- **Board of Directors**
  Budget and Finance Committee

July 11, 2000 Board Meeting

9-2

Subject

Use of Funds above the Maximum Reserve Level in the Rate Stabilization Fund

Description

If Metropolitan's fixed charge coverage ratio is at or above 1.2, the amount in the Water Rate Stabilization Fund in excess of the maximum reserve level may be used for any lawful purpose as determined by the board. The fixed charge coverage ratio is estimated to be 1.27 for FY2000.

Higher water sales and lower expenditures during the current fiscal year are estimated to result in total reserve balances between $65 to $75 million in excess of the maximum reserve level in the Rate Stabilization Fund. Final calculations of reserve balances will be prepared after the close of the fiscal year. Water sales for May 1999 through April 2000 (cash year 2000) were 1.97 million acre-feet, or about 14 percent higher than the budgeted 1.73 million acre-feet. As a result, water sales revenues are expected to exceed the budget estimate by about $81 million at year-end. Revenues from property taxes and hydroelectric power sales are also estimated to be greater than the budgeted amounts by approximately $12 million and $6 million, respectively. In addition, total year-end expenditures are expected to be about $42 million less than the budgeted amount of $931 million. Approximately $10 million of the favorable variance in total expenditures is attributed to the initial success of Phases I and II of the re-organization effort. This includes lower costs for consulting and other outside services, and reductions in operating equipment purchases. In addition, power costs on the Colorado River Aqueduct have been lower than anticipated, payments for off-stream Colorado River storage programs did not occur, and debt service payments have been lower than anticipated as the first debt payment for the November 1999 revenue bond sale will not occur until July 2000.

The Subcommittee on Financial Policies and Reporting considered several options for use of these funds at its May 23, 2000 meeting. They included options to:

- Reduce the water rate by $20 per acre-foot for the next four years, reflecting the cost savings and deferrals from the re-organization and the anticipated reduction in fixed costs from the financing options approved by the board on May 17, 2000;
- Implement a refund program similar to the one in 1996 to provide each member agency the option of a cash refund or a credit to their water bill;
- Implement a program providing each member agency with a credit to their water bill based on cost savings and deferrals from the re-organization, the anticipated reduction in fixed costs from the financing options approved by the board on May 17, 2000, and savings from an increase in Pay-As-You-Go funding in lieu of issuing additional debt;
- Implement a credit program and cash defeasance of debt whereby cash reserves in excess of the maximum reserve level are used to reduce Metropolitan's future debt service obligations paid from operating revenues;
- Establish a replacement fund for annual depreciation and replacement with current revenues on an ongoing basis.

At the May 23, 2000 meeting, the subcommittee recommended that the funds be used to defease debt. Staff was directed to evaluate the most beneficial defeasance structure, analyze the impact of a cash defeasance without a credit program, and provide additional details about how a credit program would be administered.

The subcommittee's recommendation to defease debt was based on the business judgement that this approach increases financial flexibility. Using funds to defease debt leads to lower fixed costs. These lower costs result in lower future water rates and charges. Lower future costs will be distributed among the member agencies in proportion to their relative use of the Metropolitan system. As Metropolitan completes the new rate structure, the lower cost structure will translate to benefits for all member agencies. Defeasance of debt has been a practice of municipal utilities to reduce debt service costs during a period of uncertainty as they enter the competitive power markets.

In response to the requests of the subcommittee, staff examined a number of alternatives to cash defease debt and presented these alternatives to the subcommittee at its June 27, 2000 meeting. All of the cash defeasance alternatives presented resulted in lower debt service costs thereby reducing annual revenue requirements in certain years. The cash defeasance alternatives presented to the subcommittee were as follows:

- Option 1: Use $75 million to defease debt and reduce debt service costs by $18 million per year over a five-year period beginning with FY 2002;
- Option 2: Use $75 million to defease debt and reduce debt service costs by $4 million per year beginning with FY 2002 and $29 million per year for FY 2019-2021;
- Option 3: Use $113 million ($75 million plus $38 million of savings from the interim credit program) to defease debt and reduce debt service costs by $27 million per year over a five-year period beginning with FY 2002;
- Option 4: Use $113 million to defease debt and reduce debt service costs by $6 million per year beginning with FY 2002 and $44 million per year for FY 2019-2021;
- Option 5: Use $75 million to defease debt and the debt service cost reductions in Option 1($18 million per year) to defease additional debt. By utilizing this approach total debt service costs will be reduced by $18 to $25 million per year over a ten-year period beginning with FY 2002.

At the June 27, 2000 meeting, the subcommittee recommended by a four to one vote Option 5 with an amendment. The amendment to Option 5 is to have staff re-evaluate existing financial parameters for establishing the use of future funds over the maximum reserve level in the rate stabilization fund and determine appropriate financial measures and targets for the board to use in consideration of the total amount of debt that Metropolitan should defease with cash reserves in the future. The subcommittee requested quantitative financial targets be established that would help direct the board in determining the appropriate use of cash reserves in the future (use cash to defease additional debt or use cash for other lawful purposes including credits to the member agencies).

Policy

Metropolitan Water District Administrative Code Section 5202(e)

Subcommittee Recommendation

Option #5

Approve the subcommittee's recommendation to reduce debt through a cash defeasance. Option five as amended has staff re-evaluate existing financial parameters for establishing the use of funds over the maximum reserve level. Also, staff will determine appropriate financial measures and targets for the board to use in consideration of the total amount of debt that Metropolitan should defease with cash reserves in the future. Using funds in this manner leads to lower costs over the long term resulting in lower water rates and charges in the future. Lower costs will be distributed among the member agencies in proportion to their relative use of the Metropolitan system. As Metropolitan completes the new rate structure, the lower cost structure translates to benefits for all of the member agencies.

Fiscal Impact: Use of $174 million for a cash defeasance. Reductions in annual debt service payments from fiscal year 2001-02 to fiscal year 2010-11 of between $18 million and $25 million per year.

Brian G. Thomas 6/28/2000

Brian G. Thomas *Date*

Chief Financial Officer

Ronald R. Gastelum 6/28/2000

General Manager *Date*

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