MEMORANDUM

EUGENE WATER & ELECTRIC BOARD

Rely on us.

TO: Commissioners Schlossberg, Brown, Carlson, Barofsky, and McRae

FROM: Deborah Hart, CFO; Adam Rue, Fiscal Services Supervisor; and Alicia Voorhees and Ben Sachdeva, Senior Financial Analysts

DATE: October 1, 2021

SUBJECT: 2022 Draft Budgets, Long-Term Financial Plans Update, and Price Proposal Overview

OBJECTIVE: Direction on 2022 Budget and Price Changes

Issue

Board Policy SD6 and Oregon Statutes require that staff annually prepare Electric and Water Utility balanced budgets for Board approval by the end of the preceding calendar year. The foundation of the Electric and Water Utilities' budgets are the long-term financial plans (LTFP), which help ensure that the budgets approved provide long-term financial stability for both utilities and EWEB's strategic plan, which drives organizational initiatives and objectives. Staff has prepared draft 2022 budgets and updated LTFPs for the Board's consideration.

Based on Board direction provided at the October 5th meeting, staff will develop budgets and price proposals for consideration at the November 2nd Board meeting and approval at the December 7th meeting.

Background

In recent years, actions have been taken that have improved both the Water and Electric Utilities' financial resiliency and maintain low rates. Those efforts provided both Utilities with much needed financial headroom in challenging economic times, as businesses, residential customers, and government agencies all faced financial pressures related to the pandemic and high levels of unemployment. Recent efforts to reduce pension costs, refinance debt, and lower operating costs have allowed both Utilities to increase capital investment without an increase in overall customer rates.

After five years of no overall rate increase for either utility, both utilities will be requesting approval of increases in the overall revenue requirements. The compound annual CPI rate for the five years EWEB didn't increase overall rates was 2.2% annually, or 11.1%. EWEB was able to forego overall rate increases while facing these inflationary pressures, as well as BPA cost increases, and lowered demand related to stressed economic conditions. During this time EWEB was able to maintain funding for limited income programs, conservation, and infrastructure investments.

EWEB annually prepares organizational budgets and uses this information for each Utility's Cost of Service Analysis (COSA). The results of this analysis can be recommendations to modify pricing among or within customer classes for retail water and power supply service. The COSA will be presented at the November board meeting.

Discussion

A primary focus for 2022 and beyond continues to be updating infrastructure that supports EWEB's strategic direction in *Improving Resiliency* and *Fostering Customer Confidence*, as well as the core values of Safety, Reliability, Responsibility and Community. The current financial plans incorporate the level of capital spending, recommended at the July 7th Board meeting, which will support these values and organizational priorities.

The July Integrated Capital and Financial Plan provided an update of the strategic and operational priorities and the capital plans required to meet those objectives. This included an overview of the assumptions and the financial and rate impacts of those decisions. The plan includes funding for key strategic priorities, such as AMI, Second Source, and transmission and distribution system enhancement to the electric system, as well as compulsory and risk-based projects. Finally, both the Holiday Farm fire and COVID-19 have challenged management to better understand which investments today would improve EWEB's resiliency in providing drinking water and electricity to the community. Any further direction on capital spending, would be incorporated into plans going forward.

Overarching Forecast Assumptions and Outcomes

The assumptions used in creating forecasts and budgets influence the results. The following assumptions have been used in developing the current forecasts and are anticipated to be used in creating the 2022 budget. Utility specific assumptions are noted on the Attachments.

At the July Meeting, the Board directed staff to prepare the draft 2022 budgets based on the assumptions presented. Since July, the following assumptions have been incorporated into the 2022 base year:

Both Utilities

- Conservative revenue and uncollectible assumptions related to COVID-19 and associated economic conditions
- Capital improvement plans generally as presented in July
- Labor Cost Escalation – fully loaded costs are indexed to a combination of inflation factors and expected labor market comparators and benefits costs escalations
- Non-Labor O&M Escalation is 2.0%
- Updated direct labor and overhead budgeted shifts due to capital
- Updated reserves, bond, and rate funding assumptions for CIP

Electric

As drafted, the Electric Utility LTFP indicates an overall average revenue requirement increase of 3.25% in 2022. This will be the first increase in six years. The Electric LTFP outcome is included in Attachment 1. With the price assumptions noted, financial metrics are within Board targets for all years of the plan.

Water

As drafted, the Water Utility LTFP indicates an overall average revenue requirement increase of 4.0% in 2022. The water utility imposed a temporary watershed recovery fee in July of 2021 and prior to that fee implementation, water rates had not increased in the previous five years. All Board approved financial metrics remain within target across the ten-year plan. The Water LTFP outcome is included in Attachment 2.

Changes since July Financial Plan update to Board

Since July, the financial plans have been updated to reflect a variety of changes to both utilities:

- Reflect a base year of 2022 preliminary budget instead of 2021 budget
- Updated labor costs and FTE trajectory
- Revised reserves balances to reflect to date 2021 balances
- Modified funding of capital based on revised reserves, rate funded, and bond funding assumptions
- Updated revenue forecasts

In July the Electric Utility was anticipating an increase of 4.25% in 2022 and a compound growth rate of 28.18%. The current projections are 3.25% and 30.67% respectively. Although the BPA pass-thru was lower than expected, the benefit of that change was offset by an error in the first five years of the hydro assumption, which was discovered and corrected in the budget review process.

In July the Water Utility was anticipating an increase of 9% in 2022 and a compound growth rate of 60.77%. The current projections are 4% and 56.86% respectively. The lower increase in 2022 is due to a change in timing of increases to better align with the construction of a second treatment plant, with increases generally deferred to later years. Timing of borrowing and fine tuning of overhead assumptions accounts for the reduction over the 10-year period.

2022 Budgets

Draft budgets were developed in alignment with EWEB's strategic priorities and total $389 million for the water and electric utilities. Some of the high priority capital projects include resiliency work, advance metering and other modernization upgrades, as well as continued Carmen-Smith relicensing work.

The total draft budget is $57.8 million (17.5%) higher than 2021. The increase is due to the following changes:

- Electric Utility Purchased Power cost is $20.8 million higher than 2021 due to higher budgeted volumes and market prices, which impacted both purchased power and wholesale revenue
- All Other Electric O&M is $17.6 million higher than 2021. The primary drivers include technology modernization, higher generation costs for dam safety and operations, and higher transmission and distribution costs
- Water Capital cost is $8.0 million higher
- Water O&M is $4.3 million higher due to Watershed Protection investments (later added to 2021 budget through budget amendment) and technology modernization
- Electric Capital cost is $3.7 million higher
- Higher Electric debt service of $1.4 million

Total budgets are higher in 2022 as compared to 2021 and therefore an increase in the overall revenue requirement is required for both utilities. As a public utility, EWEB sets pricing based on the cost to serve each customer class. At the November Board meeting, staff will present the results of the cost-of-service analysis which may result in recommended price changes within customer classes.

Inflationary pressures
The COVID-19 Pandemic has created supply chain disruptions that, for some goods, resulted in significant inflationary pressure. Federal Stimulus funding driving up demand, layered on top of reductions in manufacturing, delays in shipping, and freight container shortages, have pushed up prices for some materials. EWEB's financial experts however do not believe that this will persist beyond the next two or three quarters[1]. They cite circumstances such as low population growth, low savings rates, and high national debt which historically do not support persistent high levels of inflation. The Federal Reserve forecasts[2] inflation of 3.4% in 2021 but moderating back to 2.1% and 2.2% in 2022 and 2023, respectively, before returning to its target rate of 2.0% for longer term projections. The State of Oregon is projecting a similar trajectory[3], with higher numbers for 2021 and then falling in subsequent years.

However, should EWEB experience inflation of 5% in non-labor O&M and Capital over the next two years, it would put pressure on the plans. Unmitigated, it would result in a 5% rate increase for Water and a 2% rate increase for Electric over the 10-year plan. The CPI impact was applied to non-labor O&M and excludes power costs, which reduced the rate impact for the Electric Utility.

As a part of EWEB's normal planning process, the following conservative assumptions are already included in the forecast:

- Conservative revenue assumptions of
    - 95% of historical 5-year average consumption for Water, resulting in a contribution margin risk tolerance of approximately $1 million per year for the first five years
    - 90% of expected surplus hydro for Electric, resulting in a contribution margin risk tolerance of approximately $8 million per year for the first five years
    - 2% reduced consumption for Electric to account for continued economic impacts of COVID19, resulting in an additional $1.5 million contribution margin in conservatism
    - Higher uncollectible expense than 2020 for both utilities
- 3% inflation in capital plan, and a contingency is included on a project-by-project basis based on the specific nature and risks for the project
- 5% interest rates on future borrowing
- Continued above CPI labor-benefits assumptions and below historical vacancies

If the conservative assumptions are not sufficient to absorb the additional inflation, EWEB can "turn the dials", through timing and scope of capital investments, adjustments to program offerings, or changes in service levels. The Electric utility impact of the higher CPI assumption for non-labor O&M and Capital is $34 million and $17 million for the Water Utility, over the 10-year period. Corresponding reductions in expenditures or a combination of rate increases, and reduced expenditures could be used to mitigate the impacts of unanticipated inflation.

Recommendation
Management recommends the Board direct staff to prepare the 2022 proposed budgets using the assumptions set forth in this document.

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1 Dellis, D. (2021, September 20). *2022 US Inflation Outlook,* Piper Sandler Financial Strategies
2 https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20210616.htm
3 https://www.oregon.gov/das/OEA/Documents/forecast0921.pdf

Requested Board Action

Management is not requesting Board action at the October 5th meeting; however, staff is requesting that the Board provide direction on the assumptions included in the draft budget. In addition, staff is requesting direction on investment levels for future capital plans. At the November 2nd Board meeting, Management will present the budgets and price change proposals which are scheduled to be approved at the December 7th Board meeting.

Attachment 1 - Summary of Electric LTFP Price Assumptions and Outcomes
Attachment 2 - Summary of Water LTFP Price Assumptions and Outcomes

Attachment 1

Summary of Electric LTFP Revenue Requirement Assumptions and Outcomes (000's omitted)

Yellow = within 10% of target

Red = below target

Key Metrics	Current Target	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
Reserves and Cash	$85,720	$102,000	$102,000	$102,000	$100,000	$108,000	$107,000	$120,000	$129,000	$131,000	$119,000
Debt Service Coverage Ratio	1.75	2.07	1.79	1.79	1.78	2.41	2.08	2.21	2.01	1.75	1.75
Days Cash	>150 Days	156	174	172	161	177	173	194	202	196	175
Bond Funding			$82M			$58M			$39M		

Revenue Requirement Assumptions:

Price Schedule		2022	2023	2024	2025	2026	2027	2028	2029	2030	
General Rate Increase		2.75%	4.50%	2.25%	5.00%		2.00%			0.25%	
BPA Increase		0.50%		2.50%		2.50%		2.50%		2.50%	
Average overall price impact	**30.67%**	**3.25%**	**4.50%**	**4.75%**	**5.00%**	**2.50%**	**2.00%**	**2.50%**	**0.00%**	**2.75%**	**0.00%**

Key Assumptions

- Retail load approximately 2.3 million MWh's, roughly 2% higher than 2021 budget, but still below 2020 by 4% due to reduced commercial demand and large industrial customer departure
- Contribution margin risk tolerance of $8.4 million which represents 90% generation or a 11.5% load reduction
- Similar contribution margin risk tolerance through 2026, expected conditions 2027-2031
- BPA rate increase of 1% assumed in October 2021 and 6% assumed in October 2023, 2025, 2027, and 2029, which translates to 0.5% and 2.5%, respectively, for EWEB customer-owners.
- $51/MWh melded mid-market price curve in 2022 decreasing to $47/MWh in 2031
- Environmental Commodities represent roughly $3.0 million of wholesale revenue
- Leaburg generation revenue not included in the financial plan through 2027, pending future Board decision on the facility
- Use of $19.2 million of Rate Stabilization Reserve funds for capital work starting in 2022
- $1.0 million per year contribution to meter replacement reserve starting 2021 based on 12-year estimated life and the funds begin to draw down in 2027, at which point we no longer contribute to the fund

Attachment 2

Summary of Water LTFP Revenue Requirement Assumptions and Outcomes (000's omitted)

Yellow = within 10% of target

Red = below target

Key Metrics	Current Target	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
Reserves & Cash	$12,700	$27,900	$29,800	$34,500	$28,700	$23,700	$23,100	$22,200	$18,700	$15,500	$13,500
AWS Reserve Balance		$4,400	$2,800	$0	$0	$0	$0	$0	$0	$0	$0
AMI Reserve		$0	$0	$300	$800	$1,400	$2,000	$2,600	$3,100	$3,700	$4,300
Total Cash Reserves	$12,700	$32,300	$32,600	$34,800	$29,500	$25,100	$25,100	$24,800	$21,800	$19,200	$17,800

Bond Funding			$45M			$85MM			$20M		
DSC	2.00-2.50	3.31	2.94	3.31	3.63	2.06	2.12	2.14	2.16	2.21	2.13
Days Cash	> 150 days	446	484	466	407	340	325	298	251	213	190
Average impact resulting from change in revenue requirement	56.86%	4.00%	9.00%	12.00%	3.00%	3.00%	3.00%	5.00%	3.50%	2.00%	2.00%

Key Assumptions

- Consumption of approximately 7.7 million kgal.
- Contribution margin risk tolerance of $1 million, which represents (95%) of 5-year average consumption.
- Annual revenue requirement without second sources increases 35.53%, compounded over the next 10 years.
- Annual contributions to AMI reserve begin in 2024 and are based on 20-year estimated life
- $1.5 million System Development Charge reserve draw for debt service payments in 2022
- Rate stabilization Fund draws starting in 2027 through 2031 of $10.5 million over the plan
- Includes watershed recovery fee funding and expenditure