THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

INFORMATION

- Board of Directors
  Finance and Insurance Committee

2/9/2016 Board Meeting

[Board Letter Number]

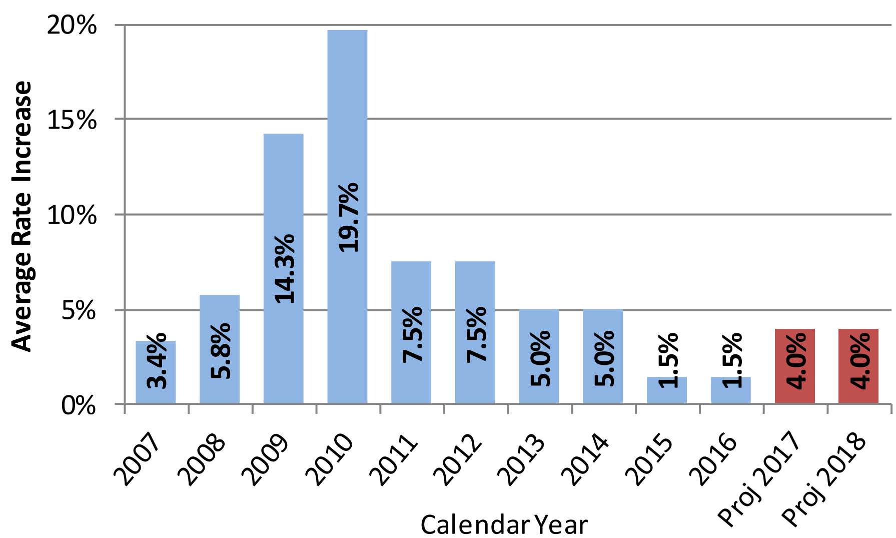
Subject

Proposed biennial budget and revenue requirements for fiscal years 2016/17 and 2017/18; estimated water rates and charges for calendar years 2017 and 2018 to meet revenue requirements; and ten-year forecast.

Executive Summary

This letter presents the proposed biennial budget and revenue requirements for fiscal years 2016/17 and 2017/18 (FY 2016/17 and FY 2017/18), estimated water rates and charges for calendar years 2017 and 2018 to meet the proposed budget, and a ten-year financial forecast. This budget provides funding for Metropolitan's key priorities while working to achieve and maintain all financial policy guidelines, with proposed overall rate increases of 4.0 percent in each year of the proposed biennial budget, and the ten-year forecast projects overall rate increases in the range of 4 to 5 percent thereafter for the remainder of the ten-year period. The proposed overall rate increases of 4.0 percent are squarely within the previous projection of rate increases between 3 to 5 percent. The estimated rates are based on Metropolitan's current methodology for developing rates and charges to produce the necessary revenue required to cover costs.

Figure 1: Historic and Projected Overall Rate Increases



Attachment 1 provides the Biennial Budget for FY 2016/17 and FY 2017/18. It includes the Summary, describing the proposed appropriations, fund summaries, sources of funds, uses of funds, staffing plan, and summary of the financing for the Capital Investment Plan; the Departmental budget information; and a new section of the document which describes the General District Requirements, comprised of the State Water Project, Colorado River Aqueduct, Supply Programs, Demand Management, and Capital Financing.

Attachment 2 provides the Ten-Year Financial Forecast.

Table 1: Estimated Full Service Rates and Charges

Rates and Charges Effective January 1st	2016 Approved	2017 Estimated	$ increase (Decrease)	2018 Estimated	$ increase (Decrease)
Full Service Untreated Volumetric Cost ($/AF)					
Tier 1	$594	$666	12.1%	$695	4.4%
Tier 2	$728	$760	4.4%	$781	2.8%
Treatment Surcharge ($/AF) (1)	$348	$313	(10.1%)	$320	2.2%
Full Service Treated Volumetric Cost ($/AF)					
Tier 1	$942	$979	3.9%	$1,015	3.7%
Tier 2	$1,076	$1,073	(0.3%)	$1,101	2.6%
Readiness-to-Serve Charge ($M)	$153	$135	(11.8%)	$140	3.7%
Capacity Charge ($/cfs)	$10,900	$8,000	(26.6%)	$8,700	8.8%

(1) A proposal will be presented to the Board for consideration to address fixed cost recovery of Treatment costs which are currently only recovered through a volumetric rate.

Description

Key Assumptions

In response to continuing drought conditions, in 2015 the Governor of the state of California called for Californians to reduce statewide water use by 25 percent. The Governor's Executive Order is likely to remain in place until October 2016 and could continue beyond as conditions warrant. In addition, Metropolitan implemented a Water Supply Allocation, asking member agencies to reduce wholesale water demands by 15 percent for Fiscal Year 2015/16 (FY 2015/16). Metropolitan has weathered these supply challenges by realizing the benefits of supply and storage investments made over the last 20 years.

Metropolitan continues to be prepared to meet the challenges of reliably supplying water to its service area throughout a variety of hydrologic conditions. Metropolitan has a diverse portfolio of water supplies, which have been augmented by additional programs approved by the Board over the last biennial budget period. Metropolitan's substantial investments in storage and supply programs are available to store supplies for future periods should calendar year 2016 be hydrologically wet. Metropolitan's water sales can vary widely. It is reasonable for Metropolitan to determine its biennial budget and rate setting processes on more normal conditions and rely on cash reserves to buffer revenue and cost volatility.

Water sales projection: Water sales are projected to be 1.7 million acre-feet (MAF) for both years of the biennial budget, below the 1.75 MAF budgeted for FY 2015/16. These projections assume an average year hydrology, and reflect the expectation that demands will continue to be dampened for some period due to consumer response to the drought and the Governor's Executive Order. The projection also incorporates the implementation of local resource projects, such as the San Diego County Water Authority (SDCWA) Carlsbad desalination project and the Orange County Groundwater Replenishment System expansion project, both of which will be operational in 2016 and produce a combined 80 thousand acre-feet (TAF) annually. The recent water sales trend is shown in **Attachment 1**, Biennial Budget Summary.

State Water Project (SWP): Assumes deliveries into the region of 865 TAF for FY 2016/17 and 882 TAF for FY 2017/18. This is based on a 50 percent allocation, net of deliveries to Metropolitan's SWP storage programs.

Colorado River Aqueduct (CRA): Assumes deliveries into the region of 857 TAF for FY 2016/17 and 882 TAF for FY 2017/18. This assumes diversions at Intake of approximately 1.0 MAF, and accounts for utilization of Metropolitan's Colorado River storage programs.

Capital Investment Plan (CIP): Assumes that expenditures for the CIP will be managed by focusing on projects that are critical to maintaining water quality, reliability and safety. The CIP for the biennial period totals $400 million. FY 2016/17 and FY 2017/18 are $200 million each, which is $68 million less than the budget for FY

2015/16 and $156 million less for the same biennial period when compared to the prior ten-year forecast. The CIP reflects the deferral of facility expansion and other projects that do not enhance reliability or system delivery flexibility while addressing aging infrastructure.

In the last biennial budget, the Board established a target of funding 60 percent of the projected expenditures in the CIP from revenues (PAYGo). This level of PAYGo funding has been maintained, which is $240 million over the biennial period, and is appropriate given the significant portion of the CIP that is focused on replacement and refurbishment of capital facilities. Using a higher level of PAYGo also lessens the pressure on water rates from debt service payments in future years and provides financial flexibility in years when revenues may be lower than expected. Compared to the same biennial period in the prior ten-year forecast, this $240 million PAYGo funding is $164 million lower.

The impact of lowering the CIP and resulting PAYGo expenditures provides significant cost relief to keep the necessary rate increases in the 3 to 5 percent range in the face of increasing costs for other expenditures.

Resolution of Reimbursement: The biennial budget proposes to fund 60 percent of capital expenditures from operating revenues, or PAYGo. In order to preserve financial flexibility to meet unexpected contingencies, a Resolution of Reimbursement will be provided to the Board for consideration and approval. The Resolution of Reimbursement would authorize the use of tax-exempt bond proceeds or other forms of indebtedness to reimburse capital expenditures for projects funded from the General Fund and the Replacement and Refurbishment (R&R) Fund. The availability of debt funding sources for capital projects initially paid or to be paid by the General Fund and R&R Fund would provide Metropolitan with additional financial flexibility by funding all or a portion of planned CIP expenditures from bond proceeds.

Operations and Maintenance (O&M): The FY 2016/17 budget includes $417.7 million for O&M, including labor and benefits, water treatment chemicals, power, solids handling, professional services, and operating equipment purchases. This is $0.9 million, or 0.2 percent, lower than the FY 2015/16 budget of $418.5 million, due primarily to efforts to manage O&M cost levels as low as possible.

The FY 2017/18 budget includes $419.8 million for O&M, including labor and benefits, water treatment chemicals, power, solids handling, professional services, and operating equipment purchases. This is $2.1 million, or 0.5 percent, higher than the FY 2016/17 budget, due primarily to inflationary increases in costs.

The biennial budget assumes funding for approximately 1,840 full time equivalent employees, less than the authorized regular full time position count of 1,912 in FY 2016/17 and 1,910 in FY 2017/18. The reduced funding was achieved by unfunding positions and assuming that some positions would remain vacant for portions of the budget year. This reduction in staffing helps ensure that Metropolitan can manage O&M expenses to keep required rate increases as low as possible. Metropolitan will continue to provide full funding of the annual required contribution to its pension and Other Post-Employment Benefits obligations (OPEB, or retiree medical) accounts. Previous investments to address underfunded liabilities, including OPEB, have resulted in lower benefits costs in the biennial budget period.

Maintain the ad valorem tax rate at the current level: It is proposed that the Board continue to suspend the ad valorem tax limit pursuant to the MWD Act, as the Board has done since the FY 2013/14 tax levy, to maintain the ad valorem tax rate at the current level of .0035 percent of assessed value for both fiscal years. This is projected to generate ad valorem tax revenues of $98.3 million in FY 2016/17 and $100.5 million in FY 2017/18. Over the biennial budget period, maintaining the ad valorem tax rate at the current level is essential to the fiscal integrity of the District as it will provide revenues that can be used to pay for growing state water contract costs, help to maintain a balance between fixed and variable revenues, and reduce the need for future water rate increases.

A public hearing at which interested parties may provide input regarding action on ad valorem tax rates pursuant to Section 124.5 of the MWD Act is proposed at the same time and place as the Board sets for the public hearing on proposed rates and charges.

SDCWA exchange agreement set-aside: Due to the SDCWA's litigation challenging Metropolitan's rates, Metropolitan currently holds $228.2 million in its financial reserves in accordance with the 2003 Amended and Restated Exchange Agreement between Metropolitan and SDCWA (exchange agreement). This amount includes $188.3 million associated with exchange agreement water deliveries from January 2011 through December 2014, $35.3 million associated with exchange agreement water deliveries since January 2015, and accumulated interest on both amounts. Amounts held pursuant to the exchange agreement will continue to accumulate while the litigation, including all appeals, is pending based on the quantities of exchange agreement water that Metropolitan provides to SDCWA and the amount of charges disputed by SDCWA. In accordance with the exchange agreement, the amounts held are SDCWA's payments under the exchange agreement that are in dispute and interest earned thereon, which is based on Metropolitan's investment portfolio. The amounts held do not include the statutory prejudgment interest award or statutory post-judgement interest, neither of which the exchange agreement requires to be held.

To provide greater clarity on the amount of the exchange agreement set-aside, Metropolitan proposes to establish a designated fund to hold these amounts. The fund would be separate from Metropolitan's Water Rate Stabilization Fund and Revenue Remainder Fund and would continue to be invested with Metropolitan's short-term investments managed by the Treasurer until such time as the litigation is resolved.

Working capital: Staff will propose to the Board that Metropolitan make working capital borrowings, in part, to pay for O&M costs and replenish the reserve funds pending a final decision in the litigation.

Continued Funding of Key Priorities

Management of Water Storage Accounts: Metropolitan has made significant investments in the ability to develop supplies and store water to ensure regional water supply reliability, and as the last several years have demonstrated, Metropolitan has realized the benefits of those supply and storage investments. Current storage balances are low, due to successive years of withdrawals. The proposed biennial budget provides funding for continued use of storage in Metropolitan's service area, the Central Valley, and the Colorado River system. Supply programs are budgeted at $78.7 million for FY 2016/17 and $81.7 million for FY 2017/18. Supply programs and the proposed budget are discussed in **Attachment 1**.

Demand Management costs: Demand Management costs include Metropolitan's Conservation Credits Program (CCP) costs and the Local Resources Program (LRP) costs. To ensure that Metropolitan's member agencies and retail water agencies meet the per capita water consumption reductions in SB X7-7 of 20 percent by 2020, the CCP budget is proposed to increase from $20 million in the FY 2015/16 budget to $27 million in FY 2016/17 and $32 million in FY 2017/18. These amounts include the external administrative costs to manage the incentive payments. The LRP expenditures of approximately $43.7 million in FY 2016/17 and $41.9 million in FY 2017/18 continue to reflect incentives for LRP projects, existing and anticipated, which are eligible based on project costs.

In addition, $4.4 million is budgeted in FY 2016/17 and $2.0 million in FY 2017/18 for Future Supply Actions to support the 2015 Update to the Integrated Resources Plan. Demand Management costs in the proposed budget are discussed in **Attachment 1**.

Proposed Revenue Requirements

To support Metropolitan's biennial budget, ten-year forecast, and financial planning, the revenue requirements for FY 2016/17 are estimated to be $1.6 billion and for FY 2017/18 are estimated to be $1.6 billion. As shown in Table 2, the revenue requirement for FY 2016/17 is about $64 million more than the revenue requirement used to set rates for FY 2015/16. Expenditures are projected to slightly increase by approximately $53 million compared to the FY 2015/16 revenue requirement, while revenue offsets are projected to be about $11 million lower. Capital paid for with operating revenues (PAYGo) decreases by $101 million, offset by higher costs for the SWP, CRA power, Demand Management costs and Supply Programs costs.

In FY 2017/18, expenditures are projected to be approximately $7 million more than FY 2016/17. Increases are budgeted for SWP costs, CRA power costs and debt service. Revenue offsets are $7 million higher, offsetting the net increase in expenditures.

Table 2: Estimated Revenue Requirements for FY 2016/17 and FY 2017/18, $ millions

Fiscal Year Ending	2015/16 Adopted	2016/17 Proposed	2017/18 Proposed
Departmental and Other O&M	390	393	395
Variable Treatment	28	24	25
State Water Project (without Variable Power)	328	435	447
State Water Project Variable Power	187	147	153
CRA Power	37	47	54
Supply Programs	66	79	82
Demand Management	62	75	76
Debt Service	325	328	344
PAYGO	221	120	120
Change in Required Reserves	18	65	25
Subtotal Expenditures	**1,661**	**1,714**	**1,721**
Revenue Offsets	150	139	146
Total Revenue Requirement	**1,511**	**1,575**	**1,574**

Rates and Charges for 2017 and 2018

The estimated rates and charges to support the estimated revenue requirements were developed using the methodology previously approved by the Board and implemented since the Board adopted the current rate structure in October 2001. An overall rate increase of 4.0 percent effective January 1, 2017 and January 1, 2018 is appropriate to cover the costs in the proposed budget for FY 2016/17 and FY 2017/18, meet financial policy guidelines with the exception of revenue bond coverage, and maintain steady rates for the future.

The specific elements of the proposed rate increase effective January 1, 2017 and January 1, 2018 are shown in Table 3, "Estimated Rates and Charges". The estimated rates and charges for FY 2016/17 are based on the proposed revenue requirement of $1.6 billion shown in Table 2. The existing rates, which were effective January 1, 2016, and the rates under a 4.0 percent increase, effective January 1, 2017, would generate combined revenue of $1.5 billion based on total sales of 1.7 MAF, of which 822 TAF is treated and 180 TAF is untreated exchange agreement water.

The estimated rates and charges for FY 2017/18 are based on the proposed revenue requirement of $1.6 billion shown in Table 2. Projected revenues from rates and charges in FY 2017/18 are $1.5 billion on total sales of 1.7 MAF, of which 826 TAF is treated and 195 TAF is untreated exchange agreement water.

<u>Treatment costs</u>: Over the last 18 months, staff has thoroughly reviewed operating and capital financing costs assigned to the Treatment service function to ensure that only costs associated with providing treatment service are included. Going forward, capital projects at the Treatment plants will be reviewed to ensure they are appropriately identified to the service function served.

A proposal will be presented to the Board for consideration to address fixed cost recovery of Treatment costs which are currently only recovered through a volumetric rate.

Table 3: Estimated Rates and Charges

Rates & Charges Effective January 1st	2016	2017	% Change	2018	% Change
Tier 1 Supply Rate ($/AF)	$156	$201	28.8%	$209	4.0%
Tier 2 Supply Rate ($/AF)	$290	$295	1.7%	$295	0.0%
System Access Rate ($/AF)	$259	$289	11.6%	$299	3.5%
Water Stewardship Rate ($/AF)	$41	$52	26.8%	$55	5.8%
System Power Rate ($/AF)	$138	$124	(10.1%)	$132	6.5%
Full Service Untreated Volumetric Cost ($/AF)					
Tier 1	$594	$666	12.1%	$695	4.4%
Tier 2	$728	$760	4.4%	$781	2.8%
Treatment Surcharge ($/AF) (1)	$348	$313	(10.1%)	$320	2.2%
Full Service Treated Volumetric Cost ($/AF)					
Tier 1	$942	$979	3.9%	$1,015	3.7%
Tier 2	$1,076	$1,073	(0.3%)	$1,101	2.6%
Readiness-to-Serve Charge ($M)	$153	$135	(11.8%)	$140	3.7%
Capacity Charge ($/cfs)	$10,900	$8,000	(26.6%)	$8,700	8.8%
Overall rate increase			4.0%		4.0%

(1) A proposal will be presented to the Board for consideration to address fixed cost recovery of Treatment costs which are currently only recovered through a volumetric rate.

Metropolitan's volumetric rates recover operating costs as well as the portion of the conveyance and distribution system capital costs that are associated with meeting average water demands. The Readiness-to-Serve (RTS) Charge recovers system capital costs for emergency storage capacity and ensures there is adequate capacity in the conveyance and distribution systems to reliably deliver supplies during emergencies and major facility outages. The Capacity Charge recovers distribution system capital costs necessary to provide peaking capacity on Metropolitan's distribution system during the summer.

The rates estimated for January 1, 2017 reflect higher costs for SWP costs, Demand Management costs, Supply Program costs, and CRA Power costs, offset by a reduction in PAYGo amounts. The Treatment Surcharge decreases due to the lower PAYGo amounts, as do the Readiness-to-Serve Charge and the Capacity Charge. The Capacity Charge is also lower due to the decrease in sales from 1.75 MAF in FY 2015/16 to 1.70 MAF in FY 2016/17 and FY 2017/18, which is projected to lower the amount of the system capacity needed to meet peak demands. Considering the increase in volumetric rates and the decrease in fixed charges, overall rate impacts to member agencies should be reflective of an overall rate increase of 4.0 percent.

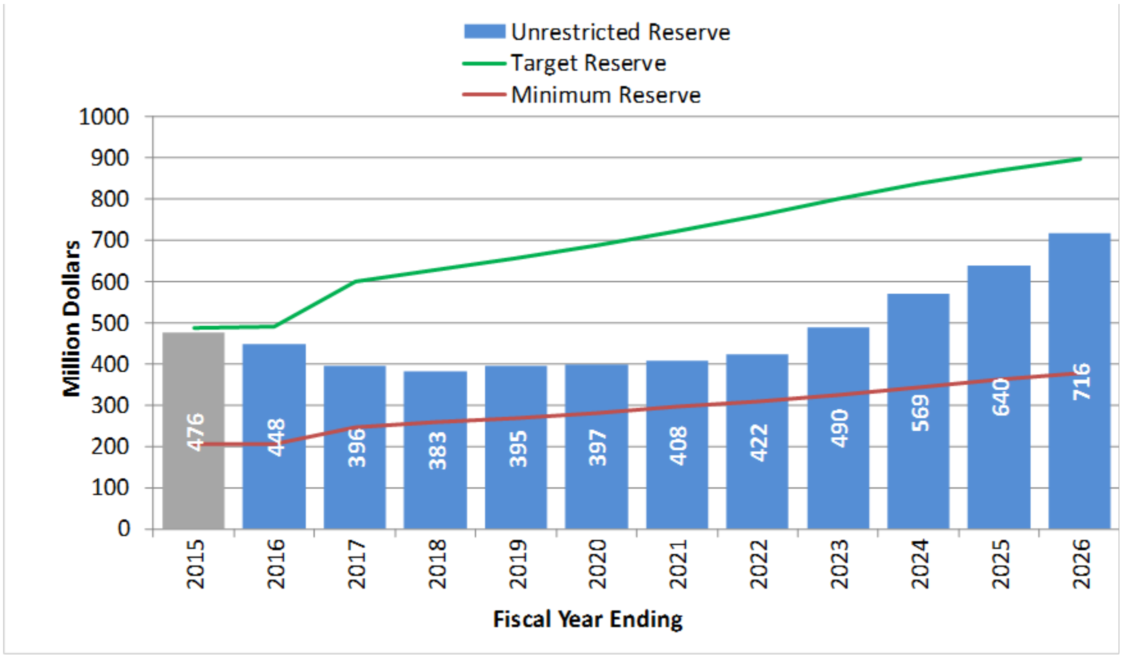
Rates effective January 1, 2018 are largely consistent with the 4.0 percent overall increases in costs as there are no significant cost changes from FY 2016/17 to FY 2017/18. The increase in the Capacity Charge is a little higher than the 4.0 percent overall increase due to a decrease in the expected aggregate member agency peak day demands; the total dollars recovered by the charge are increasing by 4.3 percent. The Tier 1 Supply Rate increase is due to the change in costs that are assigned to the Supply function, specifically the SWP Delta Water Charges and the Supply Programs.

Ten-Year Forecast

The proposed biennial budget sets the foundation for consistent, reasonable rate increases over the ten-year planning period. Investments previously made to address underfunded liabilities resulted in lower labor costs, and combined with maintaining the ad valorem tax rate at its current level throughout the ten-year period and reduced

CIP expenditures, help offset Metropolitan's forecasted share of the cost of the California Water Fix should that project move forward. Rate increases from FY 2018/19 through FY 2025/26 are projected to be 4 to 5 percent each year. The ten-year forecast is presented in **Attachment 2**.

Figure 2: Project Rate Increases, Reserves and Financial Indicators



Ave Rate Increase	1.5%	1.5%	4.0%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Sales, MAF	1.90	1.63	1.70	1.70	1.75	1.75	1.75	1.75	1.80	1.80	1.80	1.80
Rev. Bond Cvg	2.7	1.5	1.6	1.6	1.7	1.8	1.9	2.0	2.3	2.4	2.6	2.7
Fixed Chg Cvg	2.4	1.3	1.3	1.3	1.4	1.4	1.4	1.4	1.5	1.5	1.5	1.5
PAYGO, $M	210	99	120	120	120	120	120	123	127	130	133	137

Next Steps

The following sets forth the proposed schedule for the biennial budget and revenue requirements for fiscal years 2016/17 and 2017/18, and proposed water rates and charges for calendar years 2017 and 2018.

February 8, 2016	F&I Committee, Workshop #1
February 23, 2016	Workshop #2
February 26, 2016	Notice to Legislature
March 7, 2016	F&I Committee, Workshop #3
March 8, 2016	Public Hearing on estimated water rates and charges and suspension of the tax limit pursuant to Section 124.5 of the MWD Act
March 22, 2016	Workshop #4
April 11, 2016	F&I Committee, Recommend Biennial Budget and Calendar Year rates and charges
	Workshop #5, if needed
April 12, 2016	Board action, approving Biennial Budget and Calendar Year rates and charges

Policy

Metropolitan Water District Act Section 61: Ordinances, Resolutions and Orders

Metropolitan Water District Act Section 124.5: Ad Valorem Tax Limitation

Metropolitan Water District Act Section 130: General Powers to Provide Water Services

Metropolitan Water District Act Section 133: Fixing of Water Rates

Metropolitan Water District Act Section 134: Adequacy of Water Rates; Uniformity of Rates

Metropolitan Water District Act Section 134.5: Water Standby or Availability of Service Charge

Metropolitan Water District Administrative Code Section 4304: Apportionment of Revenues and Setting of Water Rates

Metropolitan Water District Administrative Code Section 5107: Biennial Budget Process

Metropolitan Water District Administrative Code Section 5200(b): Funds Established

Fiscal Impact

The proposed biennial budget provides funding for Metropolitan's key priorities while working to achieve and maintain Metropolitan's financial policy guidelines, with proposed overall rate increases of 4.0 percent in each year of the proposed biennial budget.

Name *Date*
Title

Jeffrey Kightlinger *Date*
General Manager

Attachment 1 – Biennial Budget FY 2016/17 and FY 2017/18
Attachment 2 – Ten-Year Financial Forecast

Ref# 30T