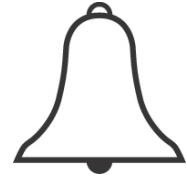


Santa Margarita Water District



MEMORANDUM

TO: Board of Directors

DATE: January 20, 2017

FROM: Daniel Ferons

SUBJECT: Capital Improvement Program

SUMMARY

Issue: The District adopted the Fiscal Year 2017 Budget in conjunction with the District's Strategic Business Plan. The District has reviewed the actual results for the five-month period ending November 2016 and adjusted its projections for the remainder of Fiscal 2017 based on changes from both internal and external factors. This includes the Capital Improvement Program analysis.

Recommendation: Information Item Only

Fiscal Impact: The reforecast of the FY 2017 Capital Improvement Program projects the cash needs, purchases and expenses, and is used to determine the adequacy of rates and charges for the current fiscal year.

Previous Related Action: The Board approved the Fiscal Year 2017 budget on May 20, 2016 and annually reviews/adopts the District's budget.

Adherence to Policy: The Capital Improvement Program reforecast adheres to the District's Investment Policy, Purchasing Policy, and Reserves Policy.

Committee Status: The draft of the Capital Improvement Program was discussed with the Engineering Committee in January with no action taken by the Committee.

DISCUSSION

In conjunction with the FY 2017 Budget Reforecast, the District also began the implementation of a full restructuring of its Capital Improvement Program (CIP) analysis process. The District completed the first phase of the TERP financial system process in January and is currently working on the design of the project segment of the financial system. This will provide a more detailed reporting structure than is currently available in the District's existing systems.

As part of the design process, all CIP projects were reviewed in significantly more detail in order to begin the transition to the new financial reporting system. The review process included more detailed classifications of each project, scheduling projections, cost estimate refinements, as well as prioritization of projects. A transition reporting system is currently being used to test the data structure that will eventually be a part of the TERP financial system.

A number of CIP projects which had more complex funding requirements were identified and a separate reporting structure is being tested. Although these projects may have significant capital costs, the net cost to the District can be significantly lower when you take into account special funding instruments. These can include:

- Grants
- State Revolving Fund loans
- Expense reimbursements for new development construction costs
- Joint Ownership Agreements with other agencies

SUMMARY OF RESULTS

During the FY 2017 CIP reforecast review process, a significant number of required repairs and replacement projects were identified after the original FY 2017 Budget was created. This included repairs and new capital projects that were expected to be completed in FY 2016, but were delayed until the beginning of FY 2017. Additional new projects that were not included in the original budget were identified, as well as other CIP projects that the District is in partnership with other agencies.

Based on the combination of actual results through November 30, 2016 and the updated projections, The FY 2017 Budget Reforecast projects the gross CIP to increase by \$25.3 million to \$47.9 million for FY 2017.

Also reviewed was the cash impact of the sources of funding for the CIP projects. Several large projects include cash receipts from a number of sources, including:

- State grant programs
- Contributions related to other agencies ownership shares of CIP projects managed by the District
- New loan agreements
- Reimbursements for CIP expenditures in the new Planning Areas.

The Reforecast projects these sources of CIP funding to increase by \$11.2 million to a total of \$19.2 million for FY 2017.

Taking into account the additional outside funding for certain CIP projects, the Reforecast projects Net CIP Activity to be \$28.7 million, an increase of \$14.1 million from the original budget.

FY 2017 REFORECAST - CIP (000'S OMITTED)

	REFORECAST FY 2017	BUDGET FY 2017	VARIANCE TO ORIGINAL BUDGET
	-----	-----	-----
GROSS CIP	\$47,925	\$22,625	\$25,300
LESS: SOURCES OF CAPITAL FUNDING	(19,205)	(7,969)	(11,236)
	-----	-----	-----
<u>NET CIP ACTIVITY</u>	<u>\$28,720</u>	<u>\$14,656</u>	<u>\$14,063</u>

NOTE: THE FY 2017 BUDGET INCLUDES A SHIFT OF \$2.5 MILLION OF TERP RELATED EXPENSES THAT WERE BUDGETED AS OTHER CAPEX, BUT WERE TRANSFERRED TO CIP.

ANALYSIS OF RESULTS

As the District designs its new financial system, a key task is to identify the critical information that is required to be able to generate useful reports as well as specifying the structure of the new reports. This will allow staff to generate a more effective way to monitor and analyze the District's CIP projects.

During the first phase of the TERP process, staff identified the general structure of the financial systems as it relates to the District's capital projects. To ensure that the optimal structure meets the needs of the District, a number of models are being designed to test the proposed structure before the TERP system is finalized.

As a part of this testing, data from all the different existing systems was extracted and imported into the test models. Through this process, additional projects that were omitted from the original budget were uncovered and subsequently included in the reforecast.

Actual expenditures for the Fiscal Year through November 30, 2017 were included in this systems test environment to serve as the base of the reforecast projections. A number of projects were expected to be substantially completed in FY 2016, but experienced delays into FY 2017. For example, the Lake Mission Viejo APW project was projected to have \$500 thousand in costs recognized in FY 2017 original budget. Due to timing issues, the majority of costs projected to be incurred in the last quarter of FY 2016 were recognized the first quarter of FY 2017. This generated a variance of \$4.6 million for this project alone in FY 2017. The total budget for the project did not change, but the variance was a timing issue. This situation also affected a number of other projects.

As a part of the design of the new system, individual projects have been grouped by facility and/or major project description in order to more easily track total project activity. Because projects can have multiple phases or have multiple funding sources, each phase or project segment is identified separately. The grouping codes allow the District to quickly view the project as a whole as well as eliminating duplicate reporting. (Table 1)

TABLE 1

**GROSS CIP SUMMARY - FY 2017 REFORECAST
 (EXCLUDES FUNDING SUPPORT)**

GROSS CASHFLOW (EXCL FUNDING SUPPORT)

FACILITY_NAME	TOTAL_BGT	ACTIVITY THROUGH 6/30/2016	REFORECAST FY2017
3A CONVEYANCE Total	\$10,051,960	\$0	\$0
3A WRP Total	5,121,240	0	731,606
AMP PS Total	86,928	0	0
ASPHALT REPAVING Total	227,712	0	0
BAKER TREATMENT PLANT Total	35,037,799	29,738,522	4,906,314
BARRIER WATER TREATMENT Total	6,051,960	0	0
CASTA RESERVOIR Total	389,640	11,719	377,921
CATHODIC PROTECTION Total	2,297,835	39,827	329,280
COTO DE CAZA LS Total	2,154,095	64,791	551,777
DIRECT POTABLE REUSE Total	551,960	0	183,987
ENGLISH CANYON LS Total	1,081,280	0	0
ENGLISH CANYON SEWER Total	0	0	0
ETM LAKEFILL LINE Total	843,300	336	842,964
FOOTHILL RESERVOIR Total	353,300	7,630	345,670
FORCE MAINS Total	80,773	0	80,773
GOBERNADORA Total	19,739,120	18,529,959	568,155
HEADQUARTERS Total	167,320	0	167,320
HORNO LS Total	2,461,219	0	0
HYDRAULIC RESTRICTIONS Total	4,046,187	0	0
ISLAND PASTURE RESERVOIR Total	327,167	7,970	106,483
LA PATA INTERTIE PROJECT Total	227,712	0	0
LA PAZ PS Total	210,815	62,643	148,172
LADERA LS Total	224,619	0	0
LAKE MISSION VIEJO Total	5,605,880	474,047	5,131,833
LOS ALISOS WTP Total	669,629	287,705	381,925
LOS PATRONES HIGHLINE Total	1,070,000	910,561	159,439
LYONS Total	17,309	0	17,309
MEADOW RIDGE LS Total	102,187	0	0
MELINDA PS Total	62,165	14,249	47,916
MESA PS Total	44,619	0	44,619
MONTEREY VILLA PS Total	484,640	0	0
PLANO LS Total	601,568	0	6,924
PLANO RESERVOIR Total	733,920	0	0
PW PIPELINE Total	1,240,000	0	114,783
RANCHO TRABUCO RESERVOIR Total	196,547	0	196,547
RESERVOIR SYSTEMS Total	713,856	0	0
RW CONVERSIONS Total	23,734,111	190,719	1,540,993
RW PIPELINE Total	156,600	4,500	50,700
SAN JUAN CREEK LS Total	525,980	0	450,205
SAN JUAN WATERSHED Total	155,248,253	0	1,513,316
SCADA Total	1,015,901	502,941	146,795
SJBA Total	465,011	156,157	308,854
SOCWA Total	10,459,223	5,565,222	1,633,534

TABLE 1 (continued)

**GROSS CIP SUMMARY - FY 2017 REFORECAST
 (EXCLUDES FUNDING SUPPORT)**

GROSS CASHFLOW (EXCL FUNDING SUPPORT)

FACILITY_NAME	TOTAL_BGT	ACTIVITY THROUGH 6/30/2016	REFORECAST FY2017
SOUTH RANCH LS Total	422,880	0	43,987
STARR RESERVOIR Total	263,475	7,389	256,086
TALEGA LS Total	189,140	0	0
TERP Total	4,980,207	1	1,703,000
TRABUCO RIDGE RESERVOIR Total	428,475	12,843	415,632
TRAMPAS RESERVOIR Total	127,588,880	2,348,140	778,046
UNDESIGNATED PW Total	166,667	0	0
UNDESIGNATED RW Total	166,667	0	0
UNDESIGNATED WW Total	166,667	0	0
UPPER CHIQUITA RESERVOIR Total	713,658	157,065	112,439
UPPER OSO RESERVOIR Total	448,605	0	140,261
VALVE REPLACEMENT Total	556,807	123	187,404
WW REPAIR Total	677,712	0	250,000
PA'S - CFD REIMBURSED Total	27,041,333	13,838,224	9,092,569
PA'S - SMWD BONDS Total	30,066,569	6,279,566	998,893
PLANT SUMMARY - 3A Total	14,410,321	0	3,718,691
PLANT SUMMARY - CHIQUITA Total	27,569,796	2,346,227	5,070,224
PLANT SUMMARY - OSO CRK Total	5,210,433	116,413	1,289,647
<u>GROSS CIP</u>	<u>\$540,222,562</u>	<u>\$83,166,641</u>	<u>\$47,924,769</u>

GROSS CIP

The Gross CIP incorporates the District's capital expenditures for internally funded projects. Gross CIP includes projects that the District is constructing for the new Planning Areas and developments for which the District will be reimbursed for the construction costs. Gross CIP also includes the total cost of projects that are jointly owned by other districts or agencies for which the District collects reimbursement for our partners' share of the costs. For CIP projects that are managed by other districts or agencies, the Gross CIP includes the District's share of costs.

For the FY 2017 Reforecast, the Gross CIP is projected to be \$47.9 million, an increase of \$25.3 million over the original budget. This increase is a result of additional repairs/replacement activity, and shifts in the timing of expenses from FY 2016 to FY 2017. Additional new projects that were not included in the original budget were identified, as well as other CIP projects that the District is in partnership with other agencies.

CIP FUNDING OFFSETS

A critical component of the District's management of its CAPEX program is the ability of the District to utilize alternative funding sources, especially with some of the District's larger projects. It is also important to recognize that a significant portion of the District's CIP includes construction projects in the new Planning Areas which will be reimbursed either by the developer or from bond funds managed by other districts or agencies. The key components of these funding offsets include:

- Reimbursements from Planning Area construction - \$12.8 million
- Lake Mission Viejo APW loan from the City of Mission Viejo - \$3.0 million
- Grant funding – \$1.6 million
- Partner contributions and other reimbursements - \$1.6 million

For the FY 2017 Reforecast, the total CIP funding offsets are projected to be \$19.2 million or an increase of \$11.2 million over the original budget. As with the Gross CIP, a large amount of reimbursements for FY 2016 activity was shifted to FY 2017, explaining a significant portion of the increase.

NET CIP CASH ACTIVITY

Net CIP Cash Activity are the Gross CIP expenses incurred by the District less the CIP Funding Offsets. This represents the net current year cash costs of the CIP projects to the District. For the FY 2017 Reforecast, Net CIP Cash Activity is projected to increase the cash deficit by (\$14.1) million to (\$28.7) million of net CIP costs. The primary drivers of the increase are the combination of factors detailed previously in the Gross CIP section. The additional CIP Funding Offsets help to limit the increased use of cash. (Table 2)

TABLE 2

	REFORECAST FY 2017 (000'S OMITTED)
GROSS CIP	
CIP - CAPITAL REPAIRS/REPLACEMENT	\$12,262
CIP - NEW DEVELOPMENT	18,773
CIP - RELIABILITY/REGIONAL PROJECTS	16,890

<u>TOTAL GROSS CIP ADDITIONS</u>	<u>47,925</u>
CIP FUNDING OFFSETS	
NEW BOND/LOAN PROCEEDS/LEASES	3,000
GRANT PROCEEDS	1,637
CAPITAL REIMBURSEMENTS	14,568

<u>TOTAL CIP FUNDING OFFSETS</u>	<u>19,205</u>

<u>NET CIP CASH ACTIVITY</u>	<u>(\$28,720)</u>

In the FY 2017 Reforecast, Net Cash Flow Available for CAPEX Activity is only \$6.9 million in FY 2017, so the Net Consolidated Cash Flow for the District is a cash deficit of (\$24.0) million (including \$2.2 million of other CAPEX costs). A portion of the cash deficit will be funded by cash from previously issued bond funds that are reserved for specific uses. However, the last bond issuance was completed several years ago, so there is only a limited amount of available cash in these remaining funds.

Although the District currently has sufficient unrestricted cash available to cover the deficit, the District's cash balances have been declining significantly over the past several years. Further declines in the District's cash balances will affect the District's credit rating which can increase the overall cost of borrowing money in the future.

TOPICS FOR FURTHER DISCUSSION

In order to fund the District's current CAPEX program, significant changes in the District's cash sources must be considered. The District's two primary sources of cash generation need to be

reviewed to determine the optimal structure that both adequately funds critical CAPEX projects, and minimizes the financial impact on the District's customers.

The District's current rate structure, based on the rate study performed in 2015, did not adequately provide sufficient funding when large structural changes in the business occurred. Events such as the recent drought reduction mandates from the state and subsequent relaxing of the rules caused large fluctuations in customer water usage and added to the uncertainty of cash generation from rates.

The District is currently analyzing the current rate structure in order to determine the level of funding necessary to properly fund operating activities. In addition, the rate structure must also support certain debt service that is repaid from operating funds, replenish cash reserves that have been depleted over the past several years, as well as fund certain CAPEX that adequately maintains the District's infrastructure.

The District is also currently analyzing various debt instruments that can fund longer term CAPEX projects. The use of rates has certain restrictions which limit their ability to fund certain CAPEX projects, so the District must explore other funding sources to support these large projects. Because several of the projects provide benefits to all customers and are long term solutions to the District's structural goals, long term debt instruments are a more stable and predictable source of funding for these types of long term assets.

The use of reserves and the related cash balances must also be reviewed since both are a critical part of the District's financial structure. Although the District has a significant cash balance, the constant use of reserves has substantially depleted the District's cash levels over time. Cash balances are one of several factors that affect the District's credit rating which in turn will affect the District's borrowing costs if debt instruments are issued.