CAPITAL FINANCING

OVERVIEW

Capital financing costs are Metropolitan's expenditures for revenue bond debt service, General Obligation bond debt service, debt administration costs, the funding of capital expenditures from current operating revenues, or Pay-As-You-Go (PAYGo), and State Revolving Fund (SRF) Loan payments.

The budgeted costs for capital financing are as follows:

Capital Financing Cost Summary, $ millions

	2014/15 Actual	2015/16 Budget	2016/17 Proposed	Change from 2015/16	2017/18 Proposed	Change from 2016/17
Debt Service, net of BABs Reimbursement	$266.3	$296.4	$298.7	$2.3	$318.3	$19.6
GO Bond Debt Service	23.4	23.3	23.3	0	18.8	(4.5)
SRF Loan	1.3	1.3	1.3	0	1.3	0
Debt Administration	2.7	3.7	5.5	1.8	6.0	0.5
PAYGo	210.2	221.0	120.0	(101.0)	120.0	0
Total[1]	**$503.9**	**$545.7**	**$448.6**	**$(97.1)**	**$464.4**	**$15.8**

[1] Does not include Departmental costs reflected elsewhere in this Budget.

Budgeted amounts for Capital Financing represent the expenditures for existing and future debt service, anticipated debt administration costs to support the debt portfolio, and lower PAYGo amounts to support a lower Capital Investment Plan. Metropolitan generally incurs long-term debt to finance projects or purchase assets which will have useful lives equal to or greater than the related debt. Revenue supported debt can be authorized by Metropolitan's Board of Directors.

CAPITAL INVESTMENT PLAN

The Capital Investment Plan (CIP) for FY 2016/17 and FY 2017/18 is estimated to be $200.0 million in each fiscal year. It is proposed to be funded by current operating revenues (PAYGo) and revenue bond proceeds. The FY 2016/17 CIP is $67.9 million lower than the FY 2015/16 Adopted budget, and the FY 2017/18 CIP is unchanged from FY 2016/17. The largest areas of expenditures in the biennial budget are Infrastructure Reliability and Water Quality.

PAYGo Percentage of Funding, $ millions

	2015/16 Budget	2016/17 Proposed	2017/18 Proposed
Capital Investment Plan expenses	$267.9	$200.0	$200.0
Project Funding:			
New Bond Issues		110.0	80.0
Prior Bond Funds/Construction Fund		20.0	50.0
Grants and Loans Funds			
Operating Revenues (PAYGo)	221.0	120.0	120.0
R&R Fund	47.0		
PAYGo Percentage of Funding	100.0%	60.0%	60.0%

In FY 2016/17 and FY 2017/18, the percentage of capital that is funded by debt will be set at 40 percent, consistent with the FY 2014/15 and FY 2015/16 ten-year forecast for this time period. The projected average percentage of capital funded from debt will be 40 percent over the ten years of the long-range forecast.

OUTSTANDING DEBT

Metropolitan has total long-term debt outstanding of $4.24 billion as of December 31, 2015. Metropolitan's debt issues are summarized below and discussed in detail thereafter.

Outstanding Debt, $'s, as of December 31, 2015

Issue	Debt Outstanding
Long-Term Debt:	
Water Revenue Refunding Bonds, 1993 Series A	$86,540,000
Water Revenue Bonds, 2000 Authorization, Series B-3	88,800,000
Water Revenue Bonds, 2005 Authorization, Series C	175,000,000
Water Revenue Refunding Bonds, 2006 Series B	24,055,000
Water Revenue Bonds, 2006 Authorization, Series A	389,235,000
Water Revenue Refunding Bonds, 2008 Series A-2(1)	62,465,000
Water Revenue Refunding Bonds, 2008 Series B	126,980,000
Water Revenue Refunding Bonds, 2008 Series C	34,700,000
Water Revenue Bonds, 2008 Authorization, Series A	183,525,000
Water Revenue Refunding Bonds, 2009 Series A-2(1)	104,180,000
Water Revenue Refunding Bonds, 2009 Series B	106,690,000
Water Revenue Refunding Bonds, 2009 Series C	91,165,000
Water Revenue Bonds, 2008 Authorization, Series B	12,735,000
Water Revenue Bonds, 2008 Authorization, Series C(2)	78,385,000
Water Revenue Bonds, 2008 Authorization, Series D(2)	250,000,000
Water Revenue Refunding Bonds, 2009 Series D	58,860,000
Water Revenue Refunding Bonds, 2009 Series E	15,590,000
Water Revenue Bonds, 2010 Authorization, Series A(2)	250,000,000
Water Revenue Refunding Bonds, 2010 Series B	79,330,000
Water Revenue Refunding Bonds, 2011 Series A1-A4(1)	228,875,000
Water Revenue Refunding Bonds, 2011 Series B	35,760,000
Water Revenue Refunding Bonds, 2011 Series C	147,935,000
Water Revenue Refunding Bonds, 2012 Series A	181,180,000
Water Revenue Refunding Bonds, 2012 Series B-1 and B-2(1)	98,585,000
Water Revenue Refunding Bonds, 2012 Series C	190,600,000
Water Revenue Refunding Bonds, 2012 Series D	605,000
Water Revenue Refunding Bonds, 2012 Series E3	31,220,000
Water Revenue Refunding Bonds, 2012 Series F	59,335,000
Water Revenue Refunding Bonds, 2012 Series G	111,890,000
Special Variable Rate Water Revenue Refunding Bonds, 2013 Series D(1)	87,445,000
Special Variable Rate Water Revenue Refunding Bonds, 2013 Series E(1)	104,820,000
Water Revenue Refunding Bonds, 2014 Series A	95,935,000
Water Revenue Refunding Bonds, 2014 Series B	10,575,000
Water Revenue Refunding Bonds, 2014 Series C1-C3	30,335,000
Special Variable Rate Water Revenue Refunding Bonds, 2014 Series D(1)	63,575,000
Water Revenue Refunding Bonds, 2014 Series E	86,060,000
Water Revenue Refunding Bonds, 2014 Series G1-G5	57,840,000
Special Variable Rate Water Revenue Refunding Bonds, 2015 Series A-1 and A-2(1)	188,900,000
Water Revenue Bonds, 2015 Series A	208,255,000
Total Revenue Bonds	**$4,237,960,000**
Waterworks General Obligation Refunding Bonds, 2009 Series A	$33,485,000
Waterworks General Obligation Refunding Bonds, 2010 Series A	27,290,000
Waterworks General Obligation Refunding Bonds, 2014 Series A	49,645,000
Total General Obligation Bonds	**$110,420,000**
Total Long-Term Debt:	**$4,348,380,000**

(1) Outstanding variable rate obligation.
(2) Designated as "Build America Bonds" pursuant to the American Recovery and Reinvestment Act of 2009.

DEBT SERVICE

Debt Service payments in FY 2016/17 are budgeted at $328.6 million and includes $23.3 million in General Obligation bond debt service, $298.7million in revenue bond debt service, $1.3 million for SRF Loan payments, and $5.3 million for debt administration costs.

Debt Service payments in FY 2017/18 are budgeted at $344.4 million and include $18.8 million in General Obligation bond debt service, $318.3 million in revenue bond debt service, $1.3 for SRF Loan payments, and $6.0 million for debt administration costs. Total debt service costs in FY 2017/18 are expected to be $15.8 million more than the FY 2016/17 payments due to new money bond issues.

Interest payments on synthetic fixed rate debt were calculated at their associated swap rates plus any spread (if known). Interest rates on variable rate debt were calculated at 0.45 percent for FY 2016/17 and 0.80 percent for FY 2017/18.

Outstanding variable rate debt on December 31, 2015 was approximately $1.03 billion, including bonds bearing interest in the Index Mode or Flexible Index Mode, special variable rate bonds initially designated as self-liquidity bonds, and variable rate demand obligations supported by standby bond purchase agreements between Metropolitan and various liquidity providers. Of the $1.03 billion, $493.6 million are treated by Metropolitan as fixed rate debt by virtue of interest rate swap agreements. The remaining $534 million of variable rate obligations represent approximately 12.6 percent of total outstanding water revenue bonds.

Going forward, Metropolitan will finance its construction program through a combination of fixed-rate debt and variable rate debt. Metropolitan intends to issue approximately $110 million of new debt in FY 2016/17 and $80 million of new debt in FY 2017/18.

DEBT RATINGS

Credit risk is the risk that a financial loss will be incurred if a counterparty to a transaction does not fulfil its financial obligations in a timely manner. This is measured by the assignment of a rating by a nationally recognized statistical credit rating organization. Strong credit ratings provide tangible benefits to ratepayers in the form of reduced debt service cost. A strong credit rating provides better access to capital markets, lower interest rates and better terms on debt, and access to a greater variety of debt products. Prudent financial management policies have resulted in bond ratings of AAA from Standard & Poor's, Aa1 from Moody's, and AA+ from Fitch.

DEBT POLICY AND COVERAGE

Metropolitan is subject to limitations on additional revenue bonds. Resolution 8329 (the "Master Revenue Bond Resolution"), adopted by Metropolitan's Board in 1991 and subsequently supplemented and amended, provides for the issuance of Metropolitan's revenue bonds. The Master Revenue Bond Resolution limits the issuance of additional obligations payable from Net Operating Revenues, among other things, through the requirement that Metropolitan must meet an Additional Bonds Test, as defined in the Master Revenue Bond Resolution.

The Metropolitan Act also provides two additional limitations on indebtedness. The Act provides for a limit on general obligation bonds, water revenue bonds and other indebtedness at 15 percent of the assessed value of all taxable property within Metropolitan's service area. As of December 31, 2015, outstanding general obligation bonds, water revenue bonds and other evidences of indebtedness in the amount of $4.35 billion represented approximately 0.18 percent of the FY 2015/16 taxable assessed valuation of $2,451 billion. The second limitation under the Act specifies that no revenue bonds may be issued, except for the purpose of refunding, unless the amount of net assets of Metropolitan as shown on its balance sheet as of the end of the last fiscal year prior to the issuance of the bonds equals at least 100 percent of the aggregate amount of revenue bonds outstanding following the issuance of the bonds. The net assets of Metropolitan at June 30, 2015 were $6.9 billion. The aggregate amount of revenue bonds outstanding as of December 31, 2015 was $4.24 billion.

Metropolitan has also established its own policy regarding debt management. The purpose is to maintain a balance between current funding sources and debt financing to retain Metropolitan's financing flexibility. Flexibility allows Metropolitan to use a variety of revenue or debt-financing alternatives, including issuing low-cost variable rate and other revenue supported obligations.

Metropolitan's debt management policy is to:

- Maintain an annual revenue bond debt coverage ratio of at least 2.0 times coverage;
- Maintain an annual fixed charge coverage ratio of at least 1.2 times coverage;
- Limit debt-funded capital to no more than 40 percent of the total capital program over the ten-year planning period; and
- Limit variable rate debt such that the net interest cost increase due to interest rate changes is no more than $5 million, and limit the maximum amount of variable rate bonds to 40 percent of outstanding revenue bond debt (excluding variable rate bonds associated with interest rate swap agreements).

In order to comply with the debt management policy, Metropolitan has taken the following measures:

Revenue Bond Debt Coverage Ratio

This policy ensures that Metropolitan has sufficient annual operating revenues to pay its operating expenses and meet its debt service obligations on its revenue bonds and other senior debt. The revenue bond debt coverage ratio is defined as Metropolitan's net operating revenue (current year's operating revenue less the current year's operating expenses) divided by the current year's debt service on all revenue bonds and other senior debt. The target is 2.0 times. In FY 2016/17 and FY 2017/18, the projected debt coverage ratio is 1.60 and 1.60 times, respectively.

Fixed Charge Coverage Ratio

In addition to revenue bond debt service coverage, Metropolitan also measures total coverage of all fixed obligations after payment of operating expenditures. This additional measure is used to account for Metropolitan's recurring capital costs for the State Water Contract, which are funded after debt service on revenue bonds and other parity obligations. Rating agencies expect that a financially sound utility consistently demonstrate an ability to fund all recurring costs, whether they are operating expenditures, debt service payments or other contractual payments. Metropolitan's fixed charge coverage ratio target is 1.2 times. In FY 2016/17 and FY 2017/18, the projected debt coverage ratio is 1.30 and 1.30, respectively. These levels help maintain strong credit ratings and access to the capital markets at low cost.

BUDGET HIGHLIGHTS

The budget for Capital Financing is decreasing from the FY 2015/16 budget due to lower CIP expenditures overall. The FY 2017/18 Capital Financing budget is higher than FY 2016/17 as new debt is issued to finance the CIP. Lower overall Capital Financing costs provide increased financial flexibility and resiliency.