

MEMORANDUM

TO: Borrego Water District

FR: Dennis G. Ciocca
Senior Vice President
Stern Brothers & Co.

RE: Water System Reporting Methods
and Future Borrowing Capacity

DATE: January 19, 2011

On December 15, 2010, I attended a Board of Directors meeting at the Borrego Water District at which time the 2010 Audit was presented as well as a proposal which Stern Brothers had obtained from Capital One Corporation (herein referred to as "Capital Corp.") to lend the District \$1.5 million for water system improvements. Because there was not a detailed plan for the expenditure of these funds staff was requested to generate a water system capital improvement budget and I was requested to return to this private placement lender for a potential increase in the amount of funds that might be generated.

Because the request for financing had been increased in amount, and updated financial results were available, Capital Corp. reasonably requested substantial additional data, including operating results for the water system for the fiscal year ending June 30, 2010. As was detailed in a prior report I recently submitted, the District has never reported financial results for the water system (or for that matter the sewer system) as a whole but rather as a series of "Improvement Districts" which historically track the development of these enterprises.

I therefore submitted the 2010 audit of the District as well as the staff prepared spread sheet reporting the fiscal year results of each Improvement District to the representatives of Capital Corp. Because the staff report also did not aggregate the results of these operations as those of a water or sewer enterprise, I personally prepared a summary statement of the results as a water system enterprise fund. These financial reports have been previously provided to the District in my e-mail dated January 11, 2010. In that report, I also suggested that the District adopt a future policy of reporting both the water and sewer enterprises as individual funds in future audits.

This morning I received a call from Capital Corp. advising me that upon review of the updated financial reports and in consideration of the request for possible additional funding, they were suspending their offer to provide private financing for the District's Water System until such time as enterprise fund accounting becomes available. Frankly, this was a disappointment but not a surprise when one considers that the financial data they were requested to make a decision upon was not only unaudited but had been further modified by an outside party (i.e. myself).

However, it is significant that Capital Corp. remains interested in providing funding to the District for Water System improvements, but needs a higher level of comfort with the financial reporting. In consideration of the due diligence requirements being placed upon all financial industries at this time such a request is not unreasonable.

It therefore appears that my prior suggestion to develop an enterprise fund reporting system in future audits now becomes an absolute requirement in order to obtain future access to the public borrowing markets. I

have discussed this process with your auditor, Harvey Schroeder of Diehl, Evans & Company, and while the initial process of converting the reporting technique will be cumbersome (a balance sheet will need to be developed for both the water and sewer systems) it is not only possible but needs to be done in order to bring the Borrego Water District's financial reporting systems into a comparable status with the vast majority of public agencies throughout the State.

It has further come to my attention that an engineering company out of San Diego is in the process of developing a water rate study for the District. It is my personal opinion that this rate study needs to be processed in conjunction with the change over to a enterprise fund reporting system as the results of one study may influence the outcome of the other. It may very well be that future water rates in the District may be comprised of a basic (District wide) water rate as adjusted by individual considerations within specific "Service Areas" (previously referred to as Improvement Districts) to reflect additional costs of service within those geographical areas.

Finally, from the perspective of a financial industry professional, I would think that careful consideration of future capital needs within the future Water System Enterprise be considered prior to completing the rate study.

Having served as either investment banker or placement agent on the District's last five bond issues dating back to 1996 we stand ready to provide any assistance the District may desire in this process.

On January 19, I sent you a brief report discussing the fact that the lender that had originally proposed a private placement of \$1.5 million for water system improvements had, upon review of the 2010 audit, withdrawn their offer pending improved reporting procedures in order to completely analyze the cash flow available to repay debt. Subsequent to this time I have had a conversation with your auditor, Harvey Schroder, and find my conclusions in that report are also validated by the audit itself. For simplicities sake let me summarize my conclusions:

1. Due to the 2010 operating results the District is no longer in a position to borrow in the capital markets. Just how serious this situation has become would take an analysis of prior audits, but for now suffice it to say the situation is serious and needs to be immediately addressed.
2. Assuming corrective action is taken immediately, it will take at least a year (until a new audit is available) before the District might be able to borrow again in the public credit markets. The longer it takes for the District to correct this cash flow situation, the longer it will take to regain credibility in the securities markets.
3. It is my understanding that the District has engaged an engineering firm to undertake a rate study for the water system. Prior to the time this study is completed a careful analysis needs to be made of the current and future cash flow needs (including capital investment costs) over an extended period of time (say 5 to 10 years).
4. It would be a waste of both time and money to proceed with a rate study without having first internally determining the long term needs of the system. This comment is not a negative reflection on the prior operations of the District, but the fact that with the growth that has been experienced over the past several years a more comprehensive reporting system needs to be implemented.

Please feel free to call upon me for any additional assistance that I might provide. You are authorized to distribute this memorandum at the Board Meeting of January 26, 2011.

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