MWD
METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

BOARD ACTION

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

June 10, 2003 Board Meeting

Revised 9-1

Subject

Approve fiscal year 2003/04 annual budget

Description

Three challenges that dominated much of the current year will continue to drive activities in 2003/04: Setting a long-term course for State Water Project (CALFED) and Colorado River water supplies, continuing to meet our local IRP goals and system water quality standards (which will increase future costs of operations and maintenance, and capital costs), and enhancing efficiency by improving business processes and measuring our progress.

Accomplishments during 2002/03 include: the completion of the reorganization, the resumption of tunneling at the Arrowhead East and West tunnels on the Inland Feeder project, the completion of the Ozone Retrofit project at the Mills filtration plant, completion of the Lake Mathews Outlet Tower tunnel, and the successful re-operation of the system to accommodate significantly higher use of State Water Project supplies. Other accomplishments include the complete shutdown of the Colorado River Aqueduct for refurbishment, the refunding of $311 million in outstanding debt for a present value savings of $22.4 million, the successful implementation of the new rate structure, completion of the Information Technology Strategic Plan and the implementation of a small Business Outreach Program. The coming year will mark the first deliveries of ozone-treated water, and see the use of water from Diamond Valley Lake.

Although we have been successful in many areas several challenges remain a focus of our efforts. Demand for water in Southern California remains high. Metropolitan will supply more than 2.3 million acre-feet in fiscal year 2002/03. It is projected that system demands will be about 2.2 million acre-feet in 2003/04. Continued economic growth in Metropolitan's service area, including a robust demand for housing, is contributing to the demand for water. Metropolitan must work hard to ensure that the challenges it faces in meeting these demands and maintaining excellent water quality do not result in unexpected or unmanageable financial impacts to the member agencies and their customers.

The 2003/04 budget supports the Chief Executive Officer's business plan. The business plan focuses on four areas – (1) customers, (2) financials, (3) business process improvement, and (4) learning and growth (employee development). The business plan identifies strategies that will be employed to meet Metropolitan's mission. Each strategy has initiatives and associated activities that will start, continue, or be completed during the coming year. In this way, we continue to align activities within the organization with the strategic directions of the Board of Directors. A strategy map summarizing the basic strategies is shown in Figure 1.

Accountability and Performance Measurement

Performance measures were first included in the 2001/02 budget. This year additional performance measures have been added and others will continue to be developed to measure our success in implementing the major strategies shown in Figure 1. These measures are one way to help the Board, employees and the public monitor Metropolitan's progress in achieving its objectives. Figure 2 shows the linkage between Metropolitan's mission, strategies and performance measures.

Appendix 1 of the 2003/04 Budget Executive Summary includes Metropolitan wide performance measures for each strategy and identifies additional measures that will be developed.

Figure 1. Strategy Map

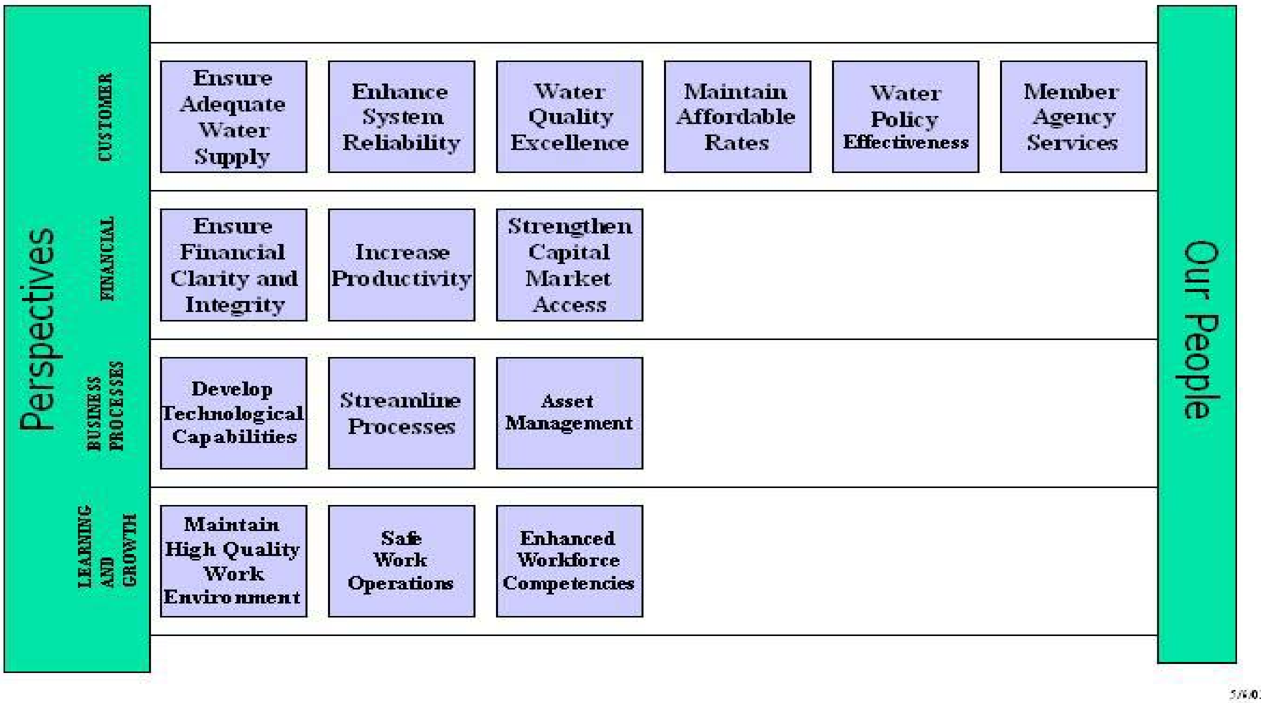
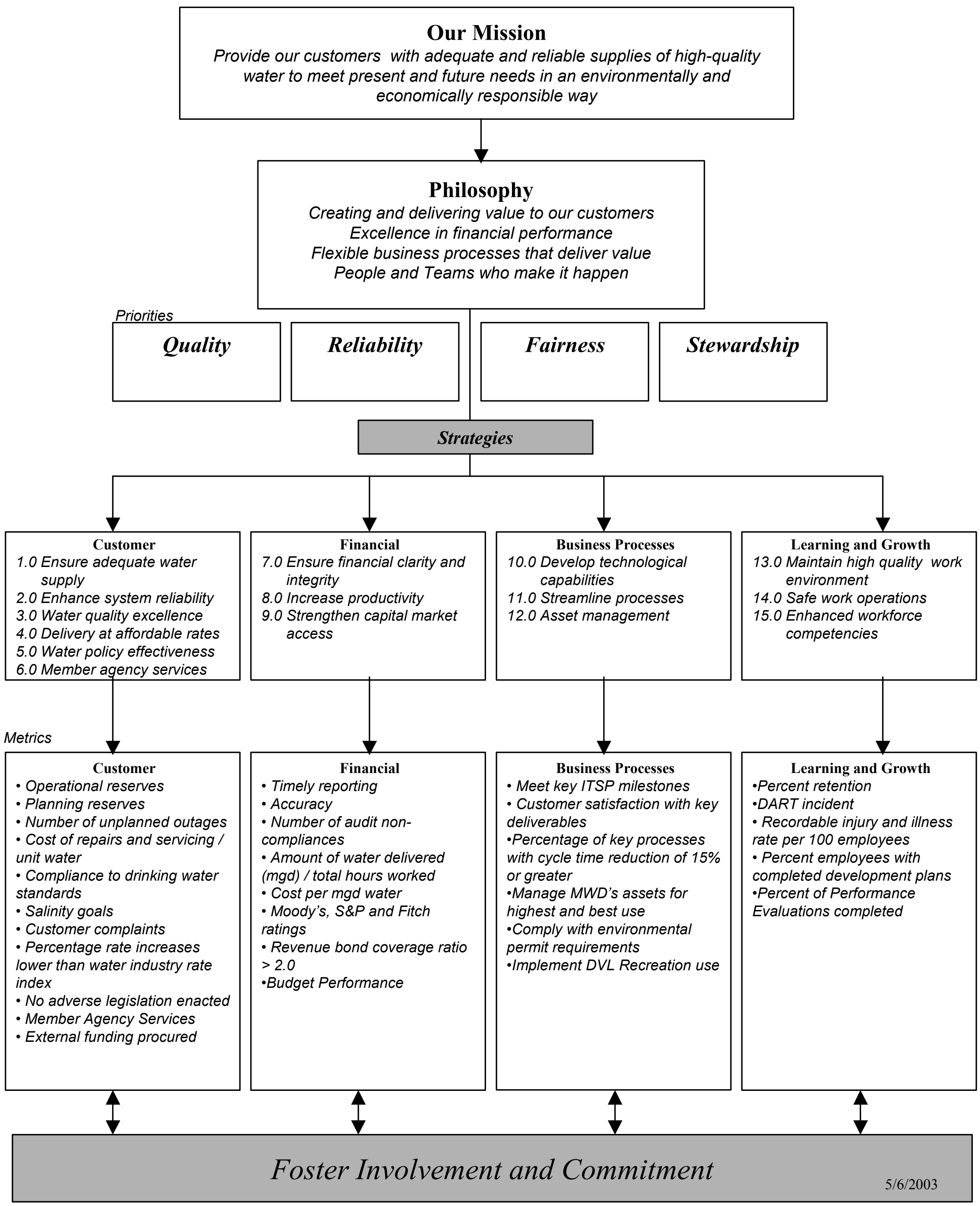


Figure 2. CEO's Business Plan Flowchart



MAJOR STRATEGIES AND INITIATIVES

As seen in Figure 1, Metropolitan will undertake 15 major strategies to meet its mission in the coming years. Under the four perspectives of customer, financial, business processes and learning and growth the 15 strategies include:

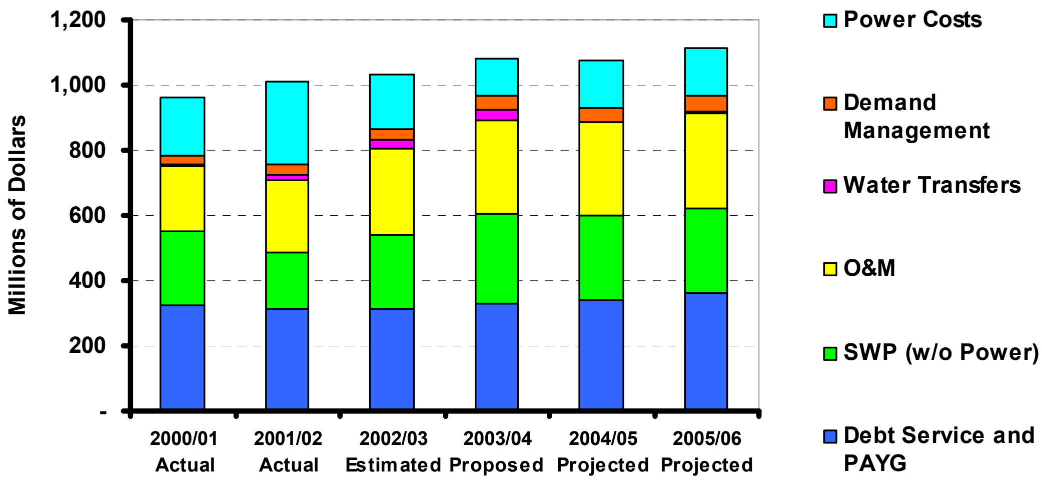
1. Ensure adequate water supply: Develop resources to ensure adequate planning and operating reserves through 2025. Important initiatives include implementing the board-approved Integrated Resources Plan (IRP); implementing the Local Resources Program and conservation programs; developing the seawater desalination program; securing water transfers as needed and pursuing Colorado River Programs, including a Quantification Settlement Agreement, an important initiative within this strategy.
2. Enhance system reliability: Maximize effectiveness of maintenance activities and implement replacement projects and new improvements to achieve Metropolitan's goal of delivering water without interruption. Initiatives include implementing the board-approved Capital Investment Plan (CIP) and implementing the Maintenance Action Plan.
3. Water quality excellence: Develop and implement comprehensive programs to ensure Metropolitan delivers water that meets all water quality regulations and objectives. Initiatives include the implementation of the Ozone Retrofit Program at Jensen filtration plant and proceeding with improvements at other plants to allow for cost effective treatment of higher blends of State Water Project supplies.
4. Maintain affordable rates: Manage costs to ensure that average annual rate increases are below the average annual change in rates for large water utilities in the Southwest. Initiatives include continued refunding of debt, prudent investment and management of Metropolitan financial assets, competitive bidding of contracts and annual review of Metropolitan activities and their cost.
5. Water policy effectiveness: Provide leadership and proactively address local, statewide and national issues to ensure that water policy changes are positive and coordinated with member agencies.
6. Member agency services: Work with Metropolitan's member agencies to assist in coordination and delivery of common water policy themes and actions to assure that Metropolitan is addressing those issues that are most important to its member agencies.
7. Ensure financial clarity and integrity: Assure member agencies, rating agencies, the Legislature, and the public that Metropolitan is effectively managing the public's finances through consistent, clear, and timely financial policies and reporting.
8. Increase productivity: Improve productivity through application of technology, enhanced skills training, and clear communication of objectives to all employees.
9. Strengthen capital market access: Ensure that Metropolitan continues to have access to capital markets at cost-effective rates by maintaining credit ratings of AA or better.
10. Develop technological capabilities: Implement technology to improve business processes and provide enhanced tools for employees to improve productivity. Initiatives include implementation of major information technology programs identified in the Information Technology Strategic Plan such as increasing automation through the Water System Control Master Plan, upgrading business systems and integrating databases.
11. Streamline processes: Reduce cycle time for business processes to increase productivity and improve morale. Initiatives include the implementation of certification for the replenishment and agricultural programs through the Internet and increased on-line access to information for member agency staff and board members. Self service human resources systems and web-based business systems will also be utilized to reduce cycle times.

12. Asset management: Maintain all Metropolitan property in condition needed to support current and planned future operations. Identify surplus lands and sell or exchange for highest market value. Initiatives include the maintenance management program and the mapping of all Metropolitan property along the Colorado River Aqueduct.
13. Maintain high quality work environment: Provide a safe workplace and the tools necessary to enhance the capabilities and competencies of our employees to maintain a high level of service to our customers.
14. Safe work operations: Emphasize work practices that ensure the health and safety of the workforce.
15. Enhance workforce competencies: Provide tools and career paths to continually improve the workforce skills and competencies. Initiatives include employee development plans, timely evaluations and the continued improvement of training for management and staff.

BUDGET TREND

To provide a clear picture where we are headed, Figure 3, Six-year Budget Trend, shows the major cost categories over the past three years, as well as the three-year forecast. The major cost drivers continue to be rising debt service due to the continued need to fund capital improvements, higher operations and maintenance cost for labor and water treatment, rising demand management costs for increased local resources investments, increasing SWP costs for operations and maintenance and escalation in power costs. As shown in the graph, from 2000/01 to 2003/04 expenditures are projected to increase by about $118 million, an average annual increase of about 3.9 percent. From 2003/04 through 2005/06 expenditures are expected to rise an additional $67 million, or about 3 percent per year. Over this entire period the trend in expenditures would average about 3.6 percent per year. The proposed budget assumes that any funds over the maximum target for the Water Rate Stabilization Fund would be used to offset capital funding needs and that the PAYG amount from revenues would be $95 million.

Figure 3. Six-year Budget Trend



Receipts and Funding Sources

Estimated receipts total $1.09 billion, with water sales of $808 million accounting for the majority of revenues. These revenues are based on projected acre-feet sales of 2.23 million acre-feet. Other revenues include readiness to serve charge revenues of $80 million, revenues from the capacity charge of $22.5 million, and tax revenues at about $98 million. In addition, interest earnings are projected to be $42.7 million, while power and other miscellaneous sales are expected to generate about $34 million. Power revenues have increased due to the sale of forward purchase contracts for supplemental energy that were intended for Colorado River Aqueduct pumping. Capital projects will be funded from a combination of bond proceeds, revenues and existing balances from the PAYG fund. These sources will provide another $297.8 million. Finally, the Water Transfer Fund will help pay for $32.5 million of supply. Total funding sources will be about $1.42 billion.

Uses of Funds

Total cash outlays for State Water Contract payments, supply programs, Colorado River Aqueduct power, debt service, demand management programs, operations and maintenance and the CIP is budgeted at over $1.28 billion. This is about $106 million greater than the 2002/03 budget and $81 million greater than projected (see Table 1. 2003/04 Uses and Sources of Funds). In addition, fund deposits total $140 million and include $95 million deposited to the PAYG fund and $45 million deposited to the Water Transfer Fund. Total uses of funds are budgeted at $1.42 billion.

State Water Project costs are estimated to be about $30 million higher than in the 2002/03 budget, reflecting higher base operations and maintenance costs due to increased maintenance activity for replacements and rehabilitation, unanticipated repair costs from 2003 and under collections from prior years.

Debt service is anticipated to be $8.2 million higher than in the 2002/03 budget reflecting a planned $218 million bond issue needed to fund the CIP. The bond issue is planned for late 2003 or early 2004.

Colorado River Aqueduct power costs are down from the 2002/03 budget of $48.9 million by almost $32 million reflecting the decreased availability of Colorado River supplies. This decrease is offset by increased power costs on the State Water Project.

Demand management costs including the Local Resources Program and Conservation Credits Program are budgeted at $43.8 million. This is a $9.0 million increase due to increased local supply yield from participating projects.

Operations and maintenance costs are increasing by about $25 million (9 percent) compared to projected costs for 2002/03 and about $39 million (16 percent) from the 2002/03 budget. Primary drivers include: adjustments to salaries and benefits required by existing labor agreements and the filling of critical vacancies, chemical and sludge handling costs associated with meeting water quality standards and blending of higher levels of State Water Project supplies. The sludge handling, chemical and utilities costs for water treatment are adding over $18 million compared to last year's budget. Increases in labor costs account for another $11 million compared to the 2002/03 budget, despite the decrease of 43 budgeted positions. The personnel complement for 2003/04 is 2,022 positions compared to the 2002/03 budget of 2,065. The increase in labor costs is primarily driven by Memoranda of Understanding (MOU) with the bargaining units and the need to fill vacancies.

Professional service needs for the 2003/04 budget are about $65 million, an increase of $25 million or 62 percent compared to the 2002/03 budget. The vast majority of this increase ($23.5 million) reflects the increased activity on the CIP. The proposed CIP includes 85 new projects and continued work on 280 ongoing projects. Professional services for O&M are increasing $1.3 million due to continued efforts on CALFED and increased activity in the outdoor conservation program.

The CIP is budgeted at $297.8 million, or about $59 million higher than the 2002/03 budget. The major projects in this upcoming budget year include the Inland Feeder Project Arrowhead Tunnels, the oxidation retrofit projects at Jensen and Skinner, as well as infrastructure reliability and improvement projects. There are 365 projects in the CIP. Many of these projects require design work in 2003/04.

TABLE 1. 2003/04 ANNUAL BUDGET USES AND SOURCES OF FUNDS – CASH BASIS

	2002/03 Budget	2002/03 Projected	2003/04 Proposed Budget	Change from 2002/03 Budget	Change from 2002/03 Projected
USES OF FUNDS					
Expenditures					
State Water Contract	343.8	342.9	374.1	30.3	31.2
Supply Programs	36.7	26.8	31.5	(5.2)	4.7
Colorado River Power	48.9	55.6	17.1	(31.8)	(38.5)
Debt Service and Bond Defeasance	225.4	221.5	233.1	7.7	11.6
Demand Management	38.4	34.8	43.8	5.3	9.0
Operations and Maintenance	245.7	261.6	286.3	40.6	24.7
Subtotal Expenditures	**938.9**	**943.2**	**985.9**	**47.0**	**42.6**
Capital Investment Plan	238.8	259.5	297.8	59.0	38.3
Fund Deposits	164.9	223.3	140.0	(24.9)	(83.3)
TOTAL USES OF FUNDS	**1,342.6**	**1,426.1**	**1,423.7**	**81.1**	**(2.3)**
SOURCES OF FUNDS					
Receipts					
Taxes and Annexation Fees	102.1	105.6	98.0	(4.1)	(7.6)
Interest	29.4	39.1	41.8	12.4	2.7
Power & Misc.	19.8	37.6	34.0	14.2	(3.7)
Fixed Charges	90.5	89.1	102.5	12.1	13.4
Water Sales	811.4	868.3	807.9	(3.5)	(60.4)
Subtotal Receipts	**1,053.2**	**1,139.8**	**1,084.2**	**31.0**	**(55.6)**
Fund Withdrawals					
Transfer Fund	50.6	26.8	31.5	(19.1)	4.7
PAYG Funds for Construction	140.1	92.8	122.5	(17.6)	29.8
Bond Funds for Construction	98.7	166.8	175.3	76.6	8.5
Decrease in Reserves	-	-	10.2	10.2	10.2
Subtotal Fund Withdrawals	**289.5**	**286.3**	**339.5**	**50.1**	**53.3**
TOTAL SOURCES OF FUNDS	**$1,342.6**	**$1,426.0**	**$1,423.7**	**$81.1**	**($2.3)**

Reserves

The maximum reserve level target for the Water Rate Stabilization and Revenue Remainder Funds as of June 30, 2004 is estimated to be $358 million. Based on projected receipts and cash outlays, it is estimated that reserves will be about $16 million below this target if sales are 2.23 million acre-feet. If reserves are again above the maximum reserve level then the Board will consider options for the use of those funds at that time.

Attachment 1, Fiscal Year 2003/04 Budget Summary, discusses the sources of funds including receipts and fund withdrawals and uses of funds including expenditures and fund deposits.

Policy

Metropolitan Water District Administrative Code § 5107: Annual Budget

California Environmental Quality Act (CEQA)

CEQA determination for Options #1 and #2:

The proposed actions associated with approving the budget are not defined as a project under CEQA because they involve continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed actions are not subject to CEQA because they involve the creation of government funding mechanisms or other government fiscal activities, which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment (Section 15378(b)(4) of the State CEQA Guidelines). For those anticipated projects listed in the budget that may require subsequent board approval, a CEQA review will be carried out, and if appropriate, environmental documentation for such projects will be prepared and processed in accordance with CEQA and the State CEQA Guidelines.

The CEQA determination is: Determine that the proposed actions are not subject to CEQA pursuant to Sections 15378(b)(2) and 15378(b)(4) of the State CEQA Guidelines.

Board Options/Fiscal Impacts

Option #1

Adopt the CEQA determination and

a. Approve the 2003/04 Budget;

b. Appropriate $752.8 million for the projected annual cash outlays for Metropolitan O&M and operating equipment, power costs on the Colorado River Aqueduct, SWP operations, maintenance, power and replacement costs and SWP capital charges; demand management programs including the local resources and conservation credits program; and costs associated with supply programs paid from the Water Transfer Fund;

c. Appropriate as continuing appropriations, $210.7 million for debt service on Metropolitan general obligation and revenue bonds;

d. Authorize $22.4 million to be used to cash defease debt as directed by the Board in July 2000;

e. Authorize the use of $140 million in operating revenues for fund deposits including $45 million to the Water Transfer Fund and $95 million to the PAYG Fund;

~~f.~~ ~~Authorize as continuing appropriations the expenditure of $287.8 million for the Capital Investment Program to be funded by a combination of bond proceeds and PAYG;~~

~~g.~~f. Authorize the continued use of the Water Transfer Fund to pay for water transfers and sunset any further deposits to the Water Transfer Fund after June 30, 2004; and

~~h.~~g. Authorize the use of any funds over the maximum reserve level target as of June 30, 2003 to be used in-lieu of issuing additional debt to fund the CIP in 2003/04.

Fiscal Impact: $1.424 billion

Option #2

Adopt the CEQA determination and approve the 2003/04 Annual Budget with changes as recommended by the Board.

Fiscal Impact: Impact depends on adopted changes.

Staff Recommendation

Option #1

Brian G. Thomas	6/4/2003
Brian G. Thomas	*Date*
Chief Financial Officer	

Ronald R. Gastelum	6/4/2003
Ronald R. Gastelum	*Date*
Chief Executive Officer	

Attachment 1 – Fiscal Year 2003/04 Budget Summary

BLA #2222

Fiscal Year 2003/04

Budget Summary

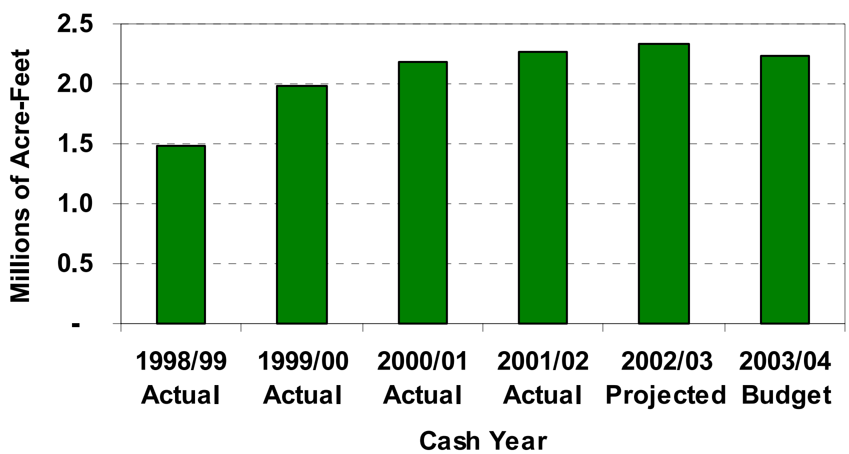
The budget summary includes a discussion of: (1) cash basis Sources and Uses of Funds, (2) an accrual basis pro-forma Statement of Operations, and (3) the proposed staffing complement. The budget is developed and monitored on a cash basis. This means that revenues and expenses are recognized when cash is received and cash is paid. The pro-forma Statement of Operations is prepared using an accrual basis of accounting and is included for information only. Accrual basis accounting recognizes transactions when they occur and are measurable, regardless of the timing of related cash flows.

SOURCES OF FUNDS

Estimated receipts from water sales, readiness-to-serve charge, capacity charge, taxes, interest, power recoveries and other income are projected to be $1.09 billion for fiscal year 2003/04. This is $31.9 million more than the 2002/03 budget and about $54.7 million less than projected for 2002/03. High sales contributed to the additional revenues in 2002/03. While sales in 2003/04 are projected to be higher than average, they are anticipated to be about 110,000 acre-feet less than in 2002/03.

Water sales for 2002/03 are projected to be 2.34 million acre-feet (MAF), the third highest in Metropolitan's history. Receipts from water sales for 2003/04 are estimated to be $807.9 million based on water sales of 2.23 MAF during the May through April period. The 2003/04 sales estimate was developed from input from the member agencies. Figure 1 shows the five-year trend of water sales.

Figure 1. Five-Year Trend of Water Sales



The 2003/04 water sales mix includes 1.99 MAF of firm sales, 0.11 MAF of replenishment sales, and 0.134 MAF of agricultural sales. Treated sales are estimated to be 1.42 MAF, 64 percent of total sales.

Water Rates and Charges

As stated earlier, water sales receipts are budgeted at $807.9 million and are based on rates and charges adopted by the Board for fiscal year 2003/04 as shown on Table 1.

Table 1. 2003/04 Water Rates and Charges

	Effective January 1, 2003	Effective January 1, 2004
Tier 1 Supply Rate ($/AF)	$73	$73
Tier 2 Supply Rate ($/AF)	$154	$154
System Access Rate ($/AF)	$141	$163
System Power Rate ($/AF)	$89	$60
Water Stewardship Rate ($/AF)	$23	$30
Full Service Untreated Volumetric Cost ($/af)		
Tier 1 Full Service Untreated Cost ($/af)	$326	$326
Tier 2 Full Service Untreated Cost ($/af)	$407	$407
Replenishment Water Rate Untreated ($/AF)	$233	$233
Interim Agricultural Water Program Untreated ($/AF)	$236	$236
Treatment Surcharge ($/AF)	$82	$92
Full Service Treated Volumetric Cost ($/af)		
Tier 1 Full Service Treated Cost ($/af)	$408	$418
Tier 2 Full Service Treated Cost ($/af)	$489	$499
Replenishment Water Rate Treated ($/af)	$290	$300
Interim Agricultural Water Program Treated	$294	$304
Readiness-to-Serve Charge ($M)	$80.0	$80.0
Capacity Charge ($/cfs)	$6,100	$6,100
Peaking Surcharge ($/cfs)	$18,300	N/A

The overall increase in rates and charges revenue in 2003/04 is approximately two percent as a result of a $10-per-acre-foot increase in the treatment surcharge. This represents the first increase in Metropolitan's rates and charges since January 1997. Certain elements of the unbundled rate are increasing while others are decreasing, reflecting changes in Metropolitan's cost of service. An increase in the system access rate and water stewardship rate are offset by a decrease in the system power rate, resulting in no change to the untreated water rate.

A brief overview of the rate structure is included at the end of the Executive Summary.

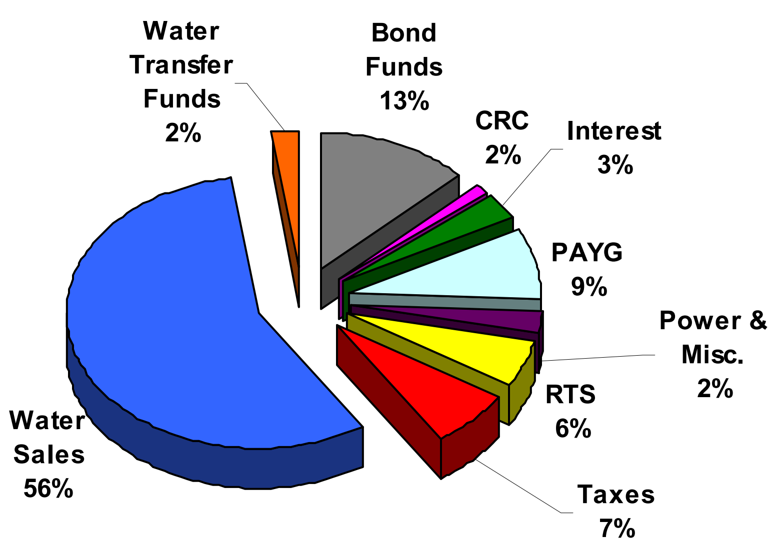
Income from the readiness-to-serve charge (RTS) for 2003/04 is estimated to be $80 million, which is unchanged from 2002/03. The RTS is a fixed charge that recovers a portion of the system conveyance, distribution and system capacity that is on standby to provide emergency service and operational flexibility. The capacity reservation charge (CRC) has been modified to be a simple capacity charge based on recent member agency daily peaking trends, and collections are estimated to be $22.5 million, an increase of $15.6 million over 2002/03 revenues of $6.9 million. The revised rate structure went into effect on January 1, 2003 so the CRC was collected for 6 months during fiscal year 2002/03. Beginning in fiscal year 2003/04 the charge will be collected for the entire year.

Revenues from taxes and annexation fees, which will be used to pay voter-approved debt service on general obligation bonds and a portion of the capital costs of the State Water Contract, are estimated to be $98.0 million.

Interest earnings are estimated to total $42.7 million, excluding trust accounts and construction funds. Receipts from power sales are estimated to be $33.9 million and include $17.9 million from small hydro facilities and the Wadsworth pumping plant at Diamond Valley Lake and $16.0 million from the sale of forward purchase agreements for supplemental energy on the Colorado River Aqueduct. Due to a reduced allocation of Colorado River supplies, Metropolitan will be a net seller of energy in 2003/04. Supplemental energy purchased through forward contracts will be sold in the wholesale power market.

The Capital Improvement Program (CIP) will be funded from $174.8 million of debt proceeds and $122.5 million from current revenues and PAYG fund balances. Costs totaling $31.5 million for water transfers and storage programs will be paid from the Water Transfer Fund. In total, $1.42 billion will be available for expenditures and other obligations. Figure 2 shows the relative contribution of the above sources of funds.

Figure 2. Sources of Funds



USES OF FUNDS

Colorado River Aqueduct Power

Colorado River Aqueduct pumping costs are projected to be $17.1 million. This is $31.7 million less than the 2002/03 budget and $38.5 million less than the 2002/03 projection. The significant decrease in pumping cost is due to the reduction in available Colorado River supplies. Diversions are estimated to range from a low of about 0.61 MAF without the Quantification Settlement Agreement (QSA), which includes additional surplus Colorado River water and access to water from programs such as the Palo Verde Irrigation District Land Management, Crop Rotation and Water Supply Program to a high of about 0.80 MAF with the implementation of the QSA. If the QSA is implemented pumping costs will increase from these levels. Any increased pumping costs will be offset by reductions in State Water Project (SWP) power costs as less water is taken from the SWP.

State Water Contract

State Water Contract (SWC) expenditures of $374.1million are projected to be $30.3 million more than the current year's budget and $31.2 million more than 2002/03 projected of $342.9 million. The increased use of available SWP supplies has led to higher SWP power costs in 2002/03 and this trend will continue in 2003/04. Deliveries through the SWP are expected to be 1.45 MAF in 2003/04 which includes a seventy percent allocation of SWP Table A supplies, the use of carryover storage and additional supplies from transfer and storage programs. Power costs are expected to be about $96.0 million or $16.0 million less than the projected 2002/03 power costs of $112.0 million. In addition, the State Water Contract 2003/04 minimum operations maintenance power and replacement charge is $35.4 million higher than projected 2002/03 costs due to increased maintenance activity for replacements and rehabilitation, unanticipated repair costs from 2003 and under collections from prior years.

Demand Management Costs

Metropolitan provides financial assistance to its member agencies for the development of local water recycling and groundwater recovery projects through the Local Resources Program. Metropolitan also provides financial assistance for the development of conservation programs through the Conservation Credits Program (CCP).

Metropolitan has entered into agreements to provide financial assistance to 53 water recycling projects. Thirty-seven of these projects are in operation and the remaining sixteen projects are under design or construction. Recycling projects that receive Metropolitan contributions are expected to produce over 103,000 acre-feet of recycled water, principally for landscape irrigation, nurseries, groundwater recharge and industrial uses in 2003/04 at a cost to Metropolitan of about $19.8 million.

Metropolitan has entered into agreements to provide financial assistance to 22 projects to recover contaminated groundwater. Operating groundwater recovery projects are expected to produce about 48,900 acre-feet in 2003/04 at a cost to Metropolitan of about $9 million.

Metropolitan's CCP provides financial assistance to local agency conservation programs. The budget for 2003/04 totals $15.0 million, and it is expected that 150,000 ultra-low-flow toilets will be installed. In addition, program funds will continue to support commercial, industrial, and landscape conservation efforts by local agencies. The recent launch of a commercial and industrial program has generated significant interest from several member agencies and about $2.7 million will be spent funding commercial and industrial programs. New conservation efforts initiated in 2002/03 targeted the development of outdoor landscape water use efficiency and education. These efforts will continue in 2003/04.

Operations and Maintenance

The 2003/04 operations and maintenance (O&M) budget, including operating equipment purchases, is estimated to be $286.3 million. This is $40.6 million more than the current year budget of $245.7 million and $26.0 million more than the 2002/03 projected. Reasons for the increased O&M costs include higher chemical, power and sludge disposal costs due to increased use of SWP supplies and more stringent water quality standards, higher labor costs due to existing labor agreements and the filling of vacancies and other increases in O&M for insurance premiums, advertising and professional services for the outdoor conservation program and higher professional and non-professional services costs for additional activities.

Treatment costs for power, chemicals and sludge disposal are $41.2 million, an increase of $18.6 million from 2002/03 budgeted costs of $22.6 million. Treatment costs are expected to remain significantly higher than historical levels due to the increased use of available SWP supplies and high prices for chemicals and extensive sludge management operations. Staff is continuing to refine the estimate of 2003/04 treatment costs as more information becomes available.

O&M labor costs are $168.4 million, or 7.2 percent higher than the 2002/03 budget of $157.1 million. The increase in labor costs reflects salary and benefit adjustments associated with negotiated labor contracts ($3.9 million), the filling of vacancies ($9.3 million) and merit increases ($2.2 million) offset by a reduction of $4.1 million for vacancy factors and a reduction in the total number of positions.

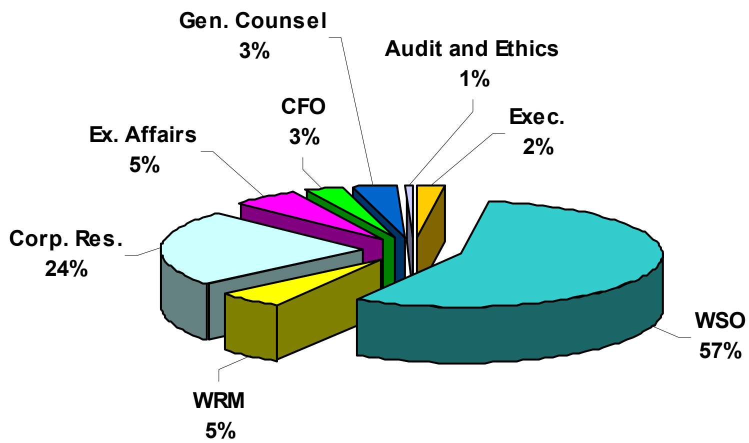
With completion of the reorganization, management will focus on filling critical vacancies to improve business processes and achieve efficiencies. Total full-time regular positions are down 16 from the 2002/03 budget of 1963 to 1947. Temporary positions (district and agency) are at 75, a decrease of 27 from the 2002/03 budget.

Other increases in departmental O&M costs include $4.2 million for non-professional outside services for increased weed abatement activity at Diamond Valley Lake and Lake Skinner and the initiation of recreation operations at Diamond Valley Lake. The O&M consulting budget for professional services is $1.3 million higher than the 2002/03 budget due to increased activity for CALFED Stage 1 programs and projects and increased activity with the outdoor conservation program. Other increases from the 2002/03 budget include $1.6 million for advertising for the outdoor conservation program, $0.4 million for additional security, $0.4 million for service contracts, $0.4 million for memberships and subscriptions and $0.4 million for utilities.

Operating equipment purchases will decrease slightly from the 2002/03 budget and total $6.9 million for 2003/04.

Figure 3 shows the breakdown of the departmental budget by Group for 2003/04.

Figure 3. Proposed Departmental Budget



An overview of the proposed O&M budget is shown in Table 6.

Water Transfer Fund

Deposits into the Water Transfer Fund are $45.0 million for 2003/04, the same as in 2002/03. The current policy sunsets the water transfer fund on June 30, 2004. It is recommended that $45 million from operating revenues be deposited in 2003/04 and that any end-of-year balance be held over to future years for the purpose of purchasing water transfers and investing in long-term water banking, storage and transfer programs.

Depending on the timing for the implementation of the QSA and evolving water supply conditions, 2003/04 payments from the Water Transfer Fund for transfers and storage programs are estimated to range from $31.5 million to $94.2 million. In 2002/03 a total of $26.8 million was disbursed from the fund for the operation of the Imperial Irrigation District/MWD conservation agreement, Semitropic storage agreement, Arvin-Edison water storage agreement and the purchase of supplies through the San Bernardino Valley Municipal Water District agreement and Sacramento Valley transfers. Major expenditures for 2003/04 will include, $10.9 million for the Imperial Irrigation District/MWD conservation agreement, $6.2 million for the Semitropic agreement, $3.7 million for the San Bernardino Valley Municipal Water District agreement, $9.5 million for Sacramento Valley transfers and $1.2 million for the Arvin-Edison program. The operation of these programs is expected to yield between 0.15 MAF and 0.20 MAF of supply in 2003/04. An additional $62.7 million for the Palo Verde Land Management and Water Supply Program could be spent from the Water Transfer Fund if the ongoing discussions regarding Colorado River supply issues result in the implementation of a QSA.

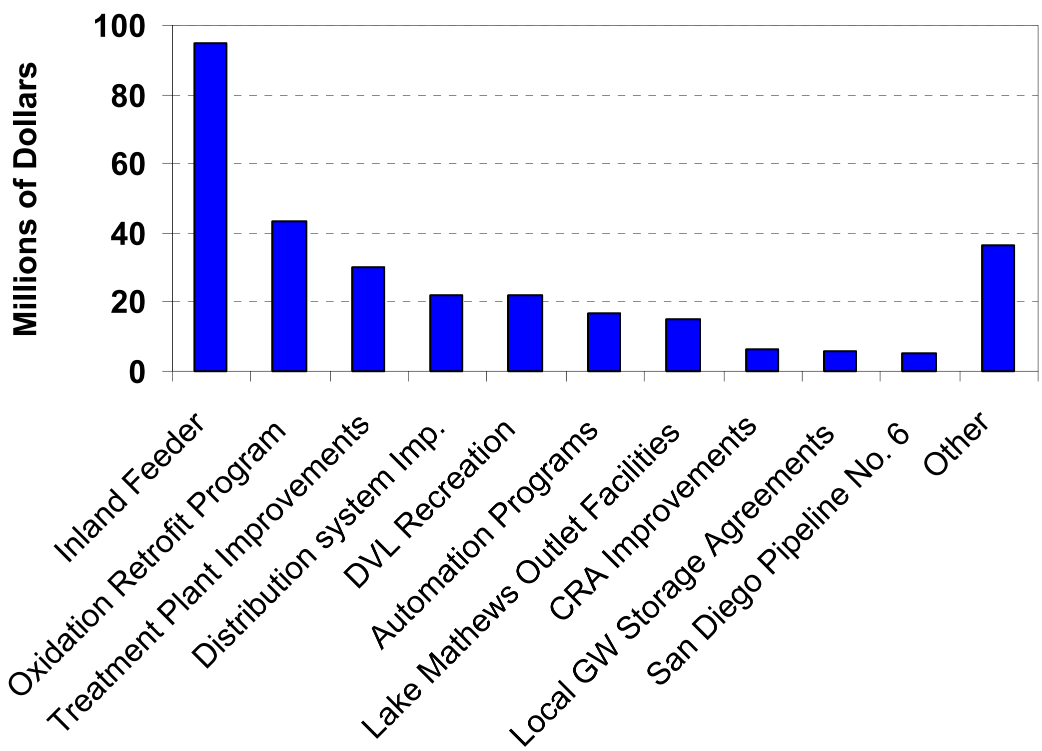
Annual Capital Investment Plan

The Capital Investment Plan (CIP) for 2003/04 is $297.3 million. The detail of each project within the CIP is discussed in the CIP Appendix.

The 2003/04 CIP is $37.8 million higher than the projected expenditures for 2002/03. Major CIP projects in design and/or construction include the Inland Feeder, Oxidation Retrofit Program, Lake Mathews Outlet Facilities, treatment plant improvements, Diamond Valley Lake Recreation, local groundwater storage agreements, San Diego Pipeline No. 6, distribution system improvements, Colorado River Aqueduct (CRA) improvements, and system control and automation programs.

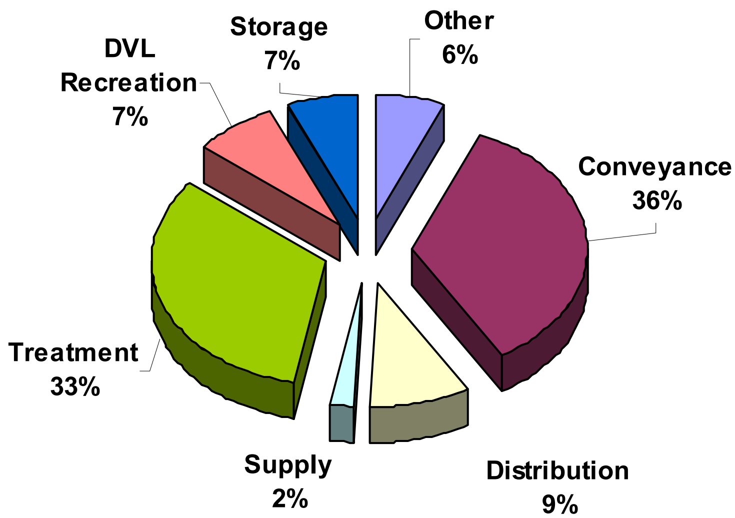
The projects listed above account for approximately 88 percent of the total CIP expenditures. Figure 4 shows the major projects included in the 2003/04 CIP.

Figure 4. 2003/04 Proposed Capital Investment Plan – Major Expenditures



Programs are categorized as source of supply, conveyance and aqueduct, storage, treatment, distribution, and general. The 2003/04 expenditure plan by major service function category is shown on Figure 5.

Figure 5. Capital Investment Plan by Major Service Function



PAYG Financing

It is expected that Metropolitan will end the 2002/03 year between $50 to $60 million over the maximum reserve level. Of this amount the proposed budget reserves $22.4 million to cash defease debt in 2003/04 in accordance with a board action in July 2000. The July 2000 board action directed staff to cash defease $83 million in outstanding debt and to use the annual savings from this initial cash defeasance to cash defease additional debt. The proposed budget transfers the remaining balance of the amount over the maximum reserve level as of June 30, 2003 to the PAYG fund to be used in-lieu of issuing additional debt in 2003/04. In June 2002, in order to fund expected system replacements and refurbishments, the Board adopted an asset replacement and refurbishment policy that established a goal of increasing the annual deposit to PAYG by $5 million per year. Consistent with this policy the 2003/04 proposed budget includes a $95 million deposit to the PAYG fund.

Debt Service

Debt service payments are projected to be $211.1 million and include $49.2 million in general obligation (G.O.) bond debt service and $161.9 million in revenue bond debt service. Total debt service costs are $6.7 million more than the 2002/03 budget. Metropolitan currently has over $3.4 billion in outstanding debt. Of this amount, $2.94 million is revenue bond debt of which 32.5 percent is in a variable rate mode (either directly or though interest rate swaps). Even with the increased use of PAYG available from funds over the maximum reserve level in 2002/03, to fund the CIP, a bond sale of about $218 million is needed for 2003/04. The proceeds from the sale will be used to finance a portion of the CIP. Over the next five years it is expected that an additional $1.6 billion in debt will be issued to fund the CIP. The cost of debt is assumed to be 2.5 percent and 5 percent for variable and fixed rate debt respectively in 2003/04.

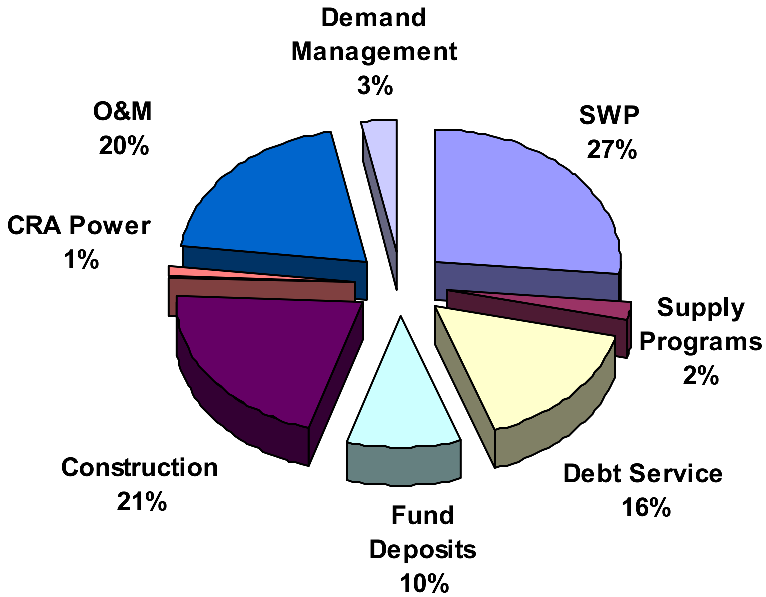
Reserve Transfers

The net activity for required reserve transfers is projected to be a decrease of $1.27 million. This activity results from end of year adjustments to required reserve balances (e.g. O&M fund). All bond covenants and board policies regarding reserves will be complied with under the proposed budget.

Total uses of funds are $1.42 billion. Figure 6 shows the breakdown of expenditures and other obligations that make up the Uses of Funds for 2003/04.

The 2003/04 proposed budget is shown on Table 5 2003/04 Annual Budget, Uses and Sources of Funds.

Figure 6. Uses of Funds



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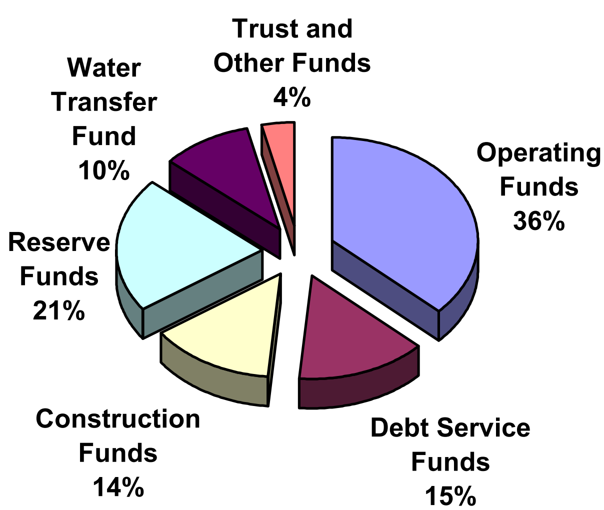
Fund Balances and Reserve Levels

Fund balances are projected to be $1.02 billion at June 30, 2004. Of that total, $584 million is restricted by bond covenants, contracts, or board policy, and $438 million is unrestricted. Table 2 shows a breakdown of reserves by fund type. Figure 7 shows the distribution of funds by type.

Table 2. Projected Fund Balances at June 30, 2004 ($millions)

	Restricted		Unrestricted	Total
	Contractual	Board		
Operating Funds	135	94	149	378
Debt Service Funds	149			149
Construction Funds	67		74	141
Stabilization Funds			215	215
Water Transfer Fund		102		102
Trust and Other Funds	37			37
Total	**388**	**196**	**438**	**1,022**

Figure 7. Fund Distribution by Type



The minimum and maximum reserve levels are projected to be $148.0 million and $358.3 million, respectively at June 30, 2004. Based on projected receipts and cash outlays, it is estimated that reserves will be about $16.0 million under the maximum amount at June 30, 2004. This estimate assumes total sales of 2.23 MAF. The sales estimate is developed with member agency input and reflects current conditions and the expected trend into next year.

Above average precipitation during the 2003 winter months or a cool summer could decrease sales significantly.

STAFFING

The total proposed personnel complement for 2003/04 is 2,022 positions, down 43 positions compared to 2002/03. The personnel complement is broken down on Table 3.

Table 3. 2003/04 Regular and Temporary Positions

	2000/01 Budget	2001/02 Budget	2002/03 Budget	2003/04 Budget	Change from 2002/03
Regular Full Time Positions	1,855	1,960	1,963	1,947	-16
District Temporary Positions	105	75	54	35	-19
Agency Temporary Positions	150	33	48	40	-8
Total	**2,110**	**2,068**	**2,065**	**2,022**	**-43**

Of the total positions, 1,674 are dedicated to operations and maintenance activities and 348 will be working on the CIP.

The breakdown between O&M and the CIP is shown in Table 4 below.

Table 4. 2003/04 O&M and Capital Staffing Levels

	O&M	Capital	Total
Regular Full Time Positions	1,624	323	1,947
District and Agency Temporary Positions	50	25	75
Total	**1,674**	**348**	**2,022**

Table 5. 2003/04 Budget Uses and Sources of Funds – Cash Basis **($ in Thousands)**

	2002/03 Budget	2002/03 Projected	2003/04 Proposed Budget	2003/04 Budget Compared to 2002/03 Budget	2003/04 Budget Compared to 2002/03 Projected
USES OF FUNDS					
Operating Expenditures					
State Water Contract	343,754	342,935	374,104	30,349	31,168
Supply Programs	36,724	26,758	31,492	(5,233)	4,734
Colorado River Power Costs	48,884	55,561	17,090	(31,794)	(38,471)
Debt Service	225,369	221,529	233,084	7,714	11,554
Demand Management Costs	38,446	34,811	43,792	5,346	8,981
Departmental O&M	207,711	220,908	229,621	21,910	8,712
Treatment O&M	22,569	27,755	41,214	18,645	13,459
Other O&M	17,246	12,981	15,494	(1,752)	2,513
Subtotal Operating Expenditures	**940,703**	**943,239**	**985,889**	**45,185**	**42,649**
Capital Investment Plan	238,834	259,520	297,836	63,201	42,515
Fund Deposits					
Deposit to Water Transfer Fund	45,000	45,000	45,000	-	-
Deposit to PAYG Fund	90,000	130,000	95,000	5,000	(35,000)
Increase in Reserves	28,089	48,295	-	(28,089)	(48,295)
Subtotal Fund Deposits	**163,089**	**223,295**	**140,000**	**(23,089)**	**(83,295)**
TOTAL USES OF FUNDS	**$1,342,627**	**$1,426,054**	**$1,423,724**	**$81,097**	**($2,330)**
SOURCES OF FUNDS					
Receipts					
Taxes/Annexation Fees	102,110	105,644	98,010	(4,100)	(7,634)
Interest	29,378	39,084	41,776	12,398	2,692
Power & Misc.	19,773	37,646	33,951	14,178	(3,694)
Readiness to Serve Charge	80,000	80,305	80,000	-	(305)
Capacity Charge	10,454	8,844	22,546	12,092	13,702
Water Sales Revenue	811,440	868,253	807,891	(3,549)	(60,362)
Subtotal Receipts	**1,053,155**	**1,139,776**	**1,084,174**	**31,019**	**(55,602)**
Fund Withdrawals					
Transfer Fund	50,638	26,758	31,492	(19,146)	4,734
PAYG Funds for Construction	140,100	92,769	122,540	(17,560)	29,771
Bond Funds for Construction	98,734	166,751	175,295	76,561	8,544
Decrease in Reserves	-	-	10,223	10,223	10,223
Subtotal Fund Withdrawals	**289,472**	**286,278**	**339,550**	**50,078**	**53,272**
TOTAL SOURCES OF FUNDS	**$1,342,627**	**$1,426,054**	**$1,423,724**	**$81,097**	**($2,330)**

Table 6. 2003/04 Operations & Maintenance Budget Summary

Departmental Units	2002/03 Budget	2002/03 Projected	2003/04 Proposed	Change: Proposed to Budget	%	Change: Proposed to Projected	%
Executive Offices	6,065,700	6,724,600	6,621,000	555,300	9.2%	(103,600)	-1.5%
Water Systems Operations	129,405,400	143,855,600	159,342,400	29,937,000	23.1%	15,486,800	10.8%
Water Resource Management	14,067,800	13,176,700	15,233,800	1,166,000	8.3%	2,057,100	15.6%
Corporate Resources	64,981,300	67,060,700	66,790,100	1,808,800	2.8%	(270,600)	-0.4%
External Affairs	11,510,100	14,179,600	15,159,000	3,648,900	31.7%	979,400	6.9%
Office of the Chief Financial Officer	7,994,400	8,373,800	8,665,400	671,000	8.4%	291,600	3.5%
Subtotal - Executive Officer's Department	**234,024,700**	**253,371,000**	**271,811,700**	**37,787,000**	**16.1%**	**18,440,700**	**7.3%**
General Counsel	8,690,600	8,525,000	9,723,900	1,033,300	11.9%	1,198,900	14.1%
Audit	1,682,600	1,137,000	1,666,600	(16,000)	-1.0%	529,600	46.6%
Ethics Office	280,800	144,900	256,000	(24,800)	-8.8%	111,100	76.7%
Total Departmental Budget	**244,678,700**	**263,177,900**	**283,458,200**	**38,779,500**	**18.3%**	**20,280,300**	**7.7%**
Other:							
Transfer Programs O&M		226,806	383,610	383,610		156,804	69.1%
Leases	400,000	400,000	367,000	(33,000)	-8.3%	(33,000)	-8.3%
Association Dues	1,430,000	1,430,000	1,599,400	169,400	11.8%	169,400	11.8%
Debt Administration	2,216,400	2,216,400	3,166,600	950,200	42.9%	950,200	42.9%
Contingency	2,427,200	-	2,864,500	437,300	18.0%	2,864,500	
Property Tax	607,000	607,000	215,000	(392,000)	-64.6%	(392,000)	-64.6%
Wadsworth Pumping Plant (DVL)		1,329,590	-	-		(1,329,590)	-100.0%
Overhead Credit from Construction	(14,514,300)	(14,514,300)	(12,623,511)	1,890,789	-13.0%	1,890,789	-13.0%
Subtotal - Other	**(7,433,700)**	**(8,304,504)**	**(4,027,401)**	**3,406,299**	**-45.8%**	**4,277,103**	**-51.5%**
TOTAL OPERATIONS & MAINTENANCE	**237,244,800**	**254,873,396**	**279,430,799**	**42,185,999**	**17.8%**	**24,557,403**	**9.6%**
Operating Equipment	6,966,000	5,471,500	6,897,700	(68,300)	-1.0%	1,426,200	26.1%
Desktop and Laptop Computers	1,500,000	1,300,000					
GRAND TOTAL MWD & O&M	**245,710,800**	**260,344,896**	**286,328,499**	**40,617,699**	**16.5%**	**25,983,603**	**10.0%**

PRO-FORMA STATEMENT OF OPERATIONS (ACCRUAL BASIS)

Metropolitan operates as a utility enterprise and prepares its financial statements using the accrual basis of accounting. Under accrual accounting, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred regardless of the timing of related cash flows. However, as is typical for a government utility, the water rates and charges are based on the cash needs approach and therefore the annual revenue requirements and budget are prepared on a cash basis. This pro-forma statement of operations is provided as additional information.

Operating revenues for fiscal year 2003/04 are estimated to be $964.9 million. This estimate is based on water sales of 2.27 MAF during the July through June period. Water sales income is projected to be $844.4 million. The RTS will raise $80.0 million. Income from the capacity charge will be $22.5 million. Hydroelectric power and other income is estimated to be $17.9 million.

Operating expenses are projected to be $857.7 million. This is $58.4 million more than projected 2002/03. Cost of Water Delivered (COWD) is projected to be $329.4 million, or $29.4 million more than the current year estimate. COWD reflects the moving average cost of water delivered from water in inventory. It is based on the power costs to deliver Colorado River water and State Water Project water and O&M on the State Water Project.

Operations and maintenance (O&M) costs are estimated to be $281.9 million. This is $25.8 million more than estimated expenditures for 2002/03. A portion of the increase is associated with higher water treatment costs, increased labor costs, and additional operational activities.

Net income of $147.9 million will be used to fund principal payments on outstanding debt, pay a portion of the State Water Contract capital costs, fund the PAYG construction program, and fund equipment purchases and reserve adjustments.

Table 7 provides the Comparative Statement of Operations.

TABLE 7. COMPARATIVE STATEMENTS OF OPERATIONS ($ IN MILLIONS)

	2001/02 Actual	2002/03 Budget	2002/03 Projected	2003/04 Proposed	Change Budget to Proposed	Change Projected to Proposed
Operating Revenues:						
Water Sales	868.5	803.1	880.1	844.4	41.3	(35.6)
RTS	80.0	80.0	80.0	80.0	-	-
Capacity Charge	-	13.6	8.0	22.5	8.9	14.5
Hydroelectric Power and Other	18.2	22.5	20.4	17.9	(4.6)	(2.5)
Total Operating Revenues	966.7	919.2	950.9	964.9	45.7	(23.6)
Operating Expenses:						
Operations & Maintenance	216.9	244.4	256.1	281.9	37.5	25.8
Cost of Water Delivered	370.4	239.8	300.0	329.4	89.6	29.4
Water Management Programs, Net	32.8	38.4	38.3	43.8	5.4	5.5
Depreciation & Amortization	177.1	181.8	204.8	202.6	20.8	(2.3)
Total Operating Expenses	**797.2**	**704.4**	**799.2**	**857.7**	**153.3**	**58.4**
Operating Income	**169.5**	**214.8**	**189.2**	**107.2**	**(107.6)**	**(82.0)**
Other Income (Expense):						
Net Taxes/Annexations	101.8	103.0	97.0	95.6	(7.4)	(1.4)
Interest Income	45.8	40.5	40.5	41.8	1.3	1.3
Bond Interest Expense	(117.7)	(107.7)	(104.7)	(96.7)	11.0	8.0
Member Agency Distributions	(33.4)	-	-	-	-	-
Miscellaneous Income (Expense)	(5.9)	-	-	-	-	-
Total Other Income - Net	**(9.4)**	**35.8**	**32.8**	**40.7**	**4.9**	**7.9**
Net Income	**160.1**	**250.6**	**222.0**	**147.9**	**(102.7)**	**(74.1)**
Water Sales (MAF)	**2.33**	**2.15**	**2.35**	**2.27**	**0.12**	**(0.08)**