REPORT FROM

OFFICE OF PUBLIC ACCOUNTABILITY

Date: April 20, 2020

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 2020-2021 Preliminary Budget

RECOMMENDATIONS

1. Given pandemic-related uncertainties in operations, finance, and the economy, OPA recommends that the Department of Water & Power Board of Commissioners (Board) approve a "provisional" budget for Fiscal Year (FY) 2020-2021. In September 2020, DWP will prepare decoupling adjustments (discussed below, p. 3) for adoption by the Board in October 2020, affecting power and water rates on January 1, 2021. At that time, knowing the size of that already-authorized adjustment, as an additional budgeting step in September or later, changes to the provisional budget could be adopted with less uncertainty and more flexibility. DWP needs to maintain a balance between its revenue and costs for essential services. OPA believes this more flexible procedural course will best allow the Board to adopt a timely budget before June 1, 2020, and adjust that budget during the fiscal year as more information becomes available.

   OPA's recommendations below are based on analysis of the DWP's preliminary budget of March 31, 2020 for the Water & Power funds.

2. OPA recommends that the Department of Water & Power Board of Commissioners approve a FY 2020-2021 budget for the **Water Division** that does not exceed the appropriations approved for FY 2019-2020. Specifically, OPA recommends the Board:

   a. Direct the management to present a water budget with a capital expenditure no higher than $831 million for FY 2020-2021. That is approximately $128 million *more* than the current year estimate for capital expenditure prepared at the time of the preliminary budget.

3. OPA similarly recommends that the Board approve a Fiscal Year 2020-2021 budget for the **Power Division** that does not exceed the appropriations approved for FY 2019-2020. Specifically, OPA recommends the Board:

    a. Direct the management to present a power budget with a capital expenditure no higher than $1,653 million for FY 2020-2021. That is the highest capital expenditure rate budget that DWP proposed in support of its 2016 rate authorization. That is approximately $227 million *more* than the current year estimate for capital expenditure prepared at the time of the preliminary budget.

    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 $26 million *higher* than DWP's 2019-2020 estimate prepared at the time of the preliminary budget.)

4. OPA recommends, for the preliminary budget Joint System, that DWP elaborate on the Major Technology Investments multi-year and one-year projects in the provisional budget so that the leading division for each major project is identified with the funding level. OPA thinks this new Major Technology Investments section and detail is a good improvement to the budget process.

OPA has been monitoring industry-wide contraction in utility revenues since March. At this time, it is OPA's opinion that the DWP could serve the public best by avoiding the potential for unrecovered costs from revenue dropping and other factors.

DISCUSSION

DWP is unable to do all the capital work that was authorized in the 2016 rate review. While many factors could have made its plans achievable, reality has not been so hospitable. Sales for power 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. Incentives to invest in productivity were built into the rate structure to provide "room to grow" in 2020-2021, but were not pursued.

The current conditions imposed by the pandemic do not suggest DWP will be able to increase overall activity in fiscal year 2020-2021 to a level that exceeds budgets authorized *or* estimated at the time of the preliminary budget for 2019-2020.

Decoupling revenue is the amount of revenue that is added to DWP's revenue requirement by the Board each year in October, because it was not collected in the prior fiscal year ending June. The adjustment is based on the prior fiscal year's base rates (not pass-through rates) falling below (upward adjustment) or above (downward adjustment) the base rate targets established in the 2016 rate review. Currently and due to the state of emergency, estimates of the size of that decoupling revenue are highly uncertain. The DWP can currently estimate decoupling revenue, but how much it will affect power and water rates on January 1, 2021 very much remains to be seen. To combine this previously-authorized rate adjustment process, with additional increases in the proposed budget, could inflict a sharper than planned rate increase on customers at a time when the economy is just beginning to recover, hopefully early in 2021. So greater flexibility is needed in FY2020-2021 budgeting, and a provisional budget with FY2020-2021 adjustments in September or later may provide some of that flexibility. For example, to increase power system costs by 5.1%, and then add decoupling revenue of <u>more</u> than 2%, will likely produce even less revenue as demand contracts in response to the increased rates of 7%. DWP may want to adjust the provisional budget FY2020-2021 upward or downward depending on pandemic and economic conditions, in addition to the then known impact of the decoupling adjustment result.

In the growth years leading up to this point, decoupling revenue has been adding 2% for power and 0.06% for water. There is little point in driving up unrecovered costs to levels that not necessitated by the current level of achieved activity (capital or O&M), when that activity level has taken so many years to arrive at the estimated amounts for 2019-2020. The current year activities for budgeting FY2020-2021 were estimated before extensive shut-down orders slowed DWP work down. Therefore they serve as a very useful guide in preserving work delivery capability and core utility needs.

<u>**Power Budget**</u>

DWP's Power Division does not expect to expend more than $1,426 million in capital improvements for fiscal year 2019-2020. The rate impacts of the PSRP portion of capital expenditures are uncapped. Setting even higher budget numbers than the rate authorization ($1,653 million) assumes DWP can do that much work.

The Power Division's O&M budget request for 2020-2021 of $1,483 million is an increase of $121 million over its current estimate for 2019-2020. For perspective, this one-year increase is 138% higher than the O&M increase planned for the entire five year rate period. DWP also proposes depreciation (including property tax and other items) of $707 million, an increase of $84 million above its current estimate for 2019-2020. This presumes a level of capital expenditure unlikely to occur by the end of fiscal year 2021.

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 expended only $2.6 million of the $100 million for that item in 2018-2019, and expects to expend only $15.5 million of the $66 million authorized for 2019-2020. A budget approval no larger than 2019-2020 would not likely provide a constraint and would nevertheless allow DWP to increase current activity levels.

OPA recommends that DWP manage up to $587 million for PSRP capital in 2020-2021. OPA also recommends that DWP continue to aim at spending 80% of PSRP in distribution and substation capital.

OPA notes that its recommendation not to exceed $587 for PSRP capital is more lenient than holding DWP to its expected 2019-2020 PSRP capital estimate, which is $561 million, or about $26 million lower.

Any capital needed to de-commission plant, like infilling ocean cooling water channels, can ordinarily be spent long after the use ends, as in the Navajo power plant facility.

OTHER OBSERVATIONS ON THE 2020-2021 WATER & POWER PRELIMINARY BUDGETS

1. Based on DWP's then-current estimates for 2018-2019, the 2019-2020 labor budgets appeared to be a reasonable stretch goal. DWP came close, and expected to be only $17.2 million below the authorized level when it prepared its preliminary budget.

2. Nominal labor budget changes for 2020-2021 are in Figures 1 and 2 below.
   - 2020-2021 nominal total labor cost: **$2,519 million**. (See Figure 1.)
   - 2020-2021 nominal percentage change**:** 0%.
   - Long-term compound nominal change: 6.0%. (See Figure 2.)

   - For comparison, trends related to the nominal total labor cost previously <u>authorized</u> was composed of:
     - Wages & salary
       - $1,575 million (2019-2020), $1,457 million (2018-2019), and $1,282 million (2017-2018)

- Health
  - $363 million (2019-2020), $334 million (2018-2019), and $314 million (2017-2018)
  - DWP may have very little flexibility in 2020-2021 to reduce this below the $396 proposed in the preliminary budget. This amount is $30 million higher than what the Board authorized in 2019-2020.
- Retirement
  - $590 million (2019-2020), $532 million (2018-2019), and $503 million (2017-2018).
  - It is worth noting that the actual retirement expenditure in 2018-2019 was only $426 ($106 million lower) due to favorable input factors. A similar change between authorized and actual amounts may be on the planning horizon due to unfavorable pandemic-driven response in the stock market. The preliminary or provisional budget would not be able to estimate those factors in advance very well due to very abnormal volatility in the investment portfolio, and the uncertain trajectory of recovery it must navigate.
  - The preliminary budget amount of $462 million for 2020-2021 is $127 million *lower* than the prior year's authorization.

- The OPA would encourage the Board to authorize in the provisional budget flexibility to keep <u>total</u> labor costs at or below last year's authorization levels for <u>all three items</u>: wages, health care and retirement.

  - That is consistent generally with the 0% change for these costs on a combined basis that DWP had in its preliminary budget.
  - Further, OPA would encourage the Board to authorize management to expend some of its total labor budget on inter-City costs of expediting positions needed for utility-specific functions in IT.
  - This would include needed expertise and vendor-specific experience with utility applications DWP has not been able to gain while using legacy systems, and will support the Major Technology Investments in the Joint System. This is needed for DWP to invest in productivity and contain growth in O&M.

3. 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:

   - 2017-2018: 4.8%
   - 2018-2019: 5.3%
   - 2019-2020: 5.7%
   - **2020-2021 proposed: 5.4%** (See Figure 3.)

   These changes illustrate the magnitude of inflationary effects over a longer time.

BEYOND THE BUDGET

With the changes recommended by OPA, DWP should be able to solidify its progress over the last four years, while it stabilizes revenue levels that have been illusive prior to the pandemic orders. Later in 2020, in preparation for a four year rate review, DWP can better assess its needs with more comprehensive plans.

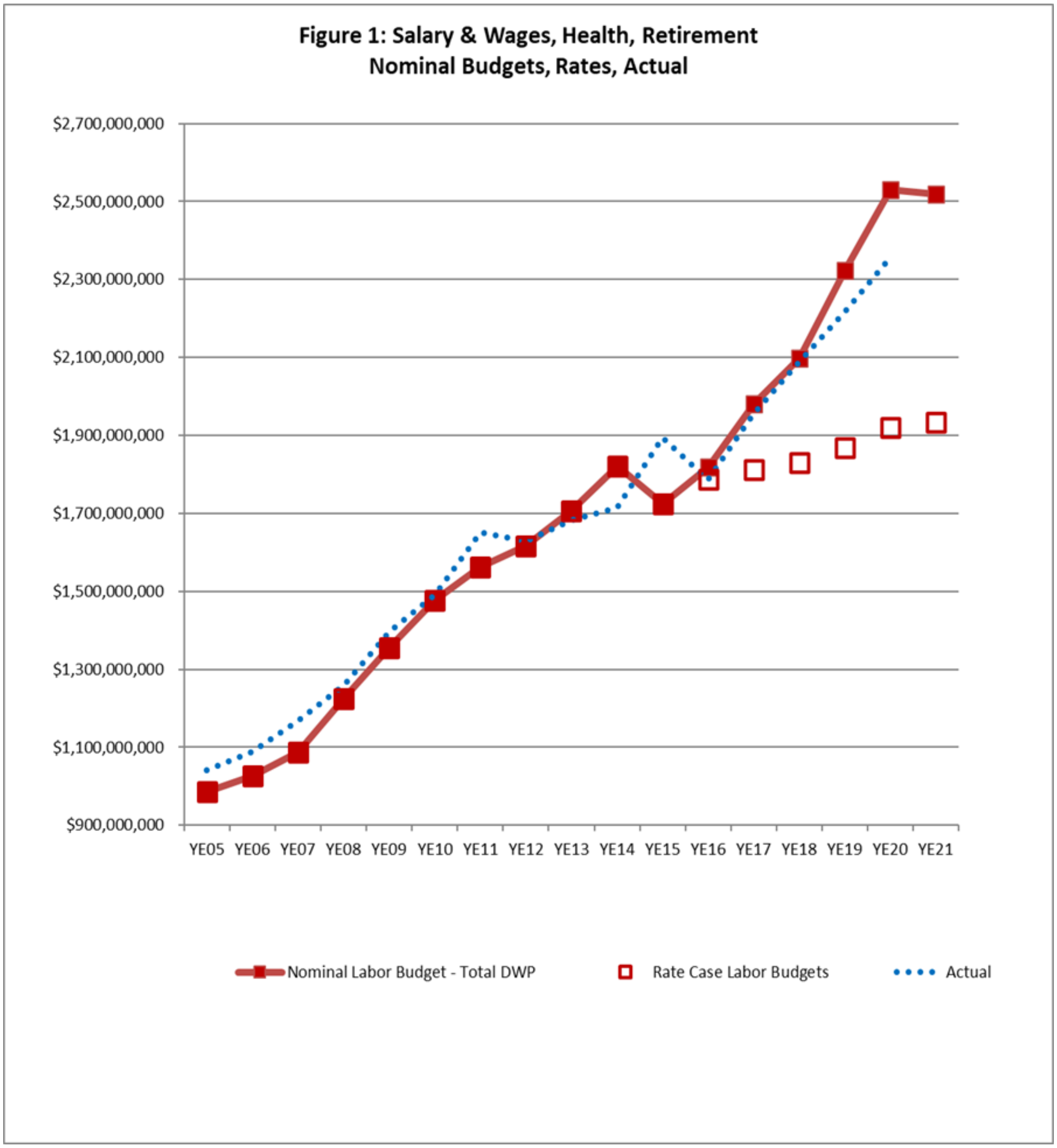
Figure 1: Salary & Wages, Health, Retirement
Nominal Budgets, Rates, Actual
$2,700,000,000
$2,500,000,000
$2,300,000,000
$2,100,000,000
$1,900,000,000
$1,700,000,000
$1,500,000,000
$1,300,000,000
$1,100,000,000
$900,000,000
YE05 YE06 YE07 YE08 YE09 YE10 YE11 YE12 YE13 YE14 YE15 YE16 YE17 YE18 YE19 YE20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

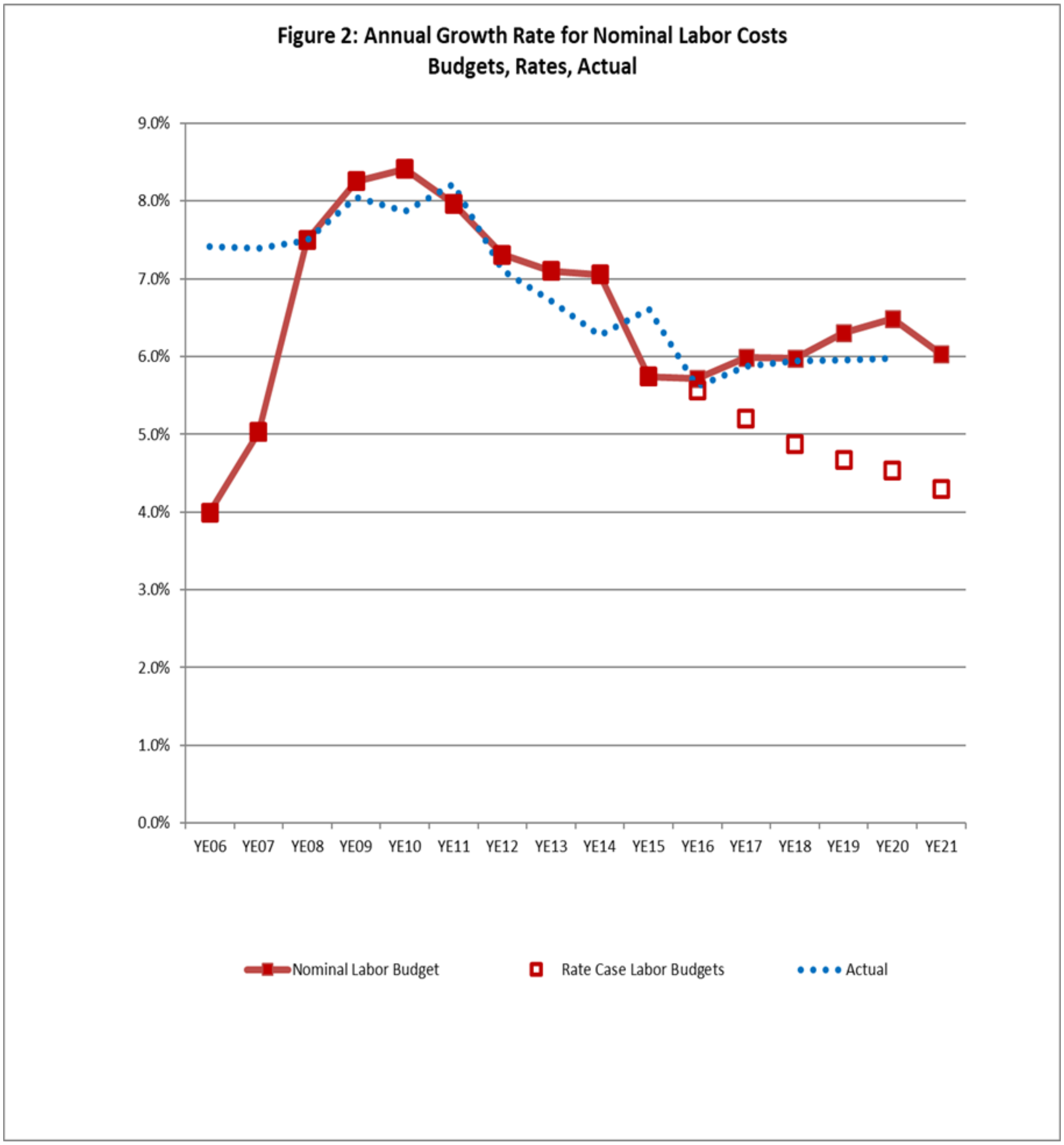
Figure 2: Annual Growth Rate for Nominal Labor Costs
Budgets, Rates, Actual
9.0%
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
YE06
YE07
YE08
YE09
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YE11
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YE21
Nominal Labor Budget
Rate Case Labor Budgets
Actual

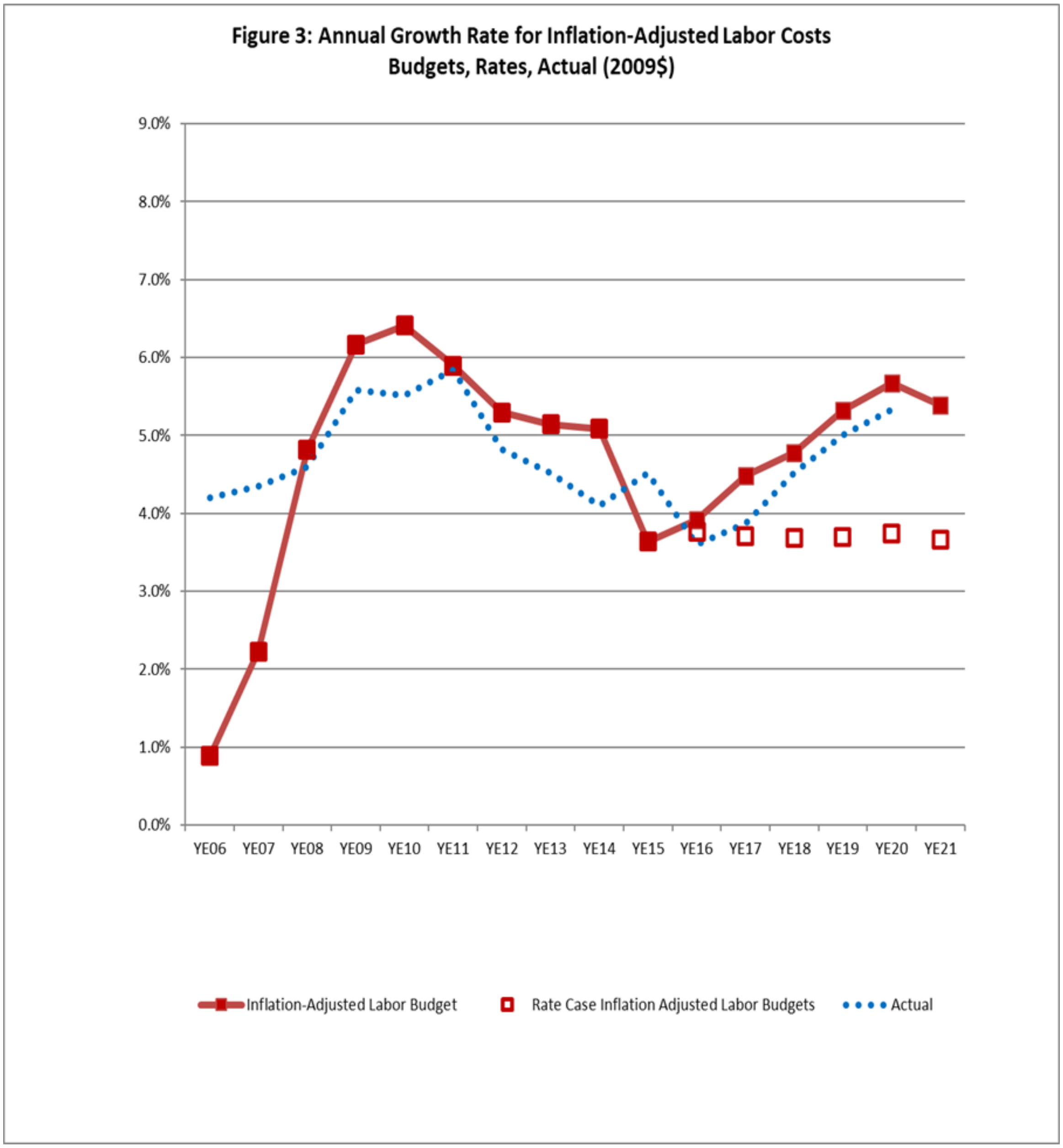
Figure 3: Annual Growth Rate for Inflation-Adjusted Labor Costs
Budgets, Rates, Actual (2009$)
9.0%
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
YE06
YE07
YE08
YE09
YE10
YE11
YE12
YE13
YE14
YE15
YE16
YE17
YE18
YE19
YE20
YE21
Inflation-Adjusted Labor Budget
Rate Case Inflation Adjusted Labor Budgets
Actual

ATTACHMENT A

PRIOR OPA BUDGET RECOMMENDATIONS

OPA recommendations and advice for the **2019-2020 budget** were:

- Approve the Fiscal Year (FY) 2019-2020 budget for the Water Division.
- 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).
- OPA recommends the following changes for the Power Division proposed budget:
    - 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.
    - 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.)

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'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 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
Martin Adams, General Manager & Chief Engineer, Department of Water and Power