FINAL REPORT

City of San Luis Obispo

Review of 2022 Base Year Rate Adjustment

Submitted electronically: March 28, 2022

R3 CONSULTING GROUP, INC.

RESOURCES · RESPECT · RESPONSIBILITY

March 28, 2022

Ms. Jordan Lane
Solid Waste and Recycling Coordinator
Public Utilities
879 Morro, San Luis Obispo, CA 93401
submitted via email: jlane@slocity.org

SUBJECT: Review of San Luis Garbage Company's 2022 Base Year Rate Application – Final Report

Dear Ms. Lane,

R3 Consulting Group (R3) is engaged by the City of San Luis Obispo (City) to review the 2022 Base Year Rate Applications of its franchised hauler, San Luis Garbage Company (SLG). This report presents the results of R3's review the revised 2022 Base Year rate adjustment for SLG.

SLG's original 2020 Base Year Rate Application calculated a net shortfall in revenues for 2022 of approximately ***$2,080,000***, which equates to a rate increase of **18.71%**. Subsequent to completion of the review, the Rate Application was revised to reflect a rate increase of **17.75%,** based on a revised revenue shortfall of approximately ***$1,820,700***.

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We appreciate the opportunity to be of service to the City and would like to thank SLG's staff for their support during the review. Staff were very responsive and provided us with requested information in a timely fashion.

Sincerely,

Jordan Muratsuchi | *Sr. Project Analyst*
R3 Consulting Group, Inc.
916.655.2104 | jmuratsuchi@r3cgi.com

Garth Schultz | *Principal*
R3 Consulting Group, Inc.
510.292.0853 | gschultz@r3cgi.com

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1. INTRODUCTION

Background

Service Areas

The City has exclusive franchise agreements with SLG to collect and remove for disposal and recycling, residential and commercial solid waste and recyclable materials, which expire in 2025, with the City's option to extend up to three years. The City has a separate agreement with SLG for the collection and processing of organic waste at the Kompogas Facility, which expires 20 years after commencement of facility operation.

In addition to the City, SLG also services accounts in unincorporated San Luis Obispo County. SLG's parent company, Waste Connections, services multiple franchise regions with individual agreements.

Overview of Rate Setting Process

Per Article 9 of the City's franchise agreement (Agreement) with SLG, the "Franchisee" (SLG) shall submit to applications to the City for rate review annually, which shall be in accordance with the procedures described in the "City of San Luis Obispo Rate Setting Process and Methodology Manual for Integrated Solid Waste Management Rates" (Rate Manual), except as that may be modified by the City from time to time.

That methodology primarily involves two distinct rate setting methodologies:

- Interim Year Rate Setting Process; and
- Base Year Rate Setting Process.

Base year rate adjustments occur every three (3) years with indexed based rate adjustments used to set the rates for the two (2) years between rate adjustments.

The City and SLG both recognize that updates to the Rate Setting Manual, established in 1994, are warranted to reflect modern industry standard practices and a changing regulatory environment.

Base Year Rate Setting Process

For the upcoming rate year (January 1, 2022 - December 31, 2022) the current rates are to be adjusted based on the Base Year Rate Setting Process.

With the Base Year Rate Application, the franchised hauler submits financial statements for the previously completed fiscal year, which serve as the base documents for the Rate Application.

The Base Year Rate Application is based on three years of data:

- Actual results for the most recently completed year (2020), which are based on the audited financial statements;
- Projected results for the current year (2021), which are to be based on year-to-date information available at the time the application is submitted; and
- Projected results for the next year (2022 - the Base Year).

Rates are established for each Base Year based on the hauler's projected revenue requirement.

The revenue requirement is defined as the sum of the following:

- Allowed costs;
- Allowable operating profit; and
- Pass through costs.

Scope of Analysis

The review of the Base Year Rate Application included but was not limited to the following:

- Reviewed and documented the prior 2018 Base Year Rate Application adjustments, and their potential application to the 2022 Base Year Rate Application;
- Reviewed the 2022 Base Year Rate Application for consistency with the Rate Setting Manual Methodology;
- Reviewed the 2022 Base Year Rate Application for mathematical accuracy;
- Reviewed SLG's 2019 and 2020 audited financial statements;
- Reviewed 2021 and 2022 projected revenues and expenses for reasonableness, including general consistency with changes in reported revenues, accounts, and tonnages;
- Reviewed SLG's survey of rates in neighboring communities.

2. REVIEW OF RATE APPLICATION

Allowable Operating Ratio Costs

Direct Labor

SLG projected a 6.98% increase in Direct Labor costs for 2022 as compared to 2021 (a 7.92% increase projected in 2022 compared to 2020). SLG attributed the increased cost from 2020 to 2021 to several factors including the need for additional staff as well as increased competition for employees, stating that they are finding it difficult to retain drivers. SLG reported that multiple drivers have left the company in recent years, some of whom have joined other municipalities and others who left California entirely citing high living expenses.

SLG believes that the underlying reason for losing employees is low wages and benefits. Additionally, SLG specifically noted that competing with public pension benefits has been difficult. SLG offers a 401k retirement plan however they note that it's not as desirable as a public pension unless additional funds can be used to offset the amount that employees are paying into the 401k. This is opposed to a public pension which is fully provided for.

Assessment

SLG's requested a 6.98% increase in total direct labor in 2022 compared to 2021. R3 understands there is a national driver shortage across the solid waste industry, leading to high competition in most areas. Furthermore, due to the effects of the COVID-19 pandemic the labor market as a whole is seeing high demand for employees and as a result, an overall increase in wages.

R3 concurs that increased competition for solid waste employees is real and that an increase to SLG's labor rates may be reasonable in light of that reality. SLG provided limited data for comparison. R3 suggested an alternative and justifiable adjustment method using standard labor data from the Bureau of Labor Statistics (BLS). R3 suggested an overall increase to Direct Labor of 3.60% (from 2021 expenses), consistent with the Bureau of Labor Statistics (BLS) findings on year-over-year (ending June 2021) total compensation growth in the private industry in California (Pacific Division). Upon discussion between the City and SLG, it was determined that no adjustment to the Rate Application was necessary.

Adjustments

No adjustment.

Corporate Overhead

SLG projected a 6.14% increase Corporate Overhead between 2020 and 2022, which includes a 5.30% increase from 2021 to 2022.

Assessment

According to page I-6 in the Rate Setting Manual, SLG's Corporate Overhead expense to the City cannot exceed $120,000 per year in 1994 dollars. SLG calculated their actual Corporate Overhead, and then subtracted out the appropriate limitation such that the total Corporate Overhead being assigned to the City is at the maximum amount.

Adjustments

No adjustment.

Office Salaries

SLG's projected 2022 Office Salary expense is 8.68% higher than its 2021 reported expense, 84.82% higher than its 2020 reported expense, and 19.51% higher than its 2019 reported expense. SLG experienced a decrease in office salaries in 2020 compared to 2019, in part due to COVID-19. The 2021 projected office salaries expense is 10% above 2019 levels.

Assessment

SLG's projected 2022 Office Salaries were calculated based on increases in employee wages, in the same fashion as Direct Labor, described in the previous section. SLG attributed its projected increase in Office Salaries to both increased wages and additional positions.R3 concurs that there are changes currently occurring in the economy and labor market as the COVID-19 pandemic continues. The labor market, as a whole, is seeing high demand for employees and as a result, wages have increased in most, if not all industries.

R3 suggested an overall increase to Office Salaries by 3.60% (from 2021 expenses), which is consistent with BLS findings on year-over-year total compensation growth in the private industry in California (Pacific Division). Upon discussion between the City and SLG, it was determined that no adjustment to the Rate Application was necessary.

Adjustments

No adjustments.

General and Administrative Costs

G&A costs represent the single largest overall expense category for SLG and include a wide range of expenses. SLG projects a 22.53% increase in total G&A costs, which is mainly the result of increases in Depreciation (e.g., vehicles, equipment) (38.95% / $341,716 increase), insurance (10.98% / $109,178 increase), interest (31.58% / $41,432 increase) and Outside Services (71.05% / $462,658 increase).

We assessed each expense item included in G&A costs and noted only minor increases to most expense items. In addition to further analyzing the specific expenses listed above, we also looked further into Bad Debt.

Assessment

SLG's total G&A expenses decreased 1.23% in 2020 (from 2019) and are projected to decrease by 3.73% in 2021 compared to 2020. SLG projects a 22.53% increase in the 2022 compared to 2021, which corresponds to a 16.51% increase compared to 2019.

SLG projects minor increases in expense for most items covered under G&A, however we further analyzed the items noted below:

Depreciation

SLG used a 7-year straight-line method for calculating its depreciation on vehicles and containers, which is in alignment with the Rate Setting Manual. However, today most franchises agree to a more realistic 10-year depreciation schedule. Additionally, SLG is currently operating vehicles and utilizing containers that have passed the designated 7-year mark. SLG allocates depreciation from their total company amount to each individual franchise based on percentages of container counts, customer counts, and vehicle driver hours.

R3 recommends the City and SLG incorporate a 10-year depreciation schedule for all new vehicles and containers into future updates to the Rate Setting Manual. Modifying the depreciation schedule for vehicles and containers is a key potential component for the Rate Setting Manual update.

Insurance

SLG's provided the supporting documentation for the increase in insurance costs, including an email from its insurance company and the respective insurance quote. SLG provided calculations for the insurance increase based on the quote for all their franchise collection areas, and then proportioned the City's individual cost based on prior percentage allotments. SLG's calculations follow logical consistency and are accurate based on the quote from the insurance agency.

Interest

SLG provided the sources and amounts of total company debt, as well as their calculation of interest rates. Using a weighted interest rate and the debt net book value, SLG calculated the associated interest expense for all company operations and then allocated an amount to the City using the percentage of City franchise depreciation (debt) to the company. SLG's interest calculations for 2022 and 2023 are logically consistent and match the rate application, however R3 notes that SLG used the 2022 Allocation Factor when allocating 2021 interest to the City. The difference in the allocation factor to the City between 2021 and 2022 is 1%, thus the result is immaterial.

Outside Services

The majority of expenses incurred under Outside Services is the organic processing that occurs at the Hitachi Zosen Inova (HZI) Facility; however, this category also includes costs for outsourced repair, disposal of rejected material from HZI, engineering fees, monitoring, and maintenance fees.

SLG projects a 2022 increase of 71.05% from 2021, which amounts to $462,658. This increase is due almost entirely to HZI requesting an increase in its service fee (organics processing fee). SLG reported this increase to be $457,500 in 2022.

SLG provided documentation supporting the increase of $457,500, including a copy of the requesting letter from HZI, excerpts from SLG's agreement with HZI, and detailed calculations for the total Outside Services expense. SLG was only able to provide a few excerpts from their agreement with HZI due to confidentiality. These excerpts support HZI's ability to request an adjustment to their service fee, however HZI's ability to increase their fee is contingent on SLG receiving a corresponding rate increase from the City.

Furthermore, since the fees being paid to HZI are for organic waste post-processing, an adjustment was made to reclassify HZI expenses as pass-through Tipping Fees, not subject to SLG's operating margin. This adjustment removed the full HZI 2022 expense ($1,011,109) from Outside Services and relocated them to Tipping Fees. The Rate Setting Manual defines tipping fees to include "transfer station, transformation facility, and landfill charges". As Tipping Fees, payments to HZI are considered pass-through costs.

It is standard industry practice for such expenses to be treated as pass-through costs. This adjustment would reduce SLG's operating profit.

Bad Debt

SLG increased their allowance for bad debt from $3,349 in 2020 to $12,017 in 2021, 2022, and 2023, citing an increase in Bad Debt due to the City pausing enforcement on the property lien process in lieu of COVID-19. However, the City documented that Bad Debt placed on property liens closely hovered around an average of $2,500 in recent years. Thus, Bad Debt was adjusted to $2,500.

This projected Bad Debt is less than 1% of commercial and residential rate revenues, this falls within what we consider to be a reasonable range.

Adjustments

Depreciation: No Adjustment.; Insurance: No Adjustment; Interest: No Adjustment; Outside Services: Recategorized $1,011,109 in HZI fees as Pass-Through costs (refer to Pass-Through Costs section below); Bad Debt: Reduced by $9,517.

Operating Ratio

The Rate Setting Manual establishes a range of from 90% to 94% for the target operating ratio (profit) used to calculate the Base Year rate adjustment.

Assessment

SLG's Rate Application set its 2022 profit level equal to an 93% operating ratio, consistent with the range set forth in the Rate Setting Manual.

Adjustments

The above adjustments reduced SLG's projected operating profit by **$76,821**.

Pass-Through Costs (Not Allowable on Profit Ratio)

Tipping Fees

SLG provided supporting documentation, including letters from Cold Canyon signaling the changes in tipping fees.

Assessment

As noted previously, an adjustment to Outside Services expense was made which reclassifies HZI organic processing expenses as tipping fees (pass-through costs). With this adjustment, the $1,011,109 in HZI fees would be added to this Tipping Fees category. This is consistent with the Rate Setting Manual.

Adjustments

Incorporated $1,011,109 in HZI fees as Tipping fees in this category and removed HZI fees from G&A (Outside Services).

Franchise Fees & IWMA Fees

SLG remits to the City a monthly Franchise Fee of 10% of gross revenues. This fee is considered a pass-through cost adjusted each year equal to any rate adjustment.

In addition to franchise fees, SLG also remits an IWMA fee to San Luis Obispo Integrated Waste Management Authority. During review of this Rate Application, and due to shifts in the the Authority's approach to IWMA fee setting, it was determined that the best course of action was to review IWMA fee revenue and expense from the rate application.

Assessment

SLG projects a 2022 Franchise Fee / IWMA Fee expense increase of approximately 15%. SLG provided supporting documentation for its historical Franchise Fees (matching the City's record) and IWMA fees. SLG provided calculations for projected Franchise Fees and IWMA Fees, delineating the two fees individually. The fees are based on the total revenue matching the rate application, and SLG incorporates the revised IWMA fee structure into the projected 2022 values.

R3's analysis idenfitied a recommended adjustment to the Rate Setting Manual's franchise fee calculation methodology to match projected revenue more accurately with required revenue. This is described in more detail later in this report.

Adjustments

Decreased IWMA fee expense by $363,770. Decreased Revene Offsets by $191,165.

AB 939 Fees

SLG remits to the City a fixed AB 939 fee every month to support the City's AB 939 program(s). This fee is considered a pass-through cost adjusted each year equal to any rate adjustment.

Assessment

SLG provided supporting documentation for its historical and projected AB 939 fees, which matched the City's records. The City and SLG also agreed to increase the AB 939 fee by an additional $100,000 annually to recover reveues to implement unfunded State mandate SB 1383.

Adjustments

$100,000 City-directed increase to AB 939 Fee.

Lease Payment to Affiliate Companies

SLG reported that it leases the operations center and offices located at Old Santa Fe Road from an affiliated entity, as disclosed in the audited financial statements. Lease payments are adjusted annually by CPI.

Assessment

SLG projects a 2022 increase of 5.30% in Lease Payments, in comparison to 2021, and a 6.78% increase compared to 2020.

Adjustments

No adjustment.

Total Projected Expenses

SLG's total projected expenses are comprised of Allowable Costs (those from which profit can be generated on), Operating Profit, and Pass-through costs. The sum of these expenses yields the total revenue requirement - the total annual revenue required from rate payers. The total revenue requirement based on the revised Rate Application is $13,983,124, reduced from the original Rate Application of $14,430,723.

Total Projected Revenues

SLG projected a 1.00% increase in total revenues for 2022 as compared the current 2021 projected revenues. The total revenues projected for 2022 are 13.96% higher than 2019 reported revenues.

Assessment

SLG provided actual total revenues for years 2019 and 2020 in support of its projected revenues. Additionally, SLG projects continued increases in number of accounts serviced, tonnage collected, and revenue. 2020 residential revenue was reported to have increased compared to 2019. We assessed the reasonableness of SLG's projected residential and commercial revenues and based on this analysis we found SLG's revenue projections to be reasonable.

Adjustments

No adjustment.

3. CALCULATION OF THE PERCENT CHANGE IN RATES

The Rate Setting Manual's methodology for calculating the total percent change in existing rates should be adjusted when the Rate Setting Manual is revised. The Rate Setting Manual calculates the "Percent Change in Residential and Non-Residential Revenue Requirement" (line 22 of the application) by dividing the net revenue shortfall/surplus by the total rate revenue expected without a Base Year increase.

The Rate Setting Manual then instructs the applicant to further adjust the calculated result, to account for additional franchise fees to be paid on the net revenue shortfall (line 24 of the application).

The following calculations demonstrate the current Rate Setting Manual's methodology:

A

$$\text{\% Change in Rate Rev. Requirement (Line 22)} = \frac{\text{Net Shortfall (Surplus)}}{\text{Total Rate Revenue without an Adjustment}} * 100\%$$

B

$$\text{\% Total Change in Existing Rates (Line 24)} = \frac{\text{\% Change in Rate Rev. Requirement}}{100\% - \text{Franchise Fee \%}} * 100\%$$

The reccomended calculation for future update to the Rate Setting Manual is presented below:

$$\text{\% Change in Existing Rates} = \frac{\text{Revenue Requirement}}{\text{Total Rate Revenue without an Adjustment}} - 1 * 100\%$$

This change is recommended to be included in updates to the 1994 Rate Setting Manual, which all parties have expressed interest in modifying.

4. FINDINGS

Revised Rate Adjustment

SLG's original 2022 Base Year Rate Application calculated a net shortfall in revenues for 2022 of approximately ***$2,080,000***, which equates to a rate increase of **18.71%**. The revised increase subsequent to completion of this review is **17.75%**. That is based on a revised revenue shortfall of approximately ***$1,820,700*** and is primarily due to the adjustment categorizing the anaerobic digester cost as pass-through tipping fees.

The difference between the adjusted rate adjustment and SLG's calculated rate adjustment is due to the following:

- Reduced Bad Debt expense by $9,517 to align with City's records of average bad debt place on property lien process.
- Reassigned HZI expenses ($1,011,109) to be pass-through costs, removing them from the "Outside Services" (line 39) expense and adding them into the "Total Tipping Fee" (line 52) expense. The Rate Setting Manual defines tipping fees to include "transfer station, transformation facility, and landfill charges". As tipping fees, payments to HZI are considered pass-through costs. This is standard practice in the industry for such expenses to be treated as pass-through costs and additionally, HZI cannot increase SLG's fees without the City approving and associated rate increase.
- Reduced operating profit by $76,821 because of the above adjustments.
- Increased AB 939 fees by $100,000 as a City-directed change to recover reveunes for compliance with SB 1383.
- Removed IWMA fees from revenues and expenses.