STAFF SUMMARY

TO: Board of Directors
FROM: Frederick A. Laskey, Executive Director
DATE: February 8, 2006
SUBJECT: Proposed FY07 Current Expense Budget

COMMITTEE: Administration & Finance

X Vote
_____ Information

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Preparer/Title

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This staff summary recommends transmittal to the MWRA Advisory Board of a Proposed FY07 Current Expense Budget (CEB) for review and comment. The Proposed FY07 CEB recommends an increase in rates and charges of 9.8% and includes the use of a total $35.7 million in reserves. The single largest driver of the increase in the CEB continues to be the significant debt burden, which is compounded by extraordinary increases in costs of energy, other utilities and health care. The Proposed FY07 does not include an assumption for the receipt of debt service assistance, which, if received, could significantly mitigate the proposed 9.8% increase in rates and charges for FY07.

RECOMMENDATION:

To approve transmittal of the Proposed FY07 Current Expense Budget (CEB) to the MWRA Advisory Board for review and comment.

DISCUSSION:

This staff summary presents an overview of the Proposed FY07 Current Expense Budget. In addition, the staff summary lays out the proposed FY07 CEB rate revenue requirement and estimates of out year increases.

Summary

The proposed budget for fiscal year 2007 includes $600.8 million in total expenses before a debt service offset of $19.1 million (from the use of $19.1 million of bond redemption funds to defease debt due in FY07), for a net expense total of $581.7 million.

Total expenses include $357.3 million or 59.5% for capital financing costs and $243.4 million or 40.5% for operating expenses, of which $202.8 million is for direct expenses and $40.6 million is for indirect expenses. Total expenses increase by $56.8 million over the FY06 budget; $30.7 million of the increase is for capital financing (before offsets), $17.1 million for direct expenses, and $3.6 for indirect expenses. The significant factors impacting increases in expenses are debt service, up by $30.1 million or 9.4% as compared to FY06, utilities, which are $6 million, or 23.4% higher than they were in the FY06 CEB, and wages, salaries and fringe benefits, up $6.2 million, primarily due to collective bargaining, step increases and greater expenses for health insurance.

Proposed FY07 revenues, excluding rate revenue, totals $63.2 million, an increase of $10.5 million over the FY06 budget. The proposed FY07 non-rate revenue budget includes $33.9 for investment income, $16.6 million in use of rate stabilization funds; and $12.7 million in other user charges and other revenue, including an estimated $1.3 million from the sale of renewable energy portfolio credits.

The proposed rate revenue requirement for FY07 is $518.5 million, an increase of 9.8 percent over the final FY06 rate revenue requirement. As noted, the proposed budget includes the use of $35.7 million from reserves to reduce the rate revenue requirement needed to be raised from member communities ($16.6 million in Rate Stabilization funds to enhance revenue and $19.1 million in Bond Redemption funds to reduce debt service costs). The proposed rate revenue requirement is $18.6 million higher than the $513.5 million FY07 planning estimate presented at the approval of the FY06 budget in June, reflecting significant increases in utilities, health care and debt service, as described above.

The table below provides a comparison of the FY07 Proposed (CEB) to the FY06 CEB. Additional detail by line item is provided as an attachment.

Proposed FY07 Current Expense Budget ($ in Millions)	**FY06 Approved**	**FY07 Proposed**	**$ Change**	**% Change**
Directs	$185.7	$202.8	$17.1	9.2%
Indirects	$37.0	$40.6	3.6	9.6%
Sub-Total Operating Expenses	$222.8	$243.4	$20.7	9.3%
Capital Financing (before Offsets)	$326.6	$357.3	$30.7	9.4%
Offsets:				
Bond Redemption	($14.4)	($19.1)	(4.6)	32.1%
Variable Rate Savings	0.0	0.0	0.0	N/A
Debt Service Assistance	(10.0)	0.0	10.0	-100.0%
Sub-Total Capital Financing	$302.1	$338.2	$36.1	11.9%
Total Expenses	$524.9	$581.7	$56.8	10.8%
Interest Income	30.1	$33.9	$3.8	12.6%
Non-Rate Revenue	6.9	7.7	0.8	11.8%
Other Revenue	5.0	5.0	0.0	0.1%
Rate Stabilization	10.7	16.6	5.9	54.6%
Rate Revenue	472.2	518.5	46.3	9.8%
Total Revenue & Income	$524.9	$581.7	$56.8	10.8%

Rate Revenue Increase	**4.2%**	**9.8%**
Combined Use of Reserves	**$25.2**	**$35.7**

The following pages provide greater detail on the composition of the proposed budget.

Capital Financing

Proposed FY07 capital financing costs total $357.3 million, which accounts for 59.5% of total expenses (before debt service offsets). The proposed CEB includes $19.1 million in debt service offsets, comprised entirely of bond redemption savings. For FY07, the proposed budget assumes a 4.75% interest rate for variable rate debt.

Capital financing costs increase by $30.7 million or 9.4% compared to the FY06 CEB. The increase is primarily comprised of amounts due on outstanding indebtedness, but does reflects the impact of the financing planned to close in March 2006 as well as the full fiscal year cost impact of fall 2006 borrowings. The proposed capital financing budget for FY07 includes:

- $346.8 million in principal and interest payments on outstanding MWRA debt and SRF loans.

- $11.1 million in debt service to support a $150 million fixed rate issue in October 2006 and $75 million in SRF borrowings.

- $3 million to fund ongoing capital projects with current revenue and to meet coverage requirements.

The proposed FY07 debt service budget does not include savings from re-financing debt. If MWRA is able to take advantage of opportunities during the year, any savings will be used to reduce rate revenue requirements in future years.

Direct Expenses

Direct expenses are proposed to increase by $17.1 million, from $185.7 million to $202.8 million, or 9.2%.

- The single largest line item increase, $5.9 million or 23.4%, is Utilities. Over half of this increase, $3 million, is for electricity, primarily reflecting continuation of the higher than budgeted prices that are being experienced now and that have forced consideration of an amendment to the FY06 budget. Diesel fuel accounts for $2 million or 34 percent of the increase due to higher prices ($1.2 million) and Deer Island's participation in the load response program ($0.8 million).

- MWRA personnel are projected to decline in the proposed budget; 1,255 positions are budgeted, fifteen less than the 1,270 budgeted in the FY06 CEB. Nonetheless, the labor components of the budget (four line items- Wages & Salaries, Overtime, Fringe Benefits, and Workers' Compensation) are proposed to increase by a combined $6.3 million, primarily due to collective bargaining and step increases and greater expenses for health insurance.

- The expense of maintaining MWRA's facilities and infrastructure is proposed to increase by $3.7 million or 18.1%, from $20.5 million to $24.2 million. The proposed Deer Island maintenance budget is $11.1 million, up $1.7 million or 18.1% from FY06; portions of the plant are now over 10 years old. The Field Operations Department's projected maintenance budget is $7.6 million, up $1.9 million or 34% from FY06. Approximately one-half of the increase is attributed to new facilities: increased service contracts for the Carroll Water Treatment Plant and maintenance contracts for Union Park. To put the MWRA maintenance budget in context, the replacement cost of all MWRA's assets is estimated at over $12 billion.

- The Chemicals line item is proposed to increase by $1.2 million, 16.2%, from $7.4 million to $8.6 million, primarily due to new disinfection requirements anticipated to be incorporated in the renewal of the NPDES permit for the Deer Island Treatment Plant ($480,000) and higher prices ($400,000).

<u>Indirect Expenses</u>

Proposed indirect expenses for FY07 total $40.6 million, an increase of $3.6 million or 9.6% from the FY06 approved budget. Significant changes are noted below:

- Insurance premiums are assumed to increase by $150,000 based on estimates to either renew existing policies and/or procure insurance policies similar to the existing program. New policies will be renewed and/or procured in FY06 for coverage in FY07, based upon an evaluation of the marketplace. Staff plans to update the Board at its March meeting on the status of renewal and/or procurement of insurance.

- The proposed budget includes an addition of $2.97 million to meeting the Operating Reserve requirement. Under its general bond resolution requirements, the required balance is one-sixth of operating expenses for the year. Based on the proposed FY07 CEB, the required balance is $35.9 million as compared to the current balance of $32.9 million.

- The Proposed FY07 budget includes $25 million for operating expenses, debt service on prior watershed land purchased and payments in lieu of taxes (PILOT) for Division of Water Supply Protection (formerly MDC Division of Watershed Management). The budget is comprised of $11.9 million for operating expenses, $6.6 million for PILOT, and $6.5 million for debt service on prior land purchases. The Proposed FY07 budget for watershed operating expenses assumes legislative approval (pending) for the waiver of an Indirect Cost fee assessed to the Watershed Supply Protection Trust (the Trust) by the Executive Office of Administration, of which approximately one-half ($1.1 million) reverts back to the Trust. The amount of this Indirect Cost fee for FY06 is approximately $1.8 million, which, if refunded, would be available to fund additional Trust expenses and expected overspending in MWRA expenses in FY06.

- The proposed FY07 includes a contribution to MWRA's retirement fund of $4 million, an increase of $0.5 million compared to the FY06 approved budget. This contribution is based on the most recent actuarial valuation report.

Revenue

Proposed FY07 non-rate revenue totals $63.2 million or $10.5 million more than the FY06 approved budget. The proposed non-rate revenue budget includes:

- $33.9 million in interest income, an increase of $3.8 million over the FY06 approved budget due to higher interest rate assumptions for investments and greater than projected fund balances
- $16.6 million in Rate Stabilization funds.
- $7.7 million in other user charges, an increase of $0.8 million from the FY06 approved budget.
- $5.0 million in other revenue, including $2.2 million in permit fees and penalties and $1.3 million from the sale of Deer Island's renewable portfolio credits and revenue from the load response program.

The proposed rate revenue requirement for FY07 is $518.5 million, an increase of 9.8% over the final FY06 rate revenue requirement. The rate revenue requirement is the difference between total expenses of $600.8 million (before offsets), less non-rate revenue of $63.2 million, less debt service offsets of $19.1 million.

Planning Estimates and Future Rate Increases

MWRA's planning estimates are projections based on a series of assumptions about future spending (operating and capital), interest rates, inflation, and other factors. MWRA uses the planning estimates to model and project what future rate increases might be based upon these assumption, as well as to test the impact of changes to assumptions on future rate increases. The planning estimates are not predictions of what rate increases will be; rather they provide the context and framework for guiding financial policy and management decisions of MWRA that ultimately determine the level of actual rate increases on an annual basis.

The planning estimates generally incorporate the use of reasonably conservative financial assumptions. The projection of future rate increases upon the basis of conservative assumptions benefits MWRA by providing assurance to the rating agencies that MWRA anticipates to raise revenues sufficient to pay for its operations and outstanding debt obligations presently and over the long-term. Additionally, conservative forecasts of rate revenue increases enable member communities to adequately plan and budget for future payments to MWRA.

The table below presents estimated future rate increases and household charges based on the Proposed FY07 CEB. The planning estimates shown below assume no restoration of debt service assistance from the Commonwealth as well as use of combined reserves (rate stabilization and bond redemption) through FY2010 to smooth the rate increases. Attachment C provides additional planning estimate detail.

MWRA Planning Estimates (based on Proposed FY07 CEB Inputs)										
Proposed FY07 CEB	**FY2007**	**FY2008**	**FY2009**	**FY2010**	**FY2011**	**FY2012**	**FY2013**	**FY2014**	**FY2015**	**FY2016**
Total Rate Revenue ($ in Mil)	$ 518.5	$ 563.5	$ 612.2	$ 665.4	$ 700.2	$ 730.7	$ 759.2	$ 763.2	$ 770.6	$ 759.1
Rate Revenue Increase	9.8%	8.7%	8.7%	8.7%	5.2%	4.4%	3.9%	0.5%	1.0%	-1.5%
Use of Reserves ($ in Mil)	$ 35.7	$ 34.4	$ 7.1	$ 5.9	$ -	$ -	$ -	$ -	$ -	$ -
Estimated Household Charges										
Charge based on DEP Data (weighted)	$ 675	$ 726	$ 780	$ 840	$ 883	$ 923	$ 962	$ 1,012	$ 1,035	$ 1,041
Charge based on 90,000 gal. (weighted)	$ 996	$ 1,071	$ 1,152	$ 1,239	$ 1,303	$ 1,362	$ 1,420	$ 1,446	$ 1,478	$ 1,487

CEB Review and Adoption Process

The Advisory Board has 60 days from the transmittal of the proposed CEB to review the budget and prepare comments and recommendations. During the review period, Advisory Board and MWRA staff will continue to meet and evaluate the impact of changing circumstances as they arise. Following the transmittal by the Advisory board of its comments and recommendations to MWRA, the Board considers the recommendations proposed by the Advisory Board at budget hearings usually held in May and which staff will schedule in the near future. Staff presents the final budget and schedule of assessments and charges for fiscal year 2007 to the Board in June 2006.

Attachments

Attachment A - Proposed FY07 Current Expense Budget
Attachment B - Proposed FY07 Direct Expense Budget by Division
Attachment C - Proposed FY07 CEB Planning Estimates