



Comments and Recommendations on the Proposed Amendment to the FY06 Current Expense Budget

I. OVERVIEW

INTRODUCTION

As of January 25, 2006, the MWRA submitted a proposed amendment to the FY06 Current Expense Budget to the Advisory Board for its review and comment. Due primarily to increased costs and usage of electricity and diesel fuel, the Authority estimates that it faces greater than budgeted spending of \$5.39 million in FY06. The agency anticipates that non-rate revenue of an estimated \$2.05 million will contribute to closing the budget gap. Authority staff propose the remaining \$3.34 million come from an additional drawdown from the rate stabilization fund.

The Authority's budget policies call for a current expense budget amendment if there is any increase in total current expenses, an increase of 5% or more in total division expenses, or an increase in any expense line item of 15% or more if that line item is at least 2.5% of total current expenses. Increased spending meets two of these criteria: an increase in total current expenses and a 23% increase in *Utilities* expense (which is 4.8% of all current expenses). This is the first budget amendment (other than the unusual budget crisis and elimination of the entire debt service assistance program in FY03) since 1999, and reflects the much greater assumption of risk in the Authority's budget, particularly for Operations expense.

As provided for in the enabling act (Section 8(b) of Chapter 372 of the Acts of 1984), the Advisory Board has at least 30 days prior to the Authority's adoption of the amendment to review and comment on the proposed amendment. The Advisory Board anticipates discussion of draft *Comments and Recommendations* at the February 17 meeting of the Executive Committee and consideration and a vote at the February 23rd meeting of the full Advisory Board. Following transmittal of *Comments and Recommendations* to the MWRA, the Authority's Board of Directors will consider action on the amendment as soon as the March 8 meeting.

EXECUTIVE SUMMARY

Review of the Amendment

The MWRA has submitted to the Advisory Board a proposed amendment to the FY06 Current Expense Budget. The amendment identifies increased expenses of nearly \$5.4 million (1% of the total budget), to be covered by projected increases in non rate revenue and charges of \$2 million plus a withdrawal of nearly \$3.4 million from the funds remaining in the rate stabilization fund. (See Table 1 on page 3.)

The increased expenses include an additional \$6 million in *Direct Expense* spending and \$0.4 million for *Indirect Expenses* partially offset by a credit for interest paid on some outstanding debt of \$1 million. The principal driver of increased expenses is greater than budgeted use and price for electricity, diesel fuel and natural gas. Other factors impacting the FY06 budget include increased costs for health insurance, cost increases for certain chemicals, increased production of sludge pellets, and rising short term interest rates.

Updated forecasts and assumptions for the remainder of FY06 point to additional increases estimated at \$1.3 million offset by a similar estimate for reduced expenses in other areas. Thus the estimate of the budget gap remains essentially unchanged since the amendment was drafted: \$3.34 million after use of just over \$2 million from other non-rate revenues and income. ***The Advisory Board recommends that the Authority offset the gap with updated reductions in spending forecasts (particularly following resolution of the disputed A&F administrative charges for the Watershed Trust) plus additional income estimated for higher levels of participation in the load response program (through which the Authority substitutes electricity purchases for Deer Island with increased operation of the backup combustion turbine generators). The remaining amounts should be covered by greater than budgeted Investment Income, reserving rate stabilization funds to ease the pace of rate increases in future years.***

The Authority is expected to act on the amendment some time in the spring. In the meantime, it has been important to identify the need for the amendment and to identify alternatives for closing the budget gap.

Pressure on FY07 and Future Budgets

These cost increases can be expected to impact future budgets as well. While the Authority has, in recent years, achieved significant cost savings in such as areas as reduced staffing levels, limitations on the use of overtime, efficiencies in operations and maintenance, and renegotiated contracts for purchased electricity and for residuals processing services, these other externally imposed cost increases present new challenges for the Authority's budgets. These challenges are particularly difficult to absorb in the next several years as capital financing expense is projected to rise steeply from \$326.5 million today to a projected \$443.4 million by FY 2010, an increase of more than \$115 million over the four-year period. Rate stabilization funds, which in the past have served to ease rate increases, are quickly being drawn down over the next several years. And debt service assistance funding, while being gradually reintroduced in the last three years, is still much lower than when the program was fully funded five and more years ago and remains enough of an uncertainty that the Authority does not include receipt of such funds in the planning projections.

For FY07, the 9.8% (or \$46.3 million) increase would have been a 17.4% or \$81.9 million increase had the Authority not drawn down \$35.7 million in Rate Stabilization (and Bond Redemption Fund) Reserves, the highest use of these funds in any one year (with the exception of FY03, when Debt Service Assistance was eliminated mid-year). (See Table 2 and Figure 1 on page 4.)

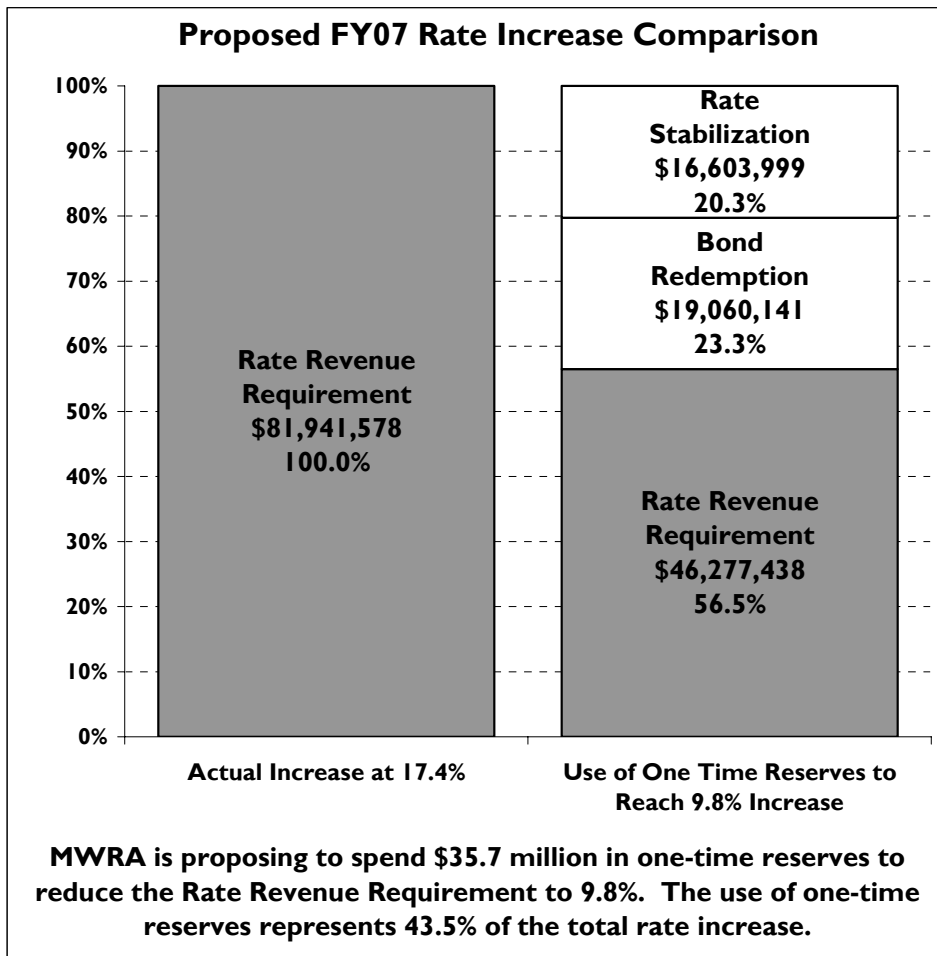
Table 1

Fiscal Year 2006 Current Expense Budget Amendment			
	MWRA Final FY06 Budget	Proposed Adjustments	Percentage Difference
Direct Expenses			
Wages and Salaries	\$81,374,007	\$0	0.0%
Overtime	3,623,241	85,000	2.3%
Fringe Benefits	13,681,934	317,000	2.3%
Workers' Compensation	1,200,000	(400,000)	-33.3%
Chemicals	7,417,960	(142,000)	-1.9%
Utilities and Energy	25,338,635	5,858,000	23.1%
Maintenance	20,491,588	0	0.0%
Training and Meetings	253,690	(50,000)	-19.7%
Professional Services	7,021,597	161,000	2.3%
Other Materials	3,781,117	15,000	0.4%
Other Services	21,557,797	174,452	0.8%
Subtotal	\$185,741,566	\$6,018,452	3.2%
Indirect Expenses			
Insurance	\$2,350,000	\$0	0.0%
Watershed/PILOT	24,302,167	(500,000)	-2.1%
BECO Payment	4,547,350	150,000	3.3%
Mitigation	1,380,000	720,000	52.2%
Addition to Reserves	866,000	0	0.0%
Retirement Fund	3,578,000	0	0.0%
Subtotal	\$37,023,517	\$370,000	1.0%
Debt Service			
Debt Service	\$312,149,194	(\$1,000,000)	-0.3%
Debt Service Assistance	(10,000,000)	0	0.0%
Subtotal	\$302,149,194	(\$1,000,000)	-0.3%
TOTAL EXPENSES	\$524,914,277	\$5,388,452	1.0%
NON-RATE REVENUE AND INCOME			
Other User Charges	\$6,916,528	\$753,251	10.9%
Other Revenue	4,959,994	1,298,000	26.2%
Rate Stabilization	10,739,948	3,337,201	31.1%
Investment Income	30,078,007	0	0.0%
Subtotal	\$52,694,477	\$5,388,452	10.2%
RATE REVENUE	\$472,219,800	\$0	0.0%
TOTAL REVENUE	\$524,914,277	\$5,388,452	1.0%
PROJECTED FY06 DEFICIT		\$5,388,452	

Table 2

The Full Rate Revenue Requirement for the Proposed Fiscal Year 2007 CEB	
FY06 Rate Revenue Requirement is:	\$472,219,800
The <u>ACTUAL</u> FY07 Rate Revenue Requirement is:	\$554,161,378
An Increase of:	\$81,941,578
or:	17.4%
MWRA is Proposing to Utilize One-Time Reserves in FY07 to Reduce the Rate Revenue Requirement to Under 10%	
Actual FY07 Rate Revenue Requirement	\$554,161,378
Bond Redemption	(19,060,141)
Rate Stabilization	(16,603,999)
Revised FY07 Rate Revenue Requirement	\$518,497,238
An Increase of:	\$46,277,438
or:	9.8%

Figure 1



II. THE REVIEW OF EXPENSES AND REVENUES

The Authority has forecast expenses totaling \$5,388,452 greater than the budgeted amounts by June 30, 2006, or 1% of the \$524,914,277 budgeted for total expenses. Of this amount, Direct Expense spending is expected to reach \$6,018,452 more than budgeted, Indirect Expense spending is projected to be \$370,000 more than budgeted, and Debt Service expense is expected to be \$1,000,000 less than budgeted.

DIRECT EXPENSES

Wages and Salaries. The Authority has budgeted \$81,374,007 for *Wages and Salaries* expense in FY06. While the proposed amendment did not include any changes to this category of expense, more recently two developments are worth noting. Staff report that the Leave Balance Accrual, which accounts for accumulated earned vacation and sick leave, had not been fully reflected in the approved budget. The amount is currently estimated to be on the order of \$500,000; calculations are ongoing. A second update has been provided for revised levels of spending in the Support Division: staff now forecast that spending will be \$607,870 lower than budgeted for the Division.

Overtime. The Authority has forecast an \$85,000 increase to *Overtime* expense from the \$3,623,241 in the approved budget. The increase is in the Operations Division and covers weather and pipe break emergencies beyond what had been assumed in the approved budget.

Fringe Benefits. Staff report that forecasts for additional *Health Insurance* expense remain the same at \$317,000 more than the \$11,666,661 included in the approved budget. However, *Unemployment Insurance* is now expected to be over the \$60,000 budget by \$57,000 and *Medicare* expense is forecast to be \$27,806 more than the \$1,022,700 originally budgeted. Lower spending for *Tuition* expense of \$14,364 as compared to the \$31,000 budgeted leaves a net increase of \$70,442 in additional pressure on the budget.

Workers' Compensation. The proposed amendment forecast that this category of expense would be \$400,000 lower than the \$1,200,000 budgeted for FY06. However, more recent estimates put under spending closer to \$377,000 by year end, adding \$23,000 to the estimate of the budget gap.

Chemicals. The proposed amendment anticipates lower spending on *Chemicals* of \$142,000 as compared to the \$7,417,960 budgeted, based on lower usage more than offsetting projected increases in pricing. The most notable reduction is for *Hydrogen Peroxide* usage at the Deer Island Wastewater Treatment Plant resulting in a forecast of underspending of \$164,000. Usage or price increases for other chemicals, such as hydrofluosilic acid and sodium hydroxide are offset by lower spending for soda ash and sodium hypochlorite.

Utilities. The proposed amendment anticipates increased spending of \$5,858,000 for *Utilities* expense, as compared to the \$25,338,635 budgeted, primarily due to increased price and usage of *Electricity* and *Diesel Fuel*. For *Electricity*, increased pricing totaling \$2,853,00 (as compared to the \$19,923,952 budgeted) was partially offset by lower usage at Deer Island (due to increased operation of the combustion turbine generators in support of participation in the

load response program and increased operation during certain wet weather events) and by lower and later usage at several Field Operations facilities. *Diesel Fuel* expense increased by \$2,850,000 (compared to the \$2,872,592 budgeted) due to pricing increases of \$1,381,000 and \$1,540,000 for increased use to participate in the load response program of ISO New England. Increases in Deer Island *Diesel Fuel* expense is partially offset by \$2,178,000 in payments through the renewable portfolio credits and price response programs managed by ISO New England, an increase of \$1,678,000 over payments of \$500,000 assumed in the approved FY06 budget.

A portion of the expanded Combustion Turbine Generator (CTG) use during the fall of 2005 was the result of a shut down of electricity supplied through the cross harbor cable. The Authority had to operate the CTGs for a period of time, which, in the absence of a payment through the load response program, is more expensive than purchased electricity. This event and subsequent, side by side operation to ensure reliability during the next major wet weather event, resulted in significant additional consumption of diesel fuel beyond the budgeted amounts. Reliability of electricity supply will continue to be a concern for the Authority. **Work with NStar to ensure improved reliability of purchased electricity. Continue to make equipment and operational modifications to minimize start up of the CTGs during periods of interruptions in electricity supply.**

More recently, Authority staff have updated the forecast for energy use and price at Deer Island and now anticipate additional costs of \$671,522 for *Electricity*. The amount is expected to be partially offset by additional participation in the price response program (as requested by ISO New England).

While the relatively mild winter thus far has resulted in eased pressures on price and usage assumptions of natural gas, electricity and diesel fuel, prices remain well above levels experienced in recent years. Energy costs can be expected to be the largest driver of increases to Direct Expenses in the years ahead.

Maintenance. The Authority anticipates no changes to the \$20,491,588 budgeted for *Maintenance* expense for FY06. Any increases for greater than budgeted or unbudgeted *Maintenance* expense, such as the hydropower turbine repairs at Deer Island, are to be absorbed within the existing budget.

Training and Meetings. The proposed budget amendment anticipates \$50,000 in lower spending on *Training and Meetings*, as compared to the \$253,690 budgeted. The lower spending is based on forecasts for the Operations Division.

Professional Services. The proposed amendment includes \$161,000 in increased *Professional Services* spending, as compared to the \$7,021,597 budgeted for FY06. The amount includes \$75,000 for construction and fitout at Chelsea (to accommodate the move of a number of employees from the Charlestown Navy Yard) and additional funding for erosion evaluation and survey work. Updated estimates also identify lower spending of \$131,248 for lower training and claims administration expense.

Other Materials. The proposed amendment includes \$15,000 in increased spending as compared to the \$3,781,117 budgeted. Staff report that the primary driver of the increased spending is to support the transfer of core borings being moved from the Fore River Shipyard.

Other Services. The proposed amendment includes \$174,452 for increased spending as compared to the \$21,557,797 budgeted. Much of the increase, \$650,000, is for additional *Sludge Pelletization* costs, as compared to the \$11,062,000 budgeted. Other cost increases for relocation of the records center and for communications improvements are offset by lower rent and landfill reservation fee expense.

INDIRECT EXPENSES

Insurance. The amendment assumes no change to the \$2,350,000 budget for *Insurance* expense. However, *Premiums* expense has been nearly 10% below budget; the budget for this portion of the *Insurance* category is \$1,650,000 for the year.

Watershed Reimbursement. MWRA helped establish the Water Supply Protection Trust (Trust) in FY05. The establishment of the Trust for the FY05 budget shifted funding for the Office of Watershed Management from the Commonwealth's General Fund to a separate account intended to provide a reliable stream of revenue for watershed protection independent of the state budget process. During spring 2005, MWRA was informed by the Commonwealth the Trust is subject to an Executive Office of Administration and Finance (A&F) Overhead Charge to cover expenses incurred by the Commonwealth in managing the Trust. The A&F Overhead Charge is assessed upon all trusts managed by state employees unless explicitly exempted by the Executive Office of Administration and Finance. In FY06, MWRA estimates the A&F charge to be approximately \$2.1 million.

In response to the surprise supplemental charges to the Trust, the MWRA and the MWRA Advisory Board have jointly submitted legislation to waive the A&F Charge. Identical language has been approved by both the House and Senate in the FY06 Supplemental Appropriation Bill currently in conference committee. A waiver of the A&F fee would provide MWRA with a minimum of \$1.4 million refund on FY05 expenses. If the legislation is enacted prior to the end of FY06, MWRA should account for the refunded and avoided costs within the CEB. **Revise the FY06 *Watershed Reimbursement* line item to reflect the savings generated from the jointly sponsored A&F Waiver legislation if the proposed legislation is enacted prior to the end of FY06.**

The Office of Watershed Management is budgeting \$12,077,755 in FY06 for operating and capital costs. The total watershed operations budget includes \$2.1 million to cover the FY06 A&F Charge. Through December, spending on watershed operations is estimated at \$5.1 million, or 51%, of the total FY06 budget, excluding the supplemental A&F Charge. The Office of Watershed Management staff project FY06 year-end spending to be close to budget. **Update the *Watershed Reimbursement* line item in the FY06 budget to reflect any revised year-end spending projections.**

Watershed/PILOT. MWRA is budgeting \$6,894,824 in FY06 to compensate 31 watershed communities for *Payments In Lieu of Taxes (PILOT)* for land owned by the

Commonwealth. This is an annual charge to MWRA and is managed by Division of Water Supply Protection staff at the Department of Conservation and Recreation.

The *PILOT* calculation is based on multiplying the Department of Revenue valuation of watershed property by the highest local property tax classification. The *PILOT* legislation also ensures that the total charges to the MWRA can never be less than that of the previous year regardless if the land or tax rates decrease. These two factors provide distinct financial advantages for MWRA *PILOT* communities.

Every five years, the Department of Revenue undertakes a formal process to revalue *PILOT* charges. This process updates local tax rates, accounts for the purchase of new property and reflects changes in land values. The latest revaluation process took place in 2005. The MWRA FY06 budget included a 32% increase in the *PILOT* line item from the prior fiscal year in anticipation of additional costs associated with the revaluation. The revaluation process is now complete and Division of Water Supply Protection has requested a payment of \$5,913,792 for FY06.

In response to preliminary discussions with DCR staff regarding the *PILOT* payment, MWRA reduced the projected outlay by \$500,000 within the FY06 Budget Amendment. With the formal request now in hand, MWRA can reduce the FY06 *PILOT* payment event further. **Reduce the budgeted FY06 *PILOT* by an additional \$481,032, reflecting the January 26th payment request by DCR.**

HEEC Agreement. In the proposed amendment, the Authority anticipates \$150,000 in increased payments to the Harbor Electric Company (a subsidiary of the Boston Edison Company, now NStar). This category of expense is the repayment of the investment over a 25-year period of the installation of the cross-harbor cable to Deer Island and the construction of the power substation in South Boston, plus annual operating and maintenance costs. The approved budget includes \$4,547,350 for these charges. The increased payments are for new projects in FY06 including the design elements for the auto synchronizing controls and SCADA enhancements.

Mitigation. The proposed amendment includes \$720,000 for additional *Mitigation* expense to fund upfront the remaining cost of fire equipment as part of the agreement with Winthrop.

Additions to Reserves. The proposed amendment assumes no additional accruals to fund the *Operating Reserve* requirement, as compared to the \$866,000 in the approved budget. Increases to Operating Costs and therefore to the *Operating Reserve* requirement resulting from the cost increases in this amendment will be reflected in the FY07 budget.

Retirement Fund. The proposed amendment assumes no further increases to the annual payment into the *Retirement Fund* for FY06, beyond the \$3,578,000 in the approved budget.

Debt Service

State Revolving Loan Fund (SRF). The Authority has been able to borrow at higher levels than assumed in the budget from the State Revolving Loan Fund. While this results in lower cost

debt for the Authority, it does increase the debt service in this category from \$2,238,509 to \$4,181,777 for an increase of \$1,943,268.

Debt Service for a New FY06 Borrowing. The Authority had budgeted \$5,773,959 for debt service associated with a new borrowing during the budget year. The timing of this borrowing is now later than assumed in the budget, resulting in estimates of lower payment during FY06; the amount will be determined when the borrowing is priced. Lower expense from the later borrowing and from savings on a planned \$550 million in refundings are expected to fully offset any greater than budgeted costs in other areas of Debt Service expense.

Commercial Paper Interest Expense. As the Authority completes certain major projects, commercial paper that had been used to finance these projects must be replaced with long term borrowings; until these borrowings are made, interest on the applicable commercial paper can no longer be capitalized and must be paid from the current expense budget. The Authority budgeted \$1,875,000 for these payments but the delay in the FY06 borrowing has resulted in revised estimates of interest expense, projected to rise to \$3,000,000. Again, this greater than budgeted expense is expected to be offset by savings and lower expense associated with the spring borrowing.

Debt Service Assistance. The Authority has budgeted receipt of \$10,000,000 from the Debt Service Assistance fund, expected to be paid during the spring. The amount is treated as an offset to Debt Service expense. Depending on the level of activity in the program from other communities, this amount could be somewhat different from the \$10 million estimate. **Update Debt Service Assistance receipts prior to finalizing the Budget Amendment.**

REVENUE AND INCOME

Rate Revenue. The proposed amendment assumes no additional revenue will be raised through water and sewer rates in order to close the budget gap.

Other User Charges. The proposed amendment includes revenue of \$753,251 in addition to the \$6,916,528 in the approved budget. The additional revenues reflect unbudgeted entrance fees from the *Town of Reading* and the *Dedham/Westwood Water District*, both of which were approved for entry into the Authority's water system this fiscal year, plus a balancing accrual for additional *Water* use at Deer Island.

Other Revenue. The proposed budget amendment includes revenue of \$1,298,000 in addition to the \$4,959,994 in the approved budget. Payments totaling \$1,478,000 from the *price response program* and for the sale of *renewable portfolio standard certificates* plus \$120,000 for retroactive credit associated with *Hingham*, were partially offset by lower *hydropower revenue* at the Cosgrove hydropower facility. More recently, staff estimate price response revenues at a level at least \$200,000 more than assumed in the amendment. **Revisit income forecast from the price response program and increase assumptions by at least \$200,000.** Additional funds of \$40,528 for a credit payment from NStar to correct a billing at the Norumbega Reservoir are also projected.

Investment Income. The proposed amendment assumes that budgeted *Investment Income* of \$30,078,007 will not change. Through January, the Authority has accrued more than \$2,873,440 in greater than budgeted *Investment Income*. **Reassess estimates for all categories of *Investment Income* and increase assumed revenue by the amount needed to close the budget gap.**

Rate Stabilization Fund. The proposed amendment is assuming an increase of \$3,337,201 to the use of \$10,739,948 already budgeted for use from the *Rate Stabilization Fund* in FY06. The additional amount to be withdrawn may fluctuate depending on the identification of additional FY06 costs that may arise as the second half of the year progresses as well as the potential for lower costs and increased non rate revenues in the coming months. **Substitute *Investment Income* for use of *Rate Stabilization Funds* to close the budget gap; reserve any *Rate Stabilization Funds* to ease the pace of water and sewer rate increases in future years.**