



● **Board of Directors**
Finance and Insurance Committee

3/8/2022 Board Meeting

9-2

Subject

Review of the applicability of the Metropolitan Water District Act Section 124.5 ad valorem property tax limitation for fiscal years 2022/23 through 2025/26

Executive Summary

Metropolitan has the statutory authority to levy property taxes to pay its expenses pursuant to the Metropolitan Water District Act (MWD Act). MWD Act, § 124. Since its creation, voters in Metropolitan's service area have approved the use of property taxes to pay for Metropolitan's major system investments and improvements, including for the Colorado River Aqueduct (CRA), other improvements, and for Metropolitan's participation in the State Water Project (SWP). More recently in Metropolitan's history, Section 124.5 of the MWD Act was enacted to provide a mechanism to limit Metropolitan's ad valorem property taxes, but it does not apply if the Board of Directors makes the required determination that it is essential to Metropolitan's fiscal integrity to collect property taxes in excess of that limit.

Section 124.5 limits property taxes to the amount needed to pay: (1) Metropolitan's general obligation bonded indebtedness (GO bonds), and (2) Metropolitan's portion of bonds used to finance construction of SWP facilities for the benefit of Metropolitan (Burns-Porter bonds). However, the Section also provides that "the restrictions contained in this Section *do not apply* if the board of directors of the district, following a hearing held to consider that issue, finds that *a tax in excess of these restrictions is essential to the fiscal integrity of the district,*" and written notice is provided to the Legislature in the manner specified therein. (Emphasis added.) The Section 124.5 limitation, if applicable, does not affect the collection of property taxes to pay Metropolitan's general obligation bonds. If applicable, the Section does limit collection of property taxes to pay Metropolitan's State Water Contract (SWC) obligations for the SWP. Since fiscal year (FY) 2013/14, the Board has determined that it was essential to Metropolitan's fiscal integrity to collect property tax revenues in excess of the Section 124.5 limit and has maintained the current 0.0035 percent property tax rate to ensure payment of the SWC obligations in excess of the statutory limit. The rate of 0.0035 percent is the lowest property tax rate ever collected by Metropolitan.

Metropolitan's current budget and rate proposals also assume application of a 0.0035 property tax rate. The proposed budget for FYs 2022/23 and 2023/24 and rates and charges for calendar years (CYs) 2023 and 2024 presented to the Finance and Insurance Committee in February included a projection of approximately \$166 million per year in property tax revenues, which assumes the tax rate remains at 0.0035 percent. The Ten-Year Financial Forecast also uses a 0.0035 percent property tax rate assumption for its projections.

This letter recommends a Section 124.5 determination for the next four fiscal years, which covers a transitional financial and strategic planning period for Metropolitan. During the four-year period, Metropolitan will be completing the 2020 Integrated Resources Plan, continuing with a rate refinement review process, undertaking a long-term financial plan, and addressing Metropolitan's role as it approaches 100 years. Accordingly, the four-year proposed determination provides certainty with regards to property tax revenue assumptions for those processes and better aligns with the inherent volatility of Metropolitan's water revenues under its current rate structure, which spans more than a two-year biennial budget period.

The Board will hold the required public hearing on March 8, 2022, and it will consider whether to make the necessary finding regarding the applicability of Section 124.5 on April 12, 2022, along with its consideration of the proposed biennial budget for FYs 2022/23 and 2023/24, rates for CYs 2023 and 2024, and charges for CY 2023. Notice of the hearing has been published for the public and provided to the Legislature. The public may provide comments and listen to the hearing using the information provided at <https://mwdh2o.legistar.com/Calendar.aspx>.

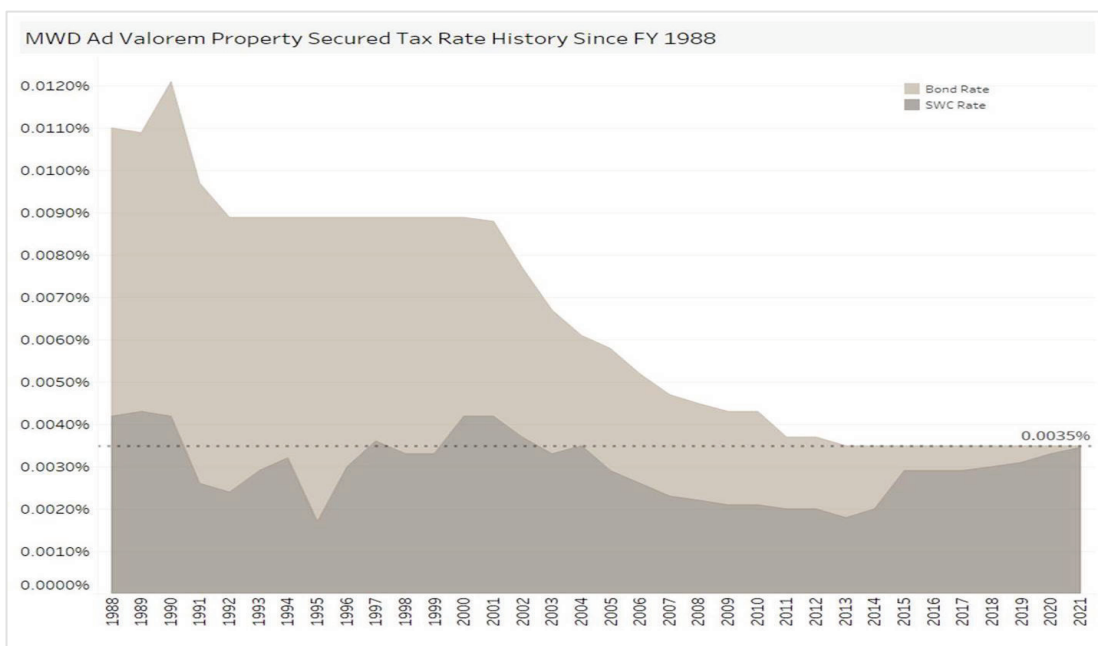
Details

History of Metropolitan’s Property Tax Revenues

The shift in revenue sources from primarily property taxes to primarily water revenues provides a backdrop to Metropolitan’s history. The MWD Act authorizes Metropolitan to “levy and collect taxes on all property within the district for the purposes of carrying on the operations and paying the obligations of the district,” pursuant to Section 124. Prior to 1942, Metropolitan was constructing the CRA and had no water to sell; hence, all revenues came from property taxes approved by the voters for the CRA. In FY 1941/42, when Metropolitan began to sell water, most of Metropolitan’s revenues were still derived from property taxes. In 1960, Metropolitan executed its SWC and the voters approved the collection of property taxes to pay for Metropolitan’s SWC costs. By 1974, 50 percent of Metropolitan’s revenues came from water transactions, with the remainder derived primarily from property taxes.

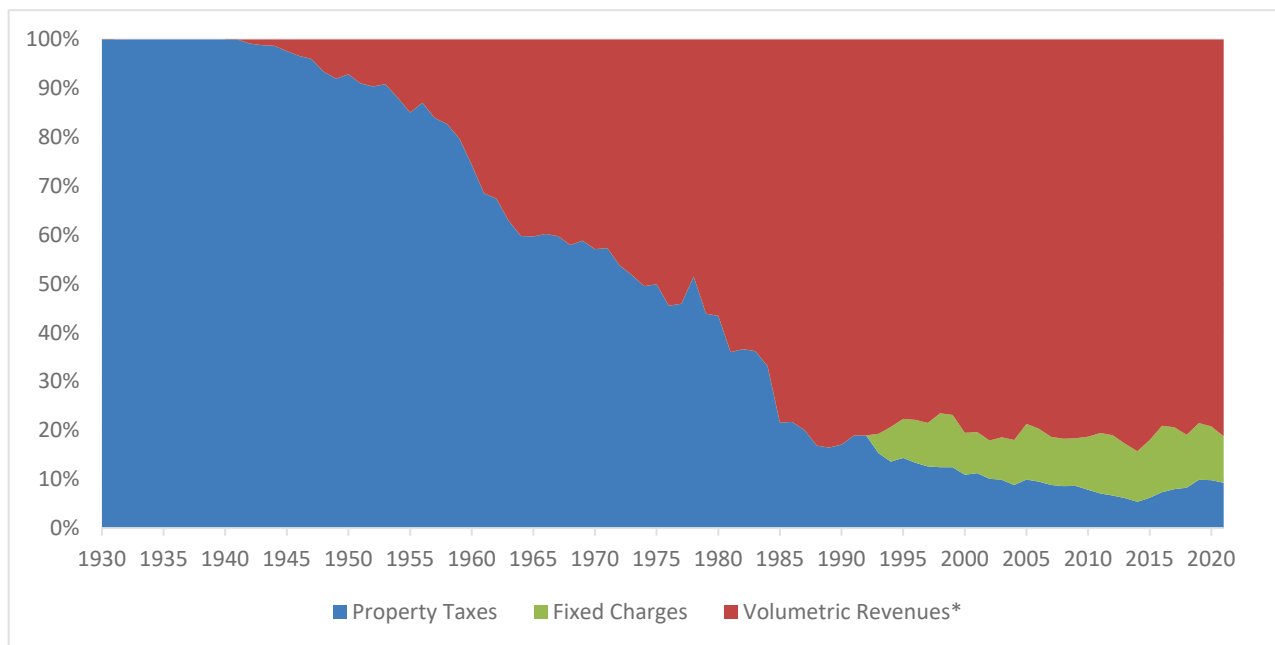
In 1984, the Legislature adopted SB 1445, amending the MWD Act to add Section 124.5, among other sections. Effective FY 1990/91, Section 124.5 limited Metropolitan’s annual property tax levy at the amount needed to pay the total of annual debt service on the GO bonds and Burns-Porter bonds, unless after notice and hearing the Board finds that collecting property tax revenues beyond that limitation is essential to the District’s fiscal integrity. In 1984, when SB 1445 was enacted, Metropolitan collected property taxes at the rate of 0.0237 percent, which resulted in revenues below the Section 124.5 limit at the time. However, as bond indebtedness on GO bonds and Burns-Porter bonds are paid down, the Section 124.5 limit also decreases and reduces the amount of property tax revenues that can be levied. At the same time, SWC costs continue to increase. Figure 1 shows Metropolitan’s history of declining property tax rates.

Figure 1: Historical MWD Ad Valorem Property Tax Rates



Tax levy limits in Section 124.5 accelerated the shift of Metropolitan's revenues away from fixed property taxes to variable revenues. Since FY 2013/14, Metropolitan's Board has adopted a determination that it is essential to fiscal integrity to exceed the Section 124.5 limit and set the property tax rate at 0.0035 percent, approximately 1/7 of the 0.0237 percent rate in place at the time Section 124.5 was passed. In FY 2022/23, property taxes are projected to be about 9 percent of total revenue sources with water revenues from transactions accounting for about 78 percent of total revenues. Total volumetric revenues, which include power sales, interest income and other miscellaneous revenues, are about 82 percent of total revenues. Fixed Charges, which include the Readiness-To-Serve Charge and Capacity Charge, are about 9 percent of total revenues. **Figure 2** shows the history of the revenue source mix since 1930.

Figure 2: Historical Revenue Sources



* Includes water sales, exchanges, and wheeling

Background Regarding State Water Contract Obligations and Voter Approval of Property Taxes

Metropolitan is one of 29 agencies that contract with the State for participation in the SWP. Metropolitan's SWC was the first contract executed, and the prototype for the State Water Contracts that followed, and its terms were validated by the California Supreme Court in *Metropolitan Water Dist. v. Marquardt* (1963) 59 Cal.2d 159. Metropolitan is the largest participant in the SWP in terms of the number of residents in its service area, the allocation of SWP water that it has contracted to potentially receive, and the allocation of SWP infrastructure and power costs. As a result, Metropolitan pays the highest percentage of total annual payments made to the Department of Water Resources of all the agencies with State Water Contracts.

Under the SWC, Metropolitan is obligated to pay allocable portions of the cost of construction of the SWP system and ongoing operating and maintenance costs. Metropolitan is obligated to pay these fixed costs regardless of quantities of water available and received from the project. In contrast, a smaller portion of payments are based on actual deliveries of water received for the costs of power and offsets for credits received. **Approximately 70 percent of Metropolitan's SWC obligations are fixed and unrelated to the quantity of water delivered.**

The ability of State Water Contractors to levy property taxes sufficient to satisfy their SWC obligations was a foundation of the Burns-Porter Act, and a factor relied on by California voters in approving it. *Goodman v. County of Riverside* (1983) 140 Cal.App.3d 900, 905-06; see also, *Alameda County Flood Control v. Department*

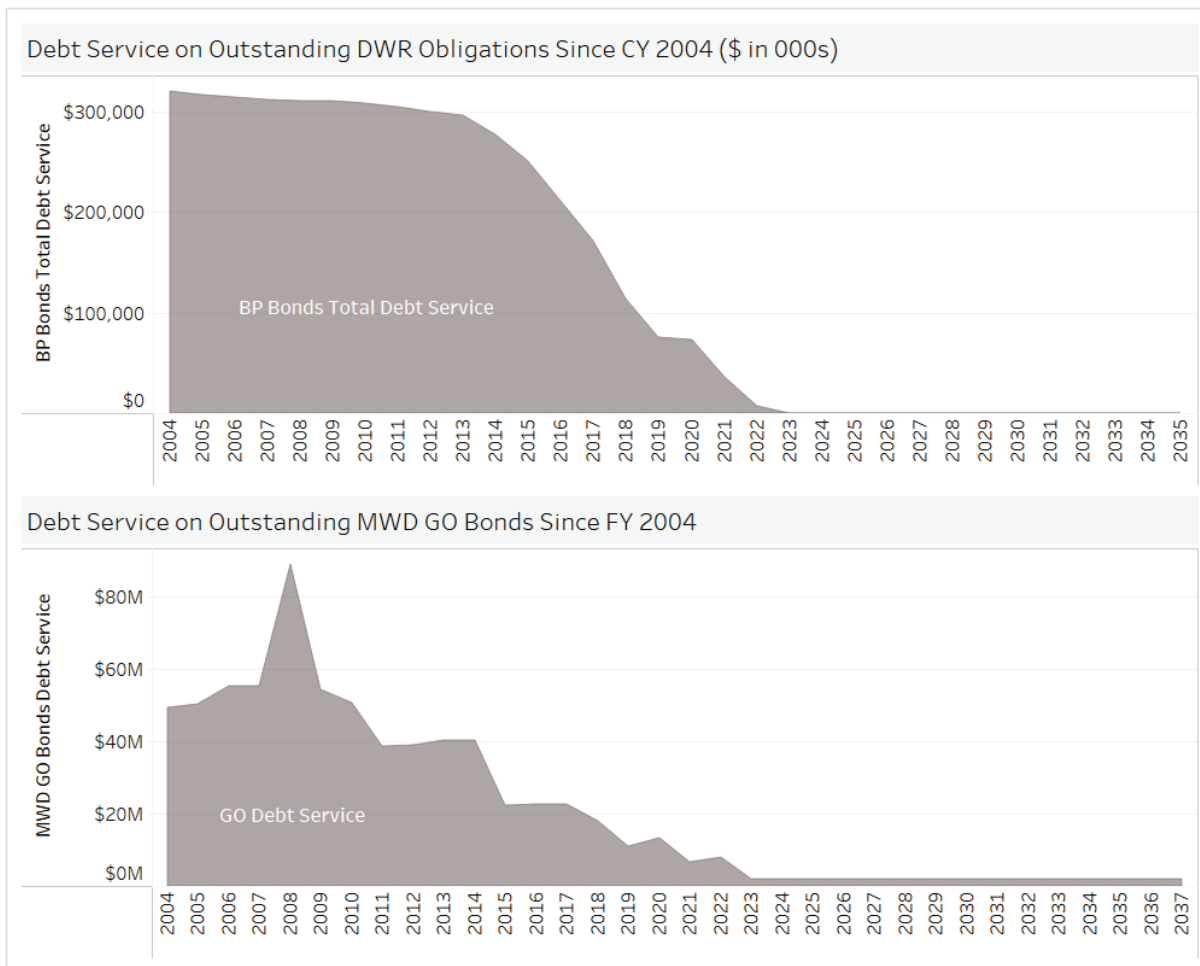
of Water Resources, *Antelope Valley-East Kern Water Agency* (2013) 213 Cal. App. 4th 1163. In approving the Burns-Porter Act, California’s voters approved “an indebtedness in the amount necessary for building, operating, maintaining, and replacing the [State Water] Project, and they intended that the costs were to be met by payments from local agencies with water contracts. Further, the voters necessarily approved the use of local property taxes whenever the boards of directors of the agencies determined such use to be necessary to fund their water contract obligations” *Goodman*, 140 Cal.App.3d at 910. Thus, SWC obligations are voter-approved indebtedness that may be funded by override property taxes (taxes above the one percent general tax limit established by Article XIII A (Proposition 13) of the State constitution).

Many SWP contractors substantially rely on property taxes to satisfy their SWC obligations. Metropolitan is unique in that since FY 1990/91, and unless otherwise determined by the Board, Section 124.5 has reduced its property taxes to a declining balance of its share of the Burns-Porter bonds—which has become an increasingly smaller portion of Metropolitan’s SWC payment obligation.

Review of State Water Project Costs

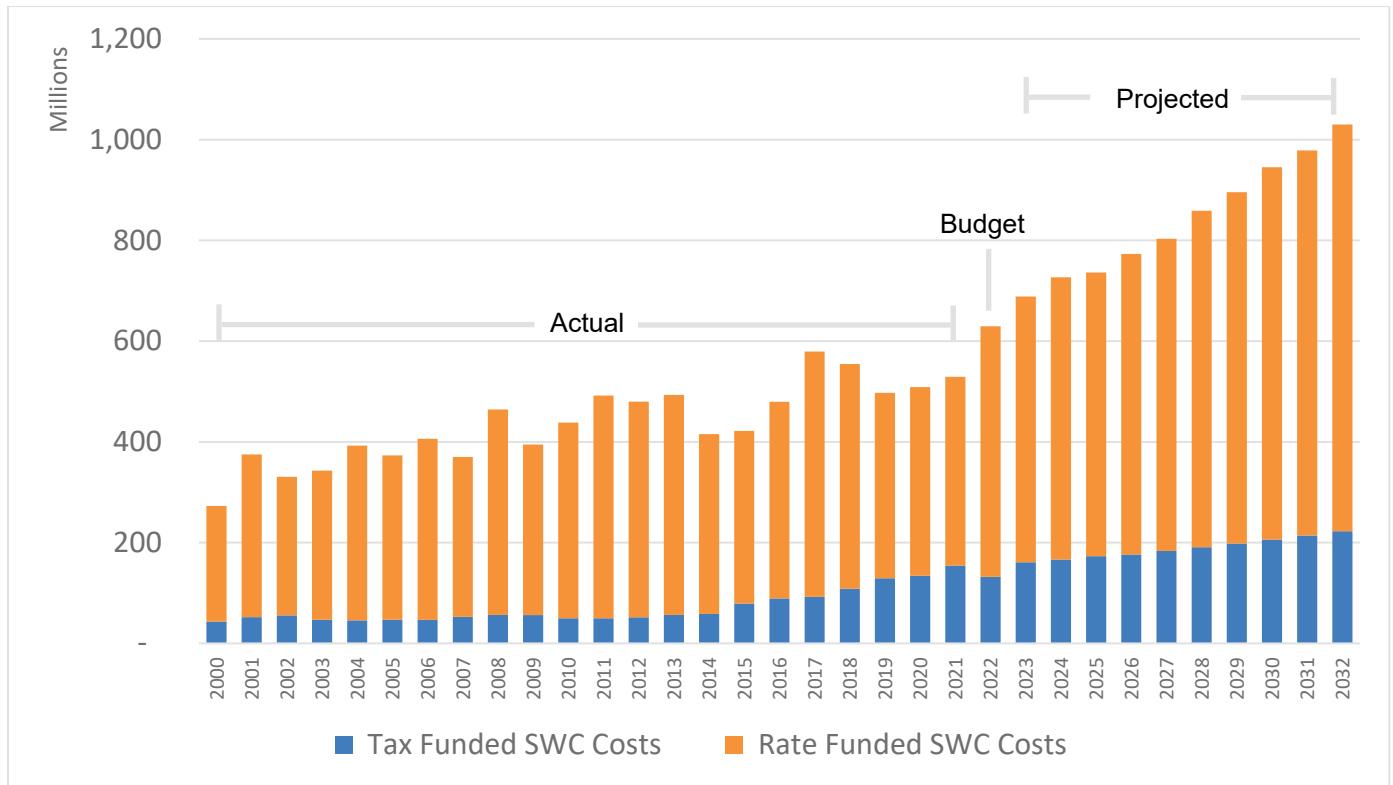
Prior to FY 2013/14, under Section 124.5’s restriction, the property tax rate had decreased steadily in line with the decreasing debt service for the GO bonds and Burns-Porter bonds. The property tax rate would continue to decrease as the GO bonds and Burns-Porter bonds are ultimately paid off; provided the Board does not make a determination that the Section 124.5 limitation would not apply. Since FY 2013/14, the Board has determined that it was essential to Metropolitan’s fiscal integrity to maintain the current 0.0035 percent property tax rate. **Figure 3** shows the declining debt service that is the subject of Section 124.5, shown since 2004.

Figure 3: Debt Service on Outstanding DWR Burns-Porter Bonds and MWD GO Bonds



Conversely, Metropolitan's SWC payment obligations have been increasing and are expected to continue to increase. For example, the State is expecting substantial costs associated with repair and replacement of the 50-year-old SWP infrastructure, such as the Oroville Spillway repair, work necessary to address subsidence damage, and California Aqueduct improvements. **Figure 4** shows the portion of SWC costs paid with property tax revenues, assuming Metropolitan maintains the 0.0035 percent in excess of the Section 124.5 limitation.

Figure 4: State Water Contract Costs



Proposed Budget SWC costs of \$688.7 million in FY 2022/23 and \$726.7 million in FY 2023/24 comprise approximately 35 percent of Metropolitan's annual expenditures and are Metropolitan's single largest cost category. If property taxes are reduced to Section 124.5 limits, in FY 2022/23 the amount of property taxes available to satisfy SWC obligations will only be approximately \$0.6 million, and the proportion of SWC obligations that would be covered would be less than one tenth of 1.0 percent, even though the voters approved use of the property taxes to pay for Metropolitan's SWC obligations.

What is the Meaning of “Essential to Fiscal Integrity” in Section 124.5?

The determination of fiscal integrity is a determination of financial health and strength. Although the Legislature set a limit on property taxes, it left the determination of necessity for fiscal integrity to the discretion of the Board. Section 124.5 does not define the meaning of “essential to fiscal integrity.” Merriam-Webster defines “essential” in many ways, including “of the utmost importance,” and “something necessary, indispensable, or unavoidable.” “Fiscal” simply means it is related to a financial issue. And “integrity” is defined by Merriam-Webster as “an unimpaired condition: soundness,” or “the quality or state of being complete or undivided.” (Definitions taken from www.merriam-webster.com/dictionary.) Accordingly, “essential to fiscal integrity” is reasonably interpreted to mean important or valuable for financial soundness or to financial health/condition. “Essential to fiscal integrity” does not mean an act is necessary to avoid an emergency financial crisis. Nowhere in Section 124.5 does the Legislature reference a need for the existence of a fiscal “emergency.”

In the absence of a statutory definition of the phrase “essential to fiscal integrity,” Metropolitan has looked to financial industry standards and its own financial policies to evaluate whether continuing the current fixed property tax revenues is essential to its fiscal integrity.

Financial Industry Guidance for Evaluating Fiscal Integrity

Credit rating agencies provide criteria for rating debt issued by public agencies based on various financial, demographic, legal and socio-economic factors, among others. Essentially, ratings provide an overview of an agency’s financial health, i.e., fiscal integrity, to assess risk exposure generally and (in this instance) an agency’s ability to repay its debt obligations. In the previous report to the Board on this matter, staff cited Fitch Rating’s U.S. Water and Sewer Rating Criteria, published November 29, 2018. In it, Fitch set forth relevant criteria that provided guidance on this matter. Whereas Fitch was more explicit with some of its recommended targets—specifically the proportion of fixed revenue to total revenue, today it operates under an updated set of criteria published March 18, 2021, designed to give it more flexibility in evaluating the unique circumstances of public agencies.

Instead of stating an explicit target of 30 percent or more of fixed revenue to total revenue, Fitch now more broadly describes (and relies on) “revenue defensibility” as key elements to assessing the financial health of a public agency in the water and sewer sector. Fitch’s rating process includes an analysis of a utility’s financial flexibility under certain stress-test scenarios over a five-year horizon.

“[P]articular aspects of [Fitch’s] criteria may have applicability depending on the type of operations and related risks of a given utility.” However, one criterion that stands out is the significance fixed revenue (such as Metropolitan’s property taxes) has for purposes of evaluating an agency’s fiscal health.

Fitch Criteria: Revenue Defensibility entails “...an assessment of a utility’s exposure to demand volatility and the flexibility within its rate-setting framework to recover costs of service and maintain operating profitability.”

- “In its assessment of revenue defensibility, Fitch analyzes the historical patterns of revenue performance through economic and investment cycles, as well as growth trends over time, considering the **utility’s revenue mix**, customer characteristics, contractual framework, the economic underpinnings of its service area, and its capability to preserve revenue generation through rate increases or other measures.” (Page 4.)
- “Fitch may also determine the rate flexibility assessment to be higher...if characteristics are present that would tend to...lead to overall revenue stability...**utilities who collect a significant amount of revenues from fixed charges, including revenues from property taxes or assessments, etc., may be assessed higher...given the nature of this income would...ensure greater revenue stability...**” (Page 7.)
- “Fitch evaluates a utility’s vulnerability to sudden drops in demand and the impact on revenue defensibility...” (Page 7.)

Applying Fitch’s revised criteria for fixed revenues to Metropolitan supports that maintaining property tax revenues (a fixed revenue source) is essential to Metropolitan’s fiscal integrity. Metropolitan is a voluntary cooperative with varying collective demands from its member agencies based on, among other things, hydrological conditions, availability of local resources, and availability of Metropolitan’s own water system and resources. Accordingly, fixed revenue sources help Metropolitan respond to such demand volatility. Additionally, SWP capital costs are consistently growing and are projected to continue to grow. Maintaining a fixed revenue source for that purpose enhances Metropolitan’s ability to manage growing SWP capital and other costs. Moreover, property taxes represent nearly 50 percent of Metropolitan’s fixed revenues (and 8 percent of total revenues). All fixed revenue sources for Metropolitan represent only about 18 percent of total revenues, making property tax revenues essential to Metropolitan’s fiscal integrity and supportive of its current high credit ratings, in accordance with Fitch’s stated importance of revenue defensibility.

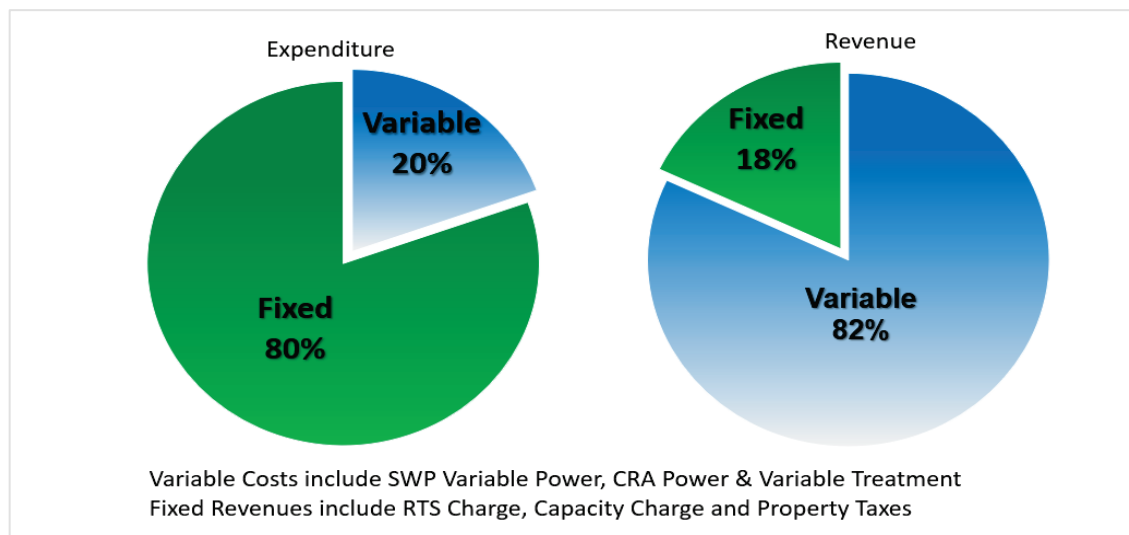
Metropolitan Financial Policies Provide Guidance for Evaluating Fiscal Integrity

Metropolitan's Board has adopted financial policies that are also relevant to determining its fiscal integrity. The Metropolitan Water District Administrative Code provides a fixed-charge coverage ratio of 1.2 times and a minimum and target for reserves at Section 5202. The Board has also adopted a revenue bond coverage target of 2.0 times. A reduction in fixed charges increases dependence on variable revenue, thereby increasing the likelihood of not meeting Metropolitan's financial policies during periods of low water transactions.

Limiting Property Taxes Pursuant to Section 124.5 Would Reduce Metropolitan's Fixed Revenues

Transfer of revenue from a fixed source to a volumetric rate or charge does not strengthen Metropolitan's financial integrity. Metropolitan's expenditures consist mostly of fixed costs (80 percent), while its fixed revenue sources make up only about 18 percent of total revenue. If the Section 124.5 limit were implemented, Metropolitan would lose about \$163 million in property tax revenues annually, or about half of its fixed revenues.

Figure 5: Fixed vs. Variable Components of Metropolitan Revenues and Expenditures – Proposed FY 2022/23 Budget



Current hydrologic conditions are less predictable and more extreme as our climate changes and, therefore, volumetric revenues have become even more unpredictable. This increased volatility in water transactions further supports a finding that maintaining fixed property tax revenues is essential to increasing revenue stability, which is key to fiscal integrity. Without Metropolitan's property tax and fixed charges, additional volumetric rates and/or higher volumetric rates would be required to cover total expenses.

Summary of Review

Continuing an Ad Valorem Property Tax Rate at the Existing Rate is Essential to Fiscal Integrity

Considering the significance of achieving a financially healthy mix between variable and fixed revenue sources, it is important that the Board maintain fixed sources in line with growing increased SWP fixed costs. Service area voters approved property tax levies for the purpose of paying Metropolitan's SWC obligations, which are projected to be approximately \$699 million and \$781 million for FYs 2022/23 and 2023/24, respectively. If the property tax rate continues at its current 0.0035 percent rate, property tax revenue would pay about 22 percent of that SWC obligation. If the property tax rate were reduced to the Section 124.5 limits, property tax revenue would pay less than 2 percent of the SWC obligation. Continuing the current tax rate of 0.0035 significantly contributes to Metropolitan's long-term fiscal health and stability. It maintains diversity in fixed revenue sources, balancing

the mechanisms for funding the immediate and anticipated obligations of the SWC. It also helps maintain Metropolitan's creditworthiness as measured by various national credit rating agencies through their established methodologies. Maintaining Metropolitan's fixed revenue sources also provides the Board with flexibility as it funds Metropolitan's SWC obligations and other obligations, and is in line with credit rating criteria.

Maintenance of fixed revenues also supports Metropolitan's financial policies. Metropolitan has adopted a set of financial policies, including revenue bond coverage and fixed-charge coverage targets, capital paid for from revenues (Pay-As-You-Go, or PAYGO), and reserve policies that support Metropolitan's strong credit ratings. An important element of these financial policies is a diversity of revenue sources and fixed revenue sources. Utilities funded primarily from variable volumetric charges face economic risks because volumes of deliveries are subject to declines in revenue based on hydrology and consumption changes.

Property taxes are also important to fiscal health because they help Metropolitan equitably distribute the costs of Metropolitan's services. As a wholesale water agency, Metropolitan's customers are its 26 member agencies. Each member agency pays volumetric rates based on the amount of water Metropolitan sells and delivers to it. In contrast, property taxes are levied directly on residents and businesses that are property owners within Metropolitan's service area. All property owners within Metropolitan's service area benefit from the water system that allows water to be sold and delivered in Southern California, thereby enhancing those properties. Property taxes ensure that residences and businesses pay a modest share of costs of maintaining and improving the Metropolitan water delivery system.

Four-Year Determination of the Applicability of the MWD Act Section 124.5 limitation is Appropriate

Staff proposes that a four-year determination of the applicability of Section 124.5 is appropriate given (1) the flexibility required to manage Metropolitan's finances during current drought conditions, (2) the time required to complete ongoing financial and strategic planning efforts, (3) inherent volatility found in Metropolitan's financial profile, and (4) the scope of financial planning timeframes.

First, Metropolitan is currently managing an ongoing drought emergency, during which it is essential to maintain financial flexibility to ensure the reliability of Metropolitan's services. It is essential that Metropolitan maintain its dedicated fixed revenue sources to pay the SWC costs the voters approved and intended for Metropolitan to pay with property taxes, thereby freeing up volumetric revenues to address current emergency drought conditions. Second, Metropolitan is currently undergoing and commencing various financial and strategic planning processes and it is appropriate to fix the Section 124.5 determination during this timeframe required to complete and implement those processes. For example, Metropolitan is undergoing a rate refinement review process that is likely to span longer than the next biennial budget cycle, and in that process, the Board will consider whether "Property Tax Alternatives" should be incorporated in Metropolitan's rate structure. Similarly, the ten-year term for the member agencies' Purchase Orders and the applicability of the Tier 2 Supply rate ends December 31, 2024. The Board will need to consider whether to adopt any alternative to the Purchase Order structure. Accordingly, maintaining a set determination through the time period of these significant reviews provides more financial certainty to Metropolitan investors. The four-year term will also provide the Board with time to consider whether Section 124.5 continues to be necessary or appropriate given updated circumstances and following any updates to Metropolitan's rate structure. The additional time of this determination also will allow the Board to discuss whether to seek legislative amendment of Section 124.5 to establish a different standard than what is currently required.

Third, the recommended four-year timeframe of this determination better aligns with the inherent volatility of Metropolitan's water revenues, which spans more than a two-year biennial budget period. Fourth, the timeframe of a four-year determination is within the scope of typical time horizons used in the financial sector for various projections and analysis. For example, three- to five-year business plans, five-year or greater coverage projections for revenue bond disclosures, Fitch's rating stress-test scenarios covering a five-year horizon, and in fact, Metropolitan's own ten-year financial forecast all support the reasonableness of the timeframe of this proposed determination.

Conclusion and Next Steps

A determination that continued collection of fixed property tax revenues in excess of the Section 124.5 limit for FYs 22/23-25/26 is supported by the information and analysis provided herein, as well as additional supporting information available at <https://www.mwdh2o.com/who-we-are/budget-finance/property-tax-rate-for-fy-202021/>, which includes information on past determinations and the currently proposed determination.

The Board will hold a **public hearing on March 8, 2022**, to receive public comments on the applicability of Section 124.5. At its regular April meeting on **April 12, 2022**, the Board will determine whether it is essential to fiscal integrity to continue to collect property taxes in excess of the Section 124.5 limit for FYs 2022/23 through 2025/26. If it makes such a finding, Section 124.5 will not apply in that timeframe. **In August of each year, the Board may then set the property tax rate for the appropriate fiscal year in excess of the Section 124.5 limit or at any rate below the 124.5 limit. The determination does not require the Board to set any particular tax rate.** However, the proposed FYs 2022/23 and 2023/24 proposed budget and CY 2023 and 2024 rates and charges contain an assumption that the property tax rate will be continued at 0.0035 percent.

Policy

Metropolitan Water District Act Section 124: Taxes, Levy and Limitation

Metropolitan Water District Act Section 124.5: Ad Valorem Tax Limitation

Metropolitan Water District Act Section 130: General Powers to Provide Water Services

Metropolitan Water District Act Section 133: Fixing of Water Rates

Metropolitan Water District Act Section 134: Adequacy of Water Rates; Uniformity of Rates Metropolitan Water

District Act Section 134.5: Water Standby or Availability of Service Charge

Metropolitan Water District Administrative Code Section 4301: Cost of Service and Revenue Requirement

Metropolitan Water District Administrative Code Section 4304: Apportionment of Revenues and Setting of Water Rates

Metropolitan Water District Administrative Code Section 5107: Biennial Budget Process

Metropolitan Water District Administrative Code Section 5109: Capital Financing

Metropolitan Water District Administrative Code Section 5112: State Water Contract Payments

Metropolitan Water District Administrative Code Section 5200(b): Funds Established

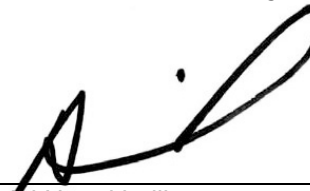
Fiscal Impact

If the Section 124.5 limitation applies and property tax revenues are reduced, revenue requirements from rates and charges will increase.



Katano Kasaine
Assistant General Manager/CFO

2/25/2022
Date



Adel Hagekhalil
General Manager

2/25/2022
Date