THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

INFORMATION

- Board of Directors
  Finance and Insurance Committee

9/10/2019 Board Meeting

9-2

Subject

Mid-cycle Biennial Budget Review

Executive Summary

In April 2018, the Board approved the Metropolitan Water District of Southern California's (Metropolitan) biennial budget for fiscal years (FY) 2018/19 and 2019/20. At its April and May 2018 meetings, the Board also approved the associated rates and charges for calendar year (CY) 2019 and 2020. This year, at its regular April and May meetings, the Board approved charges for CY 2020. The mid-cycle update provides an opportunity to review results of the first year of the two-year budget, review the outlook for the second year of the two-year budget, and highlight financial issues to be addressed in the next biennial budget and rate-setting cycle, which formally begins in February 2020.

At the midpoint of the biennial budget period, water transactions[1] for FY 2018/19 are 1.42 million acre-feet (MAF), 232 thousand acre-feet (TAF) or 14 percent, less than the FY 2018/19 budget of 1.65 MAF, primarily due to cooler and wetter conditions of the past winter and improvement in member agencies' local supplies. Revenues are $206.0 million under budget due to the lower water transactions. Expenditures are $172.9 million under the amount of the adopted budget.

As of June 30, 2019, the balance in unrestricted reserves, which are held in the Water Rate Stabilization Fund and the Revenue Remainder Fund, is $461 million. Unrestricted reserves are $13 million lower than the beginning of the fiscal year-end and are $204 million over the minimum. The $461 million balance is $165 million lower than the target.

The outlook for FY 2019/20 shows revenues will continue to be below budget and expenditures, with the exception of capital expenditures, will be slightly lower than budget. Capital expenditures are projected to be approximately $100 million more than the FY 2019/20 budget. For these reasons, staff proposes to adjust the financing plan for capital expenditures.

Description

FY 2018/19 Review

As presented at the Finance & Insurance Committee Meeting of August 19, 2018, water transactions for FY 2018/19 were 1.42 MAF, 232 TAF or 14 percent, less than the FY 2018/19 budget of 1.65 MAF, resulting in revenues that are about $206.0 million under budget. Expenditures were also under budget by approximately $173 million.

Water revenues were lower than budgeted due primarily to lower demands and to decreased deliveries to member agencies whose local supplies benefitted from the cool and wet winter. Expenditures were lower than the amount of the adopted budget for several reasons. Operations and Maintenance expenditures, which were $456.4 million, came in under budget due to prudent management of expenses and lower third-party claims. The State Water

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[1] Includes water sales, exchanges and wheeling.

Contract (SWC) expenditures were lower due to lower On-Aqueduct Power and Minimum Operations Maintenance Power & Replacement (OMP&R) expenses. Banking water in Lake Mead reduced energy expenditures. Demand Management and Supply Programs also came in lower than the amount of the adopted budget. However, the reduction in expenditures was less than the reduction in water transactions revenues. As a result, the year-end balance in unrestricted reserves declined by $13 million to $461 million. The $461 million in unrestricted reserves is $204 million over the minimum and $165 million below the target, which in FY2018/19 is $626 million.

Coverage ratios at fiscal year-end are calculated to be 1.43 times for Revenue Bond Debt Service coverage (Senior and Subordinate liens), below the target level of 2.0 times, and 1.40 times for Fixed Charge coverage, above the target level of 1.2 times. The adopted budget projected Revenue Bond Debt Service coverage of 1.6 times and a Fixed Charge coverage ratio of 1.5 times.

FY 2019/20 Outlook

Planning Assumptions for the Adopted Biennial Budget

Key planning assumptions for the FY 2019/20 budget year were as follows at the time the Board adopted the budget: water transactions of 1.75 MAF; use of operating revenues ($120 million) and bond funds ($80 million) to fund budgeted capital expenditures of $200 million; a 50 percent allocation for the State Water Project (SWP) and approximately 838 TAF from the Colorado River Aqueduct; continued funding for conservation and the Local Resources Program (LRP) incentives and funding of supply programs in the region, the Central Valley and the Colorado River system.

Forecast at Mid-Cycle of Biennial Budget

Historically, water revenues and expenditures can quickly change under different local hydrologic conditions. Accordingly, Metropolitan sets its biennial budget and rate-setting processes on average potential conditions and relies on water storage and cash reserves to buffer water demand, revenue and cost volatility. Over the last eight fiscal years, Metropolitan has experienced five drought years[2] bookended by very wet years. However, in the present biennial budget period, both fiscal years have been wet years. FY 2018/19 was the wettest year ever recorded in the Feather River Watershed, and the FY 2018/19 water transactions of 1.42 MAF were the lowest since the 1980s. Metropolitan continues to experience the aftermath of very wet conditions from the winter of 2018/19, resulting in forecasted water transactions for FY 2019/20 at 1.55 MAF, 203 TAF under budget, and forecasted revenues below budget of $201 million. While revenues are expected to be below budget, Metropolitan continues taking steps to meet future dry conditions by storing a record amount of water in storage programs, managing Operations and Maintenance expenditures, maintaining a diverse water supply portfolio, and funding conservation and local resource development.

Unbudgeted expenditures include $26 million for Antelope Valley-East Kern Water Agency High Desert Water Bank Program (AVEK) and $13 million for the Cyclic Cost-Offset Credit program. Authorization for any additional funding for the Regional Recycled Water program is not included in the forecast.

SWC expenditures are forecasted to be slightly over budget. OMP&R costs for CY 2020 are lower as SWC costs are forecasted to be below the projected amounts in prior Statements of Charges. These lower SWC costs are offset by higher capital costs and higher variable energy costs to pump the FY 2019/20 SWP allocation. Colorado River Aqueduct power costs are under budget due to lower energy requirements since Colorado River supplies into the region have been minimized and diverted to storage. The FY 2019/20 budget included funding of approximately $13 million for California WaterFix. This amount remains in the budget awaiting the determination by the Newsom administration to advance a single-tunnel conveyance solution in the Delta to address climate change resiliency and protect the State Water Project Delta conveyance from earthquake risk, consistent with Governor Newsom's Executive Order N-10-19.

Variations in revenues and costs due to hydrology, local resource conditions, emergencies and outages, and economic conditions are managed by use of financial reserves, specifically the Water Rate Stabilization Fund and

[2] FYs 2011/12 through 2015/16

the Revenue Remainder Fund. Absent actions to manage the use of operating revenues in FY 2019/20, unrestricted reserves are projected to decrease by $136 million to $325 million, which is $56 million over the minimum.

Balance of Exchange Agreement Set-Aside

The unrestricted reserves as of June 30, 2019 of $461 million do not include funds held in the Exchange Agreement Set-Aside Fund.

Due to San Diego County Water Authority's (SDCWA) litigation challenging Metropolitan's transportation rate components and pursuant to the exchange agreement between Metropolitan and SDCWA, Metropolitan is required to set aside funds based on the quantities of exchange water that Metropolitan provides to SDCWA and the portion of the payments disputed by SDCWA. This set-aside amount includes disputed payments of the Water Stewardship Rate, paid as a component of the contract price for exchange, and interest earned thereon, which is based on the interest rate earned by Metropolitan's investment portfolio. In April 2016, Metropolitan transferred these funds from unrestricted financial reserves to a new designated fund, the Exchange Agreement Set-Aside Fund. As of June 30, 2019, Metropolitan had set aside $56.5 million in the Exchange Agreement Set-Aside Fund. The amounts held do not include the statutory prejudgment interest, post-judgment interest, attorneys' fees, or costs awarded by the trial court, none of which the exchange agreement requires to be held. Metropolitan has suspended the collection of the Water Stewardship Rate (WSR) on Exchange Agreement deliveries through the end of calendar year 2020, pending the completion of the demand management cost allocation study. Therefore, the Set-Aside Fund balance is increasing in FY 2019/20 only to the extent there is interest earned.

Impact of Suspension of Collecting the Water Stewardship Rate on Exchange Deliveries

In April 2018, the Board approved suspension of billing and collection of the WSR on exchange agreement deliveries to SDCWA for calendar years 2018 through 2020. The total effect of the suspension, taking into consideration the lower revenues over the three calendar years, may be up to approximately $45.8 million by the end of CY 2020 as shown in Table 1 below.

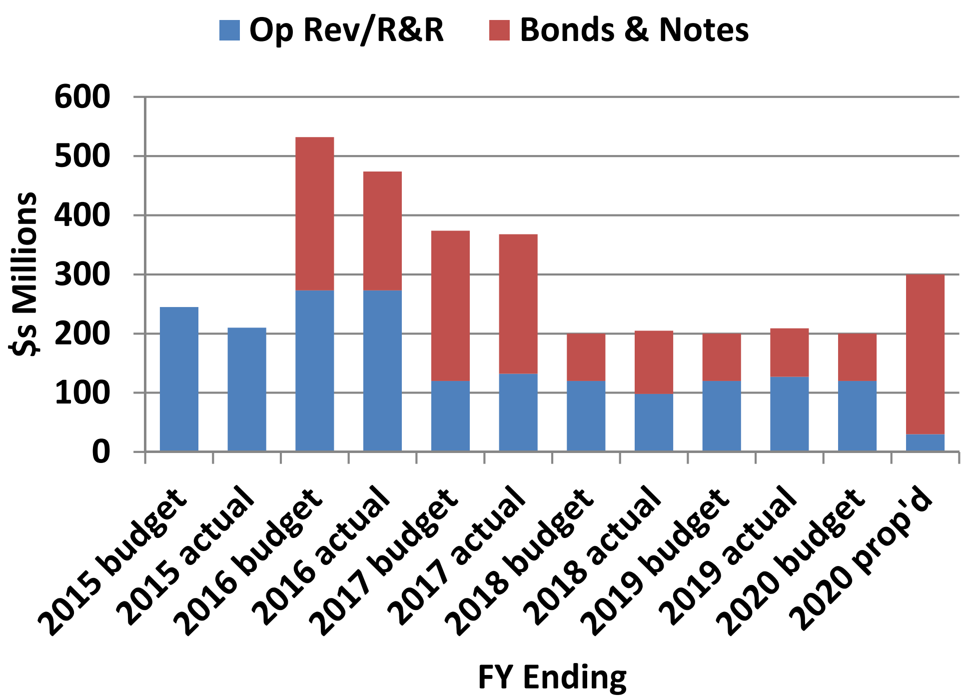
Table 1: Suspension of Collecting the Water Stewardship Rate on Exchange Agreement Deliveries

	Actual CY 2018	**Forecasted CY 2019**	**Forecasted CY 2020**	**Total**
Exchange Deliveries, AF	207,700	239,667	274,500	721,867
WSR Suspended Revenues on Exchange	$11,423,500	$16,537,021	$17,842,500	$45,803,021

Capital Financing, Biennial Budget FY 2014/15 and 2015/16 through FY 2018/19 and 2019/20

Beginning with the FY 2014/15 budget, Metropolitan has planned to use a greater amount of operating revenues to fund capital expenditures. Over this period, a significant amount of the planned capital spending is for Rehabilitation & Replacement (R&R) projects. R&R expenditures are appropriately funded by operating revenues, as the useful life is generally less than a newly constructed facility. The use of increased amounts of operating revenues to fund capital expenditures mitigates future increases in water rates and charges, provides financial flexibility, and supports Metropolitan's high credit ratings. Using operating revenues to fund capital expenditures helps ensure that Metropolitan meets or achieves its coverage targets by generating a margin of revenues over operating and debt expenditures. The following Graph 1 shows the planned and actual use of operating revenues and bonds to fund capital expenditures.

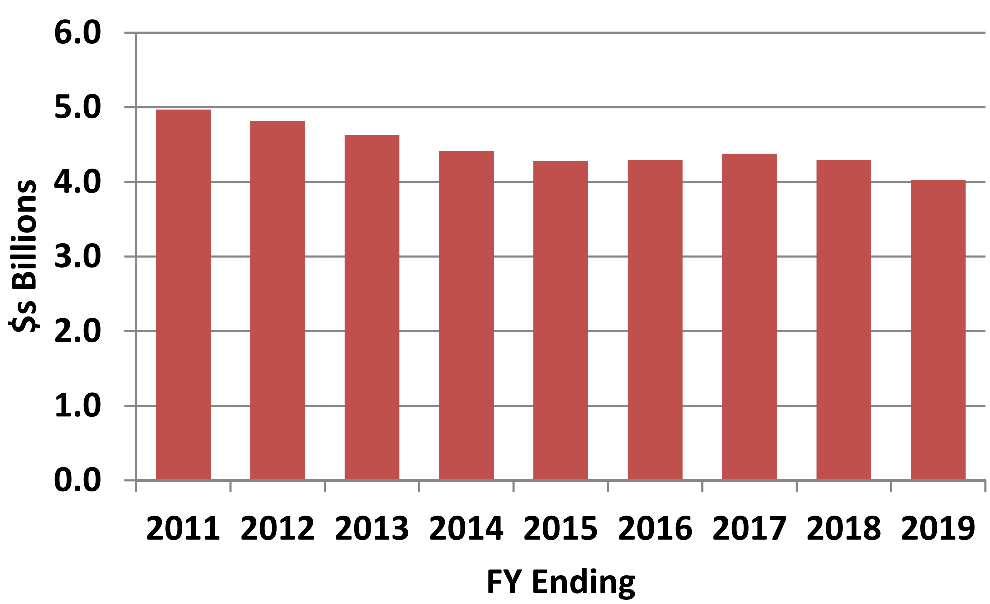
Graph 1: Budgeted and Actual Capital Expenditure Funding



Beginning with FY 2014/15, Metropolitan has budgeted to fund 60 percent or more of capital expenditures from operating revenues. From FY 2014/15 through FY 2018/19, approximately 57 percent of the actual capital expenditures were funded from operating revenues. Consistent with the need for financial flexibility, in FY 2015/16 and 2016/17 subsequently approved capital expenditures necessitated a change to the planned capital funding

The increased use of operating revenues to fund capital expenditures has reduced the amount of bonds that need to be issued, and since FY 2010/11, the amount of outstanding debt, consisting of General Obligation bonds, Revenues Bonds, and other notes and loans, has been decreasing as shown in **Graph 2** below.

Graph 2: Outstanding Debt



Capital Expenditures, FY 2019/20

The planned capital spending as developed by Engineering Services and presented in the capital expenditures section of the FYs 2018/19 and 2019/20 Biennial Budget was estimated to be $514 million over the biennium. Over the last several years, actual expenditures for planned capital projects have been about 20 percent below planned spending. In keeping with that trend, the capital expenditures in the FYs 2018/19 and 2019/20 Biennial Budget were set at 80 percent of Engineering's planned spending or $200 million in each fiscal year. The capital expenditure funding as presented in the FYs 2018/19 and 2019/20 Biennial Budget consisted of $120 million from operating revenues and $80 million from revenue bonds for each fiscal year, or 60 percent from operating revenues and 40 percent from bonds.

Capital expenditures for FY 2018/19 were $213 million, $13 million over the amount of the adopted budget of $200M. For FY 2018/19, Metropolitan issued $80 million in bonds to fund capital expenditures and used operating revenues to fund the balance.

Capital expenditures for FY 2019/20 are forecasted at $300 million, $100 million higher than the amount included in the FY 2019/20 revenue requirement. Unlike the past several years, capital expenditures are forecasted to occur at a faster rate than budgeted.

Recent changes in the appropriation process streamlined capital appropriations, expediting capital project expenditures. In October 2018, the long-term practice of requiring projects to be incrementally funded by phase through detailed monthly requests to the Board of Directors was changed by:

- appropriating all of the estimated funds required to perform the planned capital work through the end of June 2020;
- authorizing the General Manager to initiate or proceed with all planned capital projects for fiscal years 2018/19 and 2019/20; and,
- delegating to the General Manager the authority to determine whether a project is exempt from the California Environmental Quality Act.

The overall result has been an expedited process to complete design work and award construction contracts, thereby also expediting capital expenditures on several major projects such as:

- replacement of the 6.9kV power cables to all nine pumps at each of the five Colorado River Aqueduct Pumping Plants – $16.5 million;
- replacement of the Greg Avenue Pumping Facility – $21 million;
- refurbishment of the sumps and circulating water systems at each of the five CRA Pumping Plants - $26.9 million; and,
- seismic improvements to the Union Station Headquarters Building – $44 million.

The long-term effort to plan and implement the relining of the Prestressed Concrete Cylinder Pipe sections of the Sepulveda and Second Lower Feeders cleared several permitting and operational hurdles, including pre-qualifying contractors and pre-ordering the steel pipe liner segments. Two major contracts have been awarded to date with steel pipe liners currently being fabricated for a third contract to be awarded in FY 2020/21.

Proposed Capital Financing, FY 2019/20

In order to maintain reserves, Metropolitan proposes to adjust the planned capital financing for FY 2019/20 while still using a combination of operating revenues and bond funds. This adjustment from the planned capital financing in the current biennial budget is a result of lower operating revenues and the anticipated acceleration of $100 million in planned capital expenditures. It is proposed that $30 million of capital expenditures be funded from operating revenues and $270 million be funded from bond funds, or 10 percent from operating revenues and 90 percent from bonds. The use of bonds to fund $270 million of capital expenditures will conserve reserves that may be necessary to buffer changes to revenues and expenditures and to mitigate future rate increases.

Over the past nine fiscal years, Metropolitan has been steadily reducing its overall debt obligations by aggressively using operating revenues to fund a significant portion of its capital expenditures and by carefully managing the overall capital expenditure budget. This policy approach allows Metropolitan the flexibility to adjust its capital funding when changed conditions warrant adjustments. Furthermore, the current debt market is very favorable for municipal bonds, making this a good time to issue low-interest debt.

Metropolitan has executed a $200 million Short-Term Revolving Credit Facility under which Metropolitan may borrow from time-to-time. Funds drawn under the Short-Term Revolving Credit Facility may be used for any lawful purpose. No draws were made in FY 2018/19. The current financial forecast for FY 2019/20 assumes a draw of $100 million in October 2019 to fund capital expenditures until bonds are issued later this fiscal year, at which time the draw will be repaid.

In July 2019, the Board adopted a resolution authorizing the reimbursement of capital expenditures from bond proceeds for FYs 2018/19 and 2019/20. This resolution allows Metropolitan to issue bonds later in FY 2019/20 and reimburse the use of operating revenues used to pay for capital expenditures from May 10, 2019 (60 days prior to the adoption) forward, and makes the proposed change to the capital financing plan for FY 2019/20 feasible.

With the proposed changes to the capital financing for FY 2019/20, the unrestricted reserves at June 30, 2020, are forecasted to be $415 million, $146 million over the minimum. The proposed change will be effective only if the Board approves the bonds when they are brought before the Board for action.

Summary

The biennial budget adopted by the Board met the Board's financial policies by providing anticipated revenues that met the anticipated cost of Metropolitan's services, met the Fixed Charge coverage target, and promoted long-term fiscal sustainability goals as reflected in the ten-year forecast. The biennial budget also projected the Revenue Bond Debt Service coverage would meet target within five fiscal years. However, the lower revenue forecast based on the recent extraordinary wet year will result in lower financial policy coverage ratios at the end of FY 2019/20. The Revenue Bond Debt Service coverage (Senior and Subordinate liens) is forecasted to be 1.4 times, below the target level of 2.0 times, and the Fixed Charge coverage is forecasted to be 1.2 times, at the target level of 1.2 times. In addition, planned capital expenditures are accelerated by the more recent streamlined capital appropriations process, which results in capital expenditures exceeding the budget for FY 2019/20. For all these reasons, staff recommends an adjustment in financing capital expenditures to increase bond funds.

Items that May Impact the Next Biennial Budget, FY 2020/21and FY 2021/22

Metropolitan will begin work in the fall on its next biennial budget, covering FY 2020/21 and FY 2021/22, and rates and charges effective January 1, 2021, and January 1, 2022. Significant issues to consider for the next biennial budget are discussed below.

- <u>Water Transactions</u>: Metropolitan's fiscal year average water transactions over the last fifteen years is about 1.9 MAF. However, the average over the last five fiscal years (FY 2014/15 thru FY 2018/19) is about 1.62 MAF. Taking the FY 2019/20 forecast of 1.55 MAF into account, the five-year average of water transactions (for FY2015/16 through FY2019/20) decreases to 1.55 MAF. Changing demographics, demand management, and improved hydrologic conditions since FY 2016/17 have contributed to Metropolitan's lower water transactions. While hydrologic conditions are unpredictable and cycles of low sales are expected, it may be that Metropolitan is moving to a new, lower level of water transactions. The current ten-year forecast assumes fiscal year transactions of 1.8 MAF from FY 2020/21 through FY 2027/28. Metropolitan will evaluate whether to lower budgeted transactions. The prospect of lower, long-term transactions will have an impact on Metropolitan's future revenues and funding decisions.

- <u>Cost to Replenish Storage</u>: Metropolitan is projected to have a record 4 MAF in storage by December 2019 as a result of recent favorable hydrologic conditions. Given lower water transactions and improved local conditions, Metropolitan will carefully consider implementation of future storage actions.

- <u>Demand Management and Resource and System Resiliency</u>: Metropolitan's current rates support $43 million per year for conservation and approximately $43 million in LRP incentives. Appropriate levels needed to fund conservation and local resource investment programs will be reviewed in the next biennial budget and long-range forecast.

Also undetermined at this time is the direction and cost of the Regional Recycled Water Program for FY 2019/20. Current estimates for environmental planning over the next three years under a traditional programmatic environmental impact report approach are $20 million to $33 million.

The estimated costs of the California WaterFix/Delta conveyance are currently factored into the ten-year forecast beginning in FY 2018/19. Metropolitan is committed to supporting and participating in the construction of a Delta conveyance project that meets the reliability level established in the 2015 Integrated Resources Plan Update. However, a revised construction schedule and updated cost estimates need to be reflected in the next biennial budget and ten-year forecast.

- Long-Range Financial Forecast: As part of the biennial budget and rate-setting process, the ten-year forecast will be updated to incorporate changes to water transactions, revenues and expenditures, and any other changes to underlying assumptions such as investment and funding decisions.

Policy

Metropolitan Administrative Code Section 5107: Biennial Budget Process

Metropolitan Administrative Code Section 5108: Appropriations

Metropolitan Administrative Code Section 5109: Capital Financing

Metropolitan Administrative Code Section 5200: Funds Established

Metropolitan Administrative Code Section 5202: Fund Parameters

Fiscal Impact

For FY 2019/20, forecasted total revenues are $201 million below budget; using $120 million of operating revenues to fund capital expenditures, total expenditures would be $8 million under budget. Unrestricted reserves at June 30, 2020 would be $325 million, $56 million over the minimum and $329 million below target. With the proposed change to capital financing to use $30 million in operating revenues to fund capital expenditures with the balance funded with bond funds, total expenditures would be $98 million under budget. Under this updated financing plan, unrestricted reserves at June 30, 2020, are forecasted to be $415 million, $146 million over the minimum and $239 million below target. Revenue Bond Debt Service coverage (Senior and Subordinate liens) is forecasted to be 1.4 times, below the target level of 2.0 times, and the Fixed Charge coverage is forecasted to be 1.2 times, at the target level of 1.2 times.

8/22/2019

June M. Skillman — *Date*
Interim Assistant General Manager/
Chief Financial Officer

8/28/2019

Jeffrey Kightlinger — *Date*
General Manager

Ref# cfo12668664