REPORT FROM

OFFICE OF PUBLIC ACCOUNTABILITY

Date:	March 17, 2017
To:	The Board of Water and Power Commissioners
From:	Frederick H. Pickel, Ph.D., Executive Director/Ratepayer Advocate
Subject:	Advice of the OPA on Fiscal Year 2017-2018 Preliminary Budget

OPINION

OPA recommends that the Department of Water & Power Board of Commissioners authorize the transmittal of the Fiscal Year 2017-2018 preliminary budget. Recommendations concerning final adoption of the budget are discussed below, and may be refined further through discussion with DWP staff.

BACKGROUND

OPA remains concerned about higher than targeted growth in labor costs, and under-performing capital procurements. The previously adopted **2016-2017** budget included $169M more in labor costs than the approved rate budgets. This was a 10% increase, rather than the 0.8% planned in the rate budgets. The preliminary 2017-2018 labor budget is 15% larger than planned in the rate budget.

OPA was informed during the 2016-2017 budget review period that the costs in the rate budgets adopted in March 2016 could not be executed. Reportedly, outsourcing rules and procedures of the City Council can generate negotiation and arbitration delays of 18 months, before a contracting process that already takes 12 months. DWP asserted that such delays could prevent it from initiating planned capital work for half of the five year rate period.

As the Board and City Council may recall, for 2016-2017 the DWP cut $250M of non-labor costs, to offset for the $169M of additional labor costs. The vast majority of those cuts were to capital work. Because DWP had planned to outsource the majority of this capital work, the majority of the cuts were to capital projects DWP expected to outsource and manage.

In the 2015-2016 rate review, the OPA advised both the Board and the City Council that it had reservations about DWP's ability to execute project management of outsourcing at the planned level:

> "In OPA's opinion, the total labor costs requested in the proposed rate cases, when compared against recent DWP service levels and infrastructure replacement projects, are **too low**. In other words, the cycle of underperforming labor is likely to continue, as there are not enough workers under existing work rules and processes to deliver the maintenance and capital work. Therefore, DWP may expend both firm overhead and benefits on simply moving slower than forecasted.
>
> With reference to industry standards, labor costs at DWP are **too high** if staffing levels *and* total compensation are used." (January 15, 2016 OPA Report, Comments on Labor Costs, p. 3.)

DWP's rate budgets planned to attain a very high "gear ratio" by blending its low incremental labor with high levels of outsourcing, thus leveraging its project management, technical expertise, and knowledge of how the DWP and the City integrate work with construction contractors. From 2003 to 2015, there has been a relatively consistent relationship between DWP's labor costs and increases in capital costs. That gear ratio is approximately 70%: for every dollar of added labor costs, *capital servicing costs* have gone up by 70 cents.[1] DWP cannot, by "better" management or performance, convert its labor to capital at ratios of 90-100% in the next few years.

The preliminary **2017-2018** budget includes approximately **$270M** more in labor costs than the rate budgets. About 33% of all new operating revenues, for the full five year rate period, would be allocated to labor costs. This is a 6% increase from 2016-2017's authorized labor budgets, and is 15% larger than the rate budgets. This level of labor expenditure exceeds that planned for 2020-2021 by $170M. See Figures 1 and 2, below. The amount of capital and contracting work that has been cut from the rate budgets is not easy for the public to understand. Nor are the consequences.

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[1] Capital servicing costs are those dollars that go in the revenue requirement before calculating what the rate needs to be to support the investments identified. OPA defines capital servicing costs as debt service for the bond interest and redemptions, insurance and property taxes that support ownership of utility plant and property. This is a classical measure, not exactly matched to DWP's unique accounting practices, and hence an approximation.

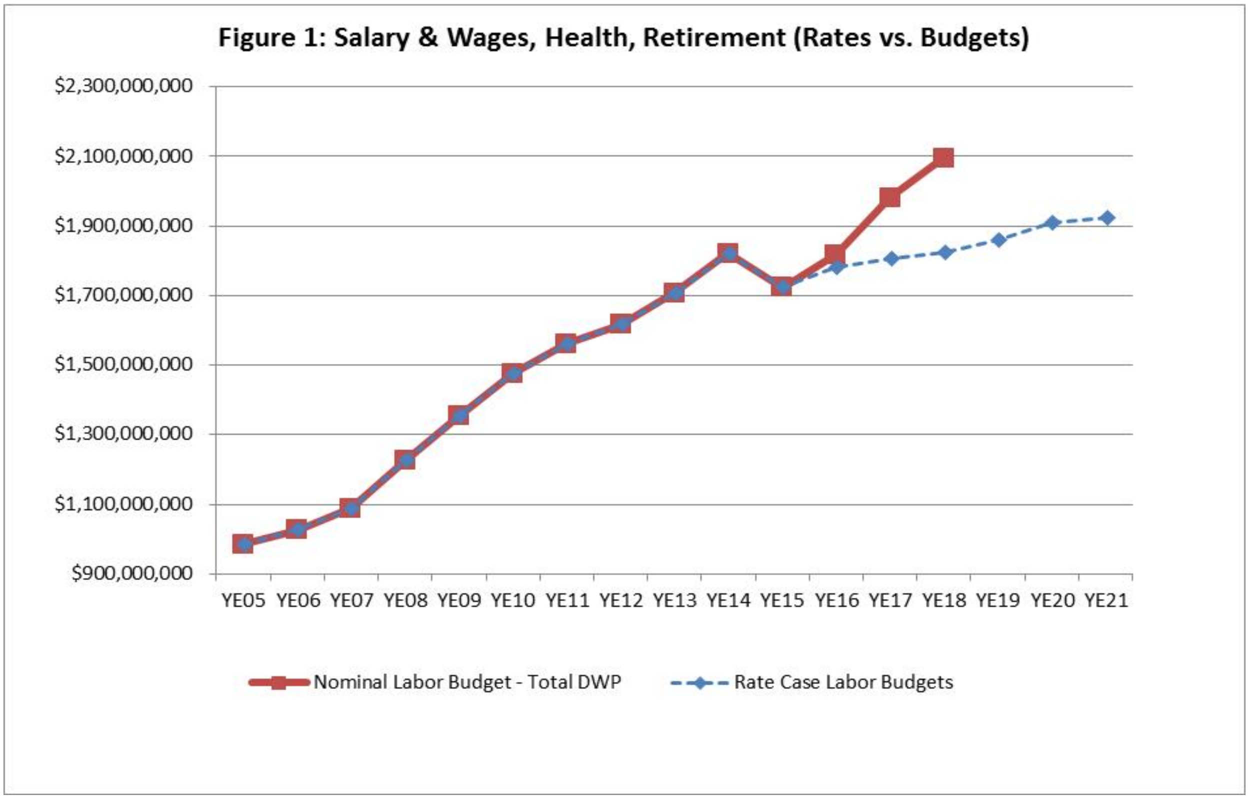
Figure 1: Salary & Wages, Health, Retirement (Rates vs. Budgets)
$2,300,000,000
$2,100,000,000
$1,900,000,000
$1,700,000,000
$1,500,000,000
$1,300,000,000
$1,100,000,000
$900,000,000
YE05 YE06 YE07 YE08 YE09 YE10 YE11 YE12 YE13 YE14 YE15 YE16 YE17 YE18 YE19 YE20 YE21
Nominal Labor Budget - Total DWP
Rate Case Labor Budgets

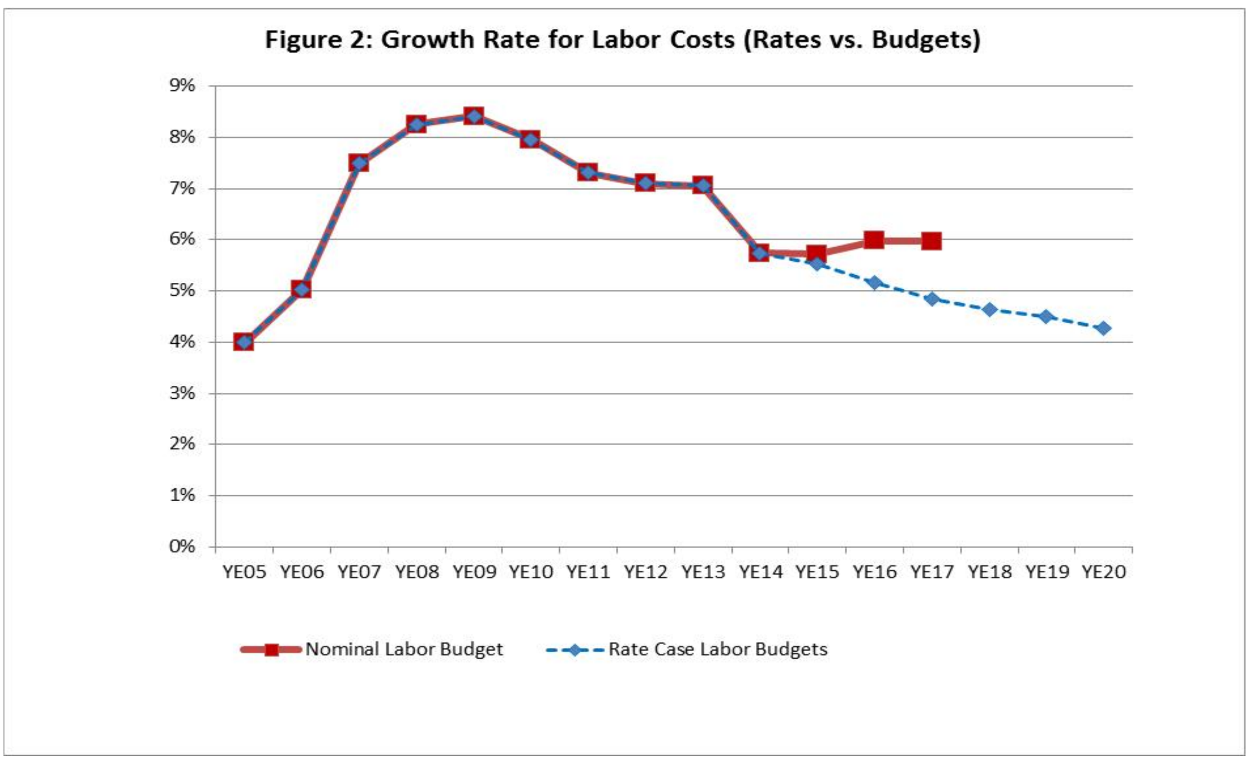
Figure 2: Growth Rate for Labor Costs (Rates vs. Budgets)
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
YE05 YE06 YE07 YE08 YE09 YE10 YE11 YE12 YE13 YE14 YE15 YE16 YE17 YE18 YE19 YE20
Nominal Labor Budget
Rate Case Labor Budgets

DWP is also proposing what it describes as $353,000 of "technical corrections" to move base rate functional accounts into pass-through (i.e., surcharge) rates.

DISCUSSION

The preliminary budget proposal involves cutting non-labor budgets, including contract work, at a rate over 100% of unplanned labor costs. This results in a labor budget that grows at a rate *more than* twice that of national inflation.[2] DWP has a limited amount of leverage remaining. It cannot reasonably expect to convert 100% of rising labor costs to capital. DWP is more likely than not going to fall even further behind on capital programs, while consuming dwindling debt capacity. For this reason, OPA suggests that the "pay-as-you-go" cash portion of the projects have higher public visibility. (As a short-hand, this is often called "pay go" cash.)

- Between $200M and $300M of cash was collected in 2015-2016 rates for capital work that was not performed in that year. Amounts of cash collected but not used for capital projects can be anticipated for the current and future years, as DWP slowly grows into the expanded capital levels authorized.

- When unused cash, raised for capital in **base rates,** is added to retained earnings, used for debt reduction or for labor costs, the Board can easily lose sight of how much of this unused cash was collected for deferred project work. DWP should safeguard "pay-go" cash raised for capital in a way the public and decision-makers can observe.

- Unused cash, raised for capital that is funded by surcharges ("**flow through accounts**"), does not yet have established public disclosures. Ratepayers cannot readily see that the cash portion of unexpended capital is returned to them in a rate reducing adjustment. In other words, that the adjustment was smaller than it otherwise would have been, without the "pay-go" cash being returned.

[2] An examination of **actual** expenditures from 2015-2016 ($1,787 billion) with estimated expenditures for 2016-2017 ($2,021.3 billion) demonstrates 13% growth in expected labor costs for 2016-2017. The growth rate from the **adopted** 2016-2017 period is smaller, but is not the most current assessment of what labor will cost. Comparing the adopted 2016-2017 budget for labor ($1,981.2) to the preliminary budget of 2017-2018 ($2,098.7) produces 6% growth. Management challenges for labor cost controls are accelerating, posing impossible downward adjustments for fiscal year 2018-2019. (See Figure 1, p. 2.)

In approved rates, DWP has targeted compound labor cost growth of 4% by 2020, and expects a post-2020 productivity adjustment of -2% per year. Cutting contract work and non-labor costs to support a trend that is *gaining momentum* in the opposite direction is unwise. DWP cannot afford to fall further behind industry norms, while it remodels its workforce to meet changing demands.

Now would be a good time to discuss the significant and growing difference between rate budgets and annual budgets. Their cumulative effect can be foreseen as approximating more than $1B in structural blocks to planned outsourcing and time delay. Because Measure RRR was not passed by the voters, the City Council needs formally voted requests from the DWP Board, when and if the DWP Board finds it cannot execute the rate budgets because of a focused, ripe limitation in its authority. Further, the City Council needs feedback on impediments to the rate budgets to make intelligent and informed decisions in labor negotiations.

With respect to the proposed move of items from base rate to flow through accounts, OPA has been shown less than $400,000 of account moves from base rate to flow through rates. However, because base rates are capped and surcharge rates are not, the correct way to address this slippery slope is to reduce the base rate revenue, for all the amounts moved out of base rates. Additionally, one should not be able to replace a $100,000 base rate item with a $500,000 revised budget for that item, after changing it to a flow-through account. OPA believes that a budget that makes a downward change in the base rate revenue should await the mid-term review process.

RECOMMENDATIONS: PAST AND PENDING

OPA's recommendations and advice for the **<u>2016-2017 budget</u>** were as follows:

- First, DWP must not rely on a balance sheet item of "unrecovered costs" or "regulatory assets" to smooth additional labor costs into future rates. Such practices "kick the can down the road" to future ratepayers.

- Second, DWP must convert labor costs and construction work in progress into infrastructure to a <u>far</u> greater extent than the last two years.

- Third, DWP must gain additional agility in hiring and procurement. DWP is constrained in many ways from deploying capital at the planned pace.

OPA will continue to confer with DWP staff between now and the final budget adoption. Items it will discuss, and which may come before the board as recommendations for the **<u>2017-2018 budget</u>**, cover the following topics:

- The Board may wish to consider an informal identification of unused "pay-go" cash and its uses, to preserve its *availability* for deferred capital work. Using this cash to top off those minimum cash reserves that were spent on other items during the year does not render it available, cumulatively, when the rate period ends.[3]

- The Board may wish to seek specific management identification of the three largest impediments to the rate budget for 2017-2018, for the purpose of publicly discussing the next steps. The Board may wish to initiate a dialogue with the City Council about actions needed **in** the 2017-2018 budget year, in order to resolve those impediments in time for the next year's budget.

- The Board could annually request publication of all capital work that DWP planned in the rates to outsource, but cut from the rate budget.

DWP's unrestricted net position (retained earnings) for fiscal year end 2016 was $2.872 billion for power and $392 million for water, an increase (cash flow) of $273M and $14M, respectively.[4] The Board has the opportunity each year to holistically balance and reassess its incremental decisions, by which "pay-go" cash is deployed to: 1) reduce leverage for bondholders, 2) reduce employment liabilities for employees, and 3) preserve capital project funds for ratepayers. It can allocate the unused "pay-go" cash however it chooses, but OPA believes it should deliberate on those choices at least annually.

OPA may revise these recommendations, after conferring with DWP's staff, and will report again when the final budget is ripe for adoption.

cc: The Honorable Eric Garcetti, Mayor
David Wright, General Manager, Department of Water and Power

[3] In an extreme case, failing to preserve "pay go" cash can appear to operate as an incentive to slow work, increase overtime's contribution to wage compensation, reset the assumptions that drive pension contribution, or force permanent increases to staffing, any one of which could result in crowding-out 30% of planned investment.
[4] 2016 City of Los Angeles Comprehensive Annual Financial Report (CAFR), p. 46; 2015 CAFR, p. 48.