REPORT FROM

OFFICE OF PUBLIC ACCOUNTABILITY

Date: May 24, 2019

To: The Board of Water and Power Commissioners

From: Frederick H. Pickel, Ph.D., Executive Director/Ratepayer Advocate

Subject: OPA Report on the Department of Water & Power Fiscal Year 2019-2020 Final Budget

RECOMMEDATIONS

1. OPA recommends that the Department of Water & Power Board of Commissioners approve the Fiscal Year (FY) 2019-2020 budget for the Water Division.

2. OPA recommends that the Board direct the management to establish budgets for joint services that help identify persistent under-investment in DWP's means and methods of management, but particularly focusing on the tools needed to better operate those joint services that both operating divisions rely on (e.g., budget, fleet, human resources, customer service and IT).

3. OPA recommends the following changes for the Power Division proposed budget:

   a. Direct the management to present a power budget with a capital expenditure no higher than $1,653 million for FY 2019-2020. That is the highest capital expenditure rate budget that DWP proposed in support of its 2016 rate authorization.

   b. Direct the management to present a power budget with a Power System Reliability Program (PSRP) capital expenditure no higher than $587 million. That is the highest PSRP capital expenditure rate budget proposed during the review of the 2016 five year rate plan. (This amount is $46 million higher than DWP's 2019-2020 rate budget.)

DISCUSSION

DWP has exceeded its 2018-2019 appropriations for salaries and wages by modest amounts, and is unable to do all the capital work that was authorized in the 2016 rate review. It has essential maintenance costs that also are not aligned with the forecasts done to set the rates. The forecasts that DWP initiated in 2014, refined in 2015, and used to obtain rate authorization in early 2016 are now very stale, and cannot be executed. A new four year plan is needed. While many factors could have made its plans achievable, reality has not been so hospitable. Sales were lower than planned, labor costs were higher than planned, and many costs have been changed by weather, gas market disruption, policy decisions, litigation, and both hiring and contracting constraints.

Power Budget

DWP's Power Division did not have sufficient resources to expend $864 million of planned capital improvements for fiscal years ending (FYE) 2016, 2017, and 2018. The rate impacts of the PSRP portion of capital expenditures are uncapped. Setting even higher budget numbers than the rate authorization assumes DWP can do that much work. Over the same 3 years, DWP's Power Division over-shot planned amounts of capitalized labor by $181 million, and planned amounts of operations and maintenance (O&M) labor by $78 million, a cumulative forecast of spending that was $258 million different than planned. Contracts for power capital work were reduced in those same 3 years by $516 million.

The Power Division's O&M budget request for 2019-2020 of $1,389 million is an increase of $104 million over its current estimate for 2018-2019. That request is also $262 million higher than the 2019-2020 rate budget. For perspective, this one-year increase is 300% higher than the O&M increase planned for the entire five year rate period. (e.g., $1,127 million - $1,039 million.)

OPA has previously objected to moving cost elements from capped base rate costs into the uncapped costs in the PSRP. Smart grid job numbers or costs were not included in PSRP capital job numbers, and *were* included in 2016 base rates. DWP has sufficient spending flexibility in its base rates for many of the sub-components it needs to modernize its distribution (better meters, communications, IT), and is significantly under-expended in base rates due to the changes in its repowering plans.

DWP sought and obtained $100 million of additional PSRP capital in the annual 2018-2019 budget for information systems, to support distribution automation. This increased rates faster than planned. It currently expects to expend only $3 million of the $100 million for that item in FYE 2019.

OPA recommends that DWP manage up to $587 million for PSRP capital in 2019-2020. OPA also recommends that DWP continue to aim at spending 80% of PSRP in distribution and substation capital. IT is, at this time, primarily a capped, base rate cost.

The purpose of PSRP capital expenditures is not to absorb anything that does not fit in base rates. Generation facilities that are not distribution or transmission facilities (or inspection of them) on the plant's property are not included. A rate review would be the appropriate process to evaluate changes in the scope of PSRP. Because "reliability" is a core mission of DWP's power services, in theory every expense the Power Division has would be eligible for inclusion in PSRP were there not specifically defined capital budgets that segregate costs that are in base rates.

While the DWP has presented the Board with information showing it has exceeded the PSRP budget in 2017-2018, that presentation depends on the Board's annual budget, which was well below the levels used to set the 2016 rates. DWP's 2017-2018 actual capital expenditures in PSRP were $53 million *below* the 2016 rate budget for that year. Power Division overall was under its 2017-2018 capital rate budgets by $234 million.

OPA notes that its recommendation not to exceed $587 for PSRP capital is more lenient than holding DWP to its 2016 PSRP capital rate budget for 2019-2020, which was $541 million, or about $46 million lower.

General Budget Comments

The constraint DWP faces is not in its capital budgets, but in the appropriations for wages and salaries needed to do all the work, both capital and O&M. OPA supports these appropriations. DWP would reduce contract work for 2019-2020 by $904M.

With the changes recommended by OPA, DWP should be able to solidify its progress over the last three years, while it presents the Board with more comprehensive plans for moving ahead beyond fiscal year 2020.

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OTHER OBSERVATIONS ON THE 2018-2019 BUDGET

Below, OPA has used **bold** lettering to call attention to the proposed budget, in the context of historical information.

1. Cumulatively, the budgets recommended to the Board are above the estimated labor cost in the 2016 authorized rates as follows:
    - 2016-2017: $169M
    - 2017-2018: $272M
    - 2018-2019: $456M
    - **2019-2020: $616M**
        - Total: $1,513M

2. DWP has reduced non-labor (contracting) costs from the 2016 authorized rates as follows:
    - 2016-2017: $250M
    - 2017-2018: $542M
    - 2018-2019: $708M
    - **2019-2020: $904M**
        - Total: $2,404M

    - Important contract reductions within the power budget include: $137M for Scattergood repowering, and $324M for renewable power development.

    - Important contract reductions within the water budget include: $200M in water recycling, $192M for Owens Valley Master Project, $168M for water trunk line replacement, $32M for groundwater remediation, and $32M in mainline replacement.

3. Cumulatively, the amount of planned capital investment for fiscal year end (FYE) 2016, 2017, 2018 that has and has not been executed as planned in the 2016 authorized rates is:
    - Power executed: $3.627 billion (81%)
    - Power unexecuted: $864 million (19%)
    - Water executed: $2.119 billion (71%)
    - Water unexecuted: $865 million (29%)

    DWP included in rates a cash funding portion of the unexecuted capital expenditures. DWP rates included $251 million for power cash funding of capital in advance of the expenditures, and $188 million for water cash funding of capital in advance of the expenditures. These rate elements have allowed DWP to manage revenues that were lower than planned.

4. Based on DWP's current estimates for 2018-2019, and the increase it was able to achieve above 2017-2018, DWP's labor budget appears to be a reasonable stretch goal.

5. The long term, compound annual growth rate of total compensation (salary, benefits, and retirement), using the Gross Domestic Product implicit price deflator to adjust for inflation in constant 2009 dollars is:

    - 2016-2017: 4.0%.
    - 2017-2018: 4.3%
    - 2018-2019 estimated: 4.8%
    - **2019-2020 proposed: 5.4%** (See Figure 3.)

    Nominal changes for 2019-2020 are in Figures 1 and 2 below. These illustrate the magnitude of inflationary effects over a longer time.

    - 2019-2020 nominal total labor cost: **$2,530,450,300**[1]. (See Figure 1.)
    - 2019-2020 nominal percentage change**:** 8.9%.
    - Long-term compound *nominal* change: 6.5%. (See Figure 2.)

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[1] DWP provides a figure that is approximately $5 million higher, which incorporates wages not in the receipts and appropriations salaries and wages line item, from which OPA derives this figure. In OPA's opinion, the difference in measures would have to be far larger to become material. The additional labor costs arise from labor costs included in another cost classification.

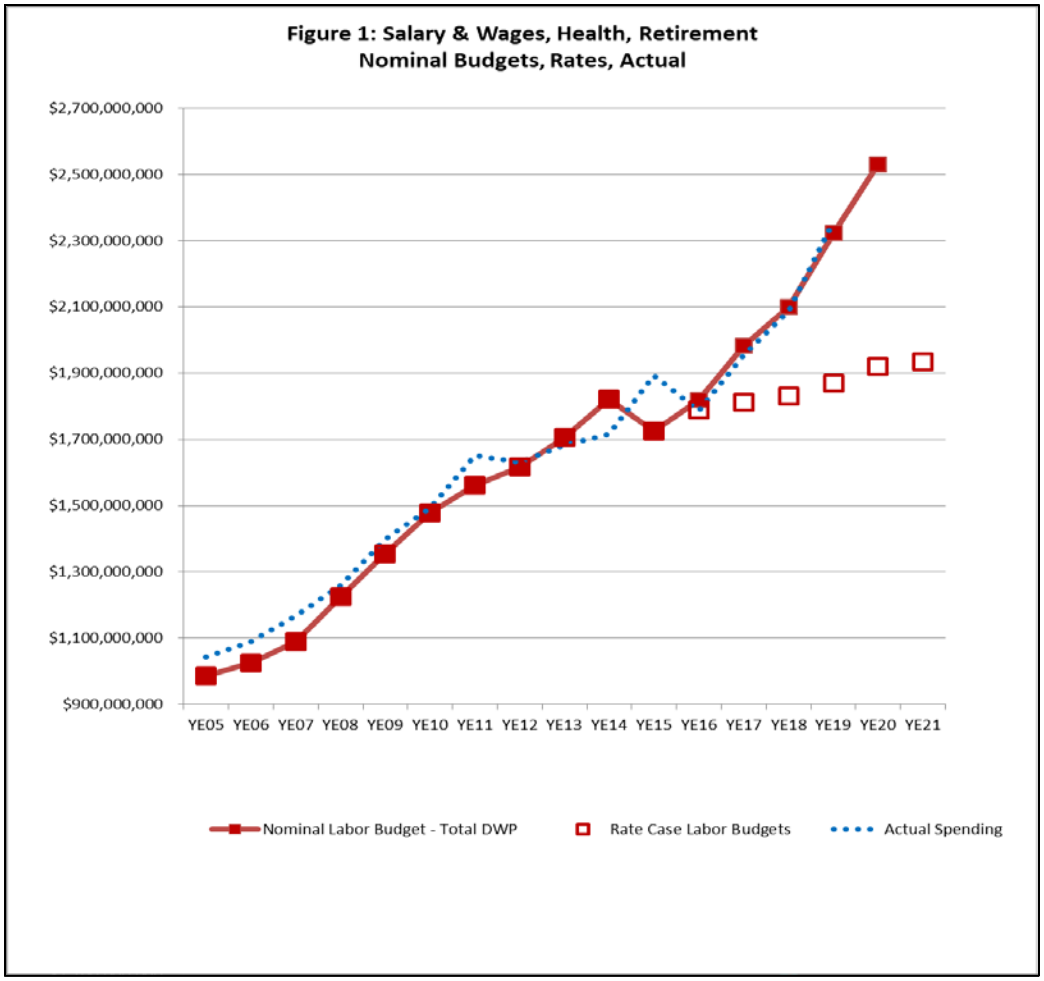
Figure 1: Salary & Wages, Health, Retirement
Nominal Budgets, Rates, Actual
$2,700,000,000
$2,500,000,000
$2,300,000,000
$2,100,000,000
$1,900,000,000
$1,700,000,000
$1,500,000,000
$1,300,000,000
$1,100,000,000
$900,000,000
YE05 YE06 YE07 YE08 YE09 YE10 YE11 YE12 YE13 YE14 YE15 YE16 YE17 YE18 YE19 YE20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

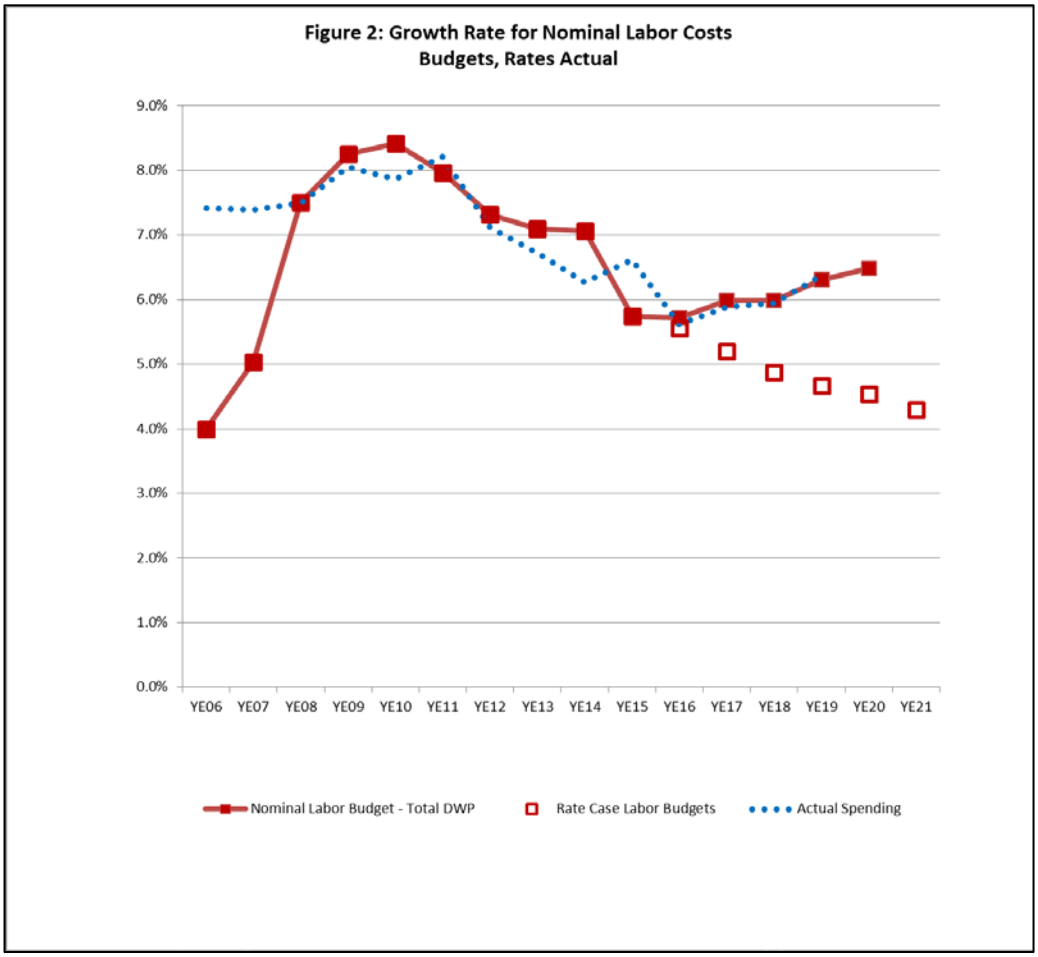
Figure 2: Growth Rate for Nominal Labor Costs
Budgets, Rates Actual
9.0%
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
YE06 YE07 YE08 YE09 YE10 YE11 YE12 YE13 YE14 YE15 YE16 YE17 YE18 YE19 YE20 YE21
Nominal Labor Budget - Total DWP
Rate Case Labor Budgets
Actual Spending

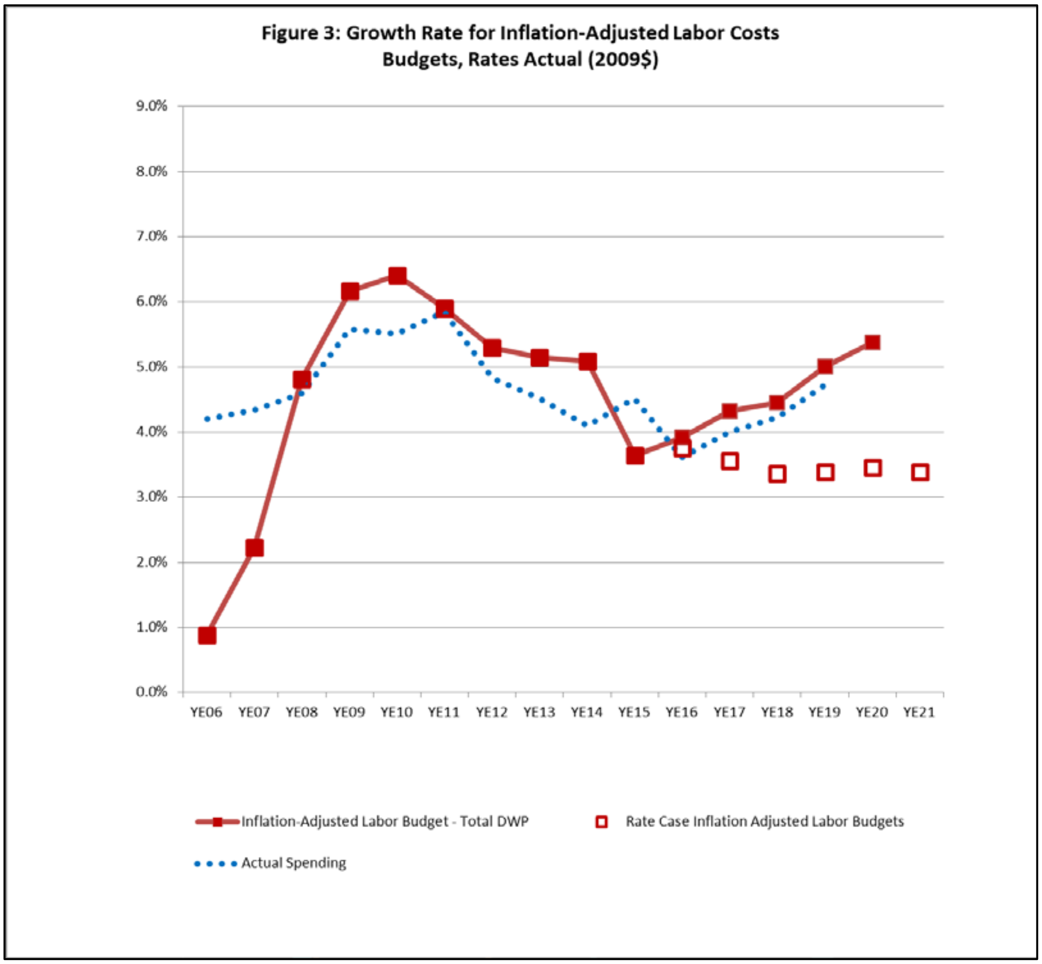
Figure 3: Growth Rate for Inflation-Adjusted Labor Costs
Budgets, Rates Actual (2009$)
9.0%
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
YE06 YE07 YE08 YE09 YE10 YE11 YE12 YE13 YE14 YE15 YE16 YE17 YE18 YE19 YE20 YE21
Inflation-Adjusted Labor Budget - Total DWP
Rate Case Inflation Adjusted Labor Budgets
Actual Spending

ATTACHMENT A

PRIOR OPA BUDGET RECOMMENDATIONS

OPA's recommendations and advice for the **2016-2017 budget** were:

- First, DWP should 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 far 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 recommendations and advice for the **2017-2018 preliminary budget** were:

- Consider an informal identification of unused cash, to preserve its availability for deferred capital work when the rate period ends.
- Identify the three largest impediments to the rate budget for 2017-2018 so that work to resolve those impediments can begin.
- Publish all capital work that DWP planned in the rates to outsource, but cut from the rate budget.

OPA recommendations and advice made in the context of the **2016 power rate review** were:

- Annually report on the prior years' DWP City Service payments of all types, whether or not payments are returned to DWP, when presenting budget estimates. (Prior years include the last closed year and the current year's estimate and year-to-date values.)
- Annually report on those external relationships and expenditures of DWP identified by OPA on its Exhibit T-1.

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