MARINA COAST WATER DISTRICT
MONTEREY COUNTY WATER RESOURCES AGENCY
REGIONAL DESALINATION PROJECT
Conceptual Level Financing Plan

Document Overview

This document represents a conceptual level financing plan for the Monterey Area Regional Desalination Project (the "Project" or "RDP"), portions of which will be owned separately by the Monterey County Water Resources Agency ("MCWRA"), the Marina Coast Water District ("MCWD"), and California American Water Company ("Cal-Am" or "CAW"). This conceptual plan is an interim step toward selecting and executing a preferred financing plan from among several alternatives. This report sets forth some of the key criteria and considerations in selecting the preferred financing plan. This plan is subject to significant conditions and assumptions which could and likely will change over time. These conditions include changes in the financial markets, litigation considerations, permit and project timing, and the availability of Private Activity Bond capacity from the State of California. The next few sections discuss the overarching issues which would impact any financing undertaken for the Project. After these issues are discussed three financing alternatives are presented and analyzed. These alternatives are:

1) Project Financing from a group of Banks and/or Institutional Investors.
2) Investment-Grade Rated Tax-Exempt Private Activity or Taxable Bonds.
3) Non-Rated Tax-Exempt Private Activity or Taxable Bonds.

For each alternative, there are numerous viable paths to financing the Project and all alternatives could be viable. However, based on market conditions today and Project funding requirements, Project Financing from a group of Banks and/or Institutional Investors appears to be the most cost effective and feasible in the current market given existing conditions and assumptions. The current recommendation is that the financing team pursues Project Financing from a group of Banks and/or Institutional Investors while continuing to pursue the alternatives of obtaining an Investment Grade Rating and Private Activity Bond allocation from the State of California. As the alternatives are further developed and the schedule and circumstances dictate, the most cost effective and feasible alternative will be developed and recommended. Further recommendations are as follows.

- Keep all current financing plan discussions on parallel paths as it is too early to determine the least cost alternative with the highest probability of being financed;
- Diligently pursue Private Activity Bond ("PAB") allocation; including development of a debt issuance schedule which dovetails with the overall Project schedule; particular focus should be given to the commencement of documentation and the related legal and disclosure expense incurrence;
- Engage one or more of the ratings agencies in a formal dialogue regarding the potential for a rating for the Project;

- Discuss and pursue the potential for alternatives that could enhance the security of the financing from the investor or lender standpoint;
- Continue to pursue State Revolving Fund financing and other forms of inexpensive state financing or grants for the Project and ensure that overall Project financing structures being developed allow the incorporation of such financing if and when it becomes available;
- Continue development and evaluation of these alternatives and provide periodic reports as appropriate.

Although market conditions and other factors always can impact the timing of these financing alternatives, considering the commitment to purchase water included in the WPA, the existing ratebase of water users, the mutual guarantees of performance by the three Parties, the essentiality of the Regional Desalination Project to the long term water needs of the area, the professional and pragmatic approach to permitting and litigation being implemented by the Parties, and the availability of multiple sources of financing, including State Revolving Fund loans, Project Finance, taxable and tax-exempt bonding, both rated and non-rated, it is the opinion of Piper Jaffray that the Regional Desalination Project is financeable through a combination of these sources of financing.

Overarching Issues

Timing Risk - The four year construction period for this project presents a financing challenge. This, in conjunction with the multi-contract nature of the Project and the attendant risk of timely, on-budget completion, integration and start-up are likely the greatest credit concerns for potential lenders/bond investors for the project. In addition, potential construction period interest costs under certain possible financing structures are very high. Concerns about development progress and timing prior to full permitting and the commencement of construction are also important to the financing discussion because no bond or loan transaction can close until those items are addressed. For this reason, short term development financing options, specifically the CAW Credit Line and the CAW Loan (see discussion under the heading Financial Plan Timing below) as well as other interim financing alternatives, will be pursued in order to continue development activities on the Project. In later sections, the construction period interest issue as well as construction risk will be discussed. Both can be dealt with but the nature of this construction project makes it crucially important that these issues are dealt with in a way that is both cost effective and acceptable to lenders and investors.

Construction Risk - This is a significant credit acquisition risk associated with this Project. Because of the long construction period and large scope (MCWRA extraction facilities, MCWD desalination facilities, Cal-Am distribution facilities, related facilities and equipment, etc.), lenders and/or rating agencies desire comfort that the entire Project will be completed, integrated and operational on time and on budget. One accepted method to reduce risk would be the use of an engineer, procure and construct ("E/P/C") contract designed to provide a layer of financial coverage in the event of construction related issues. Another accepted way to provide such comfort would be engagement of a single responsible contractor under a design/build ("D/B") or design/build/operate ("D/B/O") agreement with a firm price, schedule and performance, with appropriate contract remedies, at least for the MCWD desalination plant, the part of the Project with the highest cost. Execution of the Project in pieces under several

different contracts with different contractors, possibly using "cost plus" contracts or construction plans that pose possibility of cost overruns and/or delays, diminishes the ability to successfully rate or finance it in the financial markets. For this reason, alternative project delivery approaches, in addition to the more traditional design/bid/build approach, will be evaluated by the Parties (collectively MCWD, MCWRA and CAW).

Technology Risk - Because of the nature of the facility, it is believed that technology risk will not be a major concern for potential lenders or rating agencies. If reasonable, proven technology is chosen, the facilities are constructed by qualified firm(s), and they are operated and maintained properly, then this risk will not be a major issue. Operation risk will be a larger concern but should be mitigated by the use of a strong EPC, D/B or D/B/O contract with a qualified firm, if this project delivery approach is selected by the Parties.

Litigation Risk – The Project had its genesis in regulatory litigation regarding the use of ground and surface water in the Monterey Region, ultimately resulting in a Cease and Desist Order issued by the State Water Resources Control Board which requires Cal-Am to greatly reduce the utilization of the Carmel River as the source of supply for its customers. For this reason, an alternative source of supply is required to meet the existing public health requirements of the existing customers.

It is anticipated that there will be continued litigation regarding the EIR, and potentially other unforeseen litigation. While the impact of various lawsuits is difficult to assess, some understanding of the Project viability threshold will need to be undertaken by legal counsel to the Public Agencies (MCWD and MCWRA collectively). At this point in time the current litigation is precluding the Project from receiving a private activity bond allocation. The presence of litigation, whether valid or not, could also preclude certain types of investors from participating in the project. It is noted that certain investors may be willing to work toward underwriting the project even with litigation or threatened litigation, depending upon legal counsel interpretation of the situation, although it is understood qualified legal counsel would not provide a prediction of litigation outcome. It is presumed that substantially all litigation would need to be cleared before funding of the Project whether that is through a taxable or tax exempt debt placement.

Financing Flexibility – Any financing plan must include the ability to accommodate potential grant funding and low interest cost State Revolving Fund ("SRF") loans (see later Section "SRF Loans"). Application has been made to various state agencies for provision of grants and SRF loans. The availability of these funding sources is uncertain; however, given their impact in reducing total project cost, any financing plan needs to accommodate their availability and the potential to prepay all or part of a debt placement. These options would lower total repayment costs; however, given the shorter 20 year amortization of an SRF loan the immediate reduction in cost to the Cal-Am ratepayers may be somewhat muted.

Financing Rating & Credit Enhancement

In the view of Piper Jaffray, the central security to this transaction is the Water Purchase Agreement (the "WPA" or "Agreement") and the associated "revenues." Under the WPA, MCWRA and MCWD ratepayers and assesses will not be responsible for payments for development of the Project.

The WPA outlines many of the important business deal points between the three parties, and provides a framework for executing the underlying components of the transaction including the Prime Documents, Outfall Agreement and Cal-Am financing documents. The contract is structured in a manner such that Cal-Am is required to pay for water once the facilities are operational. Conversely, Cal-Am does not make any Product Water Contract Payments until the Acceptance Date, unless there is a Regional Desalination Project Cessation, at which point Cal-Am is responsible to reimburse MCWD and MCWRA for Initial Capital Costs, and to retire or prepay any Indebtedness (paraphrased from WPA Section 7.4, and assuming no fault of MCWD or MCWRA).

Thus from a credit perspective there are two threshold items which need to be discussed with the rating agencies during the upcoming months:

1) Payor concentration
2) Ratability of a "standard" revenue pledge covenant

As a corollary to these discussions other credit enhancement mechanisms also need to be discussed with the rating agencies and the parties to the WPA to determine their viability.

Given a single payor in Cal-Am, albeit supported by revenues from a relatively sizable and diverse ratepayer population, the question becomes: will the rating agencies look through this concentration risk to the rate base when analyzing the credit? There is precedent for this analysis in other municipal financings, however, concentration levels are typically lower and involve a pledge of Public Agency revenues in most cases.

Traditionally, a Public Agency would covenant to set rates for service such that net revenues of the system (net of operation and maintenance expense) are sufficient to provide a defined minimum level of debt service coverage, typically ranging from 1.10-1.25x. Given the confines of the WPA, is there an ability to make a similar pledge? In a related question, what is the mechanism for adjusting rates to meet the pledge, particularly with respect to the CPUC? And how would that ratemaking process impact the covenant? The answers to these questions will be pursued and the results reported to the Parties as appropriate.

As discussed in later sections, MCWRA and MCWD have engaged municipal bond underwriters, Citigroup and Hutchinson Shockey Erley & Co ("HSE"), for the MCWRA and MCWD agencies, respectively. These underwriters have considered, on a preliminary basis, a variety of scenarios assuming the use of tax exempt private activity bond financing, the availability of which will be discussed in the next section. Both underwriters assumed a single issuer for evaluation purposes, but the bonds for the MCWRA and MCWD project components would be issued separately by each agency. The

underwriters have also made credit rating assumptions which need to be tested as part of the further development of a financing plan.   In general, Piper Jaffray concurs with the preliminary assumptions and estimates used in the various analyses by these underwriters, particularly with respect to:

1) Capital costs;
2) Interest rates for the various scenarios;
3) Project fund investment rate assumptions;
4) Debt service reserve fund sizing and related interest earning assumptions;
5) General debt structure considerations.

Piper Jaffray has not yet undertaken an analysis of the various costs of issuance. It is anticipated that this would become part of a subsequent financing plan update when many of the open items have been resolved, such as ability to obtain a rating and whether the financing will be taxable or tax-exempt. It is noted that the estimated costs of issuance provided by the underwriters is adequate to meet these expenses.

The underwriters for MCWRA, Citigroup, have considered several scenarios that, in the opinion of Piper Jaffray, are not currently viable. Specifically, the underwriter for MCWRA has considered scenarios in which the rate base would make payments during the construction period in order to pay for the interest during construction as it is incurred. This funding scenario is not contemplated in the WPA, since it would be payment for water prior to receipt of the water. Although not currently viable, it is recommended that the financing team keep these scenarios in consideration, although rewriting or modifying the WPA to allow for prepayment by the Cal-Am ratepayers prior to receiving service would be challenging. Other potential changes to the WPA could include the concepts of either an amendment to the agreement and appeal to the CPUC to allow for a more flexible net revenue pledge or a virtual lockbox type of agreement with Cal-Am, both of which present significant challenges to approval.

The final rating consideration is the cost of obtaining a rating. Generally the cost of rating governmental borrowers is much less expensive than private borrowers or project financings.   Further, ongoing surveillance expenses are much greater for the non-governmental sector. For example a $400mm governmental lease revenue bond rating would cost approximately $125,000 for ratings from two agencies , while a $400mm project financing would be priced at $270,000 upfront plus $47,500 in annual surveillance expense resulting in a present value cost of $775,000 (discounted at 7.50%). While these are not the largest expense items in the budget, they could become relatively significant in the event of a Project Cessation, and as such the financing team needs to be cognizant of their incurrence. It is assumed that the cost of issuance budget will be able to accommodate either rating engagement.

Finally, on this topic, Piper Jaffray notes that if bonds financing the Project, whether taxable or tax-exempt, could be rated in the “A” category, cost effective bond insurance may become available. Piper Jaffray recommends waiting until there is some rating clarity and then, if warranted, investigating the possibility of credit enhancing bonds with either insurance or a bank letter of credit. If it is determined that any rating on the bonds would be in the BBB category or below, the chances of attracting credit enhancement in the current market would be low.

Private Activity Bond Issuance

Tax-exempt municipal bonds are debt obligations of state and local governments. Typically they are used to finance projects which are owned by a governmental body and benefit the public directly or indirectly. A municipal security is considered a private activity bond if it meets either of two sets of conditions set out in Section 141 of the Internal Revenue Code. A municipal security is a private activity bond if, with certain exceptions, more than 10% of the proceeds of the issue are used for any private business use (the “private business use test”) and the payment of the principal of or interest on more than 10% of the proceeds of such issue is secured by or payable from property used for a private business use (the “private security or payment test”).

The WPA is structured such that MCWD and MCWRA will own the facilities being financed including the source water wells, source water pipeline and desalination plant, and a portion of the product water pipeline. Under this part of the test the public agencies would be able to issue traditional municipal securities. However the WPA is structured such that Cal-Am, a private business, will receive the majority of the water product from the project and will be responsible for debt service associated with the financing of the project via payment for the product water, thus precluding traditional tax exempt issuance. As a result the Project would need private activity bond allocation to be financed on a tax-exempt basis.

MCWD and MCWRA have ongoing discussions with the California Pollution Control Financing Authority (“CPCFA”), an agency of the State of California regarding their applications for private activity bond allocations. It is understood that currently the CPCFA has enough allocation to finance the Project based on a carryforward of its unused private activity bond volume cap. In recent communications CPCFA staff has indicated that pending litigation must be resolved and the Coastal Commission Permit obtained before this allocation can be given to the Project. Thus it is unclear whether the tax exempt financing option is viable at this time. Given the potential benefit of a tax exempt issuance it is recommended that the financing team continue to pursue this allocation.

If CPCFA does grant the allocation and is the issuer of the bonds (making a related loan of proceeds to the Project), it may impose debt issuance restrictions. If the financing received a rating in the “A” category, CPCFA will allow a very broad distribution of the offering, thus allowing for the greatest potential set of investors and presumably the lowest interest cost. A rating in the “BBB” category or lower will result in significant restrictions on the bond sale, thus limiting the pool of investors and likely resulting in higher interest rates. The CPCFA bond issuance guidelines impose the following restrictions:

1) A requirement that purchasers of the bonds are limited to “Qualified Institutional Buyers”;
2) The Bonds must be placed to no more than 35 QIB’s;
3) Minimum denominations of $250,000.

If the Bonds are below investment grade, or will not be rated, further debt issuance restrictions can be imposed and would be decided on a case by case basis. This would serve to further limit the marketability of the bonds resulting in higher interest rates. Further there may be secondary market restrictions which could result in an illiquidity penalty.

Tax Exempt Private Activity Bonds

In today's market environment, an "A" rated bond issue appears to be a reasonable financing mechanism for the Project from a rate and structure point of view. A market for a transaction of this size is available and the main question would not be whether the deal can get done but at what interest rate levels. This market will also likely provide the longest term and amortization and most favorable prepayment provisions for the purpose of accommodating a possible later SRF loan as well as for basic refinancing flexibility in later years.

The only substantial drawback of financing the Project in this way is the fact that all bonds will likely need to be issued all at once at the start of construction and thus will incur significant capitalized interest expense. On this point, the MCWRA underwriter has considered financing alternatives that contemplate a staggered issuance of bonds for the Project. In the opinion of Piper Jaffray, the viability of the staggered multi-tranche alternative is low. From either a rating agency or bond marketing point of view this alternative would transfer significant construction and financing uncertainty to the bond investor. Piper Jaffray does not believe either investment grade or high yield investors will take these risks under current market conditions.

See the discussions above on the ability to obtain private activity bonding authority in the requisite amount for the Project and on the prospects and process for determining whether and how bonds financing the Project can attain an "A" level rating.

It is estimated that in today's market Project bonds at this rating level would price at an interest rate of approximately 6%. This interest rate is in line with the estimates from both HSE and Citigroup.

At this point, Piper Jaffray's tax-exempt high yield desk indicates that it is unlikely the market will support a "BBB-" or lower rated transaction of this size for the Project. Record outflows over the past 6 months from tax-exempt high yield funds have left this segment of the municipal market with historically low demand for new issues and very high interest rates for smaller issues that do get done. Piper Jaffray believes there is limited viability in this financing alternative at present. Conversations with Citigroup and its underwriting desk confirm the state of this market segment, although no one has categorically said the financing cannot be accomplished. HSE tends to have a cautiously optimistic view of this market.

Conditions in this market could change quickly. In particular, if and when significant inflows return to these funds, their appetite for new issues will likely be robust immediately and a deal of this size financing the Project could be achieved. The financing team will continue to monitor conditions in this market.

Hypothetically, if a deal was possible in this market, the rate would likely be approximately 7.5 – 8.5%. A small volume of non-rated tax exempt new issues are currently being done in this range.

Taxable Municipal Bonds

If anything, the taxable municipal market is less active now than the tax-exempt high yield market. However, the potential investor audience for an "A" rated taxable bond issue is potentially large enough because of the chance to attract "cross-over" buyers from the traditional project finance market. This is a market that will likely allow favorable term and amortization structure but that will be much less flexible with prepayment provisions. For example, an extraordinary call exercisable in the event that SRF funds become available later will likely be expensive and anything resembling a 10 year optional call will likely be completely unavailable. As we saw with Build America Bonds during the last two years, "make-whole" calls would be the norm. In addition, we would still have the capitalized interest problem in this market. In fact, it would be worse than the tax-exempt situation because rates would be higher. With this said, if an "A" level rating can be obtained for a project bond issue and if it is also determined that private activity authority is not available or practical, then a taxable bond issue is a viable option. If, on the other hand, the bonds were to be rated in the "BBB" category or below, the situation would be the same or worse than for a similarly rated tax-exempt issue – i.e. not a viable option now.

Piper Jaffray's best estimate in today's market is that an "A" rated taxable issue appropriate for the project would need to be priced at a level of 7% or higher in order to get done with the term and requisite SRF related prepay provisions. Piper Jaffray also believes that an optional call would be available only at a 'make-whole" premium.

Project Loan or Project Finance Bond Alternative

This Project can also be financed in the traditional project finance lending market. This market includes large U.S. and international banks as well as large insurance companies and pension funds. The market is only accessible to large projects with strong sponsors, high quality partners for offtake, construction, operation and other major risk categories well addressed and little or no technology risk. The Project satisfies each of these criteria. In addition, Piper Jaffray has had initial conversations with three major institutional lenders within this market and received significant preliminary interest from each. This financing is large enough that no single entity would fund the loan in its entirety. The likely execution would involve the initial solicitation and choice of a large, qualified lead lender who would then work with MCWD, MCWRA, Cal-Am and their advisors and attorneys to put together a loan structure and syndicate of lenders.

The process of assembling a due diligence/information package for the purposes of soliciting term sheets from potential lead lenders will be similar to that for working with rating agencies to determine whether and at what level a Project backed bond issue could be rated. In addition, such an information package will also overlap significantly with the set of material that will be required for the purposes of preparing a preliminary official statement for a bond offering. Thus, at least to the point of choosing a lead lender, these processes can be run concurrently. If and when MCWD, MCWRA, Cal-Am and their advisors determine that the project loan option is the best one and, accordingly, choose a lead lender, it will no longer be workable to concurrently pursue a bond financing. Choice of lead lender and agreement to preliminary loan terms and structure with that lead lender will constitute a choice of

financing path for the Project. Until that time, however, all bond options can and should be investigated and monitored.

Based on preliminary discussions with potential project lenders, we believe that a syndicated project loan is viable and would carry an interest rate of approximately 4.35% during construction (3 month London Interbank Offered Rate (LIBOR) plus 4%) but floating and adjustable quarterly and 7.25% fixed during the permanent, operational phase of the project (approximately 10 year LIBOR swap plus 4%). One major benefit of this route is that the loan would be drawn as funds are needed. For this reason construction period interest would be significantly lower than any of the bonding alternatives. The next section presents a summary discussion and comparison of the alternatives. Overall, in the current market environment, the syndicated project loan option appears now to be preferable from the point of view of overall debt service requirements as well as execution certainty.

State Water Resources Control Board State Revolving Fund (SRF) Loans

In a letter dated May 4, 2011, from the US Environmental Protection Agency (USEPA) to the California State Water Resources Control Board (SWRCB), the USEPA confirmed the eligibility of the Regional Desalination Project for SRF loans. SRF Loan eligibility was further confirmed in a meeting with SWRCB Division of Financial Assistance staff on May 11, 2011. In summary, the Regional Desalination Project is eligible for SRF Loans so long as the following, along with other criteria, can be demonstrated in the final loan application to the SWRCB:

1. The project must be identified in and support the State's Non-Point Source (NPS) Program or the nine element watershed plans required by Section 319(h) or for groundwater protection under Section 319(i) of the federal Clean Water Act, and

2. The project must demonstrate direct water quality benefits.

After meeting with SWRCB Division of Financial Assistance staff on May 11th, it became clear that the Regional Desalination Project clearly addresses both of these areas. For Section 319(h) of the Clean Water Act, the Regional Desalination Project addresses NPS impacts upon the Carmel River. For Section 319(i), the Regional Desalination Project addresses groundwater reclamation of and protection to the Salinas Groundwater Basin.

The remaining steps in confirming and securing SRF Loan funds are to complete the necessary application documents, obtain review and concurrence of those documents with SWRCB Division of Financial Assistance staff, and obtain final approval from the State Water Resources Control Board. These activities are presently under way.

Comparative Analysis of Conceptual Financial Alternatives

Since financial markets have been more volatile in the last two years than during most historical periods, the lowest cost to the ratepayers is to utilize short term debt to fund the initial tasks necessary to implement the Project. The financing of the Project will proceed with the CAW Financing and potentially other interim financing as the initial tranches to complete the permitting, environmental, litigation

support, financing arrangements, and other tasks that will enhance the ability of the Parties to place the long term debt at the lowest cost to the ratepayers. As these tasks are completed, the conditions of the financial markets will be monitored and the lowest cost overall funding alternative that is feasible will be recommended. In all cases, the use of State Revolving Fund loans and grant funding will be pursued to the maximum degree possible.

For current market conditions, the following analysis of the conceptual financing alternatives provides the basis for the recommendation to pursue Project Financing from a group of Banks or Institutional Investors while also continuing to pursue an allocation for PABs from the State of California and to investigate the ability to obtain an investment grade rating for a bond funding alternative. It is noted that each of these scenarios meets the CPUC approval requirements.

Debt Statistic	Non-Rated Tax Exempt PAB	"A" Rated, Tax Exempt PAB	Project Finance (1)
Coupon Rate	7.500%	6.000%	7.250%
All-in TIC:	7.640%	6.129%	5.542%
Max Annual Net Debt Service:	38,605,170	30,215,645	27,939,368
Aggregate Net Debt Service:	1,003,666,920	785,547,270	709,819,076

	Non-Rated Tax Exempt PAB	"A" Rated, Tax Exempt PAB	Project Finance (1)
Sources Of Funds (2)			
Par Amount of Bonds	458,735,000	418,385,000	322,569,487
Total Sources	458,735,000	418,385,000	322,569,487
Uses Of Funds			
Project Fund - MCWD	222,350,163	222,350,163	226,810,000
Project Fund - MCWRA	54,729,936	54,729,936	55,700,000
Construction Period Interest	129,191,947	93,280,751	18,216,804
Deposit to Debt Service Reserve Fund (DSRF)	45,873,500	41,838,500	13,862,300
Underwriter Discount/Lender Origination	4,587,350	4,183,850	6,451,390
Costs of Issuance	2,000,000	2,000,000	1,528,993
Rounding Amount	2,103	1,799	-
Total Uses	458,735,000	418,385,000	322,569,487

(1) Project Finance assumes variable rate during construction, fixed at 7.25% thereafter
(2) For all alternatives, State Revolving Fund Loans and grant funding will be pursued

As indicated, under current market conditions, Project Financing provides the lowest apparent cost financing alternative for the ratepayers based on current market conditions and assumptions. This alternative also has the advantage in that it is the most feasible alternative, requires the fewest approvals from agencies extraneous to the Project, and is more flexible in the allowance of the utilization of SRF loans and grant funds. In addition, under current market conditions, neither the placement of more than $400 million of non-rated PABs nor the ability to obtain an investment grade rating for the PABs may be feasible, rendering these alternatives less viable for financing the Project. At the same time, further due diligence will be required by lenders to confirm their willingness to provide project financing for the Project.

Financial Plan Timing

Financing for all or a portion of the Project will be provided in at least three separate tranches. In accordance with the terms of the WPA, the financing plan being developed by the parties is being structured with the objective to obtain the maximum financing of the Project at the lowest overall total cost given then existing and anticipated market conditions and other factors.

The "Initial Tranche" occurred upon the utilization of a portion of the $8 million CAW Credit Line ("Line of Credit") provided pursuant to the terms of the WPA. The Line of Credit became effective on January 11, 2011 and provided the initial portion of financing for the Project as required in the WPA. The rate of interest under the Line of Credit is equal to Cal-Am's borrowing rate from its parent company, American Water, which is the lowest cost interim financing alternative for the ratepayers. The Line of Credit is being utilized by the parties as a means to fund the initial tasks required to deliver the Project. The initial tasks include the engineering and environmental tasks necessary for the Coastal Commission Permit, defense of the CEQA-related litigation, development of the financing plan, as well as other ancillary tasks. Expenditure of the total funds available under the Line of Credit is anticipated to occur on or around September 30, 2011.

The parties are exploring the potential to utilize the CAW Loan ($17.5 million) available under the WPA or other alternatives that provide the lowest cost to the ratepayers for the "Second Tranche" interim financing component. If applicable, this tranche would be in place by October 1, 2011. Although the rate of interest is higher for this interim financing tranche than for the Line of Credit, it is more readily available without the upfront fees and prepayment penalties associated with long term debt. It is the intention of the parties that the Second Tranche of funding would be utilized to provide necessary financing to complete the project development tasks such as retaining the D/B or D/B/O contractor, completing test wells, and attending to other tasks necessary to obtain long term financing on the most favorable terms available. Expenditure of the total funds available under the Second Tranche is anticipated to occur on or around December 31, 2012.

It is anticipated that the "Third Tranche" of financing – the long term financing for the Project – will be in place sometime in the second half of 2012. Timing of the Third Tranche is dependent on completion of the permitting process, resolution of the CEQA litigation, completion of the test wells, procurement of the D/B or D/B/O contract service provider, other related tasks, and market conditions, as well as other factors. Under current market conditions, it is anticipated that Project Financing from a bank or institutional investor will be the most cost effective financing approach for the ratepayers. Since placement of the long term financing is approximately one year away, market conditions may change. For this reason, the Parties will continue the process to obtain an allocation of PABs from the State of California and continue to investigate the feasibility of obtaining an investment grade rating for the PABs. In addition, grants and State Revolving Fund loans will be pursued during this period and the availability of these low cost alternatives will become clearer. Staged, or multiple tranches of long term financing will continue to be evaluated based upon investor interest as well as what options allow the parties to obtain the maximum financing of the Project at the lowest overall total cost.

Summary

Under current market conditions, Project Financing from a group of Banks and/or Institutional Investors appears to be the most viable and lowest cost financing alternative for the Project. The advantage of this approach in comparison to the Investment Grade Rated Tax-exempt Private Activity or Taxable Bond or the Non-Rated Tax-Exempt Private Activity or Taxable Bond is that interest during construction is minimized. With the Private Activity Bond alternatives, most if not all of the funding is obtained early in the Project and interest is accrued for the period from the bond issuance until the completion, potentially four years later. With the Project Financing from a group of Banks or Institutional Investors, funds are released to the agencies as necessary for construction of the Project and interest is not paid until the funds are released.

With current market conditions, the potential long term interest rate (7.25%) on the Project Finance Alternative is somewhat higher than the interest (6%) on Investment Grade Rated Tax-exempt Private Activity Bonds, the Project Financing alternative, due to its relatively small level of construction period interest, nonetheless appears to provide the lowest overall net debt service. Moreover, the ability to obtain an Investment Grade Rating for the Project is significantly more uncertain. The potential interest rate (7.5-8.5%) on Non-Rated Tax-Exempt Private Activity Bonds, under current market conditions, is equal to or higher than the Project Financing alternative.

Since it appears to be the most readily obtainable, lowest cost financing alternative under current market conditions, the Project Finance Alternative will be further developed as the primary financing alternative. At the same time, the feasibility of obtaining an Investment Grade Rating for the Project and an allocation of Private Activity Bonds from the State of California will also continue to be developed as will the pursuit of State Revolving Fund or other low cost financing or grants from other governmental sources.