Fiscal Sustainability

Administrative and Finance Committee
March 12, 2015

Presented by: Lisa Marie Harris, Director of Finance &
Ken Weinberg, Director of Water Resources
Agenda

- Fiscal Sustainability Overview
- Enhancing Fixed Charges and Revenue Volatility
- Supply Reliability Charge
- Non-Commodity Revenue Allocation
- Transitional Special Agricultural Water Rate
- Other Items
- Next Steps
Overarching Themes from the Fiscal Sustainability Task Force

- Rates and Charges should reflect future trends
  - Increasing fixed cost obligations for supply
  - Changing member agency purchase profiles
- Maintain Water Authority's Strong Credit Rating
  - Improve long-term credit positives
  - Address potential credit negatives
- Enhance stability and predictability of water rates
  - Address revenue volatility
- Strengthen nexus between benefit received and payment
- Address issues from Cost of Service Phase 1
March 27, 2014 Board Action

The Board authorized the following actions:

1. Defer the final decision regarding how to apply the debt and equity payment for the Carlsbad Desalination Plant to the Administration & Finance Committee for consideration of the CY 2016 rates and charges, and adopt an interim policy for the CY 2015 rates and charges that applies the debt and equity payments for the Carlsbad Desalination Plant to the Supply rate; and

2. Maintain the current policy related to the application of non-commodity revenue offsets for CY 2015 rates and charges and defer to the Administration & Finance Committee the application of revenue offsets to all revenue categories, including Treatment, to the development of the CY 2016 rates and charges; and

3. Defer to the Administration & Finance Committee all other Task Force recommendations, including modification of allocation of Storage Charge and consideration of a Supply Reliability Charge concept.
2015 Rates and Charges Action-Transitional Special Agricultural Water Rate

- Two components
  - Storage Charge exemption
  - Supply discount
- Supply discount portion enables participants to purchase water at MWD’s Tier 1 rate
  - Participant accept a lower level of water supply reliability
  - Supply discount scheduled to terminate January 1, 2015
- Extended until December 31, 2015
  - Concern over adding firm demand during shortage
  - Consider additional extension with 2016 rates
Representatives of 23 member agencies participated
- General Managers, Finance Officers, other key staff
- 8 meetings over 6-month period

Developed consensus recommendations
- **Single comprehensive balanced package**
  - Fixed revenue for supply obligations
  - Allocation of non-commodity revenues to offset rates
  - Extension of TSAWR

Identified other issues for future Board consideration

If approved, forward comprehensive package to Independent cost of service consultant
Fiscal Sustainability Process Definition

- Changing Cost Structure
- Degrading Fixed Revenue: Fixed Cost ratio
- Increase Fixed Revenue
- Identify Options
- Board Policy Issues
- Board Policy Direction
- Member agency Workgroup Task
- Regional Supply Reliability Commitments
- Develop Alternative(s)
- Analyze and Select Alternative(s)
Enhancing Fixed Charges/Revenue Volatility

Presented by: Lisa Celaya, Financial Planning Manager
Sustainability Problem Statement

- Growing fixed cost structure for supply
  - Increased contractual obligations for supply because of supply diversification
  - Risk associated with water sales volatility increasing as fixed costs increase
- Not all beneficiaries pay for supply diversification
  - Consistent users
  - Intermittent users
  - Insures member agencies loss of local supply
- Some linkage between volatility and beneficiaries pay
  - Fixed charge for supply smoothes out volatility
  - Ensures beneficiaries pay
Changing Nature of SDCWA Cost Structure

Note: Total Fixed Costs and Fixed Revenue do not include MWD’s RTS charge and Capacity Charge
Water Sales Volatility

- Volatility occurs due to variance between sales volumes used to set the Melded Supply Rate and actual sales
- Managing risk from variance in water sales volumes through reserves
  - Size of Rate Stabilization Fund will account for increasing fixed cost obligations for supply
- Growth in RSF requires increased rates
  - Build-up RSF and replenish when used
What is the appropriate level of minimum sales?

Greatest level of uncertainty

Minimum Sales and Managing Volatility

Water Sales

Total Projected Demands

Actual Water Sales
Dry Year vs. Wet Year

Decline from Dry Year to Wet Year

- 2007 Dry Year Sales
  - Total A/F Sales: 566K
- 2011 Wet Year Sales
  - Total A/F Sales: 385K

San Diego, City of
Managing Financial Impacts from Water Sales Volatility via Reserves

- Additional fixed costs increase the RSF Target & Maximum

- Policy Decision
  - Use of reserves is a one time solution to mitigate impact from loss of sales

- Impacts Rates
  - Replenishment

Impact on Reserves from change in Cost Structure

Note: Increase in Target Ending Balance on a per AF basis assumes annual water sales at 500K AF
Issue Summary

- Manage changing cost structure and revenue volatility through reserves
  - Less impact on member agency volatility
  - Volatility alone does not justify a new fixed charge
- Necessary structure for minimum sales lacks consensus
  - Trade off between minimum amount and price
  - Needs to provide more certainty than current structure
  - Minimum sales helps identify the range of volatility
Supply Reliability Charge

Presented by: Ken Weinberg, Director of Water Resources
Supply Reliability Fixed Charge

- Recognize benefit of supply diversification
- Balance with local supply development
- Ensure member agency and inter-generational equity
- New supply reliability fixed charge recognizes the benefit of past investments
  - Benefit of access to reliable supply has a value to all member agencies
Example of Linking a Reliability Charge To MWD Supply Reliability

- Multiple ways to approximate reliability of least reliable supply
- MWD is least reliable supply
  - What is the signal to develop a new more reliable supply?
  - How to value the “risk management” premium?
- Purpose of providing an example reliability charge:
  - New reliable supplies are developed to address a documented “reliability gap”
  - Which methodology best reflects benefit of QSA and Carlsbad Desalination?
Calculating a Reliability Charge Based on MWD Rates

- Use cost above least reliable supply
  - City of San Diego Desal Charge Proposal
  - Olivenhain MWD Reliability Charge include desal and IID Transfer

- Future desalinated water supply and QSA costs may be lower than MWD Tier 1 Untreated
  - Charge in place until “lines cross”
  - Projected MWD Supply rate with Bay Delta Fix compared to Carlsbad Desal or combination of Carlsbad Desal/QSA
## Alternatives To Address Fiscal Sustainability Issue: Changing Cost Structure of Supply

<table>
<thead>
<tr>
<th>No Fixed Charge Alternative (Status Quo)</th>
<th>Desal Charge</th>
<th>Reliability Charge</th>
<th>Reliability Nexus Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pay for reliable supplies through annual purchases</td>
<td>New fixed charge for Carlsbad Desal costs only</td>
<td>New fixed charge for Carlsbad Desal and IID Transfer costs</td>
<td>New fixed charge for 15% of fixed Desal and QSA costs</td>
</tr>
<tr>
<td>All QSA/Desal costs on supply rate</td>
<td>Cost difference between MWD rate and Carlsbad Desal supply cost</td>
<td>Cost differential between MWD rate and melded Carlsbad Desal and IID Transfer rate</td>
<td>Based on supply reliability metric eg: frequency of shortages, QSA/Desal share of dry year supplies</td>
</tr>
<tr>
<td>No additional fixed charges</td>
<td>Allocated on 3 year rolling average</td>
<td>Allocated on 5 year rolling average</td>
<td>Allocated on 10 year rolling average</td>
</tr>
</tbody>
</table>
# Impact on Member Agencies

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>CY 2020</th>
<th>CY 2030</th>
<th>CY 2040</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. No New Fixed Charges</td>
<td>$0M</td>
<td>$0M</td>
<td>$0M</td>
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<tr>
<td>2. Desal Charge</td>
<td>$43M</td>
<td>$42M</td>
<td>$10M</td>
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<tr>
<td>3. Reliability Charge</td>
<td>$29M</td>
<td>$41M</td>
<td>$29M</td>
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<tr>
<td>4. Reliability Nexus Charge</td>
<td>$31M</td>
<td>$45M</td>
<td>$60M</td>
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</tbody>
</table>
Scenarios Impact on Fixed Revenue to Fixed Cost Ratio

% of Fixed Costs Covered By Fixed Revenues

Calendar Year

2015 2020 2025 2030 2035 2040

20% 30% 40% 50% 60%

- Fixed Revenues vs. Fixed Costs (Status Quo)
- Fixed Revenues vs. Fixed Costs (Desal Charge)
- Fixed Revenues vs. Fixed Costs (Reliability Charge)
- Fixed Revenues vs. Fixed Costs (Reliability Nexus @ 15% Proposal)
Scenario Impact on Fixed Revenue as a Percent of Total Revenue

- % Fixed of Total Revenue (Status Quo)
- % Fixed of Total Revenue (Desal Charge)
- % Fixed of Total Revenue (Reliability Nexus @15% Proposal)
- % Fixed of Total Revenue (Reliability Charge)

Calendar Year

- 2015: 22%
- 2020: 21%
- 2025: 18%
- 2030: 16%
- 2035: 15%
- 2040: 11%

- 2015: 23%
- 2020: 19%
- 2025: 18%
- 2030: 15%
- 2035: 14%
- 2040: 11%

- 2015: 18%
- 2020: 15%
- 2025: 15%
- 2030: 14%
- 2035: 11%
- 2040: 8%
Evaluating Alternatives

Allocating charge to member agencies

- What basis best reflects the benefit received
  - Rolling average
  - Peak year demand
  - Averaging the average and the peak

- What cost responsibility period best correlates with reliability benefit?
  - 3-years
  - 5-years
  - 10-years
  - Other?
Member Agency Managers’ Recommendation: Create a New Supply Reliability Charge

- Using the “Olivenhain Methodology”
  - 25% of the cost differential between IID Transfer and Carlsbad Desalination Supply Costs and a similar quantity of MWD water at the Tier 1 Untreated Rate
  - The Calendar Year Charge would be set annually
  - Charge would diminish as the cost of IID/Desal becomes closer to MWD Tier 1 and be eliminated when the two are equal or MWD is greater than IID/Carlsbad Desal
  - Allocate to member agencies on a 5-year rolling average of M&I deliveries
Member Agency Managers’ Recommendation: Create a New Supply Reliability Charge (Cont’d)

- Little change to member agency total financial contribution with substantial member agency roll-off
  - Average increase of 0.4% - 1.3%
  - Most future costs are related to variable MWD costs
  - Additional local supply avoids MWD variable costs
  - Currently level of sales in the future – local supplies meet growth in demand
Member Agency Managers’ Recommendation: Create a New Supply Reliability Charge (Cont’d)

- After 5 years (12/31/2020) of imposing the Charge a comprehensive evaluation of the effectiveness of the Charge will be conducted and reported to the Board
  - Board not required to affirm continuation of Charge
  - No action would continue charge in existing form
  - Still subject to annual rate setting process

- Recommended Methodology Reviewed by Water Authority General Counsel and Tom Chesnutt PhD, A&N Technical Services
  - Found methodology meets general cost of service principles and California law
Questions and Discussion
Non-Commodity Revenue Allocation

Presented by: David Shank, Financial Planning Manager
Allocation of Non-Commodity Revenues: Background

- The 2013 Cost of Service Study recommended that the current method of using non-commodity revenues to offset all rate categories should be reviewed because the exclusion of Treatment from sharing in those revenue offsets may be an inconsistent application of rate setting policy.
Issues Raised by Member Agencies

- Member agencies that purchase treated water are not recovering a proportional benefit
  - Everyone benefits from untreated water rates so only those rates should be credited
- Most member agencies allocate non-commodity revenues to all rate and charge categories
  - Example – Not allocating non-commodity revenue to Ag
- The treatment rates fully recovers the cost of treatment
  - It is not an equity issue – policy application issue
- Treatment of the IAC revenues is a cost of service issue
  - Cross subsidization of rates and charges
Industry Guidelines for Non-Commodity Allocation

- Industry practice is to use non-operating or non-commodity revenue to offset all costs

Rate Category Revenue Requirement

- Customer Services Expenditures
- Storage Expenditures
- Treatment Expenditures
- Supply Expenditures
- Transportation Expenditures

= Net Revenue Requirements
Potential for Rate and Charge Cross Subsidization – IAC Example

- IAC includes 25% of the 4-year average annual projected debt service
  - Includes approximately $7.9 million of treatment debt service
- IAC not allocated to Treatment
  - Treatment debt service recovered on the IAC is not applied to offset treatment costs
  - Supply, Transportation, Customer Service and Storage receive the credit for treatment related revenues
# Current Practice – CY 2014 Rate and Charge Data

<table>
<thead>
<tr>
<th></th>
<th>Total Revenue Offsets (1)</th>
<th>Customer Service</th>
<th>Storage</th>
<th>Transportation</th>
<th>Supply</th>
<th>Treatment</th>
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<tbody>
<tr>
<td><strong>Offset Allocation Capital Only</strong></td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>11.11%</td>
<td>48.77%</td>
<td>31.20%</td>
<td>8.92%</td>
<td>0.00%</td>
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<tr>
<td><strong>Offset Allocation Capital and O&amp;M</strong></td>
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<td></td>
<td>17.06%</td>
<td>40.76%</td>
<td>30.82%</td>
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## Offsets (Capital Only)

<table>
<thead>
<tr>
<th>Offset Category</th>
<th>Total</th>
<th>Customer Service</th>
<th>Storage</th>
<th>Transportation</th>
<th>Supply</th>
<th>Treatment</th>
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<tbody>
<tr>
<td>System Capacity Charge</td>
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<td>$1.62</td>
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<tr>
<td>Treatment Capacity Charge</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.36</td>
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<tr>
<td>Standby Availability Charge</td>
<td>11.28</td>
<td>1.25</td>
<td>5.50</td>
<td>3.52</td>
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<tr>
<td>PAYGO Earnings</td>
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## Offsets (Capital and O&M)

<table>
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<th>Offset Category</th>
<th>Total</th>
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<th>Transportation</th>
<th>Supply</th>
<th>Treatment</th>
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<tbody>
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<td>Property Tax</td>
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<td>IAC</td>
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<td>Interest Earnings</td>
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<td>Twin Oak Reimbursement</td>
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<td>1.02</td>
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<td>-</td>
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<tr>
<td>Misc. Revenue</td>
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<td>1.80</td>
<td>1.37</td>
<td>0.51</td>
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</table>

**Total Offsets**(1) $76.84 $12.27 $32.91 $23.36 $7.95 $0.36

(1) Offsetting revenues rounded and stated in $ millions
### Recommended Alternative

($) in Millions)

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<thead>
<tr>
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<td><strong>Offset Allocation System Capacity Charge</strong></td>
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<tr>
<td></td>
<td>11.11%</td>
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<tr>
<td><strong>Offset Allocation (Capital Only)</strong></td>
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<tr>
<td></td>
<td>10.37%</td>
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<td>29.12%</td>
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<td><strong>Offset Allocation (Capital and O&amp;M)</strong></td>
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<td></td>
<td>16.24%</td>
<td>38.79%</td>
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<td>10.89%</td>
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<td>System Capacity Charge</td>
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<td>Treatment Capacity Charge</td>
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<td>0.74</td>
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<td>PAYGO Earnings</td>
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<td>0.15</td>
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<td><strong>Offsets (Capital and O&amp;M)</strong></td>
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<td>Property Tax</td>
<td>$11.16</td>
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<td>IAC</td>
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<td>11.40</td>
<td>8.61</td>
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<td>Interest Earnings</td>
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<td>1.23</td>
<td>0.93</td>
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<td>0.15</td>
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<tr>
<td>Twin Oak Reimbursement</td>
<td>1.02</td>
<td>1.02</td>
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<td>-</td>
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<tr>
<td>Misc. Revenue</td>
<td>4.43</td>
<td>0.72</td>
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<td>0.48</td>
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<td><strong>Estimate of Total Offsets (1)</strong></td>
<td>$76.84</td>
<td>$11.78</td>
<td>$31.59</td>
<td>$22.35</td>
<td>$7.61</td>
<td>$3.52</td>
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<tr>
<td><strong>Total Offsets for CY 2014 Rates and Charges</strong></td>
<td>$76.84</td>
<td>$12.27</td>
<td>$32.91</td>
<td>$23.36</td>
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<td><strong>Change in Offsets</strong></td>
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<td>($3.16)</td>
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<tr>
<td><strong>Estimated change in 2014 Rates and Charges</strong></td>
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<td>$1.31</td>
<td>$2/AF(2)</td>
<td>$1/AF(2)</td>
<td>($16/AF)(2)</td>
<td></td>
</tr>
</tbody>
</table>

(1) Numbers may not foot due to rounding
(2) Estimated increase/(decrease) in rates

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CY 2014 “All-in” Treated Rate = $1,303/AF
Alternative “All-in” Treated Rate = $1,293/AF
CY 2014 “All-in” Untreated Rate = $1,029/AF
Alternative “All-in” Untreated Rate = $1,035/AF
Member Agency Managers’ Recommendation: Allocate Non-Commodity Revenue to Treatment

- The general consensus of the group is that responding to the issue raised in the 2013 Cost of Service Study and improving the cost of service linkage by recognizing the payments of non-commodity charges by treated water customers requires a revision to the current practice.

Recommendation: Allocate non-commodity revenues to all rate categories based on pro rata expenditures.
Transitional Special Agricultural Water Rate

Presented by: Dana Friehauf, Acting Water Resources Manager
March 2010 – Board Approved Workgroup Recommendations on Revised SAWR

- Maintain storage charge exemption
  - Reliability benefit makes this “insurance program” cost effective to M&I customers

- Discontinue supply rate differential
  - Does not provide cost-competitive M&I water management benefit compared with dry-year transfers
  - Continuation would require annual payments for what prior to 2010 was an infrequent benefit

- Last 5 years call into question the validity of these assumptions
  - Frequency of droughts/allocations and availability/price of transfers
Extension of TSAWR beyond 2015: Background

- TSAWR customers do not pay for QSA or Carlsbad desalination supplies
  - TSAWR pay MWD Tier 1 full service rate
  - Allocations during shortages based on MWD cutback level
    - Water Authority supplies not available to mitigate shortages
    - At least 5% differential between M&I and TSAWR cutback levels

<table>
<thead>
<tr>
<th>Supply Rate Differential – CY 2015</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>SDCWA Melded Supply Rate</td>
<td>$764/AF</td>
</tr>
<tr>
<td>MWD Tier 1 Full Service Rate</td>
<td>$582/AF</td>
</tr>
<tr>
<td>Rate Differential</td>
<td>$182/AF</td>
</tr>
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</table>
Extension of TSAWR beyond 2015: Background (Cont’d)

- Supply differential extended to December 31, 2015
  - Concern over adding firm demand during supply challenges
  - Lack of available transfer water

- Ag demand adds M&I supply from MWD during allocation
  - Higher Ag cutback adds water available to M&I

- Two droughts and MWD allocations in last 5 years
  - Higher Ag cuts 4-5 years out of last 10 years
  - TSAWR is a local drought management action available any year MWD cutbacks experienced
Historical and Projected Program Agricultural Deliveries

Notes:
• Transitional SAWR commenced in January 2009.
• IAWP discontinued at end of CY 2012.
• Projections assume no supply allocations and are based on estimates from the CY 2015 rates and charges analysis.
### Estimated 2016 Financial Costs and Water Supply Benefits

<table>
<thead>
<tr>
<th>Impact at Water Authority Level</th>
<th>Impact at Retail Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional Cost to All In M&amp;I Rate <em>(with and without Proposed Reliability Charge)</em></td>
<td>Percentage Increase to All-In Water Authority Rate <em>(with and without Proposed Reliability Charge)</em></td>
</tr>
<tr>
<td><strong>$15/AF - $20/AF</strong></td>
<td><strong>1-1.5%</strong></td>
</tr>
</tbody>
</table>
Comparison of 2015 Single Year Cost of Drought Management Options To TSAWR

- **Turf Replacement**
  - $1,460 /AF
  - 600 AF in estimated savings

- **Agricultural Spot Transfers**
  - $1,500/AF
  - Quantity depends on availability

- **TSAWR**
  - $1,500/AF
  - 4,600 AF in 20% MWD cutback
  - Cost can increase or decrease with percent of MWD cutback
  - Cost dependent on supply rate differential
TSAWR Program Recommendation

Actions related to extending TSAWR

- Agriculture would be cutback at approximately twice the level of M&I in a potential FY 2016 shortage allocation
- TSAWR deliveries would be excluded from the 5 year rolling average of member agency deliveries paying the potential Reliability Charge
  - Part of estimated cost to M&I for continuation of Program
  - Financial impacts by member agency previously provided through 2040
  - Reliability Charge itself does not add any additional amount to supply rate differential or have any additional impact to M&I customers
TSAWR Program Recommendation

- **Actions related to not extending TSAWR**
  - Firm demand would be added during a potential allocation
    - When benefit paid by M&I being received
  - Discontinuing the rate differential in CY 2016 would occur in the middle of a potential fiscal year shortage allocation
    - Continue without discount to achieve benefit for M&I
    - Reallocate to all member agencies to add 6 months of QSA/Desal water to Ag customers

- **TSAWR stable source of revenue in non cutback years**
  - TSAWR accounts for 8 - 10% of sales by volume
  - Downward pressure on transportation, customer service and treatment rates in non cutback years
Member Agency Managers’ Recommendation:

- Extend the TSAWR for a 5-year period through the adoption of Calendar Year 2020 rates and charges

- Conduct a review of the cost and benefits of the program prior to adoption of Calendar Year 2021 Rates and Charges and report to the Board as part of the rate setting process
Member Agency Managers’ Recommendation: (Cont’d)

- The Board is not required to take specific action on the report for the TSAWR to be considered for approval in the CY 2021 rates and charges
  - No action means program continues
  - Still subject to annual rate setting process
Questions and Discussion
Other Items Discussed By Managers’

- **Annual Revenue Volatility**
  - General consensus that fluctuation in annual revenue were best addressed through reserves
  - Existing RSF Policy would be sufficient to handle the volatility
    - Target is equal to the financial impact of 2.5 years of wet weather or mandatory restrictions

- **Recognition of local supply benefit**
  - Water Authority recognizes local supply benefits through drought allocation incentive
  - Member agencies asked for consideration of a future financial incentive for local supply development
    - Evaluate by MWD team.
    - Discuss ideas with member agencies during FY 2016 and report results to Board.
The Complete Recommendations of the Managers on Fiscal Sustainability are:

- Implement the Supply Reliability Charge alternative and prior to December 31, 2020 staff will provide a comprehensive evaluation of its effectiveness to the Board of Directors.
- Allocate non-commodity revenues to all rate and charge categories and allocate based on current practice of the pro rata share of expenditures.
- Extend the TSAWR program through December 31, 2020, limiting eligibility to existing Board policy, at which time, and in conjunction with the evaluation of the new Supply Reliability Charge, the TSAWR program will be evaluated.
Cost of Service Review and Analysis – If Approved

- Comprehensive set of recommendations submitted to cost of service consultant
  - Recommendations reviewed for:
    - Conformity with cost of service principles
    - Compliance with California legal requirements
  - Consultant will also determine CY 2016 rates and charges

- Report will be presented at the May Board meeting
- Final report filed at the June Board meeting
Next Steps

- **March 26th Board Meeting**
  - Consider for approval the Member Agency Managers’ Recommendations
    - If approved, forward recommendations to cost of service review and analysis to ensure compliance with cost of service principles and California law

- **May 28th Board Meeting**
  - Set Public Hearing on CY 2016 Rates and Charges
    - Includes Independent Cost of Service Study

- **June 25th Board Meeting**
  - Hold Public Hearing
  - Adopt CY 2016 Rates and Charges
    - Accept Independent Cost of Service Study