MWD

METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

June 23, 1998

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

From: For: General Manager

Submitted by: Lambertus H. Becker
For Chief Financial Officer

Antonietta Christowell

Subject: Long Range Finance Plan Issues

RECOMMENDATION

For information only.

REPORT

Metropolitan is in the process of updating its Long Range Finance Plan (LRFP). Metropolitan's staff have worked closely with both the Board's Budget and Finance Committee and the MWD/Member Agency Finance Work Group (FWG) during this process. It is planned to present a preliminary final draft of the LRFP to the Board in August 1998. This letter discusses the major issues being addressed in the LRFP.

There are indications that Metropolitan's financial strength is weakening. Projections show that increasing fixed costs associated with the Capital Improvement Program, the State Water Project, Colorado River supplies and the Bay-Delta improvements could lead to the erosion of efforts to control water rates and charges to the member agencies. As fixed costs increase, the mismatch between fixed costs and variable water revenues increases and makes it more important to maintain strong reserve levels. Also of concern are the negative trends in Metropolitan's most important financial ratios: Debt service coverage, fixed charge coverage, and the debt/equity ratio. As shown on the attached graphs, revenue bond debt service coverage has dropped to 3.4 times from a level of 7.4 times five years ago, and is projected to drop to 2.0 times during the next ten years. Fixed charge coverage is currently 1.9 times and is projected to drop to 1.1 times during the next ten years. Fixed charge coverage refers to Metropolitan's ability to pay all debt service payments plus the capital component of the State Water Contract from net operating revenues. Metropolitan's revenue bond and commercial paper debt/equity ratio has risen to 71 percent from a level of 51 percent five years ago, and is projected to increase to 74 percent during the next ten years. The LRFP seeks to address these issues and provide solutions that will best serve Metropolitan's customers.

Numerous meetings have been held with the FWG to ensure that the interests and concerns of the member agencies are thoroughly addressed in the LRFP. All parties have agreed on the importance of keeping Metropolitan's financial condition strong to maintain its high credit quality to continue to provide service to its customers at the lowest possible cost. Within this context the following major issues have emerged:

Water Sales Projections

The LRFP addresses Metropolitan's financial sensitivity to water sales. Such factors as population growth, economic growth, conservation, local supplies, Los Angeles Aqueduct deliveries and groundwater production are important variables affecting Metropolitan's water sales. It is important to note that projections of relatively stable and moderate water rates increases are based in part on projections of increasing retail water demands and increasing Metropolitan water sales. If such increases do not occur or are lower than projected, water rates may need to be higher than currently projected. Historically, Metropolitan's water sales have varied in the range of +/- 20 percent, which translates to revenue variations of up to $125 million per year.

Water sales for the 1997-98 cash year (May 1997 through April 1998) were 121,000 acre-feet below the budgeted amount of 1.75 million acre-feet, reflecting above normal rainfall during the year. Because of the recharge of local surface and groundwater storage, the budget estimate of Metropolitan cash water sales for 1998-99 has been reduced to 1.6 million acre-feet from the original estimate of 1.83 million acre feet. Even with the reduced budget estimate, sales for the first two months of the 1998-99 cash water sales year (May 1998 and June 1998) are currently running about 110,000 acre-feet below budget. The revenue shortfall during these two months will be approximately $40 million. This underscores the importance of establishing a sound revenue shortfall reserve policy.

Financial Modeling

An important part of the LRFP process has been the development of a detailed financial modeling program that has allowed numerous financial scenarios to be studied. Financial projections have been made under alternative assumptions. Variables such as interest rate levels, water sales, future supply costs, construction expenditures and water management program costs can be examined at various levels for their effect on Metropolitan's financial condition.

Capital Funding

A major focus of the LRFP is on funding the Capital Improvement Program (CIP). Metropolitan's current policy is to fund the CIP 80 percent with debt and 20 percent from current revenues on a pay-as-you-go (PAYG) basis. An alternative capital funding methodology being examined would determine the mix between debt and PAYG in a more dynamic manner based on varying the PAYG levels in order to meet financial objectives. Financial constraints such as revenue bond debt service coverage, fixed charge coverage, the debt to equity ratio, credit rating strength and desired reserve levels would be examined annually, within the context of maintaining rate stability, in a long range cash flow model to calculate appropriate annual PAYG levels.

Current projections show that the increasing debt service costs associated with debt financing of the CIP will increase from $200 million per year in 1998-99 to approximately $340 million per year in 2008. The attached graphs show Metropolitan's historical and projected revenue bond debt service coverage, fixed charge coverage and debt/equity ratio through the year 2008. As discussed at the beginning of this letter, the historical and projected trends in these important financial ratios are declining. This erosion of Metropolitan's financial condition is a concern to staff, the credit rating agencies and the financial community. The LRFP seeks to provide solutions that will address these eroding financial trends and maintain Metropolitan as a financially strong institution.

Reserve Levels

Metropolitan's current working capital policy is to hold $25 million for emergency repairs and claims (the self-insured retention) and $150 million for current year revenue shortfalls. The Water Rate Stabilization Fund (WRSF) is capped at $200 million with amounts above the cap transferred to the Pay-As-You-Go (PAYG) Fund to meet the Board's 20 percent PAYG policy. It is proposed to remove this cap and make the WRSF last in the flow of funds. Historically, the WRSF has been drawn down by as much $380 million over a three year period (1991 - 1993) to cover revenue shortfalls during those years. The draw on the WRSF will be approximately $89 million for 1997-98 and is projected to be $70 million in 1998-99, without reimbursement of the General Fund for the new headquaters building, as discussed below.

To provide more certainty and predictability the LRFP will propose that the working capital reserve policy be replaced with a minimum/maximum reserve policy based on probability studies of the wet and dry periods that effect Metropolitan's water sales. The minimum reserve level would be based on an 18 month revenue shortfall estimate and the maximum level would be based on either an additional two or three year wet period. Studies have shown using a percentage of projected fixed costs to determine the reserve amounts closely reflects the reserve amounts determined in the probability studies. The percentage of fixed costs method makes the calculation of reserve levels simpler and easier to understand.

If reserve levels fall below the minimum or exceed the maximum level the General Manager would make recommendations to the Board for action to either restore the reserves or use the excess reserves for a lawful purpose. Use of excess reserves to reduce Metropolitan's debt/equity ratio, as discussed later, should have first priority.

Headquarters Building Financing

The construction of Metropolitan's new headquarters building is currently being financed from the General Fund. It has been planned to use the MWD Asset Financing Corporation (MWDAFC) to issue debt and reimburse the General Fund for approximately $129 million of these expenditures when the project is completed and the lease at Two Cal Plaza terminates. Some member agencies participating in the MWD/Member Agency Finance Work Group have indicated that given the current level of Metropolitan's funds there may be some merit to reviewing whether it is necessary to issue MWDAFC debt to reimburse the General Fund. Their approach would effectively reduce Metropolitan's debt obligations by $129 million and reduce future debt service costs. They feel that in lieu of the reimbursement, existing reserve funds should be used to fund the projected $70 million shortfall in the 1998-99 budget. Staff intends to study this issue closely and bring a recommendation to the Board before the end of this calendar year.

Industry Restructuring

An important factor driving the recommendations to come from the LRFP is the expectation that the water industry may undergo significant changes with increased competition in a manner similar to the electric industry. In order for Metropolitan to be competitive and survive in such an environment it is imperative that decisions made now be prudent and farsighted. Water rates, debt levels, credit ratings and other balance sheet considerations need to be controlled with competition in mind. A survey published by Bloomberg L.P. (a financial information and analytical services provider) of 17 private water utilities shows an average debt/eqity ratio of 53 percent compared to Metropolitan's revenue bond and commercial paper debt/equity ratio of 71 percent. Metropolitan should consider steps to reduce its debt/equity ratio in order to strengthen its competitive position in the water industry. Increasing debt levels should be controlled through the use of appropriate levels of PAYG and careful consideration of future capital expenditures.

Fixed Revenues

While the LRFP does not specifically recommend new or increased fixed revenue sources (other than the planned increases in the readiness-to-serve charge) this is a subject that should be carefully considered. This issue will be a subject addressed in Phase 3 of the Rate Refinement Process and will also be considered during development of Metropolitan's Strategic Plan.

Conclusion

The following are the major policy issues that will need to be decided by the Board:

Reserve Levels: Should the current working capital policy be replaced with the minimum/maximum reserve concept? If so, should the maximum reserve level be set on a two or three wet year basis?

Capital Funding: Should the current PAYG policy be changed to a dynamic policy based on optimizing financial ratios and smoothing revenue requirements? How are reserve levels and capital funding related?

Headquarters Building Financing: Should debt be issued by the MWDAFC to reimburse the General Fund for headquarters building construction costs?

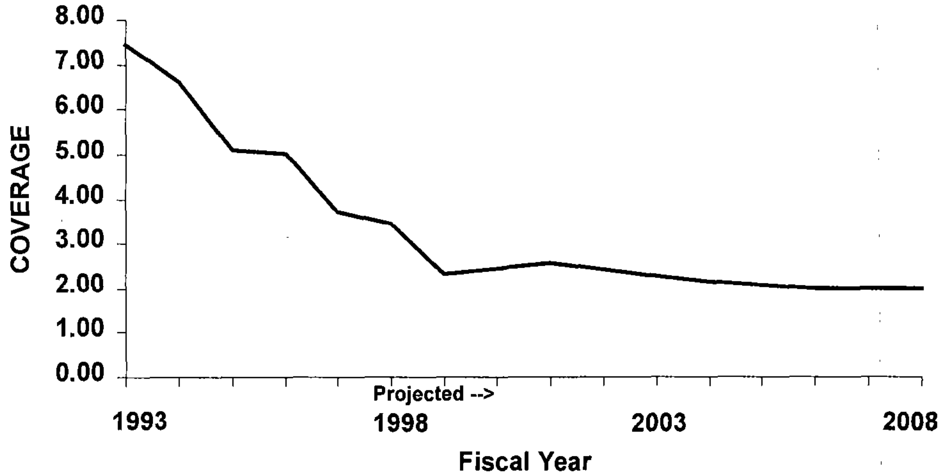
Industry Restructuring: Should Metropolitan consider proactive steps to reduce its debt/equity ratio to a lower level (60 percent) in order to improve its competitive position in the water industry?

A preliminary final version of the LRFP, with preliminary recommendations for changes in Metropolitan's financial policies, will be presented to the Board in August 1998. It is expected that the Board will consider the recommendations, make revisions as needed and act on the recommendations in September 1998.

s:\worddocs\finance\chris\98-LRFP2 \CGP:mb

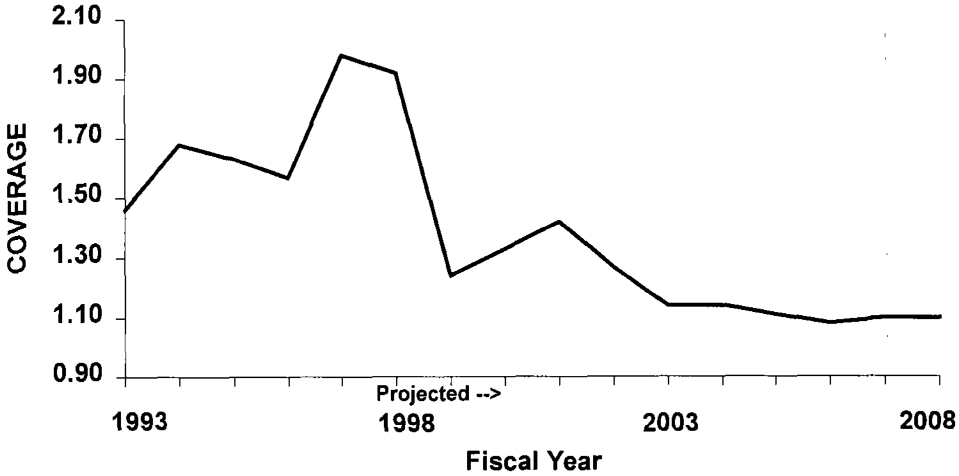
Attachments

Attachment 1
REVENUE BOND DEBT SERVICE COVERAG
1993 to 2008



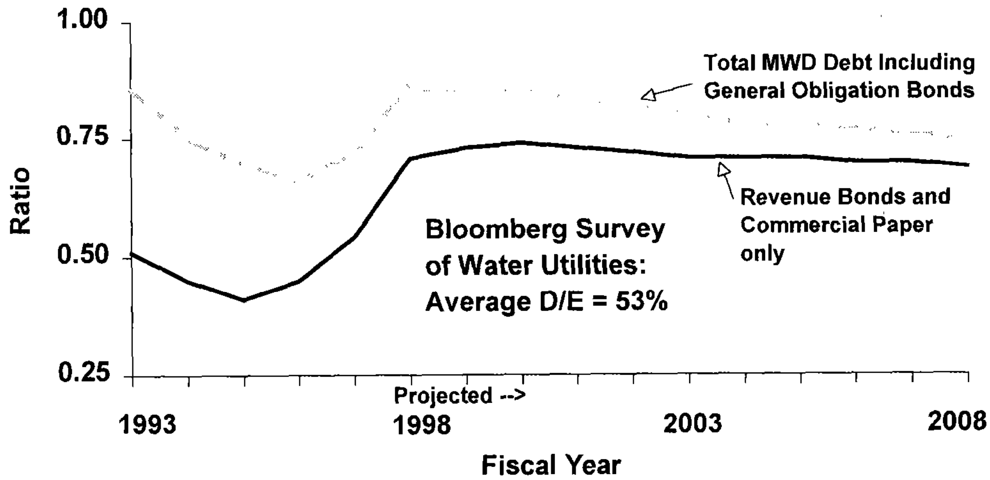
Finance and Business Services Division

FIXED CHARGE COVERAGE
1993 to 2008



Finance and Business Services Division

Attachment 2
DEBT TO EQUIT
1993 to 2008



Finance and Business Services Division