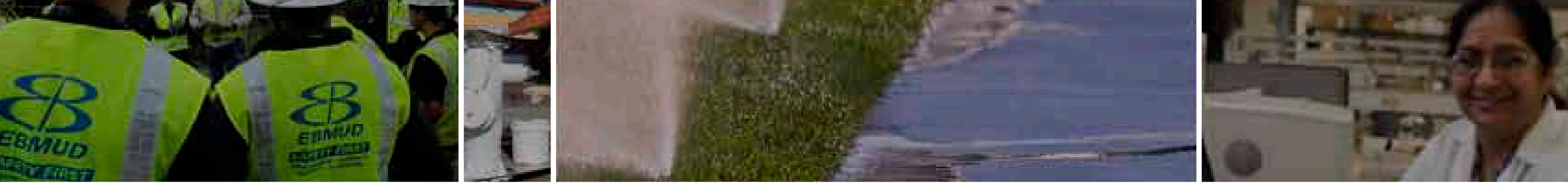

Mid-Cycle Budget Update

Fiscal Years 2018 & 2019

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FY18 & FY19 MID-CYCLE BUDGET UPDATE

EXECUTIVE SUMMARY

The Board of Directors adopts a budget appropriation and rates and charges for two consecutive fiscal years in June of odd numbered years. A key feature of the biennial budget process is the mid-cycle update which occurs in May of the first fiscal year. This mid-cycle report includes revenue and expense projections for the first and second fiscal years and any emerging financial issues that may need direction from the Board of Directors. Action at the mid-cycle is required of the Board of Directors to affirm the second year of the adopted biennial budget.

Overview

On June 27, 2017 the Board of Directors adopted a $2.03 billion biennial budget for Fiscal Years 2018 & 2019 for the Water and the Wastewater Systems. Of this amount, the FY19 budget is $1.03 billion as shown in the following table.

FY19 APPROPRIATIONS			
($ Millions)	Water	Wastewater	Total
Operations	292.5	73.1	365.6
Debt Service	210.0	31.9	242.0
Capital Appropriation	367.5	51.1	418.6
Total	**869.9**	**156.2**	**1,026.1**

This biennial budget focuses on the Strategic Plan priorities of increasing infrastructure investments in and maintenance of aging infrastructure and managing the financial and operational impacts of severely reduced consumption. Progress had been made in each of these priorities during FY18.

In FY18, the total amount of capital investments is anticipated to be $320.0 million or $285.0 million for the Water System and $35.0 million for the Wastewater System. Of this amount, more than 75 percent is dedicated to aging infrastructure. The major capital projects driving the investment include upgrades to water treatment plants, replacing deteriorated pipelines, completion of Chabot Dam upgrade, rehabilitation and maintenance of reservoirs, and rehabilitation of the wastewater treatment plant infrastructure including odor control improvements.

To manage impacts from severely reduced consumption, improvements have been realized both in the financial and operational areas. Water quality has been improved by lowering trihalomethanes (THMs) and greatly increasing sampling and monitoring. Lead testing for K-12 schools is more than 50 percent complete, and the lead voucher program and service line inventory are underway. Since water sales is the major revenue source for the Water System, financial impacts associated with billed consumption are closely monitored. At the time the FY18 & FY19 budget was developed, the process of recovering from a prolonged drought had just begun. Water consumption in FY16 had decreased to a level not seen since 1978. Past experience has demonstrated that water sales will be depressed for several years following a drought. Therefore, the FY18 & FY19 budget assumed that customers would generally maintain conservation habits developed during the drought, and over the next several years water sales would rebound slowly from the historic lows. While customers continue to use water wisely, water sales are higher than assumed in the budget. In addition, a slow start to the rainy season in FY18 contributed to higher consumption for outdoor watering.

Budget Performance

Looking forward, if the projections hold true for FY18 & FY19, both systems are expected to end each fiscal year in a strong financial position. Strategies to manage these available funds would focus on increasing revenue funded capital and reducing the amount of borrowing which results in annual debt service savings of $5.6 million starting in FY20. The details on the projections for revenues, expenditures and year-end strategies are provided in the following pages. Shown below are the highlights for each system.

<u>Water System</u>

The projected year-end net revenue and expense savings for FY18 and FY19 are anticipated to be strong. In FY18, total revenues are projected to be $69.9 million greater than budget primarily due to higher than budgeted water sales and System Capacity Charges (SCC). More than half of the revenue above budget is attributable to non-rate revenue sources. Water charges are projected to be $29.3 million greater than budget which will eliminate the planned draw of $26.0 million from the Rate Stabilization Fund which was included in the budget to lower the rate impact on customers. An increase in SCC revenue of $33.0 million above budget is a reflection of the current strong building activity within the service area combined with a conservative approach to budgeting for this economically sensitive non-rate revenue source. Operating expenses are projected to be 7 percent less than budget.

In FY19, revenues are projected to be $23.8 million or 4 percent greater than budget primarily due to water sales which are based on an assumed consumption level equivalent to FY18 of 146 million gallons per day (MGD). The FY19 budget assumed water sales of 141 MGD. The higher water sales will eliminate the planned draw of $2.0 million from the Rate Stabilization Fund included in the budget to lower the rate impact on customers similar to FY18. SCC revenues are anticipated to be $2.0 million greater than budget based on the development queue which indicates smaller infill projects compared to the last two years. FY19 operating expenses are anticipated to be 7 percent less than budget.

The capital budget for the Water System in FY18 includes $386.5 million in appropriation with a planned cash flow of $267.7 million. Projected cash flow is estimated to exceed planned by $12.3 million or 4.6 percent. The higher projected cash flow is due to meeting future water demands, particularly with New Service Installations and Water Treatment Plant Improvements. With the upward trend in housing development within the service area, the capital expenditures for new service installation doubled in FY18. Spending is more than planned for Sobrante and Upper San Leandro Water Treatment Plants due to the installation of new ozone systems. This spending falls within the total amount of appropriations approved by the Board. There are no recommended revisions to the FY19 adopted appropriation of $367.5 million or the planned cash flow of $269.8 million.

Wastewater System

The projected year-end net revenue and expense savings for FY18 and FY19 are anticipated to be strong. In FY18, total revenues are projected to be $10.2 million greater than budget primarily due to higher than budgeted non-rate revenue sources associated with Capacity Charges and Resource Recovery. Wastewater treatment revenue is less variable compared to water sales revenue which is influenced by outdoor watering and consumption trends. Treatment charges and permits revenue is projected to be $1.0 million greater than budget.

Similar to the Water System, the considerable increase in Capacity Charges revenue of $7.2 million greater than budget is a reflection of the current strong building activity within the SD-1 service area combined with a conservative approach to budgeting. Operating expenses are projected to be 3 percent less than budget.

In FY19, total revenues are projected to be $2.1 million greater than budget due to Capacity Charges and Resource Recovery. Similar to the Water System, the Capacity Charges revenue projection is lower based on the development queue which indicates smaller infill projects compared to the last two years. FY19 operating expenses are anticipated to be 3 percent less than budget.

The FY18 capital budget includes $34.4 million in appropriations with a planned cash flow expenditure of $41.4 million. Projected FY18 capital cash flow expenditures are estimated to be $35.0 million or 85 percent of the planned cash flow primarily due to delays for the Digester Upgrade, Treatment Plant Infrastructure and Nutrient Management projects. There are no recommended revisions to the FY19 appropriation of $51.1 million, or the planned cash flow of $39.5 million. The delays incurred for the projects during FY18 are not anticipated to continue into FY19. Therefore, cash flow spending may be higher at year-end than planned. In such event, spending would fall within the total amount of adopted appropriations.

Staffing

The adopted FY18 & FY19 budget authorized the addition of seven Full-time Equivalents (FTEs) in FY19, six FTEs for the Water System and one FTE for the Wastewater System. No additional positions are recommended.

Water and Wastewater Rates

No change is recommended to the adopted FY19 rate increase of 9.0 percent for the Water System and 5.0 percent for the Wastewater System.

WATER SYSTEM

Fiscal Year 2018

Summary

The projected year-end net revenue and expense savings are anticipated to be strong. In FY18, total revenues are projected to be $69.9 million greater than budget primarily due to higher than budgeted water charges and SCC. More than half of the revenue above budget is attributable to non-rate revenues sources. Operating expenses are projected to be 7 percent less than budget. The favorable FY18 year-end projection would eliminate the planned draw of $26.0 million from the Rate Stabilization Fund which was included in the budget to lower the rate impact on customers.

FY18 Water System Revenues and Expenses

($ Millions)	Amended Budget	Year-end Projection	Over/(Under) Budget	% of Budget
Operating Revenues:				
Water Charges	454.7	484.0	29.3	106%
Property Taxes	30.0	32.0	2.0	107%
Power Sales	3.7	7.4	3.7	200%
Interest Income	7.3	7.3	0.0	100%
SCC Revenues	27.0	60.0	33.0	222%
Reimbursements	11.6	11.6	0.0	100%
All Other Revenue	17.9	19.8	1.9	111%
Total Revenues	**552.2**	**622.1**	**69.9**	**113%**
Operating Expenses:				
Operations	278.1	262.0	(16.1)	94%
Debt Service	199.5	184.5	(15.0)	92%
Total Operating Expenses	**477.6**	**446.5**	**(31.1)**	**93%**

Revenues

Total revenues are projected to be $69.9 million greater than budget. Of this amount, water charges and SCC account for approximately 90 percent. The FY18 budget was based on 137 MGD with the assumption that customers would generally maintain their conservation habits and water sales would slowly increase from the FY16 historic low of 128 MGD. Although customers continue to use water wisely, water sales have increased more quickly than anticipated, but are still lower than the pre-drought consumption of 168.4 MGD in FY13. Year-end water sales are projected to be $29.3 million above budget based on sales of 146 MGD. Due to the strong building activity in the service area primarily for large multi-family residential (MFR) dwellings, the SCC revenue is projected to be $33.0 million greater than budget. Building activity fluctuates based on the region's economy and impacts this revenue source. Power sales are anticipated to be $3.7 million greater than budget due to significant runoff resulting in additional power generation. Property Taxes are anticipated to be $2.0 million greater than budget due to an increase in the assessed value of sold properties and a conservative approach to budgeting. All Other revenue is projected to be $1.9 million greater than budget due to the sale of surplus properties that were not anticipated at the time the budget was developed. These surplus properties include a $1.2 million sale of Stonewall Reservoir and vehicles.

Expense

Total operating expenses are projected to be $31.1 million or 7 percent less than budget. The major variances in spending are attributable to:

- Operations – Savings of $16.1 million are attributable to labor, higher than budgeted offset for the administration of capital which decreases operating expense by a like amount, and unspent contingency. Labor savings are due to a large number of vacant positions driven by a continuing high number of retirements, additional staff authorized in the budget combined with the associated lead time for recruitments.
- Debt Service – Savings of $15.0 million are due to conservative budgeting of commercial paper rates, the refunding of bonds issued in June 2017 combined with reducing the amount of new bonds.

Year-End Strategies

If the projection holds true, net revenues and expense savings will be strong. The additional funds in FY18 would be utilized in FY19 to increase revenue funded capital and reduce the planned debt issuance during the fiscal year.

Capital Budget

The Board approved the Water System FY18 through FY22 Capital Improvement Program (CIP) and adopted capital appropriations for the first two years of the CIP. Adopted appropriations are used to fund expenditures over a multi-year period for each capital project, while cash flows reflect the amount estimated to be spent in a given year. Water System rates are based in part on estimated cash flow expenditures.

The Water System FY18 capital budget includes $386.5 million in appropriations and $267.7 million in cash flow. Projected cash flow is estimated to exceed planned cash flow by $12.3 million due to meeting future water demands, particularly with New Service Installations and Water Treatment Plant Improvements. With the upward trend in housing development within the District’s service area, expenditures for new service installations doubled in FY18. Spending is more than planned for Sobrante and Upper San Leandro Water Treatment Plants due to the installation of new ozone systems. This spending falls within the total amount of appropriations approved by the Board.

Fiscal Year 2019

Summary – Water System

The projected Water System year-end net revenue and expense savings are anticipated to continue to be strong. In FY19, total revenues are projected to be $23.8 million greater than budget primarily due to water charges and to a lesser amount, property taxes and SCC. Operating expenses are anticipated to be 7 percent less than budget. Similar to FY18, this strong year-end projection would eliminate the planned draw of $2.0 million from the Rate Stabilization Fund which was included in the budget to lower the rate impact on customers.

FY19 Water System Revenues and Expenses				
($ Millions)	**Amended Budget**	**Year-end Projection**	**Over/(Under) Budget**	**% of Budget**
Operating Revenues:				
Water Charges	507.5	527.0	19.5	104%
Property Taxes	30.7	33.0	2.3	107%
Power Sales	3.7	3.7	0.0	100%
Interest Income	7.4	7.4	0.0	100%
SCC Revenues	28.0	30.0	2.0	107%
Reimbursements	11.9	11.9	0.0	100%
All Other Revenue	18.1	18.1	0.0	100%
Total Revenues	**607.2**	**631.1**	**23.8**	**104%**
Operating Expenses:				
Operations	292.5	278.0	(14.4)	95%
Debt Service	210.0	191.4	(18.6)	91%
Total Operating Expenses	**502.5**	**469.4**	**(33.1)**	**93%**

Revenues

Total revenues are projected to be $23.8 million greater than budget. Of this amount, water charges, the primary driver of the additional amount, are anticipated to be $19.5 million or 4 percent above budget. Other revenue sources projected above budget include Property Taxes and SCC revenues. As in FY18, continued increase in the assessed value of sold properties and a conservative approach to budgeting results in approximately $2.3 million additional revenue above budget during FY19. SCC revenues are anticipated to be $2.0 million greater than budget based on the development queue which indicates smaller infill projects compared to the last two years.

Expenses

Total operating expenses are projected to be $33.1 million or 7 percent less than budget. In comparison to FY18, higher spending is projected for Operations resulting in lower savings, but debt service savings are anticipated to be higher. The major variances in spending are attributable to:

- Operations – Savings of $14.4 million are attributable to a lower anticipated vacancy rate as progress is made to fill the vacant positions despite ongoing retirements, higher than budgeted offset for the administration of capital which decreases operating expense by a like amount, and unspent contingency.
- Debt Service – Savings of $18.6 million are due to refunding in June 2017 combined with reducing the amount of new bonds.

Year-End Strategies

If the projection holds true, net revenues and expense savings would be strong. In FY19, applying additional funds to increase revenue funded capital could reduce the planned debt issuance by approximately $75.0 million reducing the annual debt service expense by $5.0 million starting in FY20. Increasing the revenue funded capital and reducing the amount of borrowing helps to slow the growth of annual debt service and would benefit ratepayers in the future.

Capital Budget

There are no recommended revisions to the FY19 adopted appropriations of $367.5 million or the planned cash flow of $269.8 million.

Staffing

The FY19 adopted budget authorized the addition of six positions in the Water System as shown in the below table. The additional positions will reduce the reliance on contract services and support the water control systems which monitor and manage the water treatment plants, the distribution system, and the water supply systems.

FY19 Staffing Additions		
Project/Program	**Job Class**	**FTE**
Reduce reliance on fully manned & operated contract services	Heavy Equipment Operator	2.0
	Heavy Transport Operator	2.0
	Truck Driver II	1.0
Water Treatment Plant Control Systems	Associate Electrical Engineer	1.0

Bargaining Unit Changes

The following table shows the net change in bargaining unit status from the adopted FY18 budget for the addition of six FTEs.

FY19 vs. FY18 Net Change in Bargaining Unit Status (by FTE)							
Department	**Local 2019**	**Local 444**	**Local 21**	**Local 39**	**Mgmt / Conf.**	**Non-Rep**	**Civil Service Exempt**
Maintenance & Construction	1	5					
Total Net Change	**1**	**5**	**0**	**0**	**0**	**0**	**0**

WASTEWATER SYSTEM

Fiscal Year 2018

Summary

The projected year-end net revenue and expense savings are anticipated to be strong. In FY18, total revenues are projected to be $10.2 million greater than budget primarily due to Capacity Charges and Resource Recovery. Operating expenses are anticipated to be 3 percent less than budget.

FY18 Wastewater System Revenues and Expenses				
($ Millions)	**Amended Budget**	**Year-end Projection**	**Over/(Under) Budget**	**% of Budget**
Operating Revenues:				
Treatment Charges and Permits	73.3	74.3	1.0	101%
Taxes & Bond Levy	7.0	6.2	(0.8)	88%
Wet Weather	24.0	24.0	0.0	100%
Resource Recovery	8.0	11.5	3.5	144%
Interest Income	1.5	1.1	(0.4)	71%
Lab Services	4.1	4.2	0.1	101%
Reimbursements	1.4	1.3	(0.1)	93%
Capacity Charges	1.8	9.0	7.2	500%
All Other	5.7	5.5	(0.2)	96%
Total Revenues	**127.0**	**137.1**	**10.2**	**108%**
Operating Expenses:				
Operations	70.6	69.4	(1.2)	98%
Debt Service	34.7	33.1	(1.6)	95%
Total Operating Expenses	**105.2**	**102.5**	**(2.7)**	**97%**

Revenues

Total revenues are projected to be $10.2 million greater than budget. Treatment charges & permits revenue is anticipated to be $1.0 million greater than budget. Wastewater treatment revenue is less variable compared to water sales revenue which is influenced by outdoor watering and consumption trends. The strong building activity in the SD-1 service area also favorably impacts Wastewater System's revenue as demonstrated by the projected $7.2 million in Capacity Charges revenue above budget. Resource Recovery is continuing above budget at $3.5 million. The final year of the General Obligation Bond Tax Levy will bring in $0.8 million less than the budget due to an adjustment to the tax rate to ensure that the revenue collected matches the debt service. The Interest Income is projected to be $0.4 million less than the budget because of the lag in interest rate hikes.

Expenses

Total operating expenses are projected to be $2.7 million or 3 percent less than budget. The major variances in spending are attributable to:

- Operations – Savings of $1.2 million are due to lower than planned use of chemicals though optimization of solids thickening and dewatering processes, as well as careful monitoring of the dosing of chemicals, labor savings due to vacant positions driven by retirements along with additional staffing authorized in the budget, higher than budgeted offset for the administration of capital which decreases operating expense by a like amount, and unspent contingency.
- Debt Service – Savings of $1.6 million are due to conservative budgeting of commercial paper rates, the refunding of bonds issued in June 2017 and issuing a smaller new bond issuance than planned.

Year-End Strategies

If the projection holds true, net revenues and expense savings will be strong. The additional funds in FY18 would be utilized in FY19 to increase revenue funded capital by reducing the planned debt issuance during the fiscal year.

Capital Budget

The Board approved the Wastewater System FY18 through FY22 Capital Improvement Program (CIP) and adopted capital appropriations for the first two years of the CIP. Adopted appropriations are used to fund expenditures over a multi-year period for each capital project, while cash flows reflect the amount estimated to be spent in a given year. Wastewater System rates are based in part on estimated cash flow expenditures.

The FY18 capital budget includes $34.4 million in appropriations and planned cash flows of $41.4 million. Projected FY18 capital cash flow expenditures are estimated to be $35.0 million or 85 percent of the planned cash flow due to delays in the Digester Upgrade, Treatment Plant Infrastructure and Nutrient Management projects.

Fiscal Year 2019

Summary – Wastewater System

The projected year-end net revenue and expense savings are anticipated to be strong. In FY19, total revenues are projected to be $2.1 million greater than budget. Higher revenues are primarily due to Capacity Charges and Resource Recovery. Operating expenses are anticipated to be 3 percent less than budget.

FY19 Wastewater System Revenues and Expenses				
($ Millions)	**Amended Budget**	**Year-end Projection**	**Over/(Under) Budget**	**% of Budget**
Operating Revenues:				
Treatment Charges and Permits	76.9	76.9	0.0	100%
Taxes	4.9	4.9	0.0	100%
Wet Weather	25.2	25.2	0.0	100%
Resource Recovery	8.0	9.0	1.0	113%
Interest Income	1.5	1.5	0.0	100%
Lab Services	4.3	4.3	0.0	100%
Reimbusements	1.4	1.4	0.0	100%
Capacity Charges	1.9	3.0	1.1	158%
All Other	5.7	5.7	0.0	100%
Total Revenues	**129.9**	**131.9**	**2.1**	**102%**
Operating Expenses:				
Operations	73.1	71.6	(1.6)	98%
Debt Service	31.9	30.8	(1.1)	96%
Total Operating Expenses	**105.1**	**102.4**	**(2.7)**	**97%**

Revenues

Total revenues are projected to be $2.1 million greater than budget attributable to Capacity Charges and Resource Recovery which are non-rate revenue sources. The Capacity Charges revenue projection is $1.1 million greater than budget which is lower than the prior fiscal year-end projection based on the development queue which indicates smaller infill projects compared to the last two years. Resource Recovery is projected to be $1.0 million greater than budget to reflect the continuing success of the program despite growing competition from other facilities.

Expenses

Total operating expenses are projected to be $2.7 million or 3 percent less than budget. The major variances in spending are attributable to:

- <u>Operations</u> – The $1.6 million savings are attributable to a lower anticipated vacancy rate as progress is made to fill the vacant positions despite ongoing retirements, higher than budgeted offset for the administration of capital which decreases operating expense by a like amount, and unspent contingency.

- Debt Service – Savings of $1.1 million are due to the refunding of bonds issued in June 2017 and issuing a smaller new bond issuance than planned.

Year-End Strategies

If the projection holds true, net revenues and expense savings would be strong. In FY19, applying additional revenues to increase revenue funded capital could reduce the planned debt issuance by approximately $10.0 million reducing the annual debt service expense by $0.6 million starting in FY20. Increasing the revenue funded capital and reducing the amount of borrowing helps to slow the growth of annual debt service and would benefit ratepayers in the future.

Capital Budget

There are no recommended revisions to the FY19 approved capital appropriations of $51.1 million, or the planned cash flow of $39.5 million which is sufficient to meet CIP funding needs. The delays incurred for the projects during FY18 are not anticipated to continue into FY19. Therefore, planned cash flow spending may be higher at year-end due to these projects. In such event, spending would fall within the total amount of appropriations adopted by the Board.

Staffing

The FY19 adopted budget authorized the addition of one position in the Wastewater System as shown in the below table. The additional position will support the increased workload due to the requirements of the National Fire Protection Association (NFPA) 70E standards for electrical safety in the workplace and preventative maintenance.

FY19 Staffing Addition		
Project/Program	**Job Class**	**FTE**
Electrical Integrity Program	Electrical Technician	1.0

Bargaining Unit Changes

The following table shows the net change in bargaining unit status from the adopted FY18 budget for the addition of one FTE.

FY19 vs. FY18 Net Change in Bargaining Unit Status (by FTE)							
Department	**Local 2019**	**Local 444**	**Local 21**	**Local 39**	**Mgmt / Conf.**	**Non-Rep**	**Civil Service Exempt**
Wastewater		1					
Total Net Change	**0**	**1**	**0**	**0**	**0**	**0**	**0**