



BORREGO WATER DISTRICT

November 20, 2013

To the Honorable President and Members of the Board of Directors and Customers of the Borrego Water District:

State law requires that all general-purpose local governments and special districts publish each fiscal year a complete set of financial statements presented in conformity with generally accepted accounting principles (GAAP) and audited in accordance with generally accepted auditing standards by a firm of licensed certified public accountants. The Annual Financial Report of the Borrego Water District ("BWD" or "District") for fiscal year ended June 30, 2013, is hereby submitted as required. Hosaka, Rotherham & Company, a firm of licensed certified public accountants, has audited the District's financial statements.

Generally Accepted Accounting Principles (GAAP) requires that management provide a narrative introduction, overview, and analysis to accompany the financial statements in the form of the Management's Discussion and Analysis (MD&A) section. This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The District's MD&A can be found immediately after the Independent Auditors' Report.

Management assumes full responsibility for the completeness and reliability of the information contained in this letter, the MD&A and the accompanying financial statements, based upon a comprehensive framework of internal control that it has established for this purpose. Because the cost of internal control should not exceed anticipated benefits, the objective is to provide reasonable, rather than absolute, assurance that the financial statements are free of any material misstatements.

The goal of the independent audit was to provide reasonable assurance that the financial statements of the District for the fiscal year ended June 30, 2013, are free of material misstatements. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The independent auditor concluded based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the District's financial statements for the fiscal year ended June 30, 2013, are fairly presented in conformity with GAAP. The Independent Auditors' Report is presented as the first component of the financial section of this report.

PROFILE OF THE DISTRICT

The District was established in 1962 as State of California special district (Water Code § 35565) to provide water, sewer, flood control and gnat abatement for areas in the Borrego Springs community. The District presently serves approximately 2,100 customers. Borrego Springs is an unincorporated community of 3,500 full-time and more than 6,000 winter residents located in the northeast corner of San Diego County approximately 90 miles drive from San Diego.

Borrego Springs is surrounded on all sides by the Anza-Borrego Desert State Park ("the Park") and serves as the primary gateway for visitors to the Park. The Park is a vast desert wilderness (1,000 square miles). It was designated as a National Natural Landmark in 1974 and a Biosphere Reserve in the 1980's by the United Nations. The Park contains the largest area of designated wilderness area within the State of California.

Governance

A five-member board of directors works as a team to govern the affairs of the District. The board is elected at large by the registered voters residing within the District's boundaries, with vacant positions that occur between elections appointed by the existing board and during election years by the San Diego County Board of Supervisors if there is no competition for a seat on the board. The directors, who are elected or appointed, are residents and have the same concerns as their constituents. The board members, who serve four-year staggered terms, are responsible for establishing the direction of the District through adopting policies and ordinances for the smooth running of the District, ensuring that sound fiscal policy exists and that sound management practices and controls are in place for accountability, adopting the annual budget, approving personnel policies and organizational structure, hiring the District's General Manager and hiring other advisors to the board, such as the District's General Counsel, financial and other advisors. The General Manager is responsible for carrying out the policies and ordinances approved by the District board, for overseeing the day-to-day operations of the District and for meeting or exceeding the financial objectives set forth in the annual budget approved by the board.

Groundwater Supply, Usage & Availability

The Borrego Valley Groundwater Basin (BVGB), a Pleistocene era water deposit is presently the community's sole source of water. Today, annual withdrawals exceed replenishment by more than 4 to 1. The California Department of Water Resources (DWR) estimates that more than 450,000 acre-feet of water have been overdrawn in Borrego Valley since 1945 (an acre-foot of water is equal to 325,851 gallons)

The current rate of groundwater pumping produces an average annual overdraft of about 15,000 acre-feet of water per year. This rate of overdraft is equivalent to about 1,500 40-foot-long tanker trucks of water leaving the Borrego Valley up the Montezuma Grade every day. At the current rate of use, the groundwater supply is not sustainable.

The largest water level declines are found in the northern part of basin where most of the agricultural acreage is concentrated and in the southwestern part of the basin. Water levels in the upper aquifer of the basin have declined as much as 170 feet since 1945 when water levels were first mapped by the United States Geological Survey (USGS). Since about 1990 water levels in these wells have declined about 2.7 feet per year.

Since 1982 when the USGS produced definitive evidence that withdrawals from the BVGB exceeded natural recharge to the extent that serious economic, social, and environmental harms were likely to occur, the Borrego Water District (the District), assisted with grants from federal, state, and local agencies has spent approximately \$5.6 million (on a Present Value [PV] basis) primarily to study the physical parameters of the overdraft, to fallow a few hundred acres of farmland, to identify potential alternative sources of supply, and the costs to build a pipeline to the Borrego Valley (the Valley).

Approximately \$2.3 million was spent since 2009 for data collection and analysis including: the \$500,000 USGS *Evaluation of Ground-Water Conditions and Land Subsidence in the Borrego Valley, California* (the District paid approximately \$345,000 for some of this work); the \$900,000 U.S. Department of the Interior, Bureau of Reclamation (Reclamation) *Southeast California Regional Basin Study* (the District contributed \$12,000 cash and \$450,000 in-kind studies); the \$300,000 U.S. Environmental Protection Agency (USEPA) *Borrego Springs Pipeline Feasibility Study* (the District paid more than \$100,000 of this work), and DWR's Southern Region spent approximately \$645,000 on various activities investigating the Borrego Valley Groundwater Basin (the District paid DWR about \$135,000 for some of this work).

Yet, according to the USGS report due out in final form next year, the net result has been that the

overdraft has more than doubled since 1982; increasing from about 6,000 acre-feet per year (AFY) to about 15,000 AFY.

Of the current average annual withdrawals from the BVGB, agricultural irrigation in the Valley uses about 14,000 acre feet per year [AFY] (70%), recreational uses (golf courses) are about 4,000 AFY (20%) and residential/commercial uses about 2,000 AFY (10%) of a total approximately 19,000 AFY average of annual withdrawals from the BVGB. Natural annual average replenishment of the BVGB approximates 4,900 AFY. Residential/commercial users are metered and largely supplied by the District. Agriculture and recreational water users have their own wells for irrigation purposes and pump directly from the basin.

The deleterious effects of this continuing drawdown have created two environmental integrity concerns for the region due to the proximity of the Anza-Borrego Desert State Park (ABDSP):

A Threat to Wilderness Values - The overdraft has been a factor in the degradation of the vast mesquite woodlands or "bosques" that once thrived at the lower end of Borrego Valley. Also, water-related habitats, such as those found near springs, seeps, cienegas and wetlands represent a precious resource in the desert ecosystems of the Park can also be influenced by declining groundwater levels; and

A Threat to Preserving Borrego Springs as a Gateway for Visitors to the Park - The average cash contribution to the region from visitors to the Park is estimated to be approximately \$40 million annually (BBC Consulting, Denver, Colorado: "Potential Impacts of Wind Farm Development Near Anza-Borrego Desert State Park" [August 20, 2012] study for the Anza-Borrego Foundation). Preliminary results from the recent USGS study projects a complete dewatering of the upper aquifer of the BVGB within approximately 50-years at current withdrawal rates. Presently, there is uncertainty concerning the amount of and potential cost of economically extractable potable water that will be available from the middle and lower aquifers once the upper aquifer of the BVGB is dewatered.

A concern is that water extracted from the remaining lower aquifer tiers of the BVGB may be less potable and may require expensive advanced treatment of the extracted water from these lower basin levels. Pumping from deeper and deeper for remaining extractable water is likely to also require the relocation of existing production wells, additional wells and distribution lines, and greater pumping costs, further increasing extracted water costs for all beneficial uses. It is likely that as the upper aquifer is dewatered, potable water for commercial and residential use will cost more than today.

During FY 2013, the Board continued to work with the USGS study team on its groundwater management model for the BVGB to ensure that the physical parameters of the basin are fully defined and that options for managing the basin and for importing water for storage, recharge, and supplemental supply are fully evaluated on a timely basis.

Importation of water may be possible to address the Valley's groundwater overdraft if a reasonably priced, sustainable source of supply can be identified to augment the supply presently available from the BVGB. Untreated imported water costs would be higher than what Borrego Valley pumpers presently experience, about \$200 per acre-foot for non-potable water for irrigation use and about \$900 per acre-foot for potable water (District customers). The cost of conveying water depends on the distance moving it from the source of supply to the area of need. Presently, Reclamation is concluding their basin study with the District and other regional interests to determine importation alternatives, including the cost for a conveyance pipeline to bring water to the Valley, and addressing impacts from climate change.

The District adopted a groundwater management plan under Assembly Bill 3030 in 2002. The District has

broad authority, though the AB 3030 process, to manage a groundwater basin. Water Code section 10753.9(c) gives the District the authority to limit or suspend groundwater extractions in the area covered by the groundwater management plan if the District has determined, after appropriate study, that "groundwater replenishment programs or other alternative sources of water supply have proved insufficient or infeasible to lessen the demand for groundwater." Water Code section 10754.2 authorizes the District to impose "equitable annual fees and assessments for groundwater management" within the area covered by the groundwater management plan.

The area covered by the groundwater management plan is the District's boundaries, which encompasses almost all of the Borrego Valley Groundwater Basin. In combination with Water Code sections 35408 and 35409, which give the District broad authority to commence litigation to protect a groundwater basin if necessary, the District has the necessary tools in order to attempt to bring the basin into balance but has neither had the plan implementation funds nor the community support necessary to use this basin management authority in the past.

The only groundwater management planning and implementation funds presently available are through the California Department of Water Resources (DWR) Integrated Regional Management (IRWM) program. Thus, in 2009, the District applied to DWR and received approval to form the Anza-Borrego Desert (ABD) IRWM Region. The ABD Region was formed out of necessity after being denied inclusion in the San Diego, Coachella Valley and Imperial Valley Integrated Regional Management Group's (IRWMG's).

The District has provided all of the ABD-IRWM funding to date, \$328,425. With this funding a multiparty stakeholder process was conducted involving 17 stakeholder meetings, all noticed and open to the public per DWR's IRWM planning guidelines, 12 steering committee conference calls were held with the San Diego County Department of Planning and Development Services (PDS) and the Resource Conservation District of Greater San Diego (RCD), the two other partnering governmental agencies that formed the ABD IRWMG, and two DWR planning grant applications were developed (in 2010 and 2012).

The planning tasks in the round two planning grant request to DWR submitted in March 2012 included a forecast of declining water quality from the continuing overdraft of the BVGB and an estimate of the economic consequences of the overdraft to District customers. These are two critical elements for a plan to manage the BVGB. To date, neither of these planning elements has been adequately addressed by the several previous federal, state, and locally-funded studies conducted in the Borrego Valley since 1982. DWR denied the ABD Region's IRWM round two planning grant request for \$841,779 in December 2012.

During this year, the District became a member of the Borrego Water Coalition (BWC). The BWC comprises local leaders from the Chamber of Commerce, agriculture, Borrego Water District, education, golf, lodging, State Park and recreation. The BWC represents all the major pumpers and water users of the BVGB. The District has also agreed to participate with BWC, the Anza-Borrego Desert State Park (ABDSP), Anza-Borrego Foundation (ABF), and the Steele/Burnand Anza-Borrego (SBAB) Desert Research Center, University of California, Irvine in submitting a National Science Foundation (NSF) grant request for the NSF's Water Sustainability and Climate (WSC) program. This grant request is for about \$3,000,000.

The District is not a member of the San Diego County Water Authority (SDCWA), the regional member of the Metropolitan Water District of Southern California (MWD) that imports supplemental water into San Diego County.

FACTORS AFFECTING FINANCIAL CONDITION

The information presented in the financial statements is perhaps best understood when it is considered from the broader perspective of the specific environment within which the District operates.

Local Economy

The local economy and the income of retirees living in the Borrego community continues to be affected by the general downturn in the economy of California and the nation. Uncertainty over long-term water supply may be slowing new development in the Borrego Valley (Valley). Additionally, there is growing concern in the Valley over the long-term impacts of declining water table levels on the Park's desert ecosystems. Loss of wilderness values to the park has the potential to affect the number of visitors to the park. For example, in recent years the non-native Sahara mustard plant has devastated the beautiful fields of wildflowers normally found in the Valley. This invasive species has created damage to the local ecosystems of the Valley and presently shows little sign of abatement. Instead of fields of wildflowers that have attracted thousands of visitors in the spring, as the wildflower fields have declined in recent years, so have the number of visitors to the Valley.

Previous Fiscal Years Spending by the District

The District continues to work itself out of the financial situation that was inherited from the past Board and general manager who between FY 2008 - FY 2011 spent more than \$6.3 million of the District's cash reserves. This spending resulted in the District losing its good credit rating. The District has not been able to borrow in the public bond market for its capital improvement program (CIP) and has deferred major repair and replacement (R&R) projects until it is creditworthy again.

Long-Term Financial Planning

The District's present Board of Directors is aware of the need to restore the District's financial stability and return to creditworthiness. Through a coordinated strategic process, the Board has established a series of policies and plans to effectively meet the District's anticipated future revenue needs. The principles the District has adopted for returning to revenue sufficiency include: (a) the active management and projection of monthly cash flow during the year; (b) holding expenditures below the annual budget; (c) no increases in salaries and benefits for employees; (d) deference of large capital expenditures until the District is able to borrow again in the public bond markets; and (e) implementing a thirty percent (30%) revenue increase in FY 2012 that took effect July 1, 2011, a revenue increase of twenty percent (20%) for FY 2013 that took effect after August 18th, 2012 and was reflected initially in the September 2012 water and sewer bills, and a revenue increase of 13.75% for sewer rates, 15% for water base rates, and 19% for water commodity rates for FY 2014 that will go into effect July 1, 2013. Additionally, the District has additional ten percent (10%) for sewer rates and fifteen percent (15%) of potential revenue increases available to it, which may be instituted between FY 2015 - FY 2016, if necessary, to re-establish its creditworthiness for borrowing in the capital markets. These revenue increases were approved under the public Proposition 218 process the District underwent in June 2011.

The primary driver for the long-term financial viability of the District, as well as the economy of the Valley and well-being of the Park is the necessity of resolving the overdraft of the BVGB (see section on Groundwater Supply, Usage & Availability above).

RELEVANT FINANCIAL POLICIES

Reserve Policy

The District has established a Reserve Fund Policy to anticipate and to prepare for future funding requirements as well as for unforeseen events. The Reserve Fund Policy establishes restricted and unrestricted reserves and describes the flow of funds to and from the various reserves. A copy of the District's current Reserve Policy is available on the District's website.

Risk Management

The District is a member of the California Joint Powers Insurance Authority (JPIA).

Pension and Other Post-Employment Benefits

The District contributes to the California Public Employees Retirement System (CalPERS), an agent multiple-employer public employees defined benefit pension plan for its personnel. CalPERS provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. Additional information about the District's pension arrangements and post-employment benefits can be found in the notes to the financial statements. In FY 2012, the Board changed the pension program from three percent (3%) per year of active service at retirement that was instituted by the prior Board in 2009, back to its previous two percent (2%) per year of active service at retirement. This new pension policy is in effect for employees of the District hired after April 1, 2012 only.

Investment Policy

The Investment Policy establishes guidelines for the investment of available funds. The Investment Policy incorporates the Prudent Investor Standards. The primary objectives, in priority order, of the District's investment activities are the following: 1) safety, 2) liquidity, and 3) yield. The District's funds are invested in a variety of investments, in accordance with California government code, as described in the notes to the financial statements. The District minimizes interest rate risk by investing a greater portion of its funds in short term investments and minimizes credit risk by investing a majority of its funds diversified investment pools.

Internal Controls

The District is responsible for establishing and maintaining an internal control structure designed to ensure that the District's assets are protected from loss, theft, or misuse, and to ensure that adequate accounting data are compiled for the preparation of financial statements in conformity with GAAP. The internal structure is designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that; 1) the cost of control should not exceed the benefits likely to be derived; and 2) the valuation of costs and benefits requires estimates and judgments by management.

Respectfully submitted,


Jerry Rolwing
General Manager