Financial Sustainability

Financial Strengths

The Metropolitan Water District has significant financial strengths, including:

a. **Essential service**. Metropolitan provides half of the water used in a 5,200 square mile service area by almost 19 million people. The average rainfall in this service area ranges from less than 10 inches in some of the inland areas to over 20 inches in the foothills.

b. **Large, diversified service territory**. Metropolitan's service area represents an economy that is larger than all but 14 countries, with a population of around 19 million people. This population is expected to grow by 5.5 million people in the next 20 years.

c. **Strong member agencies**. Metropolitan delivers water at wholesale to 26 member public agencies. These agencies are diverse, including cities, municipal water districts and a county water authority. The member agencies are strong credits themselves, providing water in a semi-arid region.

d. **Rate setting authority**. The Metropolitan Water District Act (Act) provides the Board with the power to set rates and charges in the Metropolitan's service area. These rates and charges are not subject to review or approval by the California Public Utilities Commission or any other regulatory or legislative body.

e. **Taxing authority**. Metropolitan has the authority to levy ad valorem property taxes in its service territory to fund debt service on its general obligation bonds and to pay fixed costs associated with the State Water Project. Taxes are determined by the Metropolitan Board and are limited at this time to the sum of debt service on Metropolitan's general obligation bond debt service and Metropolitan's share of the Burns Porter Bonds issued to finance the State Water Project. Additional general obligation bonds must be approved by the voters in the six county service territories.

f. **Revenue bond authority**. The Act includes the power to issue revenue bonds (debt service supported by a pledge of operating revenues) with approval by the Board. This is significant as the Board makes this determination in its sole discretion.

g. **Prudent financial policies and sufficient reserves**. Over the years, Metropolitan has implemented sound financial policies, including maintaining adequate reserves, strong debt service coverage ratios, and proactive investment and debt management practices. These policies and practices have been recognized in Metropolitan's long-term revenue bond debt ratings, resulting in ratings of AAA by Standard and Poor's, AA+ by Fitch Ratings, and Aa2 from Moody's. Metropolitan's strong credit ratings result in ready access to credit markets at favorable borrowing costs.

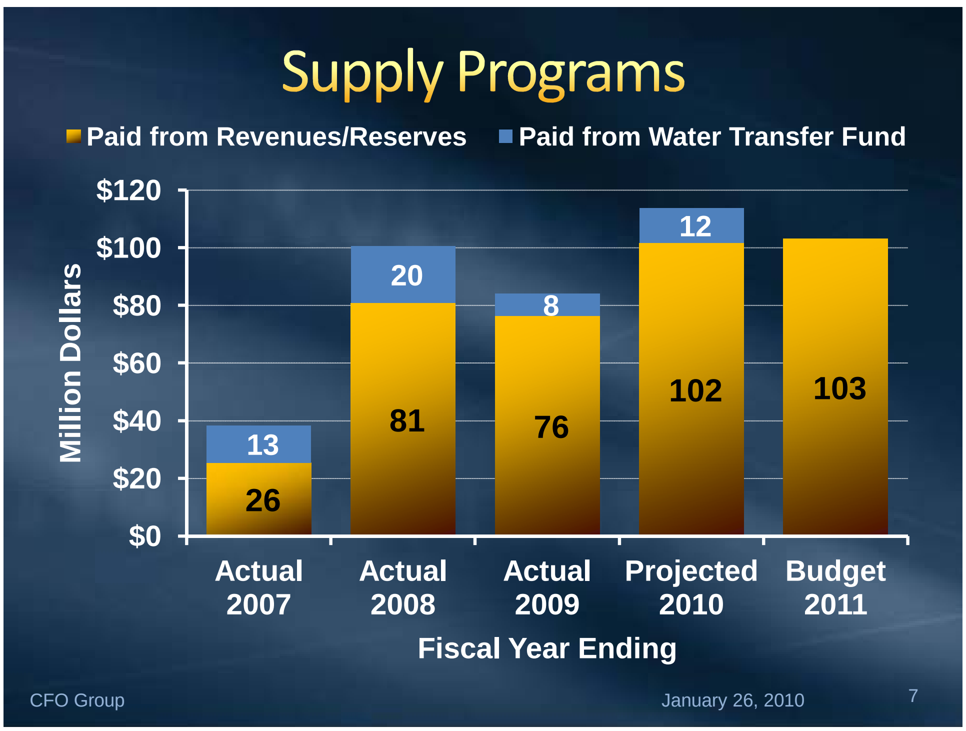
Financial Challenges

But, Metropolitan faces significant challenges in the future, including:

a. **Threats to existing water supply**. Environmental regulations, drought and climate change are threatening Metropolitan's two major sources of supply – water from the Colorado River and the Bay-Delta.

b. **Replacing low cost supplies**. Available water supplies from Metropolitan's historic contracts have been lost to other agencies and the environment. Replacing these low cost supplies with new water means higher costs for those future supplies. Expenditures to fund new water purchases, water-use efficiency and recycled or desalinated water will cost orders of magnitude more than the water replaced (see Figure 1, for trends in the cost of water supply since 2007).

Figure 1.



c. **Infrastructure replacement**. As Metropolitan's storage, conveyance and treatment system ages, the capital costs associated with replacing and rehabilitating these facilities will take an increasingly large share of capital resources. Currently, about $175 million of Metropolitan's $328 million capital program is for infrastructure reliability. Replacement and rehabilitation expenditures are projected to be over $300 million in ten years (see Figure 2, below).

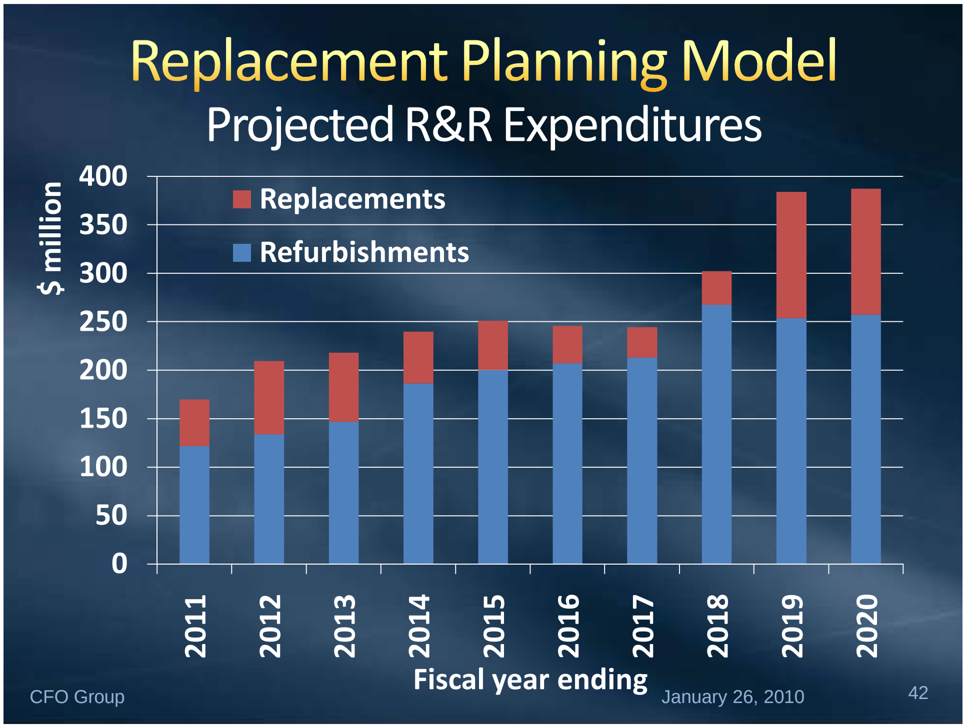


Figure 2.

d. **Increasingly stringent regulatory standards**. With improving science, enhanced monitoring, and detection of new compounds comes additional water quality regulations. Complying with new regulations to ensure continued safe and reliable water supplies will put added pressure on both capital, and operating and maintenance expenditure budgets.

e. **Environmental regulations**. Environmental regulations are limiting pumping from the delta. Addressing the issue will require additional capital investments in facilities and restoration to ensure continued access to imported supplies at best, and at worst reduce Metropolitan's ability to access this supply.

f. **Large fixed costs relative to fixed revenues**. About 80 percent of Metropolitan's expenditures do not vary with the amount of water sold in a given year. About 80 percent of Metropolitan's revenues are dependent on the sale of water. As a result, when sales volumes fall as a result of rainfall, drought, environmental restriction or local supply development, water revenues fall. Since costs must be paid, water rates must increase to generate the same amount of revenue.

g. **Resistance to rate increases**. As water supplies have been restricted, Metropolitan has allocated water to its member agencies, resulting in mandatory conservation and other water use restrictions at the local level. As described above, lower sales results in higher rates in order to generate the same level of revenues – especially during the current economic downturn, higher water rates are increasingly unpopular, leading to resistance by local elected and appointed officials.

h. **Need for major capital outlays to resolve delta issues**. In addition to repair and rehabilitation, Metropolitan will need to invest billions of dollars in a long-term delta solution. Without additional fixed revenues, take-or-pay arrangements with its member agencies, or similar mechanisms, water rates will need to increase in the future to service the debt associated with investments in the delta.

i. **Energy costs**. Metropolitan expends about $250 million a year for energy to pump water through the Colorado Aqueduct and State Water Project. As long-term contracts for low-cost hydropower from Hoover Dam and the associated contracts with Southern California Edison terminate in 2017, Metropolitan's cost for energy to pump water from the Colorado River are projected to increase from the present $60 million a year to over $120 million a year. In addition, rising cost of energy associated with the state's transition to renewable energy and low carbon emitting resources is also expected to have significant impacts on the price of wholesale energy available to move Colorado River and State Water Project supplies.

j. **Long-term unfunded liabilities**. Similar to many other public agencies, Metropolitan has an unfunded long-term obligation associated with retired medical benefits. Metropolitan funds its retired medical premiums on a pay as you go basis. The unfunded portion of the benefit is approximately $400 million. In addition, Metropolitan is a member of the California Public Employee Retirement System (CalPERS). CalPERS states that Metropolitan is currently about 93 percent funded, with an unfunded obligation of about $100 million. Metropolitan pays the required contribution to CalPERS each year.

Current Strategies

As Metropolitan deals with current challenges, including restricted water supplies and sales, it has addressed both revenues and expenditures:

a. **Use of reserves**. Over the past four years, about $100 million has been withdrawn from reserves to help mitigate necessary rate increases.

b. **Capital management**. In order to manage rates, about $240 million of capital work was deferred to 2011/12. Metropolitan conducts an annual review of the capital program, reprioritizing work as required to ensure that necessary projects move forward in a timely manner. The current ten year capital program includes over 300 projects. Each year a cross functional team evaluates all capital requests, based on criteria including project necessity (e.g., regulatory requirement), board directive, cost-efficiency/productivity, risk of failure, and disruption of service. In addition, cost estimates are updated on an annual basis. Finally, the most significant construction projects are reviewed on a monthly basis with management to evaluate progress and cost variance.

c. **Cost management**. Since 2008, Metropolitan's operating and maintenance budget has declined from $352 million to the proposed budget of $338 million in 2010/11 (see figure 3.). This reduction reflects continued reductions in headcount, optimizing chemical usage, deferring equipment purchases, and reducing expenditures on advertising, travel, and overtime.

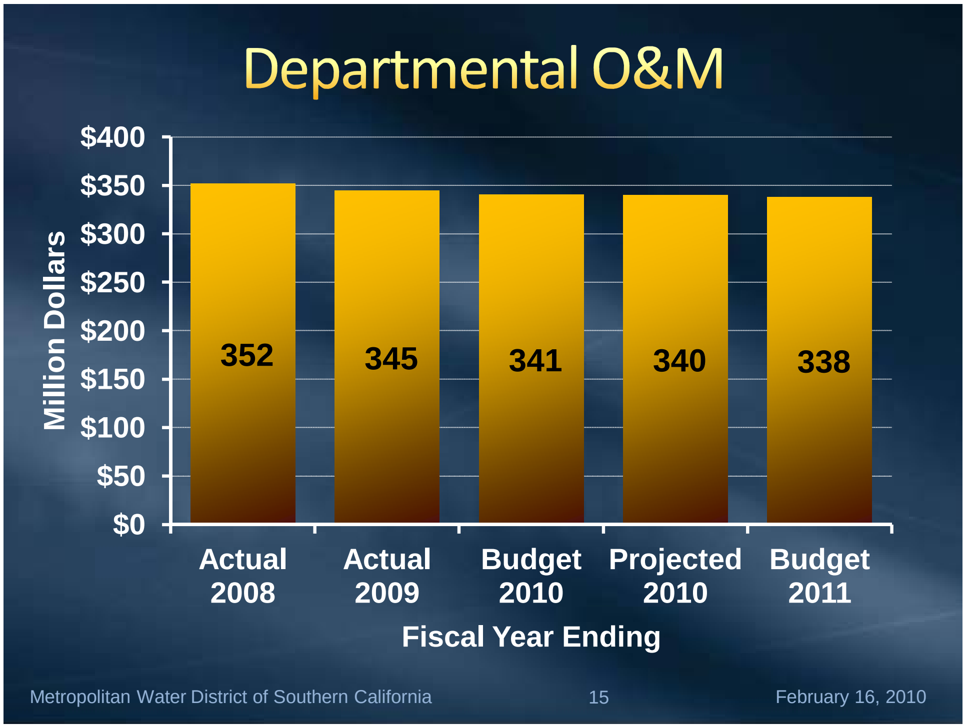


Figure 3.

d. **Debt financing and restructuring**. Metropolitan currently has $4.6 billion of outstanding revenue bond debt. In order to mitigate the impact on water rates, approximately 90 percent of the capital program over the past four years was financed with debt. Metropolitan also refunded and restructured debt, utilizing low cost variable rate debt, as well as traditional tax-exempt fixed rate debt and new Build America Bonds. The true interest cost on the $2.5 billion of new money and refunding bonds issued since 2005 was about 4 percent.

e. **Capital financing with revenues**. In order to maintain debt service coverage ratios, reduce leverage and long-term cost, and provide for a sustainable balance sheet, Metropolitan should increase funding of capital from current revenues (rather than debt). Current plans call for 25-30 percent of the almost $1.9 billion of capital funding over the next five years to be funded from revenues. These actions will restore debt service coverage ratios to board targets, helping to ensure continued access to low cost financing.

f. **Asset/Liability management**. The foundation of Metropolitan's financial strategy is asset/liability management. Under this strategy, Metropolitan reduces its vulnerability to changing interest rates because short-term financial assets (the investment portfolio) are matched with short-term debt obligations (e.g., variable rate demand obligations). As short-term interest rates rise, earnings on Metropolitan's investment portfolio will rise, offsetting the increase in the cost of short-term debt.

g. **Flexibility and responsiveness**. Metropolitan's existing financial policies enable Metropolitan to react to market conditions in a timely and responsive manner. This was demonstrated during over the past two years as financial markets collapsed.

Metropolitan was able to refund auction rate securities, secure bank lines of credit at very competitive rates, and issue fixed rate debt in the midst of the crisis. Policies that enable such fast action include authority for refunding transactions without additional board action, delegation of approval for transactions to an ad hoc committee, and a broad mix of pre-approved financing vehicles. In addition, a well-trained legal and finance staff works with a robust team of financial consultants (i.e., financial advisors, bond counsel, investment bankers).

h. **Investor relations**. Metropolitan takes a proactive role, working with investors, money managers, and rating agencies to educate and update investors on Metropolitan's plans and activities. Outreach efforts include direct presentations, "internet roadshows" and electronic updates. Metropolitan provides timely financial information through its Web site and the EMMA system. As an example, Metropolitan publishes quarterly financial statements, along with annual financials and official statements on its website. As a result of these efforts, Metropolitan's has a very solid name in the financial market.

i. **Long-term forecasting and planning**. Metropolitan prepares annual operating budgets. In addition, working with its member agencies, Metropolitan develops five and ten year estimates of costs and revenues to provide forecasts of water rates and charges (as an example, see Figure 4). Such planning provides flexibility and transparency to future conditions.

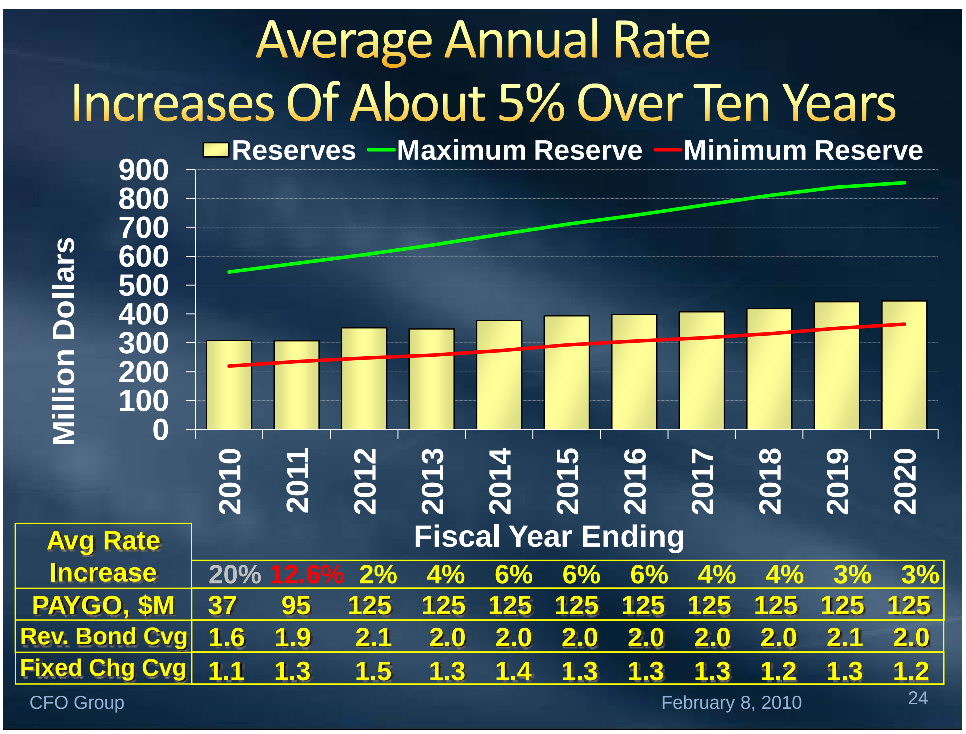


Figure 4.

j. **Water rate increases**. As current water sales have been reduced, and future water sales projections revised to reflect supply constrained conditions, water rates have been raised about 40 percent over the past three years, with another 10-13 percent increase anticipated in 2011 (see Figure 4). The Board's stated objective is to collect the full cost of service in fiscal year 2010/11. As shown in Figure 4, average annual water rate increases over the next decade are estimated to be about 5.5 percent, as it becomes necessary to fund additional debt service, delta improvements, water quality improvements, and higher cost water supplies.

k. **Public outreach**. As the price of water increases, and the need for additional capital investment rises, it is important for the water industry to develop messages about the importance of water supply to the economy, as well as the value of water as a commodity. The public, including residential, industrial and commercial customers need to prepare for and plan on the cost of water rising over time.

l. **Develop additional financial sources**. Metropolitan owns substantial real estate. Leveraging these assets to generate lease revenue is one way to offset costs in the future. In addition, aggressively pursuing federal and state funding for capital projects reduces debt costs. Metropolitan has actively supported low interest financing through tax credit bonds, in addition to recently receiving $40 million in grants to help fund water treatment improvements.

m. **Develop cost-effective energy resources**. The risk of higher and more volatile energy costs is one of the more critical cost drivers for Metropolitan. Pursuing long-term contracts, equity shares and other investments in cost-effective energy resources is an important strategy to managing costs and water rates in the future. As noted in the energy white paper, Metropolitan is pursuing a number of alternatives to help stabilize energy cost in the future.

n. **Begin funding long-term liabilities**. While quantifying unfunded liabilities is an important step, it is only the first step. It is important to recognize and begin funding these liabilities – the ten year plan includes funding the annual required contribution for retiree medical benefits. This will pre-fund this benefit, accruing costs as the benefit is earned, and reducing long-term costs.

Long-term Objectives

a. **Long-term cost sharing**. One of the important risks facing Metropolitan is institutional. At this time, many member agencies and retail agencies actively seek alternatives to paying Metropolitan for water supply, even if the cost of those alternatives are higher than Metropolitan's current rates. Recognizing that Metropolitan has invested in capacity for the benefit of all of the members, developing a long-term cost sharing method is critical to the ongoing ability of Metropolitan to leverage the existing investments and ensure cost-effective alternatives for Southern California's water future. Developing such a long-term financing mechanism is even more critical as the state considers investing $10-20 billion in improvements in the delta. Over the next two years, Metropolitan will be working with the member agencies to develop alternatives to the purchase order agreements that expire in 2012. This provides the opportunity to restructure payment streams, commitments and obligations in ways that will foster efficient and effective water resource use and investments. This may require a change in the way Metropolitan assesses rates and charges.

b. **Financing new water sources**. As Metropolitan looks at different water resources (e.g., recycling, desalination and groundwater recovery), different financing mechanisms may be required. Such mechanisms include take-or-pay contracts for delivery of project water, capacity charges, standby charges and ad valorem taxes. Retaining Metropolitan's existing tax levy would be one way to mitigate future costs associated with the development of such resources.

Core Competencies

Metropolitan has developed competencies over the decades to help address the many financial challenges of the future. These include:

a. **Capable and skilled staff**. Metropolitan's debt and investment managers are among the best in the public sector, with investment returns consistently exceeding benchmarks and debt cost among the lowest in the nation. The business relationships developed over many years work to Metropolitan's advantage in terms of low cost financing and return on investments.

b. **Ability to innovate**. Metropolitan is one of the leaders in the public sector in terms of developing and utilizing more efficient financing mechanisms. Asset/liability management enables Metropolitan to utilize financing tools such as variable rate debt to manage risk and lower cost. Hiring outside investment managers to work with treasury staff allows focus on different sectors of the portfolio in a cost-effective manner. The Board's support for changes and flexibility to take advantage of market conditions fosters an environment that ensures efficient execution on both the buy and the sell side of the business.

c. **Distribution of risk**. Because of Metropolitan's reach in the service area, and the strength of the collective balance sheet, risk is distributed over a large base. This distribution of risk provides support for investments in technology, large scale projects (e.g., Diamond Valley Lake), and large water transfers that would be too burdensome on any single agency.

d. **Strong analytical capabilities**. Metropolitan, either in house or through its consulting relationships has developed powerful analytical tools. These include financial modeling, budgeting, accounting and investment models. Metropolitan uses these tools to manage a $1.6 billion interest rate swap portfolio, a $1 billion investment portfolio, and develop financial sensitivities and scenarios for the future.

e. **Rate and planning expertise**. Metropolitan staff is trained in cost-of-service and rate design, as well as long-term planning. This core competency is necessary as circumstances change over time, and adjustments to rates and charges are required.

f. **Risk management**. Metropolitan has formal risk management practices, including an energy risk management process, general risk management practices (e.g., insurance, training, and safety practices). The evaluation of risk and early identification of ways to mitigate risk are a foundation of the agency's financial management function. This evaluation and management is an agency wide effort, including line organizations, the legal department, and the audit department.

Business Functions and Processes

Fundamental business functions and processes to help meet objectives include:

a. **Annual budget process**. The annual budget process involves all sectors of Metropolitan and is the fundamental short-term planning and management tool.

b. **Capital planning process**. Metropolitan uses its Capital Investment Plan to develop projects, ensure visibility to the board and stakeholders, and look at long-term impacts. The CIP is updated on an annual basis, but includes costs and cash flow for ten years.

c. **Rate setting process**. Metropolitan's administrative code requires that rates be reviewed on an annual basis. As part of the process for determining rates and charges, the cost-of-service study is updated on an annual basis. In addition, the rate setting cycle provides for an opportunity for the board and member agencies to evaluate the proposed budget. For the past four years, the budget and rates have been adopted in the same month.

d. **Long-range finance plan**. Every three to five years, Metropolitan updates its long-range finance plan. This process takes between one and two years, incorporating the results of the capital planning process and the Integrated Resources Plan. The resulting plan includes revenues and rates, as well as risks affecting costs, revenues and rates and charges.

e. **Annual financial reporting**. Each year, Metropolitan produces an audited annual financial report, providing accounting statements consistent with generally accepted accounting principles. This audited report is a critical control mechanism.

Conclusion

Metropolitan has significant financial strengths as long as the political consensus remains that it is important for Southern California to pool its resources on water supply and work as a region. Though there are significant challenges looming on the horizon, Metropolitan is well poised to meet those challenges in a manner that continues to provide Southern California with a very reliable, cost-effective supply of high quality water.