

AFUERO DE CHORRO WATER COMPANY
2020 ANNUAL MEETING OF SHAREHOLDERS

The questions from the shareholders covered four general areas of concern:

1. The connection between the CC&R's and the Mutual requirements and what is the difference between an accessory building and a primary residence;
2. The timing and availability of will serve letters for the lots within the Mutual;
3. The ability to enforce conservation measures; and
4. The potential for annexation by the City.

Questions 1 – Connection between the CC&R's and the Mutual requirements

The Mutual was originally formed as a non-profit mutual benefit corporation to operate an HOA for the subdivision and provide water service. The Articles of the HOA were revised in 2008 to make it a Mutual Water Company and to drop the HOA provisions. Accordingly, the Mutual is no longer directly tied to the CC&R's and simply provides water service.

The CC&R's, which were last revised in 1984, provide that there can only be one single family home per lot except for lots 18 and 19, which can have two. However, the CC&R's do allow each single family home to be accompanied by a guesthouse. There is no definition of what constitutes a guesthouse or mother in law unit in the CC&R's, but the County code defines it as being no more than two bedrooms and one bathroom with is within 50 feet of the main residence and no more than 40% of the square footage of the main residence up to 600 ft. Anything larger than this would be a second primary residence unless the County granted a variance.

The Mutual has historically accommodated guesthouses under the same meter with a primary residence and the guesthouse shares the allocation of water with the primary residence. This is consistent with the current Bylaws, which defines a residence as a single family residence duly permitted within the Mutual's service area.

Question 2 – Time and Availability of Service to New Lots and Residences

The purpose of the Mutual is to serve water to its Members. A member is the owner of a lot within the service area of the Mutual and the Mutual requires a separate service connection for each primary residence on a lot. There are only two lots which are allowed to have multiple residences under the CC&R's, which are lots 18 and 19, however, this is not separately stated in the Bylaws of the Mutual.

The Mutual provides a mechanism for the issuance of new membership interests as lots are created by subdivision within the service area of the Mutual. This mechanism includes four basis requirements: (i) a new lot must have been legally created pursuant to the rules of the County; (ii) the capacity of the Mutual's water system must be sufficient to service the new lot and residence built thereon without adversely impacting existing members and fire protection within the service area; (iii) the Mutual must have an active permit from the Department of Corporations to issue the new membership; and (iv) the member must be a new membership fee and the new service assessment to cover all costs of the Mutual to serve the new lot/residence.

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There is a potential conflict between the first requirement that there be a legal lot and the second requirement that the Mutual must have sufficient capacity to serve the new lot. The Mutual currently only has capacity to serve up to 40 residential connections. This number is based upon the analysis of the engineering firm that certifies the water system and the limiting factor is the availability of groundwater from the Mutual's wells. According to the Wallace Group, the groundwater that is available to the Mutual is only sufficient to service 40 residential connections and the fire protection system. This places a limit on the number of service connections that are available regardless of any change in the County rules that might allow additional subdivision of lots.

There is some concern that this means individuals who have not utilized their right to subdivide could lose the ability to obtain water service if additional lots are subdivided for residential development below the 10 acre threshold. The Mutual Bylaws do not currently address the issue of priority, so this is something that the Board may want to consider. One proposal was to issue all member interests now to ensure that existing members can protect their right to subdivide. This would be possible, but would require changes to the Bylaws. It would also result in the Mutual being fully built out given the constraints of the existing water system. Once built out, the Mutual would have no need to issue new membership interests and the annual permitting requirement would no longer apply.

There was also some concern about litigation is lot owners cannot get will serve letters for their lots, but the Bylaws are very clear on this issue and the County should not be issuing building permits for any new residence unless a will serve is available. A lot owner could not force the Mutual to build new infrastructure unless the lot owner was capable of paying the entire cost and obtaining a new water source for the Mutual. It is very unlikely that this would be financially feasible or desirable.

Question 3 – Enforcement of Conservation Measures

As the Mutual's system gets closer to full buildout, the efficient allocation and use of water during periods of drought will become critical given the limited water supply available to the Mutual. The Mutual can use two mechanisms to enforce this. One is the rate mechanism, although this has limited viability due to the fact that a Mutual can only charge rates that are consistent with its cost of service, including reasonable reserves. The Mutual can justify higher rates as usage, costs and potential risks associated with water availability go up, but it cannot charge punitive rates. The other mechanism would be to cut off water service to members who exceed their allotment of water. Although the Board would have authority to take action for a violation of the Mutual's rules, a complete cutoff is potentially a problem due to health and safety concerns. The Mutual could install additional equipment at the meter to constrain service and prevent excess usage, but this would be expensive.

Question 4 – The Potential for Annexation

I understand that new developments are being built on property adjacent to the Mutual which will have water service from the City. This does create the potential that at some point in the future, the City will either envelop the Mutual or seek to annex it, but the City would not likely take that step unless there was a request by the Mutual and the City perceived a benefit to taking over water service. In my experience, Cities only take over Mutuals that are troubled or having water service or quality issues and the City will typically rebuild the water delivery system within the Mutual service area and assess the cost of the new infrastructure against the properties that are being served. This can be very expensive, but the one potential upside for the members of the Mutual who favor additional subdivision within the service area is that the City may have access to additional water supply that would allow for a higher density of homes.