THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

BOARD ACTION

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

6/11/2013 Board Meeting

8-1

Subject

Mid-cycle Biennial Budget Review and Recommendations for Use of Reserves over Target

Executive Summary

In April 2012, the Board approved Metropolitan Water District of Southern California's (Metropolitan) biennial budget and associated rates and charges for fiscal years (FY) 2012/13 and 2013/14. The biennial budget was prepared on the modified accrual basis of accounting as approved by the Board in January 2012. At the midpoint of the biennial budget, revenues are expected to exceed budget for FY 2012/13 due to water sales forecasted to be 161 thousand acre-feet (TAF) over the budgeted amount of 1.7 million acre-feet (MAF). Expenses are expected to come in under budget primarily due to a number of unforecasted cost reductions. The result is that modified accrual reserve balances are anticipated to end the year approximately $75 million above the maximum reserve target established in Administrative Code 5202(e). This provides the Board with the opportunity to address other financial priorities such as increased funding of capital costs from current operating revenues (PAYGO), decreasing the liability for other post employment benefits (OPEB), and setting aside monies in the Water Transfer Fund for future water management actions.

Details

FY 2012/13 Review

As reported at the April 2013 Finance & Insurance (F&I) Committee meeting, and more recently updated at the May F&I Committee meeting, water sales revenues are expected to be higher than budget by about $108 million. Expenditures are forecasted to be $137 million below budget.

Water sales revenues are expected to be higher due to the current dry hydrologic conditions. The dry hydrology has both reduced local supplies, which are being replaced by deliveries from Metropolitan, and increased demands.

Expenditures are forecasted to be below budget due to careful management of costs and expenses, lower power costs as a result of lower than expected deliveries of State Water Project (SWP) water, and a number of one-time cost reductions. Specifically:

- A credit of $22.5 million for SWP costs, which resulted from the Department of Water Resources (DWR) amending provisions of its General Bond Resolution relating to its Debt Service Reserve Account (the "Springing Amendment"), reducing the amount of reserves DWR is required to maintain.
- A credit of $14.3 million for full SWP rate management credits. Rate management credits result from a provision of the State Water Contract that provides for the reduction of capital charges based on differences between DWR's collections from the SWP contractors and the actual amounts paid for capital related charges. These credits are allocated to each SWP contractor in proportion to their total repayment of capital charges to DWR. These credits are unpredictable; the last prior year that full rate management credits were available was FY 2002/03.
- A reduction of $9.6 million to SWP Off Aqueduct Power Costs due to reduced operating costs for Reid Gardner Unit 4 (RG4) in calendar year 2013. DWR's participation in RG4 expires in July 2013.

- A reduction in Colorado River Aqueduct (CRA) power costs of $16.3 million due to maximizing the use of Benefit Energy from Southern California Edison, and lower charges for Hoover and Parker energy.
- Lower debt service costs of approximately $7.8 million due to refinancing of Water Revenue Bonds, lower debt administration costs, and lower interest rates on variable rate debt obligations.
- Departmental Operations and Maintenance (O&M) expenditures forecasted to be $10 million under budget due to careful management of advertising expenses, professional services, chemical costs, and labor costs.

Metropolitan's financial picture and outlook is much improved from prior years. Higher revenues and lower costs are anticipated to increase unrestricted reserves by approximately $217 million to $549 million, after consideration for the change in Required Reserves. Coverage ratios at fiscal year-end are forecasted to be 2.4 times for Revenue Bond Debt Service coverage and 1.8 times for Fixed Charge coverage, above the target levels of 2.0 times and 1.2 times, respectively.

FY 2013/14 Outlook

Key planning assumptions for FY 2013/14 were sales of 1.7 MAF, an increase in operating revenues to fund capital (PAYGO) to $125 million from $55 million in FY 2012/13, and an increase in OPEB funding to $10 million from $5 million in FY 2012/13. The FY 2013/14 Budget also assumed a SWP allocation of 55 percent for calendar year 2013 and 50 percent for calendar year 2014, and CRA deliveries in the fiscal year of 890 TAF. With the adopted 5 percent rate increase in FY 2013/14, future rate increases were forecasted to moderate to the 3 to 5 percent range.

The budget assumptions and the 5 percent rate increases effective January 1, 2013 and January 1, 2014 resulted in the rates and charges shown in Table 1 below:

Table 1: Summary of Rates and Charges, Effective January 1 (per AF)

Rates and charges:	**2012**	**2013**	**2014**
Tier 1 Full Service, Untreated	$560	$593	$593
Tier 1 Full Service, Treated	$794	$847	$890
Readiness-to-Serve Charge, millions	$146	$142	$166
Capacity Charge, per cfs	$7,400	$6,400	$8,600

The rates and charges adopted by the Board in April 2012 effective January 1, 2014 recover the full costs to serve in FY 2013/14 based on budgeted costs and 1.7 MAF of sales. In particular, the January 1, 2014 increase provides revenues to meet increased investments in water treatment facilities, including the oxidation retrofit program at Weymouth and improvements at Jensen, Diemer and Weymouth, as well as to fund the PAYGO increase of $70 million, which is reflected in the Readiness-to-Serve Charge and Capacity Charge increases, and is incorporated in the System Access Rate.

Due to the current dry hydrologic conditions, demands could increase over budget for the first half of FY 2013/14. However, the outcome of the second half of the fiscal year is unknown. Metropolitan's demands can vary by ±30 percent, so sales could quickly decline under different local hydrological conditions.

On the expenditure side, at this time there is nothing that would indicate that expenditures as forecasted will be substantially below budget. A significant portion of the expenditure increase identified for FY 2013/14 is directed towards meeting Metropolitan's Board guidelines for PAYGO.

It is too early to know if the calendar year 2014 SWP allocation assumption of 50 percent will be achieved. The SWP allocation for calendar year 2013 is holding at 35 percent, down from the budget assumption of 55 percent. Supply management actions are expected in late 2013 to manage the difference between demands and supplies, currently estimated to be between 195 TAF and 595 TAF. These actions could place upward pressure on the

FY 2013/14 Budget, which only includes $37 million for Supply Programs, to refill storage or implement transfers.

SWP variable energy costs can vary significantly from one fiscal year to the next depending on supply conditions, water management actions taken by Metropolitan or other State Water Contractors, and energy market conditions. SWP variable energy costs could be higher, depending on which supply management actions are taken to meet the increased demands in FY 2012/13 and FY 2013/14.

For CRA power, no supplemental power purchases were budgeted in FY 2013/14. If Colorado River supply programs are activated to meet supply shortfalls, additional market power purchases will likely be required. Regardless of whether power is purchased for the SWP or the CRA, California power markets are experiencing upward price pressures. San Onofre Nuclear Generating Station, a 2,250 MW nuclear power plant south of San Clemente, will be off-line for the second summer in a row. The dry hydrology in California is resulting in lower hydroelectric generation from Northern and Central California facilities, and runoff in the Pacific Northwest is slightly below normal. California relies heavily on in-state and imported hydroelectricity to meet demands from early spring to mid-summer. Current Southern California forward power prices are 35 percent higher than last year, after adjusting for the cost impact of emissions allowances.

Departmental O&M is expected to be on budget. Labor budgets will be managed to absorb the AFSCME class study cost impacts as well as upward pressures on PERS retirement contribution rates due to changes PERS is making to its amortization and smoothing policies.

Given the continued upward pressures on costs, staff does not recommend any change to the 5 percent increase approved by the Board for January 1, 2014. For rate setting purposes, the 1.7 MAF for FY 2013/14 and 1.75 MAF for FY 2014/15 and beyond are reasonable assumptions given Metropolitan's sales volatility. Metropolitan will be well positioned to maintain reasonable and predictable rate increases while meeting financial policies and maintaining solid reserve levels. Forgoing the approved rate increase for January 2014 would inevitably result in higher rate increases in the future.

Update of Capital Investment Plan

The FY 2012/13 and 2013/14 Biennial Budget included expenditures of $257.3 million and $294.6 million, respectively, for the Capital Investment Plan (CIP). The current projection for FY 2012/13 and FY 2013/14 is $140 million and $214 million, respectively. Total spending for the biennial budget is projected to be $197.9 million under budget. The variance is due primarily to low, highly competitive bids on the Weymouth oxidation retrofit project, reduced costs for solids handling at the Jensen water treatment plant and timing of other projects.

The CIP is funded by a combination of debt and current operating revenues (PAYGO). The two largest areas of expenditures in the biennial CIP are Infrastructure Reliability and Water Quality. It is anticipated that infrastructure reliability will become a larger part of the CIP as more facilities reach the end of their service life and require replacement and refurbishment (R&R). The lower than anticipated capital spending coupled with the increase in PAYGO funding to $125 million in FY 2013/14 will postpone the need to issue $200 million of capital funding during the current FY 2012/13 and FY 2013/14 biennial budget.

Recommendations on Use of Reserves over the Maximum Reserve Target

Metropolitan Administrative Code Section 5202 establishes the minimum and the maximum unrestricted reserve balances as of the end of each fiscal year, which are held in the Revenue Remainder Fund and the Water Rate Stabilization Fund. At the end of FY 2012/13, the anticipated unrestricted reserve balance is $549 million, approximately $75 million above the maximum reserve target of $474 million. Administrative Code Section 5202(e) states that "funds in excess of such targeted amount shall be utilized for capital expenditures of the District in lieu of the issuance of additional debt, or for the redemption, defeasance or purchase of outstanding bonds or commercial paper of the District as determined by the Board. Provided that the District's fixed charge coverage ratio is at or above 1.2 amounts in the Water Rate Stabilization Fund may be expended for any lawful purpose of the District, as determined by the Board of Directors…."

Given that reserves are over the maximum reserve target and that the fixed charge coverage ratio is forecasted to be 1.8 times, the Board has the opportunity to address a number of financial objectives that have been underfunded or deferred over the past several years. Since FY 2007/08, PAYGO has been funded at less than one-half of the board-established policy and instead Metropolitan has relied more heavily on bonds to fund capital projects. In addition, Metropolitan has delayed the funding of an OPEB trust, resulting in a liability for OPEB of approximately $545 million as of the most recent actuarial valuation. Pre-funding OPEB until the annual funding equals the Annual Required Contribution is a prudent fiscal practice that recognizes the cost of OPEB over the active service life of employees and results in a lower unfunded liability in the future. Finally, Metropolitan is forecasting the need to implement water management actions to align water demands and supplies, including potential use of storage supplies. Setting aside monies now will mitigate future costs incurred to replace that use of storage.

Based on the foregoing, staff recommends that the projected approximate $75 million above the reserve target be used to fund these three areas, such that one-third will be transferred to the Replacement and Refurbishment Fund (PAYGO); one-third will be transferred to the OPEB Trust, and one-third will be transferred to the Water Transfer Fund to offset future expenditures associated with FY 2013/14 water management actions, including but not limited to water transfer purchases, energy costs associated with additional pumping requirements, and/or takes of water from Central Valley storage programs. All financial transactions will be made as of June 30, 2013 once the final audit has been completed, and may differ from the estimate of $75 million.

Plans for the Next Biennial Budget, FY 2014/15 and FY 2015/16

Metropolitan will begin work in the fall on its next biennial budget, covering FY 2014/15 and FY 2015/16, and rates and charges effective January 1, 2015 and January 1, 2016. In particular the next biennial budget will focus on:

- Continued close scrutiny and management of costs to keep rate increases reasonable and predictable.
- Careful review of the CIP to ensure system reliability is maintained.
- Review and update of financial reserve targets to ensure they are reasonable and consistent with the modified accrual basis of accounting.
- Development of a ten-year financial forecast that, to the extent possible, will incorporate projected costs and rate impacts of the Bay-Delta Conservation Plan and Delta Habitat Conservation and Conveyance Program.
- Proposals to develop increased fixed revenue sources.
- Proposals to address the expiration of the Purchase Orders on December 31, 2014.

Policy

Metropolitan Administrative Code Section 5200(h): Funds Established

Metropolitan Administrative Code Section 5202(e): Fund Parameters

California Environmental Quality Act (CEQA)

CEQA determination for Options #1 and #2: The proposed action is not defined as a project under CEQA because it involves continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed action is not subject to CEQA because it involves 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).

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

CEQA determination for Option #3: None required

Board Options

Option #1

Adopt the CEQA determination and authorize the use of reserves over the reserve target established in Administrative Code Section 5202, estimated at $75 million, and transfer monies to the Replacement and Refurbishment (PAYGO) Fund, the OPEB Trust and the Water Transfer Fund in FY 2012/13, as specified by the Board.

Fiscal Impact: Reduce reserves by $75 million (approximately) by transferring an equivalent amount in total to the Replacement and Refurbishment (PAYGO) Fund, the OPEB Trust, and the Water Transfer Fund

Business Analysis: Not applicable

Option #2

Adopt the CEQA determination and reduce the approved rate increase effective January 1, 2014 from 5 percent to 3 percent.

Fiscal Impact: Reduction of annual revenues of approximately $28 million, resulting in lower reserves and higher future rate increases

Business Analysis: Not applicable

Option #3

Do not authorize the use of reserves over the target established in Administrative Code Section 5202.

Fiscal Impact: Reserves would remain over the target established in Administrative Code Section 5202.

Business Analysis: Not applicable

Staff Recommendation

Option #1

Gary Breaux *Chief Financial Officer*	5/30/2013 *Date*
Jeffrey Kightlinger *General Manager*	5/30/2013 *Date*

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