- Board of Directors
  Finance and Insurance Committee

9/14/2021 Board Meeting

9-5

Subject

Mid-cycle Biennial Budget Review

Executive Summary

This mid-cycle update of the Board-approved biennial budget for fiscal year (FY) 2020/21 and FY 2021/22 (the "Adopted Budget") provides an opportunity to review results of the first year of the two-year budget. This update will help the Board to better understand the key drivers of change, particularly as it concerns the impact of COVID-19. This update also provides an opportunity to review the outlook for the second year of the two-year budget. A reflective and a prospective analysis herein highlights key financial areas to be addressed in the next biennial budget and rate-setting process that formally begins in February 2022. As a reminder, the Adopted Budget includes overall rate increases of 3 percent in calendar year (CY) 2021 and 4 percent in CY 2022, which the Board has approved. The Adopted Budget also reflects modifications made by staff in March 2020 to further reduce costs and overall rate increases as a result of the anticipated financial impact of the COVID-19 pandemic. In addition to the expense modifications proposed by staff, the Board directed staff to revisit and consider additional potential cost-cutting measures. In September 2020, the Board approved additional cost-containment measures, and in December 2020, the Board approved a payment deferral program for its 26 member agencies. To date, no member agency has utilized the deferment program.

At the midpoint of the biennial budget period, water transactions[1] for FY 2020/21 are 1.57 million acre-feet (MAF), 30 thousand acre-feet (TAF) less than the FY 2020/21 budgeted amount of 1.60 MAF. Revenues are $26.0 million under budget due to lower water transactions. Expenditures are $202.2 million under budget primarily due to lower State Water Project (SWP) power costs resulting from the low SWP allocation and cost savings in departmental O&M attributed to board-directed cuts, cost savings due to the impact of COVID-19, and other factors.

Unrestricted reserves provide a buffer against rate spikes resulting from lower water sales but, in practice, also provides a funding source for unforeseen expenditures. The reserves help to provide stable and predictable water rates while minimizing emergency rate increases.

As of June 30, 2021, the balance in unrestricted reserves, which are held in the Water Rate Stabilization Fund and the Revenue Remainder Fund, was $595 million on a modified accrual basis. The unrestricted reserves balance was $146.9 million higher than the beginning of the budget period. These reserves are $331 million over the minimum reserves level and $47 million below the target reserves level.

For the second year of the budget, there is a high probability that water demands on Metropolitan will be below the budgeted 1.6 MAF, reducing revenues and potentially reducing the reserves. When combined with potential unbudgeted expenses for dry-year transfers, increased demand management funding, operational impacts due to ongoing dry conditions, and increased power costs due to the drought's impacts on the electric market, there are many things that could cause a draw on reserves in the second budget year.

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[1] Includes water sales, exchanges and wheeling.

Given the current status of unrestricted reserves, which are currently within the range of the established policy minimum reserves levels and target reserves levels, staff does not recommend any changes to the approved 4 percent rate increase for CY 2022. Moreover, staff does not recommend any changes to the second year of the current biennial budget.

Description

Prior Board Actions

The originally proposed budget for the current biennial period (the "Proposed Budget") had been reviewed and discussed in workshops with the Board prior to the onset of the COVID-19 pandemic. The Proposed Budget called for 5 percent rate increases in CYs 2021 and 2022. When Metropolitan declared an emergency to respond to the pandemic, staff rapidly changed the budget proposal to reduce expenditures, revised the approach to capital program funding, and reduced the overall rate increases to 3 percent in CY 2021 and 4 percent in CY 2022.

In April 2020, the Board approved the revised biennial budget for FY 2020/21 and FY 2021/22 (the Adopted Budget) and the supporting overall rate increases of 3 percent in CY 2021 and 4 percent in CY 2022. The Board also directed the following:

1. Board review of the Adopted Budget and rates at the September 2020 meeting to consider the impacts resulting from the COVID-19 crisis.
2. Staff review and consideration of six specific issues for the biennial budget cycle of FYs 2020/21 and 2021/22 by August 31, 2020.

In September of 2020, the Board received an update on the requested six areas of review for cost containment and approved the following cost-containment measures to address the COVID-19 financial impacts:

1. Continue to track COVID-19 impacts to the member agencies with a focus on retail payment delinquencies. If there is interest from the member agencies, develop a payment deferral program that also exempts penalties or interest for those agencies that record and report significant delinquencies and likewise grant deferrals to their customers. Bring back any deferral program criteria to the Board for review and consideration.
2. Monitor water demands, sales and expenditures, and prepare additional cost-containment measures, as needed, for mid-cycle budget review.
3. Maintain the current rates adopted by the Board to address the impacts of lower water sales and lower revenues while maintaining current credit ratings.
4. Include in the mid-year budget review new revenue generation options, including a groundwater replenishment program.
5. A moratorium on non-emergency, unbudgeted proposals for the remaining part of the fiscal year that have not been anticipated in the budget.

FY 2020-21 Review

The Adopted Budget was preceded by circumstances that resulted in lower revenues and lower available reserves to mitigate future rate increases. In the prior biennial budget period, Metropolitan had the lowest water transactions in nearly 40 years, with transactions of approximately 1.40 MAF each year.

As presented recently at the Finance and Insurance Committee meeting of August 16, 2021, water transactions for FY 2020/21 were 1.57 MAF, 30 TAF less than the FY 2020/21 budget of 1.6 MAF, resulting in revenues that are $26.0 million under budget.

Expenditures were under budget by $202.2 million, driven primarily by the low State Water Contract on-aqueduct power costs as a result of the low Table A allocation (20 percent in 2020 and 5 percent in 2021) and $62 million in lower O&M expenditures. Demand Management also came in lower due to reductions in advertising per board direction in response to COVID-19. Additionally, due to favorable market conditions and Metropolitan's strong financial position, Metropolitan refinanced approximately $478.9 million in debt, remarketed $1.06 billion of variable rate bonds, and issued $207.4 million of new money debt at pricing levels lower than expected or budgeted, saving $13 million in debt service costs for FY 2020/21.

Unrestricted reserves provide a buffer against rate spikes resulting from lower water sales but, in practice, also provides a funding source for unforeseen expenditures. The reserves help to provide stable and predictable water rates while minimizing emergency rate increases. The reserves have a minimum level and a target reserve level.

As of June 30, 2021, the balance in unrestricted reserves, which are held in the Water Rate Stabilization Fund and the Revenue Remainder Fund, was $595 million on a modified accrual basis. The unrestricted reserves balance was $146.9 million higher than the beginning of the budget period. These reserves are $331 million over the minimum reserves level and $47 million below the target reserves level.

The coverage ratio for FY 2020/21 was 2.02 times for Revenue Bond Debt Service coverage (Senior and Subordinate liens), which meets the target bond coverage level of 2.0 times. Similarly, the coverage ratio for FY 2020/21 was 2.22 times for Fixed Charge coverage, above the target level of 1.2 times.

Payment Deferral Program and Delinquencies

In December of 2020, the Board approved the COVID-19 Member Agency Payment Deferment Program. The program provided the member agencies a process to potentially defer payment obligations for water transactions occurring from January 1, 2021, through June 30, 2021. There were no delinquencies related to COVID, and no member agencies utilized the deferment program.

O&M Expenditures and Cost Containment

The Board directed staff to revisit and consider the following specific cost-containment budget areas: suspension of the director inspection trip program and fleet vehicle purchases. Efforts to contain costs were instituted early in the crisis as management directed staff to cut all non-essential travel and put in place a process that requires review of all operating equipment requests as to urgent need and elevated approval by the Chief Operating Officer. Staff has implemented the specified cost-containment strategies directed by the Board, which successfully reduced costs.

Expenditures were lower than budget for several additional reasons. Operations and Maintenance expenditures, which were $473.7 million, came in $62 million under budget primarily due to prudent management of expenses, reduced costs of employee benefits from the projection in the budget, and the impact of COVID-19. As a result of COVID-19 restrictions, the Director Inspection trip program and travel, training, and seminars were suspended; community outreach events were canceled, rescheduled, or shifted to virtual events; and the level of building security services was reduced. Many maintenance projects were deferred or delayed, which resulted in reduced professional, non-professional, expensed equipment, and repairs and maintenance costs; and employee-related work expenses such as transit reimbursements, management and employee events, and office supplies were cut or reduced.

Review of New Revenue Generation Options

The request to look at new revenue generation options, including a groundwater replenishment program, was included in the issues to be taken up by the Rate Refinement Workgroup. The Rate Refinement Workgroup, which is made up of member agency representatives, was established on January 13, 2021, to evaluate potential refinements to Metropolitan's rate structure. The focus of discussions over the past nine months in the workgroup has been on establishing proposed changes to Metropolitan's Rate Structure Framework Principles that will serve as a benchmark to compare refinements as well as discussions on demand management cost recovery alternatives. Metropolitan staff are committed to continuing rate refinement discussions to evaluate potential refinements, such as a new groundwater replenishment program.

Moratorium on Non-Emergency, Unbudgeted Proposals

Unbudgeted expenditures that were approved by the Board after the Board adopted the budget include: the work of the Shaw Law Group to review Metropolitan's Equal Employment Opportunity processes, battery energy storage systems at Joseph Jensen Water Treatment Plant, Robert A. Skinner Water Treatment Plant, F. E. Weymouth Water Treatment Plant, and OC-88 Pumping Plant; dry-year transfers to support Metropolitan's reliable service in a historic dry year, and participation in the Sites Reservoir project. Although these expenditures were not budgeted, the funding source came from savings within the FY 2020/21 budget.

Drought Impacts on Water Storage and Future Cost to Replenish Storage Reserves

For the first time in six years, Metropolitan is drawing down its storage accounts as part of its Water Surplus and Drought Management Strategy to meet regional water demands. This is required due to ongoing dry conditions, especially in the Western Sierra Nevada Mountains, with a 5 percent Table A allocation for CY 2021. Current projections for 2021 call on a nearly 700,000 AF draw on storage by Metropolitan. Replenishing storage will come at a considerable cost. At a conservative cost of $200 per AF, it would cost $140 million in power cost just to move the water into the service area. Additionally, approximately 400,000 AF of that total is withdrawn from SWP storage accounts, leaving approximately 600,000 AF in SWP storage accounts. Due to operational constraints, a 15 percent SWP Table A allocation is needed to meet the demands in 2022 for the service areas where Metropolitan meets demands primarily with SWP resources. Therefore, there is a high likelihood that Metropolitan will need to take extraordinary actions to maintain reliable service through 2022 that will necessitate expenditures beyond those budgeted for FY 2021/22. As a reference point for participation in dry-year transfer markets, Metropolitan paid approximately $630 per AF for north of Delta transfers in 2021. When Metropolitan is able to refill its water storage, it will incur an unbudgeted power and supply program expense that will cause a substantial draw on unrestricted reserves.

FY 2021/22 Outlook

Depending on the continued severity of COVID-19 restrictions, we can expect some departmental O&M savings to continue in FY 2021/22. This includes possible savings for: Director inspection trip program and travel, training and seminars, community outreach events, building security, professional and non-professional services, expensed equipment, and employee-related work expenses such as transit reimbursements, management and employee events, office supplies, vanpool lease, and copier charges.

Despite these anticipated departmental O&M savings in FY2021/22, there are many areas in which we expect to see increased costs and lower revenues resulting from lower water sales. These include higher power, conservation and demand management costs in FY2021/22.

The current hydrologic conditions have led to unprecedented impacts on the California electricity market. For the first time since the Oroville Reservoir was initially filled, the lake is too low to generate hydropower. In July, the power operations and planning team presented to the Engineering and Operations Committee on the potential impacts to Metropolitan's power costs during FY 2021/22. Based on the current impacts to the wholesale electricity market and the need to operate the Colorado River Aqueduct (CRA) at the full 8-pump flow, ***Metropolitan may see costs for operating the CRA increase from approximately $58 million budgeted to nearly $100 million.*** These are unavoidable costs needed to maintain reliable service to our member agencies.

The conservation activity in FY 2020/21 was below budget primarily due to reduced conservation advertising activity in response to COVID-19. However, conservation and other demand management program funding is anticipated to increase in FY 2021/22. In August 2021, the Board declared a Water Supply Alert and called for consumers and businesses to voluntarily reduce their water use and help preserve the region's storage reserves. The dry conditions have motivated additional interest in boosting expenditures for demand management programs and advertising. At the adjourned August 2021 committee meetings, staff provided an update to the Board to increase conservation advertising in response to the Governor's statewide call for a voluntary reduction of 15 percent of water use**. Since the Board has not approved a collection mechanism for demand management, funds available for demand management is limited to funds in the Water Stewardship Fund. These funds are projected to be exhausted in FY 2022/23**. As such, the Board must establish a new demand management rate, charge or other revenue collection mechanism that goes into effect no later than CY 2023 to ensure continued funding of the demand management programs approved by the Board.

In the first year of the biennial budget, Metropolitan realized an increase in unrestricted reserves with an ending balance below the target. For the second year of the budget, there is a high probability that water demands on Metropolitan will be below the budgeted 1.6 MAF, reducing revenues and potentially reducing reserves. Also, when combined with potential unbudgeted expenses for dry year transfers, increased demand management funding, operational impacts due to ongoing dry conditions and increased power costs due to the drought's impacts on the electric market, there are many things that could cause a draw on reserves in the second budget year.

Given the current status of unrestricted reserves, which are currently within the range of the established policy minimum reserves levels and target reserves levels, staff does not recommend any changes to the approved 4 percent rate increase for CY 2022. Moreover, staff does not recommend any changes to the second year of the current biennial budget.

Items that May Impact the Next Biennial Budget, FY 2022/23 and FY 2023/24

Metropolitan will begin work in the fall on its next biennial budget, covering FY 2022/23 and FY 2023/24, and rates and charges effective January 1, 2023, and January 1, 2024. Significant issues to consider for the next biennial budget include:

- Lower Water Transactions: Metropolitan's fiscal year average water transactions over the last twenty years is about 1.9 MAF. However, the average over the last five fiscal years (FY 2015/16 thru FY 2020/21) is about 1.5 MAF. Changing demographics, demand management, and improved hydrologic conditions from FY 2016/17 through FY 2018/19 have contributed to Metropolitan's lower water transactions. While hydrologic conditions are unpredictable and cycles of low sales are expected, it may be that Metropolitan is moving to a new lower level of average water transactions. The current ten-year forecast assumes fiscal year transactions of 1.6 MAF to 1.75 MAF from FY 2021/22 through FY 2029/30. Metropolitan will evaluate whether to lower budgeted water transactions for the next budget and for the ten-year forecasts.
- Higher Costs due to Drought: Water Year 2022 will start with a 0 percent SWP Table A allocation, and the Colorado River will have the first-ever declared allocation. There may be a need to take unbudgeted actions to continue to provide reliable water service to our member agencies, especially to meet the needs of the service areas in the distribution system where Metropolitan uses primarily SWP water to meet demands. Additionally, based on the current electric market, a prolonged drought will increase electricity prices.
- Demand Management Cost Recovery: **Currently, Metropolitan's demand management programs are projected to run out of funding in FY 2022/23**. As such, the Board must establish a new demand management rate, charge or other revenue collection mechanism that goes into effect no later than CY 2023 to ensure continued funding of demand management.
- Cost of Resiliency Projects: Currently, only planning dollars are included for the Regional Recycled Water Project and Delta Conveyance Project. Inclusion of the full construction costs for either would necessitate additional rate increases above the current ten-year forecast.

Next Steps

The development of the next biennial budget is underway. In February 2022, the Board will be presented with a proposed biennial budget and revenue requirements for FY 2022/23 and 2023/24; proposed water rates and charges for calendar years 2023 and 2024; and an updated 10-year forecast.

Policy

Metropolitan Administrative Code Section 5107: Biennial Budget Process

Metropolitan Administrative Code Section 5108: Appropriations

Metropolitan Administrative Code Section 5109: Capital Financing

Metropolitan Administrative Code Section 5200: Funds Established

Metropolitan Administrative Code Section 5202: Fund Parameters

By Minute Item 51828, on December 10, 2019, the Board directed staff: (1) to incorporate the use of the 2019/20 fiscal-year-end balance of the Water Stewardship Fund to fund all demand management costs in the proposed fiscal years 2020/21 and 2021/22 Biennial Budget; and (2) to not incorporate the Water Stewardship Rate, or any other rates or charges to recover demand management costs, with the proposed rates and charges for calendar years 2021 and 2022.

By Minute Item 51962, on April 14, 2020, the Board approved the biennial budget for FYs 2020/21 and 2021/22; adopted resolutions fixing and adopting the water rates and charges for CYs 2021 and 2022; and adopted the resolution finding that for FYs 2020/21 and 2021/22, the ad valorem property tax rate limitation of Metropolitan Water District Act Section 124.5 is not applicable because it is essential to Metropolitan's fiscal integrity to collect ad valorem property taxes in excess of the limitation.

By Minute Item 51987, on May 12, 2020, the Board approved the continuance of Metropolitan's Water Standby Charge for FY 2020/21.

By Minute Item 52116, on September 15, 2020, the Board approved cost-containment measures recommended in Board Letter 8-1, as amended by the Board, to address the COVID-19 financial impacts.

By Minute Item 52204, on December 8, 2020, the Board adopted the COVID-19 Member Agency Payment Deferment Program and amend the Administrative Code to add Section 4519 delegating authority to the General Manager to administer the Program.

By Minute Item 52327, on April 13, 2021, the Board approved resolutions fixing and adopting a Readiness-to-Serve Charge and a Capacity Charge for calendar year 2022.

By Minute Item 52372, on May 11, 2021, the Board approved the continuance of Metropolitan's Water Standby Charge for FY 2021/22.

Fiscal Impact

None. This is an informational report.

Katano Kasaine 9/1/2021

Katano Kasaine *Date*
Assistant General Manager/
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9/1/2021

Adel Hagekhalil *Date*
General Manager

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