Fee. It was established to fund AVR's pre-purchase of replacement water from MWA or to acquire water rights should such water rights become available.

Since their inception, AVR collected $2,700,000 in a combination of Supply Facilities Fees and Supplemental Water Acquisition Fees and they purchased $2,650,000 in pre-purchase of Replacement Water from the Mojave Water Agency (MWA) or water rights.

In the current Rate Case AVR had proposed an increase in the Supply Facilities Fee from $800 to $900 per residential unit and an increase in the Supplemental Water Acquisition Fee from $3,500 to $5,000 per residential unit or residential equivalent unit. So far, this has not been approved by the CPUC. If in the second half of this decade the level of residential, commercial, and industrial construction approach half of the average annual volumes experienced in 2004 through 2006, AVR could collect $3,000,000 a year in such fees.

The Supplemental Water Acquisition Fees and to a lesser extent the Supply Facilities Fees could substantially increase the "Net" Cash Flow of the water company without increasing the "Net" Income of AVR because these fees flow through the Advance Fees Accounts on the Balance Sheet. It is critical for the Town to Review AVR's current and future request for increases in such fees and to monitor the amount of funds collected and use of these funds by AVR.

If the Town of Apple Valley were to purchase AVR it could generate Revenue through Connection of Fees for new water company customers associated with new development projects. If the Town of Apple Valley were to acquire AVR and established a connection fee of $8,000 per residential unit, and an average of 500 housing units were built each year, the total Revenue from such connection fees would be $4,000,000. It would also be reasonable to charge Connection Fees for commercial developments and industrial projects.

We strongly recommend that the Town not rely upon Connection Fees to fund ongoing Operating Expenses or the debt service on bonds used to purchase AVR or any other water company. The amount of Revenue derived from Connection Fees depends upon the level of new construction. Hence, Revenue will fluctuate as new construction increases for decreases. During 2005 and 2006, developers pulled permits for approximately 1,000 single-family residential units in the Town. From 2010 through the first eight months of 2011, approximately five (5) housing units were permitted each year. We think it is imprudent to assume the construction of new housing units will increase in any meaningful number before 2015 or even 2020. Connection Fees are best used to fund capital expenditures for a water system when construction levels are high.

Implication for Rate Increases

This section estimates the increase in Water Rates that would be required if the Town of Apple Valley were to purchase AVR. It also estimates the required increase in Water Rates if Park Water Company or The Carlyle Group's Infrastructure Fund were to own AVR. The impact of the Town's ownership on the water company is discussed first. This is followed by a discussion of the three factors that would cause an increase in Water Rates if AVR remained a private water company. This section concludes with a discussion on the anticipated increases in Water Rates and other Cash Receipts of the water company from the ratepayers.

The table below estimates the extent to which Water Rates would have to be increased in order to achieve AVR's required Rate of Return on its Rate Base Assets; the potential increase in Water Rates if the level water usage does not rebound from 2010 - 2011 levels; and, the effective increase in water bill payments due to the recapture of AVR's under-billed **Revenue** caused by the recent declines in the level of water usage.

Organization of the Following Table

The Table below has four columns. The first column is labeled "Adjusted Bartle Wells -2012." It reflects the Pro-forma Revenue ($19,483,000) of the Water Company if it were to be purchased by the Town. As previously discussed, it reflects the BRWC's best estimates of the Water Company's Revenue and Expenses for 2012. This column also reflects the previously estimated positive Cash Flow of $553,732 that is projected to be realized in 2012.
The second column is identified as "DRA-Total at Present Rates 2012." The values in this column are associated with the CPUC-DRA's estimate of Revenue and Net Income of AVR, given the projected level of water usage for 2012 agreed to by the DRA and AVR in the Settlement Agreement, and the present (2011) Water Rates. The third and fourth columns are labeled: "DRA-11.44% Rate Increase" and "AVR-14.83% Rate Increase." The values in these two columns reflect the agreed to projected level of water usage in 2012 with either a rate increase of 11.44% recommended by the CPUC-DRA or an increase of 14.83% still being requested by AVR.

In the case of columns two and three, the Rate Base of AVR is the same at $40,602,915. The Rate Base for column four is slightly higher at $40,786,416. The difference represents, primarily, additional capital expenditures proposed by AVR that have not been approved by the DRA. Most of the assets are in the Domestic Water System of AVR. Only a small portion is attributed to AVR's Irrigation System. There is no Rate Base associated with the Adjusted Bartle Wells-2012 analysis because it is not used by the BRWC to determine the level of Revenue required if the Town were to purchase the Water Company.

The Table below reflects the Pro-Forma level of Revenue required under all four scenarios. The BRWC has adopted Bartle Wells' Pro-Forma Revenue Estimate of $19,483,000. The Pro-Forma Revenue given present (2011) Water Rates, and the water level usage agreed to by DRA and AVR, is $19,923,381. The DRA's approved increase of 11.44% would result in required pro-forma Revenue of $22,140,000. AVR's requested increase of 14.83% would require Pro-Forma Revenue of $22,810,000. The Rate Base, Revenue, and Net Income information was obtained from Tables 1 through 6 of the Joint Comparison-Exhibit B of the Settlement Agreement.

RANCHOS WATER COMPANY AND TOWN OF APPLE VALLEY'S WATER COMPANY
REQUIRED RATE INCREASE TO ACHIEVE REQUIRED GOALS FOR YEAR 2012
November 5, 2011

	Adjusted Bartle Wells 2012	DRA-Total at Present Rates 2012	DRA-11.44% Rate Increase 2012	AVR-14.83% Rate Increase 2012
Rate Base				
AVR Rate Base-Domestic		$ 40,317,992	$ 40,317,992	$ 40,501,331
AVR Rate Base-Irrigation		$ 284,923	$ 284,923	$ 285,085
AVR Total Rate Base		$ 40,602,915	$ 40,602,915	$ 40,786,416
Require Net Income				
Authorized Rate of Return on Rate Base			9.42%	9.42%
Projected or Required After Tax Net Income		$ 220,244	$ 3,824,795	$ 3,842,080
Revenue				
Total Operating Revenues (Pro Forma)-Domestic		$ 19,668,381	$ 21,918,000	$ 22,584,700
Total Operating Revenues (Pro Forma)-Irrigation		$ 255,000	$ 222,000	$ 225,300
Total Operating Revenues (Proforma)	$ 19,483,000	$ 19,923,381	$ 22,140,000	$ 22,810,000
Increase in Pro-Forma Revenue due to the Increase in Water Rates		$ -	$ 2,216,619	$ 2,886,619
Percent Increase in Revenue Over Present Rates			11.13%	14.49%
Cash Flow of Town Owned Water Company	$ 553,732			
Adjustment for Actual Water Usage Being 30% Less than Budgeted in 2012				
Revenue Billed in 2012		$ 15,540,237	$ 17,269,200	$ 17,791,800
Percent of Revenue not Billed 22%				
Amount of Revenue Not Billed		$ (4,383,144)	$ (4,870,800)	$ (5,018,200)
Less Reduction in Operating Expenses 47%		$ 2,060,078	$ 2,289,276	$ 2,358,554
Marginal Decrease in Before Tax Net Income due to Less than Budgeted Water Usage		$ (2,323,066)	$ (2,581,524)	$ (2,659,646)
Additional Revenue Required Through Rate Increases		$ 2,323,066	$ 2,581,524	$ 2,659,646
P ercent Increase in Water Rates over 2011		14.95%	16.61%	17.11%
Recapture of Under-Billed Revenue				
Projected Amount of Under billed Revenue by -2012			$ 9,000,000	$ 9,000,000
Annual Amount of Under-Billed Revenue Recovered With Interest (Required Return) through Surcharges			$ 2,100,000	$ 2,100,000
Effective Water Rates				
Percent Rates Would Have to be Increased to Realized Proforma Revenue at Current AVR Water Volumes			16.61%	17.11%
Rate Increase Include in Revenue Figures			11.13%	14.49%
Total Rate Increase from Present Levels to Achieve Require Return on AVR's Asset Rate Base			27.74%	31.60%
Total Rate Increase from Present Levels to Recapture Estimated Deferred Debit Balances			13.51%	13.51%
Total Estimated Rate Increase from Current Levels to Achieve Require Return and Recapture			41.25%	45.12%
Total Rate Increase required for the Town of Apple Valley to achieve a positive Ash Flow	0.00%			

Note: The above calculations for AVR do not consider Supplemental Water Acquisitions Fees or Supply Facilities Fees because they do not have any significant impact on Net Income.

If Town of Apple Valley Owned the Water Company

If the Town of Apple Valley were to purchase AVR, it would likely not have to raise rates, because it is expected to experience a positive Cash Flow of $553,732 in 2012. This is reflected in the Table above. The latter increase does not reflect any increase in property taxes due to the issuance of General Obligation bonds, or Mello-Roos Bonds, in order to fund the purchase, nor does it account for any additional water rate increases to fund the debt service of Revenue-based financing. The impact of Higher Property Taxes is discussed in a later section of this report. For reasons that will be discussed, it is highly unlikely that the Cash Flow of a Town-Owned Water Company would be used to service the debt issued by the Town of Apple Valley to acquire AVR.

In normal economic times, a Town-Owned Water Company would receive an estimated $2,000,000 to $6,000,000 in Connection Fees, a portion of which could be used to offset approximately $3,700,000 in expenditures for capital improvements that have been budgeted in the Cash Flow of the Town-Owned Water Company. In normal times, it would not be necessary for Water Rates to increase. Unfortunately, in the current economy, the level of real estate development is not likely to generate any substantial level of Connection Fees before 2015.

If AVR Remained a Private Water Company

If the Park Water Company or the Infrastructure Fund of the Carlyle Group were to own AVR, it would likely receive rate increases over the next few years because of three factors. The first factor is the requirement to increase After Tax Net Income in order to compensate for increases in the AVR's operating costs and increases in AVR's Rate Base. In 2010, the CPUC determined the After Tax Rate of Return that AVR must realize in 2012 through 2014 would be 9.42%. The second factor would be the eventual downward adjustment in projected water usage if the Town's actual water usage remains near current levels rather than rebounding to more "normal" levels. If Operating Costs and the Rate Base remain constant, but the water usage remains at current levels, the Water Rates would have to increase in order enable AVR to realize the required Rate of Return. The third factor relates to the recapture of under-billed Revenue through Surcharges. The latter does not actually increase the Water Rates but it does increase the amount billed to the ratepayers. From the ratepayers' prospective, Surcharges represent a temporary rate increase.

Rate Base and Operating Cost Driven Water Rate Increases

The CPUC's authorized Rate of Return is 9.42%, which when multiplied by the DRA's approved Rate Base of $40,602,915 results in a required Net Income of $3,824,795. In order to achieve that projected Net Income, the DRA has approved the Water Rates to be increased by 11.44% from present (2011) levels.

If the projected water usage in 2012 were multiplied by 2011 Water Rates, the Pro-Forma Revenue would be $19,923,381. The DRA's approved increase of 11.44% would result in required pro-forma Revenue of $22,140,000. This represents an increase of $2,216,619 in the Pro-Forma 2012 projected level of water usage at present (2011) Water Rates. When the same Rate of Return is multiplied by AVR's proposed Rate Base of $40,786,416, it results in a required Net Income in 2012 of $3,842,080. AVR is proposing that the Water Rates be increased by 14.83% from present rate levels in order to realize the required Net Income given AVR's determination of the Rate Base. AVR's requested increase of 14.83% would require Pro-Forma Revenue of $22,810,000. This reflects an increase of $2,886,619 over projected 2012 Pro-Forma Revenue at Present Water Rates. The rate increase is likely be somewhere between the rate increased approved by the DRA and that proposed by AVR. In addition, the DRA has recommended a rate increase of 2.5% in 2013 and another 2.5% for 2014.

Rate Increase Required to Compensate for Drop in Water Usage

As was previously discussed, the level of water usage by the ratepayers of AVR during 2010 and the first 7 months of 2011 was approximately 70% of the amount of water delivered by AVR in 2007 and 2008; and the amount actually billed to the ratepayers was approximately 78% of the Revenue budgeted by the DRA and AVR for those 19 months. The difference between the amount billed to the ratepayers and the amount reported as Revenue by AVR is referred to as under-billed Revenue, which is added to the Deferred Debit accounts of AVR. The savings in Operating Expenses when the actual water usage is less than the budgeted volume are deducted from the Deferred Debit Accounts. The shortfall in Revenue net of the associated cost savings for a given year will be invoiced to the ratepayers of AVR over the three subsequent years as Surcharges. This procedure is designed to normalize the impact of short-term fluctuations in the level of water usage on Water Rates. If the level of usage is below pro-forma levels in one year, it could be balanced by excess usage in a subsequent year.

Should the level of actual water usage remain substantially below pro-forma for a period of time, the DRA of the CPU will authorize Surcharges to AVR Ratepayers to reduce the Balances in the Deferred Debit Accounts. This method of compensating for shortfalls in the actual level of water usage compared to what was budgeted in the Rate Case hearings is an acceptable solution, provided the deviations are only a small percentage of the pro-forma Revenue, or the duration of the shortfall is for a short period of time. This has not been the case for AVR since 2008. Consequently, a substantial balance has built up in the Deferred Debit Accounts that is currently being recaptured as Surcharges to the ratepayers at an estimated rate of $2,100,000 per year. This will continue unless AVR's level of water usage rebounds to its 2007-2008 levels or the budgeted level of water usage is reduced to reflect a new normal level of usage. This is discussed in detail in the next subsection.

There are two schools of thought regarding the extent of an economic rebound. One assumes the levels of water usage will rebound to pre-recession levels once the economy recovers. Members of this school attribute most of the decline in usage to a decrease in household incomes. When household incomes recover, the level of water usage will return to pre-recession levels. The second school of thought attributes most of the decline to the recent rise in Water Rates that have caused households to take extreme steps to conserve their consumption of water. In the last two years, a significant number of AVR ratepayers have allowed their lawns, trees, and shrubs to die. In some cases, they have installed rock gardens and drought-resistant landscaping. Members of this school believe there has been a paradigm shift related to the attitude of households in the Town of Apple Valley towards water consumption. Consequently, any increase in water consumption due to the economic recovery will be offset by a greater level of conservation due to the higher cost of water. For reasons previously discussed, the Town of Apple Valley BRWC believes the level of water usage in the Town of Apple Valley will not increase significantly from current levels between now and 2020. In fact, the BRWC believes total water usage could actually decline over the next few years because of the continued replacement of water-intensive landscaping with rock gardens and drought-resistant landscaping and more intensive efforts to conserve water. The BRWC also believes that, for planning purposes, should assume that the U.S. and California economies will continue to grow at a relatively slow rate between now and 2020, indicating a very slow residential growth for the Town.

The DRA appears to have taken the position that water usage will rebound to almost pre-recession levels. This benefits the ratepayer in the short term because the Pro-Forma Revenue necessary to generate the required Rate of Return on AVR's Rate Base can be allocated over a larger volume of water, thus lowering the rate per acre-foot of water. For example ,if in the current Rate Case before the CPUC, the DRA were to adopt a water usage rate of 22% below current pro-forma levels, the Revenue generated under the Scenario "DRA-Total at Present Rates 2012" would be $15,540,237. The Water Rates would have to be increased by substantially to replace the lost Revenue of $4,383,144 offset by the Operating Cost savings of $2,060,078. This would represent a 14.95% increase. Because the level of water usage that generated the actual Revenue of $15,540,237 at Present (2011) Rates would be the same, the Water Rates would have to increase by 14.95% to generate an additional $2,323,066 in Revenue.

This would also be true for the two other scenarios. In the scenario in which the Water Rates were increased by 11.44% as approved by the DRA, the actual expected water usage would generate billed Revenue of $17,269,200, which would be $4,870,800 less than the pro-forma Revenue of $22,140,000. The latter is the Revenue that has to be realized in order to generate an After Tax Net Income of $3,824,795 and, therefore, an After Tax Rate of Return of 9.42% on AVR's 2012 Rate Base as estimated by the DRA. The Water Rates would have

to be increased sufficiently to replace the lost Revenue of $4,870,800 offset by the Operating Cost savings of $2,289,276. This would represent a 16.61% increase. Because the level of water usage that generated the billed Revenue of $17,269,200 at DRA approved rates would be the same, the Water Rates would have increase by 16.61% from 2011 levels to generate an additional $2,581,524 in billed Revenue.

If the Water Rates were increased by 14.83% as requested by AVR in the Settlement Agreement, the actual expected water usage would generate billed Revenue of $17,791,800, which would be $5,018, 200 less than the pro-forma Revenue of $22,810,000. This is the Revenue that has to be realized in order to generate an After Tax Net Income of $3,842,080 and, therefore, an After Tax Rate of Return of 9.42% on AVR's 2012 Rate Base as proposed by AVR. The Water Rates would have to be increased sufficiently to replace the lost Revenue of $5,018,200 offset by the Operating Costs savings of $2,358,554. This would represent a 17.11% increase. Because the level of water usage that generated the billed Revenue of $17,791,800 at AVR proposed rates would be the same, the Water Rates would have increase by 17.11% from 2011 levels to generate an additional $2,659,646 in billed Revenue.

If the level of water usage does not rebound substantially by 2014, AVR will be pushing the CPUC to set Water Rates based on more realistic estimates of water usage. The collection of Supplemental Water Acquisition Fees in prior to 2008 appears to have been used to fund in part the leasing of water rights through the pre-purchasing of Replacement Water from the Mojave Water Agency prior to 2012. Supplemental Water Acquisition Fees are not expected to be material until after 2014, because the level of new construction in the Town of Apple Valley is not expected to be significant before 2015, if not later. As a result, the owners of AVR would have to fund substantial negative Cash Flows from operations caused by the under-billing of Revenue, were it not for the fact that AVR will be collecting approximately $2,100,000 from Surcharges. The combination of Surcharges, water rate increases and an increase in the level of water usage may reduce the levels of negative Cash Flows to manageable levels in 2012 through 2014. If the Park Water Company is purchased by the Carlyle Group's Infrastructure Fund, AVR may live with relatively small levels of negative Cash Flows from 2012 through 2014; but it is not likely to do so after the 2015 Rate Case.

It appears the Park Water Company has succeeded in getting the DRA to adopt a lower water usage level in this current Rate Case. Chris Schilling recently indicated that actual water usage had increase to 74% of budgeted levels and they believe that the Revenue shortfall in 2012 would be close to 13% in 2012 instead of 22% as it was during 2010 and the first 7 months of 2011. Should prove to be the case the shortfall of under-billed Revenue net of cost savings would be 6.9% rather than 11.7% of Budgeted Revenue. Under such a scenario, the Surcharges of $2,100,000 would exceed the charges to Deferred Debit

Account due to the extent under-billed Revenue exceeded the Operational Cost Savings. At 6.9%, the latter would be approximately $1,500,000. It is conceivable that the estimated $9,000,000 balance in the Deferred Debit Accounts could be reduced by $500,000 to $1,000,000 in 2012.

If the ratepayers' level of water usage remained approximately 22% below pro-forma levels, and AVR and DRA agreed to base the Water Rates on actual water usage, the present Water Rates would have to increase by 16.61%. This would be in addition to the 11.13% (nominal 11.44%) approved by the DRA for 2012, or 17.11%, in addition to the 14.49% (nominal 14.83%) proposed by AVR in the Settlement Agreement. The combined rate increase for 2012, due to increases in Operating Costs and the Rate Base, and the increase required to eliminate under-billing, would be 27.74% for the DRA-11.44% Scenario and 31.60% for the AVR-14.83% Rate Increase Scenario. Again, it is not likely there would be any increase in the Water Rates before 2015 due to lower assumptions as to water usage. The actual projected increase in Revenue, per the Tables in the Settlement Agreement due to rate increases over present rates, is 11.13% for the DRA recommended program and 14.49% for AVR's proposal. Both are less than the nominal rates referred to in the Settlement Agreement. The discrepancy may be due to rounding or perhaps the effect of the Tiered Pricing associated with conservation. For this analysis, the lower rate increases were used.

Surcharges for Under-Billed Revenue Offset by Operational Cost Savings

The above Table also estimates the average annual recapture of the Under-Billed Revenue through Surcharges. As previously discussed, there was approximately $8,500,000 in two asset accounts on the November 30, 2010 Balance Sheet of AVR. Regulatory Accounts-Short Term had a balance of $1,855,695 and Regulatory Accounts-Long Term had a balance of $6,642,939. The total of both accounts was $8,498,535. At the current level of water usage, these accounts are being added to at the rate of $2,500,000 to $2,600,000 per year, which is the amount of Under-Billed Revenue net of Operational Costs Savings. These additions to the Deferred Debit Accounts are being offset by approximately $2,100,000 in Surcharges to the ratepayers in 2011 and 2012. Hence, the account balances in the two Deferred Debit accounts are estimated to be increasing at the combined rate of $500,000 per year. If this were to be the case in 2012, the combined balance in these two accounts at the end of 2012 would be approximately $8,000,000 to $10,000,000.

The following Table details how the CPUC-DRA's proposed Rate Base was determined. The information was obtained from Tables 17 and 19 in Exhibit B to the Settlement Agreement. The amounts depicted in the table represent average balances for 2012. There is one column for the Domestic Water System and a second column for the Irrigation Water system. The third column is the sum of the two. On average, there will be $107,962,734 in Plant in Service assets during 2012. To this is added amounts for Work in Progress and Materials &

Supplies and $920,309 for the average Working Cash balance. This is not an estimate of AVR's current Cash balance. Rather it is an estimate of the average dollar amount of expenses that will be incurred in 2012 for which Revenue will not been received until later. Chris Schilling indicated there is typically a 3-month lag between when expenses are incurred and when the Revenue is received.

The estimate average balance in the Working Cash Account is negotiated between the DRA and AVR. The subtotal of this group of assets is $109,353,835. From this is deducted Depreciation Reserves, Advances, Contributions, Unamortized ITC and Deferred Income Tax; $1,381 is added for Method 5 Adjustments; and, $607,294 is added for the Main Office assets allocated to AVR. This results in an average Total Rate Base of $40,602,915.

Two pertinent observations can be made regarding Total Rate Base. The first is that the Deferred Debit Accounts are not included in the Rate Base, because they are not included in Plant and Equipment. The Assets in the Rate Base earn an annual Rate of Return of 9.42%. Given a marginal Federal and State tax rate of approximately 40%, this is equivalent to a pre-tax Rate of Return of 15.70%. As of October 21, 2011, 10-Year T- Bills are earning a pre-tax return of approximately 3.0%.

The interest rate on a 30-year mortgage on a single family home is 4.2%. Again, this is a pre-tax return to the investor. The CPUC only allows AVR to earn an interest rate equal to the 90 day commercial paper rate on the balance in its the Deferred Debit Accounts. That rate was approximately 1% in November of 2004.

While a pre-tax rate of return of 15.7% would be extremely high if all the assets in the rate Base were valued at current replacement cost; however a significant portion of the assets in AVR's plant and equipment were installed years ago. Their depreciated value is substantially below replacement costs. It is difficult to draw any conclusions regarding whether or not the Rate of Return is too high unless we have a reliable estimate of today's depreciated replacement costs. The fact that AVR's 2012 Cash Flow excluding Surcharges is about breakeven suggests the Rate of Return is not too high.

APPLE VALLEY RANCHOS WATER COMPANY
SUMMARY OF CPUC-DRA'S PROPOSED RATE BASE FOR 2012
November 5, 2011

Average Balances	DRA's 2012 Rate Base for Domestic	DRA's 2012 Rate Base for Irrigation	DRA's 2012 Rate Base Total
Plant in Service	$ 107,325,949	$ 636,785	$ 107,962,734
Work in Progress	160,000	-	160,000
Materials & Supplies	310,792	-	310,792
Working Cash	913,223	7,086	920,309
Subtotal	108,709,964	643,871	109,353,835
Less:			
Depreciation Reserves	(27,287,416)	(237,132)	(27,524,548)
Advances	(31,082,962)	-	(31,082,962)
Contributions	(2,022,998)	(42,743)	(2,065,741)
Unamortized ITC	(61,418)		(61,418)
Deferred Income Tax	(8,541,077)	(83,849)	(8,624,926)
Subtotal	(68,995,871)	(363,724)	(69,359,595)
Plus:			
Method 5 Adjustment	1,381	0	1,381
Net District Rate Base	39,715,474	280,147	39,995,621
Plus:			
Main Office	602,518	4,776	607,294
Total Rate Base	$ 40,317,992	$ 284,923	40,602,915

The values in this table were obtained from Table17 and Table 19 in Exhibit B of the Settlement Agreement

The 15.7% Pre-Tax Rate of Return gives AVR an incentive to install new plant and equipment on which they can realize a high return for a low level of risk. This can benefit the Town of Apple Valley in that AVR has a built in economic incentive to invest in the extension of the Water System. On the other hand, the Town has to monitor AVR's investment program to ensure that they do not over invest and therefore raise the Water Rates more than is necessary.

A 9.42% Rate of Return, on an average balance of $920,309, generates an additional After Tax Net Income requirement of $86,693. The marginal State and Federal Tax Rate on AVR is approximately 40%; hence, the Pre-Tax additional Net Income requirement is $144,489. This reflects a Pre-Tax return of 15.7%. The typical household in the Town of Apple Valley has to settle for a 0.25% interest rate (Rate of Return) on the cash it has on deposit in the bank. The CPUC should also reevaluate the appropriateness of a 15.7% pretax return on a low risk investment.

In the Table above that summarizes the estimated increases in Water Rates, the increase in Pro-Forma Revenue in 2012, due to the DRA's accepted 11.44% increase in the Water Rates, was $2,216,619, and the increase in Pro-Forma Revenue, because of AVR's proposed increase of 14.83%, is $2,886,619. If the level water usage remains at 30% of the budgeted amount it would be necessary to increase billed Revenue by an additional $2,581,524 or 16.61% in the case of

the DRA proposed scenario. In the case of the AVR scenario, billed Revenue would have to increase by $2,659,646 or 17.11%.

Representatives of Park Water Company would argue that the increase in rates to compensate for actual water usage being less than budgeted would not have to be nearly that much because the level of water usage is going up so the shortfall will be less. For purposes of estimating the potential increase in Water Rates over the next four (4) years, we believe the sum of both rates would provide a reasonable estimate. In the case of the DRA scenario, the combined rate increase over present levels would be 27.74%; and for the AVR scenario, the rate increase would be 31.60%.

Combined Impact of All Three Factors on AVR Water Rates

An annual Surcharge to the AVR ratepayers is currently about $2,100,000. It would be equivalent to an effective Water Rate increase of 13.51% over $15,540,237 of estimated billed Revenue in 2012 at 2011 rates. The table above that depicts the required rate increases for AVR reflects a Surcharge equivalent to a 13.51% Water Rate increase for both the DRA-11.44% Rate Increase scenario and the AVR-14.83% Rate Increase Scenario. When the latter equivalent water rate increase due to the Surcharge are combined with the regular Water Rate increases approved by the DRA or proposed by AVR in the current rate case and the estimated increase in Water Rates required to compensate for the lower level of water usage, the estimated increase in the typical ratepayers water bill above 2011 levels was estimated to be between 41.25% and 45.12%. These preliminary estimates of the potential water rate increases do not include the usual cost of living increases of 2.5% per year that will also be incorporated in to the Water Rates in 2013 and 2014. Surcharges are expected to begin to diminish within two and a half years after either water usage and/or Water Rates increase sufficiently to eliminate significant under under-billing of Revenue. There is not likely to be any substantial reduction in the Surcharges billed to the ratepayers until after 2015.

Additional Cash Receipts that May Be Realized by AVR if It Were Purchased by the Carlyle Group

The BRWC is concerned that AVR would be able to obtain approvals from the CPUC to substantially increase the Revenue and other Cash Receipts it would receive from ratepayers in the Town of Apple Valley if it were purchased by the Carlyle Group's Infrastructure Fund. The information discussed in the preceding subsection is presented differently in the following table in order to illustrate the various ways in which AVR may be able obtain additional fees and charges from its customers, thereby substantially increasing the effective Water Rates to the AVR ratepayers and the Cash Flow to the water company.

The Table below has two columns on the left that depict the increase in Water Rates. The column titled "Rate-Increases DRA- Estimates 2012" is based on the DRA estimates in the Settlement Agreement for the year 2012. The column identified as "Rate-Increases AVR-Estimates 2012" reflects the AVR estimates in the same Settlement Agreement. The two columns on the right hand side of the table contain dollar amounts related to the DRA-11.44% Rate Increase for 2012 and the AVR-14.83% Rate Increase for 2012.

The starting point is the projected amount of Billed Revenue for 2012 based on 2011 Water Rates and an estimate of what will be the actual water usage in 2012. For purposes of this analysis, it was assumed that the actual water usage in 2012 would be close to the levels experienced in 2010 and the first 7 months of 2011, which is believed to be approximately 70% of the projected levels agreed to by the DRA and AVR. Because of fixed and variable billing factors, a 30% reduction in water usage would translate to a 22% decline in billed Revenue. As such, the amount of Billed Revenue if the Water Rates remained at 2011 levels would be $15,540,237 for both scenarios. This level of Revenue represents 100% of the budgeted level of water usage for 2012 current Revenue and 2011 Water Rates.

To this is added the estimated increase of $1,728,963 in Billed Revenue due to the DRA recommended 11.13% (nominal 11.44%) Water Rate increase in the Settlement Agreement and a corresponding increase of $2,251,563 in Billed Revenue due to AVR's proposed 14.49% (nominal 14.83%) increase in the Water Rate. This would result in $17,269,200 of Billed Revenue in 2012 for the DRA scenario and $17,791,800 of billed Revenue for the AVR scenario.

SUMMARY OF PROPOSED AND POTENTIAL INCREASES IN WATER RATES AND OTHER ITEMS BY AVR AND THEIR IMPACT ON THE INCOME AND CASH FROW OF AVR AND THE RATEPAYERS
November 5, 2011

	Rate Increases DRA-Estimates 2012	Rate Increases AVR-Estimates 2012	DRA-11.44% Rate Increase 2012	AVR-14.83% Rate Increase 2012
Revenue				
Amount of Billed Revune at 2011 Rates and 2010-2011 Levels of Water Usage (78% of Projected Levels)	100.00%	100.00%	$ 15,540,237	$ 15,540,237
Add: Increase in Billed Revenue due to DRA or AVR Water Rate Increases	11.13%	14.49%	$ 1,728,963	$ 2,251,563
Estimated Billed Revenue if Water Usage is 78% of DRA and AVR Projected 2012 Water Usage			$ 17,269,200	$ 17,791,800
Add: Increase in Billed Revenue due to Equivalent Water Rate Increase to Adjust for 22% Lower Level of Water Usage	16.61%	17.11%	$ 2,581,524	$ 2,659,646
Projected Revenue in the Settlement Agreement			$ 19,850,724	$ 20,451,446
Estimated Increase in Effective Water Rates Required to Generate Revenue in Settlement Agreement Given Given Water Usage at 78% of Projected Usage	127.74%	131.60%		
Less Expenses			$ (16,025,929)	$ (16,609,366)
Require Net Income				
Authorized Rate of Return on Rate Base is 9.42% Required After Tax Net Income			$ 3,824,795	$ 3,842,080
Additional Cash Receipts for AVR				
Annual Amount of Under-Billed Revenue Recovered With Interest (Required Return) Through Tier I Charges	13.51%	13.51%	$ 2,100,000	$ 2,100,000
Cumulative Rate Increase and Combined Net Income and Recapture of Unbilled Revenue (Tier I Charges)	141.25%	145.12%	$ 5,924,795	$ 5,942,080
Supplemental Water Acquisition Fees at 500 Housing Units per Year Plus 20% for Commercial and Industrial Projects Assuming Fees at $5,000 per Unit	19.30%	19.30%	$ 3,000,000	$ 3,000,000
Cumulative Rate Increase and Combined Net Income, Recapture of Unbilled Revenue through Surcharges and Supplemental Water Acquisition Fees (500 units, $5,000)	160.56%	164.42%	$ 8,924,795	$ 8,942,080
Additional Supplemental Water Acquisition Fees if Development Activity Doubles	19.30%	19.30%	$ 3,000,000	$ 3,000,000
Cumulative Rate Increase and Combined Net Income, Recapture of Unbilled Revenue (Tier I Charges) and Supplemental Water Acquisition Fees (1,000 units, $5,000)	179.86%	183.73%	$ 11,924,795	$ 11,942,080
Additional Supplemental Water Acquisition Fees if the Unit Charge incrases from $5,000 to $10,000 at the Development Rate of 1,000 Housing Units per Year.	38.61%	38.61%	$ 6,000,000	$ 6,000,000
Cumulative Rate Increase and Combined Net Income, Recapture of Unbilled Revenue (Tier I Charges) and Supplemental Water Acquisition Fees (1,000 units, $10,000)	218.47%	222.34%	$ 17,924,795	$ 17,942,080
Comparison to AVR's Rate Base				
AVR's Rate Base in 2012 per Settlement Agreement			$ 40,602,915	$ 40,786,416
Combined Net Income, Recapture of Unbilled Revenue (Tier I Charges) and Supplemental Water Acquisition Fees (500 units, $5,000) as a Percent of AVR's Rate Base			22.0%	21.9%
Combined Net Income, Recapture of Unbilled Revenue (Tier I Charges) and Supplemental Water Acquisition Fees (1,000 units, $10,000) as a Percent of AVR's Rate Base			44.1%	44.0%

As previously discussed, in order to eliminate any under billed Revenue in 2012, it would be necessary to substantially increase the Water Rates so as to add $2,581,524 of Billed Revenue for the DRA scenario and $2,659,646 for the AVR scenario. This would result in a Water Rate increase of 16.61% in the case of

the DRA estimates and 17.11% for the AVR proposal. With these additions, the Revenue actually billed in 2012 would be $19,850,724 under the DRA scenario and $20,451,446 for the AVR scenario. The Water Rates for the DRA Estimates would be 127.74% of the 2011 rates, which reflect a 27.74% increase in the Water Rates. The Water Rates for the AVR Estimates would be 131.60% of the 2011 rates. Under the AVR proposal, the Water Rates would have to increase by 31.60%.

When AVR's expenses are deducted from Billed Revenue, the After Tax Net Income required to earn a 9.42% Rate Return on the Rate Base is $3,824,795 for the DRA-Estimates and $3,842,080 for the AVR-Estimates. The estimated Cash Flow that would be generated in 2012 under both scenarios is approximately $2,300,000 less than the After Tax Net Income before consideration of the Surcharges.

AVR would receive additional Cash Receipts from its customers and ratepayers. The first is in the form of Surcharges that are currently being billed at level of $2,100,000. Discussions with Chris Schilling suggest that Surcharges will continue at that level for a few years before diminishing until the actual level of water usage approaches budgeted levels. This could occur as early as 2015. It would require an additional 30 months after the last year in which there was under-billed Revenue to eliminate such Surcharges.

The second significant source of Cash Flow in the Water Company is the collection of Supplemental Water Acquisition Fees and, to a lesser extent, the collection of Supply Facilities Fees. The CPUC currently authorizes the AVR to charge the new water customer a Supplemental Water Acquisition Fee of $3,500 per residential unit and an additional $800 per units for the Supply Facilities Fee. AVR has requested that the fees be increased to $5,000 and $900 respectively.

This increase has yet to be approved by the CPUC. Connections for multi-family residential, industrial, and commercial development are substantially higher and would be increased accordingly. As previously discussed, a $5,000 Supplemental Water Acquisition Fee alone would generate $2,500,000 if the level of construction were 500 units per year. An additional 10% for commercial and 10% for industrial projects would result in $3,000,000 in supplemental fees being collected in a year. The collection of such fees is a nontaxable event. A cash receipt of $3,000,000 is reflected in the above table. It would add 19.30% to the average water bill but it would only be borne by new construction. Existing ratepayers would not experience any increase in their Water Rates. After 2015, AVR could experience $3,000,000 in additional Cash Flow less the amount used to purchase of water rights and/or to pre-purchase Replacement Water or the amount invested in Plant.

The Table also reflects the fact that, towards the end of this decade, construction levels could reach 1,000 residential units per year. If the Supplemental Water

Acquisition Fee were to remain at $5,000 per unit, it would generate an additional $3,000,000 in Cash Receipts. It is also possible that, by the end of this decade, Supplemental Water Acquisition Fees could equal $10,000 per unit. If this were the case, another $6,000,000 would be added to the annual Cash Flow of the water company. If that were the case, the Combination of AVR's After Tax Net Income and Cash Receipts from other sources could be as high as $17,900,000. This is depicted in the above Table.

This would be excessive given the fact that, in 2012, the Rate Base of AVR was approximately $40,600,000 in the DRA Scenario and almost $40,800,000 in the AVR Scenario. If $3,000,000 were to be collected by AVR due to Supplemental Water Acquisition Fees, the combination of those fees, plus After Tax Net Income and the recapture of under-billed Revenue, would total approximately $8,900,000 in a single year. This would be 22% of AVR's Rate Base for 2012. If the CPUC were to approve Supplemental Water Acquisition Fees of $10,000 per unit, and the level of construction were to double, the combination of After-Tax Net Income and Cash Receipts from other sources for a single year would be $17,9 00,000, or over 44% of AVR's Rate Base. In both cases, the cash received is excessive when compared to the water company's Rate Base.

We are not suggesting that this would actually occur. What we are requesting is that procedures be put in place by the CPUC to preclude this from occurring. Also, the Town of Apple Valley should be given sufficient financial information by AVR each year so that the Town can ascertain that AVR is properly investing the funds derived from the Supplement Water Acquisition Fees and the Supply Facilities Fees and to endure that such fees will not become excessive.

Conclusions Regarding Potential Rate Increases

If the Town of Apple Valley were to purchase AVR, it would likely not have to raise Water Rates, because it is expected to experience a positive Cash Flow of $553,732 in 2012. There would, however have to be an increase in property taxes due to the issuance of General Obligation bonds, or Mello-Roos Bonds, in order to fund the purchase.

If the Park Water Company or the Infrastructure Fund of the Carlyle Group were to own AVR, it would likely receive rate increases over the next few years because of three factors. The first factor is the requirement to increase After Tax Net Income in order to compensate for increases in the AVR's operating costs and increases in AVR's Rate Base.

In 2012 AVR's total Rate Base is projected to be approximately $40,500,000. The Deferred Debit Accounts are not included in the Rate Base, because they are not included in Plant and Equipment. In 2010, the CPUC determined the After Tax Annual Rate of Return that AVR must realize in 2012 through 2014 on its Rate Base would be 9.42%. Given a marginal Federal and State tax rate of

approximately 40%, this is equivalent to a pre-tax Rate of Return of 15.70%. As of October 21, 2011, 10-Year T-Bills are earning a pre-tax return of approximately 3.0%. The interest rate on a 30-year mortgage on a single family home is 4.2%. Again, this is a pre-tax return to the investor. The CPUC only allows AVR to earn an interest rate equal to the 90 day commercial paper rate on the balance in its the Deferred Debit Accounts. That rate was approximately 1% in November of 2004.

While a pre-tax rate of return of 15.7% would be extremely high if all the assets in the rate Base were valued at current replacement cost; however a significant portion of the assets in AVR's plant and equipment were installed years ago. Their depreciated value is substantially below replacement costs. It is difficult to draw any conclusions regarding whether or not the Rate of Return is too high unless we have a reliable estimate of today's depreciated replacement costs. The fact that AVR's 2012 Cash Flow including Surcharges is about breakeven suggests the Rate of Return is not too high.

The 15.7% Pre-Tax Rate of Return gives AVR an incentive to install new plant and equipment on which they can realize a high return for a low level of risk. This can benefit the Town of Apple Valley in that AVR has a built in economic incentive to invest in the extension of the Water System. On the other hand, the Town has to monitor AVR's investment program to ensure that they do not over invest and therefore raise the Water Rates more than is necessary.

The actual projected increase in Revenue due to increases over present Water Rates is 11.13% for the DRA recommended program and 14.49% for AVR's proposal in the Settlement Agreement. The CPUC approved rate will most likely be somewhere between the two.

The second factor that would generate pressure for High Water Rates would be the downward adjustment in projected water usage if the Town's actual water usage remains near current levels rather than rebounding to more "normal" levels. If the ratepayers' level of water usage remained approximately 22% below pro-forma levels, and AVR and DRA agreed to base the Water Rates on actual water usage, the present Water Rates would have to increase by approximately 17%.

The combined rate increase for 2012, due to increases in operating costs and the Rate Base, and the increase required to eliminate under-billing, would be approximately 30%. It is highly unlikely there would be any increase in the Water Rates before 2015 due to lower assumptions as to water usage.

Representatives of Park Water Company would argue that the increase in rates to compensate for actual water usage being less than budgeted would not have to be nearly that much because the level of water usage is going up so the shortfall will be less. Notwithstanding AVR's good intentions, we believe the

combined Water Rate increase over present levels due to both factors would likely be in the order of 30%.

The third factor that contributes to an effective increase in Water Rates relates to the recapture of under-billed Revenue through Surcharges. The latter does not actually increase the Water Rates but it does increase the amount billed to the ratepayers. From the ratepayers' prospective, "Surcharges" represent a 30-month temporary rate increase.

An annual Surcharge to the AVR ratepayers is currently about $2,100,000. It would be equivalent to an effective Water Rate increase of 13.51%. When the increase due to the Surcharge is combined with the regular Water Rate increases and the estimated increase in Water Rates required to compensate for the lower level of water usage, the estimated increase in the typical ratepayers water bill above 2011 levels would be about 43%. These preliminary estimates of the potential water rate increases do not include the usual cost of living increases of 2.5% per year that will also be incorporated in to the Water Rates in 2013 and 2014.

Surcharges are expected to begin to diminish within two and a half years after either water usage and/or Water Rates increase sufficiently to eliminate any under under-billing of Revenue. There is not likely to be any substantial reduction in the Surcharges billed to the ratepayers until after 2015. From the ratepayers prospective the best possible scenario after 2015 is that reductions in the Surcharges offset some of the increase in the actual Water Rates. While this may occur, for planning purposes the AVR ratepayers should anticipate a 40% to 50% increase from current rates after 2014.

Another significant source of Cash Flow to the Water Company is the collection of Supplemental Water Acquisition Fees and, to a lesser extent, the collection of Supply Facilities Fees. The collection of such fees is a nontaxable event. After 2015, AVR could experience $3,000,000 in additional Cash Flow less the amount used to purchase of water rights and/or to pre-purchase Replacement Water or the amount invested in Plant. Such Fees would add 19.30% to the average water bill; but it would only be borne by new construction. Existing ratepayers would not experience any increase in their water bill.

Towards the end of this decade, construction levels could reach 1,000 residential units per year. If the Supplemental Water Acquisition Fee were to remain at $5,000 per unit, it would generate an additional $3,000,000 in Cash Receipts. It is also possible that, by the end of this decade, Supplemental Water Acquisition Fees could equal $10,000 per unit. If this were the case, another $6,000,000 would be added to the annual Cash Receipts of the water company.

The Finance Committee is not suggesting that this would actually occur. What we are requesting is that the CPUC put procedures in place to preclude this from

occurring. Also, the Town of Apple Valley should be given sufficient financial information by AVR each year so that the Town can ascertain that AVR is properly investing the funds derived from the Supplement Water Acquisition Fees and the Supply Facilities Fees and to endure that such fees will not become excessive.

The Supplemental Water Acquisition Fees and to a lesser extent the Supply Facilities Fees could substantially increase the Cash Flow of the water company without increasing the Net Income of AVR, because these fees flow through the Balance Sheet rather than the Income Statement. It is critical for the Town to Review AVR's current and future request for increases in such fees; to monitor the amount of funds collected and AVR's use of these funds.

General Concern of the BRWC

When the economy of the High Desert begins to recover and the level of construction activity in the Town of Apple Valley approaches more normal levels; AVR will realize a substantial level of positive Cash Flow from the collection of Supplemental Water Acquisition Fees and to a lesser extent from Supply Facilities fees. The BRWC of the Town of Apple Valley is concerned that the funds collected may not be used to purchase water rights, to pre-purchase Replacement Water from the MWA or to invest in the extension of the large water mains, wells, and water tanks in the growth areas of the Town such as the North Apple Valley Industrial area. The BRWC is also concerned that the unused funds could be diverted to the investors of the Carlyle Group's Infrastructure Fund either by the payment of dividends, or loans by AVR to the Infrastructure Fund.

The BRWC is also concerned that over time, the Carlyle Group may burden the water company with an extensive level of debt like many of the Wall Street investment bankers and hedge funds did with commercial banks and industrial corporations during the last decade. Such excessive leverage and "creative financing techniques" could interrupt the orderly replacement of plant and equipment; and prevent AVR from making necessary investments in new backbone water mains, reservoirs, wells and booster pumps to deliver water to the expansion areas of the Town of Apple Valley.

The BRWC is also concerned that AVR may sell the water rights it currently owns or will purchase with the funds generated by the collection of Supplemental Water Acquisitions Fees. The water rights that AVR currently owns do not significantly add to the Water Rates because AVR's cost basis in such water rights are extremely low or negligible due to the Mojave Water Agency (MWA) adjudication process. If AVR were to sell these water rights and then lease them back, the annual cost to lease the water rights would be added to AVR's annual operating costs. Such an increase in AVR's annual operating costs would lead to higher Water Rates.

The BRWC believes that steps should be taken to prevent excessive Rates of Return from being realized on the Water Company's Rate Base. The pre-tax Rate of Return of 15.7% on the balance of AVR's Rate Base appears to be high. The pre-tax return of 15.7 percent was derived by dividing the 9.42% required Rate of Return by 100% minus the marginal Federal and State Marginal Tax Rate of 40%. The Town should challenge the appropriateness of such a high Rate of Return when the CPUC next determines the Required Rate of Return. The current required Rate of Return was determined in 2010 and therefore not eligible for review in this Rate Case. The next CPUC review of the Rate of Return may be in 2013 the year before the next round of Rate Case hearing.

It has been very difficult for the BRWC to comprehend what AVR has actually been doing because the financial information AVR provides to the Town is fragmented and incomplete. For example: AVR does not provide a Source and Use of Funds Statement, which would have revealed the collection of Supplemental Water Acquisition Fees and the use of those fees within AVR. The Town's BRWC's requests for Cash Flow statements (Source and Use of Funds Statements) have been repeatedly denied by the Park Water Company. In addition, AVR does not provide any supporting detail on the Deferred Debit and Deferred Credit accounts on its Balance Sheet; nor does AVR provide information as to the portion of its Revenue that is under-billed in a fiscal year. The BRWC is concerned that AVR will continue to provide incomplete financial information. The BRWC recommends that the Town of Apple take steps to ensure that the CPUC include various stipulations in its approval of the "Merger or Purchase" between Park Water Company and the Carlyle Group's Infrastructure Fund to prevent the Carlyle Group from using the Supplemental Water Acquisition Fees and Supply Facilities Fees for purposes other than for which they were originally intended and from over-leveraging AVR in order to generate a higher return on their equity investment in the water company.

Recommended Stipulations for CPUC

The BRWC recommends that stipulations such as the following be included as conditions of the CPUC's approval of the Merger between the Park Water Company and the Carlyle Group's Infrastructure Fund:

1. Within one year after the cash received by AVR from the collection of Supplemental Water Acquisition Fees or Supply Facilities Fees must be used to purchase water rights, pre-purchase Replacement Water or invest in backbone level plant and equipment. Such acquisitions should not add to the Rate Base of AVR; however, the repayment of the fees to the customers would add to the Rate Base of AVR.

2. AVR shall provide The Town of Apple Valley on an annual basis with a clear and transparent accounting of the collection of Supplemental Water

Acquisitions Fees and Supply Facilities Fees, and clearly indicate with backup accounting data, that these fees were invested in the acquisition of Water Rights, the pre-purchase of Replacement Water or plant and equipment that were not included in the AVR Rate Base at the time of acquisition.

3. The Cash collected by AVR from Supplemental Water Acquisition Fees and Supply Facilities Fees that has not been used to purchase water rights and or invested in authorized plant and equipment shall be held in a separate trust fund of AVR similar to the Trust Fund of a real estate Broker or a separate Capital Investment Fund Account. The cash in the trust fund shall not be commingled with the cash of AVR. The Cash in such Trust Fund shall not be available to the creditors of AVR should AVR declare bankruptcy or the creditors of AVR lien the assets of AVR.

4. Supplemental Water Acquisition Fees should not exceed $3,500 per unit and Supple Facilities Fees should not exceed $800 per unit in the current Rate Case. In addition, AVR should be required to justify the multipliers used to determine Supplemental Water Acquisition Fees for Commercial, Industrial and multi-family projects. AVR should also be required to justify Supply Facilities fees for larger connections.

5. Any water rights that are purchased with Supplemental Water Acquisitions Fees or any of the water rights currently owned by AVR shall not be sold by AVR. Any water rights currently owned by AVR or purchased in the future shall not be used as collateral for any loan of AVR, the Carlyle Group's Infrastructure Fund or any affiliate of these entities. Should AVR or its successors file bankruptcy such water right shall not be assigned to the creditor of AVR. To the extent, such a stipulation is not permitted then the Town of Apple Valley should be given a right of first refusal to purchase AVR at a fair market value consistent with the type of right given to the City of Missoula, Montana in connection with Carlyle's acquisition of Mountain Water Company.

6. Dividends should be limited to Positive Retained Earnings reduced by any Balances in the Deferred Debit Accounts. Such balances represent unbilled Revenue. Furthermore, AVR shall not make any distributions that would cause AVR's equity to fall below 45 percent of its Rate Base.

7. AVR or its successor shall not be able to lease water rights from an affiliate of AVR or the Carlyle Group, the Carlyle Group's Infrastructure Fund or any successor to such fund.

8. The Ratio of Debt to Total Asset Value of AVR shall not exceed 0.60 at any time after the merger. The Advanced Credits and Other Deferred credits shall be treated as debt for purposes of this calculation.

9. If any material amounts of AVR utility assets that are pledged or otherwise encumbered to secure debt issuances are divested, the net proceeds of the sale must be used to pay down the debt, or be reinvested in utility assets in accordance with the security agreement under which the debt was issued.

10. AVR or its successor shall not guarantee or be a borrower on any loans that involve entities other than AVR.

11. AVR shall not be allowed to be a principal in any derivative type transaction or to insure or guarantee such a transaction.

12. AVR shall provide to the Town of Apple Valley a complete set of financial statements similar to the financial statements required of publicly owned industrial companies registered with the SEC. Such Financial Statements shall include a Balance Sheet, Income Statement, Source, and Use of Funds Statement in addition to supporting statements to the level of detail that would enable the Town of Apple Valley to verify that the above stipulations are being followed. Such financial statements shall be provided to the Town within 60 days after the end of AVR's fiscal year. This financial information should also include a forecast for the current fiscal year.

13. More stipulations may be appropriate to assure that over-leveraging does not occur.

The BRWC's fundamental concern is that the Carlyle Group through its infrastructure Fund will purchase Park Water Company; and over time place a substantial amount of debt either directly or indirectly on AVR. To the extent that the Carlyle Group over- leverages the water company and pays the shareholders excessive returns it would result in substantially higher water bills as compared to the present and relative to adjacent cities that own water companies. Moreover, it would likely lead to a lack of investment in system upgrades, thus inhibiting the responsible growth of the Town of Apple Valley relative to neighboring cities. Accordingly, the above recommendations are aimed at preventing such a situation from arising.

Since the adoption of Proposition 218 by the voters of the State of California, it is now extremely difficult for a city to obtain approval from two thirds of the voters to purchase a water company. AVR has a monopoly to supply water. If the ratepayers and the Town were not satisfied, it would be almost impossible for the Town to purchase AVR. In this new world of post Proposition 218, it is more critical for the CPUC to protect the ratepayers and the Town who are stakeholders in the water company without any effective recourse to purchase the water company. For this reason, it is imperative that the CPUC require AVR

to provide the Town with sufficient information so that it can monitor the activities of AVR.

The Montana Public Utility Commission adopted several proposed stipulated conditions, which it called "Ringed Fencing Conditions" to the approval of the merger between the Park Water Company and the Carlyle Group's Infrastructure Fund. Exhibit C is a copy of the proposed conditions.

Condemnation Value of AVR

As of November 2011, the Park Water Company and the Carlyle Group have no interest in selling AVR to the Town through a negotiated sale. They are moving forward with the merger, which will most likely be approved by the CPUC; and has all but been approved by the Montana Public Utility Commission. The objective of this subsection is to discuss the range of values that could be awarded by the Court in a condemnation proceeding in order to estimate the cost to acquire the AVR through condemnation and the risk associated with such an effort.

As noted in the Bartle Wells Report the Town will be acquiring a water utility plant, which consists of wells, land, pumping plant (including structures and equipment), water treatment equipment and distribution mains, reservoirs and tanks, meters, hydrants, vehicles and general office equipment. The acquisition would also include rights –of-way and easements. The Town would be purchasing the assets of a privately owned water company within the Town's incorporated area.

It was the conclusion of the Bartle Wells Report that the Town of Apple Valley would not be purchasing any water rights. From the annual reports filed by AVR with the CPUC, the rate case documents and conversations between Bartle Wells Associates and the Mojave Water Agency, there does not appear to be separate water rights held by AVR, which would not revert to the Town should it acquire the assets of the water companies and begin operations of the water utility. Customer Advances of approximately $31,000,000 would be assumed by the Town and would not be repaid over their current payment schedules and terms.

The Bartle Wells Study considered four different methodologies to estimate the total Acquisition cost to the Town. They were (1) The allocation of the Purchase Price of the Park Water Company, (2) the current Reproduction Cost less Depreciation, (3) the capitalization of Net Income and (4) the Sales of Other Water Systems.

Allocation of the Purchase Price of Park Water Company

The first method was based on an allocation of the purchase price that the Carlyle Group is willing to pay for the Park Water to the two water utility companies it owns. According to Bartle Wells Associates, the purchase price for the Park Water Company was $102,000,000. The price was allocated based on the number of connections. The Mountain Water Company in Missoula, Montana with 22,300 connections was assigned 53% or $54,060,000 of the total purchase price. AVR with 19,500 was allocated 47% or $47,094,000 of the purchase price. This is discussed on pages 17 through 19 of the Bartle Wells Report.

Members of the BRWC recognize there are limitations to this method of analysis. It did not take into consideration the fact that as of November 30, 2010 there was approximately $54.4 million of Long Term Debt, $42.1 million of Intercompany Advances and Payables that presumably are owed to the Mountain Water Company, $6.4 million in Deferred Credits and 1.4 million in Advances for Construction. In fact, the Capital Stock and Surplus Account of Park Water Company showed a deficit of $17,665,000. The company had a negative equity instead of a significant positive equity on its Balance Sheet. Assuming the Intercompany Advances and Payables are to sister companies that would cancel out in a consolidated balance sheet, there appears to be approximately $60 million in Debt that would be assumed by the Carlyle Group's Infrastructure Fund. This would suggest the purchase price of the assets of the two water companies would be closer to $162,000,000. We do not have enough information to know this with any certainty.

In addition, the allocation of the purchase price is only based on the number of connections. It does not take into consideration relative levels of Revenue, profitability, After Tax Cash Flow or the depreciated value of the replacement costs of the plant and equipment of the Two Assets. The Rate Base of AVR is approximately $40.5 million. The Rate Base of the Mountain Water Company is not discussed in the Bartle Wells Report perhaps because Bartle Wells Associates does not have access to such information. What we do know from the Bartle Wells Report is that the Carlyle Group, in the response to the Town's Data Request, stated, "they evaluated the future potential earnings generated by the water companies owned and operated by Park Water. Carlyle based their financial projection on the principles of utility economic regulation. They made assumptions on rate base, projected Revenues and expenses, depreciation, income taxes, and rate of return on the rate base. Their financial projections assumed that excess Cash Flow would be available for future dividends." This suggests that the allocation of the purchase price was made on the basis of Cash Flow projections, which is what one would expect of the Carlyle Group. No information was provided about the Cash Flow of the Mountain Water Company.

In fact, little information was provided about the Cash Flow of AVR. A portion of the Purchase Price of Park Water Company should be attributed to the division

that operates a public utility system in the southeastern portion of Los Angeles County. That public utility has 27,158 active customers as of December 31, 2010. That operation may generate positive Cash Flow for the Park Water Company. On the other hand, a water utility management company may not have the investment upside of private utility companies to the Carlyle Group and therefore be substantially less valuable per connection. Nevertheless, that operation likely has a value materially greater than zero.

The Bartle Wells Report values the assets of AVR at $48 million based on the Town assuming responsibility for the repayment of the Advanced Fees. Because of the limited information provided in the Bartle Wells Report, the Finance Committee could not determine if this estimate of AVR's value would hold up under a more extensive investigation. Chris Schilling, the CEO of the Park Water Company argues that the price paid Mr. Wheeler for the entire Park Water Company that enables him to have a substantially tax free exchange would be far less than multiple buyers would pay for the individual companies. The Finance Committee is of the opinion that experts in a condemnation proceeding using this method could argue that the purchase of AVR is somewhat less than $48 million or substantially more than $48 million. A much more extensive investigation would have to be conducted to refine the purchase price based on this method of valuation.

Current Reproduction Cost less Depreciation

The Bartle Wells Report refers to this method as The Reproduction Cost New Less Depreciation (RCNLD); and further comments that this method produced its highest estimate of the Value of the Assets of AVR. This approach estimates what it would cost to replace or reproduce existing utility assets, less their accumulated depreciation due to age and wear and tear.

In the Bartle Wells Report RCNLD is calculated by escalating the original cost of the assets by the Handy-Whitman Index of Public Utility Construction Costs to current Dollars. From this amount a depreciation component, representing the loss of value of the existing assets due to age and condition, adjusted to account for any remaining salvage value of the asset is subtracted. The Cost of the Advances is also subtracted from the RCNLD. The result is an approximation of the value of the utility that accounts for the current cost to replace it, the depreciation due to age and wear and tear and the Advances due to developers.

Table 9 in the Bartle Wells Report details the RCNLD calculation for AVR in 2011. The current reproduction value before depreciation is approximately $162 million. This compares to an historical cost of $103 million for the Utility Plant in Service. The accumulated depreciation on historical costs is almost $24 million.

When it is deducted from $103 million, the resulting Net Book Value is $79 million. When Bartle Wells Associates deducts the same amount of depreciation

from $162 million it results in an estimate of Reproduction Cost New Less Depreciation of almost $139 million. The RCNLD estimate of value is approximately $59 million higher than AVR's historical cost net of depreciation. There is a question as to whether or not the accumulated depreciation in the RCNLD calculation should be greater than what was calculated based on historical costs. If the accumulated depreciation increased proportionate to the increase in the cost index, the accumulated depreciation for RCNLD would be $37 million or $13 million higher than used in Table 9. This adjustment would reduce the RCNLD to $126 million.

In the Bartle Wells Report, slightly more than $31 million was deducted from the RCNLD estimate to account for Advances to developers. As previously discussed, such Advances are zero interest loans to AVR that are typically repaid over 40 years. The present value of such Advances is probably around 35% of book value. Hence, the deduction for Advances should be approximately $11 million. The intangibles at 10% of the RCNLD would be almost $13 million. With these adjustments, the estimated Reproduction Cost Value of AVR's Plant and Equipment less Accumulated Depreciation plus an allowance for Intangibles and a deduction for Advances results in an estimated value of $128 million.

The Town presently does not have the expertise to assess whether or not the Park Water Company will be successful in persuading the court that the value of AVR for purposes of Condemnation should be based on reproduction costs and that the reproduction costs are substantially higher than $128 million. It is possible that the court may value AVR at a higher value. The Finance Committee has no way of knowing what value would be determined by the court.

Capitalization of Net Income

In the Bartle Wells Report, the third method used to estimate the value is the capitalization of Net Income earned by AVR to estimate the value of the water facilities. Net income is defined as operating Revenues less operating expenses less Income Taxes. The capitalization of Net Income is calculated by dividing the After Tax Net Income of the utility by an appropriate capitalization rate. Bartle Wells Associates opined that the appropriate Capitalization Rate for a public utility is the Rate of Return authorized by the California Public Utilities Commission, which for AVR was 9.42%.

In the Current Rate Case before the CPUC, the projected After Tax Net Income for AVR is $3,855,000 given the proposed rates and the authorized rate of return by the CPUC. Dividing Net Income by the authorized rate of return of 9.42% produces an estimated value of $40.9 million. This is exactly equal to the Rate Base of AVR, which is not too surprising because the budgeted After Tax Net Income in the Rate Case must equal the product of the authorized Rate of Return and the Rate Base. There are two critical questions related to this method of analysis.

The first question is whether the budgeted After Tax Net Income will be realized in 2012. Because the actual water usage will likely be substantially less than the budgeted volumes, the After Tax Net Income will probably be substantially less. In fact, if the water usage in 2012 turns out to be 30% less than was budgeted the Net Income would be approximately $2.6 million less than $3,855,000. If the actual 2012 Net Income for AVR were only $1,255,000, the estimated value based on the capitalization of income method would only be $13,300,000 given a Capitalization Rate of 9.42%.

The second question is whether the authorized Rate of Return of 9.42% is the appropriate capitalization rate. We think not. Capitalization Rates are usually determined by obtaining information on sales prices and Net Income from the sale of other water utility. This information is used to estimate the capitalization rate for each sale. The Capitalization Rate is then determined by the appraiser. The 9.42% Rate of Return is more of a conceptual rate authorized by the CPUC that when multiplied by the companies Rate Base that reflects historical costs results in an Net Income figure that will enable the utility to be economically viable. It is not based on the sale prices of utility companies.

The Bartle Wells Report does not give much weight to this estimated of value. The discussion is brief and even though it generates the lowest estimate of AVR's Market Value at $40.9 million it is not used Bartle Wells Associates as the lowest value for AVR. The Bartle Wells Report identifies the $48 million determined by the allocation of the Purchase Price of the Park Water Company as the lowest estimate of AVR's value in its analysis. The Finance Committee believes that the $40.9 million estimate of AVR's value should be considered. The actual value could more or less than this figure.

Sales of Other Water Systems

The last approach used by Bartle Wells Associates to value AVR's water facilities is to examine the sales of other water systems that were comparable to AVR. The Bartle Wells Report describes the criteria for a sale to be comparable; the sources of sale information and the difficulty in comparing the sale of water utility companies. Nevertheless, Bartle Wells Associates identified four sales that it had been involved in that it thought would qualify as comparable sales. They are briefly described below.

In April 2001, the City of Yuba City purchased a water system from the Hillcrest Water Company, owned by a sole proprietor. The water system was adjacent to the City-owned water system and the service area was being annexed into the City. The sale was accomplished through "friendly" condemnation where the City and the owners negotiated and stipulated to a purchase price that the condemnation court accepted. The sales price for the Hillcrest water system was $3,400,000. The number of water customers was 4,475; so that the purchase

price per customer was $760. The Net Book Value (NBV) of the water system was $2,406,900. The ratio of price to NBV was 141%.

In January 2002, California-American Water Company (Cal-Am) completed the acquisition of four water systems owned by Citizens Utilities of California (CUCC), which had been approved by the CPUC in September 2001. The sales price for the CUCC systems assigned to Cal-Am was $161,320,000. The approximately number of water customers was 66,000; thus, the average price per customer was $2,444. The Net Book Value estimated for the CUCC facilities was $96,767,000; hence, the ratio of price to NBV was 167%.

In May 2003, the Montara Water and Sanitary District (MWSD) acquired the water facilities in Montara and Moss Beach from Cal-Am by means of stipulated judgment in an eminent domain (condemnation) proceeding in San Mateo Superior Court. The acquisition price was the result of a settlement between MWSD and Cal-Am. The purchase price was $11,097,000. The number of water customers was 1,635; thus, the average price per customer was $6,787. The Net Book Value estimated for the Montara water facilities was approximately $5,158,700 so the ratio of price to NBV would be 215%.

In 2008, the San Lorenzo Valley Water District (SLVWD) acquired the Felton water system from Cal-Am. The purchase resulted from a settlement of a condemnation court case in Santa Cruz County Superior Court. The settlement stated that SLVW would pay Cal-Am $13.4 million of which $2.9 million was the assumption of a Safe Drinking Water State Revolving Fund loan and $10.5 million in Cash. The $13.4 million represents the fair market value of the operating assets of the Felton Water System. The Felton operating assets included utility plant in service as well as watershed land and commercial timber. Utility plant included pipelines, water treatment plant, storage reservoirs, fire hydrants, service connections, and meters. The purchase included general plant, such as furniture, equipment, vehicles, and materials and supplies. Finally, the purchase price considered land rights and water rights.

According to reports filed with the CPUC there were around 1,300 water customers in the Felton District. The average acquisition cost per customer was therefore around $10,300. Other data filed with the CPUC regarding Cal-Am's acquisition of the CUCC water system indicate a Net Book Value of approximately $5,500,000. The ratio of the acquisition value to NBV was 244%.

The Bartle Wells Report does not draw a clear estimate of market value using the Sales Comparable Method. A few paragraphs later in the report it notes: The Net Book Value of AVR as of 2011 was $79.2 million. Using a Price to NBV of 200% would result in an acquisition price of $158.4 million. This is the highest estimate of value of the four methods; yet Bartle Wells Associates for purposes of its updated feasible study used the value of $121.5 million that it estimated using the Reproduction Cost New Less Depreciation (RCNLD) method as the highest

probable acquisition cost to the Town of Apple Valley. The report further states that the lowest probable acquisition cost used in its feasibility study was $48 million, which was based on the price the Carlyle Group is willing to pay for the Park Water Company.

Conclusions as to AVR's Condemnation Value

The value that the court would place on AVR in an eminent domain (condemnation) proceeding could range widely. Chris Schilling has indicated that the Park Water Company's attorneys will argue that the assets of AVR are worth several hundred million dollars. The Town's attorneys and experts will likely make the case that the assets of AVR are worth much less. However, to be conservative, the Town should be prepared to accept a condemnation price of greater the $200 million even though an objective assessment of value may be only a fraction of this sum.

In the Bartle Wells Study the use of $121 million as the highest probable acquisition cost to the Town of Apple Valley and $48 million as the lowest probable acquisition cost is acceptable even though the actual award by the court could be higher or lower. Both values are only used to estimate the service debt associated with the various types of financing. This is a reasonable range for purposes of the feasibility study and adequate for the purposes of the Finance Committee.

The Finance Committee has not been able to reconcile the fact that AVR, which has experienced substantial negative Cash Flows since 2008 and will likely not generate a positive Cash Flow without Surcharges in 2012, could have a market value of $121 million or even $48 million. Such market values can only be justified if the buyer believes that it will be able to raise Water Rates, Supplemental Water Acquisition Fees, and Supply Facilities Fees substantially in future years. If AVR is not able to convinced the CPUC to approve such rates the Carlyle Investment Group will not achieve its investment goals over the next several years.

The Finance Committee is also concerned that The Town could end up substantially overpaying for the Water Company if it purchased the water company through the condemnation process. If the court set the value of AVR at the $200 million figure the Town would be substantially over paying for the Water Company.

Cost to Acquire AVR

The Bartle Wells Report describes the various transaction costs that the Town can expect to incur in the proposed acquisition of AVR. Such cost would be above and beyond the purchase price of the utility. Any acquisition would require the use of consulting engineers, financial advisors, legal counsel and appraisers.

The acquisition may also require review under the California Environmental Quality Act (CEQA) and incur annexation costs to bring the water system completely within the jurisdiction of the Town.

Detail Transaction Costs Estimates

The report also provides an estimate of the costs associated with each service. Bartle Wells Associates points out the costs will vary depending on the method of acquisition. A negotiated purchase between the Town and the private water utility would have the lowest transaction costs, while an acquisition through condemnation would have higher associated expenses. Increased costs with a condemnation stem primarily from increased legal fees and spending associated with the use of expert witnesses. The following subsection describes the different cost components associated with the acquisition of AVR as well as the estimated fees.

Engineering Consultant

The Town would be required to engage a consulting engineer to review the condition of the water system and determine the need for capital improvements. As previously discussed AVR has identified the need for substantial capital improvements in the pending rate case. The adequacy of these improvements should be evaluated. Revisions to the AVR proposed capital investment program could change the projected Cash Flow of the company after acquisition. It may also build a case for a lower purchase price in the court trial because of a need to replace more of the installed distribution system. The Bartle Wells Study projects an Engineering Consultant Fee of $800,000 in the case of a Negotiated Purchase and $1,100,000 for a purchase through Condemnation.

Financial and Accounting Services

According to the Bartle Wells Report the Town would also require the use of financial and accounting assistance. Financial consultants would advise the Town on debt financing issues and review the Water Rates and charges. An account would be required to review past financial statements from the utility, including historical annual reports, and review billing and accounting records. The cost of such financial consulting and accounting services were estimated by Bartle Wells and Associates to be $250,000 for a negotiated purchase and $400,000 for a purchase through condemnation.

Town Counsel

According to the Bartle Wells Report resources would be needed to support the Town Counsel in negotiations and the legal aspects of the acquisition, including the processing and filing of legal documents. The Town can expect that condemnation proceedings would add a level of complexity, and therefore costs,

to this item. Under a negotiated purchase the Town Counsel fees are projected to be $250,000. They are estimated to be $500,000 under a condemnation procedure.

CEQA and Annexation

There will be costs associated with the environmental review of the acquisition. The cost estimated in the Bartle Wells Report assumes that there will be a negative declaration and no environmental impact report would be required, The Town may also need to annex some new land into the Town boundaries in order to make the boundaries of the Town and the AVR service areas more co-terminus. Bartle Wells Associates estimated the cost associated with the CEQA and annexation effort would be $100,000 regardless of the method of purchase.

Appraisals

The Town will need to retain an independent appraiser to value the water utility. The appraisal of the system should include all water facilities, intangible assets, water rights, and land that would be acquired by the Town. The Bartle Wells Report emphases it is a crucial component of any successful acquisition. The appraisal would form the basis for initial offers to the companies. In a condemnation proceeding, the appraisal would be further supported by the opinion of expert testimony used to establish fair market value for the utility. Bartle Wells Associates that the appraisal for a negotiated purchase would cost $200,000. If AVR were to be purchased through condemnation the cost was estimated to be $500,000.

Condemnation Attorney and Trial

If the Town of should choose to proceed with condemnation proceedings, it would require the services of an attorney specializing in this type of procedure. Within the condemnation proceedings there would likely be two trials. The first trial would determine whether or not the Town had the "right to take" AVR from the Park Water Company. Apparently, the Town would have to demonstrate to the court that it has a real need to condemn the water company. The Town would have to convince the court that it has a right to take the water company. The court may not agree that the Town has the right to take AVR and the condemnation procedure would be terminated. Chris Shilling the Co-CEO of the Park Water Company has said that they would contest the Town's right to take. Ultimately, the Town is likely to be able to establish that the acquisition of AVR's system is in the public benefit. However, there is always some risk to the Town that it may incur substantial cost preparing for the first trial and not be able to purchase AVR. The odds of the Town obtaining the right to take are unknown at this time; but they are less than 100%.

If the court determines the Town has a right to take AVR from the Park Water Company or the Carlyle Group's Infrastructure Fund there would be a second trial to determine the purchase price. The Bartle Wells Report estimates the total legal costs for the Condemnation Attorney and Trial would be $1,000,000.

Contingency Reserve

The Bartle Wells Report recommended the Town a contingency reserve to cover cost overruns of 18%. This equated to $288,000 in the case of a negotiated purchase and $648,000 in the case of purchasing AVR through condemnation. Bartle Wells Associates estimated the total transaction costs for a negotiated purchase would be $1,888,000. The total estimated cost for an acquisition would be $4,248,000.

Conclusions Regarding Transaction Costs

The transaction costs that are relevant are the cost associated with the acquisition of AVR through condemnation. The Park Water Company have made it clear that the Town will have to acquire AVR through a condemnation proceeding.

Within the condemnation proceedings there would most likely be two trials. The first trial would determine whether or not the Town had the "right to take" AVR from the Park Water Company. The Town would have to demonstrate to the court that it has a real need to condemn the water company. Ultimately, the Town is likely to be able to establish that the acquisition of AVR's system is in the public benefit. However, there is always some risk that the court could rule that the Town does not have the right to take AVR and the condemnation procedure would be terminated. Chris Shilling the Co-CEO of the Park Water Company has said that they would contest the Town's right to take. The risk to the Town is that it may incur substantial cost preparing for the first trial and not be able to purchase AVR. The odds of the Town obtaining the right to take are unknown at this time; but they are definitely less than 100%.

If the court determines the Town has a right to take AVR from the Park Water Company or the Carlyle Group's Infrastructure Fund there would be a second trial to determine the purchase price.

The Bartle Wells Report estimated that the total transaction costs would be $4,248,000. This includes a cost allowance of $1,000,000 for fees paid to the Condemnation attorney and trial costs. Litigation costs almost always exceed initial budgets. For planning purposes the Finance Committee assumed the costs would be $2,000,000. Hence, the total transaction costs associated with the purchase of AVR would be budgeted at $5,248,000.

Financing Options

This section reviews the various financing options that are available to the Town to Acquire AVR. The portion of the Bartle Wells Report that describes the various options was copied into this analysis.

Bartle Wells Associates evaluated four major financing options that are available to the Town of Apple Valley for acquiring the AVR system. Each of these financing methods has been used by public agencies to acquire water systems from private owners. The Montara Water and Sanitary District issued general obligation bonds; Santa Cruz County issued Mello-Roos (special tax) bonds; Yuba City issued certificates of participation; and Madera County used assessment bonds for a small acquisition. Financing would include funding the purchase of water facilities and land and the funding of transaction costs. The four methods of financing that Bartle Wells Associates investigated include:

- General Obligation Bonds
- Mello-Roos Community Facilities District (Special Tax) Bonds
- Assessment Bonds
- Revenue-Supported Borrowing

General Obligation Bonds

General obligation (GO) bonds are debt instruments secured by the full faith and credit of the borrower. They would be paid back through the unlimited power of the Town to levy property taxes at any rate or amount necessary to pay semi-annual debt service payments. These taxes would be levied at an equal percentage on all assessed property value within the Town of Apple Valley. Taxpayers in the Town of Apple Valley would pay higher property taxes because of this financing.

GO bonds require approval by 2/3 of registered voters. The principal and interest to repay GO bonds would be paid with a general tax based on the assessed value of property. The Town of Apple Valley would have to prepare a ballot measure and would have to indicate the maximum bonds authorized by the vote and an estimate of the maximum property tax. Each year the Town would set the property tax rate per $100 of assessed value and provide the tax rate to the County, who collects the tax payments and remits them to the Town. The tax rate will more than likely decline over the life of the GO bonds assuming annual increases in assessed values of property within the town.

The clearest advantage of a GO bond is its low cost. Since GO bonds are backed by the pledge that all necessary Revenues will be raised through increased property taxes, they typically carry the lowest risk in the municipal market, which is reflected in their low interest rates. They do not require a reserve fund and they have the lowest issuance costs of the four financing

methods reviewed. GO bonds are also relatively simple to administer, as they require no changes in the manner in which property taxes are collected. They are collected along with the other taxes, assessments, and special charges on the property tax bill.

Since GO bonds are dependent on property tax Revenues, their impact on residents of Apple Valley would be proportional to the assessed valuation of property owned by residents. Proposition 13 limits annual increases in the assessed valuation of property to 2% per year, provided that property was not transferred in ownership during the year. When property is transferred between owners, properties are re-assessed to reflect the new market value. Newer property owners, with higher assessed values, would bear a high tax burden because of this financing.

Additionally, if the boundaries of the Town of Apple Valley are not co-terminus with the boundaries of the utility being acquired, those within the Town limits would be effectively financing the acquisition for those served by the utilities but located outside the Town limits.

Mello-Roos Community Facilities District Bonds

Mello-Roos or "special tax" bonds may also be used to finance the construction or acquisition of facilities and land. Moreover, they can be used to finance certain, limited types of services and pay for limited operation and maintenance. Under the terms of the Mello-Roos Community Facilities Act of 1982, public entities, such as cities and counties, are allowed to form Community Facilities Districts (CFD), and once formed, these Districts can issue bonds upon 2/3 approval of registered voters within the District. Importantly, a CFD need not be co-terminus with the boundaries of the municipality forming the District.

Bonds issued by a CFD can be used to purchase any real property with an estimated useful life of more than five years. They are *not* secured by the unlimited power of a local government to levy property taxes. Instead, a special tax is levied on all properties within the CFD in order to pay semi-annual debt service requirements. This special tax is not an *ad valorem* tax but instead based on a special tax formula. There is considerable flexibility in its structure, with factors such as square footage developed, density of development, acreage, and zoning commonly being used to calculate the tax. Equivalent water meters can be used in the case of acquiring water facilities. Taxpayers in the proposed CFD would pay higher taxes because of this financing. The special tax is fixed and does not change over the life of the bonds. Increase property values would not affect the level of the special tax. Moreover, the special tax is not tied to use of the water system, such as water consumption or metered water sales.

A CFD can provide for the prepayment of special tax before bonds are issued. But after bonds are issued any prepayment of special taxes would be very

difficult and would require a complex formula. Moreover, early refunding of the bonds could be difficult and would more than likely require a recalculation of the special tax and may require another vote with 2/3 voter approval of any change in the special tax.

Mello-Roos bonds have the advantage of flexibility. In this case, the Town could design the CFD boundaries to be co-terminus with the boundary of the service area of the utility. This would ensure that only those properties directly impacted by the acquisition would be assessed the special tax. In addition, because there is no requirement that the tax be based on the "special benefit" a parcel receives, the District can tailor the rate and method of apportionment to best meet Revenue requirements and the political environment, potentially improving the likelihood of voter approval.

At the same time, Mello-Roos financings are very complex. The flexibility allowed in constructing the special tax apportionment also means that these formulas can be very intricate and difficult for the property owner to understand. Engineering and financial analysis would be required to develop the special tax formula. Additionally, because Mello-Roos bonds are not secured by the full faith and credit of the issuing agency, they are considered riskier than GO bonds and carry higher interest rates. Mello-Roos bonds also typically provide for a reserve fund and bond insurance may be advisable, two factors which also increase the effective cost of this type of financing for the Town.

Assessment Bonds

The Town could possibly use assessment bonds to finance the acquisition of the water company. The Town has experience with assessment bonds. Assessment District No. 3 Improvement Bonds (1915 Act bonds) are outstanding and were originally issued by the Apple Valley Water District in 1988 to fund public improvements. Assessment District No. 2-B sold limited obligation improvement refunding bonds in 1991 to fund sanitary sewer facilities. These bonds were refunded with a 1996 assessment bond issue. The Apple Valley Water District has issued Special Assessment District 98-1, 1915 Improvement bonds to finance sewer improvements in the Jess Ranch area.

Assessment bonds are typically used to finance capital improvements to a relatively small area where the special benefits of the public project can be readily assigned to assessed properties benefiting from the project. They may not be the best method to finance a large water system acquisition for the whole Town, which could provide a general benefit to the public at large. One general benefit of a publicly owned water system is fire protection.

The most common assessment bonds used by local governments to finance public projects are issued under the Improvement Bond Act of 1915. The 1915 Act, which only involves the issuance of bonds, requires another stature to

establish the assessment district, authorize public improvements, and impose the assessments. Typically, the Improvement Bond Act of 1913 (or sometimes the Act of 1911) is used. The use of assessment bond financing and the establishment of an assessment district are subject to Proposition 218, which added Article XIID to the California Constitution.

An assessment bond is a financing method where bonds are secured by liens placed upon all property within a defined geographic area (the assessment district). Similar to both GO bonds and special tax bonds, owners of impacted parcels of land would fund the cost of annual debt service.

Assessments are not taxes, and their individual size is not tied to the assessed valuation of the property. Instead, assessments are calculated based on the proportional "special benefit" that a property receives from the improvement to be financed. Undeveloped land must be included in the assessment district. As with community facilities districts, the local government is allowed some latitude in determining the method of apportionment. In this context, the Town would likely choose some proxy for water use such as lot size or type of customer to determine the size of the assessment for each parcel.

The procedure to issue assessment bonds and to set assessments for water service is described as follows. After the size of the assessment is determined, a notice is mailed to all impacted property owners along with a ballot, and a public hearing is held within 45 days to address constituent concerns and tally the vote to protest the project. Votes are weighted according to the proportional financial obligation of the affected property. A majority protest means that the district cannot be formed. If approved (i.e., not a majority protest), individual assessments are then placed as liens on property as security for any future bond issues. The property owner has the option of paying off the lien in cash, with that amount then being deducted from the total size of any bond issue, or deferring payment for a time generally up to 30 years.

The assessment district creates a fixed dollar amount special assessment lien on each property of the district. The lien lasts for ten years or until bonds are issued, whichever happens first. If bonds are issued, the lien is for the term of the bonds, plus four years.

Special assessment bonds are secured by the unpaid amount of the fixed assessment liens on property. State law governs their payment dates so that principal is paid annually on September 2 and interest is paid semiannually on March 2 and September 2.

There are two opportunities to pay off assessment debt. The first is during the minimum 30-day cash payment period after the creation of the district. During that period, the principal amount of the assessment may be paid in whole or in part. When the bonds are sold, that person's share of any bond reserve and

discount is rebated to that person. The second is after bond issuance; when a person can prepay that person's share of the total principal amount, any prepayment penalty, a share of interest to the next available bond call date, and administrative costs.

As with community facilities districts, assessment districts have the advantage of flexibility; the boundaries of the district can be created such that they are co-terminus with the boundaries of the service area of the utility. In addition, because assessments related to water service are not considered taxes under California law, they are not subject to 2/3 voter approval. Assessments must comply with Proposition 218, which outlines the legal framework to establish and use the assessments in raising local Revenue.

Assessment bonds do have a number of disadvantages over other financing options, which when taken together may make this a higher cost method to finance the acquisition. Issuance costs are higher than for GO bonds, as there are increased costs associated with the creation of the district and the need for a civil engineer to determine the special benefit for each parcel and to calculate the assessments. In addition, since debt service is only secured by the liens on property and not by the unlimited power of the Town to levy taxes, assessment bonds are considered riskier investments. To provide the bonds with appropriate security and allow for successful marketing, the property securing the lien must have value sufficient to cover the assessment. As a general guideline, the ratio of assessed value to assessment lien should be at least 3:1. In either case, assessment bonds will likely carry higher total interest costs than GO bonds and require a one year reserve fund.

Revenue-Supported Borrowing

There are two major Revenue-supported borrowing options available to the Town to finance this purchase. With this type of financing, the Town does not incur any further indebtedness; instead, the Town must pledge a portion of the enterprise's future net Revenues to meet the debt service. Revenue bonds take a number of different forms, to include public enterprise Revenue bonds, public lease Revenue bonds, and certificates of participation.

Public Enterprise Revenue Bonds

Traditional Revenue bonds can be used to finance any public improvement of Revenue producing nature. They are secured by a lien upon future Revenues of the proposed improvement. Approval of a Revenue bond is subject to provisions of the Revenue Bond Law of 1941; they can be issued upon adoption by majority vote of the governing body of the local agency. A majority vote must be obtained at an election on the proposition of issuing bonds.

Most Revenue bonds are issued by means of a joint powers authority (JPA) that

does not require an election or voter approval. The joint powers authority can be a financing authority created by the two public agencies, such as a city and its redevelopment agency. If a JPA is used, then the more typical financing is the use of certificates of participation, which are described below.

Effective marketing of Revenue bonds requires a well-established operating history of the enterprise to ensure that future Revenues will meet required debt service. The issuer may also have to covenant to establish rates and charges that are sufficient to meet debt service.

Financing Leases and Certificates of Participation

Slightly different than traditional Revenue bonds, but used more frequently, is lease financing using certificates of participation (COPs). The Town has previously issued certificates of participation. In 1999, the Town sold COPs to finance the construction of the New Town Hall and new county office building. In 2001, the Town sold variable rate demand COPs to refund the 1999 COPs.

COPs would allow the Town to enter into a tax-exempt lease financing arrangement in lieu of issuing bonds. In this arrangement, a third-party owner would purchase the water company and then lease the system back to the Town. Security for the lease is supported solely by the net Revenues of the Town's water system. The lease can be structured as an installment sale/purchase agreement, in which the Town would assume ownership of the facilities at the closing of financing, typically two or three weeks after the COP sale. The Town has experience with an installment sale/purchase agreement. In 2004, the Town entered into an installment purchase agreement with the Mojave Desert and Mountain Integrated Waste Management Authority. The agreement was established when the Authority issued Revenue bonds to refund bonds that were originally issued to fund the design and construction of a materials recovery facility. The Town's installment payments come from service Revenues that consist primarily of rates and charges imposed by the Town for solid waste management services.

In the context of this proposed financing, a non-profit corporation or joint powers authority (like the Apple Valley Public Financing Authority) would purchase the utility and then subsequently lease or sell it because of an installment sale to the Town of Apple Valley. As with any lease or installment sale, structured payments have both principal and interest components and are tax-exempt. The lessor assigns its rights to receive future lease or installment payments to a trustee and undivided shares of these future payments can subsequently be issued as "certificates of participation" and marketed to third-party investors. In practice, the structure, marketing, and sale of COPs is very similar to that of traditional Revenue bonds, and their security is provided only through the ability of the utility to produce net Revenues sufficient to meet its payments.

The use of COPs would offer Apple Valley the ability to finance this acquisition with Revenues generated solely from the customers receiving service from the publicly owned water utility. There would be no obligation on the Town to raise taxes or meet debt service with resources from its general fund. Since the acquisition is paid back from Water Rates and service charges, the distribution of financial burden is judged equitable because it is spread proportionally among customers based on water use. In addition, COPs do not require voter approval in a general election and do not count as indebtedness under state constitutional debt limitations.

COPs may be the highest total cost method of financing the acquisition as they are viewed as riskier investments in the bond market and as such must carry higher interest rates. A reserve fund is generally required. In addition, COPs must comply with "debt service coverage requirements." This means that net Revenues, after meeting all operating and maintenance expenses, must be 125% of the maximum annual debt service. This is similar to the debt service coverage requirement applicable to the Mojave Waste Management Authority's installment purchase agreement. This coverage requirement means higher rates for customers; but may also allow the Town to build capital reserves.

Cost of Financing for the Four Financing Options and Four Condemnation Prices

This section describes the methodology used to determine the total amount of debt that would be issued for each of the four purchase price assumptions related to the acquisition of AVR. The four purchases prices considered were (1) The probable lowest estimate of $48 million in the Bartle Wells Report, (2) an $80 million price which is approximately half of the estimated purchase of the Park Water Company by the Carlyle Group, (3) the probable highest estimate of $121 million in the Bartle Wells Report and (4) an extremely high estimate of $200 million, which was less than suggested by Mr. Schilling. The latter is probably the upper range of what would be awarded in a condemnation proceeding.

The Total amount of the Bond or COP issue for each of the four purchase prices was estimated along with the annual debt service and the Reserve Fund for each of the four financing options. The four financing options evaluated were (1) General Obligations Bonds, (2) Special Tax Bonds such as Mello-Roos Bonds, (3) Assessment Bonds and (4) a COP. A table was developed for each of the four options. The Issuance Costs assumed for each of the four options were the same as in the Bartle Wells Report. A miscellaneous fee of $10,000 was assumed in each case. The Underwriter's Discount was based on the fee structure used in the Bartle Wells Report. The Transactions Costs were assumed to be $5,248,000, which is $1,000,000 more than used in the Bartle Wells Report. The Finance Committee thought the provision for legal costs should be increased by $1,000,000.

The analysis assumes reserves would be established at the time of the issuance of the bonds or the COPs. Owning the water systems would require the Town to establish reserves at the beginning of public operation. The Town would start with zero reserves and would need to fund them quickly. Reserves would be required for: capital expenditures, operating expenses, replacements, vehicles, equipment, emergency, and water rate stabilization. How much to fund and target levels to be held in the reserves would be established by policy. This analysis adopted the same recommended in the Bartle Wells Study; except in the case of GO bonds, Special Tax Bonds and Assessment bonds the required reserve for each financing option was increased by $10 million in order to have sufficient funds cover any shortfalls in Operating Income and to make capital investments such as in North Apple Valley to accommodate future growth. In the case of the COP option, the additional $10 million was not added to the required reserves; because we wanted to test whether or not a Town-Owned Water Company could generate sufficient Cash Flow to service the debt without the added burden of an additional $10 million reserve.

The interest rates assumed for each financing option were the same as in the Bartle Wells Report. They ranged from a low of 5.25% for General Obligation Bonds to a high of 7.00% for Assessment Bonds. In each case the loans were fully amortized over 25 years based on annual principal and interest payments. The annual Debt Service was calculated in the same manner as was done in the Bartle Wells Report. The allowances for delinquencies and administrative costs were calculated based on the same formulas

It was further assumed that the Town of Apple Valley would be able to issue bonds for all the funds required. Both the members of the BRWC and the Town staff questioned whether that would be realistic in today's economic environment. There may in fact be a limitation on the amount of funds that could be raised in 2012 for the acquisition of AVR. Should the Town decide to move forward with the acquisition, this issue would have to be investigated in more depth? Each of the four financing options is discussed below:

General Obligation Bonds

General Obligation Bonds are generally the least expensive to issue and have the lowest interest rate of the financing options. General Obligation Bonds do not require an Underwriter's Discount and they do not require a reserve requirement. We have assumed a $10 million reserve that would be funded at the time the bonds are issued. GO bonds carry the lowest interest rate which Bartle Wells Report estimated would be in the range of 5.25%. Overall debt service on General Obligation Bonds was estimated to range from $4.6 million to on to $15.7 million per year over 25 years.

APPLE VALLEY RANCHOS WATER COMPANY
FINANCING OPTIONS FOR ACQUISITION - GENERAL OBLIGATION BONDS
November 14, 2011

	Stock Price Lower Est.	Medium Price Estimate	RCNLD High Estimate	Very High Price Estimate
Amount Issued				
Total Estimated Acquisition Costs (1)	$ 53,248,000	$ 85,248,000	$ 126,248,000	$ 205,248,000
AVR's Acquisition Costs	48,000,000	80,000,000	121,000,000	200,000,000
Transaction Costs	5,248,000	5,248,000	5,248,000	5,248,000
Issuance Costs	$ 285,000	$ 285,000	$ 285,000	$ 285,000
Financial Advisor	100,000	100,000	100,000	100,000
Bond Counsel	100,000	100,000	100,000	100,000
Expenses	20,000	20,000	20,000	20,000
Trustee	15,000	15,000	15,000	15,000
Bond Ratings	40,000	40,000	40,000	40,000
Special Tax Consultant	0	0	0	0
Assessment Engineer	0	0	0	0
Underwriter's Discount (2)	0	0	0	0
Bond Insurance + Surety	0	0	0	0
Miscellaneous	10,000	10,000	10,000	10,000
Reserve Fund (3)	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000
Total Issue	$ 63,543,000	$ 95,543,000	$ 136,543,000	$ 215,543,000
Annual Debt Service				
Term in Years	25	25	25	25
Interest Rate (4)	5.25%	5.25%	5.25%	5.25%
Annual Debt Service on Loan	$ 4,622,160	$ 6,949,861	$ 9,932,228	$ 15,678,739
Add:				
Annual Deliquence (1.5%)	-	-	-	-
Annual Administration	-	-	-	-
Total Annual Debt Service + Administration	$ 4,622,160	$ 6,949,861	$ 9,932,228	$ 15,678,739

(1) Purchase Price Estimate plus Transaction Cost based on Condemnation
(2) 0% for GO Bonds; 1.5% for Special Tax and Assessment Bonds; 1% for COP's
(3) A reserve Fund Equal to $10,000,000 plus one year's Debt Service if an Assessment Bond or a COP
(4) Estimated for Financial Planning Purposes. Rates mayvary based on Market Conditions

Special Tax Bonds (Mello-Roos Bonds)

For a Special Tax Bond, the average interest rate was projected to be 6.25% by Bartle Wells Associates, which reflects the lower security of that method of financing. Issuance costs are greater than GO bonds because of the complexity of the special tax bonds and the need for a special tax consultant. Bond underwriters are allowed to charge an Underwriter's Discount with Special Tax Bonds, which was assumed to be 1.5% of the total amount issued. A reserve fund equal to one year's debt service would be required. Special Tax Bond levies are also subject to delinquencies (assumed to be 1.5% of the total annual Debt Payment) and annual administration costs (assumed to be $50,000). These costs are consistent with the Bartle Wells Report. The Underwriter's Discount would range from $1,060,000 to $3,600,000. The reserves would range from a low of $15.8 million to $29.5 million. The annual debt service for a Special Tax Bond would range from $5,791,000 to $19,468,000.

APPLE VALLEY RANCHOS WATER COMPANY
FINANCING OPTIONS FOR ACQUISITION - SPECIAL TAX BONDS
November 14, 2011

	Stock Price Lower Est.	Medium Price Estimate	RCNLD High Estimate	Very High Price Estimate
Amount Issued				
Total Estimated Acquisition Costs (1)	$ 53,248,000	$ 85,248,000	$ 126,248,000	$ 205,248,000
AVR's Acquisition Costs	48,000,000	80,000,000	121,000,000	200,000,000
Transaction Costs	5,248,000	5,248,000	5,248,000	5,248,000
Issuance Costs	$ 495,000	$ 495,000	$ 495,000	$ 495,000
Financial Advisor	150,000	150,000	150,000	150,000
Bond Counsel	150,000	150,000	150,000	150,000
Expenses	40,000	40,000	40,000	40,000
Trustee	15,000	15,000	15,000	15,000
Bond Ratings	40,000	40,000	40,000	40,000
Special Tax Consultant	100,000	100,000	100,000	100,000
Assessment Engineer	0	0	0	0
Underwriter's Discount (2)	1,060,000	1,600,000	2,300,000	3,600,000
Bond Insurance + Surety	0	0	0	0
Miscellaneous	10,000	10,000	10,000	10,000
Reserve Fund (3)	$ 15,800,000	$ 18,700,000	$ 22,400,000	$ 29,500,000
Total Issue	$ 70,613,000	$ 106,053,000	$ 151,453,000	$ 238,853,000
Annual Debt Service				
Term in Years	25	25	25	25
Interest Rate (4)	6.25%	6.25%	6.25%	6.25%
Annual Debt Service on Loan	$ 5,655,721	$ 8,494,275	$ 12,130,570	$ 19,130,840
Add:				
Addual Deliquence (1.5%)	85,000	128,000	182,000	287,000
Annual Administration	50,000	50,000	50,000	50,000
Total Annual Debt Service + Administration	$ 5,790,721	$ 8,672,275	$ 12,362,570	$ 19,467,840

(1) Purchase Price Estimate plus Transaction Cost based on Condemnation
(2) 0% for GO Bonds; 1.5% for Special Tax and Assessment Bonds; 1% for COP's
(3) A reserve Fund Equal to $10,000,000 plus one year's Debt Service if an Assessment Bond or a COP
(4) Estimated for Financial Planning Purposes. Rates mayvary based on Market Conditions

Assessment Bonds

The Bartle Wells Report assumed an assessment bond would have an interest rate of 7.00%, because they have one of the highest risk of all municipal financings. Issuance costs, Underwriter's Discount, and annual delinquencies are also assumed to be about the same as for a Special Tax Bond. The Underwriters Discounts range from $1.1 million to $3.7 million. Annual delinquencies were assumed to be 1.5% of annual debt service. Annual administration costs were assumed to be $75,000. In total, the average annual debt service plus admin costs for an assessment bond was estimated to range from $6.3 million to $21.0 million.

APPLE VALLEY RANCHOS WATER COMPANY
FINANCING OPTIONS FOR ACQUISITION - ASSESSMENT BONDS
November 14, 2011

	Stock Price Lower Est.	Medium Price Estimate	RCNLD High Estimate	Very High Price Estimate
Amount Issued				
Total Estimated Acquisition Costs (1)	$ 53,248,000	$ 85,248,000	$ 126,248,000	$ 205,248,000
AVR's Acquisition Costs	48,000,000	80,000,000	121,000,000	200,000,000
Transaction Costs	5,248,000	5,248,000	5,248,000	5,248,000
Issuance Costs	$ 455,000	$ 455,000	$ 455,000	$ 455,000
Financial Advisor	150,000	150,000	150,000	150,000
Bond Counsel	150,000	150,000	150,000	150,000
Expenses	40,000	40,000	40,000	40,000
Trustee	15,000	15,000	15,000	15,000
Bond Ratings	0	0	0	0
Special Tax Consultant	0	0	0	0
Assessment Engineer	100,000	100,000	100,000	100,000
Underwriter's Discount (2)	1,100,000	1,650,000	2,350,000	3,700,000
Bond Insurance + Surety	0	0	0	0
Miscellaneous	10,000	10,000	10,000	10,000
Reserve Fund (3)	$ 16,300,000	$ 19,400,000	$ 23,400,000	$ 31,100,000
Total Issue	$ 71,113,000	$ 106,763,000	$ 152,463,000	$ 240,513,000
Annual Debt Service				
Term in Years	25	25	25	25
Interest Rate (4)	7.00%	7.00%	7.00%	7.00%
Annual Debt Service on Loan	$ 6,102,243	$ 9,161,388	$ 13,082,929	$ 20,638,545
Add:				
Annual Deliquence (1.5%)	92,000	138,000	197,000	310,000
Annual Administration	75,000	75,000	75,000	75,000
Total Annual Debt Service + Administration	$ 6,269,243	$ 9,374,388	$ 13,354,929	$ 21,023,545

(1) Purchase Price Estimate plus Transaction Cost based on Condemnation
(2) 0% for GO Bonds; 1.5% for Special Tax and Assessment Bonds; 1% for COP's
(3) A reserve Fund Equal to $10,000,000 plus one year's Debt Service if an Assessment Bond or a COP
(4) Estimated for Financial Planning Purposes. Rates mayvary based on Market Conditions

Certificates of Participation-COPs

In the Bartle Wells Report the average interest rate for COPs was assumed to be 6.75%. Issuance costs would be lower than for Special Tax and Assessment Bonds; but the COPs are required to be rated. They would need an investment grade rating to be sold. A reserve fund equal to one year's debt service would be required. Because of market acceptance, the Underwriter's Discount for COPs (estimated at 1%) would be lower than for Special Tax or Assessment Bonds. This marketing cost is expected to range from $595,000 to $2,300,000. The average annual COP payment is estimated to range from $4.9 million to $19.0 million.

APPLE VALLEY RANCHOS WATER COMPANY
FINANCING OPTIONS FOR ACQUISITION - COP's
November 14, 2011

	Stock Price Lower Est.	Medium Price Estimate	RCNLD High Estimate	Very High Price Estimate
Amount Issued				
Total Estimated Acquisition Costs (1)	$ 53,248,000	$ 85,248,000	$ 126,248,000	$ 205,248,000
AVR's Acquisition Costs	48,000,000	80,000,000	121,000,000	200,000,000
Transaction Costs	5,248,000	5,248,000	5,248,000	5,248,000
Issuance Costs	$ 295,000	$ 295,000	$ 295,000	$ 295,000
Financial Advisor	100,000	100,000	100,000	100,000
Bond Counsel	100,000	100,000	100,000	100,000
Expenses	20,000	20,000	20,000	20,000
Trustee	15,000	15,000	15,000	15,000
Bond Ratings	60,000	60,000	60,000	60,000
Special Tax Consultant	0	0	0	0
Assessment Engineer	0	0	0	0
Underwriter's Discount (2)	595,000	945,000	1,400,000	2,300,000
Bond Insurance + Surety	0	0	0	0
Miscellaneous	10,000	10,000	10,000	10,000
Reserve Fund (3)	$ 5,000,000	$ 8,000,000	$ 11,800,000	$ 19,100,000
Total Issue	$ 59,148,000	$ 94,498,000	$ 139,753,000	$ 226,953,000
Annual Debt Service				
Term in Years	25	25	25	25
Interest Rate (4)	6.75%	6.75%	6.75%	6.75%
Annual Debt Service on Loan	$ 4,961,743	$ 7,927,145	$ 11,723,448	$ 19,038,386
Add:				
Annual Deliquence (1.5%)	-	-	-	-
Annual Administration	-	-	-	-
Total Annual Debt Service + Administration	$ 4,961,743	$ 7,927,145	$ 11,723,448	$ 19,038,386

(1) Purchase Price Estimate plus Transaction Cost based on Condemnation
(2) 0% for GO Bonds; 1.5% for Special Tax and Assessment Bonds; 1% for COP's
(3) A reserve Fund Equal to one year's Debt Service if an Assessment Bond or a COP
(4) Estimated for Financial Planning Purposes. Rates mayvary based on Market Conditions

Cost of Financing Conclusions

The following Table summarizes the annual estimated Debt Service payment required for each of the four financing options given the four assumed purchase prices for AVR that ranged from $48 million to $200 million. The General Obligation Bonds would require the lowest level of Debt Service. Special Tax Bonds are second. Certificates of Participations actually rank third. Their Debt Service payments appear to be less than Special Tax Bonds; however, it does not include the $10 million in additional reserves that were factored into the other financing options. The lease desirable from a cost prospective is Assessment Bonds.

APPLE VALLEY RANCHOS WATER COMPANY
SUMMARY OF ANNUAL DEBT SERVICE BY FINANCING OPTION
November 14, 2011

	Stock Price Lower Est.	Medium Price Estimate	RCNLD High Estimate	Very High Price Estimate
AVR Purchase Price	$ 48,000,000	$ 80,000,000	$ 121,000,000	$ 200,000,000
Annual Debt Service - General Obligation Bonds	$ 4,622,160	$ 6,949,861	$ 9,932,228	$ 15,678,739
Annual Debt Service - Special Tax Bonds	$ 5,790,721	$ 8,672,275	$ 12,362,570	$ 19,467,840
Annual Debt Service - Assessment Bonds	$ 6,269,243	$ 9,374,388	$ 13,354,929	$ 21,023,545
Annual Debt Service - Certificates of Participation	$ 4,961,743	$ 7,927,145	$ 11,723,448	$ 19,038,386

The annual debt service range from a low of $4.6 million for a General Obligation Bond associated with a $48 million purchase price, to high of $21 million for the use of Assessment Bonds to finance a $200 million acquisition.

Property Tax Impact of General Obligation Bonds

This section converts the annual debt service requirements for General Obligation Bond financing or Special Tax Bonds to an increase in annual property taxes per Single Family Home or Apartment, which is then compared to the expected average increase per AVR Customer and per Equivalent Meter in the Amount that will be billed to the Ratepayers over the next 4 years, if The Park Water Company or the Carlyle Group were to own AVR. No such comparison was done for Assessment Bonds, because Assessment Bonds represent the most expensive option and therefore it is highly unlikely that it would be used to finance the purchase of AVR. This section also compares the Debt Service payments to the Cash Flow that is expected to be generated by the Water Company if it were owned by the Town, in order to ascertain if the Town-owned Water Company is capable of servicing the debt associated with the purchase.

General Obligation Bonds

The following Table depicts the Total Amount of General Obligation Bonds that would be issued for each of the four purchase prices ranging from $48 million to $200 million. It also presents the annual debt service for each purchase price, which range from $4.6 million to $15.7 million. The Table also contains the 2010 estimate of the total assessed value of all real estate in the Town of Apple Valley.

The latter was obtained from the Bartle Wells Study. The amount that would be borrowed ranges from a low of 1.45% to a high of 4.93% of Total Assessed Value. The Table reflects the annual tax that would have to be paid for each $100 of assessed valuation. In the case of a $48 million purchase price the annual property tax payment per $100,000 of Assessed Value is $106 dollars. In

the case of a $200 million purchase the average homeowners would pay an additional $358 per Assessed Value.

The Median Assessed value of a Single Family Home in the Town of Apple Valley was assumed to be $120,000 and an apartment unit was estimated to be $60,000. The additional annual property tax payment for a median priced Single Family Home would range from $127 in the case of a $48 million dollar purchase to $430 for a $200 million purchase. The increase in the annual property tax payment for an apartment would range from $63 to $215. Property taxes can be deducted from income for purposes of determining Federal and State Income taxes. This may result in reduced Income Taxes for perhaps 20% of the ratepayers, which would mitigate the impact of higher property taxes.

The Table also provides two estimates of the probable and potential increase in AVR's annual Water Rates over the next four years if the Town does not purchase the Water Company. One estimated is based on the number of AVR customers, which in 2011 was estimated to be 19,498. The second estimate is based on the number of Equivalent Water Meters, which The Bartle Wells Report indicated was 34,658. It is our understanding that Equivalent Water Meters accounts for the fact that some homes and certainly most commercial and industrial properties have larger connects and use substantially more water than smaller residential unit. Dividing the projected level of Billed Revenue in 2012 at current rates, estimated to be $15,540,237, by the number of AVR customers resulted in an average water bill of $797. The average household's expenditures for water would be less than this. If the Revenue is divided by the number of Equivalent Meters, the average annual Revenue per meter would be $448 or $74.67 per meter every two months. This is close to AVR's Average bimonthly water bill of $71.05.

APPLE VALLEY RANCHOS WATER COMPANY
PROPERTY TAX IMPACT OF GENERAL OBLIGATION BONDS
November 14, 2011

		Stock Price Lower Est.	Medium Price Estimate	RCNLD High Estimate	Very High Price Estimate
AVR Purchase Price		$ 48,000,000	$ 80,000,000	$ 121,000,300	$ 200,000,000
Total Amount Issued		$ 63,543,000	$ 95,543,000	$ 135,543,300	$ 215,543,000
Annual Debt Service		$ 4,622,160	$ 6,949,861	$ 9,932,228	$ 15,678,739
Total Assessed Value in Apple Valley		$ 4,375,000,000	$4,375,000,000	$4,375,000,300	$4,375,000,000
Amount Borrowed as Percent to Total Assessed Value		1.45%	2.18%	3.12%	4.93%
Annual Tax per $100 of Assessed Value		$ 0.100	$ 0.159	$ 0.227	$ 0.358
Annual Tax per $100,000 of Assessed Value		$ 106	$ 159	$ 227	$ 358
Median Assessed Value of a Single Family Home-2011		$ 120,000	$ 120,000	$ 120,300	$ 120,000
Average Annual Tax per Single Family Home		$ 127	$ 191	$ 272	$ 430
Median Assessed Value per Apartment Unit-2011		$ 60,000	$ 60,000	$ 50,300	$ 60,000
Average Annual Tax per Apartment Unit		$ 63	$ 95	$ 136	$ 215
Estimated Water Rate Increases					
Total Billed Revenue by AVR in 2012 at 2011 Rates		$ 15,540,237			
Estimated Number of AVR Customers (1)		19,498			
Average Annual Revenue per Customer		797			
Potential AVR Water Rate Increases per Customer					
Probable 2012 -2014 Water Rate Increase	13%	$ 143			
Adjustment for Lower Water Usage	13%	$ 104			
Total of Probable Water Rate Increases		$ 247			
Potential Water Rate Increases 2016-2019	15%	$ 120			
Total of Probable and Potential Increases	45%	$ 367			
Estimated Number of Equivalent Meters (1)		34,654			
Average Annual Revenue per Meter		$ 448			
Potential AVR Water Rate Increases per Customer					
Probable 2012 -2014 Water Rate Increase	13%	$ 81			
Adjustment for Lower Water Usage	13%	$ 58			
Total of Probable Water Rate Increases		$ 139			
Potential Water Rate Increases 2016-2019	15%	$ 67			
Total of Probable and Potential Increases	45%	$ 206			

(1) Source: Table 13 in the Bartle Wells Report

Water Rates are expected to increase by approximately 18% by 2014 from present levels. This reflects a CPUC approved rate increase of 13% in 2012 and a 2.5% increase in both 2013 and 2014. This would increase the average household annual water bill by $81. It is likely that in 2015 Water Rates will be increased by an additional 13% to adjust for the fact that actual water usage will continue to remain below budged levels over the next three years. For reasons previously discussed this would result in another $58 being added to the average annual household expenditure. Hence the combined annual increase would be $139. Our review of the economics of AVR also suggests that Water Rates would increase an additional 15% from current levels during the period 2016 through 2019. This would add another $67 to the annual average water bill. By the 2019 the average water bill is likely to increase by $206 or 46% from 2011 levels. This suggests that it would be in the economic interest of the ratepayers for the Town to purchase AVR if the price was less than $90 million.

The use of a General Obligation Bond would result in all the property owners in the Town of Apple Valley sharing in the cost to purchase AVR and any fund reserves that are included in the issue of the bonds. As a consequence, the owners of vacant land within the incorporated area of the Town of Apple Valley would bear a portion of the cost to improve the water utility company. This is probably justified in that it would tend to add to the value of their land.

Special Tax Bond (Mello-Roos Bonds)

The following Table determines the impact a Special Tax Bond would have on water customers should this acquisition be financed by Mello-Roos Special Tax Bonds. The annual tax on a typical household was calculated by dividing the Debt Service for each of the four funding levels by the estimated number of equivalent meters in the Town. The annual debt service per equivalent meter ranged from $167 if the purchase price for AVR was $48 million to $562 for a $200 million purchase price.

This suggests that the acquisition of AVR using the Special Tax Bond option would benefit a typical ratepayer so long as the purchase price did not exceed $60 million. If the purchase price exceeded that level the average annual tax payment would exceed $206. A higher price may possibly be justified if consideration was given to the potential reduction in the Water Rates after 2020 due the collection of Connection Fees.

The use of a Special Tax Bond would result in all the current Customers of the Town-Owned Water Company bearing the cost to purchase AVR and any additional reserves that are included in the issue of the bonds. New water company customers would in theory contribute their share through Connection Fees. The owners of vacant land within the incorporated area of the Town would not be responsible for any of the cost for improving water utility company. This gives the owners of vacant land a free ride until the property is sole for development. At that point, in time higher Connection Fees would, in theory, reduce the value of the land.

APPLE VALLEY RANCHOS WATER COMPANY
PROPERTY TAX IMPACT OF SPECIAL TAX BONDS
November 14, 2011

		Stock Price Lower Est.	Medium Price Estimate	RCNLD High Estimate	Very High Price Estimate
AVR Purchase Price		$ 48,000,000	$ 80,000,000	$ 121,000,000	$ 200,000,000
Total Amount Issued		$ 70,613,000	$ 106,053,000	$ 151,453,000	$ 238,853,000
Annual Debt Service		$ 5,790,721	$ 8,672,275	$ 12,362,570	$ 19,467,840
Total Assessed Value in Apple Valley		$ 4,375,000,000	$4,375,000,000	$4,375,000,000	$4,375,000,000
Amount Borrowed as Percent to Total Assessed Value		1.61%	2.42%	3.46%	5.46%
Estimated Number of Equilivant Meters		34,654	34,654	34,654	34,654
Annual Cost per Equilivant Meter		$ 167	$ 250	$ 357	$ 562
Estimated Water Rate Increases					
Total Billed Revenue by AVR in 2012 at 2011 Rates		$ 15,540,237			
Estimated Number of AVR Customers (1)		19,498			
Average Annual Revenue per Customer		797			
Potential AVR Water Rate Increases per Customer					
Probable 2012 -2014 Water Rate Increase	18%	$ 143			
Adjustment for Lower Water Usage	13%	$ 104			
Total of Probable Water Rate Increases		$ 247			
Potential Water Rate Increases 2016-201	15%	$ 120			
Total of Probable and Potential Increase	46%	$ 367			
Estimated Number of Equivalent Meters (1)		34,654			
Average Annual Revenue per Meter		$ 448			
Potential AVR Water Rate Increases per Customer					
Probable 2012 -2014 Water Rate Increase	18%	$ 81			
Adjustment for Lower Water Usage	13%	$ 58			
Total of Probable Water Rate Increases		$ 139			
Potential Water Rate Increases 2016-201	15%	$ 67			
Total of Probable and Potential Increase	46%	$ 206			

(1) Source: Table 13 in the Bartle Wells Report

Impact of COP Issuance on Water Rates

In a manner similar to GO Bonds and Special Tax Bonds the Table below estimates what the annual cost to service the debt used to acquire AVR would be per Equivalent Meter. It also estimates the extent to which Water Rates would have to be increased in order to have sufficient Cash Flow to cover the annual debt service for each of the four assumed purchase prices.

In the case of a $48 million purchase price, the annual debt service per Equivalent Meter would be $143. For a $200 million purchase price, it would be $549. This suggests that at a $70 million purchase price the typical ratepayer would have an annual payment under the COP option that would be approximately the same as the $206 expected increase in its water bill by the year 2019.

APPLE VALLEY RANCHOS WATER COMPANY
ESTIMATED IMPACT ON WATER RATES FROM ISSURANCE OF A COP
November 14, 2011

	Stock Price Lower Est.	Medium Price Estimate	RCNLD High Estimate	Very High Price Estimate
AVR Purchase Price	$ 48,000,000	$ 80,000,000	$ 121,000,000	$ 200,000,000
Total Amount Issued	$ 59,148,000	$ 94,498,000	$ 139,753,000	$ 226,953,000
Annual Debt Service	$ 4,961,743	$ 7,927,145	$ 11,723,448	$ 19,038,386
Total Assessed Value in Apple Valley	$ 4,375,000,000	$4,375,000,000	$4,375,000,000	$4,375,000,000
Amount Borrowed as Percent to Total Assessed Value	1.35%	2.16%	3.19%	5.19%
Estimated Number of Equilivant Meters	34,654	34,654	34,654	34,654
Annual Cost per Equilivant Meter	$ 143	$ 229	$ 338	$ 549
BRWC Estimate of Town-Owend Water Company in 2012				
Budgeted Revenue	$ 19,483,000			
Billed Revenue	$ 15,196,740			
Net Income	$ 2,579,794			
Net Revenue per Bartle Wells Study	$ 6,016,000			
Net Revenue	$ 1,692,321			
Net Cash Flow	$ 553,732	$ 553,732	$ 553,732	$ 553,732
Less: Annual Debt Service	$ (4,961,743)	$ (7,927,145)	$ (11,723,448)	$ (19,038,386)
Additional Cash Flow or Revenue Required to Service Bor	$ 4,408,011	$ 7,373,413	$ 11,169,715	$ 18,484,654
Required Increase in Water Rates over Billed Revenue	29.0%	48.5%	73.5%	121.6%
Estimated Water Rate Increases				
Total Billed Revenue by AVR in 2012 at 2011 Rates	$ 15,540,237			
Estimated Number of AVR Customers (1)	19,498			
Average Annual Revenue per Customer	797			
Potential AVR Water Rate Increases per Customer				
Probable 2012 -2014 Water Rate Increase 18%	$ 143			
Adjustment for Lower Water Usage 13%	$ 104			
Total of Probable Water Rate Increases	$ 247			
Potential Water Rate Increases 2016-201 15%	$ 120			
Total of Probable and Potential Increase 46%	$ 367			
Estimated Number of Equivalent Meters (1)	34,654			
Average Annual Revenue per Meter	$ 448			
Potential AVR Water Rate Increases per Customer				
Probable 2012 -2014 Water Rate Increase 18%	$ 81			
Adjustment for Lower Water Usage 13%	$ 58			
Total of Probable Water Rate Increases	$ 139			
Potential Water Rate Increases 2016-201 15%	$ 67			
Total of Probable and Potential Increase 46%	$ 206			

(1) Source: Table 13 in the Bartle Wells Report

With an annual debt service ranging from $5.0 million to $19.0 million, total Cash Flow of the Town-owned Water Company before debt service would have to be at least $6.2 million to $23.8 million in order to meet required coverage tests. This is based on the observation in the Bartle Wells Report that the Cash Flow of the Water Company would have to be at least 125% of the annual debt service. The Cash Flow of the Water Company in 2012, if it were owned by the Town, was estimated to be $553,732. The Bartle Wells Report estimated the Net Revenue of the Town-owned Water Company to be $6,016,000 in 2012. The Report indicated the entire amount was available to the service debt. This is definitely not the case.

For a $48 million purchase, the Revenue of the Water Company would have to be increased $5.6 million. This would require a 37.2% increase in the Water Rates. At an $80 million purchase price, the rates would have to increase by 61.6%. At $121 million, the rates would have to rise 92.8%; and at $200 million, the rates would have to increase by 153.0% from 2011 levels. One of the primary reasons for purchasing the Water Company is to stabilize Water Rates at or near current levels. Consequently, the Town would not be able to purchase AVR and stabilize water rates. For this reason, the Town will not utilize the COP financing option to fund the purchase of AVR.

Conclusions Related to Financing Options

The only two viable financing options that could be used to purchase AVR are the General Obligation Bonds and the Special Tax Bonds. The use of any form of Revenue financing such as COPs would necessitate a 37% increase in Water Rates if the purchase price were $48 million to 153% in the case of a $200 million acquisition price. The substantial increase in Water Rates would be counter to the primary goal, which is eliminating increases in Water Rates.

Dividing the projected level of Billed Revenue in 2012 at current rates, estimated to be $15,540,237, by the number of Equivalent Meters, the average annual Revenue per meter would be $448 or $74.67 per meter every two months. This is close to AVR's Average bimonthly water bill of $71.05 that was presented to the BRWC.

Water rates are expected to increase by approximately 18% by 2014 from present levels. This would increase the average household annual water bill by $81. In 2015, Water Rates will be increased by an additional 13% or $58 to adjust for the fact that actual water usage will continue to remain below budged levels over the next three years. The combined annual increase for probable increase would be $139. Our review of the economics of AVR also suggests Water Rates would increase an additional 15% during the period 2016 through 2019. This would add another $67 to the annual average water bill. By 2019, the average water bill is likely to increase by $206 or 46% from 2011 levels. This suggests that it would be in the economic interest of the ratepayers for the Town to purchase AVR if the price was less than $90 million. At that price, the annual debt service per Equivalent Meter would be less than the expected increase in the average ratepayer's water bill. A higher price may possibly be justified if consideration was given to the potential reduction in the Water Rates after 2020 due the collection of Connection Fees.

The use of a General Obligation Bond would result in all the property owners in the Town sharing in the cost to purchase AVR and fund any reserves that are included in the bond issue. Consequently, the owners of vacant land within the incorporated area of the Town of Apple Valley would bear a portion of the cost for improving the water utility company. This is probably justified in that it would

tend to add to the value of their land.
If Special Tax Bonds are used to finance the purchase, the annual debt service per equivalent meter ranged from $167 if the purchase price for AVR was $48 million to $562 for a $200 million purchase price. This suggests that the acquisition of AVR using the Special Tax Bond option would benefit a typical ratepayer so long as the purchase price did not exceed $60 million. If the purchase price exceeded that level, the average annual debt service per household would exceed the expected increase of $206 in the average water bill by 2019. Again, a higher price may possibly be justified if consideration was given to the potential reduction in the Water Rates after 2020 due the collection of Connection Fees.

The use of a Special Tax Bond would result in all the current Customers of the Town-Owned Water Company bearing the cost to purchase AVR and any additional reserves that are included in the issue of the bonds. New water company customers would in theory contribute their share through higher Connection Fees. The owners of vacant land within the incorporated area of the Town would not be responsible for any of the cost for improving water utility company. This gives the owners of vacant land a free ride until the property is sole for development.

Overall Conclusions and Recommendations

During the 2011 fiscal year, AVR is expected to breakeven in terms of Cash Flow if the Surcharges of $2,100,000 are included. In 2012, water rate increases will increase budgeted Revenue by $2,500,000 and Billed Revenue by $2,000,000. Net Pre-Tax Income is expected to increase by the same amount. At a 40% marginal tax rate, state and federal taxes would be approximately $800,000; hence After Tax Net Income and Cash Flow will be increased by $1,200,000 due to the rate Increase. As a result, AVR is expected to realize a positive Cash Flow of $1,200,000 in 2012. This is not much considering the Carlyle Group is willing to pay somewhere between $40 and $75 million to purchase AVR.

In order to earn the desired rate of return on the Carlyle Groups investment it will have to increase substantially the Cash Flow of AVR. This will most likely be done by (1) raising water rates, (2) investing in plant and equipment on which it would earn a pre-tax rate of return of 15.7%, (3) lobby the CPUC to get higher Supplemental Water Acquisition Fees (Connection Fees) and (4) placing debt on AVR so as to earn a higher return on Equity. It is conceivable that by 2019, water rates would increase by 40% to 50% from present levels; and connection fees could increase to $10,000 per unit from $3,500 today.

There are three courses of action available to the Town of Apple Valley; (1) Purchase AVR through a condemnation proceeding and operate the water company. (2) Accept the fact that the Carlyle Group will own AVR and hope that they will run the company in a responsible way keeping rate and fee increases to

a minimum. This is referred to as the Passive Monitoring Program. (3) Actively monitor the activities of AVR and its interaction with the CPUC; in order to minimize the increase in Water Rates and Supplemental Water Fees. This would also enable the Town to be in a position to purchase AVR in seven years or so when the Carlyle Group is expected to liquidate its investment in AVR. If the Town is effective at keeping Water Rate and Fee increases to a minimum, the future purchase price of AVR would be less than if the Carlyle Group was not actively monitored.

Acquisition of AVR

Presently, Park Water Company and the Carlyle Group do not want to sell AVR to anyone. They intend to complete the merger and manage the water company for the next several years. If the Town desired to acquire the assets of AVR immediately, it would require a condemnation proceeding. The problem created by this approach is that the purchase price will be determined by the Court. The purchase price could range from less than $40 million to substantially higher price. The Court could determine the acquisition price to be $60 million, $90 million or more. It is difficult to justify paying $90 million for a company that actually has a $2 million negative Cash Flow from current operations. However, if the Court awarded the owner of AVR $60 or $90 million in the condemnation trial, the Town would have to issue bonds and purchase the water company immediately. If the Court determined the price to be $100 million or more the Town may not be able to raise the funds through a bond issue. In that case, it would not be able to purchase AVR, and the owner of AVR would likely sue the Town.

If the Town were to purchase AVR for $90 million using General Obligation Bonds the average increase in annual Property Taxes per household would be approximately $206, which is equal to the anticipated increase in the average annual water bill by 2019 due to a 46% increase in Water Rates. The average household in Apple Valley pays $448 per year for water. This is equivalent to $74.67 every two months. If the Town were to purchase AVR using Special Tax Bonds (Mello-Roos), it would be limited to a $60 million dollar purchase. This assumes the Town would not be willing to burden the ratepayers with a Property Tax increase that exceeded the expected increase in their water bill over the next 8 years.

Both of these financing option would require a 2/3 vote of approval by the voters of the Town of Apple Valley. Most members on the BRWC believe it would be extremely difficult to get 2/3 of the voters to approve the Town's acquisition of AVR, because other than the likelihood of substantial increases Water Rates there are no other serious deficiencies in the delivery of water to the residents of Apple Valley.

COPs do not require voter approval in a general election and do not count as indebtedness under the state constitutional debt limitations. Unfortunately, the Town would not be able to issue COPs to finance the purchase of AVR, because the Town-owned Water Company is only expected to generate approximately $554,000 of Cash Flow in 2012 if the Water Rates are not increased from 2011 levels. An $80 million COPs would require approximately $9.9 million per year to service the debt.

If The Town were to acquire the AVR through condemnation it would likely incur legal and consulting fees in excess of $5 million. The annual General Fund budget for Town of Apple Valley is approximately $25 million. Last year the Town was struggling to identify $1 million in budget cuts in order to balance the Budget. Town does not have the Revenue or Cash Reserves to spend $5 million on a condemnation procedure. This is especially the case given the fact that here there is some risk the Court may not allow the Town the "right to take" AVR through condemnation proceedings.

Recommendations Related to the Acquisition of AVR

The Finance Committee recommends that the Town not attempt to purchase AVR through condemnation for the following seven reasons:

1.

2. The value set by the Court may be substantially more than the Town could fund through bond financing. The Town may not be able to raise $50 million or more through a General Obligation Bond or Specialty Tax Bond in this economic climate. The Bond Rating of the Town of Apple Valley along with many cities in California was reduced for A- to B+++.

3. The value established by the Court in a condemnation proceeding could greatly exceed AVR's real market value. Town should not substantially overpay for AVR in any acquisition.

4. The value established by the Court could exceed a purchase price that would make economic sense to the ratepayers of AVR.

    A. The Water Rates could increase from present levels by an estimated 46% between now and 2019. This would add $206 to the average annual water bill of $448. The annual increase in Property Taxes due to bond financing for the purchase of AVR should not exceed the expect increase 46% increase in the average water bill over the next 8 years. The BRWC thought it would be in the interest of the ratepayers to incur this level of higher property taxes in order to avoid any future increases in Water Rates.

B. Given this limitation, the maximum purchase price that could be funded by General Obligation Bonds is $90 million. The maximum amount that could be funded by Specialty Tax Bonds is $60 million due to higher interest rates. This assumes the interest rates the Bartle Wells Report estimated (the financial markets would require for each financing option) proves to be accurate. The BRWC is concerned that the interest rates would be substantially higher should the Town attempt such a large bond issue.

5. Both bond financing options would require a 2/3 vote of approval by the voters of the Town of Apple Valley. It would be extremely difficult to get 2/3 of the voters to approve the Town's acquisition of AVR, because other than the likelihood of substantial increases Water Rates there are no other serious deficiencies in the delivery of water to the residents of Apple Valley.

6. COPs, a form of Revenue Financing, do not require voter approval in a general election and does not count as indebtedness under the state constitutional debt limitations. Unfortunately, the Town would not be able to issue COPs to finance the purchase of AVR, because the Town-owned Water Company is only expected to generate approximately $554,000 of Cash Flow in 2012 if the Water Rates are not increased from 2011 levels. For example, an $80 million COPs would require approximately $9.9 million per year to service the debt.

   The Bartle Wells Report concluded that there would be $6 million of Net Revenue available per year to service the bond debt. This is not correct. The Cash Flow that would be available to make the bond payments would be $5.5 million less than the Bartle Wells Report indicated.

7. If the Town of Apple Valley was not able to purchase the water company either because it did not obtain voter approval; or because it could not obtain the bond financing, AVR and its owner, which would likely be the Carlyle Group, would sue the Town for damages. This could lead to a substantial award against the Town.

8. It would not be prudent for the Town in this economic environment to incur $5 million or more in legal and consulting fees, when the Towns annual General Fund budget is only $25 million.

Passive Monitoring Program

The second option is to accept the fact that the Carlyle Group will own AVR and hope that they will run the company in a responsible way that would keep rate and fee increases to a minimum. This is referred to as the Passive Monitoring Program. Historically, the Town has reacted to the increases in Water Rates

when AVR submits their proposal every three years to the CPUC. No attempt has been made to monitor the activities of AVR before the General Rate Case hearings. The advantage of this approach is that it does not involve much time and effort; the cost between rate hearings is minimal.

The disadvantages emanate from the fact that AVR will make a number of key decisions during the two years before the start of the CPUC General Rate Hearings that establish the basis for the water rate increases for the next three years. Capital expenditures that will add to the Rate Base will be made before the rate hearing. In addition, the Rate of Return that AVR will have to earn on its Rate Base is typically determined in the year before the Rate Hearings. Supplemental Water Acquisition Fees and Supply Facilities Fees could be approved by the CPUC during the off years. Debt could be also placed on the Balance Sheet of AVR before the hearings.

As a result, when the Town began to interact with the CPUC in the third year, it has lacked an understanding of what has occurred at AVR for the prior two years. The Town typically spends the first six getting up to speed. This has made it difficult for the Town to curtail significantly water rate increases or increases in a limited form of Connection Fees. In addition, the cost of getting up to speed results in substantial legal and consulting fees in the third year of the rate hearing cycle. An alternative approach is to monitor actively the AVR during all three years.

Active Monitoring Program

The BRWC's fundamental concern is that the Carlyle Group through its infrastructure Fund will purchase Park Water Company; and over time place a substantial amount of debt either directly or indirectly on AVR. To the extent that the Carlyle Group over-leverages the water company and pays the shareholders excessive returns, it would result in substantially higher water bills compared to the present and relative to adjacent city-owned water companies. Moreover, it would likely lead to a lack of investment in system upgrades, thus inhibiting the responsible growth of the Town of Apple Valley relative to neighboring cities. Accordingly, the Finance Committee recommended that the Town convince the CPUC to stipulate 12 conditions for its approval of the merger of Park Water Company and the Carlyle Group for two reasons: (1) to prevent AVR being over leveraged and (2) to require AVR to provide the Town with adequate financial information so that it can determine what AVR is doing.

The third method is to monitor actively AVR and its interaction with the CPUC; in order to minimize the increase in Water Rates and Supplemental Water Fees. The Carlyle Group has publicly indicated that it intends to sell AVR after 7 years. However, the CPUC specifies ownership will dissolve no later than September 28, 2021. The BRWC recommends that the Town consider purchasing AVR when it is available for sale. The BRWC further recommends negotiating a

purchase price for AVR-- rather than taking over AVR by hostile condemnation proceedings. This would enable the Town to know the purchase price before it decides to proceed with the acquisition. If the Town were effective at keeping Water Rate and Fee increases to a minimum, the future purchase price of AVR would be less than if the Carlyle Group was not actively monitored.

Recommendations Regarding Monitoring AVR

The Finance Committee recommends that the Town actively monitor the activities of AVR and its interactions with the CPUC; in order to be aware of AVR's intentions relative to rate and fee increases. This would enable the Town to take steps to minimize the extent of AVR's Water Rate and Connection Fee increases. This would benefit the Ratepayers after 2014 and curtail the increase in the market value of AVR.

Future Purchase of the Water Company

Later, when the Town of Apple Valley is experiencing a sustained population growth and economic expansion it could be advantageous for the Town to Purchase AVR. The Town would not have to pay Federal and State Income Taxes or Property Taxes to the County; and it should be able to reduce it Senior Management and CPUC Expenses by an estimated $1 million per year. The Water Company would be able to charge Connection Fees, which could be used to fund the extension of the water system and investment in new pipes and equipment. This would reduce the pressure to increase water rates.

After 2019, if the Town were to own the Water Company, the average annual water bill plus the average additional Property Tax Assessment could be less that the Typical water bill if AVR were to be owned by the Carlyle Group. In the years immediately after the acquisition by the Town, the typical ratepayer would pay more, because of the additional debt service on the bonds used to fund the acquisition. The section of BRWC's Report on Public vs. Private ownership describes in detail the advantages and disadvantages of a Town owned Water Company.

The Carlyle Group has indicated that it intends to sell AVR after 7 years. The BRWC should consider purchasing AVR at that point in time. The acquisition could be through a negotiated sale rather than by condemnation. This would enable the Town to know the purchase price before it decides to proceed with the acquisition. The BRWC has recommended that the CPUC include in its approval of the merger of Carlyle Group and the Park Water Company a condition that The Town be given a first right of refusal when the Carlyle Groups sells AVR in the future. There is a section in The BRWC Report on Water Rights and another section that discusses Alternative Solutions that describe steps the Town could take to prepare it to acquire AVR in the future.

Addendum No. 1

The Bartle Wells Associates' Final Report to the Town of Apple Valley entitled "Update of Feasibility Analysis of Acquisition of the Apple Valley AVR System" in July 2011.

Addendum No. 2

Resolution W-4655 - The CPUC Resolution adopting the Supplemental Water Acquisition Fees; and Memorandum of Understanding between AVR and Division of Ratepayer Advocates.

Addendum No. 5

The Montana Public Utility Commission adopted several proposed stipulated conditions, which it called "Ringed Fencing Conditions" to the approval of the merger between the Park Water Company and the Carlyle Group's Infrastructure Fund. Exhibit C is a copy of the proposed conditions.