

## ***RECOMMENDATION FOR SALE***

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The Water Committee (WC) recommends that we accept Aqua NJ's offer to purchase our Water System, pending negotiation of an acceptable contract and, of course, subject to approval of the Shareholders.

In developing this recommendation, the Water Committee finds that the decision to sell or hold hinges not on knowable facts, but rather on a) judgment regarding largely unknowable future developments, b) one's attitude about risk and c) one's point of view regarding the relative value or cost of some practices. We find that the key issues where judgment pertains, and thus the key issues driving our recommendation, are: A Professional Water Company running the MKL water system, Monthly Cost of Water Service, Long Term Costs & Financial Risks, and Community Control and Disruption. A brief comparison of point of view on each of these issues follows. More extensive data can be found in the Appendices.

### ***Professional System Management***

Our water system has run well for over 85 years. A volunteer Water System Vice President is responsible for making decisions regarding maintenance and improvement. In recent years, we have retained a professional Licensed Operator (Agra Environmental) that tests our water frequently and provides us with advice about system maintenance whenever we ask for it. A group of community volunteers (VSAs) is responsible for daily monitoring. Test results uniformly indicate excellence in all relevant quality metrics. (It is certainly true that this is a higher level of attention than most Harding residents, 90% of whom are on well water where the water is pumped directly into their houses, apply to their individual wells.) This track record and the community spirit displayed in this volunteerism are commendable and weigh in favor of retaining ownership.

Our ability to run the water system in a high quality manner has been dependent on individuals, such as Bob Edgar, Jim Irving, Bill Manser, Dave Molendyke and Newton White, all of whom developed a high level of expertise in the system. The Committee is concerned that in the future managerial volunteers may not consistently have the time or inclination to nurture the same level of knowledge as in the past. Indeed, the history of the lake has been to outsource functions that used to be performed by volunteers.

The Water Committee is also concerned that a large failure or major replacement project would tax our local expertise. Additionally we have found more than a few examples of where our volunteers have made decisions or taken actions that a professional Water Utility would not do. There are repeated incidences of lapses in VSA monitoring (more than 15 days in 2012 when the chlorine was not monitored). We are repeatedly surprised to find additional NJ State requirements and industry standards that we had no knowledge of and thus had not implemented (e.g. annual exercise of valves and hydrants, regular draining and disinfection of tanks). We fix anything we find broken and occasionally “walk” the system with Agra Environmental to see if any additional maintenance issues present themselves, but we do not have a routine maintenance ritual and do get surprised by component failures that disrupt service (e.g. the pipe leak that caused the Christmas 2012 Boil Water Notice, which Notice could have been prevented). We are creative in minimizing our repair costs where we can versus being attentive to industry standards. This somewhat informal and creative approach is a natural outgrowth of volunteerism and works well in much of our governance here at the Lake. But the Water Committee is concerned that this informality extended to management of our drinking water supply is ill advised. With increasing regulation, creative solutions may be unavailable and the committee is also concerned that the personal risks to the Board, Water Company Managers and individual VSAs operating with such informal practices is not fully recognized by the volunteers nor by the community at large.

## *Monthly Cost of Water Service*

The average monthly/recurring cost of providing water service here at the Lake will never be lower than it is now. There are no changes that are permitted by law that will reduce what it costs us to provide the current volume of water to the community. Any changes we make to ownership, quality, professional operation or risk management may only increase the average monthly cost. Usage monitoring can however change how costs are borne. If we measured usage at each household and charged accordingly (as Aqua NJ would), low usage households would see a cost reduction and high usage households would see an increase. Moreover, residents would have clear feedback on how much water they are using, which might incent more moderate usage and thus lower costs.

Aqua NJ has a stated corporate strategy of growth through acquisition. There is some concern that strategy leads them to acquire older or neglected systems that need more repair and replacement than average. That would drive up their rate base and in turn drive up our prices. Historically, Aqua NJ's rates have increased at about 5% a year (combining operational and capital costs) compared to MKL's 4.6% increase per year in underlying operational rates (electricity + Agra Environmental). MKL has a “spikey” capital expense history (see Appendix A) and has recently instituted a multi-year planning and reserving approach to prepare for and fund those investments we can anticipate

Cost comparisons are difficult to make. Aqua NJ's costs to residents vary considerably based on usage volumes and MKL's costs to residents vary considerably based on the level of investment/repairs. To understand this more fully and/or to see what it could mean to you personally, we encourage you to read Appendix D. But the Water Committee finds that in the event of sale \$573<sup>1</sup> per year per member

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<sup>1</sup> Assumes proceeds from sale are used for Lakeshore's NJDEP loan payments, reducing MKLA's rental payments to Lakeshore and thus MKLA dues. . Using this approach, in 2028 the \$87,000 will be completely used up, but the cost it was being used to subsidize – the dam loan

will be freed up and can be returned to members in a dues reduction without any change to our projected bank balances, cash flow, planned projects or ability to cope with unplanned projects in other community assets. And looking broadly at the possible ranges the yearly price for the “average” user (250 gals/residence/day) will be about \$605<sup>2</sup> with sale to Aqua NJ and has a risk of growing somewhat faster than if we hold the system. In the opinion of the majority of the Committee, that average cost premium – which amounts to \$32 per year per average household – is minimal (and within the margin of error of this report) and the decision on the sale of the water system should be based on the other factors which are discussed in this report.

This \$32 in added average cost assumes that proceeds from sale are used for 14 years to pay Lakeshore’s NJDEP loan payments, reducing MKLA’s rental payments to Lakeshore and thus MKLA dues. Alternatively, if the purchase price were put in a bank account and the earned income was used only to offset dues (and the principal was never touched), the additional average cost per household would be \$50 – 63 (depending on what one assumes about use of funds from refund for generator<sup>3</sup>). However, the Committee recommends spreading the purchase price over the remaining life of the dam loan. (The Committee recognizes that the board and community might wish to use some of the amount of \$573 made available to fund other capital expenditures or to preclude the need for future dues increases caused by inflation in other operating expenses. That decision is of course up to the Board and Community, but it does not impact the forgoing analysis. It would just represent an alternative use of the funds made available by a sale of the water system.)

It should be noted that other factors, such as individuals changing usage habits once they are charged on a volume basis, could reduce

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payments – will also be finished, so there will be no reason to increase dues back up. See Appendix D

<sup>2</sup> See Appendix D for full analysis

<sup>3</sup> See Appendix D for full details

this differential. In addition, if the leakage in our system is greater than estimated because of the steel pipes, which comprise about 10% of the mains in our system and are extensively perforated (based on the experience on Primrose Hill), or capital expenses are higher than anticipated, this could further reduce or even eliminate the differential. These factors exemplify how difficult it is to compare costs. However we acknowledge that placing a priority on keeping average monthly costs low weighs in favor of retaining ownership of the system. We also believe that these cost differentials are within the margin of error of this report and should not be the key factor in a decision on selling the water system, since the amounts being discussed are not large.

### ***Long Term Costs & Financial Risks***

The Board has a 10 year plan for future investments that covers most likely failures and repairs. We also carry insurance that should cover us against all the likeliest accidents, and have reviewed and assured ourselves with regard to the protections on our aquifer. [Questions raised at the November 2012 inform session implying vulnerability of our aquifer have been eliminated by additional due diligence completed<sup>4</sup>. Large dollar amounts of additional insurance, based on old insurance quotes, discussed at that same venue will not be required.) But we don't know what we don't know. We have a history of being surprised by unforeseen failures and of underestimating the full costs of engineering and implementing repairs and improvements. Our 10 year plan does not anticipate any need to replace or repair any of our aging tanks, to upgrade any of our cast iron pipes, nor any expenditures required by new regulations or requirements being introduced.

With regard to the cast iron main pipes: we have inspected them any time repairs have exposed a length and they appear to be in very good shape. They are all 4" in diameter, whereas NJ State standard is 6", but we do not currently anticipate any requirement to upgrade.

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<sup>4</sup> See Appendix I

With regard to the tanks: the two vertical tanks appear to be in good shape. The horizontal tank has small leaks and may need material remediation within the next 10 years.

With regard to liability: we believe we are adequately insured for most risks, indeed we have recently increased the coverage for accidental damage to our tanks and other plant. Based on due diligence completed, we do not see a material risk of chemical pollution of the aquifer. However, we are not presently insured for claims of ill health arising from natural causes (e.g. bacteria or fungi in pipes or tanks). Residents of Harding with wells also do not carry this insurance but their water is piped directly into their houses. Public water companies do carry insurance for health problems, but such companies admittedly have more risks of litigation and can get much more attractive insurance premiums. We've never experienced a Water System related lawsuit and while the cost and disruption of mounting a defense would certainly be large, we acknowledge that the possibility of such a suit is small.

How one nets out all these unknowns is very much related to one's point of view regarding risk. If you believe that the best way to handle risk is to off-load it, you favor sale. If you believe that whatever the uncertainties, the Community will do a better job of finding and implementing solutions that are in its own best interests vs. the choices made by a public utility, you favor holding.

The Water Committee recognizes that identified future investments are manageable and that the cost of off-loading the unforeseen ones may be borne in somewhat higher average monthly rates. Still it is the opinion of the majority that since water service is so incredibly important to quality of life and since surprises with regard to water systems can be very large from a cost, timing and disruption perspective, the community will be best served by placing the responsibility for the system in the hands of a Professional Water Company with the resources and State mandated responsibility for timely response.

## *Control*

So long as we own our water system, we have significant control over most decisions (although we are bound by the same State regulations as any other provider). We have in the past shown considerable creativity and frugality with regard to how we maintain the system. If we sell the system, we will have no control over the particulars or the timing of any such decisions. The provider will be guided by State regulation, industry standard practices, principles of good business and the drive to increase return for their investors.

Our members have always had control over their individual household usage, but that has never translated into any savings/costs to the member. In the event of sale, members will benefit from any effort to reduce their usage, and conversely, high volume users will “carry their own weight” financially.

There are residents who have great faith in our members’ ability and willingness to rise to whatever the occasion demands and their ability to seek out and implement in a timely fashion the solutions that protect the community’s best interests. The Water Committee recognizes the legitimacy of that point of view and understands that it would drive in favor of retaining ownership. But we also recognize that over the decades, the community has increasingly opted to pay to have services provided that once were handled by volunteers (e.g. tennis court surfacing, leaf & debris removal, water-system licensed operator, and club house cleaning for large parties). Additionally, we know that large unforeseen failures necessitate timely response and believe that the community will be best served by having all decisions in the hands of a company that is familiar with best industry practices, has the resources to address problems promptly and is accountable to State regulators.

## *Disruption*

In the event of sale, Aqua NJ will be making several changes to our system, all at their expense. Meters will be installed in the home or underground in every household and other service point (Clubhouse,

garden, etc.). Any household that does not currently have a curb stop valve will be outfitted with one at no cost to the homeowner. Automatic chlorine monitoring equipment will be installed at the pump houses. That work will create disruption for some weeks. Some households will be more significantly affected than others. The Water Committee acknowledges that disruption is never pleasant, but finds that this modest degree of change after a sale will be offset by the other factors discussed in this report.

It should be noted that some residents are concerned with selling the water system due to the recent experience with JCPL. However, the committee believes that this analogy is flawed. The electrical grid is an inter-related above ground system where failures can impact great areas. Our water system is a totally isolated system, the pipes are buried, like our gas lines and unlike our electrical wires. Only two factors, other than some cataclysmic event, which would affect us even if we retained ownership, can cause a loss of water. The first is an electrical outage that will be avoided by the installation of an automatic, natural gas generator, whether we sell or do not sell. The second is a simultaneous failure of both pumps, that is extremely unlikely. Moreover, a large company could address multiple pump failures more quickly than we could due to internal staff and relationships with many contractors.

In addition, since they get a statutory rate of return on their incremental capital expenditures, public utilities are incented to make reasonable capital expenditures to maintain their systems. NJ has been good about allowing such a return on reasonable and necessary investments by water utilities as approved by the BPU.

### ***Conclusions***

The Water Committee believes that a possibly larger average monthly cost is worth the advantages reaped in return: a system operated by a Professional Water Company at industry standard practices and not dependent on future expert volunteers, relief from any long term financial uncertainty and the burden of quickly



responding to any unforeseen failure, and the ability of individual members to manage their own household costs through moderation of usage. We recognize that parties who have faith in their neighbor's ability and willingness to rise to any unforeseen occasion and manage it creatively and frugally now and well into the future may be skeptical about a professional utility with profit motivation. Still, the Water Committee believes that were we to be building this community anew, no one would choose to build and take on the responsibilities of water service.

The Water Committee recommends that it is in the best interest of the community to accept the offer from Aqua NJ. The Committee further recommends that the expense savings from such a sale be rebated to MKL residents in the form of a dues reduction, as discussed in the next section.