THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

COMMITTEE ITEM

- **Business and Finance Committee**

October 12, 2009 Committee Meeting

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Subject

Cost of Service Review Update

Description

SUMMARY

In April 2009, the Board directed staff to work with member agencies and review Metropolitan's cost-of-service methodology for the 2010/11 rate cycle, evaluating the need for any changes and adjustments to rates and charges to reflect full cost of service. The review could result in the addition or deletion of rate components, as well as changes in the overall level of rate components.

Metropolitan staff has met with the Long Range Finance Plan (LRFP) workgroup four times since the April 2009 request, and has provided periodic updates to the Business and Finance Committee. Additionally, a workshop was held with the Board to discuss cost-of-service issues on September 22, 2009.

These workshops and updates have included discussion about changes to the existing cost-of-service methodology, including:

- Readiness-to-Serve (RTS) Charge: Currently, the RTS Charge recovers capital costs associated with standby and peak conveyance capacity and system emergency storage capacity. A portion of operations and maintenance costs could be assigned to this charge, increasing the amount of costs recovered through this fixed charge.
- Capacity Charge: The Capacity Charge recovers costs of providing peak capacity within the distribution system between May 1 and September 30 for a rolling three-year period. A portion of operations and maintenance costs could be assigned to this charge, in addition to the current capital financing costs, also increasing this fixed charge.
- System Access Rate: Costs associated with Metropolitan's use of Castaic Lake and Lake Perris for "flexible storage" of State Water Project (SWP) supplies could be allocated to the Supply component. Under the Monterey Agreement, Metropolitan has the right to borrow flexible storage water from these reservoirs in addition to Table A receipts within the year, subject to refill within five years. This water provides a dry-year yield to Metropolitan and that portion of the respective reservoirs' costs could be functionalized as a Supply-related cost. As a result, the System Access Rate could be reduced as the Supply rates increase.

Other rate structure issues will continue to be discussed, including a potential charge to recover treatment plant capacity-related costs separately from volumetric costs, a charge for growth-related infrastructure, and options for changing Metropolitan's maximum ad valorem tax rate. Longer term, the rate structure will be evaluated as the Board considers underlying policy principles regarding the appropriate role for Metropolitan as identified through the Integrated Resources Plan (IRP) Update and Strategic Policy Review discussions.

DISCUSSION

Since June 2009, Metropolitan staff has met with the LRFP workgroup to review the cost-of-service process and methodology. The LRFP workgroup reviewed how Metropolitan develops its Revenue Requirement and then assigns costs to service functions. Metropolitan's rates and charges are supported by the process of classifying and allocating costs to rate components.

In addition to an in-depth review of the cost-of-service process, the sensitivity of resulting rates and charges to changing various factors used for classifying costs was explored, as was the impact of assigning more of the SWP costs to the Supply function. The alternative of assigning a portion of the costs for Castaic Lake and Lake Perris associated with flexible storage was presented. Under the Monterey Agreement, Metropolitan has the right to borrow flexible storage water from these reservoirs in addition to Table A receipts within the year, subject to refill within five years. This water provides a dry-year yield to Metropolitan and that portion of respective reservoirs' costs could be assigned to the Supply function, consistent with the treatment of Metropolitan's reservoirs. This change would have resulted in an increase to the Supply function of about $10 million, or about $6 per acre-foot in the Tier 1 Supply Rate, and a decrease to Conveyance of the same amount, or about $5 per acre-foot to the System Access Rate, in the FY 2009/10 cost-of-service study. These rate impacts are based on rates, which fully recover the FY 2009/10 cost of service. Total SWP costs in the 2009/10 Revenue Requirement were $479 million.

Options to increase fixed charges were also examined. These include the existing RTS Charge, the Capacity Charge, and the ad valorem tax levy. Metropolitan has been reviewing other fixed costs with member agencies for some time, including a Treated Water Capacity Charge and a charge to recover the cost of infrastructure to meet growth.

Readiness-to-Serve and Capacity Charges

The RTS and Capacity Charges recover capital financing costs. Most operations and maintenance costs are currently recovered on the basis of average system use and are captured in the System Access Rate. Assigning operations and maintenance costs to peak system usage as well as average system usage would reduce the total costs recovered from the System Access Rate and increase the RTS and the Capacity Charges.

Assigning operations and maintenance costs to peak as well as average usage would have resulted in an increase to the RTS of $64 million and an increase to the Capacity Charge of $33 million. The System Access Rate revenues would have decreased by $97 million, lowering the System Access Rate by $51 per acre-foot. These rate impacts are based on rates, which fully recover the FY 2009/10 cost of service.

This alternative would result in Metropolitan collecting approximately 23 percent of its revenues from fixed charges, including the RTS, Capacity Charge and current ad valorem tax collections. This is consistent with the California Urban Water Conservation Council's (CUWCC) retail conservation pricing best management practice. Generally, this best management practice establishes the minimum amount of variable revenue an agency should recover from volumetric water sales at 70 percent[1].

Options for Metropolitan's Ad Valorem Tax Rate

The Metropolitan Water District has always assessed ad valorem taxes in its service area. When Metropolitan was first formed, it had no water to sell as the Colorado River Aqueduct was under construction. From fiscal years 1930 through 1941, Metropolitan relied entirely on tax collections, bond proceeds and interest income to finance its activities.

In the fall of 2008, the Communications and Legislative Committee discussed a legislative proposal to change Section 124.5 of the Metropolitan Water District Act to allow Metropolitan to fix the tax levy rate at the rate in effect for FY 2008/09 of .0043 percent of assessed valuations. Despite the fact that Metropolitan currently has statutory authority and voter authorization to collect a portion of its revenues through ad valorem tax assessments on property within its service territory, since FY 1990/91, Section 124.5 of the MWD Act limits property tax revenues (and thereby the tax levy) to the total needed to pay annual debt service on Metropolitan's general obligation bonds and the portion of the State Water Contract payment for debt service on state general obligation bonds (Burns-Porter bonds). As principal payments on these bonds are made, the sum of these amounts is decreasing over time.

In the 2008 legislative proposal, Metropolitan would fix its future tax levy rate at .0043 percent to cover more SWP costs and help mitigate impacts on future water rates of higher cost water supply projects, including water use efficiency projects, that benefit all users in Metropolitan's service territory.

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[1] This Best Management Practice defines a minimum percentage (70%) of water sales revenue from volumetric rates. The calculation excludes revenues from connection charges, irregular services such as fire protection, grants, and property taxes.

Options for ad valorem tax rate changes are under review by Metropolitan's legal staff to ensure that any proposals incorporate requirements of Proposition 218. The earliest date a legislative change to the MWD Act could be effective is January 1, 2011.

Treated Water Capacity Charge

The cost of providing peaking capacity to member agencies on Metropolitan's treated water system is currently recovered through the Treatment Surcharge. This charge is a uniform charge paid by all member agencies on a per-acre-foot basis for treated water deliveries. The treatment rate is set to recover the cost of providing treated water service, including capital and operating costs. Effective September 1, 2009, the Treatment Surcharge on Full Service water is $217 per acre-foot.

Infrastructure must be built to accommodate member agencies' peak treated water demands and these higher peaks result in higher capital costs. These costs are currently shared by all users uniformly, regardless of how a member agency's peaking behavior impacts costs. A charge to recover the costs of providing peaking capacity on Metropolitan's system could more equitably distribute the cost of providing this peaking capacity, and might encourage the more efficient use of Metropolitan's treated water facilities.

Cost of Infrastructure to Meet Growth

Financing new infrastructure to meet growth has been a subject of discussion among Metropolitan and its member agencies for decades. Previous efforts have included consideration of a Metropolitan connection fee and the New Demand Charge. Legislation to authorize a connection fee was explored in the early 1990's but not pursued because of strong opposition. The New Demand Charge, adopted by the Board in 1993, established an acre-foot baseline by member agency beyond which water sales would trigger the New Demand Charge. Collection of the charge was suspended by the Board in July 1996.

Currently, the costs of investment in infrastructure built to accommodate a member agency's increasing demands for Metropolitan water are recovered through several of the unbundled rate components, including the System Access Rate, the RTS, and the Capacity Charge. Some member agencies and board members have expressed concern that these costs may not be collected as equitably or efficiently as possible.

NEXT STEPS

As a result of these workshops and updates, for the FY 2010/11 rate setting cycle staff will provide alternatives for the Board's consideration, including:

- The RTS: In addition to the current capital financing costs for conveyance and storage, a portion of operations and maintenance costs currently recovered over average system use via the System Access Rate could be assigned and recovered through the RTS Charge.
- The Capacity Charge: In addition to the current capital financing costs, a portion of operations and maintenance costs currently recovered over average system use via the System Access Rate could be assigned and recovered through the Capacity Charge.
- Metropolitan's use of Castaic Lake and Lake Perris for "flexible storage": Costs associated with these facilities could be allocated to the Supply component. Under the Monterey Agreement, Metropolitan is allowed to store Table A water in these reservoirs, subject to refill. This water provides a dry-year yield to Metropolitan and that portion of respective reservoirs' costs would be functionalized as a Supply-related cost.

In the longer term, the rate structure and cost recovery could be revised as necessary to reflect potential changes to underlying policy principles on the appropriate role for Metropolitan, as identified through the IRP Update and the Strategic Policy Review discussions.

The IRP Update and Strategic Policy Review processes are currently projected to finish in Spring 2010. The LRFP workgroup would incorporate the outcome of these processes into the Cost-of-Service study in time for the 2011/12 revenue requirements and rate setting process.

Policy

Metropolitan Water District Administrative Code Sections 4301 (a) and (b): Cost of Service and Revenue Requirement and

Metropolitan Water District Administrative Code Sections 4304 (c) and (f): Apportionment of Revenues and Setting of Water Rates and Charges to Raise Firm Revenues

Fiscal Impact

These proposals would not change the overall Revenue Requirement for Metropolitan, but could increase or decrease individual rate components and charges as costs would be shifted from one rate or charge to another.

9/30/2009

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9/30/2009

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