

REPORT FROM

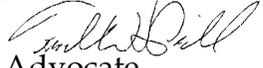
## OFFICE OF PUBLIC ACCOUNTABILITY

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Date: October 12, 2018

To: The Board of Water & Power Commissioners  
David Wright, General Manager, Department of Water & Power

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

Reference: Regulatory Assets for Fiscal Year 2017-2018; 10/16/2018 DWP Board  
Agenda Items 13 & 14

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### RECOMMENDATION

1. OPA recommends that the Board of Water & Power Commissioners (Board) approve the regulatory asset requested by the Department of Water & Power (DWP) for post-retirement benefits, as it has for pensions.
2. OPA recommends that the Board approve the regulatory asset requested by the DWP for certain stormwater capture projects, but only for the \$70 million requested. OPA recommends that the Board explore a sliding-scale of financial commitments from parties receiving DWP capital funds, to ensure efficient use of limited DWP debt issuance capacity.
3. OPA suggests that the Board discuss the cumulative effect of regulatory assets, at least once per year, before the books are closed. This will allow pre-existing regulatory assets and new ones to be considered at the same time so that the cumulative amount remains reasonable. OPA anticipates this Board discussion will be ripe at an upcoming meeting to address a regulatory asset proposal that is still pending.

### DISCUSSION

#### 1. Post-retirement Employee Benefits

In OPA's opinion, use of a regulatory asset for retirement benefits is a generally accepted utility practice. General accounting standards, inclusive of the actuarial practices exercised in applying those standards, are well-developed.

## 2. Stormwater Capture Financing of Third Parties' Facilities

OPA finds that the scale of the proposed regulatory asset for stormwater capture projects owned by third parties is small. DWP represented to OPA that \$35 million has been expended cumulatively on such third-party projects. Therefore, the \$70 million authorization requested should last DWP for many years to come.

The Board should be aware that using regulatory assets for facilities owned entirely by others is not a generally accepted water utility practice. Nor should Los Angeles expect others to follow its lead in this regard. With reference to DWP's capitalization of energy efficiency (EE) investments, this does not support a different result. DWP capitalizes these EE costs, which also involve ownership by third parties. Doing so is also not a generally accepted practice for electric utilities.

During the next year or two, OPA would recommend working on related business practices to manage the known risks. DWP's debt issuance capacity is limited. Funding partners seeking to fund their stormwater compliance obligations may not appreciate this, particularly if they do not yet have a steady source of tax revenue for stormwater themselves. It could harm ratepayers if:

- (1) stormwater capture facilities are not maintained in a manner that preserves the quantity of drinking water expected, or
- (2) the estimates of drinking water are inflated, and never subjected to verification after construction, or
- (3) the benefits of the facility (e.g., total daily maximum load (TMDL) compliance obligations of others) are disproportionate to DWP's benefits and the facility would have been constructed without DWP funds.

TMDL compliance is a large, multi-decade, multi-billion dollar effort that requires vigilance in the way DWP "shares" facility costs. Otherwise, DWP will be collecting tax revenue instead of water revenue on behalf of non-DWP entities. Because DWP is funding sources of drinking water, DWP funding agreements need more "teeth" in them than stormwater capture grants.

Benefit-based funding can be poorly executed (unfair to ratepayers) or well executed (fair to ratepayers). It will be unfair to ratepayers if DWP becomes viewed by its counter-parties as a new source of grant funds to them, and DWP bears disproportionately in the capital costs. In OPA's opinion, a facility that is necessary for a funding partner to fulfill its compliance obligations with respect to stormwater is highly unlikely to have more than 50% of the benefit appropriately allocated to DWP's new drinking water sources. Because of significant economies of scale, capital allocation to DWP becomes even more unfair to ratepayers as the facilities get smaller and the unit costs higher.

Should DWP wish to expand this stormwater capture regulatory asset beyond the \$70 million level requested, OPA will at that time recommend between 3 and 5 “sliding scale” levels of financial obligation for counter-parties that own the facilities funded by DWP, reflecting:

- 1) the character and expertise of the entity assuming the operation and maintenance obligations,
- 2) the firm or non-firm nature of the cash flow available to that entity to fund the expected operation and maintenance obligations, including a contingency for unplanned problems, and
- 3) the collateral the entity can offer DWP to secure its long-term rights in sourced drinking water, including potential refund of DWP capital in the event the facility no longer sources drinking water.

Having tough counter-party obligations may allow funding agreements to protect ratepayers’ investment, and possibly return it, if no new source of drinking water results due to a failure to maintain the facility. Maintenance costs for some types of stormwater capture facilities can have periodic maintenance expenses in the 8-20 year time frame that are sometimes as large as the original investment.

### **3. Cumulative Impacts of Regulatory Assets**

DWP has previously adopted a regulatory asset for pension costs. DWP also reports deferred cost recovery as an asset, which is in the nature of a regulatory asset, done annually. Together, all these regulatory assets represent revenue collection that is postponed.

Regulatory assets constitute a promise, on the part of the rate-setting body, to include the specified costs in the rates in a future year. OPA would propose that the “safe” zone for regulatory assets is at or below 10% of total assets. A “cautionary” zone for regulatory assets is from 11% to 15% of total assets. Regulatory assets above 15% of total assets should be viewed with skepticism.

Like hedging natural gas or using derivatives, regulatory assets are a reasonable financial tool. However, they can quickly become acutely impactful for ratepayers at the wrong time. When the economy is cooler, a utility will come to regret allowing its regulatory assets to creep upward.

OPA believes that the Board should understand the cumulative effect of these decisions. Without this visibility to the total amount each year, the Board would find it nearly impossible to exercise a fiduciary standard of care.

OPA expects to report to the Board in the near future, when the next regulatory asset is requested, regarding the cumulative impact for 2017-2018.