



Finance and Asset Management Committee

Update on Business Model Review and Refinement Ad Hoc Working Group: Fixed versus Volumetric Revenues and Reserves

Item 6d

February 11, 2025

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Fixed versus Volumetric Revenues and Reserves

Subject

- Update on Business Model Review and Refinement Ad Hoc Working Group: Fixed versus Volumetric Revenues and Reserves

Purpose

- Inform the Board on the Review for Fixed versus Volumetric Revenues and Reserves

Summary of Work Completed To-Date

Metropolitan's Reserve Policy

- Reviewed background information on Metropolitan's unrestricted reserves
- Discussed strengths & weaknesses of existing unrestricted reserve policy
- Identified list of technical and policy changes that are being analyzed and evaluated for the next Workgroup meeting, including:
 - Addressing climate impact and recent supply and sales volatility; adapting to changing operations and providing rate protection for the treated system; established a funding mechanism to reach the Target reserves; clarifying the appropriate use of reserve exceeding the target

Potential New Fixed Revenues (including items such as a voluntary level pay plan)

- Reviewed background information on fixed revenues, progress made to date to increase fixed revenues, and benchmarks compared to other water wholesalers
- Discussed potential new fixed revenues under consideration and other fixed revenue concepts (e.g. voluntary level pay plan), and their alignment with reserve policy objectives

The Use of Conservative Water Transactions Assumptions for Setting Water Rates

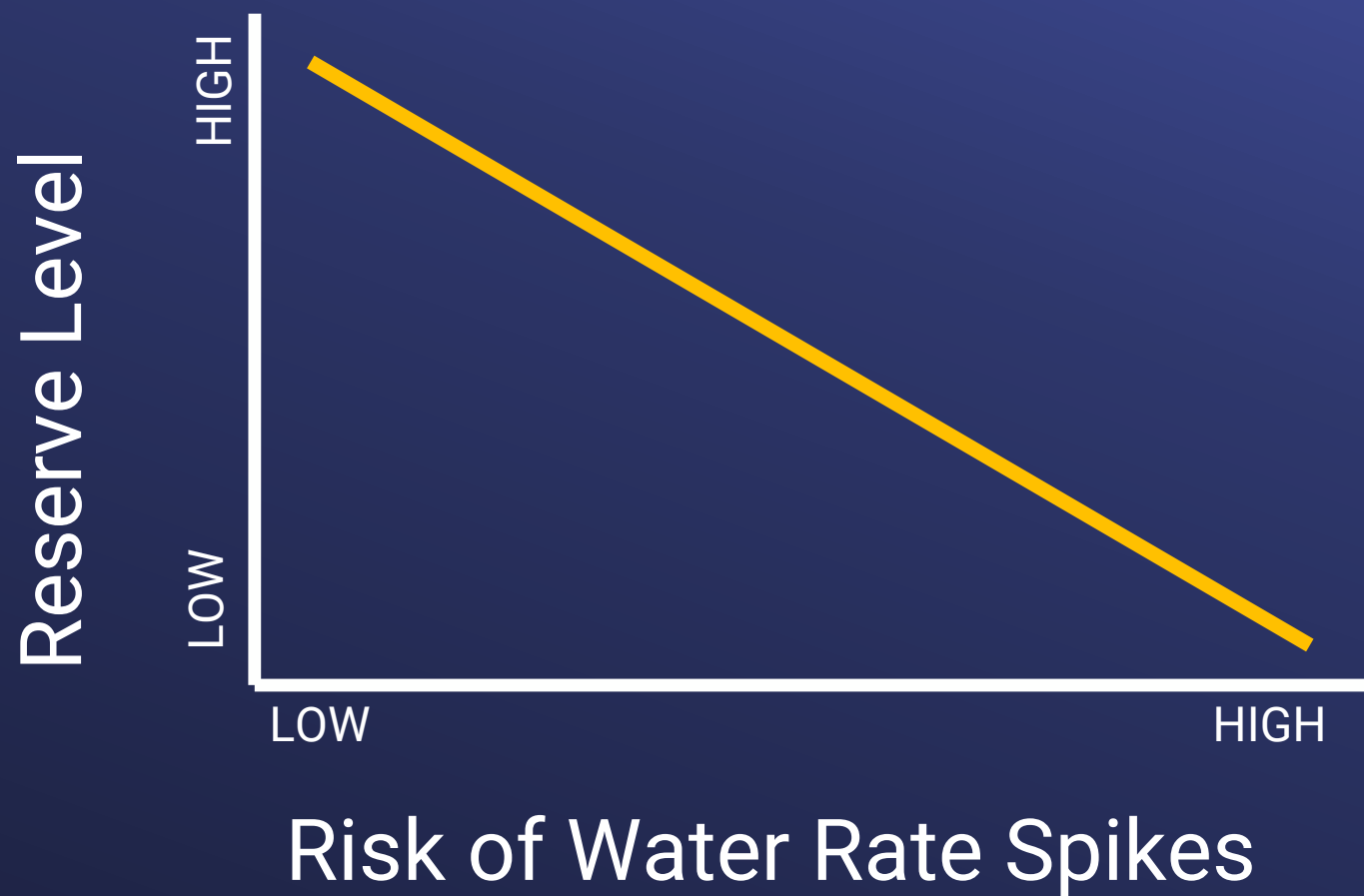
- Reviewed implication of choosing a budgeted demand forecast
- Reviewed the demand forecast assumptions for the current biennial budget, including impacts on rate increase and their relationship with the reserve policy objectives

Unrestricted Reserves

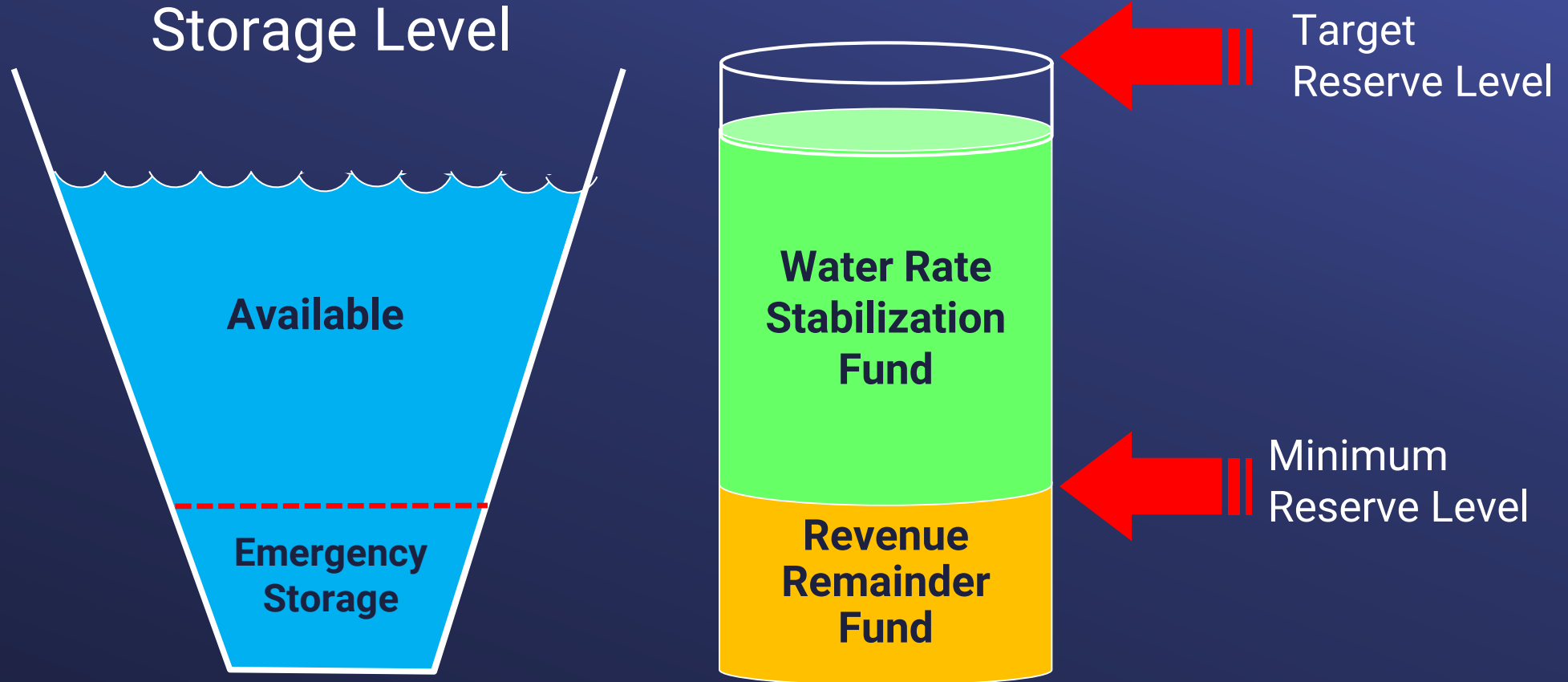
Unrestricted Reserve Fund Principles

- Current method was adopted with the 1999 Long Range Finance Plan
- MWD Administrative Code § 5202
 - Established to smooth out and/or mitigate future water rate increases
 - Provides funds to cover revenue shortfall resulting from 20% reduction in water transactions
 - Minimum fund level provides 18 months of rate protection
 - Target fund level provides additional 2 years of rate protection for a total of 3.5 years
 - Provide stable & predictable water rates
 - Provide stable rates for local water resource investment planning
 - MWD rate used as a regional benchmark

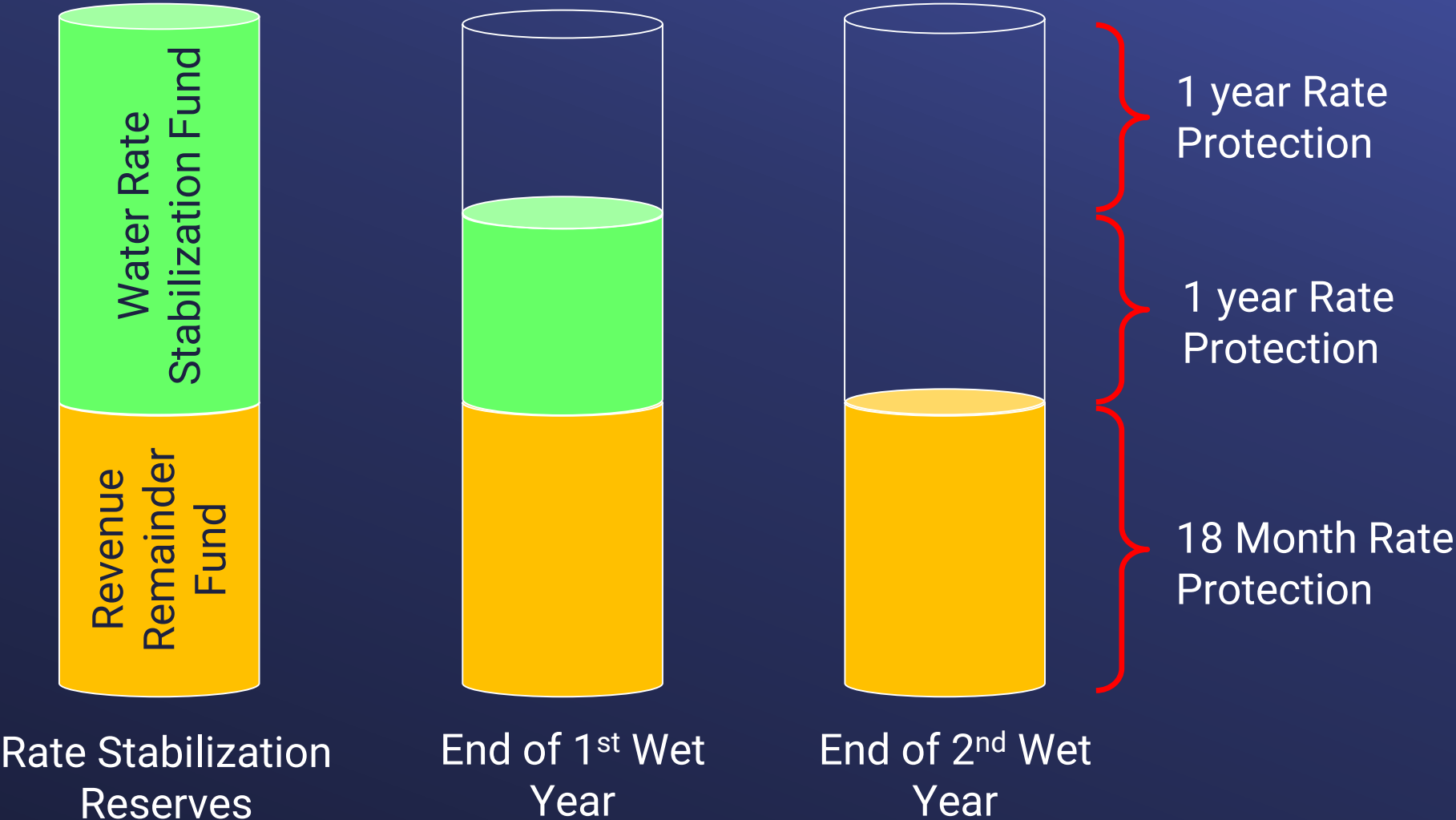
Unrestricted Reserve Level vs. Rate Spikes



Unrestricted Reserve Fund



Use of Unrestricted Reserve Fund



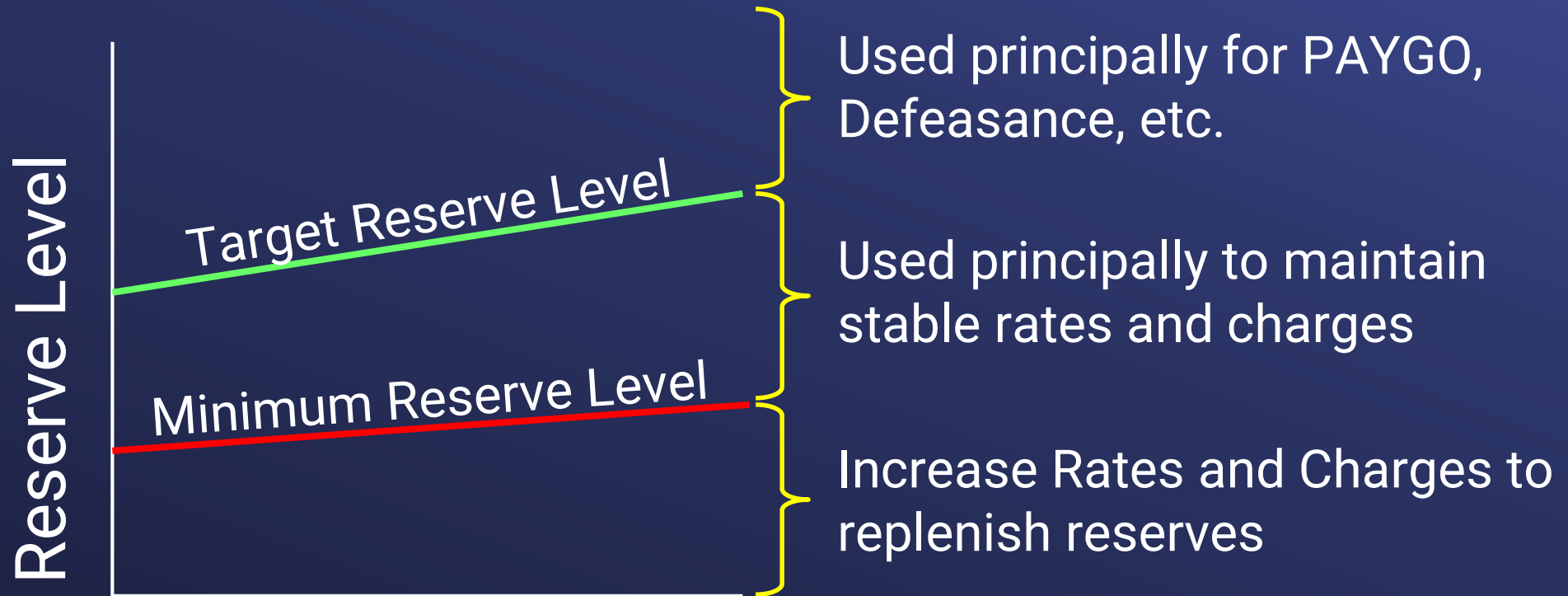
Rate Setting Timeline



Unrestricted Reserve Policy

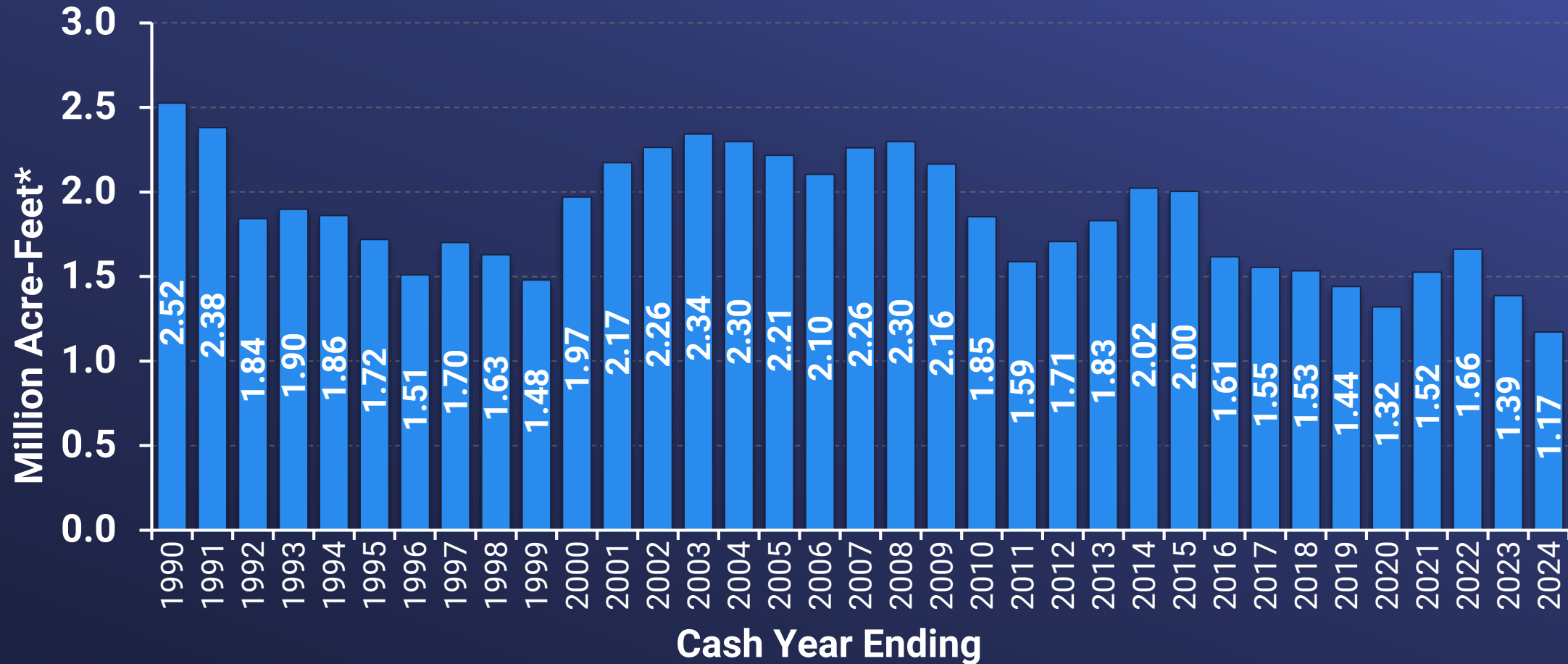
Reserve Fund Principle:

Provide stable & predictable water rates



Metropolitan's Historic Water Transactions

Water Transactions are Variable



*Water Transactions for member agencies only

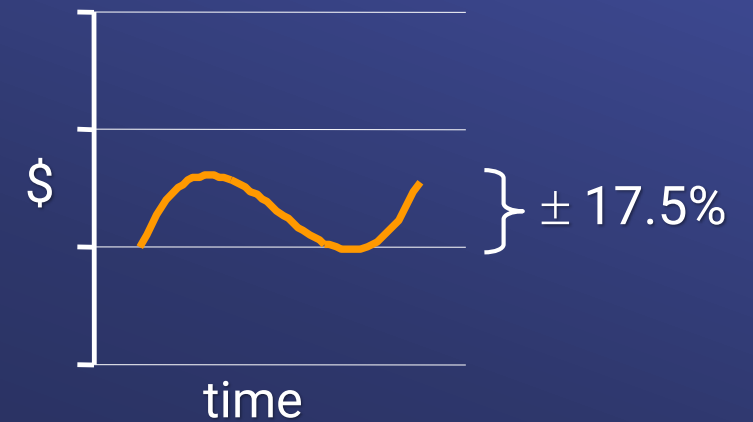
Cash year May through April generates revenues for the fiscal year July through June

Current Unrestricted Reserve Calculation

Hydrologic Risk
estimated per 1999 LRFP



Fixed Costs Recovered by Water Rate



Unrestricted Reserve Calculation

for June 30th, 2025 in millions of dollars

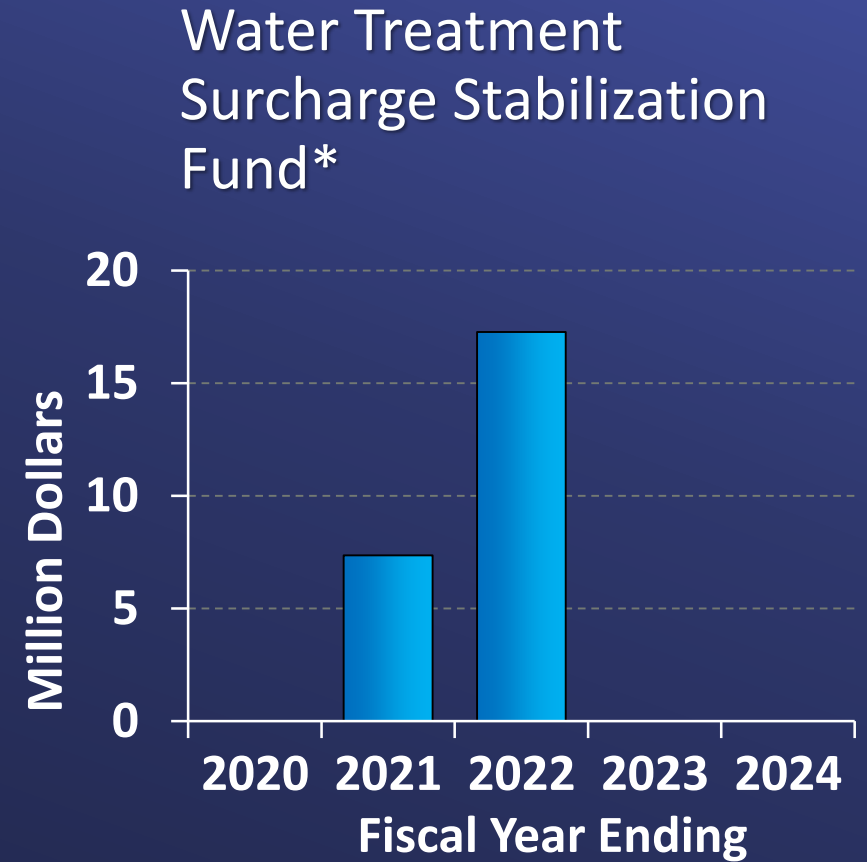
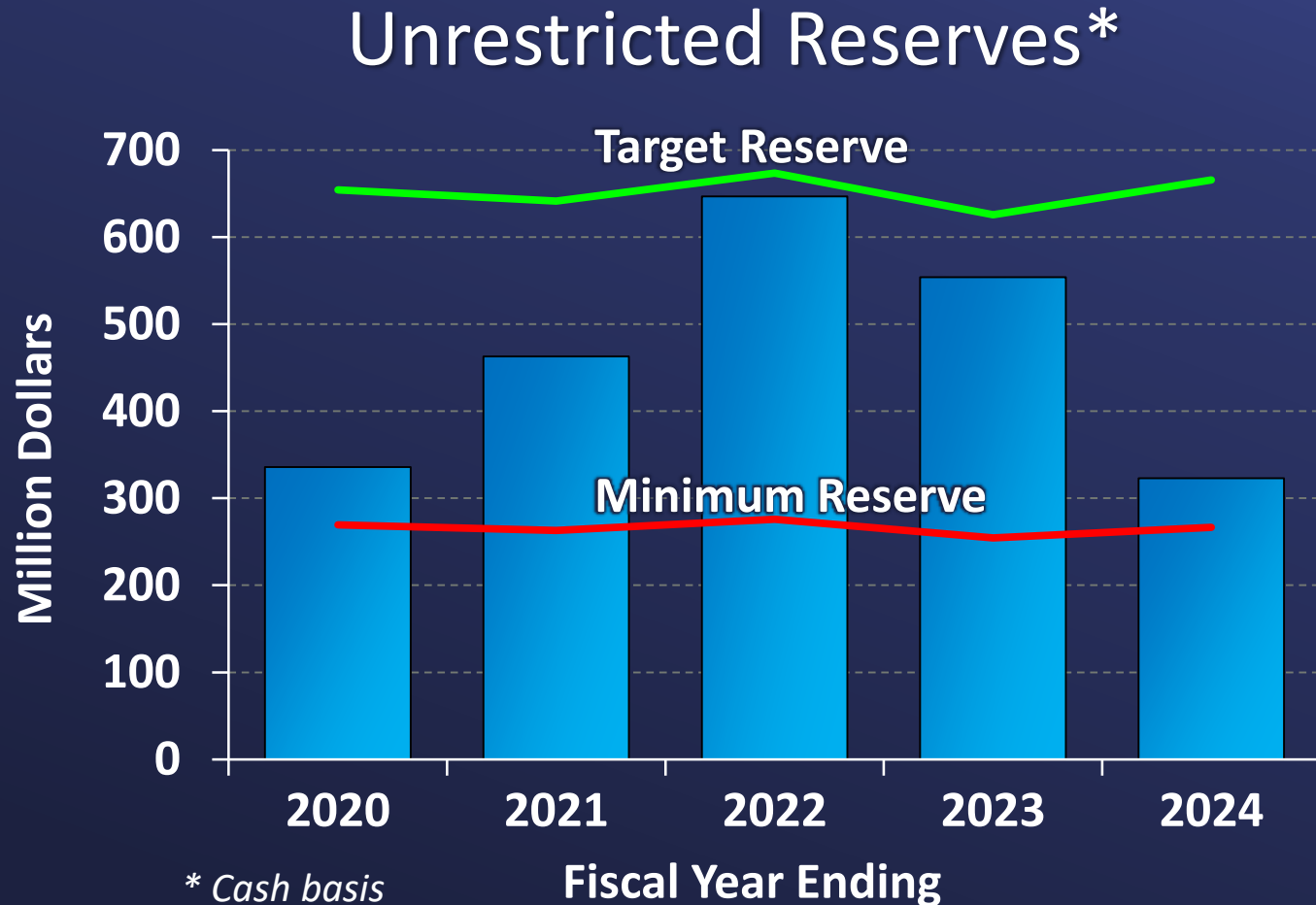
	2024/25 Budget	2025/26 Budget	2026/27 Forecast	2027/28 Forecast	2028/29 Forecast
Revenue Requirement	\$1,550	\$1,693	\$1,949	\$2,143	\$2,307
Less RTS Charge	\$174	\$185	\$188	\$202	\$219
Less Capacity Charge	\$40	\$46	\$48	\$52	\$56
Water Rate Revenue Requirements	\$1,336	\$1,462	\$1,713	\$1,889	\$2,033
Less Variable Costs					
Treatment Surcharge Rev Req.	\$315	\$342	\$342	\$362	\$369
SWC Variable Power Costs	\$241	\$238	\$236	\$235	\$233
CRA Power Costs	\$85	\$93	\$97	\$99	\$102
Fixed Costs Recovered by Water Rate	\$695	\$789	\$1,037	\$1,193	\$1,329
Percent Reserved	17.5%	17.5%	17.5%	17.5%	17.5%
Annual Amount Reserved	\$122	\$138	\$181	\$209	\$232

Minimum Reserve Level = $138 + 181 / 2$ = **\$228.8 million** ← 18 months

Target Reserve Level = $138 + 181 + 209 + 232 / 2$ = **\$644.6 million** ← 42 months

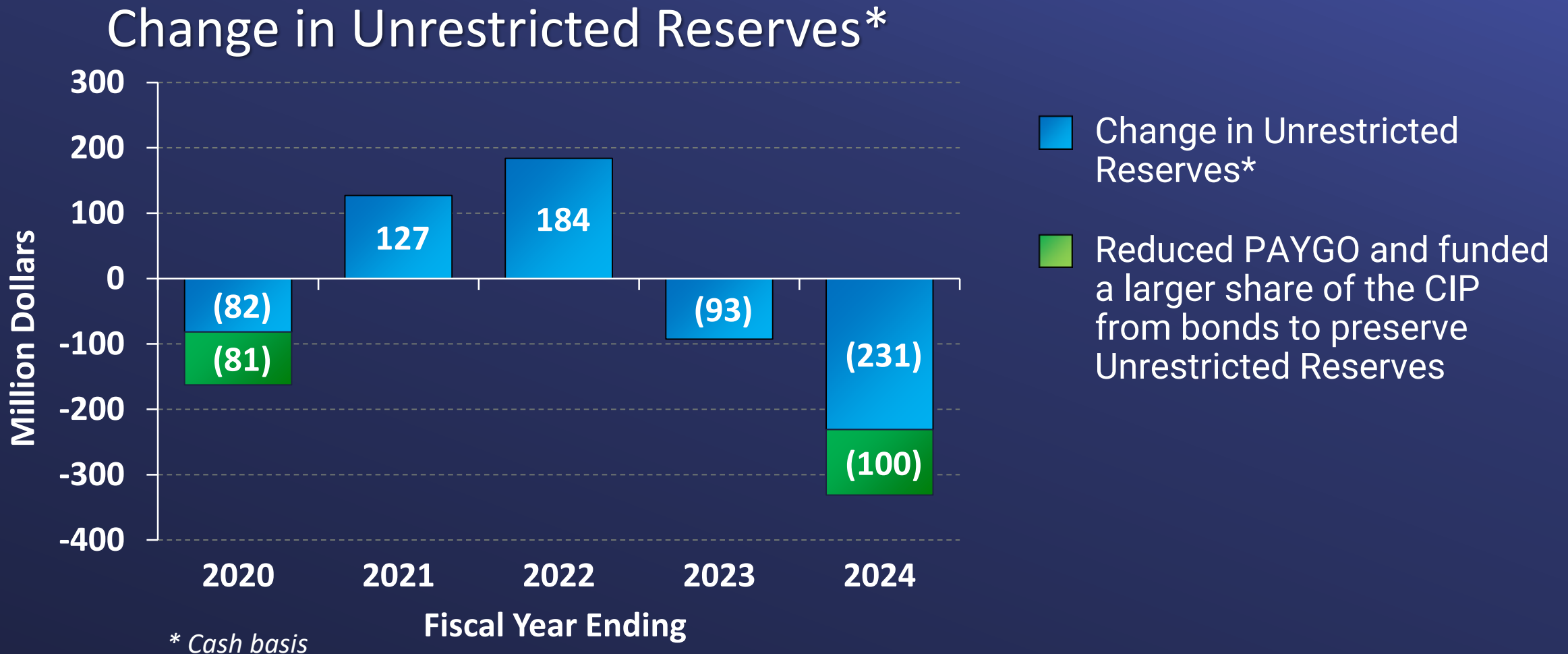
Unrestricted Reserves

5-Year Historical Perspective



Use of Unrestricted Reserves

5-Year Historical Perspective



1999 Unrestricted Reserve Policy

Observations

- The 1999 Reserve Policy has been effective, as MWD has not required an emergency rate increase to generate additional revenues outside of its regular rate-setting process
- The policy will lose its effectiveness if rates are not adopted to fully cover costs.
 - i.e. set rates based on planned draws from reserves or set rates based on one-time revenues
- PAYGO has been utilized as a supplementary tool to manage short-term revenue shortages by funding a larger share of CIP from debt in lieu of PAYGO to preserve Unrestricted Reserves
- The reserve policy's minimum and target levels are based on the revenue risk associated with lower water sales. Reserves, however, have been used to address all unforeseen cash shortages including shortfalls in treated system revenues and, for example, to add water to storage during years of surplus

1999 Unrestricted Reserve Policy

Observations (cont)

- Climate change has exacerbated volatility on both demand and supply
- The current unrestricted reserve policy does not account for the revenue shortfall on the Treatment Surcharge during times of low treated water sales. Additionally, the Treatment Surcharge Stabilization Fund, lacking both a minimum and target, also does not provide the necessary rate stabilization for treatment to cover revenue shortfalls in most years
- The policy assumes that variable supply and power costs decrease with lower water demands; however, these costs are not correlated with variations in water demands
- While the reserves policy was originally designed to provide 3.5 years of rate protection (at the target level), it lacks a funding mechanism to reach the target

Next Steps for Unrestricted Reserve Policy

Analysis underway to provide options for refinement

Technical Changes:

- Update policy to reflect climate impacts and the more recent sales volatility
 - This could include an additional reserve or a revised calculation that reflects higher volatility
 - Is 20% water transactions volatility reflective of future trends given climate change impacts? What is an appropriate target?
 - Need to consider other Business Model related changes (e.g. Treatment Surcharge, low budgeted water sales, etc.) in developing final recommendation
- Update policy to reflect disconnect between water sales and supplies
 - This could include additional reserves to cover purchasing additional supplies or other updates to the reserve calculation
- Update policy to cover rate protection for treated system

Policy Changes:

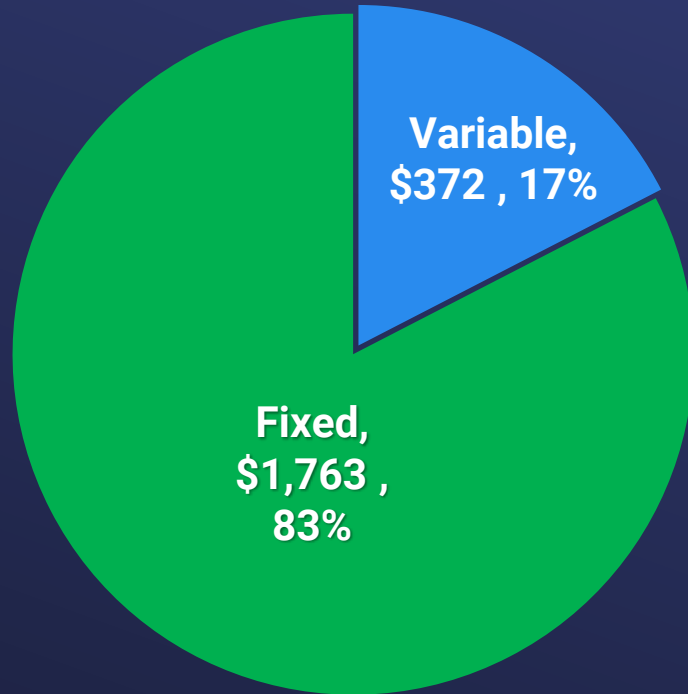
- Establish policy to provide a funding mechanism to reach the target
 - This could be done by incorporating additional funds into the revenue requirements for rate recovery or setting a conservative water sales assumption to generate additional revenues
- Expand and clarify language in Admin Code for appropriate use of reserves in excess of target levels

Potential New Fixed Revenues

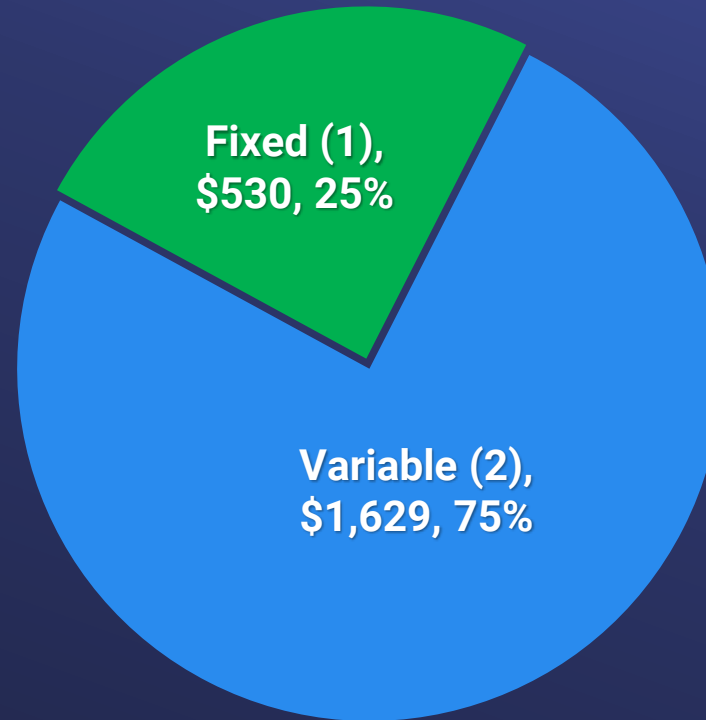
Fixed Costs vs. Variable Revenues

2024/25 Budget (\$ in Millions)

Expenditures



Revenues *



- (1) For purposes of this presentation, fixed revenues represent the revenues that do not fluctuate with the volumes of goods sold, including Readiness-to-Serve Charge, Capacity Charge, and property taxes
- (2) For purposes of this presentation, Variable Revenues includes volumetric water sales, contracted transactions like wheeling and Exchanges with SDCWA and Coachella, USBR etc. and other income including one-time revenues, grants, interest income, power sales and miscellaneous

Semi-Fixed Variable Revenues Concept

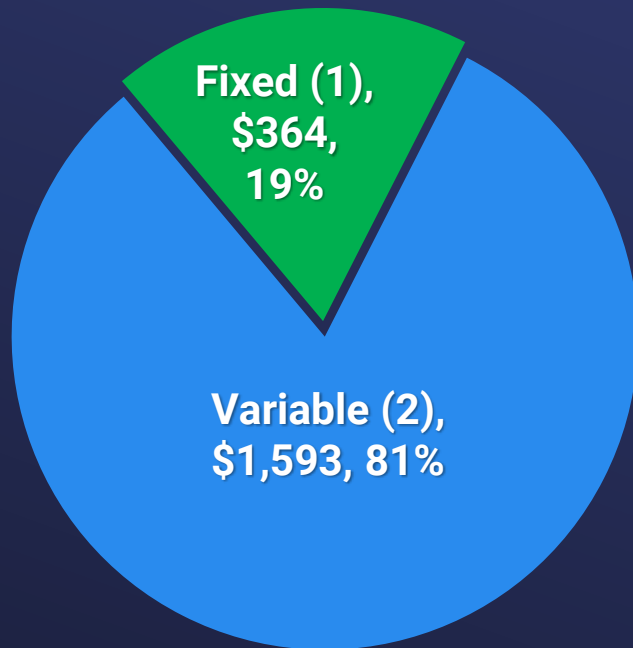
- MWD lowest water transactions forecast* is approximately 1.1 MAF → with volumetric sales revenue of ~ \$1B or 47% of revenues which could be considered semi-fixed
- 25% fixed + 47% semi-fixed = **72% of MWD Revenues are fixed + semi-fixed** → which better alignment with the 83% fixed expenditures

** The lowest water transactions forecast is estimated by evaluating various hydrological conditions*

Recent Progress to Increase Fixed Revenues

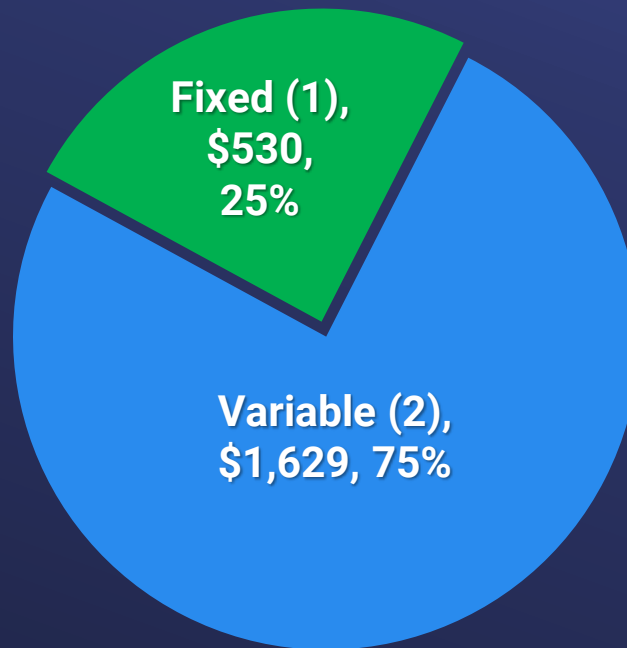
(\$ in Millions)

2023/24 Budget

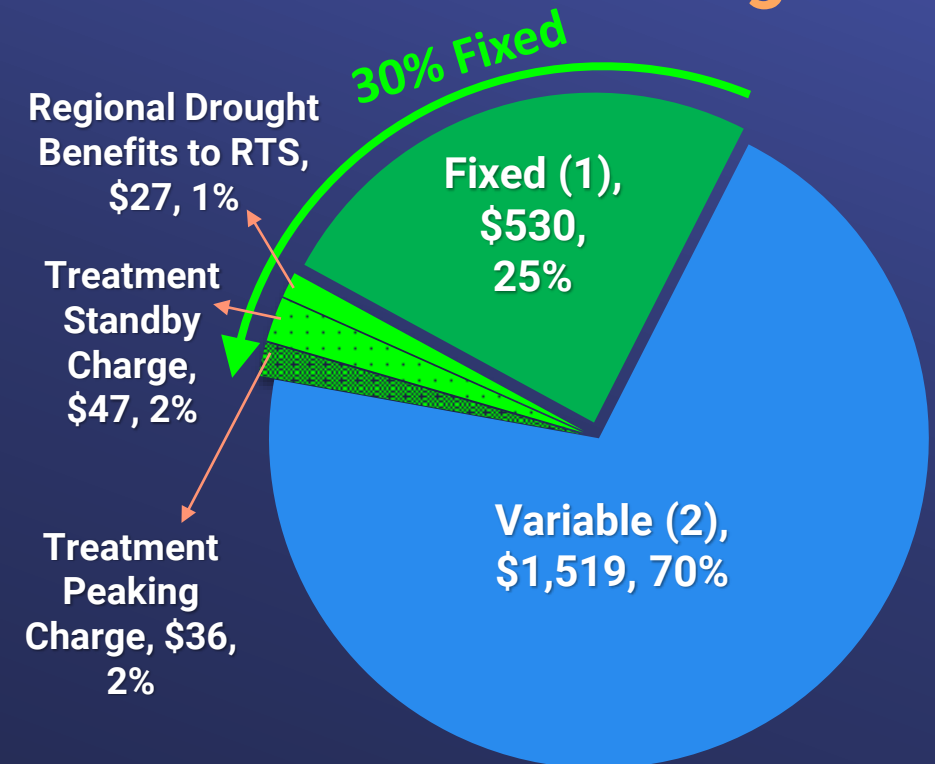


2024/25 Budget

Increase Property Taxes

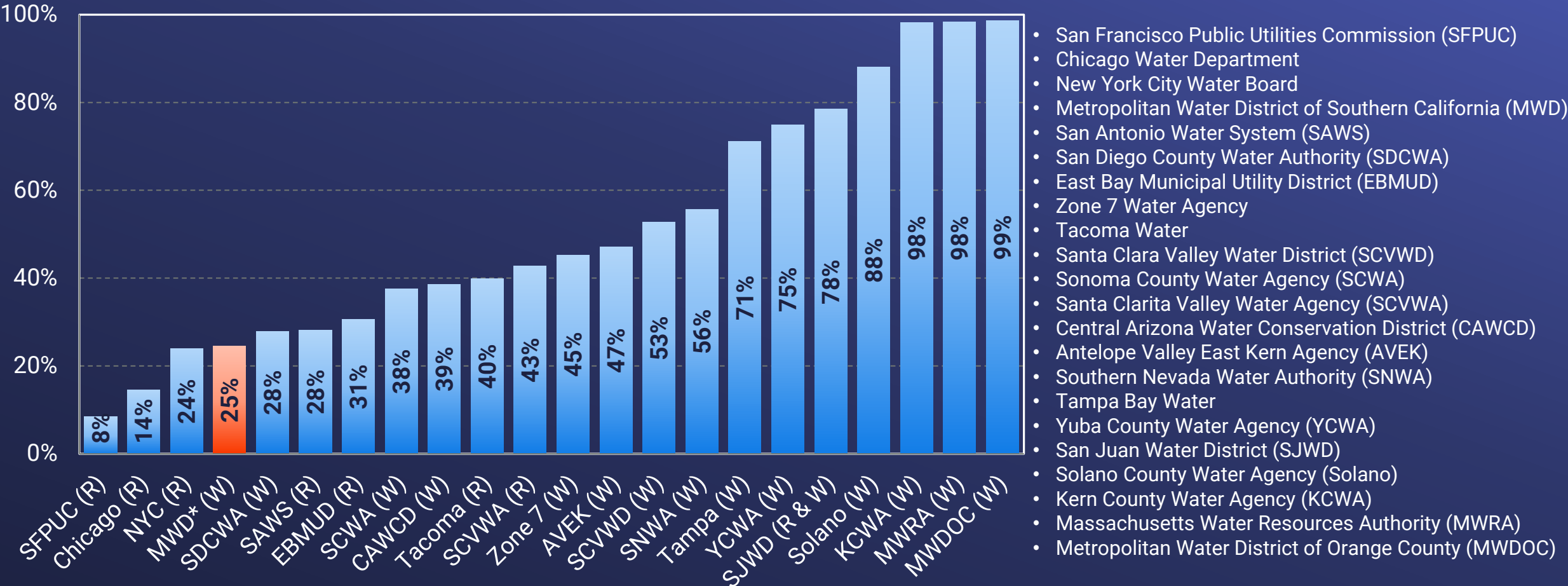


With possible New Treatment Charges



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Fixed Revenue Percentage for Wholesale Water Agencies



W = Wholesale , R = Primarily Retail, R&W = Retail & Wholesale
"Revenue and Expense Structures of Wholesale Water Agencies" survey conducted by Raftelis on June 21, 2023
* MWD based on Adopted FY 2024/25 Budget

Potential New Fixed Revenues

- Fixed Charges under Consideration
 - Treatment Peaking Charge (~\$36M)
 - Treatment Standby Charge (~\$20 - \$47M)
 - Regional Drought Benefit → RTS (\$27M)
- Level Pay Plan Concept
 - Pre-purchase / delivery of water for future use
 - Finance is assessing the level of risk during the budget
 - Similar to current Cyclic and Reverse Cyclic Program
 - Might not be needed to the extent the group moves forward on the concept of ***budgeting for lower water transactions*** which also improves overall likelihood of water transactions revenues meeting budget expectations (i.e., “semi-fixed” concept)

Conservative Water Transactions Assumptions for Water Rate Setting

Implications when Choosing a Budgeted Demand Forecast

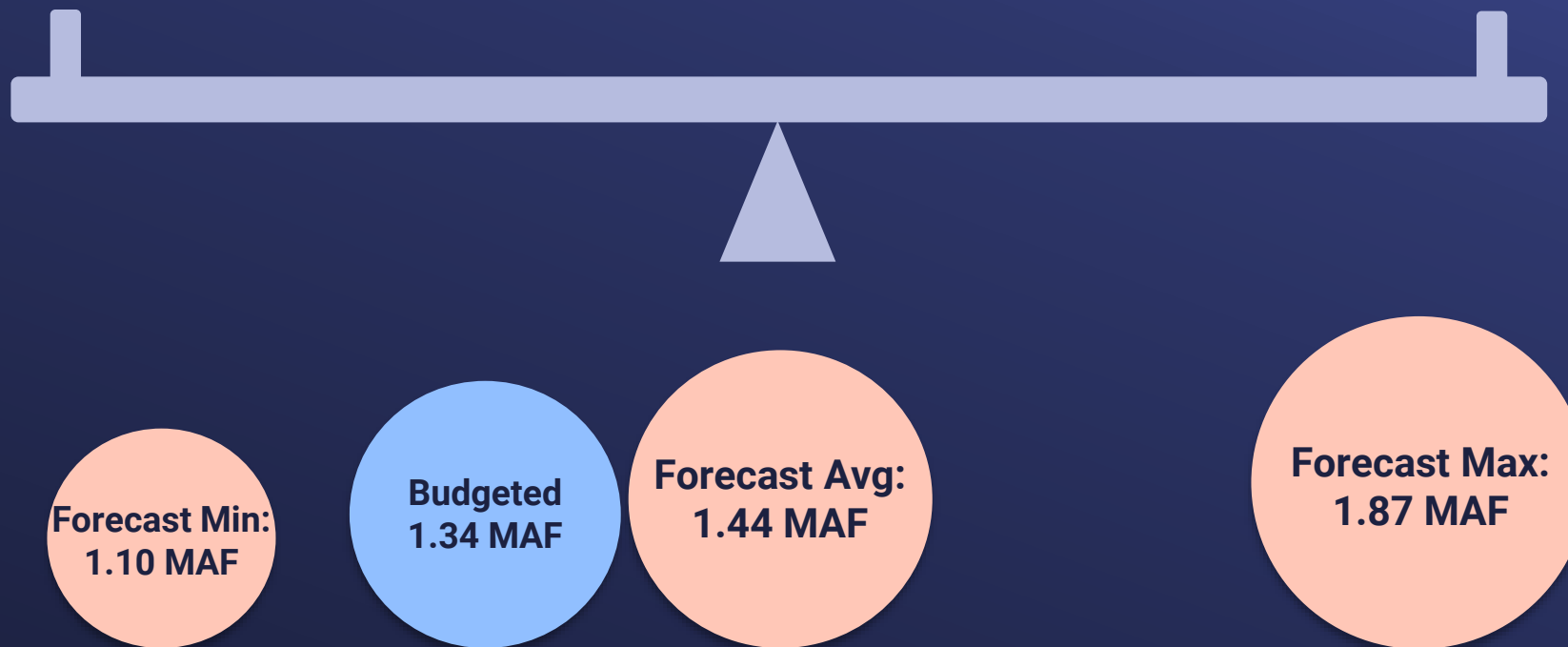
(example values from 2024/25 Budget)

Risk to Reserves

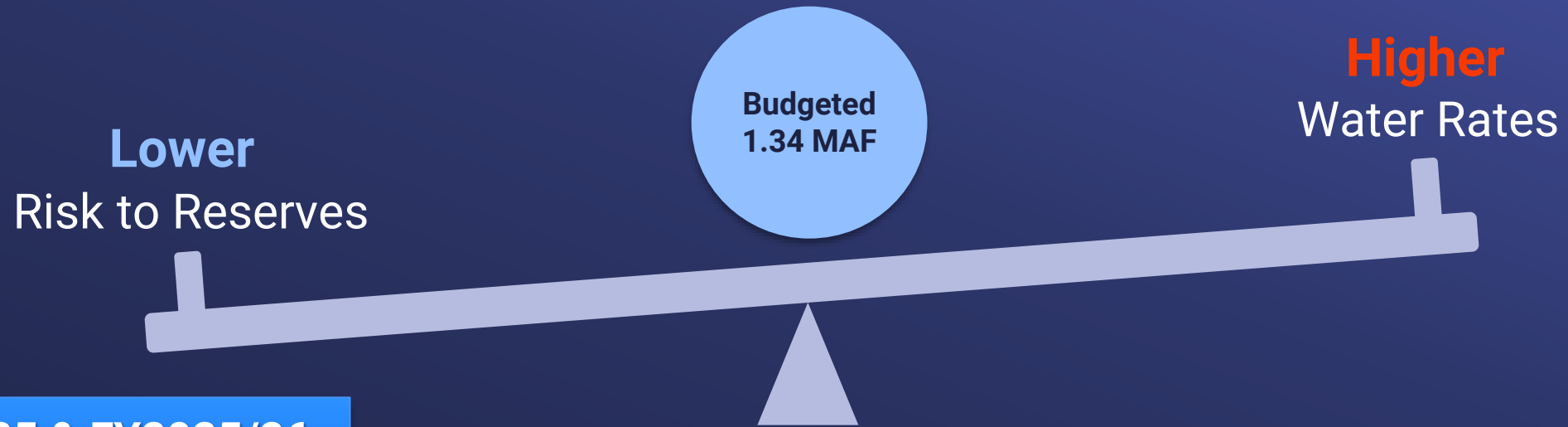
Risk of withdrawing from reserves if actual sales are lower than budgeted sales

Water Rates

Unit rates increase as budgeted sales decrease



Implications when Choosing a Budgeted Demand Forecast



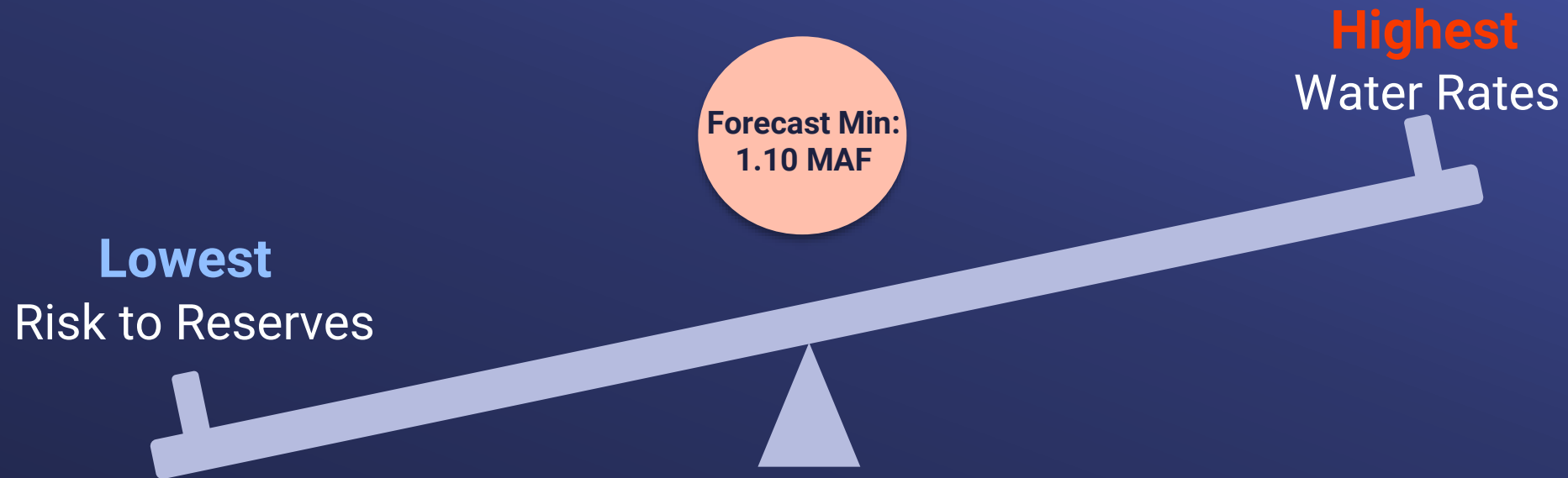
FY2024/25 & FY2025/26 Adopted Budget

Lowering budgeted water transactions by 100 TAF/yr (1.44 MAF to 1.34 MAF) increases the overall rates ~7%

Main Takeaways:

- Lower budgeted water transactions results in higher water rates needed to recover costs
- Lower budgeted water transactions have a higher likelihood of being met or exceeded
- Exceeding budgeted water transactions results in adding to reserves

Implications when Choosing a Budgeted Demand Forecast



Main Takeaways:

- Lowest budgeted water transactions results in highest water rates needed to recover costs
- Lowest budgeted water transactions have a highest likelihood of being met or exceeded
- Exceeding budgeted water transactions results in adding to reserves

Conservative Water Transactions Assumptions

Observations

- The current budget and 10-year forecast is based on a 70% exceedance level
- If future budgets maintain the 70% exceedance level for water transactions, without relying on one-time revenues or reserve draws and assuming average hydrologic conditions, unrestricted reserves would grow to meet the current target within 3-5 years
- To the extent that the MWD adopts an approach to budget at an exceedance level of 70-90%, this approach would create a mechanism to maintain reserves at the target level, providing additional protection against rate spikes

Next Steps

Business Model Review and Refinement Ad Hoc Working Group

Metropolitan's Reserve Policy, Potential New Fixed Revenues, Use of Conservative Water Transactions Assumptions for Setting Water Rates

- Analyze and review proposed changes and options to MWD's reserve policy
- Reevaluate new fixed charges and the impact of MWD's reserve policy
- Evaluate how conservative water transactions assumptions for setting water rates increased revenue certainty and ties into objectives for rate stability and MWD's reserve policy

Schedule

Feb 24, 2025	Financial Policies Business Model Support Sub-Working Group Workshop #2 <ul style="list-style-type: none">• Incorporate feedback from the Board
March 2025	<ul style="list-style-type: none">• Financial Policies Business Model Support Sub-Working Group Workshop #3• Progress Report back to Business Model Review and Refinement Ad Hoc Working Group
April 2025	Information Presentations to the FAM Committee <ul style="list-style-type: none">• Workgroup recommendations for Treated Water Cost Recovery, Fixed versus Volumetric Revenues and Reserves

