

Town of Apple Valley

Financial Feasibility Analysis for the Acquisition of the Apple Valley Ranchos Water System



February 11, 2014



Prepared by: Urban
Futures, Inc.
www.urbanfuturesinc.com

Southern California Office
3111 North Tustin, Suite 230
Orange, CA 92865
Bus: (714) 283-9334
Fax: (714) 283-5465

Northern California Office
1470 Maria Lane
Walnut Creek, CA 94596
Bus: (925) 478-7450
Fax: (925) 478-7697

Table of Contents

EXECUTIVE SUMMARY	1
INTRODUCTION	4
APPLE VALLEY RANCHOS WATER SYSTEM	5
RANGE OF PURCHASE PRICES.....	16
TRANSACTION COSTS	21
DEBT FINANCING OPTIONS	23
ESTIMATED FINANCING COSTS	29
OPERATION OF AVR SYSTEM UNDER PUBLIC OWNERSHIP	34
RISK FACTORS OF THE AVR ACQUISITION	41
FINANCIAL FEASIBILITY OF AVR ACQUISITION	42
FINDINGS AND CONDCCLUSIONS	44
NEXT STEPS	45

EXECUTIVE SUMMARY

The Town of Apple Valley is considering the acquisition of a privately owned water utility serving Town's residents and businesses. The Apple Valley Ranchos Water Company ("AVR") has grown to serve more than 65,000 people within a 50 square mile service area. The AVR water system has nearly 20,000 service connections, over 450 miles of water mains, 24 wells, 16 emergency generators, 11 storage tanks, 4 booster pump stations and 15 pressure zones. AVR is owned by Park Water Company, which was acquired by the Carlyle Group, a private equity fund. Carlyle's investment was made by Carlyle Infrastructure Partners, a fund that invests primarily in transportation and water infrastructure projects in the U.S. and Canada.

The California Public Utility Commission ("CPUC"), which regulates AVR and the Park Water Company and authorizes water rates and charges, approved the sale in November, 2011.

The Town is exploring the acquisition of AVR for a variety of reasons, including obtaining control over the ability to set water rates, connection fees, rate design, water conservation policy and system growth. It is thought that the operation of the utility under public ownership will be less expensive because of the elimination of profit, various taxes and other expenses incorporated into the current rate structure. Capital financing costs will be reduced though the ability of the town to issue tax-exempt bonds to fund new capital improvements. Public ownership of the system will make it easier for the Town to plan and will also provide greater accountability.

AVR System Acquisition Cost

This analysis provides a range of estimates for acquisition costs. We utilized three methods to estimate the possible cost to purchase the water system; reproduction cost new less depreciation ("RCNLD"), the stock price of the utility paid by Western Water Holdings, LLC. and capitalization of net income. The RCNLD value represents the high end of the price range and the stock price valuation represents the low end of the price range. The RCNLD estimate adjusted for advances and intangibles is approximately \$127.2 million. The estimated stock price is approximately \$45.4 million. Pursuant to the Agreement and Plan of Merger, Western Water Holdings, LLC acquired Park Water Company stock for \$102 million. Park Water owns Apple Valley Ranchos as well as the Mountain Water Company. When the total share payment is split between water companies pro-rata based on the number of connections, the payment for the AVR portion is about \$45.4 million. In addition to the purchase price, this report allows for transaction costs for an appraisal, attorneys, financial advisor, accountants and consulting engineer. We estimate that transaction costs will approximate 2.0% to 4.0% of the acquisition costs.

Debt Financing Options

This report reviews four debt financing options: general obligation bonds, Mello-Roos bonds, assessment bonds, and revenue-supported debt such as revenues bonds and installment sale certificates of participation. Each financing method has its own advantages and disadvantages.

General obligation bonds (“GO Bonds”) are secured by the full faith and credit and taxing power of the issuer. GO Bonds would be repaid through taxes levied at an equal percentage on all assessed property in the Town. The issuance of GO bonds requires 2/3 approval of registered voters through a ballot measure. Of the various financing options, GO bonds are the overall most cost efficient and easiest to administer. If GO Bonds are used to finance the acquisition, the property tax rate estimated to pay debt service on bonds ranges from \$65 to \$183 per \$100,000 of assessed value.

Mello-Roos special tax bonds are another option to fund the acquisition of the AVR system. The Town could form a Community Facilities District (“CFD”), and once formed, the district can issue bonds upon 2/3 approval of registered voters within the district. The boundaries of the CFD need not be co-terminus with the boundaries of the Town. The Town could draw the CFD boundary to match the boundary of the current AVR service area. Properties within the CFD would be charged a tax based on a special tax formula. The annual cost for the average connection is estimated at \$184 and \$513 respectively for the low and high purchase prices.

Assessment bonds are similar to the CFD option in that the Town can form an assessment district with boundaries that are co-terminus with the boundaries of the current AVR service area. Properties within the district would be charged an assessment based on the specific benefit received from the water system. After the assessment spread is determined by an assessment engineer, the formation of the district and levy of the assessment must be approved by a majority vote. The overall financing cost of using an assessment district is similar to that of CFD special tax bonds. Similar to a CFD, the annual cost to the average connection is estimated at \$184 for the low purchase price and \$513 for the high purchase price.

The use of installment - sale Certificates of Participation (“COPs”) would allow the Town to enter into a tax-exempt installment sale financing arrangement instead of issuing bonds. A non-profit corporation or joint powers authority, such as the Apple Valley Public Financing Authority, would purchase the utility and then subsequently sell it to the Town under the terms of an installment sale agreement. The use of COPs offers the Town the ability to finance the acquisition using revenues generated from the customers utilizing the water system. There would be no need to raise taxes or pay debt service from the general fund. In addition, COPs have the major advantage of not requiring voter approval.

If the Town uses COPs to fund the entire acquisition, water rates would need to increase by 11.04% to pay the higher RCNLD purchase price. If the Town is able to purchase the AVR system at the stock price of the utility (the lowest probable purchase price estimated

in this report), then no rate increase would be required and approximately \$5.4 million would be available annually after payment of debt service for capital funds.

System Operation Under Public Ownership

If the Town acquires the AVR system, the sources of revenue would be essentially the same as they currently exist under AVR ownership. The primary source of revenue would be water rates and charges. The current rate structure includes a meter charge that varies by meter-size along with inclining block volume charges. This report assumes that the current rate structure would stay in place if the Town acquires AVR.

Another potential revenue source is connection fees. The Town could set connection fees that pay for expansion-related capital projects which are required because of new customers. In addition, the connection fee can recover a buy-in amount related to the existing water system. Another way to collect revenue from new water customers is through advances, which is a primary method currently used by AVR. The new customer, before connecting to the water system, pays the utility an advance to recover the costs of new infrastructure. The advances must be refunded to customers over a set time period.

Overall operating costs under Town ownership would be less than under AVR ownership. Public agencies do not earn a profit on utility enterprises. Under private ownership, a return on investment is allowed by the CPUC as a cost of service to be recovered with rates and charges. A public agency does not pay federal income tax, state income tax, property taxes or franchise fees. A public agency typically does not budget for depreciation, which is a non-cash expense. A private utility includes depreciation in the revenue requirement to be recovered in the rate structure.

A small amount of revenues to local governments would be reduced under Town ownership. Based on the County Assessor's Office records, AVR currently pays property taxes in the amount of approximately \$15,000. If the property tax payments were based on the imputed stock price of AVR (based on the 2011 purchase of Park Water Company by the Carlyle Group for \$102 million), AVR should have paid approximately \$453,000 in property taxes and franchise fees to the Town in the amount of \$213,700. Both of these sources of revenue would be eliminated. However, each local government would likely see a "net benefit" from foregone water rate increases. A 35% water rate increase has already been approved by the CPUC.

This report acknowledges are a wide range of uncertainties and risk factors associated with the potential AVR acquisition. The Town would begin a new relatively complicated enterprise involving employees and a large customer base, but the Town has no actual experience operating a water system. While the Town currently owns a wastewater enterprise, acquisition of the water system would add numerous new responsibilities including supplying water, maintaining facilities, and billing and accounting for customers. Future operating costs may be higher than anticipated under this analysis because of the Town's lack of experience in running the system. Also, operations costs could increase due to rising electricity, chemical, or commodity costs over which the Town has no control.

Also, this report assumes that water rights currently held by AVR will be transferred to the

Town as part of the acquisition. It also assumes that water rights currently leased or purchased by AVR from other parties could be leased or purchased by the Town under the same terms and conditions after the acquisition

Financial Feasibility

If voters approve a new property tax, special tax, or special assessment, the acquisition of the AVR system is financially feasible. In this case the cost of the acquisition would be incurred by the property tax bill. Under these circumstances, the acquisition is feasible even at the higher purchase price assuming that voters are willing to tax themselves at a sufficiently high rate to repay required bond debt service.

Utilizing revenue bonds or installment sale COPs, the acquisition is feasible at the lower purchase price without the need for a rate increase. In this case, net revenues would be sufficient to pay debt service on bonds and there would be sufficient funds remaining for capital improvements. Assuming the higher purchase price, acquisition of the AVR system with revenue bonds or installment sale COPs is feasible with a rate increase. Net revenues remaining after the payment of operation and maintenance expenses generated from the water system must be sufficient to cover debt service, debt service coverage and future capital improvements.

The Town can also use a combination of installment sale COPs and a tax backed financing to fund the acquisition. This option may be especially appropriate if the Town is required to make the acquisition at a higher cost and does not want to impose a rate increase on water users.

INTRODUCTION

The Town is considering the financial feasibility of acquiring the privately held AVR. This report provides the financial feasibility analysis in connection with the proposed acquisition. The Town has requested that Urban Futures, Inc. ("UFI") perform the financial feasibility analysis.

Town of Apple Valley

The Town was incorporated in 1988 as a general law municipality. The Town has a Council-Manager form of government, consisting of five council members who are elected at large to serve overlapping four year terms. The Town currently provides public safety, streets, planning, zoning, waste management and general administrative services. Additionally, the Town has a public works department and operates a sewer enterprise and collects user charges to cover the cost of sewer services.

The Apple Valley Public Financing Authority was established in 1999 pursuant to the California Government code and a Joint Exercise of Powers Agreement between the Town and the Redevelopment Agency of the Town of Apple Valley. The governing commission of the Authority is comprised of all of the individuals who are members of the Town Council.

The Authority is qualified to assist in the financing of public improvements and to issue bonds.

The Town does not currently own or operate a water system. The Apple Valley Water District was merged with the Town in 1989 and by 1993 the water district was dissolved and a special enterprise fund created. In 1998 the water facilities were sold to the Apple Valley Ranchos Water Company involving an exchange of the Jess Ranch wastewater system which was sold to the Town in 1999.

Purpose of Feasibility Study

The study shows an up to date financial analysis, a pro-forma, for the acquisition of AVR by the Town. The study uses information from the report prepared by the Division of Ratepayer Advocates (“DRA”) presenting its analysis and recommendations in the AVR general rate case (“GRC”) A. 11-01-01 (the “DRA Report”). In this GRC, AVR requested authorization to increase rates charged for water service by 20% in test year 2012, by 2.35% in escalation year 2013 and by 3.35% in escalation year 2014. This feasibility analysis also utilizes the Decision Adopting a Partial Settlement and Resolving All Litigated Issues for Apple Valley Ranchos Water Company’s Test Year 2012 General Rate Case Decision 12-09-004, September 13, 2012. (the “ALJ Decision”). The decision resulted in an overall rate increase of 14.7% for 2012. Other documents used to prepare this report include the 2010 Urban Water Management Plan for the Apple Valley Ranchos Water District, the 2010 Park Water Company Urban Water Management Plan, and the Mojave Water Basin Area Watermaster Annual Report for Water Year 2011-12.

The study seeks to provide an estimate of the AVR acquisition impact from the ratepayer and taxpayer perspective. Specifically, the study identifies potential sources of water system revenue as well as potential expenses for the Town to own, operate and maintain the system. The study also explores the various financing options available to the Town to accomplish AVR acquisition. The study includes a range of assumptions and estimates and utilizes information from the most current rate case before the CPUC and the sources listed above.

APPLE VALLEY RANCHOS WATER SYSTEM

The Town’s water service is currently provided by two separate privately owned water systems. Aside from AVR, a small portion of the Town’s customers are served by Golden State Water, which provides services to approximately 2,900 customers in Apple Valley and Lucerne Valley. This financial feasibility analysis pertains only to the acquisition of AVR.

AVR Ownership

AVR was incorporated as a public utility in 1946 and is a wholly owned subsidiary of Park

Water Company ("Park"). Park is located in Downey, CA and also provides water to southeast Los Angeles County and in addition owns Mountain Water Company in Montana. Park Water and its subsidiaries provide water distribution to a total of approximately 225,000 people through 71,000 connections. The AVR water system has approximately 20,000 service connections, over 450 miles of water mains, 24 wells, 16 emergency generators, 11 storage tanks, 4 booster pump stations and 15 pressure zones.

Park Water Company has recently been acquired by Western Water Holdings, LLC, a wholly owned subsidiary of Carlyle Infrastructure Partners, L.P. The California Public Utility Commission ("CPUC"), approved the sale in November, 2011. Carlyle's investment was made by a fund that invests primarily in transportation and water infrastructure projects in the U.S. and Canada.

Regulation

As a private utility providing water services within California, AVR is currently regulated by the rules of the CPUC. AVR must apply to the CPUC for rate increases through a GRC proceeding every three years. The most recent GRC is for Test Year 2012 and escalation years 2013 and 2014. In this GRC, AVR requested authorization to increase rates charged for water service by \$3,896,590 or 20% in Test Year 2012, for \$547,241, or 2.35% for escalation year 2013, and by \$786,254, or 3.35% in Escalation Year 2014. AVR requested to use a rate of return on equity of 10.20% and a rate of return on the rate base of 9.14%

The Town and other parties have the right to request intervenor status and the Town submitted testimony before the CPUC Administrative Law Judge to protest the rate increases. AVR in turn submitted legal briefs to the judge. The judge then determined the merits of the GRC application and testimony of other parties and made a ruling with respect to the rate increases. For the GRC Test Year 2012, the judge issued a Decision Adopting Partial Settlement and Resolving All Litigated Issues For Apple Valley Ranchos Water Company's Test Year 2012 General Rate Case (the ALJ Decision) which resulted in an overall rate increase of 14.17% for 2012. The proceeding was then closed.

Current Operation of AVR

AVR currently maintains a small office in Apple Valley where administrative, accounting and customer service operations are based. AVR requested five new operating service area-level positions, which represented a 12% increase over AVR's base year number of 43 permanent full time positions for 2010. The ALJ decision found that all five positions were necessary. AVR also converted one temporary position to permanent and added a full year cost of Assistant General Manager in 2011. It is now estimated that there are 50 full time employees in the Apple Valley office of AVR.

AVR Source of Supply

AVR's production capacity includes 24 wells 11 storage tanks, 4 booster pump stations and 16 emergency generators. The average age of various infrastructure components of the system range from approximately 6.5 years to 33.5 years. The total capacity of the wells is approximately 37 million gallons per day. All wells are located in the Mojave Groundwater Basin which is adjudicated by the Mojave Basin Area Watermaster. The basin is a source of groundwater flowing from the San Bernardino Mountains. The groundwater is the only source of supply for the AVR system. According to the Mojave Basin Water Master Annual Report for Water Year 2011-12, submitted May 1, 2013, AVR currently has a Base Annual Production Right of 13,330 acre feet of water annually. However, due to groundwater shortages, the Mojave Water Master administers stipulated judgment that municipal and industrial producers in the basin can pump only 60% of this amount, or 7,998 acre feet. This is AVR's Base Free Production Allowance ("FPA"). In addition to the FPA, there is a carryover from 2010-11 of 3,292 acre feet and a carryover from previous years of 2,267 acre feet for a total production allowance of about 13,600 acre feet for water year 2011-12. Verified production for the year was 11,056 acre feet. For the Town, total FPA is 1,091 acre feet, which includes 391 acre feet carryover from the previous year. Historically, annual production for AVR has been decreasing, with 17,605 acre feet in 2007, 15,735 in 2008, 14,801 in 2009 and 14,390 in 2010. The decrease in production has been caused by the weaker economy and in part by water conservation efforts.

In past years AVR has regularly exceeded its FPA. To make up for the shortfall, AVR must lease or purchase water rights from other agencies and individuals. The estimated total cost for leased water rights for 2012 is \$1,621,000.

Water Rights

This report assumes that water rights currently held by the AVR water company will be transferred to the Town as part of the acquisition. It also assumes that water rights currently leased or purchased by AVR from other parties could be leased or purchased by the Town under the same terms and conditions after the acquisition.

Water rights in the Mojave Basin were adjudicated by a Final Judgment in the Case of City of Barstow, et. Al. v. City of Adelanto , et.al., Case No. 208688 entered January 10, 1996. Both AVR and the Town were parties to the adjudication and their respective rights to withdraw water from the basin stem from the judgment. Any party pumping in excess of the FPA is required to pay replenishment costs to Mojave Water Agency. The cost of replenishment water as well as the FPA is subject to annual review by the Watermaster and is subject to approval by Mojave Water Agency and ultimately the court in this adjudication. Over the years, free base production rights adjudicated to the parties have been decreased to the declining amounts of water available in the basin.

Current Water Rates

The tables that follow show the current water rates for the various customer classifications. The rates were adopted pursuant to the ALJ Decision 12-09-004 September 13, 2012. The rates for residential general metered service are provided below.

**Table 1
AVR Current Rate Schedule**

Schedule No. 1 - Residential General Metered Service

Quantity Rates:

Tier 1: First 13 100 cu. ft.	\$2.438
Tier 2: Over 1300 through 26 100 cu. ft.	2.742
Tier 3: All over 26 100 cu. ft.	3.047

Service Charge: Per Meter
Per Month

Meter Size	
5/8" x 3/4"	22.34
3/4"	33.51
1"	55.85
1 1/2"	111.70
2"	178.72
3"	335.10
4"	558.50
6"	1,117.00
8"	1,787.20
10"	3,239.30

Source: ALJ Decision - Attachment C

The rates for gravity irrigation service are shown below.

Table 2
AVR Current Rate Schedule

Schedule No. 2 - Gravity Irrigation Service

Quantity Rates:

For all water delivered, per 100 cu. ft.

Service Charge:	<u>Per Meter Per Month</u>
Meter Size	
5/8" x 3/4"	\$22.34
3/4"	33.51
1"	55.85
1 1/2"	111.70
2"	178.72
3"	335.10
4"	558.50
6"	1,117.00
8"	1,787.20
10"	3,239.30

Source: ALJ Decision - Attachment C

The rates for non-residential general metered services are provided below.

Table 3
AVR Current Rate Schedule

Schedule No. 3 - Non Residential General Metered Service

Quantity Rates:

For all water delivered, per 100 cu. ft. \$2,698.00

Service Charge: Per Meter
Per Month

Meter Size	
5/8" x 3/4"	22.34
3/4"	33.51
1"	55.85
1 1/2"	111.70
2"	178.72
3"	335.10
4"	558.50
6"	1,117.00
8"	1,787.20
10"	3,239.30

Source: ALJ Decision - Attachment C

The rates for non-metered fire service are shown in the following table.

Table 4
AVR Current Rate Schedule

Schedule No. 4 - Non Metered Fire Service

Rates:

Size of Service:	Per Service <u>Per Month</u>
2"	\$35
3"	52.01
4"	69.23
6"	103.67
8"	138.32
10"	166.95
12"	194.96

Source: ALJ Decision - Attachment C

Customer Base

Information regarding the AVR customer base was obtained from the ALJ Decision.

As described therein, AVR has two systems, one designated as a domestic system and another designated as an irrigation system. The irrigation system consists of a small gravity system that serves non-potable (untreated) water from irrigation well with a return flow to the Mojave River. All other customers are part of the domestic system that is a pressurized potable water system.

Irrigation Customer Base

The number of customers agreed to in the Settlement for the Industrial, Public Authority, Irrigation-Public Authority, and Irrigation-Gravity categories are indicated in the table below.

**Table 5
Irrigation Customers**

	<u>2012</u>	<u>2013</u>	<u>2014</u>
Industrial	2	2	2
Public Authority	42	42	42
Irrigation – Public Authority	5	5	5
Irrigation – Gravity	1	1	1
Totals	50	50	50

Domestic System Customer Base

For the residential, business, private fire service, irrigation pressure, and temporary construction customer base, the parties agreed to use the number of customers as proposed in the DRA’s report. The parties agreed to include the Apple Valley Country Club as a separate customer.

**Table 6
Domestic Customers**

	<u>2012</u>	<u>2013</u>	<u>2014</u>
Residential	17,476	17,476	17,476
Business	1,345	1,345	1,345
Private Fire Service	255	277	299
Irrigation Pressure	184	199	
Temporary Constriction	13	13	13
Apple Valley Country Club	1	1	1
Totals	19,274	19,311	19,348

Water Sales (Ccf per connection per year)

While the parties to the ALJ decision used different methodologies to estimate water sales for residential customers, DRA and AVR agreed to the estimated value proposed in AVR’s

rate increase application for the residential customer class. The parties had different methodologies for estimating the unit water sales for all customer classes, but after thorough review of the historic and recent data agreed to the values below.

Table 7
Water Sales Per Customer (Ccf per Connection per Year)

	<u>2012</u>	<u>2013</u>	<u>2014</u>
Residential	233.2	233.2	233.2
Business	658	658	658
Industrial	706	706	706
Public Authority	7,038	7,038	7,038
Private Fire Service	6	6	6
Irrigation - Public Authority	5,909	5,909	5,909
Irrigation – Pressure	2,290	2,290	2,290
Irrigation – Gravity	540,481	540,481	540,481
Temporary Constriction	2,542	2,542	2,542
Apple Valley Country Club	143,748	143,748	143,748

Source: ALJ Decision

Operating Revenues

Revenues at present rates consist of service charge revenue, commodity charge revenue, and miscellaneous revenue. Service charge revenue is based on the number of customers multiplied by the appropriate tariff and commodity charge revenue is calculated by multiplying the number of customers by their applicable water use and appropriate tariff. A summary of the metered revenues at AVR proposed rates for 2012 are provided below.

Table 8
Apple Valley Ranchos Water Company
Operating Revenues at AVR Proposed Rates
Test Year 2012

Metered Revenues (Thousands of Dollars)

Residential	\$16,879
Commercial	3511.1
Industrial	3.4
Public Authority	1007.1
Fire Service	244.2
Public Authority Irrigation	26.8
Irrigation-Pressure	1327.8
Irrigation-Gravity	253.1
Temporary Service	42.6
AVCC	0
Subtotal	\$23,295
Miscellaneous Rev.	87
Total Revenue	\$23,382

Source: DRA Report

Capital Improvements

AVR had proposed a variety of capital improvements including an office expansion project, booster pump station project, main replacements, main extensions, well site improvements, pump/motor replacements, new vehicles and other projects. According to the ALJ Decision, AVR presented testimony on support of a recommended capital budget of \$4,522,277 for 2011, \$4,351,158 for 2012 and \$4,503,758 for 2013. DRA reviewed the application and recommended a capital budget of \$2,451,757 for 2011, \$2,866,998 for 2012 and \$2,718,554 for 2013. The parties stipulated to a complete settlement of all the utility plant issues with the exception of the office expansion project. The parties agreed to a capital budget, for expenditures other than the office expansion project, of \$3,421,964 for 2011, \$3,697,851 for 2012 and \$3,781,997 for 2013.

A summary of the major capital improvement projects is provided below.

Table 9
Apple Valley Ranchos Water Company
Major Capital Improvement Projects

	<u>2011</u>	<u>2012</u>	<u>2013</u>
Mockingbird Booster Pump Station	\$320,000	\$320,000	\$0
Main Replacements	994,332	1,068,618	1,570,902
Emergency Main Replacements	372,814	384,791	397,153
Del Oro Main Extension	0	0	179,000
AMR	422,841	470,933	434,445
Well Site Improvements	73,500	224,600	125,400
Pump/Motor Replacements	173,987	180,084	187,702
SCADA	255,350	190,850	173,673
Air/Vacuum Instillation	40,800	42,195	43,638
Valves	31,598	32,654	33,767
Hydrants	37,463	38,745	40,069
Service Lines	192,369	200,534	206,441
Vehicles	81,900	52,100	111,600
Vactor Trailer	0	52,000	0
Utility Plant - Irrigation System	0	568,605	568,605
Totals	\$2,996,954	\$3,826,709	\$4,072,395

Source: ALJ Decision

RANGE OF PURCHASE PRICES

The Town would acquire the assets of a privately held water system within the Town limits. The acquisition would include the water utility plant, land, wells, water treatment facilities, the transmission and distribution system, water reservoirs, tanks, water meters, vehicles and office equipment. The acquisition should also include rights of way and easements. For purposes of this report, it is not assumed that the Town would be purchasing water rights beyond those already owned by AVR. We are assuming that there are no separate water rights held by AVR which would not revert to the Town in the case of an acquisition of the water system.

This report considers four different methods to estimate possible acquisition costs. We have developed estimated system costs based on these methodologies.

Stock Price

In January 2011, Park Water Company ("Park" filed with the CPUC an application requesting authority for Western Water Holdings, LLC to acquire and control Park and subsequently AVR. Park is located in Downey, CA and provides water to Southeast Los Angeles County. Park also owns AVR and Mountain West Water Company in Missoula, Montana. Park with its subsidiaries provides water distribution to approximately 225,000 people though 71,000 service connections. Western Water Holdings, LLC is a subsidiary of Carlyle Investment Partners, L.P., which was created and managed by the Carlyle Group, the global alternative asset manager. The Carlyle Group is private partnership that is owned by individual and institutional investors. In November, 2011, the CPUC approved the transfer of ownership of Park to Western Water Holdings, LLC. Western Water Holdings acquired 100% of the outstanding capital stock of Park and paid cash for the shares. The merger agreement indicates that each Park Water shareholder received \$4,177.65 for each share of Park Water common stock and also indicates the total amount paid to the shareholders was \$102 million.

Park Water was previously owned and controlled by the Wheeler Family. Park Water was incorporated in 1937 by Henry Wheeler Sr. Park is a Class A, private investor owned public water utility operating under the regulatory oversight of the CPUC and the State of California Department of Public Health and is engaged in the collection, storage, distribution and sale of water to customers located within its certified service area. The certified service area is divided into three separate water systems: Compton/Willowbrook (Compton West), Lynwood /Rancho Dominguez (Compton East), and Bellflower/Norwalk. Park provides water service to approximately 28,000 accounts in these water systems. AVR and Mountain Water Company are wholly owned subsidiary utilities of Park.

We can split the \$102 million payment price proportionately between the two Park subsidiaries based on the number of connections to estimate the stock value of AVR. Based on the Table 10 below, the estimated stock price is \$45.4 million.

Table 10
Apple Valley Ranchos Water Company
Estimated Stock Price

Total Park Water Stock Price: \$102,000,000

<u>Utility</u>	<u>Connections</u>	<u>Percentage</u>	<u>Allocated Stock Price</u>
Apple Valley Ranchos	19,274	44.54%	\$45,430,235
Mountain Water Company	24,000	55.46%	56,569,765
	43,274		\$102,000,000

This amount is relatively close to the rate base for 2013 as reported in the ALJ Decision and shown in the following table.

Table 11
Apple Valley Ranchos Water Company
2013 Rate Base Summary
(Dollars in Thousands)

Average Balances:

Plant in Service	\$111,869.40
Materials & Supplies	312.00
Working Cash	772.50

Subtotal	\$112,953.90
----------	--------------

Less:

Depreciation Reserve	\$30,112.50
Advances	31,246.10
Contributions	1,920.90
Unamortized ITC	56.60
Deferred Income Tax	8,614.10

Subtotal	\$71,950.20
----------	-------------

Plus:

Method 5 Adjustment	1.00
---------------------	------

Net District Rate Base	41,004.70
Main Office Allocation	594.40
Total Rate Base	\$41,599.10

Sauce: ALJ Decision - Attachment E

Reproduction Cost New Less Depreciation

The Reproduction Cost New Less Depreciation (“RCNLD”) method of valuation provides an estimate of what it would cost to replace existing assets accounting for accumulated depreciation due to age. For purposes of this feasibility analysis, we calculated the RCNLD by escalating the original cost of the assets by a public utility construction cost inflation index. The depreciation component representing the loss in value of the existing asset due to age and condition is then subtracted from the inflation adjusted new replacement cost. The cost of advances is also subtracted from RCNLD so that the result is an estimate of the value of the utility which accounts for the current cost to replace it, age, wear, and advances due to developers. The RCNLD produces the highest purchase price of any of the valuation methods discussed in this report.

Table 12 below provides an updated RCNLD calculation for AVR, which is approximately \$144 million. In order to provide an updated RCNLD table, UFI utilized Table 8-B - Apple Valley Ranchos Water Company Depreciation Rates in the Report on the Results of Operations - Apple Valley Ranchos Water Company Test Year 2012 and Escalation Years 2013 and 2014 Application 11-01-001 by the Division of Ratepayer Advocates (the “DRA Report”).

Two adjustments are then made to the RCNLD value estimate. An adjustment of an additional 10% for intangibles is added to the value. The second adjustment is to subtract \$31.2 million for customer advances which must be repaid. In the event that the Town purchased the water system, the Town would be required to pay back any advances. The RCNLD plus intangibles less advances totals approximately \$127.2 million and is the highest probable acquisition cost in this feasibility analysis.

Capitalization of Net Income

The capitalization of the net income of a water system can also be used to estimate its value. Net income is simply operating income less operating expenses. The capitalization of net income is determined by dividing the net income of the water system by the discount rate. The appropriate discount rate is the rate of return on the rate base authorized by the CPUC. Using figures from the ALJ Decision, net income for Test Year 2012 was \$3,798,400 and the rate of return allowed by the CPUC was 9.42%. Dividing net income by rate of return produces a capitalization of net income of \$40,322,717.

Sales of Comparable Water Systems

Another approach to value the AVR system is to examine the sales of comparable water systems. In order for the sales to be comparable and provide useful information for the Town's proposed acquisition, they must be recent in time; close in geography to the subject system; similar in size (number of customers and service connections); and arm's length transactions negotiated between a willing buyer and willing seller. Sources include decisions approving sales by CPUC of privately owned utilities regulated by CPUC. Private water companies must submit applications to the CPUC requesting the approval of the sale and transfers of the water systems and the CPUC must give approval for the transfer to take place. Sales between publicly owned water utilities are not under the jurisdiction of the CPUC and sales and transfers effectuated through condemnation may not be reported to the CPUC. Sales of water systems occur infrequently and under various circumstances. Also, most sales involve systems that are relatively small and not comparable in size to the relatively large system being considered by the Town.

Summary of Purchase Price Estimates

The RCNLD method of valuation produces the highest purchase price and is therefore the most conservative assumption for purposes of this report. As shown in Table 9, the estimated updated RCNLD value for AVR is \$127.2 million. The lowest possible acquisition cost estimate is \$45.4 million, the estimated purchase price of AVR stock. In valuing the AVR system, consideration must be given to going concern goodwill and other intangibles. The value of any water rights must also be taken into account. In addition, the cost of equipment, vehicles, furniture, software, materials and supplies may also be included. Also, the value of billing and accounting records can effect valuation. Finally, the loss of investment income to the private owners of the system can also influence valuation.

TRANSACTION COSTS

If the Town proceeds with the proposed AVR acquisition, it will incur a variety of transaction costs in addition to the actual purchase price of the utility. If the Town pursues the acquisition through condemnation, it will incur higher overall costs than it would in a normal negotiated purchase between the Town and AVR. Increased costs from condemnation stem from higher legal fees and possible spending on the use of expert witnesses. In addition to legal fees, the Town will incur costs for engineers, appraisers and financial advisors. The acquisition may also require a review under the California Environmental Quality Act ("CEQA"). In addition, the Town may incur annexation costs to bring the water system completely within the jurisdiction of the Town, as the current service areas of AVR are not coterminous with the Town boundary.

UFI estimates total transaction costs at 2.0% to 4.0% of the acquisition cost. Regarding the appraisal specifically, UFI estimates a cost of \$100,000 to \$200,000 and a time frame of four to eight months to complete the appraisal.

Engineering Consultant

The Town will be required to engage a consulting engineer to review the current condition of the AVR system and determine the need for additional capital improvements. As mentioned previously in this report, the ALJ Decision provided information for capital expenditures through 2013. Large future capital requirements could increase the risk of the acquisition and result in a change of purchase price.

Town Counsel

The Town will be required to expend resources to support the Town Counsel in negotiations and the legal aspects of the AVR acquisition including the drafting, processing and filing of legal documents. If the Town utilizes condemnation proceedings to accomplish the acquisition, the level of legal complexities faced by the Town Counsel and resulting legal costs will be higher.

Condemnation Attorney and Trial

If the Town pursues condemnation proceedings to accomplish the acquisition, it will require the services of an attorney specializing in condemnations. There may be two trials within the condemnation process; one dealing with the right to take and another establishing just compensation, the fair market value of the AVR water system. There may also be costs for expert witnesses throughout the trial.

Financial Advisor and Accountants

A financial advisor will be required to perform the financial feasibility analysis, advise the Town on debt financing issues, and conduct a review of water rates and charges as well other revenue streams available to support bond debt service and the operation of the newly acquired water system. An accountant will be required to review and analyze past AVR financial statements and documents and to review and analyze billing and accounting records.

CEQA and Environmental Review Costs

There will be costs incurred for the environmental review related to condemnation and the ultimate acquisition of the system. The current estimate assumes that there will be a negative declaration and no environmental impact report will be acquired.

Annexation Costs

The Town may need to annex additional property into the Town boundaries since the boundaries of the AVR service system and the Town are currently not coterminous.

Appraisals

The Town will be required to retain an independent appraiser to provide valuation estimates for the water system. The appraisal will need to include the value of all land, water facilities, water rights and intangible assets that will be acquired by the Town.

Contingency Reserve

The Town should maintain contingency reserves to cover unexpected expenses and cost overruns. We have assumed a contingency reserve within the 2.0% to 4.0% transaction cost estimates.

Table 13
Estimated Transaction Costs for
Acquisition of AVR System
(Assumes Condemnation)

	<u>Stock Price</u>	<u>RCNLD</u>
	\$45,430,235	\$127,200,632
Transaction Costs at 2.0%:	\$908,605	\$2,544,013
Transaction Costs at 4.0%:	\$1,817,209	\$5,088,025

Source: Urban Futures, Inc.

DEBT FINANCING OPTIONS

Methods of financing the acquisition of AVR that are currently available to the Town include the following:

- General Obligation Bonds
- Revenue Bonds
- Installment Sale Certificates of Participation
- Assessment Bonds
- Mello-Roos Community Facilities District Special Tax Bonds

General Obligation Bonds

General Obligation (“GO”) bonds are backed by the full faith and credit and taxing power of the issuer. If the Town were to issue GO bonds, the debt would be repaid from the levy of an ad valorem property tax on all real property within the Town without limit as to rate or amount. The property tax would be levied on an equal percentage on all real property, and a property owner would pay the property tax in proportion to the assessed value of his or her property. Utilizing this financing method would thus result in higher property taxes for property owners, but would not affect water rates or charges paid by ratepayers.

The issuance of GO bonds requires a 2/3 voter approval of all registered voters within the Town. The Town would be required to prepare a ballot measure that indicates the maximum par amount of bonds authorized and estimates the maximum tax rate per dollar amount of assessed valuation. After issuance of the bonds, the Town would need to set the annual tax rate per \$100 of assessed value and provide the tax rate to the County, who would then collect the taxes and remit them to the Town, who in turn would transfer moneys to a paying agent to pay debt service on bonds. As the total assessed value of the Town increased over longer periods of time, the required tax rate would decline. If the Town’s total assessed value decreased during a given year, the required tax rate would increase.

The primary advantages of GO bonds, include low interest costs, low costs of issuance, and the strong acceptance by municipal bond investors. The inherent credit strength of the GO bond structure means that the bonds would garner the highest underlying rating from the credit rating agencies when compared with other financing options. Also, the bonds would likely qualify for municipal bond insurance at the lowest insurance premium compared with other financing options. This would translate into the lowest overall interest cost and lowest underwriting costs. In addition, GO bonds do not require a reserve fund and overall costs of issuance are lower since there is no requirement for an assessment engineer’s report, rate and method of apportionment of a special tax, or some of the other costs of issuance associated with Assessment Bonds and Mello-Roos Bonds. GO bonds are also relatively simple and inexpensive to administer after issuance, as the property tax is collected along with other taxes and charges on the property tax bill.

The primary disadvantage of GO bonds is the difficult to obtain 2/3 voter requirement. Also, there is an inherent inequity in that newer property owners bear a higher tax burden than property owners who have owned their property for a longer period. Proposition 13 limits the annual increase in assessed value to 2.0% annually provided that the property did not experience a change in ownership during the year. When property transfers take place, the property is then re-assessed at the then current market value. In normal economic periods the property will be reassessed at higher values, thus disadvantaging the newest property owners.

Another disadvantage is that unlike the special tax formula for a Community Facilities District or the assessment spread for an assessment district, the debt service cost cannot be spread to property owners based on the specific or general benefit received by the property. So it can be argued that other alternatives are superior to GO bonds from the perspective of the fairness of the distribution of the cost. Additionally, it should be noted that the boundaries of the Town are not coterminous with the boundaries of the service area of AVR. This would create a situation where property owners within the Town limits are carrying the cost of acquiring the system that serves customers outside the Town limits.

Revenue Bonds

Revenue Bonds can be issued to finance any public enterprise that produces a regular stream of revenues, including water and wastewater systems, bridges and toll roads. Such bonds are secured by a lien on the future revenues generated by the project. In California, issuance of traditional revenue bonds is subject to the Revenue Bond Law of 1941, which requires that a majority vote be obtained at an election on the proposition of the bonds. The effective issuance of revenue bonds requires a well-established operating history for the enterprise, and the water enterprise system currently owned by AVR falls into this category. Advantages of Revenue Bonds include strong acceptance by rating agencies, bond insurers and institutional and retail investors, which results in relatively low interest rates compared with Assessment Bonds and CFD Special Tax bonds. However, interest rates for revenue bonds are still somewhat higher than GO bonds. Also, costs of issuance are typically lower than Assessment Bonds and CFD Special Tax Bonds but somewhat higher than GO bonds. In addition, a fully funded reserve fund is required (which may be satisfied with the use of a reserve fund surety, as described below). Because of the majority voter requirement of traditional revenue bonds, most revenue bonds are issued by means of a Joint Powers Authority (“JPA”) or as installment sale Certificates of Participation (“COPs”) that are not subject to a voter requirement. The JPA can be created with two public agencies, such as a city and redevelopment agency. The nonprofit corporation can be formed by the Town without the need for a second public agency.

Installment Sale Certificates of Participation

Under the California constitution, installment sale COPs are not subject to a voter requirement because revenues that back the COPs are derived from a special fund (a water enterprise fund in this case) rather than a general fund. This structure is used far more frequently than traditional revenue bonds because of the absence of the voter requirement. Only the governing body of the public agency is required to approve the issuance of installment sale COPs. This structure allows the Town to enter into a tax-exempt installment sale financing arrangement that is technically different from issuing bonds. Under this structure the Town can utilize a nonprofit corporation or a JPA to purchase the AVR water system which then sells the system back to the Town via an installment sale agreement. Security for the installment sale agreement is provided by the net revenues of the water system. The Town would assume ownership of the facilities at the closing of the financing. Under the installment sale, structured payments include both principal and interest and are tax exempt. The installment sale payments under the installment sale agreement would match the debt service on the publicly issued COPs. The nonprofit corporation or JPA assigns its rights to receive the payments to a trustee who in turn pays debt service on the COPs. In practice the structuring and marketing of a COPs issue is quite similar to traditional revenue bonds. As with traditional revenue bonds, installment sale COPs are very well received by rating agencies, bond insurers and institutional and retail investors. Additionally, the COPs do not count as debt under the California constitutional debt limitations.

The use of installment sale COPs would allow the Town to acquire the AVR water system using only the net revenues generated by the water system. Since the revenues are generated by water rates and service charges paid by water customers, there is an inherent fairness to this option, as debt service on the COPs is being paid by the users of the water system. There would be no requirement to raise property taxes on property owners within the Town, as with GO bonds. Nor does this structure create a burden on the Town’s general fund. This financing option would be the overall second most cost efficient option, second only to GO bonds. There would be no need for assessment engineering work or a rate and method of apportionment for special taxes, as with a CFD

It should be noted that Installment Sale COPs are subject to debt service coverage requirements. In today's market, coverage requirements for water system issues desired by the rating agencies, insurers and investors are in the range of 1.15x to 1.20x. This means that net revenues, after the payment of all operating and maintenance expenses, must cover total annual debt service requirements by this amount. Similar to traditional revenue bonds, this structure also requires a reserve fund. However, in today's marketplace for municipal bond insurance, insurers are offering the use of reserve fund surety instruments that can take the place of cash funded reserves. These reserve fund surety bonds are being offered even if an issuer does not utilize bond insurance for the given debt issue. Surety premiums for water enterprise issues are currently in the range of 3.0% to 5.0% of the notional amount of the reserve fund.

Assessment Bonds

Another option is for the Town to form a city-wide assessment district and issue assessment bonds secured by property within the assessment district. Typically an issuer uses the Improvement Bond Act of 1913 as the statute to form the district, while bonds are issued under the Improvement Bond Act of 1915. The 1915 Act allows only for the issuance of bonds. The 1913 Act is required to form the assessment district, authorize public improvements, and impose assessments on real property. The establishment of an assessment district and the use of assessment bond financing is also subject to Proposition 218, which added article XIII D to the California Constitution. The assessment bonds purchases by investors are secured by liens imposed on all real property within a designated area that benefits from the project being financed with the assessment bonds, which comprises the assessment district. As with GO bonds and CFD Special Tax Bonds, property owners would fund the cost of the AVR water system acquisition via their tax bills.

Assessments are technically different from taxes and are not tied to assessed values. Assessments are instead calculated based on the special benefit that a given property receives from the improvements being financed. Developed as well as any undeveloped property must be included in the district. The agency, through its assessment engineer, is allowed some discretion in determining the method of apportionment. The Town would need to choose a proxy for water use such as lot size and lot type to determine the appropriate assessment for each parcel.

In order to use this financing option, the Town must go through the assessment district formation process as prescribed by the 1913 Act and Proposition 218. After the size of the assessment is determined, a notice is mailed to impacted property owners along with a ballot, and a public hearing must be held within 45 days to address the concerns of the effected property owners and count the votes protesting the formation of the district. Votes are weighed in accordance with the proportional financial obligation, or assessment amount. If a majority protest is received, the district cannot be formed. If the formation is approved, assessment liens are placed on individual properties and serve as security for bonds. The property owners have the right to pay the assessment with cash during the 30 day cash collection period, which reduces the size of the required bond issue.

The formation of the assessment district creates a fixed dollar amount of special assessment lien on each property that lasts for 10 years or until bonds are issued, whichever is first. If bonds are issued, the lien is for the term of the bonds plus an additional four years. The assessment bonds sold to investors are secured by the unpaid amount of the fixed special assessment liens on each property. In addition to the 30 day cash payment period after the formation of the district, property owners can prepay assessment liens after bonds are issued. The prepayment will include any prepayment penalty, share of interest, and administrative costs.

One advantage of the assessment district option is that it provides a fair and equitable way to spread the cost of the acquisition, as the assessment spread must be based on the specific benefit received by each parcel. There would also be some flexibility to tailor the assessment to meet the needs and policy goals of the Town. Also, the boundary of the assessment district can be drawn to match the service area of the AVR water system, thus avoiding the equity problem that arises with GO bonds.

This option does have a number of disadvantages compared with other financing techniques. First is the time and expense required to complete the formation process and the need for an assessment engineer to draw the district boundaries and determine the amount of the special benefit for each parcel. This adds significantly to the costs of issuance. Also, since the bonds are secured only by fixed assessment liens rather than the unlimited taxing power pledge of a GO bond, this is considered a less secure structure by participants in the municipal bond market and as a result requires higher yields. Smaller assessment districts often need to be issued as non-rated bonds, significantly raising interest costs.

However, a large virtually city-wide assessment district encompassing the boundaries of the AVR water service area would consist of very large acreage, large number of parcels, a diverse taxpayer base, and a very high value to lien ratio. It is likely that the assessment bond issue would receive an investment grade rating (although not as high of a rating as a GO bond or revenue bond) and may qualify for municipal bond insurance. The assessment bond issue would require a fully funded reserve, and it is unlikely that the issue would qualify for a reserve fund surety bond for the entire reserve fund requirement. From the standpoint of overall costs, including cost of issuance, cost of bond insurance, and total interest cost, a GO bond or a revenue bond are still the more efficient options.

Community Facilities District Mello-Roos Bonds

Mello-Roos special tax bonds can also be used to acquire the AVR water system. In addition a Community Facilities District (“CFD”) can also be used to finance a limited amount of services and fund limited amounts of operation and maintenance. Under the Mello-Roos Community Facilities Act of 1982, public agencies are allowed to form CFD’s and once formed can issue bonds upon 2/3 approval of registered voters within the district. The boundaries of the CFD need not be coterminous with the boundaries of the Town, which is an important consideration given that the AVR water service area does not precisely match the boundaries of the Town.

Proceeds of bonds issued by a CFD can be used to purchase any real property with a useful life of five years or longer. Unlike GO bonds, Mello-Roos bonds are not secured by the full faith and credit of the issuer and not secured by the unlimited power of a local agency to levy property tax. Instead, the bonds are secured by a special tax levied on parcels within the CFD. The special tax is not an ad valorem tax but is instead a special tax based on the general benefit received by properties within the CFD. There is a substantial amount of flexibility allowed in crafting the special tax formula, with factors such as square footage of developed property, development density, acreage and zoning commonly being used as a basis to formulate the tax. For the Town, equivalent water meters can be used for the acquisition of the AVR water system. As with GO bonds and assessment bonds, taxpayers in the CFD would pay higher taxes as a result of the water system acquisition. The special tax is fixed for the life of the bond issue and would not be tied to the use of the water system as measured by water consumption or water sales.

One primary advantage of the CFD option is flexibility with regard to district boundaries and the special tax formula. The Town can create the CFD so that its boundaries are coterminous with the service

area of the AVR water system. This would ensure that only the properties affected by the acquisition would pay the special tax and provides a solution to the problem that exists with the use of GO bonds. In addition, the flexibility allowed in the design of the special tax formula means that it can be tailored to best meet revenue requirements and the then current political environment, potentially increasing the odds of approval by voters.

There are several disadvantages for the Town with respect to the CFD option. First, the 2/3 voter requirement means that passage is difficult. With regard to prepayment of special taxes, the CFD Act provides for prepayment before bonds are issued. But after the issuance of bonds, prepayment is administratively difficult and requires a relatively complex prepayment formula not readily understood by property owners. In addition, any changes to or modifications of the special tax would require 2/3 voter approval. The statutory process of forming the CFD and creating rate and method of apportionment for the special tax formula is time consuming, complex and expensive. Creating special tax formula requires the use of a special consultant which adds to the cost of issuance of the bonds and the special tax itself is not easy to understand by the typical property owner.

Unlike GO bonds, Mello-Roos bonds are not secured by the full faith and credit and unlimited taxing power of the issuer but are instead payable from a limited tax and ultimately secured by the property within the CFD. Because of the relative lack of inherent credit strength compared with GO bonds and revenue bonds, CFD issues typically carry lower credit ratings, higher costs for bond insurance and higher interest rates relative GO and revenue bonds. CFD bonds typically require a fully funded reserve and many CFD issues do not qualify for reserve fund surety instruments because of the lack of credit strength.

However, a large virtually city-wide CFD encompassing the boundaries of the AVR water service area would consist of a large acreage, a very large number of parcels, a diverse taxpayer base, and a very high value to lien ratio. It is likely that the CFD bond issue would receive an investment grade rating (although not as high of a rating as a GO bond or revenue bond) and may qualify for municipal bond insurance. The bond issue would require a fully funded reserve, and it is unlikely that the issue would qualify for a reserve fund surety bond for the entire reserve fund requirement. From the standpoint of overall costs, including cost of issuance, cost of bond insurance, and total interest cost, a GO Bond or a revenue bond are still the more efficient options.

Utilizing a Combination of Financing Options

The Town can also use a combination of installment sale COPs and a tax backed financing to fund the acquisition. This option may be especially appropriate if the Town is required to make the acquisition at a higher cost and does not want to impose a rate increase on water users. Based on the estimated bonding capacity shown in Table 19, the Town can spend up to approximately \$102 million on the acquisition using proceeds of installment sale COPs and meet debt service coverage requirements on annual debt service without imposing a rate increase. However, the Town needs to consider annual capital improvement requirements as well. In the case of a \$102 million acquisition fund, approximately \$1.5 million would be left over annually out of debt service coverage to fund capital improvements. If the Town acquired the system at the RCNLD price of \$127 million and issued the maximum amount of installment sale COPs that can be issued without a rate increase, approximately \$25 million will need to be funded with proceeds of a GO Bond, a CFD or assessment district. A \$25 million GO Bond with a 30 year term will produce an annual debt service requirement of \$1,580,236, which translates into a tax rate of about \$35 per \$100,000 in A.V.

The disadvantage of this option is that the Town will need to obtain a two-thirds vote for the GO Bonds or CFD Special Tax bonds or a majority vote to form the assessment district. Also, there will be to separate debt issuances with two different sets of issuance costs.

ESTIMATED FINANCING COSTS

Table 14 provides a detail of the financing costs for the various financing vehicles discussed in the previous section. The table also breaks out annual debt service requirements assuming a 30 year bond issue. It would also be possible to for the Town to issue bonds with a 40 year term. The analysis assumes a total acquisition cost of \$47.2 million at the stock price and \$132.8 million at the RCNLD price for the AVR system. The acquisition costs include a transaction component of 4.0% of the acquisition price, which would cover the cost of the condemnation process and the costs of various professionals involved with the acquisition. The financing methods differ in terms of interest rate, underwriter's discount, costs of issuance, and reserve fund requirement.

GO Bonds carry the lowest annual debt service and are the overall most efficient option because the bonds require no debt service reserve fund and carry the lowest costs of issuance. The estimated interest rate for GO Bonds is 4.75%. This rate is somewhat conservative given the pricing results of recent California GO bond financings. Annual debt service is estimated at about \$3.0 million using the stock price and \$8.4 million using the RCNLD price.

The use of revenue bonds or installment sale COPs provides the next most efficient financing option. Issuance costs would be somewhat higher than GO Bonds and the issue would require a fully funded reserve. However, this type of debt is still very well received by bond investors and rating agencies. The assumed interest rate is 5.25%, and again this rate is somewhat conservative given pricing results of recent revenue bond issues in California. Annual debt service is approximately \$3.4 million at the stock price and about \$9.6 million at the RCNLD price.

For CFD special tax bonds, the assumed costs of issuance are higher to cover the expense of the CFD formation process and to pay the cost of a special tax consultant to craft the rate and method of apportionment of the special tax. Special tax bonds also require a fully funded reserve and require a higher underwriting discount compared with GO Bonds or revenue bonds. Since the CFD would encompass the entire Town, it would possess favorable credit characteristics such as a large, built out and diverse taxpayer base along with a high value to lien ratio. For this reason it is realistic to assume that the bonds would obtain an investment grade rating, but that the rating would be lower compared with a GO Bonds or a revenue bond issue. The assumed interest rate of 5.50% is somewhat conservative given recent pricing results of lower investment grade special tax bond issues. Annual debt service is estimated at \$3.6 million at the stock price and \$9.9 million at the RCNLD price.

For assessment bonds, the assumed costs of issuance are higher relative to GO Bonds and revenue bonds to cover the expense of the district formation process and to pay the cost of the assessment engineer to create the assessment formula. Assessment bonds also require a full funded reserve and require a higher underwriting discount compared with GO Bonds or revenue bonds. Since the assessment district would encompass the entire Town, it would possess favorable credit characteristics such as a large, built out and diverse taxpayer base along with a high value to lien ratio. For this reason it is realistic to assume that the bonds would obtain an investment grade rating similar to a CFD special tax bond issue, but that the rating would be lower compared with GO Bonds or a revenue bond issue. The assumed interest rate of 5.50% is somewhat conservative given recent pricing results of lower

investment grade land-secured bond issues. Similar to the CFD option, annual debt service is estimated at \$3.6 million at the stock price and \$9.9 million at the RCNLD price.

Table 14

**Financing Options for AVR Acquisition
Detail of Financing Costs**

	<u>GO Bonds</u>		<u>Revenue Bonds/Installment Sale COPs</u>		<u>CFD Special Tax Bonds</u>		<u>Assessment Bonds</u>	
	Stock Price	RCNLD	Stock Price	RCNLD	Stock Price	RCNLD	Stock Price	RCNLD
AVR System Acquisition	\$45,430,235	\$127,200,632	\$45,430,235	\$127,200,632	\$45,430,235	\$127,200,632	\$45,430,235	\$127,200,632
Transaction Cost (1)	1,817,209	5,088,025	1,817,209	5,088,025	1,817,209	5,088,025	1,817,209	5,088,025
Total	\$47,247,444	\$132,288,657	\$47,247,444	\$132,288,657	\$47,247,444	\$132,288,657	\$47,247,444	\$132,288,657
Bond Counsel	80,000	110,000	90,000	120,000	100,000	130,000	100,000	130,000
Disclosure Counsel	40,000	60,000	45,000	65,000	45,000	65,000	45,000	65,000
Financial Advisor	70,000	90,000	80,000	100,000	90,000	120,000	90,000	120,000
Ratings	30,000	50,000	35,000	55,000	35,000	55,000	35,000	55,000
Trustee	10,000	13,000	10,000	13,000	10,000	13,000	10,000	13,000
Printing/Posting	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Special Tax Consultant	0	0	0	0	100,000	100,000	0	0
Assessment Engineer	0	0	0	0	0	0	100,000	100,000
Costs of Issuance	\$240,000	\$333,000	\$270,000	\$363,000	\$390,000	\$493,000	\$390,000	\$493,000
Underwriting Discount (2)	\$190,720	\$465,815	\$256,025	\$642,870	\$464,940	\$1,150,680	\$464,940	\$1,150,680
Reserve Fund (3)	\$0	\$0	\$3,429,412	\$9,562,687	\$3,556,975	\$9,899,150	\$3,556,975	\$9,899,150
Total Issue Size	\$47,680,000	\$133,090,000	\$51,205,000	\$142,860,000	\$51,660,000	\$143,835,000	\$51,660,000	\$143,835,000
Term	30	30	30	30	30	30	30	30
Interest Rate (4)	4.75%	4.75%	5.25%	5.25%	5.50%	5.50%	5.50%	5.50%
Annual Debt Service	\$2,984,231	\$8,414,500	\$3,429,412	\$9,562,687	\$3,556,975	\$9,899,150	\$3,556,975	\$9,899,150

(1) Transaction Cost is assumed to be 4.0%

(2) \$4.00 and \$3.50 per Bond for GO Bonds; \$5.00 and \$4.50 per bond for Rev. Bonds; \$9.00 and \$8.00 per bond for rated CFD and AD.

(3) Reserve fund equal to one year debt service. GO Bonds do not require a reserve fund.

(4) Current interest rate assumption for planning purposes. Interest rates are subject to change with market conditions.

Source: Urban Futures, Inc.

Property Tax Impact of General Obligation Bonds

Table 15 illustrates the impact of a GO Bond issue on property taxes for the Town. Total assessed valuation for the Town is \$4,597,049,549 for 2013. The issuance of GO Bonds would increase property taxes by a range of \$65 to \$183 per \$100,000 of A.V.

Table 15
Town Acquisition of AVR System
Estimated Property Tax Impact of GO Bonds

Acquisition at Stock Price

Annual GO Bond Debt Service	\$2,984,231
Town Assessed Value (1)	4,597,049,549
Tax per \$100,000 A.V.	\$65

Acquisition at RCNLD Price

Annual GO Bond Debt Service	\$8,414,500
Town Assessed Value (1)	4,597,049,549
Tax per \$100,000 A.V.	\$183

(1) San Bernardino County Auditor-Controller

Impact of Revenue Bonds or Installment Sale COPs on Water Rates

Revenue bonds or installment sale COPs would be backed by the net revenues of the water system. This financing method would provide a way to finance the acquisition of the system from water rates and charges alone without the use of property taxes or assessments. Table 16 estimates the impact of COP issuance on water rates. Net revenues available for debt service at current rates are drawn from Table 15 from the section **OPERATION OF AVR SYSTEM UNDER PUBLIC OWNERSHIP**. The net revenues reflect the 14.7% rate increase for 2012 as authorized by the ALJ Decision and also reflect lower operating expenses under public ownership. Assuming the stock purchase price, no rate increase is required to purchase the AVR system and surplus revenues after accounting for the debt service coverage requirement are approximately \$4.8 million. This amount can be used to fund capital improvements. If the Town were to purchase the system at the RCNLD cost, current net revenues would not be sufficient to repay debt service on the COPs. The additional net revenue required to pay the debt service and meet the 1.20x coverage requirement is approximately \$2.5 million, meaning that water rates would need to increase about 11.04% from current levels. In this case, \$1.9 million will be left for capital improvements after payment of debt service.

Table 16
Estimated Impact of Revenue Bonds or
Installment Sale COPs on Water Rates

Stock Purchase Price:	
Annual Debt Service	\$3,429,412
Net Revenue Requirement at 1.20x Coverage	\$4,115,294
Net Revenue Available for Debt Service at Current Rates	<u>8,992,000</u>
Surplus Revenue	\$4,876,706
Required Rate Increase to Repay COPs	0%
RCNLD Purchase Price:	
Annual Debt Service	\$9,562,687
Net Revenue Requirement at 1.20x Coverage	\$11,475,224
Net Revenue Available for Debt Service at Current Rates	<u>8,992,000</u>
Additional Revenue Required	\$2,483,224
Total Projected Revenues at Current Rates (Table 18)	\$22,495,300
Required Rate Increase to Repay COPs	11.04%

Impact of CFD Special Tax Bonds or Assessment Bonds

Table 17 estimates the impact of the issuance of CFD special tax bonds or assessment bonds on property owners within the Town. The use of either financing vehicle will cause the cost of the AVR acquisition to fall on property tax bills, as a special tax or annual assessment installment. There would be no impact on water rates or charges that appear on customer water bills. Under state assessment bond law, assessments must be spread to properties on the basis of specific benefit realized by the improvements financed with the assessment bonds. Under the CFD statute, special taxes can be spread to properties based on general benefit rather than specific benefit. The CFD statute allows for considerable flexibility regarding the special tax formula. It should be noted that there are also small annual administrative costs that go with either CFDs or assessment districts. This analysis makes the assumption that the special tax or annual assessment installments are spread equally to each water connection to give a sense of the per connection impact of annual debt service. At the stock purchase price, the estimated annual cost per connection is \$184 or \$15 per month. Assuming the RCNLD purchase price, the annual cost per connection is \$513, or \$43 per month.

Table 17

Estimated Impact of Issuance of CFD Special Tax Bonds or Assessment Bonds

Stock Purchase Price

Estimated Number of Connections	19,311
Annual Debt Service Requirement	\$3,556,975
Annual Cost per Connection	\$184
Monthly Cost Per Connection	\$15

RCNLD Purchase Price

Estimated Number of Connections	19,311
Annual Debt Service Requirement	\$9,899,150
Annual Cost per Connection	\$513
Monthly Cost Per Connection	\$43

OPERATION OF AVR SYSTEM UNDER PUBLIC OWNERSHIP

Organization of Enterprise After AVR Acquisition

After the acquisition, the Town Council would act as the board of directors of the water system. The Town currently acts in similar capacity with respect to the wastewater system. It would be the role of the council to establish rates and charges, set water policy, and serve as the legislative body of the system. Under public ownership, the system would no longer be regulated by the CPUC. Instead, the Town Council would be politically accountable to the Town ratepayers. The system would have a General Manager who would report to the Town Council. Financial, accounting and legal services would need to be provided. Audited financial statements for the water utility would need to be prepared as they are currently for the Town's other funds. This feasibility analysis assumes that the overall operation, maintenance, billing and human resources aspects of the water system will be similar under public ownership as they are under AVR ownership. In addition, the analysis assumes no changes in staffing or personnel levels required to operate the system.

Establishment of Reserves

The Town should develop a plan for establishing reserves as soon as possible after the acquisition of AVR. Possible categories of reserves would include operating, capital, replacement, rate stabilization, vehicles, equipment and emergency. The Town will begin the ownership of the system with no reserves, and it will be up to the Town Council and staff to design polices to determine target levels of reserves and other details of reserve

policy. Proceeds of debt issues are typically used to fund capital requirements and are not used to fund system reserves.

Revenues as Public Enterprise

Upon acquisition of AVR, the Town must be prepared to own and operate the system. The water enterprise fund must be self-sufficient and not dependent on the Town's general fund or other sources of revenue. Water enterprise revenue must be sufficient to cover all operating expenses, debt service payments, and capital requirements. The following section details the primary revenue and expense categories for the system if it were operated under public ownership.

Rates and Charges

The primary means for generating water revenues will continue to be water rates and charges. The ALJ Decision resulted in an overall rate increase of 14.7% for 2012. The current residential water rate regime utilizes a fixed plus variable structure, meaning that customers pay a fixed monthly charge to cover access to the system, and then a unit charge for each 100 cubic feet of water consumed. For the variable charge, the system utilizes an inclining block rate structure with three tiers of varying water rates. The meter service charge assists in recovering the fixed costs of the system, including meter reading and billing, that do not vary based on water usage. It is not currently anticipated that the Town would change the fundamental aspects of the current rate structure. The Town would have the option of incorporating additional elements into the rate design such as drought pricing and standby charges. AVR currently employs a low income affordability program and the Town would need to decide whether the program should be continued.

Connection Fees

Another potential source of revenue is connection fee charges billed to new customers. Upon completion of the acquisition of the AVR system, the Town can complete a separate analysis regarding connection fees and thus determine the proper amount to charge future new customers adding connections to the system. Connection fees typically have two components. The first portion of the fee is used to reimburse the system for the actual cost of the new connection, including the meter and the cost required to connect the customer to the system and set up the new customer account. The second portion of the fee is designed to recover the proportional cost of the existing and future capital assets that are required to serve the new connections.

Over the past several years, new development and thus the number of new connections within the Town has not been substantial, so the connection fee revenue generated would have been relatively minor. Connection fee revenue tends to be more volatile on a year over year basis than revenue from rates and charges and it is not recommended that a water system become overly dependent on connection fees. Rating agencies will consider over reliance on connection fee revenue as a negative credit factor. In addition, rate covenants or additional bonds tests for bond issues may limit or exclude connection fee revenue from total revenues used to calculate debt service coverage.

Taxes

The water system would be eligible to receive tax revenue under public ownership. The Revenue and Expenses under Public Ownership projection on Table 15 does not currently include any provision for tax revenue. Therefore, the current bonding capacity of the system does not assume any tax revenue as part of the net revenues available for debt service. If the Town funded the AVR acquisition with GO Bonds or CFD Special Tax Bonds, a separate ad valorem tax or special tax would be added to the tax bills of property owners within the Town to generate revenues sufficient to pay debt service on the bonds.

Advances

Advances are a method that the water system can use to help recover the costs associated with new capital facilities and infrastructure used to serve new customers. Developers advance to the utility funds necessary to build new water mains and other facilities, and the utility repays the advances interest free over a long period, up to 40 years. In past years AVR has funded a significant amount of infrastructure through advances. AVR currently has about \$31.2 million in advances. The Town can continue to use this technique to fund new infrastructure. In addition, it should be assumed that the Town would be required to repay the advances under their current terms.

Developer Contributions

The water system can also generate revenue through in-kind contributions of infrastructure. Under this type of arrangement, a developer will agree to build the new water facilities that are necessary to connect the developer's new project to the currently existing system. Unlike an advance, the contribution is not repaid.

Expenses as Public Enterprise

It is assumed for purposes of this analysis that expenses for operations and maintenance, and administrative and general expenses will be similar as a public enterprise as they are under AVR ownership. However, it is assumed that after the Town acquires AVR, it would not be responsible for the payment of federal income taxes, California income taxes or property taxes. In addition, it is assumed that the Town would not pay a franchise fee.

Operations and Maintenance

The utility under Town ownership would continue to incur expenses for the operation and maintenance of the system. Primary expenses in this category include payroll expenses to pay employees, purchased power to run water pumps and other facilities, and leased water rights to meet demand in excess of the system's FPA. To the extent that the prices of electricity and water fluctuate annually, the utility can face significant uncertainties with respect to these costs. Maintenance expenses are another major item under this category. This feasibility analysis assumes that overall operations and maintenance costs would be similar under public ownership as they currently exist under AVR. Based on the

Summary of Earnings in Appendix B of the ALJ Decision, operations and maintenance expenses were projected at about \$6.5 million for 2012.

Administrative and General

The utility under Town ownership would also continue to incur administrative and general expenses. Major expenses in this category include payroll expenses, employee benefits and a general office allocation. It is assumed that these major expense categories would be similar under Town ownership as they are under AVR ownership. Based on the Summary of Earnings in Appendix B of the ALJ Decision, administrative and general expenses were projected at about \$6.9 million for 2012. One expense that this analysis assumes would not be incurred under public ownership is the franchise requirement, estimated at \$213,700 for 2012. The Revenue and Expenses Under Public Ownership in Table 18 does not include this cost.

Overhead Costs

While there would be no corporate overhead costs under public ownership, the Town would still incur an overhead cost associated with managing the water system. A certain portion of the Town overhead cost could be allocated as a cost to the utility. This cost would cover the portion of the Town's facilities and personnel that support the water system. This would include time spent by the Town Council, Town Manager and staff supporting the water system. It is likely that overhead costs under public ownership would be significantly lower than under AVR ownership. However, this analysis does not assume any overhead cost reductions for purposes of developing The Revenue and Expenses Under Public Ownership in Table 15.

Capital Costs - Replacement

Under public ownership, the utility will continue to require annual replacements of infrastructure and equipment as it ages. The annual replacement cost is a function of the size and the age of the system. The total annual depreciation can serve as a guide to estimate the total annual cost of replacement. The total annual depreciation as reported in the DWR report is estimated at about \$2.7 million for 2012. Major replacement items for the 2011 to 2013 period included main replacements and pump/motor replacements. Spending on these items totaled approximately \$5.3 million for the three year period.

Capital Costs – New Additions

The Town will also need to fund future capital additions to the system. It may be possible to fund a portion of these requirements with advances or developer contributions as described above. In some cases, the water system will need to directly fund extensions for new service or other new capital additions and the costs may be significant. Because of the recession and relatively small amount of new development taking place over the past five years, the amount of new additions has been relatively low. As stronger

economic growth and new development returns, such funding requirements may increase.

Projected Net Revenues with 2012 Rate Increase

Table 18 provides an estimate of revenues and expenses of the water system as a public enterprise. The operating revenues reflect a 14.7% rate increase for 2012 as reported in the ALJ Decision. The revenues and expenses as reported in Attachment B of the ALJ Decision serve as the source for the table. However, property taxes, federal income taxes, and California income taxes are eliminated under public ownership, so these expenses are eliminated for the table. In addition, depreciation is not typically treated as cash funded expense with utilities, so this expense is also not included. Finally, the franchise requirement is also eliminated as an expense item.

It is assumed that annual capital costs will be paid after debt service on bonds from remaining net revenue. If the Town pays the stock price for the system, net revenue remaining after payment of debt service is approximately \$5.5 million, which would be available for capital improvements. Assuming that the Town Pays the RCNLD cost, a 11.04% rate increase would be required to create 1.20x coverage on annual debt service. In this case, approximately \$1.9 million in net revenue is left after payment of debt service, which would be available for capital improvements.

Table 18
Apple Valley Ranchos Water System
Revenue and Expenses Under Public Ownership
(At Authorized ROR)
(In Thousands)

	<u>2012</u>
Operating Revenue	\$22,495
Miscellaneous Revenue	77
Total Revenue	\$22,573
Operations and Maintenance Expenses	
Payroll Operations	\$792
Operations - Other	194
Purchased Water	0
Purchased Power	940
Leased Water Rights	1,621
Replenishment Charges	210
Chemicals	27
Payroll-Customer	630
Customers - Other	275
Uncollectibles	77
Payroll-Maintenance	420
Maintenance - Other	700
Payroll - Clearings	122
Depreciation - Clearings	271
Clearings - Other	271
Subtotal O&M	\$6,548
Administrative & General Expenses	
A&G Payroll	\$1,690
Employee Benefits	1,477
Insurance	769
Uninsured Prop. Damage	12
Reg. Comm. Expense	99
Outside Services	260
A&G - Other	486
A&G - Transferred Credit	-210
Rents	18
General Office Allocation	2,113
AVR Allocation	-32
Subtotal A&G	\$6,681
Payroll Taxes	\$352
Total Expenses	\$13,581
Net Revenue Available for Debt Service	\$8,992

Bonding Capacity

Estimated maximum bonding capacity based on net revenues from Table 18 is shown in the table below.

Table 19
Apple Valley Ranchos
Water System
Estimated Bonding Capacity as
Public Enterprise

Borrowing Term (Years)	30	40
Debt Service Coverage	120%	120%
Assumed Interest Rate	5.25%	5.45%
Assumed Rating	"A"	"A"
Bond Par Amount	\$111,979,628	\$121,032,910
Proceeds for Acquisition	\$102,246,702	\$111,118,918
Total Annual Pledged Revenues	\$8,992,000	\$8,992,000
Annual Debt Service	\$7,493,333	\$7,493,333

Loss of Revenues for Local Government

Under the current ownership structure, AVR pays property taxes and franchise fees. For 2012, the estimated property tax payment is \$453,500 and the estimated franchise fee payment is \$213,700. If the Town acquires the AVR system this source of revenue for local government would be eliminated. However, the Town can impose a franchise fee of up to 10% of annual revenues. If the Town acquired AVR at the lower acquisition cost, it can afford to impose some level of franchise fee and still meet debt service coverage and capital requirements.

RISK FACOTORS OF THE AVR ACQUISITION

There are a wide range of uncertainties and risk factors associated with the potential AVR acquisition. The Town would begin a new relatively complicated enterprise involving employees and a large customer base, but the Town has no actual experience operating a water system. While the Town currently owns a wastewater enterprise, acquisition of the water system would add numerous new responsibilities including supplying water, maintaining facilities, and billing and accounting for customers. Future operating costs may be higher than anticipated under this analysis because of the Town's lack of experience in running the system. Also, operations costs could increase due to rising electricity, chemical, or commodity costs over which the Town has no control.

The Town will be responsible for future water system replacements, additions and improvements. AVR has maintained an active capital improvement program in the past, and has added substantial system improvements in recent years. As part of the condemnation process, an engineer will review the current condition of the system and provide input regarding necessary capital improvements. However, after the Town acquires the system, it will be responsible for capital planning for decades. The cost and required timing of future capital improvements has an inherent element of uncertainty, and the Town will need to become adept at capital planning.

The Town's boundaries differ from the boundaries of the service area of the AVR system. The Town would likely acquire all of the AVR facilities and not just those facilities located in the Town's boundaries. If the Town were to use a CFD or assessment district to finance the acquisition, the boundaries of the district can be drawn to match the service area boundaries of AVR. Otherwise the Town may be required to incur the time and expense of an annexation process to bring all of the AVR facilities within Town boundaries. The ultimate cost of the annexation is unknown.

The total acquisition cost of the AVR system is still unknown. This feasibility analysis presents cost estimates including transactions cost, but the ultimate cost will depend on the condemnation judgment. The time required and the costs of the condemnation process itself are unknown, and total transactions cost may exceed the estimates provided in this report. An engineering consultant will need to review the overall condition of the water system as part of the acquisition process. There is a risk that the engineer may identify unanticipated capital costs, necessary replacements, deferred maintenance, or other issues that increase the cost of the acquisition to the Town.

There can be uncertainty with regard to accessing the municipal bond market. Interest rates are at historic long term lows but there is the potential for rates to rise before the condemnation process is concluded. Higher interest rates will mean higher property tax rates, special tax rates or assessments for property owners if the acquisition is financed via the tax bill. If revenue bonds or installment sale COPs are used, higher interest rates will cut into the system's bonding capacity, cause increases in water rates, or even make the acquisition not feasible. Disruptions or problems in the financial markets themselves can make debt issuance and therefore project acquisition not feasible.

There is risk with respect to the adequacy of the water supply. The Mojave basin is adjudicated and there are essentially continuous groundwater shortages. The

groundwater basin is in an overdraft condition and is being depleted, and maintaining water levels within the basin depends on recharging with water from the State Water Project. In past years, AVR has regularly exceeded its FPA. As a result, it must to lease water rights from other agencies and individuals. The Town will need to continue leasing water rights to maintain adequate supplies.

The Town Council will need to become knowledgeable regarding water system operations, capital requirements and issues concerning the water industry. The council will need to establish water rates, charges, and policies. The Town Manager and senior staff members will also need to become knowledgeable of the water system. Assigned staff will need to become proficient at running the day to day operations of the system. The Town may encounter problems regarding collections or high delinquencies, which would necessitate that the Town engages in burdensome and time consuming collection activities.

The Town will also be responsible for the repayment of customer advances. The estimated AVR customer advances for 2012 are approximately \$31 million. The Town would be responsible for the repayment, or would need to arrange for repayment with the current owner when the system is purchased. The Town will need to satisfy accounting and record keeping requirements with regard to the advances, which can be time consuming and expensive.

The Town should be aware that there is unaccounted for water for both the domestic and irrigation system. This means there is a certain amount of leakage or loss of water within the system. Under the ALJ Decision, the parties agreed to estimate unaccounted for water at 8.0%.

There is always a risk of higher operating or capital costs in the future due to federal or state regulations. Regulations can mandate higher treatment standards and can cause the Town to incur large capital expenses to upgrade different parts of the water system.

FINANCIAL FEASIBILITY OF AVR ACQUISITION

The financial feasibility of the acquisition is determined by a comparison of the costs and benefits of the Town acquiring AVR vs. the costs and benefits to the Town if AVR maintains current possession of the water system. The previous section reviewed some of the risks of Town ownership, including the fact that water system ownership would be a new venture for the Town, the Town would be responsible for system capital improvements, the Town may need to annex a portion of the system, the condemnation and acquisition costs are unknown, and there is a risk to the adequacy of the water supply.

One of the major benefits to public ownership is local control. The Town, along with its residents and businesses will have control over the water system. This will provide ratepayers with a greater degree of accountability. The Town Council would direct the operation and management of the system and would decide on capital improvements, system upgrades, expansions and water programs. Rate setting would be accomplished locally. The Town Council would set rates and charges rather than the CPUC. Currently, AVR applies to the CPUC every three years for a general rate increase. Under public

ownership the general rate case would not occur. In this case, future rate increase would be balanced only with the priorities of the Town Council and water customers rather than the financial interests of a for profit entity. Rate increases can also be phased in over shorter periods rather than using once per three year larger increases. Policies regarding water conservation, discounts to low income customers, and different rates and charges for different classes of customers would be established and enforced by the Town rather than the CPUC. This would provide greater ease with respect to long term planning.

Financial benefits of public ownership include the fact the rate structure will not include profits to generate a return for private shareholders. Another major benefit is that the Town would not pay federal income taxes, state income taxes or property taxes. Also, the Town has the option of instituting a franchise fee. Most municipal utilities do pay one. The Town currently collects \$213,700 as a franchise fee from AVR. If the Town does not institute a franchise fee, these funds would be available to fund operating costs or debt service for the water system. Another cost avoided under public ownership is depreciation expense, which is a non-cash expense. Under ratemaking by most public agencies that set rates on cash basis, annual depreciation expense is not included. Under public ownership, the Town can access the tax-exempt municipal bond market to fund capital improvements. In addition, the Town would be eligible for millions of dollars in State and Federal Grants to fund capital improvements that are not currently available to AVR.

However, public ownership could cause negative financial impacts. In order to finance the acquisition of the water system, the Town will need to issue a significant amount of debt that will need to be repaid through taxes levied on properties or water rates. Whether or not a rate increase is required and the magnitude of the increase is dependent on the purchase price, which will be determined through the condemnation process.

Property taxes would need to increase by a range of \$65 to \$183 per \$100,000 of assessed value to complete the AVR system acquisition using GO Bonds. A new special tax or annual assessment installment could range from \$184 to \$513 on an average per connection basis if a CFD or assessment district is used. If the Town uses revenue bonds or installment sale COPs backed by the net revenues of the water system, the Town can generate revenues sufficient to pay debt service with no rate increases if it can purchase the system at the low purchase price scenarios. If it purchases the system at the high purchase price scenarios, a rate increase of 11.04% would be necessary to generate proper debt service coverage on the debt. The Town can also use a combination of installment sale COPs and a tax backed financing to fund the acquisition.

The benefits resulting from ownership must be compared with the increases in taxes or water rates and the assumption of the various risks associated with ownership. However, it should be noted that the use of revenue bonds or installment sale COPs to purchase the system at the lower price range would result in a scenario where no rate increase would be required, no new taxes would be levied, and there would be adequate money available after payment of debt service to fund capital improvements on an annual basis.

FINDINGS AND CONCLUSIONS

If voters approve a new property tax, special tax, or special assessment, the acquisition of the AVR system is financially feasible. In this case the cost of the acquisition would be incurred by the property tax bill. Under these circumstances, the acquisition is feasible even at the higher purchase price assuming that voters are willing to tax themselves at a sufficiently high rate to repay required bond debt service. Utilizing revenue bonds or installment sale COPs, the acquisition is feasible at the lower purchase price without the need for a rate increase. In this case, net revenues would be sufficient to pay debt service on bonds and there would be sufficient funds remaining for capital improvements. Assuming the higher purchase price, acquisition of the AVR system with revenue bonds or installment sale COPs is feasible with a rate increase. Net revenues remaining after the payment of operation and maintenance expenses generated from the water system must be sufficient to cover debt service, debt service coverage and future capital improvements.

The keys to the financial feasibility of the acquisition are as follows:

- (1) Under public ownership, the water system will not be required to generate a profit for private shareholders.
- (2) The Town would not pay federal income tax, state income tax or property taxes.
- (3) As a public enterprise, the Town would set water rates on a cash basis and annual depreciation would not be included as an operation cost that must be recovered from rates and charges.
- (4) Based on the ALJ Decision, an overall rate increase of 14.7% was adopted for 2012, resulting in an increase in total revenues and net revenue available for debt service, capital improvements, and reserves.
- (5) The Town can access the municipal bond market and issue tax-exempt bonds at historically low fixed interest rates to fund the acquisition.
- (6) The Town would be eligible for millions of dollars in State and Federal grants to fund capital improvements that are not currently available to AVR.

Most of these factors reflect financial advantages that are available to any public agency.

NEXT STEPS

We recommend as a next step the Town should engage an appraiser to provide a formal appraisal for the value of the water system. A realistic indication of the value will help the Town decide other issues, like the best financing method or combination of financing methods to achieve the acquisition.

UFI had a preliminary general discussion with a specialized water system appraiser that the firm has worked with in connection with past projects. The appraiser indicated an appraisal time of four months to eight months and an estimated cost of \$100,000 to \$200,000 for systems that is similar in size and nature to the AVR system. UFI did not divulge the name of the Town or any specific identifying information to the appraiser.

After the appraised value is determined, the Town will need to take additional steps to complete the AVR acquisition, including the following:

- (1) The Town will need to apply to the Local Agency Formation Commission (LAFCO) to adjust the Town boundaries so that they are coterminous with the service area boundaries of the AVR system. If the Town uses a CFD or Assessment District to finance the acquisition, this action may not be required, as the boundaries of the district can be drawn to match the boundaries of the current AVR service area.
- (2) The Town will need to retain a consulting engineer to perform a full review of the water system and inspect all facilities. The engineer will need to prepare a report documenting the condition of the system and the required replacements, repairs, expansion, upgrades, and capital improvements. If there are a large number of unanticipated repairs or upgrades required, the cost must be reflected in the purchase price.
- (3) An accountant will be required to conduct a financial review of the records of the water system including billing records, current accounts receivable and customer advances. The Town needs to be aware of which customers would need to have advances repaid and the repayment schedule.

The Town Council will ultimately need to choose the financing method. GO bonds will require an election and a two-thirds voter approval. A CFD or assessment district would require the Town go through the formation process as required by the respective statutes. The use of Installment-Sale COPs will requires approval by the Town Council.