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METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

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EXECUTIVE SECRETARY

March 26, 1996

To: Board of Directors (Finance and Insurance Committee--Information)

From: General Manager

Submitted by: Lambertus H. Becker
Chief Financial Officer

Subject: Metropolitan's Pay-As-You-Go Program

RECOMMENDATION

For information only.

EXECUTIVE SUMMARY

Construction programs at Metropolitan have been financed by a combination of short-term debt, long-term debt, and internally generated funding (pay-as-you-go or PAYG). Staff has continually monitored and analyzed PAYG funding levels in order to determine the optimum financing structure for Metropolitan at any given point in time in order to maintain bonding capacity and provide the lowest borrowing costs. The PAYG Fund was established in 1988 and the Board established an objective to fund on a PAYG basis 20 percent of construction program expenditures.

This letter describes Metropolitan's PAYG financing program and illustrates the benefits of continuing the PAYG financing program at Metropolitan.

DETAILED REPORT

Metropolitan has funded its construction programs from a variety of sources throughout its history. Construction funding has come from short-term debt, long-term debt, and from operating revenues (pay-as-you-go or PAYG). In the early years of Metropolitan, construction expenditures were funded 100 percent from operating revenues, in other years, such as during the 1950's and early 1960's, close to 100 percent of construction requirements were funded from debt financing. Staff at Metropolitan has continually monitored and analyzed

PAYG funding levels in order to achieve optimal financing levels, maintenance of bonding capacity to provide the lowest borrowing costs to Metropolitan, and smooth rate impacts.

Since PAYG financing has a direct impact on water rates and the ability of Metropolitan to finance its capital program with revenue bond debt, the Board in 1988 after extensive review established a PAYG policy. As part of the Long Range Finance Plan process in 1987 the Board considered PAYG levels ranging from zero percent to 40 percent. Subsequently, the Board adopted section 5109 of the MWD Administrative Code which states that in order to preserve debt capacity for evolving or unexpected financial needs, the Board's objective shall be to fund on a pay-as-you-go basis 20 percent of capital program expenditures (CIP) of Metropolitan. The PAYG policy is considered a prudent method to allocate costs between current and future beneficiaries of the system. The 20 percent policy does not pertain to the financing of other capital obligations of Metropolitan, including capital obligations of Metropolitan under the State Water Project.

In developing the PAYG policy, staff and the Board examined the impact of various levels of PAYG financing on water rates, equity, external financing requirements and limitations, and other financial indicators related to the financial health of Metropolitan. Any level of PAYG funding reduces debt financing requirements, Metropolitan continually tries to balance the appropriate levels of PAYG funding and debt financing to meet capital program requirements. Through June 30, 1995, cumulative PAYG expenditures totaled 17.1 percent of the overall capital program (using 1988 as the base year). By the end of the current fiscal year, staff anticipates that cumulative PAYG expenditures will total approximately 19 percent of total construction expenditures. With the existing debt limitations in the MWD Act and the effect PAYG has on water rates, staff continues to examine PAYG levels as well as other forms of debt financing used to finance the CIP.

Assuming a capital program of $3.7 billion from 1995-96 to 2000-01 (as part of a $4.1 billion capital program from 1995-96 to 2004-05), Attachment A shows rates, debt to equity, and junior lien revenue bond debt service coverage projected for fiscal year 2000-01 for the current PAYG program (20 percent with a $90 million annual cap), and for PAYG programs of zero percent, 10 percent and 20 percent of the capital program. The following points summarize the impacts of a reduction in PAYG levels:

- Reduced PAYG levels will contribute to lower water rates in the short term, but will contribute to higher costs and abrupt rate increases over the long term.

- Reduced PAYG levels will require additional debt financing thereby reducing revenue bonding capacity (given existing financing limitation on revenue bonds).

- Reduced PAYG funding now means increased financing costs must be paid on debt that otherwise would have been avoided.

- A reduction in PAYG funding limits MWD's flexibility in its ability to stabilize water rates in periods of lower sales. During periods of lower water sales, the PAYG program may be curtailed to minimize increases in water rates.

Attachment B is a summary of water and wastewater utilities showing the PAYG percentage, credit rating and debt to equity ratio of each. The survey was compiled by a member of our senior underwriting team who was formerly a rating analyst with Standard & Poor's Ratings Group and is very knowledgeable of the rating criteria used by the credit rating agencies. As summarized on the attachment, PAYG programs have a strong correlation with credit ratings. Of the water and wastewater utilities depicted on the summary with credit ratings of at least AA, each of the utilities has a PAYG program of at least 20 percent of its capital plan. From a credit analysis point of view, high levels of debt are regarded with caution since the higher the debt, the higher the portion of current revenues required to pay for past borrowing practices. This would leave the entity with reduced financial flexibility to deal with unanticipated financial situations.

Metropolitan has been advised by members of the financial community that elimination of the PAYG program could negatively impact Metropolitan's credit rating, thereby increasing borrowing costs to Metropolitan. The rating agencies also look at the ratio of debt service to total revenues as a measure of an issuer's financial strength. Metropolitan currently has debt service of 17 percent of total revenues. Projections under the current PAYG program show debt service increasing to 30 percent of total revenues by the year 2005. Elimination of the PAYG program would increase the debt service to approximately 40 percent of total revenues in 2005, which could also negatively impact Metropolitan's credit rating.

As detailed in Metropolitan's Long Range Finance Plan, staff will continue to examine all possible financing vehicles available to Metropolitan given the current constraints present in the MWD Act. Future capital expenditures will be financed by a combination of PAYG financing, short-term debt, long-term debt, certificates of participation through the formation of a nonprofit public benefit corporation, and other financing approaches or techniques that may become available to Metropolitan to reduce overall costs of its capital program.

Attachments

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payprog.doc

ATTACHMENT A
PAYG ANALYSIS SUMMARY
PROJECTED FOR FY 2000-01

	Rate Per AF	Debt to Equity	Jr. Lien D/S Coverage
Current Strategy (20%, $90M/yr maximum)	$463	.93	2.03X
PAYG @ 10%	$443	.98	1.83X
PAYG @ 20%	$484	.86	2.28X
PAYG @ 0%	$437	1.03	1.66X

ATTACHMENT B

Utility	PAYG %	Rating	Debt to Equity	Capital Improvement Plan
City of Chicago	50%	AA/Aa	34.5%	The five year CIP is estimated at $377 million of which it is anticipated 50% will be funded by cash.
Seattle Water	40%	AA/Aa	87%	The City will meet its $600 million five year CIP on average 60% debt 40% cash with early years 90% debt 10% cash. The goal is to have debt to equity ration no greater than 58% and debt service equaling 34% of the Department's annual revenues.
Forth Worth, Texas	30%	AA/Aa	28%	The five year CIP is $130 million to be achieved 70% bonds & 30% internally generated funds.
Boston Water & Sewer Commission	26%	A/A	275%	The three year CIP is estimated at $102 million of which 26% of the program will be financed through revenues.
Orlando, FL Wastewater	25%	AA/Aa	76.3%	The $369 million five year CIP will be funded 25% on a pay-as-you-go basis.
East Bay MUD	24%	AA/Aa	60%	The five year CIP for the water utility is $1 billion. It is anticipated that 23.5% will be internally financed with District increasing its support from 15% in 1996; 19% in '97; 26% in '98; 28% in '99 and 29% in 2000.
Phoenix, AZ	23%	AA/A1	57%	The $150 million five year CIP is anticipated to be funded 23% internal cash, 77% bonds.
Muni. Metro Seattle Sewer	22%	AA+/AA1	185%	The $873 million CIP is anticipated to be financed on a 21.8% internally generated funds.
MWD	20%	AA/Aa	45% (1)	The Board of Directors has adopted a policy to fund up to 20% of the CIP on a pay-as-you-go basis.
Santa Clara Valley Water District	20%	AA-/Aa	27%	The $313 million five year CIP is anticipated to be funded 20% internal cash, 80% bonds.
Philadelphia Water & Sewer	15%	BBB/Baa	303%	The five year CIP is $493 million of which $75 million or 15.4% will be financed internally.
City of Detroit	11%	A/A	107%	The five year CIP of over $600 million will be funded from a low of 8% to a high of 19.2% of internally generated funds with the five year average of 11%.
Houston, TX Water & Sewer	10%	A-/A	83%	The five year CIP is $1.6 billion of which it is anticipated that only 10% will be financed through pay-as-you-go.

(1) Excluding General Obligation bond and commercial paper debt, which increases the ratio to 69 percent. Also excluded are capital obligations under the State Water Contract.