

Mr. Jackson,

I have provided my response to each of the substantive points that you have made below. In general, the points that you make are not accurate or convincing in nature. If you have additional questions or comments, I would be happy to address those.

My desire is that the people of Pine-Strawberry have as accurate an estimate of the costs and rate impacts as possible. The community needs this information well before any purchase agreement is made. The errors that I have identified in your analysis significantly alter the conclusions that your analysis came to.

You and Mr. Haney have addressed a great deal of concern over what my qualifications are, with the implication that someone who doesn't meet your definition shouldn't be allowed to ask questions or be taken seriously. I am a citizen of the community that has every right to ask our elected officials questions about the information that they provide to the public, to expect those questions to be answered, and too expect that the information provided be correct.

I have a Masters degree in Electrical Engineering and have been an engineer for 28 years. Large parts of my career have been spent analyzing data and building projections from data. I have experience working through what the underlying relationships and equations are that exist between data. I have spent a significant amount of time over the last 15 months becoming familiar with the public data related to the water issues for Pine-Strawberry.

The errors in your analysis don't require any special water related skills to detect. They just require an open mind and some effort to find.

Responses:

A. [Jackson]: "However, I understand that he earlier prepared an analysis that purported to value the Pine and Strawberry Water systems at \$5,400,573. This is more than double the amount that the District's project team has determined the system to be worth at present."

[Schwalm]: Yes I did do that. I took your 2003 evaluation, reverse engineered the relevant parts and rolled it forward in time and plugged in the 2006 numbers. That produced a value of \$4,657,157 for the Asset Valuation Method. I then averaged that with a value that I determined for the Subscriber Valuation based upon \$2000 per connection. It is interesting that two valuations from the same company could produce such different results.

B. [Jackson]: "a. He inflates forecast operating expenses for an "operations company" to be hired to run the acquired system. However, the District Board and General Manager have specifically stated that there are no plans to hire an operations company. The only conceivable need for such a company would be on an interim (90 day) basis while the District acquires its staff, and even this is not certain. Mr. Schwalm mistakes this

potential temporary need for a permanent presence, and his five year expense projection is therefore overstated by hundreds of thousands of dollars.

b. Mr. Schwalm further compounds his error by grossing up the District's expenses to assume additional "overhead" and "profit" for this phantom operations company.

[Schwalm]: The board has repeatedly stated that they plan to hire an operations company to run the system. Any such company is going to pay prevailing wages to the employees, just like the district will. Since that company is in business to make money for its owners, the contract with that company will include terms that allow it to cover the overhead of its corporation and to earn a profit.

I met with Mr. Haney last summer to discuss the problems that I see with the Coe and Van Loo (CVL) reports. On this topic, Mr. Haney agreed that the costs for an administrative assistant were missing. He further stated that he thought that two crews would be required, rather than the one that is forecasted in the CVL report.

I decided to take the middle ground and leave it at one crew provided by an operating company and a general manager and an administrative assistant provided by the district. I also was conservative in the amount of overhead/profit that the operating company would require and only added an additional 30% to the cost of the crew. Following Mr. Haney's recommendation of two crews would result in a cost that is substantially higher than the numbers that I used.

If the board has a new plan and makes it public, this number can be adjusted accordingly.

C. [Jackson]: "c. He erroneously adds Taxes Other Than Income to the forecast operating expense, even though as a public entity the District will not be required to pay taxes. He alleges that this offsets sales taxes that are supposedly in Brooke's sales figures. He provides no evidence to support this allegation, and there is nothing in any company data I have seen to substantiate this. However, as we have already discussed with the District Board and staff, even if sales tax revenues are included in Brooke's Metered Water Revenues, the District could negate the impact of this by simply engineering a one-time reset of the fee structure so that revenue already collected from ratepayers for sales tax purposes would be accrued by the District instead. The net result to the ratepayer is that there is no initial change in monthly bills, which is in line with the preliminary conclusion of our October 14 draft report. The net result: Mr. Schwalm's addition of these expenses is improper."

[Schwalm]: I asked Brooke about this last summer and they confirmed that sales taxes are part of Metered Revenues and that the Taxes Other Than Income is the operations budget item where the sales tax receipts are subtracted off. You were less confused about this in your 2003 valuation, as this item is included in the forecasted operations budget. This is not a case where the district is paying taxes, this is a pass through of the sales taxes collected from the rate payer on the water usage portion of his bill. In any case, the error exists whether it is ultimately something the district has to continue collecting or not. The revenue/expenses relationship is described by the following general equation:

$$(\text{BaseRateRevenue} + \text{WaterUsageRevenue} + \text{SalesTaxReceipts}) = (\text{OperationsExpenses} + \text{SalesTaxReceipts} + \text{GeneratedCash})$$

The sales tax receipts are on both sides of the equation, so they have no net effect. By dropping the Taxes Other Than Income from the operations budget, it changes the equation to the following:

$$(\text{BaseRateRevenue} + \text{WaterUsageRevenue} + \text{SalesTaxReceipts}) = (\text{OperationsExpenses} + \text{GeneratedCash})$$

This has the effect of inflating the revenue that you use in your analysis by the amount of the sales tax receipts, about \$76,000 in the 2006 ACC report. You either need to add back the Taxes Other Than Income or subtract it off of both sides of the equation. This error needs to be corrected in your analysis.

My understanding is that this is not an approach that is unique to Brooke's accounting. When I met with Mr. Haney last summer and pointed out this error in the CVL report, he stated that this had been a "red flag" to him when he saw it. Not sure why, given Economists.com's resume and credentials, it would be difficult to determine the answer to this question.

D. [Jackson]: "d. Mr. Schwalm ignores the fact that due to the construction of a new well the District is forecast to cease purchasing water in 2011, a savings of approximately \$27,000 in 2011 alone. He implies that there is some sort of issue with our forecast because in 2011 operating expenses do not increase by approximately 4.0%, the same amount as prior years. When certain expenses increase by 4.0% and other expenses (i.e, water purchases) are eliminated, the net result is that total expenses will increase by less than 4.0%. This is a rather elementary point that should easily be noticed by someone who purports to be an expert in financial forecasting."

[Schwalm]: I realize that in the CVL operations budget estimate that there is a note that says that once the immediate capital improvements are completed (which I take to mean that the Milk Ranch well is hooked into the system) that there will be no more water purchases from private well owners. This seems very much at odds with the public statements of the board as they have been making a big deal about having five additional water sharing sources to hook up once they have acquired the water companies.

It would also seem to make little operational sense to assume that there will be no more purchased water. In examining the ACC reports, it appears that the least expensive water is provided by the water sharing agreements. Strawberry gets about half of its water from water sharing agreements. It wouldn't make sense to now have to pump all of that water up from Pine.

In any case, you have subtracted off the entire amount budgeted for purchased water. The water that the district would have to pump to replace that is not without cost, so the expense for that needs to be increased. I suspect that the cost

to pump the extra water from the Milk Ranch well and to move significant volumes of water up the hill to Strawberry will negate any of the savings that you are claiming. This is an error that needs to be corrected in your analysis.

E. [Jackson]: “a. He claims that 8,245,000 gallons of water listed in Pine and Strawberry Water Companies' 2006 ACC reports under water sales represents an intra-company transfer of water between the companies. I have seen no documentation from Brooke or Mr. Schwalm to substantiate this claim. In fact, I believe it would be improper to include intra-company water transfers in the ratepayer water sales portion of the standardized ACC report. He then speculates, again with no supporting evidence, that \$39,051 of revenues should be eliminated to account for an alleged transfer payment for this water. However, he fails to acknowledge that even if his allegation about the 8,245,000 gallons of water turns out to be correct, it will not impact the revenue forecast. Our rate model calculates revenue for the last actual year of data (2006) to within 1.0% of actual revenues collected based on a set of assumptions about how much water was sold in each rate tier. If it turns out that volumes are overstated by 8,245,000 gallons, then this will necessitate a simple adjustment of the volume by rate tier assumptions. This will ensure that model revenues still accurately forecast actual revenues. Mr. Schwalm's contention is therefore not material. We have repeatedly acknowledged that there are outstanding issues regarding the volume, customer and revenue data supplied thus far by Brooke Utilities that must be resolved during the due diligence phase of this acquisition.”

[Schwalm]: I find it surprising that, given Economists.com's resume and credentials, that you would think that this is an intra-company transfer. It is common knowledge that PWCo and SWCo are separate companies that are regulated independently by the ACC. As such, transfers would need to be documented as sales between the two companies. There are some other clues as well:

- There is a footnote to the 2005 SWCo ACC report that specifically states that water transferred to Pine is included in the total water sold.
- If one adds up the SWCo totals for the water pumped and the water purchased and compares that to the water sold, the difference is less than the 8,245,000 gallons.
- Comparing total gallons sold to the 2007 numbers, where much less water was transferred to Pine, you can see that the total gallons sold dropped a similar amount to the change in the amount transferred.

I asked Brooke about this last summer and they confirmed that this is the case.

Since you are adding the revenue of PWCo and SWCo together you have to subtract out the payment that SWCo received for the transfers. I confirmed with Brooke that SWCo's revenue numbers included payment for the transferred water. I didn't get information on the amount of that payment, so I had to use the average value that PWCo paid for purchased water to determine the \$39,051. I suspect that water from SWCo is more expensive than the other water sharing agreements, so this number is probably a bit low.

This results in about a 10% error in the water usage being used in your analysis to forecast water usage revenue. You claim that your model is accurate even with this error. As will be discussed in more detail later, you have created an error in the distribution of water between the rate tiers to counter balance this particular error and also the lack of detailed data on the number of users and distribution of water usage between the three rate tiers in Strawberry. This allows you to stay in the ball park for 2009 and 2010 since you haven't moved too far away from your starting point. However, in 2011 when the different rates sets are all replaced by one rate set, a whole new set of rules apply to the projection and this error begins to affect the results.

It would seem that the community would be better served if Economists.com was more proactive in determining the answers to important issues like this one. This error needs to be corrected in your analysis.

F. [Jackson]: "b. Mr. Schwalm purports to "correct for errors" in the revenue forecast by unilaterally readjusting the assumptions for volume by rate tier. Again he provides no supporting evidence for his revised percentages; they appear to be nothing more than pure speculation. However, his analysis can be tested by calculating how much revenue his assumptions generate in the last year of actual data (2006) and then comparing it to total revenue actually collected. I performed this rather simple test and discovered that his assumptions result in revenues that are approximately \$130,000 or 12.0% below Pine and Strawberry's actual revenues collected in that year, Mr. Schwalm's assumptions therefore improperly and unreasonably depress actual and forecast revenues and should be disregarded."

[Schwalm]: This is the place where you introduced an error to counter balance the error in water volume and not knowing the distribution of customers and usage in Strawberry (as well as Pine). Your model has a 20%/20%/60% for the distribution in Pine between the 0-2000/2001-6000/6001+ gallon usage tiers. For Strawberry you have a 5%/5%/90% as the distribution.

You indicated in the November email that you have assumed that the usage was evenly split between the three rate sets that are currently in effect for Strawberry. You indicated that the 20%/20%/60% and 5%/5%/90% were determined to get the overall revenue numbers out of your model to match the numbers reported in the 2006 ACC reports.

You have no basis for thinking that these are correct from an actual distribution point of view. The values were selected to make the end result come out right. These distributions don't pass the make sense test. The 5%/5%/90% implies that most customers use almost no water and a few customers use large quantities of water.

This becomes a problem in your analysis for 2011 and on because the error that this is counter balancing goes away when everyone is consolidated into one rate

set. This has the effect of putting most of the water sold in the very highest cost rate tier which inflates expected revenue significantly.

I think I was clear in my report what assumptions I was making in coming up with a more realistic distribution. The one that I arrived at is 65%/25%/10%. This was applied for 2011 and on. Since it is based upon a set of assumptions, it isn't perfect, but it is much closer to reality than the distributions that you are using.

G. [Jackson]: "c. P. 9 -Mr. Schwalm uses a "scaled revenue analysis" to further depress forecast revenues. However, this alternative methodology appears not to factor in the increase in volume forecast to be sold by the District as it continues to grow."

[Schwalm]: I used the same number of users for each year as were used in your analysis. Your approach to modeling those first two years basically ends up being a complicated way to get to a scaled model. Due to limits on my time I decided to not try and recreate what you had done there and just go with the simpler method of getting to the same place.

The scaled model came out a bit lower than yours, but not by much. I didn't invest the time in determining why, but I suspect that the difference is due to your using a three tier rate structure in your model instead of the correct four tier rate structure.

H. [Jackson]: "d. Mr. Schwalm alleges that the Economists.com draft rate model requires 4 rate tiers instead of three. Economists.com agrees that such a hyper-technical revision would clarify any questions about how our rate model is calculating revenues. We have completed this update and have calculated the impact to be less than 1.0% of revenues over the forecast period. This technical and design revision has no material impact on the model's preliminary findings."

[Schwalm]: Thank you for acknowledging and correcting the error.

I. [Jackson]: "Mr. Schwalm also alleges that further rate increases are necessary by utilizing worst-case scenario debt service assumptions. He increases reserve payments for the acquisition loan to \$60,000 based on a highly selective reading of a quote from me in our November email exchange. My statement was as follows: "A more appropriate level (of debt reserve) is probably closer to \$60,000. It is also possible that the bond issued may not even have a reserve requirement (emphasis added)". Unsurprisingly, Mr. Schwalm chose the higher debt reserve alternative in his revised cash flow analysis, which causes the most negative impact on the District's five year cash flow. Unfortunately for him, the District's bond advisor, Stone and Youngberg, conducted research after release of our October 14 2008 draft report and confirmed that debt reserve can be incorporated into the initial loan, meaning that a separate reserve payment is not necessary. Further, Stone and Youngberg advises us that interest rates are currently lower than our draft report and Mr. Schwalm assumed, Because the District's negotiations with potential lenders remain confidential, I will not include a correction of Mr. Schwalm's substantially-overstated debt service estimates. However, I would advise Mr. Schwalm

that in the future he research these issues more thoroughly before attempting to instruct international bond advisory firms such as Stone and Youngberg on how to do their jobs.”

[Schwalm]: In looking at the numbers that you use for acquisition and CIP loan costs, it was clear that for the first 5 years there is a substantial amount of money over what would be expected, given the loan values and interest rates that you use in your analysis. I asked you why that is the case and your response in November was:

“A one year reserve of principal and interest is typically required when long-term utility debt is issued. The reserve is typically funded over the first five years of the bond issue. NOTE: in reviewing the rate model I notice that it is calculating the reserve contribution to be \$41,000 per year over the first 5 years. A more appropriate level is probably closer to \$60,000. It is also possible that the bond issued may not even have a reserve requirement -this is possible though not likely. But to be conservative we will continue to assume a reserve is required. **I have adjusted the rate model to include \$60,000 of annual reserve contribution for the first five years; it will be reflected in the final draft.** This extremely minor adjustment does not affect the rate plan or the conclusions of the report.”

I’m not sure how this is a selective reading of what you wrote, you clearly say that you are changing your rate model to be \$60,000 per year. I reflected this so that I would be consistent with what you are doing.

I don’t see how references to what Stone and Youngberg think are relevant here. I am not responsible for knowing what the two of you may or may not have said behind closed doors after your report was released. My comments are against the analysis that you put out. You put the five year accumulation of a reserve into the analysis, not me. I am just following the lead of someone with the right resume and credentials.

When the actual loan terms are made available to the public, I will reflect that.

J. [Jackson]: “a. I take issue with his claim that depreciation should be included in the analysis, which is a clear violation of the nationally-recognized cash basis ratemaking methodology we employed for this analysis.”

[Schwalm]: I have found multiple examples where depreciation is included in the forecasted operations budgets of water company valuations and the actual operations budgets of public utilities. In fact in your own 2003 valuation, you have included depreciation as part of the forecasted operations budget.

In your November email you stated:

“Unfortunately, you are confusing a valuation study with a ratemaking financial forecast. These are two fundamentally different reports prepared for different purposes using different sets of financial principles. The inclusion of depreciation is an important component of an asset valuation. However, doing long-term financial planning and ratemaking is very different. Under the AWWA-approved national standard Cash Basis of ratemaking, depreciation is NOT included in the revenue requirement, but debt principal, debt coverage and capital outlays are. The idea is that only "cash expenses should be recovered from ratepayers, and if you set rates to cover both debt principal and depreciation, you are double-dipping the ratepayers. Utilities that include depreciation in their ratemaking revenue requirements are either using the Utility Basis of ratemaking (not appropriate for PSWID) or are engaged in this double-dipping.”

Your 2003 valuation makes a forecast of the rate increases that would be required. It uses the forecasted operations budgets that include depreciation. It looks very much the same as your 2008 valuation. In 2003, were you using a Utility Basis or double-dipping?

In any case, due to the controversy over whether it should be included or not I left that out of the operations budget that I used in correcting your analysis.

K. [Jackson]: “e. He arbitrarily adds a 5.0% contingency, or \$60,000 to \$75,000 per year to the District's expense requirement. This ignores the fact that contingencies are already built into the District's expense assumptions. This double-counting of contingency expenses artificially inflates total expenses and also should be ignored.”

[Schwalm]: In your analysis, you end up with cash balances for each of the years. You label these as “Net Revenues Available for Contingency” in Table 8 of your analysis. For the first five years the values are \$107,887, \$67,023, \$145,321, \$200,020, and \$229,520. The 5% is my target for a minimum amount for this item when I figure out the rate adjustments that are required when the corrections are applied. Nothing is being double counted here, and the \$60,000 to \$75,000 is significantly less than what you are ending up with in your analysis. So if anything, I am understating the amount needed.

K. [Jackson]: “b. He uses the derisive term "creative financing" (p.2) to characterize our debt service assumptions. Such a characterization indicates a fundamental lack of experience with or understanding of utility and municipal financing. 25 year debt service issues with initial interest only payments are common and are used by utilities throughout the nation.”

[Schwalm]: If I was buying a house with these terms, it would be called creative financing. In my opinion these loan terms were selected to be able to give the public the impression that buying the water companies would have no immediate financial impact on them. That would lead to reduced concern from the community about purchasing the water companies.

In my opinion, one of the lessons learned from the failed 2003 petition effort was to not to be forth coming about what it is really going to cost. The 2003 Economists.com valuation was clear about what the cost and rate impacts would be and the public rejected that.

L. [Jackson]: “c. In my October 2008 email exchange with Mr. Schwalm I outlined several advantages and one disadvantage of our debt service assumptions. In his report he cited the one disadvantage (higher interest costs over the life of the loan) and ignored all the advantages. The result of this is that his report portrays our debt service assumptions in the worst possible light.”

[Schwalm]: Adding over a million dollars to the cost of the loan is a significant disadvantage. The public needs to understand what the cost for putting off the rate increases for two years will be. Your analysis should have addressed the presence of that additional cost.

Your November email had the following:

“This type of debt structure has several advantages. First, 25 year debt results in lower annual payments, which means rates can be lower. Second, interest only payments for the first two years allow utilities to "phase in" rate adjustments over a number of years to pay for the debt service, instead of doing a single big increase all at once. Third, by having a 25 year term, you make future ratepayers pay a larger component of the debt.”

Your second point about phasing in rate increases is not how it is being used in your analysis. The interest-only payments are being used to put-off the rate increases altogether. The big jump in rates just occurs later.

M. [Jackson]: “d. He asserts that the model we developed for the District "isn't set up to easily deal with the first two years being interest only or for multiple rate tiers that apply to a portion of the system". Once again this is blatantly incorrect. I am astounded that he would make such claims about a technical model he has never seen or operated.”

[Schwalm]: Based on my experience and what I can see in the 2008 analysis, the model doesn't appear to be very robust for this particular situation. Given the way that you have to manipulate the input data to get the first two years to work and then have no ability to adjust for changes in rules starting in 2011, it doesn't look like it handles this very well. It would probably have been better to have two separate instances of the model. One to address 2009 to 2010 and the other to address 2011 and on. Only the fundamental data values would be linked between them for the 2010 to 2011 transition.

N. [Jackson]: “e. He asserts that the CVL analysis and the Board's plans with regards to water purchases are at odds. This assertion has no basis in fact.”

[Schwalm]: As I have pointed out in earlier comments:

- The board is soliciting new water sharing agreements and CVL says that there won't be any more purchased water.
- The board has said that they plan to hire a company to operate the system and CVL wage estimates for the operations budget do not reflect this.

O. [Jackson]: “f. P. 13 -Mr. Schwalm assumes quarterly loan payments in his analysis, This is yet another incorrect assumption; as is typical for utility bonds, the debt assumes semi-annual interest payments and annual principal payments.”

[Schwalm]: You did not provide that information in your analysis and I was clear that I was making an assumption as to the repayment schedule. In any case, the terms that you outline are more costly than quarterly payments would be, so my analysis has understated the expense.