Our Region's Trusted Water Leader
San Diego County Water Authority

February 19, 2022

Katano Kasaine
Assistant General Manager, Finance and Administration
Metropolitan Water District of Southern California
P.O. Box 54153
Los Angeles, CA 90054-0153

RE: MWD's Proposed biennial budget for fiscal years 2022/23 and 2023/24; proposed water rates and charges for calendar years 2023 and 2024

Dear Katano:

As discussed at last month's finance committee meeting, attached are our initial questions and comments on the proposed 2023 and 2024 budget and rates. In addition to these comments, Director Miller requested that the budget document include actuals for fiscal year 2020/21 and projected actuals for fiscal year 2021/2022 in all summary tables comparing what is proposed for fiscal years 2022/23 and 2023/24 to the 2021/22 budget. This information will be extremely helpful in assessing our recent trends and how past budget projections compare to actuals.

We also requested at the last board meeting that the General Manager provide a schedule for the strategic planning meetings referenced in the budget transmittal (top of p. 4)[1] including Integrated Resources Plan, rate refinement and cost of service and long-term financial plan. Director Fong Sakai suggested that we add to this list MWD's Climate Action Plan, which should also be integrated with these other planning processes. We hope this schedule will be available by Tuesday so that we have the benefit of better understanding as we deliberate the budget how management will integrate these processes and the timeline for doing so.

Thank you very much and we look forward to our workshop next week.

Sincerely,

Lois Fong-Sakai	S. Gail Goldberg	//S//	Tim Smith
Lois Fong Sakai	S. Gail Goldberg	Marty Miller	Tim Smith
Director	Director	Director	Director

cc: Adel Hagekhalil, MWD General Manager

[1] All references in this letter and attachment are to the February 8, 2022 Board Memo 9-2 unless otherwise indicated.

4677 Overland Avenue, San Diego, California 92123-1233 • (858) 522-6600 • FAX (858) 522-6568 • www.sdcwa.org

Water Authority MWD Delegation's Initial Budget and Rates Questions

Actions to Reduce Expenditures and Short-Term Rate Impacts

1) It is our understanding from the budget memo (Table 2: Initially Projected Expenditures at p. 6) that there is *no proposed reduction of the previously adopted budget*; rather, the "cuts" described (Table 3: Proposed budget actions to reduce rate impacts) are solely to reduce the amount of the *increases* staff would have presented, i.e., from an 18% increase to a 10% increase. Was there any effort taken to identify actions that could be done to *reduce expenditures* authorized by the board in the last adopted budget? If so, please provide the details of that effort and potential cost savings that were identified but not recommended by management. Also, the Board approved a "no unfunded cost increase" requirement in last year's budget; please provide a list of all unfunded costs that were incurred for the current budget.

2) The budget memo states that the Board requested staff to budget and set rates "at a level lower than full cost recovery" during the last budget cycle (bottom of p. 7). What requests are being referred to by this comment? We are aware that *staff recommended* that the Board not impose the Water Stewardship Rate and instead recover demand management costs from reserves rather than allocate and recover those costs as a supply charge. Was there any other action taken by the board or requests of staff to set rates at a level that would not ensure full cost recovery? If so, please identify those actions.

3) We do not recall the board being advised that staffing levels were inadequate or that management believed our operations had become "too reliant on overtime and temporary employees" (top of p. 8). In fact, during the last discussion we had while searching for potential cost savings due to COVID, we were told that the annual $7 million in "succession planning" included employing two people in some positions for an extended period. Your memo states that it is "clearly apparent that there is a need for additional staff" (top of p.8). Please provide the details of management's assessment supporting this statement and need for 141 new positions as well as a breakdown of the positions between: 1) the 20 new positions and 12 new temporary positions included in the draft budget; 2) the 80 new positions recommended by the General Manager to be added to the budget; and 3) the remaining 41 positions (leaving aside the temporary positions) management is not recommending be filled at this time. Also advise and provide analysis on how the addition of the new positions will reduce overtime and number of temporary employees. We assume there is documented management review and assessment supporting these recommendations, and we would appreciate receiving this as soon as possible since it is a very important and impactful issue in our consideration of the proposed budget.

4) The memo states that succession planning is "ongoing;" please identify the costs of that program included in the proposed budget and whether it still involves having more than one employee filling any position for a period longer than 60-days.

5) Most of the budget actions to reduce rate impacts propose to use debt to finance expenditures that were initially planned to be funded with current rates, including supply program (would have been funded by supply rates), conservation programs (historically funded by water stewardship rate and now supply rates), and Capital Investment Plan (CIP) (reducing pay-as-you-go funding level). Similarly, using the WaterFix refund reserves to fund the tunnel project does not actually represent any cost reduction, just a change in how it is paid for. While these actions will provide current rate relief, they also increase the cost of these projects over the long run, and that cost

should be reported in the budget analysis and taken into account in terms of long-term impacts on future budget and rates.

6) The reduced use of PAYGo funding has a similar impact of shifting current costs to future generations. We are anxious to begin work on a long-range finance plan so that the board can better understand the impacts of current decision-making on future generations, including long-term rate impacts. For now, please identify where PAYGo was set in the last budget and how that PAYGo was applied. As you know, in many prior years PAYGo that was collected and planned to be used to pay current CIP costs was later needed and used to pay current operating costs, with the differential necessary to pay CIP costs being made up by the issuance of unplanned debt (again, increasing the long-term cost of these projects).

7) We strongly support the continued emphasis on the water Conservation Program; however, it is not accurate to describe that MWD is *increasing* the spending this year. The current budget already included funding at $43 million annually and for the ten-year forecast. Footnote 3 of the Fund Summary table from the current budget expressly states that Demand Management "includes conservation estimated expenditures of $25M. The conservation appropriation is $43M." The only change is that now, staff is proposing to pay these current supply costs by borrowing money rather than reducing expenditures. Our concern is that if we are having difficulty paying for these and other programs now out of current revenues, it does not bode well for future budgets and planned projects. We are concerned for the same reason about asking to potentially shift an additional $7 million in conservation costs to debt financing and would again ask that staff instead explore ways to reduce other expenditures to pay for these vital conservation measures.

Water Sales Trends

One of the key budget assumptions (middle of p. 5) states that, "[w]ater transactions include water sales, exchanges and wheeling, *which can be greatly impacted by hydrologic conditions.*" While this statement is true about MWD's volumetric sale of water, it is not true as related to its delivery of the Water Authority's exchange water, which is based on a fixed, agreed-upon schedule. We have requested many times that MWD reverse the change it made in its financial reporting to begin describing water "transactions" as opposed to its earlier practice of reporting MWD water sales.[1] While water wheeling and exchange deliveries are an important source of revenue for MWD, there are important differences between MWD water sales revenue and wheeling/exchange revenue, including that wheeling revenues under the Exchange Agreement are for all practical purposes a fixed source of revenue for MWD.

We appreciate that staff has adjusted for the downward trend in projected demand for MWD water. However, it is important to bear in mind in reviewing the budget that the "water demand" numbers for FY 2023 and 2024 *include 280,000 AF of Water Authority water*; adjusting for this factor, demand for MWD water would more accurately be stated as 1.31 and 1.26 MAF, respectively. This

[1] Prior to 2016, staff distinguished between water sales revenue and other revenue, but beginning in FY 2016 staff combined MWD water sales revenue with the Water Authority's water delivery revenue as MWD "sales." In FY 2018, MWD staff changed the reporting to describe "transactions," combining water sales and delivery revenues and in FY 2019 it began to at least break out the categories included as "transactions." MWD had taken the position in litigation that its delivery of water to the Water Authority constituted the sale of MWD water, but that contention has now been finally adjudicated. Revenue received by MWD for the delivery of the Water Authority's exchange water is just that, payment for transportation not the sale of water by MWD.

fact is especially important not only when comparing current to historical water sales, but also when planning for long term trends which will hopefully be part of the ongoing IRP and long-range financial planning efforts. These trends are also very important when assessing the overall budget including consideration of how it might be reduced rather than increased to better match anticipated long term trends. We appreciate that the General Manager has identified this budget as a "transition" budget, but we must all be wary of increasing costs and expenditures at the same time we are projecting lower water sales in the future and with what we are transitioning to not yet known or established by the board of directors.[2]

State Water Contract (SWC) Costs

We appreciate State Water Project costs in the budget draft better reflect recent hydrologic conditions than presented in prior budgets. Related to the costs associated with the SWC on page 171 of the updated proposed budget dated February 10, the per acre-foot SWC power costs for FY 2022/23 are 84% higher than those assumed in the fiscal year 2021/22 budget and almost 190% higher than they actually were in FY 2020/21. This increase is being attributed to higher market prices; *please provide the data relied on to support this power cost trend and budget request.* Director Sutley also asked this question at last month's committee meeting when the budget was first presented.

The SWC budget also includes almost a 35% increase for Delta Water Charge capital costs, which includes non-reimbursable Oroville Spillway repair expenditures. What are the details causing the increase in Delta Water Charge capital costs and what share (in dollars and percent) of the increased costs are due to the repair expenditures?

Shift of Current Supply Costs to Debt

Has staff reviewed with bond counsel its proposal (including the complete list of projects) to bond finance conservation and other current water supplies, and if so, did bond counsel provide any guidance or express any concern?

What is the assumed life of the conservation and other water supply programs that are proposed to be bond funded? How does this useful life compare to the term of the proposed bond issuance? Also, please confirm that funding these water supply programs by debt instead of current revenue will not have any impact on how MWD allocates and recovers these costs in its rates.

[2] This is by no means a criticism of MWD; indeed, the Water Authority board and staff and member agencies have devoted substantial time and effort over the past two years to identify and take cost reduction measures to address the reduced demand for water in the Water Authority's service area. Per capita potable water use in the Water Authority's service area has declined from 235 gpcd in 1990 to 124 gpcd in 2017. Sales to our member agencies declined from over 600,000 AF in 2008 to about 365,000 AF in 2020, or by almost 40%. The projected drop in demand for MWD water could in fact be greater than projected in the current budget proposal consistent with the continued downward trend we have been seeing for many years and which will be increasingly difficult to manage in the future. For a thoughtful discussion of the challenges facing both Water Authority and MWD see *Report to San Diego LAFCO, Fallbrook and Rainbow MWD Wholesaler Reorganization*, Professor Michael Hanemann, December 31, 2021. This report was prepared in response to pending proposals to annex two Water Authority member agencies into Eastern MWD in Riverside County and contains extensive discussion about the "governance" and rate challenges both Water Authority and MWD are and will be facing.

Capital Investment Plan (CIP)

First, we appreciate the change in this proposed budget to plan to fund 100% of planned CIP spending in order to (hopefully) avoid further unplanned debt issuance such as has frequently occurred with past budgets when rates were set at 80% of CIP spending.

Second, while we appreciate and fully support the need to implement projects to reduce system constraints for the State Water Project exclusive areas, the budget document does not explain why the proposed biennium CIP is increasing by $100 million, or 20%, or how this number relates to the SWP exclusive area.[3]

We suggest that management establish accounting mechanisms so that, if MWD is successful in securing outside funding, current and future rates may be adjusted in a manner that is transparent and fair to all ratepayers.

Has a value engineering analysis been conducted on MWD's plan to address aging infrastructure? Given an ongoing and increased focus on repair and refurbishment over the past few budget cycles, we request an update on what has been accomplished so far and at what cost, along with an estimate of the total remaining work and the time period over which that work is planned to be completed.

Has MWD performed a risk-based, cost/benefit analysis on its CIP to ensure it is working on its most critical projects? If so, please provide the criteria used in this analysis. Based on MWD's analysis in whatever form, has staff considered whether some projects could be deferred in order to prevent a 20% increase to this biennial CIP? Leaving aside the SWP exclusive area as presenting an extraordinary circumstance that was neglected in the past (although unknown to many board members), it is unlikely that all of the projects in the CIP present the same level of urgency. Again, we request staff analysis so that we can better understand the thinking given the impact on rates and affordability.

The proposed budget only includes planning costs for the Regional Recycled Water Program (RRWP), while the 10-year rate forecast includes the sum of projected capital and O&M costs for the implementation of the RRWP. Please add the specific O&M and capital costs (in dollar amounts) to the 10-year forecast summary table on page 216 of the updated proposed budget dated February 10.

What costs are included in the Capital Investment line item in the summary tables on pages 20 and 21 of the updated proposed budgets dated February 10? These costs ($381.4 million and $389.0 million for FYs 2022/23 and 2023/24, respectively) do not add up to the proposed annual CIP costs of $300 million, the addition of debt funding annually $18 million of conservation programs and the debt funding costs for the High Desert Water Bank ($38.4 million and $46.0 million for FYs 2022/23 and 2023/24).

Operations and Maintenance (O&M) Cost

Has management done an assessment of current positions to determine if some existing positions might be repurposed to support current priorities? Are the positions being requested under the

[3] Our December 2021 action authorized $24.5 million in funding and MWD's December 10, 2021, letter to Governor Newsom stated that $52 million of the $552 million funding request was to address SWP system constraints.

proposed budget and the pending additional 80 positions described on page 8 of the board letter needed in order to meet long-term, rather than short-term needs? Are there any outside professional services that will be reduced as a result of the new FTEs under either of these staffing levels? Also, how many of the proposed positions are requested in anticipation of implementation of the Delta tunnel and RRWP?

MWD's current staffing level is around 1,855 employees—almost 120 employees below the proposed budget and about 20 employees less than at the close of the last biennial budget. What is the assumed vacancy rate in the budget and how is that reflected in the proposed salary and benefit costs? Does management have a recruitment plan on how it plans to fill the proposed budgeted 1,974 positions and if approved, the 80 additional positions? Given known factors affecting this employment market, we believe it will be difficult if not impossible to fill staffing at this level even if approved by the board; *when does the budget assume these positions will be filled*?

Rates and Charges

The proposed budget states, "all demand management costs are functionalized as supply and collected on the Tier 1 and Tier 2 supply." What amount (in dollars) of demand management costs is allocated to the Tier 2 supply rate? If no Tier 2 sales occur, *as is assumed in the budget*, how will these demand management costs be recovered? If there are no demand management costs allocated to the Tier 2 supply rate, then please update the budget and cost of service report to correctly reflect that demand management costs are being fully allocated and recovered in the Tier 1 supply rate.

Staff indicates that 1% of the proposed 2023 "overall" rate increase is driven by the proposed rate increases being implemented in the second half of FY 2022/23. Staff reported that *we closed fiscal year 2020/21 with net revenues of $193.7 million*—in a stronger position than planned in our current biennial budget. Earlier this month, staff reported that expenditures and revenues are tracking on budget for this fiscal year. What has changed that requires this 1% catch-up? This is a material factor that should be accounted for to potentially avoid the additional 1% rate increase.

10-Year Forecast

We appreciate the commitment of the General Manager to begin work on a long-range finance plan as part of the integrated planning processes described in the board memo. In the meantime, we request a section be added to the current proposed 10-Year Forecast for *"Debt Structure and Principal Amortization,"* with 1) information and charts showing long-term outstanding debt and best service payment schedules; 2) "Significant Debt Program Assumptions"; and 3) "Schedule for Future Debt Issuance." This was requested last budget cycle, but was not implemented; we think this would be especially helpful now as the board considers increasing debt in lieu of necessary rate increases to pay costs originally expected to be paid from current revenues. This information is readily available and will increase transparency of our budget deliberations.