- **Board of Directors**
  Finance and Insurance Committee

9/15/2020 Board Meeting

8-1

Subject

Review the impacts of the COVID-19 crisis on Metropolitan's fiscal years 2020/21 and 2021/22 biennial budget and rates and charges for calendar years 2021 and 2022; approve recommended cost-containment measures to address the COVID-19 financial impacts; the General Manager has determined that the proposed action is exempt or otherwise not subject to CEQA

Executive Summary

In April 2020, the Board approved a biennial budget for fiscal year (FY) 2020/21 and FY 2021/22 and supporting overall rate increases of 3 percent in calendar year (CY) 2021 and 4 percent in CY 2022. The Board's action also directed the following:

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

The six specific cost-containment issues the Board directed staff to review and provide specific information on are the following: factoring for unrealized staffing levels; revisiting advance recruitment for overlapping staffing positions, as part of succession planning; matching Capital Investment Plan (CIP) appropriations to the slowdown in expenditures; suspending the director inspection trip program; suspending fleet vehicle purchases, and planning for strategic use of reserves and financing.

The originally proposed budget that had been reviewed and discussed in workshops with the Board called for 5 percent rate increases in CYs 2021 and 2022. When Metropolitan declared an emergency to respond to the COVID-19 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.

Since April, staff has reviewed the six specific budget issues directed by the Board, as well as other cost-cutting areas potentially available to Metropolitan. Staff has also surveyed the member agencies for the impacts of the COVID-19 pandemic on their operations and finances.

This letter will cover: (1) the results of the survey on the financial impacts caused by COVID-19 on Metropolitan's 26 members agencies and the impacts of the pandemic on Metropolitan; (2) the results of the staff review on the specific budget areas as directed by the Board and the additional cost-cutting review performed by staff; and (3) recommendations by staff on next steps.

Details

Background on Board adopted Biennial Budget for FY 2020/21 and FY 2021/22

The preparation of the proposed biennial budget for FYs 2020/21 and 2021/22 was preceded by circumstances that resulted in lower revenues and lower available reserves to mitigate future rate increases. In the 2018/19 and 2019/20 fiscal years, Metropolitan had the lowest water transactions in nearly 40 years, with transactions of approximately 1.40 million acre-feet each year. Additionally, the Board had approved the suspension of the collection of the Water Stewardship Rate for the San Diego County Water Authority exchange agreement transactions from January 1, 2018, through December 31, 2020. Then in December 2019, the Board suspended collection of the Water Stewardship Rate entirely for all member agencies in CYs 2021 and 2022. Taken together, these circumstances resulted in $206 million less revenue than budgeted in FY 2018/19, and a preliminarily reported revenue shortfall of $314 million in FY 2019/20.

As a result of the decline in revenues, an overall rate increase of nearly 12 percent would have been necessary to maintain business as usual for the next biennial budget. In the fall of 2019, in response to the decline in revenues, staff worked to identify a number of cost-cutting measures to reduce overall expenditures, such as capping the capital program, maintaining flat staffing levels, reducing debt service through refinancing, and cutting various other programs. As a result of these steps, staff was able to recommend to the Board in February 2020 a budget supported by proposed overall rate increases of 5 percent in both CYs 2021 and 2022.

After the Board completed its third budget workshop on March 10, 2020, COVID-19 spread rapidly throughout the United States, leading to stay-at-home orders, other social distancing directives, and state-of-emergency orders that went into effect throughout California and within Metropolitan's service area. Utility retailers, including some member agencies of Metropolitan and agencies that purchase water from them, anticipated many of their customers would likely be adversely impacted financially. Those impacts could result in the inability to pay utility bills, which would then create financial stress on Metropolitan's member agencies. The extent of financial impacts from COVID-19 was unknown at that time, as were any relief measures the federal and state governments might provide to assist with impacts. However, the concern was that the financial impact on our region and beyond would be significant and far-reaching.

Given the state of uncertainty, the Board asked staff to prepare alternatives to the proposed budget that would further lower the proposed overall rate increases. Metropolitan also received several letters from member agencies and sub-agencies asking Metropolitan to look at alternatives to the budget and rates proposal prepared before the COVID-19 emergency declaration. In response, staff acted immediately to revisit the proposed budget and assumptions to the anticipated economic impact of COVID-19 before the April 2020 Board meeting.

In April 2020, staff proposed, and the Board approved a revised biennial budget with supporting overall rate increases of 3 percent in CY 2021 and 4 percent in CY 2022. The revised proposal was achieved by making the following revisions to the originally proposed biennial budget:

- Freeze all non-essential employee travel and director inspection trips, curtail hiring to only essential positions, and slow expenditures on replacement equipment.
- Shift 50 thousand acre-feet of untreated water sales projections to projected treated water sales as a result of the impact Per-and Polyflournalky Substances will likely have on demand for replenishment water.
- Reduce CIP expenditure projections by $25 million in FY 2020/21 with an updated assumption that only 80 percent of planned spending could be completed in FY 2020/21, given the potential impacts of COVID-19 on the scheduling of construction work.
- Reduce Pay-Go funding of CIP expenditures to 55 percent in FY 2020/21.

In addition to approving the revised budget and rates proposal, the Board also directed the following:

1. At the September 2020 meeting, the Board will review the budget and rates to consider the impacts resulting from the COVID-19 crisis on Metropolitan and the member agencies and review the approved budget and rates.
2. Staff is directed to revisit and consider six specific items for potential cost-containment actions for the biennial budget cycle of FYs 2020/21 and 2021/22 by August 31, 2020:
    a. Factor for unrealized staffing levels;
    b. Consider revisiting advance recruitment for overlapping staffing positions, as part of succession planning;
    c. Match CIP appropriations to the slowdown in expenditures;
    d. Suspend the director inspection trip program;

e. Suspend fleet vehicle purchases; and

f. Plan for strategic use of reserves and financing.

This letter provides a review of those specific budget cost-containment areas, as well as additional recommendations to assist member agencies with potential financial impacts resulting from COVID-19.

I. Impact of COVID-19 Crisis on Member Agencies and Metropolitan

A. COVID-19 Impacts on Member Agencies

On June 1, 2020, Metropolitan distributed a questionnaire seeking information regarding financial and operational impacts on the member agencies and what financial policy changes were implemented as a result of the COVID-19 crisis. The questions covered delinquencies, demands, revenues, expenses, cost cuts, budget shortfalls, and the deferment of rate increases, CIP expenditures, and bond issuance. The questionnaire aimed to quantify the crisis impacts on the member agencies so the Metropolitan Board can determine the scope of the problem and determine the extent of potential cost-containment measures needed while maintaining reliable service.

A table with the results of the survey is attached below. Fourteen of the 26 member agencies responded, with 12 electing not to respond.

Table 1. Summary Results of June 2020 Member Agency COVID-19 Impacts Survey
14 of 26 Member Agencies Responded

Survey Question	Number of Member Agencies Responses				
	YES	Minor or Modest	NO	N/A	Total Responses
#1 Delinquency rate increase?	5	0	**8**	1	14
#2 Decreased water demands due to COVID-19?	1	0	**12**	1	14
#3 Additional expenditures due to COVID-19?	3	6	**4**	1	14
#4 Deferred or reduced CIP due to COVID-19?	4	0	**9**	1	14
#5 Delays in bonds issuance due to COVID-19?	0	0	**13**	1	14
#6 Cost cuts due to COVID-19?	**4**	6	3	1	14
#7 Deferred or reduced water rate increases?	3	0	**10**	1	14
#8 Applied for or received any relief funds?	5	0	**8**	1	14
#9 Budget shortfall due to non-payments?	3	1	**6**	4	14
Substantial Financial Impact due to COVID-19?	**3**				

The survey is limited to Metropolitan's member agencies. In the cases of cities, the financial impacts reported herein reflect only impacts to the water utility service and do not include impacts to the associated local government or municipality. In other words, the impact is specific to the water utility and not to the city's general fund or other enterprise funds. The impacts also do not reflect financial impacts to any retail or other agencies served by any of Metropolitan's member agencies. Results reflect the recorded and projected impacts during the months of March through June 2020, and in some instances, might not be sufficient to provide a complete picture of the ultimate extent of the impact of the crisis. More information on financial impacts will be available by the end of the fiscal year (June 30, 2021).

Based on the survey results, most wholesale member agencies have not encountered an increase in the rate of payment delinquencies, but several of the retail agencies they serve report some increase in delinquency rates. In addition, some of those retail agencies have delayed adoption or implementation of rate increases. Most of the 12 member agencies that did not respond have stated that they have not experienced significant impacts attributable to COVID-19.

Most agencies report a slight impact caused by additional COVID-19 related expenditures, but these expenditures were generally minor and were often offset by other cost cuts. Expenses for purchases of Personal Protective Equipment (PPE), enhanced cleaning, and costs to achieve social distancing were generally offset by reductions in travel and other expenses.

None of the member agencies reported a marked decline in water sales that could be attributed to COVID-19. Regionally, water sales have been low since the drought of 2014-2017 and generally remain low. Overall, regional retail water sales in 2020 have actually increased slightly over 2019 sales despite the obvious impacts of

COVID-19 on commercial, retail, and entertainment-related businesses. It is reasonable to assume COVID-19 has had some impact on overall demand and water sales, but overall the impacts on water usage do not appear to be significant.

In general, survey results suggest that some retail member agencies have experienced some financial impact from the COVID-19 crisis, primarily due to slight increases in payment delinquencies. However, the majority of member agencies (11 agencies or 79 percent of those agencies that responded) have not experienced substantial financial impacts due to the crisis at the utility level.

B. COVID-19 Impacts on Metropolitan

Metropolitan responded swiftly to the COVID-19 pandemic as events unfolded by suspending all facility tours, director inspection trips, and employee travel. The General Manager declared a state of emergency in mid-March and issued a stay-at-home order for all employees except operations crews. Operating crews were immediately split into micro-teams to protect employee health and avoid widespread outbreaks.

All employees that could not immediately telework were placed on Paid Administrative Leave along with field crews that were not immediately dispatched. Staff made emergency purchases of PPE, laptops, and enhancements to the District's computer network capabilities. Staff also purchased or built structural improvements to achieve social distancing at facilities and enhanced cleaning protocols throughout the District facilities.

Within 90 days of the stay-at-home order, Metropolitan has eliminated the use of Paid Administrative Leave except for a few cases where management is electing to reserve some staff for emergencies. Approximately 70 percent of Metropolitan's workforce is working from home, and 30 percent of the workforce is working on-site performing essential operations and services under COVID-19 safety protocols that include social distancing, masking, and other steps.

All expenditures directly associated with dealing with the impacts of COVID-19 have been tracked, and to date, over $350,000 in direct costs have been spent on pandemic response. Should state or federal relief become available, Metropolitan will be prepared to apply for such funds.

C. Conclusion

Generally, Metropolitan and the member agencies have spent funds on PPE, enhanced cleaning, social distancing, teleworking equipment, and other necessary steps that are directly attributable to the pandemic. However, those costs have been relatively minor and, in most cases, have been offset by reductions in travel and other office expenses.

At this time, most retail agencies have not reported a large increase in payment delinquencies. Water sales remain low throughout the service area but remain consistent with the long-term trends and have not shifted significantly due to COVID-19.

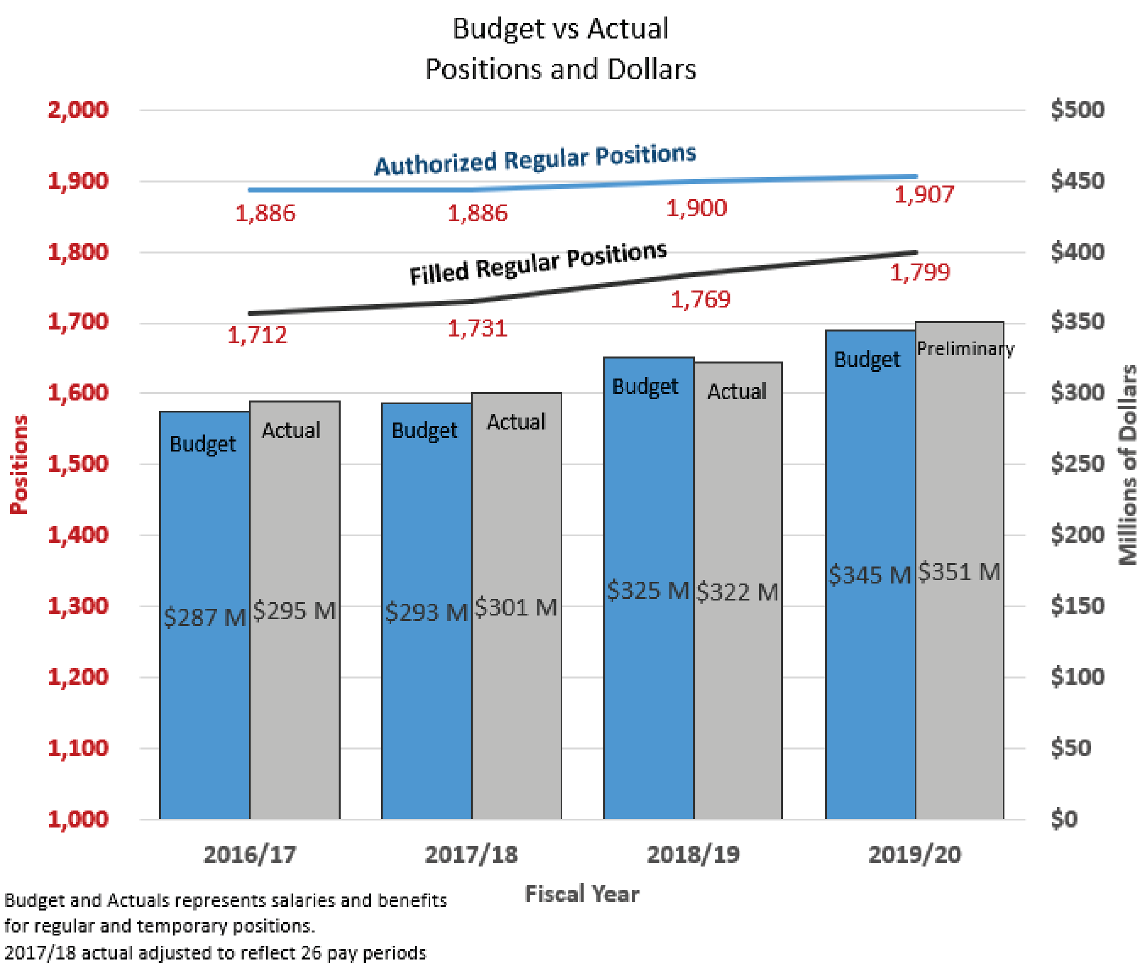
II. Cost-Containment Opportunities at Metropolitan

A. Staffing Levels and Recruitment

The Board directed staff to revisit and consider the following two staffing budgeting issues: factor for unrealized staffing levels and consider revisiting advance recruitment for overlapping staffing positions as part of succession planning.

The FY 2020/21 and FY 2021/22 Biennial Budget already factors for unrealized staffing levels by applying a vacancy factor. The Biennial Budget authorized 1,907 positions for each budget year, but the labor cost for those positions was reduced by applying a vacancy factor of 2.2 percent for each budget year. This means that Metropolitan did not budget to spend the full cost of filling 1,907 positions for the entire year; instead, Metropolitan assumed, among other factors, that a lower amount of positions would be filled considering the ebb and flow of vacancies occurring during the year. The vacancy factor is set to account for unfilled positions, as well as the use of overtime and temporary labor needed for Metropolitan to provide its services. These and other factors are used to determine a reasonable vacancy factor for budgeting total labor costs. The rate of unfilled positions is a major element in estimating the vacancy factor but is not the sole driver of costs. The labor costs budget reflects the estimated cost of completing the work necessary to provide Metropolitan's services, not just the filling of positions. It is standard budgeting practice to reduce labor costs by applying a vacancy factor to account for unrealized staffing levels.

Metropolitan's unfilled position rate usually runs around 6 percent, and it is currently running close to that percentage. The vacancy factor of 2.2 percent applied to the budgeted labor costs takes into account the rate of unfilled positions, but also accounts for anticipated accelerated hiring for succession planning, and anticipated overtime and temporary labor costs of the work necessary to be performed. When positions are not filled, much of the work is still necessary and therefore increased overtime, and temporary labor costs offset labor savings from unfilled positions. Therefore, the unfilled position rate does not directly translate into budget savings. For example, the chart below illustrates the budget vs. actuals for salaries and benefits from the prior four years. Although the filled positions were lower than the authorized positions, there was no cost savings and, therefore, staff is not recommending further changes in staffing levels or in the budgets for those positions. Onboarding and hiring of staff has slowed during the pandemic. This will likely result in a temporary increase in vacancies with some further short-term savings. Staff will report on these savings if they materialize at the mid-cycle budget review.



B. O&M Cost Containment

The Board directed staff to revisit and consider the following specific cost-containment budget areas: suspending the director inspection trip program and suspending 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 reviewed the specified cost-containment areas and also performed a broader review of costs. As a result, the General Manager is proposing to initiate the following cost-containment measures to further lower Metropolitan's expenditures:

- Suspend the director inspection trip program, including specialized inspection trips for business, media, educators, and legislative staff, for 12 months to realize savings estimated at $1.9 million.
- Suspend the purchase of all fleet vehicles to realize savings estimated at $0.6 million.
- Reduce travel, training, and conferences to realize savings estimated at $1.4 million.
- Reduce professional and non-professional services to realize savings estimated at $1.7 million. Cuts in these areas include governmental relations contracts, guard services at Headquarters due to lower occupancy, IT support services, and social media advertising, digital marketing, and creative design services. For some of these services, staff will assume responsibility or work will be deferred on lower-priority projects. Reduce spending on advertising for demand management programs during the budget period due to already low water sales to realize savings estimated at $2.0 million, while continuing the use of social media outreach utilizing staff resources.
- Defer certain maintenance projects beyond the biennium to realize about $1.5 million in savings. These include paving activity at Diamond Valley Lake Visitor Center and Searl Parkway, and deferral of new office module furniture and installation.
- Revise cost assumptions for water treatment blends, chemical dosages and costs, in light of reduced demands, to realize about $1.3 million in savings in water treatment chemicals.
- Reduce State Water Contract dues, consistent with updated cost assumptions; reduce funding for the education program (student field trips, Solar Cup), employee transit reimbursement, internship program, business outreach, and legislative sponsorships, and office supplies; and reduce community outreach activities for the Regional Recycled Water Project. These reductions along with reductions in purchasing other operating and expensed equipment realize about $1.3 million in potential savings.

These cost-containment assumptions realize total *potential* cost savings of approximately $11.7 million in FY 2020/21. These cost savings are net of approximately $350,000 of additional costs anticipated for increased janitorial services, increased hazardous waste disposal due to deep cleaning events, and increased supplies for facility COVID-19 prevention measures (PPE and facility modifications).

C. Plan for Strategic Use of Reserves and Financing

The Board directed staff to revisit and consider strategic use of reserves and financing.

Metropolitan's high credit ratings reflect sound financial performance with respect to relatively high debt service coverage and liquidity levels despite declining water demands, variable hydrologic conditions, increasing cost pressures of regulatory requirements, and current pandemic threat. In addition to a continued decline of water sales, any significant reductions in reserves, debt service coverage ratios, and/or increase in capital expenditures without revenue offsets could lead to a ratings downgrade. Lower ratings will have a significant impact on the lower cost of debt that Metropolitan has enjoyed for a number of years. This year alone, Metropolitan has saved nearly $109 million in debt service costs. Part of these savings has been factored in the reduction of our rates in the adopted FY 2020/21 and FY 2021/22 Biennial Budget.

Balancing the use of reserves and debt service ratios continues to be a budget tool for Metropolitan to moderate rate increases as we continue to provide reliable and clean water to the 26 member agencies in our service area. To keep rates low, it is necessary to reduce expenditures in order to avoid significantly reducing coverage ratios. As of June 30, 2020, Metropolitan's debt service coverage dropped from 1.55 percent to 1.39 percent, due to revenue decline at the end of the year. Finally, issuing more debt for capital can be cost-effective, but it has the negative impact of lowering coverage ratios and reducing Metropolitan's capacity to issue debt in the future for major projects. In order for Metropolitan to maintain its credit worthiness and the ability to access the capital markets for financing future projects and for future refinancing for debt service savings, the Board must continue to balance all these factors, which in the end, benefits Metropolitan and the member agencies.

As part of revising the proposed budget in March, staff recommended, and the Board approved, adjusting the use of Pay-Go funding to bond fund a greater percentage of the CIP. This allowed Metropolitan to reduce rate increases, continue CIP construction, and take advantage of historically low-interest rates. These actions were taken judiciously to avoid a large increase in its debt, which would risk credit downgrades while confronting an ongoing crisis. Metropolitan has steadily reduced its overall debt load these past 15 years, which does allow flexibility for dealing with emergencies such as this pandemic.

Additional CIP expenditures are expected to be funded with bond proceeds and will not increase the Pay-Go dollar amount assumed in the adopted budget. The debt service costs resulting from bond funding the additional CIP expenditures are absorbed in part by the expected debt service savings resulting from favorable refundings that have occurred since the development of the budget. While this additional debt is not going to have a significant impact on debt service in the short run, it does further reduce revenue bond coverage ratio in the long-term. At this time, staff recommends increased bond funding for the additional CIP expenditures and maintaining the reduction in Pay-Go funding adopted by the Board in April for FY 2020/21 and reviewing Pay-Go funding for FY 2021/22 at the Board's mid-budget cycle review scheduled for June 2021.

III. Recommended Actions

While the impacts of COVID-19 to Southern California are clearly severe and far-reaching, the economic impacts to the water utility sector thus far appear to be relatively contained. However, declining revenue, low water sales, and the reduction in reserves all lead to a need for prudent financial management at this time. Therefore, staff is proposing to initiate cost-containment measures as described above and monitor financial conditions in preparation for the mid-cycle budget review in June 2021 when more information is available. Additionally, staff would:

a. 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.

b. Monitor water demands, sales and expenditures and prepare additional cost-containment measures, as needed, for mid-cycle budget review.

c. Maintain the current rates adopted by the Board to address the impacts of lower water sales and lower revenues while maintaining current credit ratings.

Policy

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

Metropolitan Water District Administrative Code Section 5107: Biennial Budget Process

Metropolitan Water District Administrative Code Section 11104: Delegation of Responsibilities

By Minute Item 51962, dated April 10, 2019, the Board approved the FYs 2020/21 and 2021/22 Biennial Budget, adopted rates for CYs 2021 and 2022, adopted charges for CY 2021, adopted a finding that it is essential to fiscal integrity to collect ad valorem property taxes in excess of the limitations of Section 124.5, and directed the following: (1) at the September 2020 meeting, the Board will review the budget and rates to consider the impacts resulting from the COVID-19 crisis; and (2) staff is directed to revisit and consider six specific issues for the biennial budget cycle of fiscal years 2020/21 and 2021/22 by August 31, 2020.

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). In addition, the proposed action is not subject to CEQA because it involves 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).

CEQA determination for Option #2:

None required

Board Options

Option #1

Approve the following recommended cost-containment measures to address the COVID-19 financial impacts:

a. 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.
b. Monitor water demands, sales and expenditures and prepare additional cost-containment measures, as needed, for mid-cycle budget review.
c. Maintain the current rates adopted by the Board to address the impacts of lower water sales and lower revenues while maintaining current credit ratings.

Fiscal Impact: The recommended actions maintain Metropolitan's fiscal integrity, including its credit worthiness, and maintains its ability to meet expenditures in light of continued downward-trending transactions and revenues.

Option #2

Do not approve the recommended cost-containment measures to address the COVID-19 financial impacts and provide guidance to staff regarding alternative measures.

Fiscal Impact: The fiscal impact of this option will depend on the direction and alternative measures directed by the Board.

Staff Recommendation

Option #1

Katano Kasaine 8/31/2020

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

Jeffrey Kightlinger 8/31/2020

Jeffrey Kightlinger *Date*
General Manager

Ref# cfo12675965