

Pine Water Company, Inc.

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May 28, 2008

**SENT VIA ELECTRONIC MAIL
AND REGULAR U.S. MAIL**

William F. Haney, Chairman
Pine-Strawberry Water Improvement District
P.O. Box 134
Pine, AZ 85544-0134

Re: Request for Unequivocal Assurance of Performance of the Joint Well Development Agreement between Pine Water Company and Pine-Strawberry Water Improvement District dated May 1, 2007

Dear Mr. Haney:

This letter responds to your May 19, 2008 letter on behalf of the Pine Strawberry Water Improvement District (“PSWID”) relating to the Joint Well Development Agreement between Pine Water Company (“PWCo”) and Pine-Strawberry Water Improvement District dated May 1, 2007 (“K2 Agreement”). This response letter is necessary because your May 19 letter fails to address the fundamental issue raised in my May 14, 2008 letter relating to the conflict of interest surrounding Mr. Gliege. Rather than address that issue, PSWID has refused and failed to provide assurance of its performance under the K2 Agreement based on a variety of factual inaccuracies relating to the competitive bid process and project scheduling. Because such refusal constitutes an anticipatory breach of the K2 Agreement by PSWID, I am sending this letter in the hope that PSWID will respond by providing the requested unequivocal assurance of performance.

In your May 19 letter, PSWID has refused to “respond to [PWCo’s] demands for any written assurance concerning the Joint Well Development Agreement.” As Board Chairman for PSWID, your May 19 letter demonstrates the clear intent of PSWID not to perform as promised in the K2 Agreement. Rather, PSWID has treated the K2 Agreement as if it were terminated by retaining Mr. Gliege as its water counsel and refusing to explain how PSWID can reconcile Mr. Gliege’s clear conflict of interest.

*Brooke Water L.L.C. Circle City Water Co. L.L.C. Strawberry Water Co., Inc. Pine Water Co., Inc.
Payson Water Co., Inc. Navajo Water Co., Inc. Tonto Basin Water Co., Inc.*

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PSWID's retention of Mr. Gliege provides persuasive evidence that PSWID does *not* intend to perform its duties and obligations under the K2 Agreement because it is *undisputed* that Mr. Gliege currently represents Mr. Greer and Mr. Krafczyk in proceedings before the Arizona Corporation Commission (Docket No. W-03512A-07-0362) in which Greer and Krafczyk have intervened, and requested that the Corporation Commission declare the Agreement to be invalid and unlawful.

It is telling that you intentionally failed to mention, let alone address, Mr. Gliege's conflict of interest in your May 19 letter. Instead, your letter raises performance issues relating to PWCo in a transparent effort to avoid the conflict issue involving Mr. Gliege. The question of assurance for PSWID's performance of the K2 Agreement does not have any relation to PWCo's performance of its obligations under the Agreement. Rather, the need for assurance stems from the fact that Mr. Gliege is in an incompatible conflict situation and the only apparent way to reconcile that conflict is for the District to abandon or terminate the K2 Agreement.

A cursory review of the positions taken by Mr. Gliege for Mr. Krafczyk and Mr. Greer in the financing docket before the Corporation Commission illustrates that point. For example, in the Commission's financing docket Mr. Gliege filed a "Brief for Intervenors" dated February 19, 2008, in which he argued that "Pine has presented an unconstitutional contract with a party which lacks the capacity to enter the contract." *See* Brief of Intervenors, filed February 19, 2008, p. 8, lines 2-3. Mr. Gliege argues that the K2 Agreement violates the constitution, and that the District lacked capacity to execute the Agreement. In that very same docket, however, PSWID took the exact opposite position by filing a "Notice of Filing Letter Supporting Expedited Action" dated June 13, 2007, which included a May 22, 2007 letter from then PSWID Board Chairman Gary Sherlock stating that "the District' Board of Directors unanimously approved the Joint Well Development Agreement with Pine Water Company," and requesting that the Corporation Commission "do what it can to expedite the processing of the pending Application, so that we can commence this historic event." *See* Notice of Letter Supporting Expedite Action, filed June 13, 2007.

Your May 19, 2008 letter fails to address the undisputed fact that Mr. Gliege's representation of Mr. Greer and Mr. Krafczyk in those Commission proceedings conflicts with PSWID's interests and contract obligations under the K2 Agreement, as well as PSWID's position taken in that financing docket. The failure of PSWID to provide unequivocal assurance of its performance of the K2 Agreement gives rise to a variety of

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legal claims by PWCo for breach of contract, bad faith and lack of good faith and fair dealing, with resulting liability of PSWID for damages incurred by PWCo.

Rather than address these issues in your May 19 letter, you claim that PSWID cannot provide adequate assurance of performance because (1) PWCo has failed to comply with the competitive bidding requirements of Ariz. Rev. Stat. § 34-201, *et. seq.*, and (2) PWCo is behind schedule on the project. These claims are not supported by the underlying facts, and appear to be nothing more than a transparent effort to avoid the conflict issue.

PWCo has complied with the competitive bidding requirements of Ariz. Rev. Stat. § 34-201, *et. seq.*, as required by the Escrow Instructions. Initially, I wanted to mention that the Escrow Instruction requires only that PWCo's draw request to the Escrow Agent include "[a] statement that in soliciting and contracting with the contractor the procedures and requirements set forth in Title 34, Chapters 2 and 3, Arizona Revised State have been applied and satisfied as if PSWID had contracted directly for the work or materials." *See* Escrow Instructions dated February 8, 2008, p. 2, ¶ 2(b)(i). PWCo fully expects to comply with that requirement when it submits its draw request in the near future.

Further, your suggestion that PWCo did not comply with Title 34 is contrary to the underlying facts. Contrary to your May 19 letter, PSWID was fully aware of the competitive bidding process because PSWID's Designated Representative(s) and water consultant were involved in the bid process. Initially, PWCo and its designated representative John Breninger prepared a preliminary technical scoping document for the K2 well. PSWID and its hydrological engineers Hydro Systems, Inc. ("HSI") reviewed, commented on, edited and drafted the technical requirements for the bid documents.

In turn, Mr. Breninger and PWCo drafted a Request for Proposals ("RFP") for public bid. Representatives of PSWID reviewed the draft RFP prior to issuance. PWCo then issued the RFP for public bids. I have attached a copy of the RFP, along with the affidavit of publication in the *Payson Roundup*. The notice of bids was published in the *Payson Roundup* from February 28-March 7, 2008. The notice of bids also was published in the *Arizona Silver Belt*.

During the bid process, Mr. Breninger solicited interest from various licensed Arizona well drillers. Mr. Breninger also conducted a bidder's conference after issuance of the RFP. In response to the RFP, there were eight inquiries by potential bidders. Two

qualified bidders (WDC Exploration and Layne Christensen) opted not to submit a bid because of scheduling issues. Two other potential bidders (Del Rio Drilling and Drill William F. Haney Pine-Strawberry Water Improvement District May 23, 2008 Page 4

Tech Drilling) did not qualify because their drill rigs did not meet the technical requirements for the K2 well. ADT Drilling submitted the only qualified and responsive bid in response to the RFP. On March 5, 2008, PWCo opened ADT's bid. Mr. Breninger and PSWID's alternate designated representative Wes Suhr then each evaluated and scored ADT's proposal, and concluded that ADT was a responsive and qualified bidder. PWCo then issued a Notice of Intent to Award to ADT.

Under these circumstances, your suggestion that no documents have been provided to PSWID relating to the bid process is unsupported. Through its prior management and designated representatives, PSWID had full knowledge of the competitive bid process, including drafting the technical requirements, and evaluating ADT's proposal. Representatives of PSWID previously reviewed the RFP and evaluated ADT's bid. With this letter, we are again providing the District with copies of the RFP, ADT's bid, the affidavits of publication, and the bid evaluation. These documents clearly demonstrate full compliance with the competitive bid requirements of Title 34, and PSWID has no basis for refusing certification of any draw requests to the Escrow Agent.

Finally, your contention in the May 19 letter that "PWCo has failed to meet its timeline for the project" is equally erroneous. PWCO has fulfilled all of its obligations under the K2 Agreement. At the present time, PWCo is in the process of finalizing the drilling contract for the project. PWCo has been working on an appropriate agreement, surety bonds and final pricing. PWCo expects to have the contract completed in the near future, which will lead to a demand on the PSWID-PWCo escrow funds for payment of the required deposit. PSWID's refusal to certify such draw request would be a breach of contract.

We recently analyzed and modified the entire project schedule and modified the tasks, dates and work durations as needed. The current project schedule indicates completion of the project (i.e., drilling, construction and interconnection of the permanent well to PWCo's system), despite the interim delays, before May 1, 2009 as required under the K2 Agreement. In fact, PWCo believes that even less time than that recorded on the revised schedule is likely necessary to complete the project. That revised project schedule has been provided to PSWID. Gila County has issued building permits for the K2 site as it pertains to the retaining wall and water removal pit. Engineering work for the wells, retaining wall and water removal pit has been completed. We have discussed the easement issue with applicable property owners who have committed to provide access to

the property. Also, ADEQ has issued the water discharge permit for Strawberry Creek. These various milestones achieved by PWCo demonstrate PWCo's commitment to the project.

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Consequently, PWCo formally requests that PSWID provide unequivocal assurance in writing that PSWID intends to perform all of its duties and obligations under the K2 Agreement on or before ***end of business on May 30, 2008***. The failure of PSWID to provide such assurance (for a second time) will constitute an anticipatory repudiation of the K2 agreement and will result in legal action by PWCo for breach of contract and repudiation of the K2 Agreement, including money damages.

We appreciate your cooperation and look forward to PSWID's response.

Sincerely,



Robert T. Hardcastle
President

cc: RTH correspondence file
Jay Shapiro, Esq.
Richard Dickinson, PSWID Secretary (rbdickinson@msn.com)
David Allred, PWCo. Designated Representative
Myndi Brogdon, PWCo Designated Representative