THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

BOARD ACTION

- Board of Directors

11/23/2021 Special Board Meeting

7-1

Subject

Direct staff to incorporate the 100 percent Supply Alternative as the demand management cost recovery method used in the proposals for rates and charges; the General Manager has determined that the proposed action is exempt or otherwise not subject to CEQA

Executive Summary

Metropolitan's demand management program consists of the Conservation program, the Local Resources Program (LRP), and the Future Supply Actions program. For the past five years, the total annual demand management revenue requirement budget has averaged $96 million, made up of approximately $34 million for conservation, $38 million for LRP, $2 million for Future Supply Actions, and $23 million for departmental operations & maintenance net of interest income. The ten-year forecast in the current biennial budget projects those costs to increase to $151 million by fiscal year (FY) 2030/31, which does not include the potential increase in conservation due to the present drought emergency. While the Board has the discretion to increase or decrease the budget for conservation (except any contractual commitments), Future Supply Actions, and planned LRP that are not yet approved, Metropolitan has a nondiscretionary obligation to make payments under LRP agreements that are already in place. Therefore, Metropolitan must collect funds to at least pay for its nondiscretionary LRP funding commitments.

Currently, Metropolitan is not collecting revenues to fund its demand management costs. Based on prior board direction, those costs are being paid from reserves in the Water Stewardship Fund, which will run out by mid-FY 2022/23. While the Board, staff, and member agency representatives participating in a rate refinement workgroup have undergone various processes to evaluate the most appropriate cost recovery method to fund demand management going forward, and considered various alternatives, consensus on one method had not yet been reached as of the September Finance & Insurance (F&I) Committee meeting. Subsequently, on September 21, a new appellate court decision held Metropolitan's demand management costs cannot be recovered through transportation rates charged under Metropolitan's (now repealed) rate for wheeling service (wheeling rate) and the San Diego County Water Authority (SDCWA)-Metropolitan Exchange Agreement. As a result, staff has removed from the alternatives for the Board's review the alternatives that included an allocation to transportation rates. Since then, the Board and the rate refinement workgroup have reviewed and discussed the remaining alternatives, with a consensus formed in the rate refinement workgroup for use of the alternative based on a 100 percent allocation to supply ("100 percent Supply Alternative"). Accordingly, following the member agency recommendation in this letter, staff recommends that the Board direct staff to incorporate the 100 percent Supply Alternative as the demand management cost recovery method used in the proposals for rates and charges for the Board's consideration.

Details

Metropolitan's Process to Revise Demand Management Cost Recovery

Metropolitan allocated demand management costs to the transportation operational functions since the unbundling of its rate structure in 2001, which was implemented in January 2003. The functionalization of the costs was supported by the 1996 Integrated Resources Plan's (IRP) 25-year capital and resource planning, which expired this year. SDCWA challenged that allocation in court beginning in June 2010, alleging the Water Stewardship Rate could not be collected as part of Metropolitan's pre-set wheeling rate or the transportation rates charged under the SDCWA-Metropolitan Exchange Agreement. On June 21, 2017, the Court of Appeal entered a decision in *SDCWA v. Metropolitan*, 12 Cal. App. 5th 1124. The appellate court ruled Metropolitan may collect State Water Project transportation costs as part of Metropolitan's System Access Rate and System Power Rate in the wheeling rate and the Exchange Agreement price. However, the appellate court found the administrative record before it for the rates in calendar years (CYs) 2011 through 2014 did not support Metropolitan's inclusion of the Water Stewardship Rate in the wheeling rate or the transportation rates charged under the Exchange Agreement, but the opinion did not address the allocation in subsequent years based on a different record.

In April 2018, the Board directed staff to undertake a process with input from member agencies to study and determine the most appropriate allocation of demand management costs based on the review of all available information. The cost allocation study was undertaken by staff in two phases. The first phase determined an appropriate functional assignment of Metropolitan's demand management costs. Mr. Peter Mayer, P.E., principal at Water DM, made presentations to the F&I Committee and the member agency managers, and also provided a report entitled "Report on Functional Assignment of Metropolitan's Demand Management Costs" (WaterDM Report) to the Board in August 2019.

In the second phase, consideration was given to incorporating the functionalization recommendations into Metropolitan's cost-of-service process to recover demand management costs through the existing rate structure or through the development of a new rate and/or charge. Mr. Rick Giardina, Senior Vice President at Raftelis, a public utility and public agency management consulting firm, provided presentations to the F&I Committee and member agency managers, and provided a report entitled "Demand Management Cost Recovery Alternatives" (Raftelis Report). However, the Board did not come to a consensus on a cost recovery method for demand management, and it directed staff on the manner of temporarily funding demand management costs while member agency representatives further evaluated the options.

In December 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 FYs 2020/21 and 2021/22 Biennial Budget; and (2) to not include the Water Stewardship Rate, or any other rates or charges to recover demand management costs, with the proposed rates and charges for CYs 2021 and 2022. Since then, the member agencies participated in a rate refinement process in which they prioritized the review of alternatives for demand management cost recovery. In September 2021, staff presented to the F&I Committee the Demand Management Cost Recovery Alternatives being discussed by the rate refinement workgroup.

On September 21, 2021, the Court of Appeal issued a new appellate decision in which it interpreted its 2017 appellate decision. The Court of Appeal clarified that its 2017 decision regarding the Water Stewardship Rate was not limited to 2011-2014, and that it prohibits the inclusion of the Water Stewardship Rate in transportation rates charged under Metropolitan's wheeling rate and in the price term of the SDCWA-Metropolitan Exchange Agreement from 2015 forward. Accordingly, staff removed all Demand Management Cost Recovery Alternatives that include transportation rate elements for the Board Workshop on November 8, 2021. The remaining cost recovery alternatives are described in **Attachment 1 (Demand Management Cost Recovery Alternatives and Member Agency Impacts)**.

The rate refinement workgroup met to discuss the remaining alternatives on November 18, 2021. At the meeting, member agency staff recommended presenting the 100 percent Supply Alternative to the Board for its consideration. For purposes of computing estimated member agency impacts, staff used a five-year average of total sales to smooth the year-to-year variability that may occur, rather than data for one specific year, for the 100 percent Supply Alternative. Table 1 below presents the impacts to each member agency of the 100 percent Supply Alternative.

Table 1: Estimated Member Agency Impacts of 100 percent **Supply Alternative.**
In thousands of dollars, based on hypothetical $100 million demand management revenue requirement.

	100% Supply
Anaheim	$ 988
Beverly Hills	724
Burbank	1,005
Calleguas MWD	6,387
Central Basin MWD	2,741
Compton	0
Eastern MWD	6,447
Foothill MWD	564
Fullerton	479
Glendale	1,082
Inland Empire	3,875
Las Virgenes MWD	1,395
Long Beach	2,114
Los Angeles	17,616
MWDOC	14,754
Pasadena	1,295
SDCWA	16,491
San Fernando	1
San Marino	64
Santa Ana	626
Santa Monica	256
Three Valleys MWD	4,370
Torrance	1,087
Upper San Gabriel	2,837
West Basin MWD	8,045
Western MWD	4,756
Total	**$ 100,000**

Financial Outlook for Demand Management Funding

Demand management has been funded by the Water Stewardship Fund for the present biennial budget cycle. However, based on the financial outlook of demand management costs, that is not sustainable for the next biennial budget cycle. To determine the financial outlook of demand management funding, it is important to review the projected fund balance for the Water Stewardship Fund.

Chart 1. Historical and Projected Monthly Water Stewardship Fund Balance

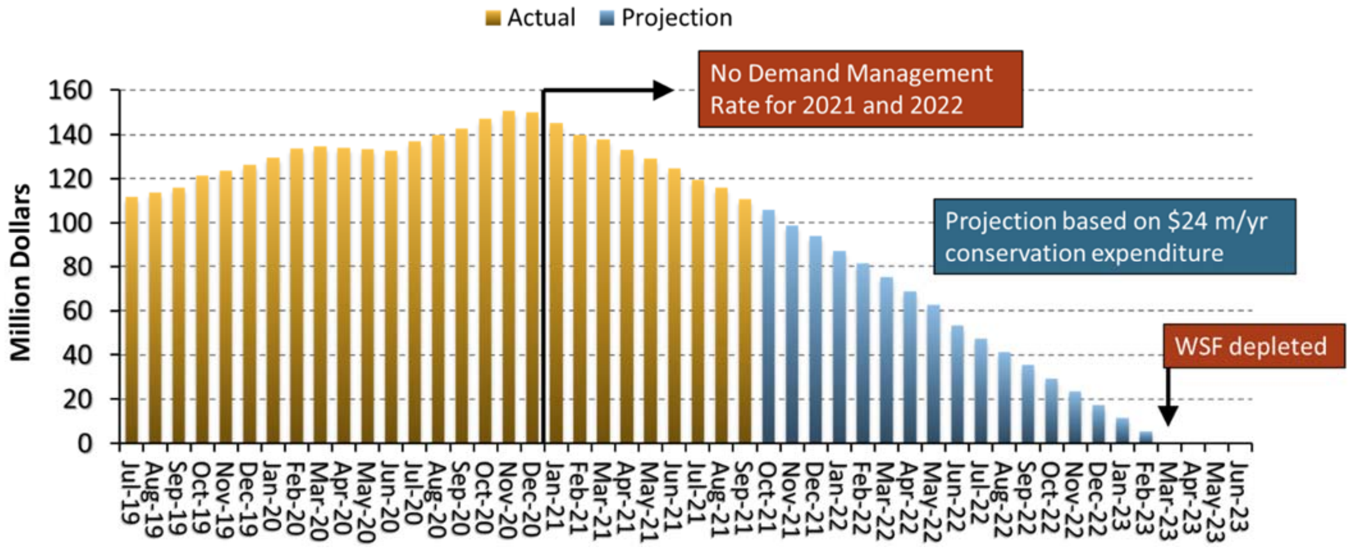

Chart 1 shows the historical monthly Water Stewardship Fund balance in orange bars from August 2019 through September 2021. In January 2021, rates and charges went into effect without a rate to recover demand management costs for CY 2021 and beyond. Consequently, the fund started to draw down in January 2021. In blue bars starting in October 2021, staff has projected the fund balance until the Water Stewardship Fund is depleted by March 2023 based on an estimate of $24 million per year in conservation funding, compared to $43 million currently appropriated per year. If the conservation funding increases above $24 million per year, the Water Stewardship Fund will be depleted earlier.

Next Steps

Metropolitan's robust demand management programs have been enormously successful and important, having helped build Southern California's current high degree of water reliability and resilience. Additionally, the successful implementation of demand management has been cost-effective and reduced the need for Metropolitan to spend on more costly infrastructure and supplemental water resources. Continuation of these successful programs will require the adoption of a funding mechanism before the existing funding runs out in FY 2022/23. Staff is requesting that the Board approve the 100 percent Supply Alternative as the demand management cost recovery method to be incorporated into the proposals for rates and charges. Staff will continue to review the rate structure with the rate refinement workgroup to bring any proposed changes to rates and charges for board consideration and incorporation into future rates and charges.

Policy

Metropolitan Water District Act Section 134: Adequacy of Water Rates; Uniformity of Rates

Metropolitan Administrative Code Section 5107: Biennial Budget Process

Metropolitan Administrative Code Section 5108: Appropriations

Metropolitan Administrative Code Section 5109: Capital Financing

Metropolitan Water District Administrative Code Section 11104: Delegation of Responsibilities

By Minute Item 51164, on April 10, 2018, the Board approved the suspension of billing and collection of the Water Stewardship Rate on exchange agreement deliveries to San Diego County Water Authority for (a) CYs 2019 and 2020 during the Demand Management cost allocation study period, and (b) CY 2018.

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 CYs 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.

California Environmental Quality Act (CEQA)

CEQA determination for Option #1:

The proposed action is not defined as a project under CEQA because it involves continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines); the creation of government funding mechanisms or other government fiscal activities, which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment (Section 15378(b)(4) of the State of CEQA Guidelines); and organizational or administrative activities of governments that will not result in direct or indirect physical changes in the environment (Section 15378(b)(5) of the State of CEQA Guidelines). Additionally, where it can be seen with certainty that there is no possibility that the proposed action may have a significant impact on the environment, the action is not subject to CEQA pursuant to Section 15061(b)(3) of the State CEQA Guidelines.

CEQA determination for Option #2:

None required

Board Options

Option #1

Direct staff to incorporate the 100 percent Supply Alternative as the demand management cost recovery method used in the proposals for rates and charges.

Fiscal Impact: The future proposed rates and charges will recover the revenue requirement as set forth by the General Manager and adopted by the Board in the future Biennial Budgets.
Business Analysis: This would enable Metropolitan to provide funding for ongoing and future demand management programs.

Option #2

Do not direct staff to incorporate the 100 percent Supply Alternative as the demand management cost recovery method in the proposals for rates and charges.
Fiscal Impact: The future proposed rates and charges will not recover the revenue requirement as set forth by the General Manager in the future proposed Biennial Budgets.
Business Analysis: This would not enable Metropolitan to provide funding for ongoing and future demand management programs, requiring further board review and the selection of an alternative demand management cost recovery method prior to adoption of the budget and rates in April 2022.

Staff Recommendation

Option #1

11/19/2021

Katano Kasaine *Date*
Assistant General Manager/
Chief Financial Officer

11/19/2021

Adel Hagekhalil *Date*
General Manager

Attachment 1 – Demand Management Cost Recovery Alternatives and Member Agency Impacts

Ref# cfo12685842

Attachment 1 - Demand Management Cost Recovery Alternatives and Member Agency Impacts

Table 1. Demand Management Cost Recovery Alternatives for Board Consideration (Remaining after September 21, 2021 Court of Appeal Decision)

Cost Recovery Component	Approx % of DM Costs	Billing Determinant	Charge / Rate
100% Supply			
Supply	100%	Sales	$/AF
Alt 3A – Functionalized Fixed Charge (revised to 100% supply)			
New sales-based fixed charge	100%	10-yr Avg Sales	Fixed $
Alt 3B – Non-Functionalized Fixed Charge based on Population			
New DM fixed charge	100%	Population	Fixed $
Alt 3B – Non-Functionalized Fixed Charge based on Assessed Valuation			
New DM fixed charge	100%	Assessed Valuation	Fixed $
Alt 3B – Non-Functionalized Fixed Charge based on 50/50 Pop/AV			
New DM fixed charge	50% 50%	Population Assessed Valuation	Fixed $

[1] Using a hypothetical Revenue Requirement share; the actual relative shares will be calculated as a part of each cost of service analysis and will differ.

Alternative: 100 percent Supply **(Recovered on volumetric sales)**

This alternative functionalizes all demand management costs to the supply function. This option excludes all other functions from demand management programs, which is not consistent with Metropolitan's consultants' analysis and conclusions regarding cost of service principles. However, it is consistent with the recent appellate court ruling. Under this option, member agencies that purchase water would incur all the costs of demand management. There would be no cost recovery from current wheeling or exchange transactions.

Alternative #3A: Revised Functionalized Fixed Charge **(Recovered based on ten-year rolling average sales)**

Demand management costs are largely fixed in nature. The LRP incentives are provided under contractual commitments with terms from 15 to 25 years, and the Board has stated a desire that conservation programs (incentives and messaging) should be funded on a consistent basis, and not ramped up and down. Following the September 21st appellate court ruling, staff modified the orginal Alternative 3A developed by Raftelis that is now solely collected on sales and functionalized to supply.

Under the modified Alternative #3A functionalized to Supply, Metropolitan would follow its cost-of-service process to functionalize demand management costs solely to Supply. Those costs could then be aggregated and apportioned to member agencies based on selected metrics, or billing determinants. Under Alternative #3A, the costs are recouped through fixed charges, not volumetric rates. In Tables 1 and 2, costs functionalized as supply have been apportioned to member agencies based on each member agency's ten-year rolling average of all sales.

Under Alternative #3A, those member agencies that have purchased relatively more full service water over the last ten years will pay more of the demand management costs through their fixed charges, as their averages increase.

Alternative #3B: Non-Functionalized Fixed Charge (Recovered as fixed charge based on AV, population, or other metric)

Alternative #3B highlights that demand management costs are a necessary and legislatively directed activity that improves reliability for all water systems in Metropolitan's service area. By providing conservation incentives that reduce the use of imported resources and LRP incentives that improve the reliability of local resources, offsetting the need to import water, even water systems without a physical connection to Metropolitan benefit. Therefore, Alternative #3B proposes a fixed charge to member agencies that aligns with the benefits of demand management for all member agencies based on use and potential use in their service areas.

In the three examples for Alternative #3B, demand management costs are aggregated and apportioned to member agencies based first on population and then on assessed valuation or a mix of both. Both metrics provide a measure of the reliance—and potential reliance—for water service on Metropolitan. Other metrics, or a combination of metrics, could be used instead.

The approximate percentages of demand management costs recovered in the alternatives are hypothetical as the actual functionalization of costs is dependent on the prospective cost-of-service analyses and budgeted expenditures. The approximate percentages are provided so member agencies can get a sense of how the alternatives might impact them. Importantly, when the Board approves one of the alternatives, it will approve a methodology, not explicit percentages or budgeted demand management expenditures.

For purposes of computing estimated member agency impacts, staff used a five-year average of total sales to smooth the year-to-year variability that may occur, rather than data for one specific year, for the 100 percent Supply Alternative.

Table 2: Estimated Member Agency Impacts of Demand Management Cost Recovery Alternatives.
In thousands of dollars, based on hypothetical $100 million demand management revenue requirement.

	100% Supply	Alt 3A - Functionalized Fixed Charge (100% Supply)	Alt #3B - Fixed Charge, Population	Alt #3B - Fixed Charge, AV	Alt #3B - 50/50 AV/Pop
Anaheim	$ 988	$ 1,201	$ 1,920	$ 1,578	$ 1,749
Beverly Hills	724	690	230	1,188	709
Burbank	1,005	907	570	810	690
Calleguas MWD	6,387	6,635	3,338	3,495	3,416
Central Basin MWD	2,741	2,907	8,247	5,056	6,651
Compton	0	51	483	158	321
Eastern MWD	6,447	6,022	4,355	2,720	3,537
Foothill MWD	564	555	433	634	533
Fullerton	479	541	715	680	697
Glendale	1,082	1,092	979	1,091	1,035
Inland Empire	3,875	3,962	4,534	3,883	4,209
Las Virgenes MWD	1,395	1,350	371	850	610
Long Beach	2,114	2,084	2,506	1,724	2,115
Los Angeles	17,616	17,803	21,258	20,730	20,994
MWDOC	14,754	14,264	12,447	17,067	14,757
Pasadena	1,295	1,244	877	1,049	963
SDCWA	16,491	17,744	17,009	17,368	17,188
San Fernando	1	2	129	66	98
San Marino	64	55	70	222	146
Santa Ana	626	736	1,756	902	1,329
Santa Monica	256	364	495	1,276	885
Three Valleys MWD	4,370	4,144	2,741	2,341	2,541
Torrance	1,087	1,056	721	992	856
Upper San Gabriel	2,837	2,213	4,587	3,580	4,084
West Basin MWD	8,045	7,614	4,301	6,929	5,615
Western MWD	4,756	4,765	4,931	3,610	4,271
Total	**$ 100,000**	**$ 100,000**	**$ 100,000**	**$ 100,000**	**$ 100,000**