- Board of Directors
  Finance and Insurance Committee

3/10/2020 Board Meeting

9-2

Subject

Review of the Metropolitan Water District Act Section 124.5 ad valorem property tax limitation for fiscal years 2020/21 and 2021/22

Executive Summary

Section 124.5 of the Metropolitan Water District Act (MWD Act) provides a mechanism to reduce Metropolitan's ad valorem property taxes, but it does not apply if the Board of Directors makes the required determination that it is essential to Metropolitan's fiscal integrity to not reduce property taxes. Section 124.5 ties property taxes to the amount needed to pay: (1) Metropolitan's general obligation bonded indebtedness, and (2) Metropolitan's portion of bonds used to finance construction of State Water Project (SWP) facilities for the benefit of Metropolitan (Burns-Porter bonds). However, the Section also provides that "the restrictions contained in this section *do not apply* if the board of directors of the district, following a hearing held to consider that issue, finds that *a tax in excess of these restrictions is essential to the fiscal integrity of the district*," and written notice is provided to the Legislature in the manner specified therein. (Emphasis added.) The Section 124.5 limitation, if applicable, does not affect the collection of property taxes to pay Metropolitan's general obligation bonds. However, the limitation, if applicable, limits collection of property taxes to pay Metropolitan's State Water Contract (SWC) obligations. Since fiscal year (FY) 2012/13, the Board has determined that it was essential to Metropolitan's fiscal integrity to maintain the current 0.0035 percent property tax rate.

The proposed budget for FYs 2020/21 and 2021/22 and rates and charges for calendar years (CYs) 2021 and 2022 presented to the Finance and Insurance Committee in February included a projection of approximately $140 million per year in property tax revenues.

The Board will hold the required public hearing on March 10, 2020, and it will consider whether to make the necessary finding on April 14, 2020, along with its consideration of the proposed biennial budget for FYs 2020/21 and 2021/22, rates for CYs 2021 and 2022, and charges for CY 2021.

Details

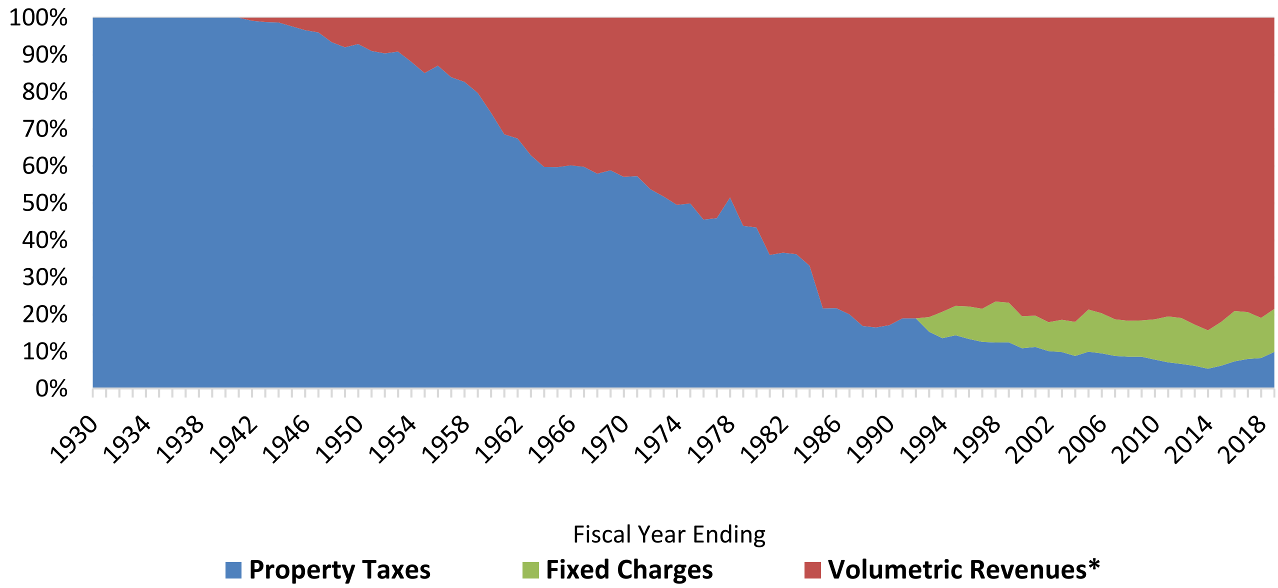
History of Metropolitan's Property Tax Revenues

The shift in revenue sources from primarily property taxes to primarily water revenues provides a backdrop to Metropolitan's history. The MWD Act authorizes Metropolitan to "levy and collect taxes on all property within the district for the purposes of carrying on the operations and paying the obligations of the district," pursuant to Section 124. Prior to 1942, Metropolitan was constructing the Colorado River Aqueduct and had no water to sell so all of its revenues came from property taxes. In FY 1941/42, when Metropolitan began to sell water, the majority of Metropolitan's revenues were still derived from property taxes. In 1960, Metropolitan executed its SWC. However, it took over 30 years, until 1974, for 50 percent of Metropolitan's revenues to come from water transactions, with the remainder derived primarily from property taxes.

In 1984, the Legislature adopted SB 1445, amending the MWD Act to add Section 124.5, among other sections. Effective FY 1990/91, Section 124.5 limits Metropolitan's annual property tax levy at the amount needed to pay the total of annual debt service on Metropolitan's general obligation bonds and Metropolitan's portion of the State Burns-Porter bonds, unless after notice and hearing the Board finds that collecting property tax revenue beyond that limitation is essential to the District's fiscal integrity. As bond indebtedness permitted to be paid from property taxes under Section 124.5 is paid down, the Section 124.5 limit decreases. In 1984, when SB 1445 was enacted, Metropolitan collected property taxes at the rate of 0.0237 percent. In FY 2013/14, the Section 124.5 limit reduced the rate to 0.0035 percent, approximately 1/7 of the 0.0237 percent rate in place at the time Section 124.5 was passed.

Tax levy limits in Section 124.5 accelerated the shift of Metropolitan's revenues away from fixed property taxes to variable revenues. Now, in FY 2020/21, property taxes are projected to be about 8 percent of total revenue sources with water revenues accounting for about 80 percent of total revenues. Total volumetric revenues which include power revenues and other transactions are about 83 percent of total revenues.

Figure 1: Historical Revenue Sources



* Includes water sales, exchanges, and wheeling

Background Regarding State Water Contract Obligations and Voter Approval of Property Taxes

Metropolitan is one of 29 agencies that contract with the State for participation in the SWP. Metropolitan's SWC was the first contract executed, and the prototype for the State Water Contracts that followed, and its terms were validated by the California Supreme Court in *Metropolitan Water Dist. v. Marquardt* (1963) 59 Cal.2d 159. Metropolitan is the largest participant in the SWP in terms of the number of residents in its service area, the allocation of SWP water that it has contracted to potentially receive, and the allocation of SWP infrastructure and power costs. As a result, Metropolitan pays the highest percentage of total annual payments made to the Department of Water Resources of all of the agencies with State Water Contracts.

Under the SWC, Metropolitan is obligated to pay allocable portions of the cost of construction of the SWP system and ongoing operating and maintenance costs. Metropolitan is obligated to pay these fixed costs regardless of quantities of water available and received from the project. In contrast, a smaller portion of payments are based on actual deliveries of water received for the costs of power and offsets for credits received. Approximately 70 percent of Metropolitan's SWC obligations are fixed and unrelated to the quantity of water delivered.

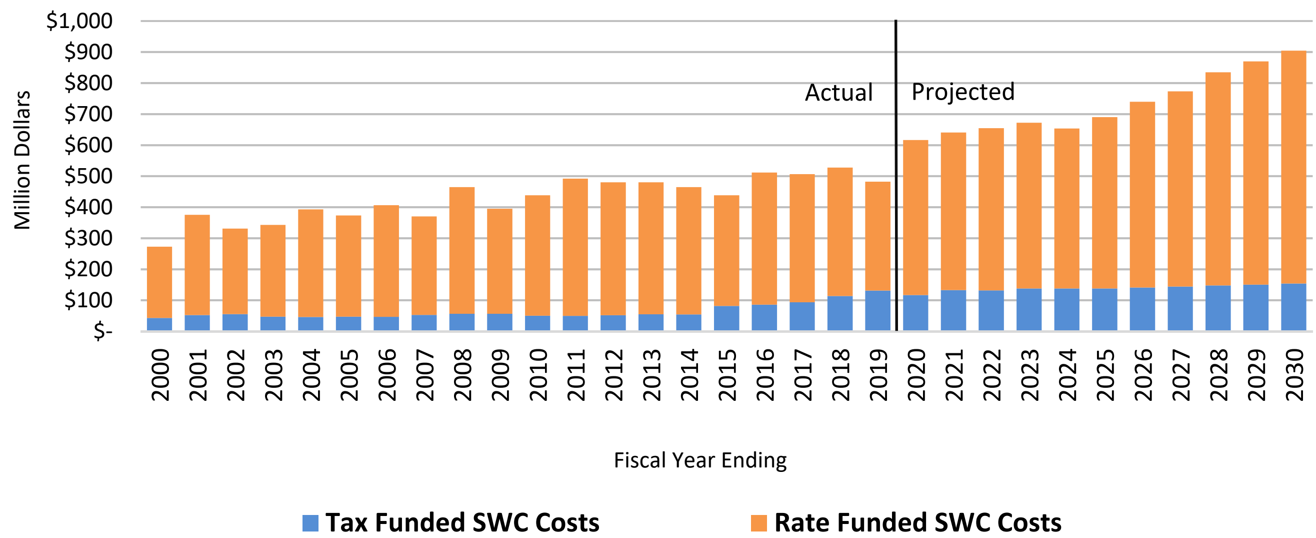
The ability of State Water Contractors to levy property taxes sufficient to satisfy their SWC obligations was a foundation of the Burns-Porter Act, and a factor relied on by California voters in approving it. *Goodman v. County of Riverside* (1983) 140 Cal.App.3d 900, 905-06; *see also, Alameda County Flood Control v. Department of Water Resources, Antelope Valley-East Kern Water Agency* (2013) 213 Cal. App. 4th 1163. In approving the Burns-Porter Act, California's voters approved "an indebtedness in the amount necessary for building, operating, maintaining, and replacing the [State Water] Project, and they intended that the costs were to be met by payments from local agencies with water contracts. Further, the voters necessarily approved the use of local property taxes whenever the boards of directors of the agencies determined such use to be necessary to fund their water contract obligations . . . ." *Goodman,* 140 Cal.App.3d at 910. Thus, SWC obligations are voter-approved indebtedness that may be funded by override property taxes (taxes above the one percent general tax limit established by Article XIIIA (Proposition 13) of the State constitution).

Most of the other contractors substantially rely on property taxes to satisfy their SWC obligations. Metropolitan is unique in that since FY 1990/91, and unless otherwise determined by the Board, Section 124.5 has reduced its property taxes to a declining balance of the State general obligation bond debt service (the Burns-Porter bonds)—which is a small portion of Metropolitan's SWC payment obligation.

Review of State Water Project Costs

Under Section 124.5's restriction, the property tax rate has been decreasing, and will continue to decrease, as the relevant bonds are paid off. In the meantime, Metropolitan's SWC obligations have been increasing and will continue to increase. For example, the State is expecting substantial costs associated with repair and replacement of the 50-year-old SWP infrastructure such as the Oroville Spillway repair, work necessary to address subsidence damage, and California Aqueduct improvements. Figure 2 shows the portion of SWC costs paid with property tax revenues, assuming Metropolitan maintains the 0.0035 percent in excess of the Section 124.5 limitation.

Figure 2: State Water Contract Costs



Budgeted SWC costs of $640.8 million in FY 2020/21 and $654.4 million in FY 2021/22 comprise approximately 36 percent of Metropolitan's annual expenditures and are Metropolitan's single largest cost category. If property taxes are reduced to Section 124.5 limits, in FY 2020/21 the amount of property taxes available to satisfy SWC obligations will only be approximately $7.6 million, and the proportion of SWC obligations that would be covered would be approximately 1.2 percent.

What is the Meaning of "Essential to Fiscal Integrity" in Section 124.5?

The determination of fiscal integrity is a determination of financial health and strength. The Legislature left that determination to the discretion of the Board. Section 124.5 does not define the meaning of "essential to fiscal integrity." Merriam-Webster defines "essential" in many ways, including "of the utmost importance," and "something necessary, indispensable, or unavoidable." "Fiscal" simply means it is related to a financial issue. And "integrity" is defined by Merriam-Webster as "an unimpaired condition: soundness," or "the quality or state of being complete or undivided." (Definitions taken from www.merriam-webster.com/dictionary.) Thus, "essential to fiscal integrity" is reasonably interpreted to mean important or valuable for financial soundness or to financial health/condition. "Essential to fiscal integrity" does not mean an act is necessary to avoid an emergency financial crisis. Nowhere in Section 124.5 does the Legislature reference a need for the existence of a fiscal "emergency."

In the absence of a statutory definition of the phrase "essential to fiscal integrity," Metropolitan has looked to financial industry standards and its own financial policies to evaluate whether continuing the current fixed property tax revenues is essential to its fiscal integrity.

Financial Industry Guidance

Bond rating agencies often provide criteria for rating debt issued by public agencies based on various financial factors. Essentially, ratings provide an overview of an agency's financial health, i.e., integrity. Fitch's U.S. Water and Sewer Rating Criteria, published November 29, 2018, sets forth relevant criteria. "[P]articular aspects of [Fitch's] criteria may have applicability depending on the type of operations and related risks of a given utility." However, one criteria that stands out is the significance fixed revenue (such as Metropolitan's property tax) has for purposes of evaluating an agency's fiscal health.

Fitch Criteria: Fixed revenue (preferably at 30 percent or more) is a tool used to manage volatility in volumetric transactions and growing costs:

- "Fitch will evaluate demand and pricing characteristics that influence revenue volatility and the tools available to the utility to respond to fluctuation in demand." (Page 1.)
- "Fitch's analysis considers the issuer's … ability to manage growth in costs over time." (Page 1.)
- "Fitch assesses the level of financial flexibility that an issuer can sustain as it encounters stresses expected to occur over the relevant forecast period." (Page 1.)
- "Because systems with greater percentages of fixed charges have less volatility in their revenue streams than systems that rely extensively or completely on volumetric charges, utilities whose fixed-charge components generate a significant amount (30 percent or more) of their revenue streams are considered stronger." (Page 2.)

Applying Fitch's criteria for fixed revenues to Metropolitan supports that maintaining property tax revenues is essential to Metropolitan's fiscal integrity. Metropolitan is a voluntary cooperative with varying demands from its member agencies based on, among other things, hydrological conditions, availability of local resources, and availability of Metropolitan's own water system and resources. Accordingly, fixed revenue sources help Metropolitan respond to such demand volatility. Additionally, Metropolitan's property tax revenues are currently used to pay for a portion of SWP capital costs. Those costs are consistently growing and are projected to continue to grow. Maintaining a fixed revenue source for that purpose enhances Metropolitan's ability to manage growing SWP capital costs. Moreover, property taxes represent about 44 percent of Metropolitan's fixed revenues (and 8 percent of total revenues). All fixed revenue sources for Metropolitan represent only about 17 percent of total revenues, making property tax revenues essential in light of the 30 percent Fitch guideline for fixed revenues sources.

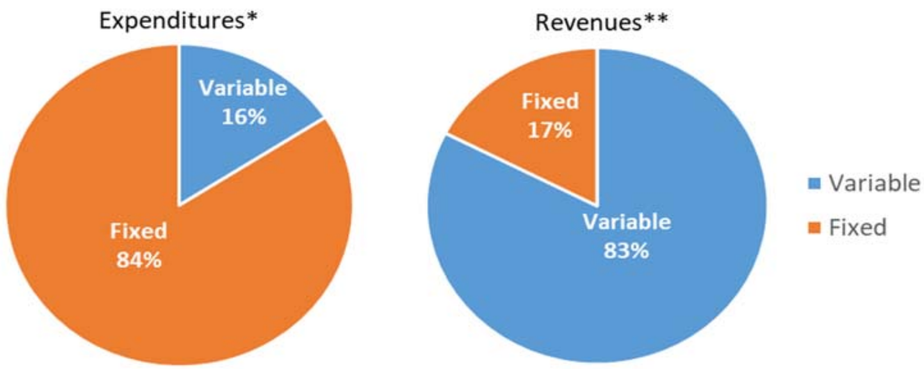
Metropolitan Financial Policies

Metropolitan's Board has adopted financial policies that are also relevant to determining its fiscal integrity. The Metropolitan Water District Administrative Code provides a fixed-charge coverage ratio of 1.2 times and a minimum and target for reserves at Section 5202. The Board has also adopted a revenue bond coverage target of 2.0 times. A reduction in fixed charges increases dependence on variable revenue, thereby increasing the likelihood of not meeting Metropolitan's financial policies during periods of low water transactions.

Impact on Fixed Revenues as a Result of Limiting Property Taxes Pursuant to Section 124.5

Transfer of revenue from a fixed source to a volumetric rate or charge does not strengthen Metropolitan's financial integrity. Metropolitan's costs consist mostly of fixed costs, while its fixed revenue sources make up only about 17 percent of total revenue. The loss of $125 million to $129 million in property tax revenues would decrease fixed revenues to 12 percent of total revenues. As mentioned, the Fitch guideline for fixed revenues is 30 percent of total revenues.

Figure 7: Fixed Costs vs. Variable Revenues - FY 2020/21 Budget



*Variable costs include SWP Variable Power, CRA Power and Variable Treatment.
**Fixed revenues include RTS Charge, Capacity Charge and Property Taxes.

Current hydrologic conditions are less predictable and more extreme as our climate changes and, therefore, volumetric revenues have become even more unpredictable. This increased volatility in water sales and other transactions supports a finding that maintaining fixed property tax revenues is essential to increasing revenue stability and subsequently fiscal integrity.

Summary of Review: Continuing an Ad Valorem Property Tax Rate at the Existing Rate is Essential to Fiscal Integrity

In light of the significance of achieving a financially healthy mix between variable and fixed revenue sources, it is important that the Board maintain fixed sources in line with growing increased SWP fixed costs. Service area voters approved property tax levies for the purpose of paying Metropolitan's SWC obligations, which costs are projected to be approximately $641 million and $654 million for FYs 2020/21 and 2021/22, respectively. If the property tax rate continues at its current 0.0035 percent rate, property tax revenue would pay about 20 percent of that SWC obligation. If the property tax rate were reduced to the Section 124.5 limits, property tax revenue would pay less than 2 percent of the SWC obligation. Continuing the current tax rate of 0.0035 significantly contributes to Metropolitan's long-term fiscal health and stability. It maintains diversity in fixed revenue sources, balancing the mechanisms for funding the immediate and anticipated obligations of the SWC for the SWP. It also helps maintain Metropolitan's creditworthiness. Maintaining Metropolitan's fixed revenue sources also provides the Board with flexibility as it funds Metropolitan's SWC obligations and other obligations.

Maintenance of fixed revenues supports Metropolitan's financial policies. Metropolitan has adopted a set of financial policies, including revenue bond coverage and fixed charge coverage targets, capital paid for from revenues (Pay-As-You-Go, or PAYGO), and reserve policies that support Metropolitan's strong credit ratings. An important element of these financial policies is a diversity of revenue sources and fixed revenue sources. Utilities funded primarily from variable volumetric charges face economic risks because sales volumes are subject to declines in revenue based on hydrology and consumption changes.

Property taxes are also important to fiscal health because they help Metropolitan equitably distribute the costs of Metropolitan's services. As a wholesale water agency, Metropolitan's customers are its 26 member agencies. Each member agency pays volumetric rates based on the amount of water Metropolitan sells and delivers to it. In contrast, property taxes are levied directly on residents and businesses that are property owners within Metropolitan's service area. All property owners within Metropolitan's service area benefit from the water system that allows water to be sold and delivered in Southern California. Property taxes ensure that residences and businesses pay a modest share of costs of the Metropolitan water delivery system.

Therefore, a determination that continued collection of fixed property tax revenues in excess of the Section 124.5 limit is supported by the information and analysis provided herein, as well as additional supporting information available at http://www.mwdh2o.com/WhoWeAre/Mission/Pages/review-applicability-of-property-tax-limit.aspx.

Next Steps

The Board will hold a public hearing on March 10, 2020 to receive public comments on the applicability of Section 124.5. At its regular April meeting, the Board will determine whether it is essential to fiscal integrity to continue to collect property taxes in excess of the Section 124.5 limit for FYs 2020/21 and 2021/22. If it makes such a finding, Section 124.5 will not apply in that timeframe. In August 2020, the Board may then set the property tax rate for FY 2020/21 in excess of the Section 124.5 limit. And in August 2021, the Board may set the property tax rate for FY 2021/22 in excess of the limit as well. The proposed FYs 2020/21 and 2021/22 budget and CY 2021 and 2022 rates and charges contain an assumption that the property tax rate will be continued at 0.0035 percent.

Proper notice of the public hearing has been provided to the Legislature and the public. This letter and additional information related to the review of Section 124.5 for FYs 2020/21 and 2021/22 is available at http://www.mwdh2o.com/WhoWeAre/Mission/Pages/review-applicability-of-property-tax-limit.aspx.

Policy

Metropolitan Water District Act Section 124: Taxes, Levy and Limitation

Metropolitan Water District Act Section 124.5: Ad Valorem Tax Limitation

Metropolitan Water District Act Section 130: General Powers to Provide Water Services

Metropolitan Water District Act Section 133: Fixing of Water Rates

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

Metropolitan Water District Act Section 134.5: Water Standby or Availability of Service Charge

Metropolitan Water District Administrative Code Section 4301: Cost of Service and Revenue Requirement

Metropolitan Water District Administrative Code Section 4304: Apportionment of Revenues and Setting of Water Rates

Metropolitan Water District Administrative Code Section 5107: Biennial Budget Process

Metropolitan Water District Administrative Code Section 5109: Capital Financing

Metropolitan Water District Administrative Code Section 5112: State Water Contract Payments

Metropolitan Water District Administrative Code Section 5200(b): Funds Established

Fiscal Impact

If the Section 124.5 limitation applies and property tax revenues are reduced, revenue requirements from rates and charges will increase.

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