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

10/13/2020 Board Meeting

9-3

Subject

Review of the Water Stewardship Fund and funding for Metropolitan's Demand Management Programs

Executive Summary

In July 2020, the Board directed staff to present to the Finance and Insurance Committee a review of Metropolitan's demand management commitments and funding issues, which were initially presented to the Water Planning and Stewardship Committee. The funds available for demand management are impacted by recent Board action to stop collecting the Water Stewardship Rate (WSR) and its interim goal of approving 170,000 acre-feet of Local Resources Program (LRP) agreements.

In December 2019, the Board voted to incorporate the 2019/20 fiscal-year-end balance of the Water Stewardship Fund to fund all demand management in the fiscal years (FYs) 2020/21 and 2021/22 Biennial Budget; and not to incorporate the WSR, or any other rates or charges to recover demand management costs, with the rates and charges for calendar years (CYs) 2021 and 2022. As a result, the Water Stewardship Fund will no longer be replenished from the WSR, or any other rate or charge, which means the revenue requirements for demand management in the current biennial budget will be funded only from the balance in the Water Stewardship Fund. Additionally, based on earlier Board action, the WSR has not been collected for contractual exchange transactions with the San Diego County Water Authority (SDCWA) since December 31, 2017. Staff projects the Water Stewardship Fund balance will be sufficient to fund the demand management revenue requirements through the end of this biennial budget (June 30, 2022), but source funding beyond this date will need to be identified.

In December 2019, the Board also decided to review any new LRP applications during this biennial period on a case-by-case basis when it directed staff to stop collecting the WSR for CYs2021 and 2022. In addition to funding commitments for the LRP, demand management expenditures also include the budgeted expenditures for conservation programs, conservation advertising, and the Future Supply Actions/Stormwater Pilot Program, and applicable operations and maintenance (O&M).

This letter reviews the demand management budget, the existing and anticipated LRP commitments, the financial impact of those commitments, and the available funding sources and the funding commitments necessary to meet Metropolitan's currently forecasted demand management programs over the ten-year financial forecast period. Based on input from the Board and the member agencies, staff will bring back funding options for consideration and adoption.

Details

Overview

Demand Management Funding

Metropolitan's regional demand management programs and approaches have a long history. Decades ago, it was recognized that demand management would be an important part of balancing regional supplies and demands. Developing new local projects and increasing water conservation efforts were seen as ways to reduce the need to increase imported supplies and offset the need to transport or store additional water into or within the Metropolitan service area, reducing infrastructure costs.

The actual production and use of local resources and conservation of water under Metropolitan's demand management programs takes place at the member agency or end-user level, meaning they produce or conserve water for their own use, and the water is not Metropolitan's. Metropolitan determined decades ago that regional investments in demand management—both conservation and local resource development—benefit all member agencies regardless of project location. These programs help to increase regional water supply reliability, reduce demands for imported water supplies, decrease the burden on Metropolitan's infrastructure and reduce system costs, and free up conveyance capacity to the benefit of all system users.

Since 2003, the WSR has funded Metropolitan's demand management programs, including conservation device rebates, turf removal, customized member agency administered programs, advertising to promote conservation, new programs within disadvantaged communities, pilot programs for stormwater capture, and incentive payments for LRP projects. In December 2019, the Board considered alternatives to the WSR, but declined at that time to select an alternative rate design to collect revenues to fund demand management.

As stated, in December 2019, the Board directed staff to use reserves from the Water Stewardship Fund to fund all demand management costs for the FYs 2020/21 and 2021/22 Biennial Budget and to bring forward proposed LRP project agreements to the Board for consideration on a case-by-case basis. The Board expected, during this period, to review the goals of Metropolitan's demand management programs through the 2020 Integrated Resources Plan (IRP) process and to subsequently adopt an alternative to the WSR to collect funding for such programs. Since then, the Board has approved three LRP agreements.

Since these Board actions in December, the world was struck by the COVID-19 pandemic, and as a result of further cuts and spending reductions, the proposed overall rate increases for 2021 and 2022 were reduced from 5 percent per year to 3 percent in 2021 and 4 percent in 2022. The Board adopted the revised budget with the reduced rate increases and directed staff to continue to look for further cost containment opportunities, review COVID-19 impacts on member agencies, and bring back a report to the Board for consideration at the September 2020 Board meeting. In September, the Board adopted staff's additional cost-cutting measures, the development of a potential payment deferment program, a review of potential revenue-generating programs, and a moratorium on projects not anticipated in the adopted budget.

Staff believes that the LRP and other Metropolitan demand management programs have significantly increased Southern California's ability to manage long-term drought and climate change. Demand management has reduced demand for imported supplies, which reduces the costs to build, expand, operate, and maintain facilities. This has a regional benefit for all member agencies throughout Southern California and will continue to be needed going forward. However, these programs need a clearly identified funding source, which has not yet been adopted by the Board. Additionally, the scope and nature of these programs are currently under review in the 2020 IRP, and they may be adjusted after the adoption of the IRP.

LRP Commitments

In October 2018, the Board affirmed its longstanding commitment to diversifying water supplies and support of local resources by increasing the goal of the LRP by 102,000 acre-feet per year (AFY) to 170,000 AFY in new LRP yield. Since approving this revised goal, the Board has authorized eight new LRP project agreements for a total of 63,200 AFY. There are currently four additional applications under review, with a total yield of 63,300 AFY. If these four applications progress and are approved by the Board, a balance of 43,500 AFY would remain to meet the LRP goal**.** Staff estimates that, based on existing commitments and planned projects, annual LRP expenditures could reach $70 million within the next ten years.

LRP Budget and Financial Projections

Though almost 490,000 acre-feet (AF) of project capacity is under contract today, Metropolitan budgets only for the estimated production under those contracts—not for the full contracted amount. For budgeting purposes, as well as for projecting the total estimated production from the program, Metropolitan reviews each of the contracts based on various factors. Annual production varies from year-to-year and depends on a variety of project-specific factors such as construction schedules, overlying demand, growth in recycled water customers, and operational constraints. Metropolitan staff considers member agency projections, historical production, and expected costs to estimate future expenditures. In addition to estimating the amount each project will produce, staff also projects the payments Metropolitan will make for those amounts, as the payments vary depending on the contract, the level of production, the cost of the project, and Metropolitan projected overall rates.

Figure 1 shows a comparison of the costs if all projects produced their maximum contract yield and the costs actually budgeted, which are based on the production projections and the actual historical amounts paid under the program.

Figure 1. Historical LRP Expenditures

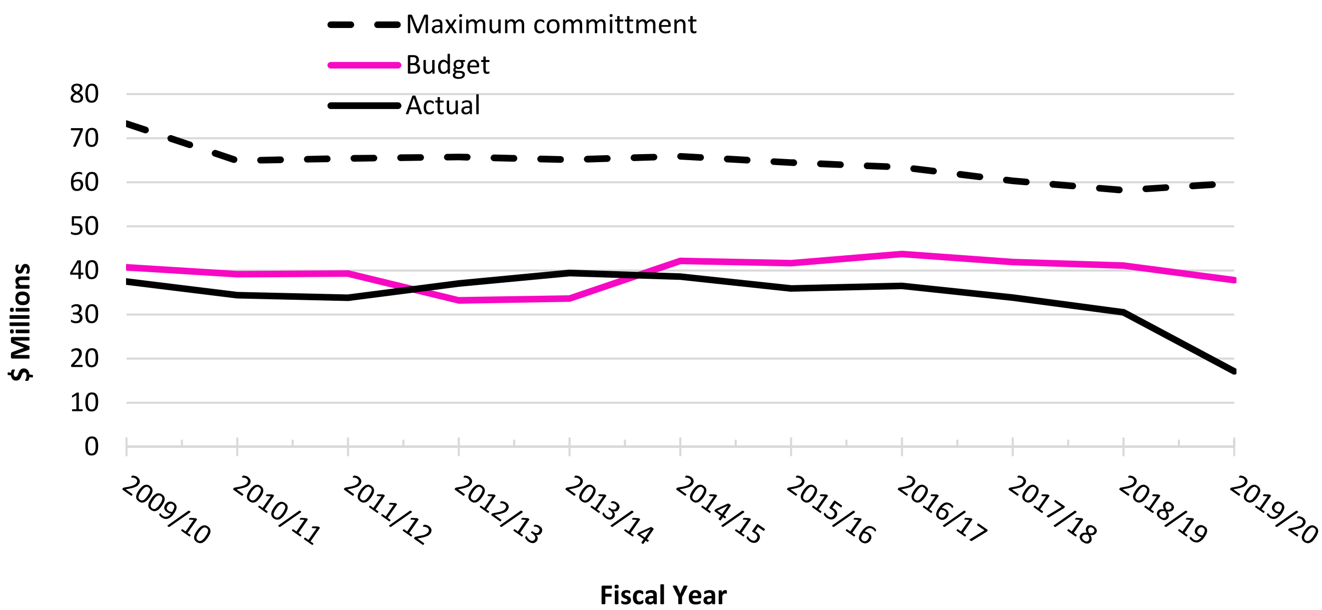

Figure 2 shows the total maximum production for LRP projects eligible for payments under contract and compares that to the estimated production that was used for the budget. The figure also shows actual incentivized LRP production for a 10-year period ending in FY 2019/20.

Figure 2. Historical LRP Production

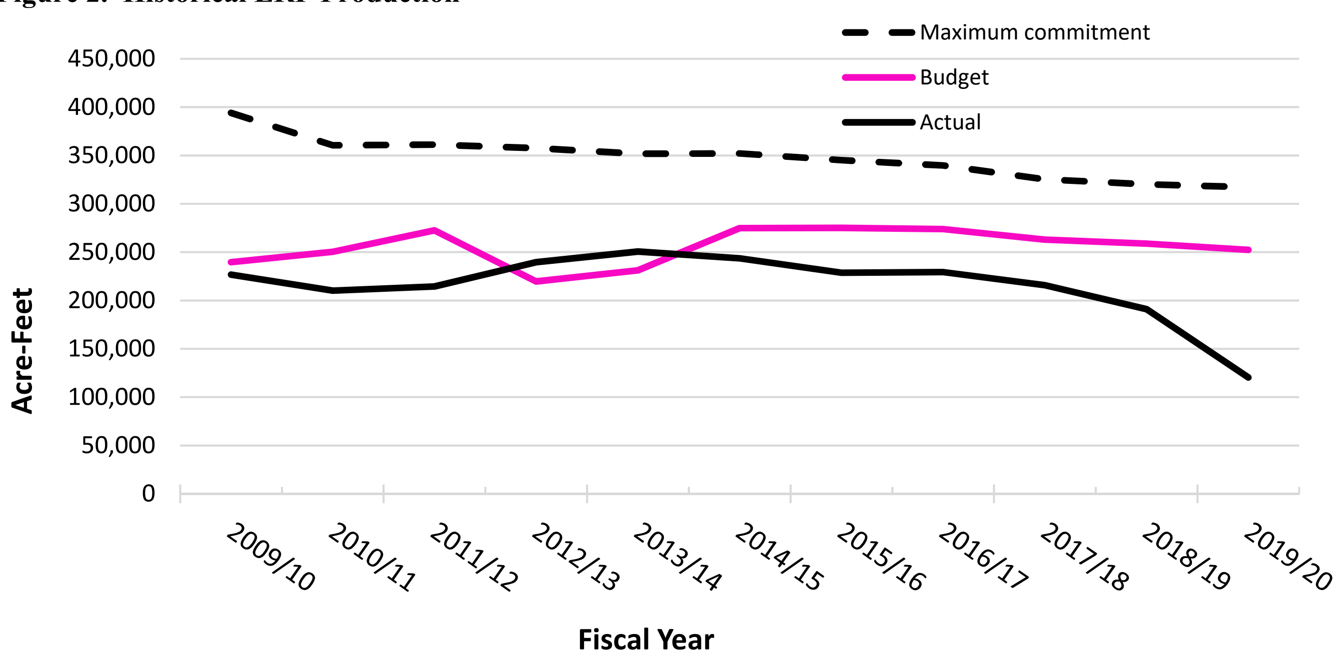

Figure 1 and Figure 2 show the actual amounts paid and produced under the program have stayed relatively consistent with the budgeted amounts for the program, except in FY 2019/20. That year, the variance from budget resulted primarily from a large LRP contract reaching its maximum production volume earlier than anticipated (and thus no longer receiving incentive payments).

Financial Outlook for Demand Management Funding

Due to the Board direction to use reserves from the Water Stewardship Fund to fund all demand management program costs in the FYs 2020/21 and 2021/22 Biennial Budget, to determine the financial outlook of demand management funding, it is important to review the projected expenditures from that fund and the forecasted revenues potentially available in CY 2023 to begin replenishing the fund.

Tables 1 and 2 provide information regarding the budgeted and projected demand management expenditures in the budget and the ten-year forecast.

Table 1. Budgeted and Projected Local Resources Program Expenditures

based on fiscal years 2020/21 and 2021/22 biennial budget and 10 year financial forecast, in million of dollars

Fiscal Year Ending	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Estimated cost of contracted LRP projects	$ 17	$ 18	$ 22	$ 22	$ 26	$ 27	$ 31	$ 31	$ 30	$ 29
On-Site Retrofit Program	2	2	3	3	3	3	3	3	3	3
Future Projects to meet 170,000 IRP Target	-	-	1	6	11	16	22	27	32	38
Total Local Resources Program	**$ 19**	**$ 20**	**$ 25**	**$ 31**	**$ 40**	**$ 47**	**$ 55**	**$ 61**	**$ 65**	**$ 70**

Based on estimated production and incentive rate for existing LRP contracts when the FYs 2020/21 and 2021/22 budget was prepared, the projected cost for LRP projects is shown on the first line in Table 1. After adoption of the budget, the Board approved two new LRP agreements for a total of 113 LRP projects, and those costs are included in the ten-year projections shown here. The third row in Table 1 shows the estimated cost of future projects (including those approved after the budget was adopted) needed to meet the 170,000 AF IRP goal. Total LRP costs are expected to increase from $19 million in FY 2020/21 to $70 million in FY2029/30. The LRP budget also includes $2 million to $3 million per year for the on-site retrofit program.

Table 2. Total Budgeted and Projected Demand Management Expenditures

based on fiscal years 2020/21 and 2021/22 biennial budget and 10 year financial forecast, in million of dollars

Fiscal Year Ending	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Local Resources Program	$ 19	$ 20	$ 25	$ 31	$ 40	$ 47	$ 55	$ 61	$ 65	$ 70
Conservation Program	24*	24*	43	43	43	43	43	43	43	43
Future Supply Actions / Stormwater Pilot	4	7	3	2	2	2	2	2	2	2
O&M costs net of interest income	21	23	26	28	30	31	34	34	35	37
Demand Management Revenue Requirement	**$ 69**	**$ 74**	**$ 97**	**$ 104**	**$ 115**	**$ 123**	**$ 133**	**$ 139**	**$ 144**	**$ 151**

* The FY2020/21 and FY 2021/22 conservation program reflects the Sept 2020 action to reduce demand management advertising by $2M, the appropriated amount remains at $43 per year.

Table 2 shows the total demand management revenue requirement, which refers to all demand management costs, including LRP, conservation, Future Supply Actions, Stormwater Pilot Program, and the O&M to support those programs. The O&M component includes costs from Water Resource Management, External Affairs, administrative and general costs from other groups, professional services, and other operating costs offset by interest income. In total, total demand management costs are expected to increase from almost $70 million in FY 2020/21 to $151 million in FY 2029/30.

The demand management revenue requirements are currently funded by the Water Stewardship Fund. Revenues for the fund are generated by the WSR, which will continue to be collected on sales through December 31, 2020. The CY 2020 WSR is set at $65 per acre-foot. However, the current WSR is not being collected on SDCWA exchange agreement transactions; and in CYs 2021 and 2022, it will not be collected from any member agencies on any transactions. During this two-year period, the 2020 Update to the IRP (2020 IRP Update) and a rate refinement process is planned to be undertaken to establish a new revenue collection mechanism to recover demand management costs.

Table 3 shows the overall adopted and estimated rate increases for all rates and charges necessary to meet all revenue requirements at Metropolitan. The second line shows the $65/AF WSR for 2020, and for CYs 2023-2030, a placeholder rate is used to show recovery of demand management costs (the hypothetical Demand Management Rate). For illustrative purposes, we have assumed a completely variable rate that applies to all forecasted water transactions. The $53/AF Demand Management Rate in 2023 represents the entire 5 percent overall rate increase for that year (based on 1.60 million acre-feet of water transactions). No increases to other rates or charges are reflected for 2023. A $53/AF rate may not generate enough revenue to recover the full cost of demand management in FY 2022/2023. Establishing a revenue collection mechanism equivalent to the current $65/AF in 2023 would require a 6.1 percent overall rate increase.

Table 3. WSR and Placeholder Demand Management Rate (CY)

Calendar Year	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Overall Rate Increase for all Rates and Charges		3%	4%	5%	5%	4%	3%	3%	3%	3%	3%
Demand Management Rate* ($/AF)	$65	-	-	$53	$65	$71	$73	$79	$82	$84	$89

* The 2020 $65/AF rate is the WSR, for CYs 2023-2030 the rate represent only a placeholder until the Board approves a method to recover demand management costs.

The $53/AF represents the entire 5% rate increase for 2023.

Table 4 shows the revenues that would be generated from the hypothetical Demand Management Rate shown in Table 3.

Table 4. Placeholder Demand Management Rate Revenues (FY)

Fiscal Year Ending	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Demand Management Revenues ($M)	**$ 47**	**$ -**	**$ 39**	**$ 96**	**$ 115**	**$ 125**	**$ 132**	**$ 140**	**$ 145**	**$ 151**

Table 4 is in fiscal years, so there can be two different calendar year rates in effect during that FY, as forecasted in Table 3. For FY 2020/21, for example, the WSR will be collected July through December 2020, and no rate will be collected for the remainder of the FY. For FY 2023, the revenues are only $39 million as a $53/AF rate is assumed to take effect in January 2023 and is, therefore, only effective for half the FY. If a $53/AF rate were to take effect earlier in July 2022, the rate would be in effect for the entire FY and would generate twice the revenues. However, a rate to fund demand management costs is not being collected in CY 2022 pursuant to the Board's action.

In Table 5, one can see the impact of the demand management revenue requirements and the projected demand management revenues on the Water Stewardship Fund balance. When subtracting the demand management revenue requirement from the demand management revenues, it shows the amount of over/(under) collection. The June 30, 2020, Water Stewardship Fund balance was $133 million. For the current biennial budget period, the $22 million and $74 million estimated under-collection will come from the Water Stewardship Fund balance. It is projected at the end of the current biennial budget period (end of FY 2021/22), the Water Stewardship Fund balance will be only $36 million. Thereafter, in FY 2022/23, the placeholder Demand Management Rate of $53/AF is anticipated to not generate enough revenue to fund the demand management programs. There would not be enough funds in the Water Stewardship Fund. As such, in FY 2022/23, there would be an estimated $21 million shortfall. Under this placeholder scenario, shortfalls would continue through the end of FY 2024/25.

Table 5. Water Stewardship Fund (WSF) (FY)

Fiscal Year Ending	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Demand Management Revenues ($M)		47	-	39	96	115	125	132	140	145	151
Demand Management Revenue Requirements ($M)		69	74	97	104	115	123	133	139	144	151
Over/(under) collection ($M)		**(22)**	**(74)**	**(57)**	**(8)**	**(1)**	**2**	**(2)**	**1**	**1**	**(0)**
End of year WSF Balance ($M)	133	111	36	-	-	-	2	1	2	3	2
Extra Funds needed ($M)				21	8	1	-	-	-	-	-

The Demand Management Rate does not generate enough revenue to fund the entire program and the WSF has been depleted.

Projected shortfalls in the Water Stewardship Fund balance can be met by: (1) taking actions to reduce demand management costs, (2) establishing a higher rate, charge, or other revenue collection mechanism that generates more revenues, or (3) establishing a replacement demand management revenue collection mechanism that goes into effect earlier than CY 2023.

Establishing any rate, charge, or other revenue collection mechanism at any time requires that Metropolitan's Board take action to replace the prior Water Stewardship Rate, by using one of the options presented to the Board in December 2019 or another option, either separately or as part of a complete rate refinement process.

Conclusion

Metropolitan's robust demand management programs have been enormously successful and have been one of the strongest tools in building 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 spending on more costly infrastructure and supplemental water supplies. To continue, these successful programs will require adoption of a funding mechanism in the rate structure that enjoys broad support from the Board and the public. Staff will be engaging with the Board and member agency staff in the months to come to bring forward options for consideration, with the goal of adopting a new funding approach by the close of CY 2021.

Policy

By Minute Item 51164, dated April 10, 2018, the Board approved 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 51356, dated October 9, 2018, the Board approved the interim LRP target to 170,000 acre-feet per year.

By Minute Item 51828, dated December 10, 2019, the Board directed staff to incorporate the use of the 2019/20 fiscal-year-end Water Stewardship Fund balance to fund all demand management costs in the FYs 2020/21 and 2021/22 Biennial Budget; and to not incorporate the Water Stewardship Rate, or any other rates or charges, to recover such costs in CYs 2021 and 2022.

By Minute Item 52043, dated July 14, 2020, the Board tabled Agenda Item 8-1, proposing that the Board: (1) confirm the goal of 170,000 AFY for LRP projects and direct staff to continue bringing forward proposed LRP project agreements for action; (2) direct staff to continue funding demand management programs through program reserves; (3) commit to completion of the IRP process, and make adjustments to LRP and other demand management programs as needed upon completion of the IRP; and (4) direct staff to assist the Board in developing a replacement funding mechanism to the WSR for 2023 forward. The Board also recommended that the issues in Item 8-1 be considered at the September meeting of the Finance and Insurance Committee, subject to approval by the Executive Committee in the following two weeks.

Fiscal Impact

To be determined based on board direction.

Katano Kasaine	10/6/2020
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Assistant General Manager/	
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General Manager	

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