Mission Country Disposal

SOLID WASTE RATE REVIEW

Cambria Community Services District
Cayucos Sanitary District

August 2019

William C. Statler

Fiscal Policy ■ Financial Planning ■ Analysis ■ Training ■ Organizational Review

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SOLID WASTE RATE REVIEW
Cambria Community Services District and
Cayucos Sanitary District

REPORT PURPOSE

On October 4, 2018, Mission Country Disposal (MCD) submitted a *Base Year* rate increase application to be effective January 1, 2019 to the Cambria Community Services District (Cambria) and Cayucos Sanitary District (Cayucos). However, due to the complexity and concerns with the rate application, two supplemental applications were submitted, with the most recent one received on July 18, 2019 (Appendix A).

The last application is the focus of this report in reviewing the MCD rate increase request in accordance with adopted Franchise Agreement provisions regarding rate increase applications and to make rate recommendations to these two agencies as appropriate.

This report also addresses the rate impact if the Franchise Fee in Cambria is increased from its current rate of 6% to 10%.

Joint Agency Review

MCD provides similar services to both Cambrai and Cayucos under formally approved franchise agreements that regulate rates and establish procedures for considering rate increases.

Because the financial information for MCD is closely related for these two agencies, this report jointly reviews rate requests and provides recommendations for each of them.

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Overview

In its latest application, <u>MCD is requesting a rate increase of 25.31% for Cambria and 26.43% for CSD.</u> The modest difference is because the Franchise Fee for the Cambria is 6% and 10% for Cayucos

<u>This compares with its initial request in October 2018 of 38.68% for Cambria and 40.40% for Cayucos</u>. As discussed in greater detail below, all of the concerns that surfaced in the iterations and further analysis that followed in addressing issues with

proposed costs for 2019 have been resolved. However, the following highlights two key cost drivers in this review, which together account for about 55% of the rate increase:

- **Materials recovery facility (MRF) costs** for "single stream" recycling (one container for all recyclables that must be sorted at an MRF) have increased from $10.17 per ton in 2017 to $67.50 per ton for 2019, an increase of 564%. This results in cost increases of $264,000 from 2017 and accounts for about 25% of the requested rate increase.

  As discussed below, it is clear from market realities (higher costs to produce higher-quality recyclables and lower prices for the resulting product from MRF operations) and the supporting data provided by MCD, that cost increases in this area are warranted. While the increase is significant, it is acceptable given market conditions and the higher cost of other alternatives.

- **Direct labor costs increased by 23%.** This accounts for about 30% of the rate increase and is primarily due to a correction from past financial statements in accounting for direct labor hours. In 2018, Waste Connections (MCD's parent company) undertook its first extensive time study in many years in analyzing direct labor hours between its four franchised companies: San Luis Garbage, South County Sanitary Service (SCSS), Morro Bay Garbage (MBG) and MCD.

  As discussed in greater detail in Appendix B, Waste Connections found that hours for MCD were under reported by about 14%, with corresponding over-reporting for MBG. This was due to organizational changes that more efficiently pooled staff between the two companies, However, time keeping records did not accurately reflect the "borrowing" of MBG staff.

  While this past error in accounting for direct labor costs is unfortunate, it is appropriate to fix it going forward as part of this *Base Year* review.

  The balance of the cost increase over two years is about 9%. This is consistent with increases experienced by SCSS from 2017 to 2019 in providing cost of living increases of about 2% per year plus an across the board increase of 5% for retention and attraction. Given the tight labor market, this portion of the direct labor cost increase is reasonable.

  It should be noted that this revised cost accounting drives other major costs that are allocated between companies based on direct labor hours, such as group health insurance, truck operating expenses, fuel and other operating expenses.

Findings

- ***Complete Application.*** With its latest application, MCD has fully provided the supporting documentation required for rate requests under the Franchise Agreements in Cambria and Cayucos. The revised application has been correctly prepared and requests an across-the-board rate increase of 25.31%.in Cambria and 26.43% in Cayucos.

- ***High Level of Service at a Reasonable Cost.*** MCD provides a broad level of high-quality services to these two agencies – including garbage, recycling and green waste collection and disposal as well as hauler-provided "waste wheeler" containers for all three services – at very competitive rates compared with many other communities. In fact, even with the recommended rate increase of 25.31% in Cambria and 26.43% in Cayuco, rates in these two agencies will be among the lowest of those surveyed. In short, these two communities have the best of both worlds: high quality services at a low cost compared with other communities.

- ***Impact if the Cambria Franchise Fee is Increased from 6% to 10%.*** The most common Franchise Fee for solid waste services within the County is 10%. The Board is interested in increasing the Cambria rate to this level. As discussed in greater detail below, this would result in a rate increase for Cambria of 32.05% in implementing MCD's requested rate increase – which would now be 26.43% like Cayucos – as well as generating the added revenue needed for MCD to pay Franchise Fees at 10% rather than 6%.

- ***Need for Updated Rate-Setting Methodology***. Several complex issues have surfaced in this review (most notably corporate overhead, greenwaste and MRF costs as well as rate structure concerns) that have not been encountered in the past in using the rate-setting methodology, which is based on the City of San Luis Obispo's *Rate Setting Process and Methodology Manual for Integrated Solid Waste Management Rates* (Rate Manual) adopted in 1994. In short, with very minor modifications, this approach has been in place for 25 years. Accordingly, given the passage of time and the emergence of issues not envisioned in 1994, it is timely to update this methodology.

  Undertaking this work is supported by Waste Connections (the parent company of MCD) as well as by the staff of many agencies serviced by Waste Connections under Franchise Agreements that reference the *Rate Manual*. This includes the County, cities of San Luis Obispo, Arroyo Grande, Grover Beach, Pismo Beach and community services districts in Avila, Nipomo and Oceano. Waste Connections has conceptually agreed to fund half of this cost; if the remaining cost is shared by the central coast agencies serviced by Waste Connections, the consultant service cost for each agency should be very modest. There are several highly respected consultant firms that could assist with this update, such as:

  HF&H Consultants
  http://hfh-consultants.com

  FCS Group
  http://fcsgroup.com

  NBS
  https://www.nbsgov.com

  MSW Consultants
  https://MSW-Consultants.com

  R3 Consulting Group
  https://r3cgi.com

  Bell & Associates
  Chris@bellassociatesinc.com

  If the governing bodies are interested in pursuing an update, the next steps include developing a funding strategy; preparing and issuing a request for proposals (RFP); and selecting the vendor.

Rate Recommendations

It is recommended that the agencies adopt an across-the-board rate increase of 25.31% in Cambria and 26.43% in Cayucos. For Cambria, this excludes any potential impact if the

Franchise Fee is increase from its current rate of 6% to 10%. (This impact is discussed later in this report.)

Rate Summary for Single Family Residential Customers

Table 1 summarizes the requested rates for single family residential (SFR) customers. As reflected in this summary, given the significant cost drivers facing MCD, the increases will be moderate under the proposed rate increase.

Table 1. Single Family Residential Rates

	Container Size (Gallons)		
	32	64	96
Current			
Cambria	$19.73	$30.28	$36.83
Cayucos	15.64	18.48	21.34
Recommended			
Cambria	24.72	37.94	46.15
Cayucos	19.77	23.36	26.98
Increase			
Cambria	4.99	7.66	9.32
Cayucos	4.13	4.88	5.64

For example, for collection of a 32-gallon garbage container (the most common SFR service level) as well as separate waste wheelers for recycling and green waste, the proposed monthly rate will increase by $4.99 in Cambria and $4.13 in Cayucos.

As reflected in this chart, rates are higher in Cambria than in Cayucos. This makes sense given Cambria's longer distance for landfill, MFR and greenwaste disposal.

BACKGROUND

On October 4, 2019, MCD submitted a *Base Year* rate increase to be effective January 1, 2019. As noted above, due to the complexity and concerns with the rate application, two supplemental applications were submitted, with the most recent one received on July 18, 2019. This application was prepared in accordance with the rate review process and methodology formally set forth in its Franchise Agreements with Cambria and Cayucos.

In establishing a rate-setting process and methodology, each of these Franchise Agreements specifically reference the City of San Luis Obispo's *Rate Setting Process and Methodology Manual for Integrated Solid Waste Management Rates*. This comprehensive approach to rate reviews was adopted by San Luis Obispo in 1994 and establishes detailed procedures for requesting rate increases and the required supporting documentation to do so. It also sets cost accounting standards and allowable operating profit ratios.

About Proposition 218 Notices

For agencies like Cambria and Cayucos that issue "Proposition 218" notices for private sector solid waste rate increases, the notice sets the maximum amount that rates can be increased at the public hearing.

Rates can be approved at lesser amounts without re-noticing. However, agencies cannot adopt higher rates – even if they only apply to a few customers – without another 45-day re-noticing. As such, the rate notices prepared for Cambria and Cayucos reflect the rates requested by MCD along with the impact in Cambria if Franchise Fees paid by MCD are increased from 6% to 10%.

As noted above, the financial information for Cambria and Cayucos is closely related. For this reason, these two agencies jointly contracted with William C. Statler (who has extensive experience in evaluating rate requests in accordance with the adopted methodology) to evaluate MCD's rate increase application.

Franchise Agreement Summary

While there are minor differences in Franchise Agreements in Cambria and Cayucos, they have similar key provisions:

Table 2. Franchise Agreement Effective Dates

Agency	Agreement	Amended
Cambria	July 27, 2001	May 27, 2010
Cayucos	August 11, 2006	March 16, 2017

- Each agency contracts with MCD for garbage, green/food waste and "single stream" recycling; and MCD provides the container (waste wheelers) for each service.
- As noted above, each agency has adopted the same rate-setting methodology.

The most significant difference is the Franchise Fee, which is 6% in Cambria and 10% in Cayucos.

RATE REVIEW WORKSCOPE

This report addresses four basic questions:

- Should MCD be granted a rate increase? And if so, how much?
- How much does it cost to provide required service levels?
- Are these costs reasonable?
- And if so, what is a reasonable level of return on these costs?

The following documents were closely reviewed in answering these questions:

- Franchise Agreements and any Amendments for each agency
- Audited financial statements for MCD for 2016 and 2017
- City of San Luis Obispo's *Rate Setting Process and Methodology Manual for Integrated Solid Waste Management Rates* (*Rate Manual*)
- MCD rate increase application and supporting documentation
- Follow-up interviews, correspondence and briefings with MCD staff
- Rate surveys of Central Coast communities

This report also addresses the rate impact if the Franchise Fee in Cambria is increased from its current rate of 6% to 10%.

REVENUE AND RATE SETTING OBJECTIVES

In considering MCD's rate increase request, it is important to note the revenue and rate setting objectives for solid waste services as set forth in the Franchise Agreements via the *Rate Manual*.

Revenues. These should be set at levels that:

- Are fair to customers and the hauler.
- Are justifiable and supportable.
- Ensure revenue adequacy.
- Provide for ongoing review and rate stability.
- Are clear and straightforward for the agency and hauler to administer.

Rate Structure. Almost any rate structure can meet the revenue principles outlined above and generate the same amount of total revenue. Moreover, almost all rate structures will result in similar costs for the *average* customer: what different rate structures tell us is how costs will be distributed among *non-average* customers. The following summarizes adopted *rate structure* principles for solid waste services:

- Promote source reduction, maximum diversion and recycling.
- Provide equity and fairness within classes of customers (similar customers should be treated similarly).
- Be environmentally sound.
- Be easy for customers to understand.

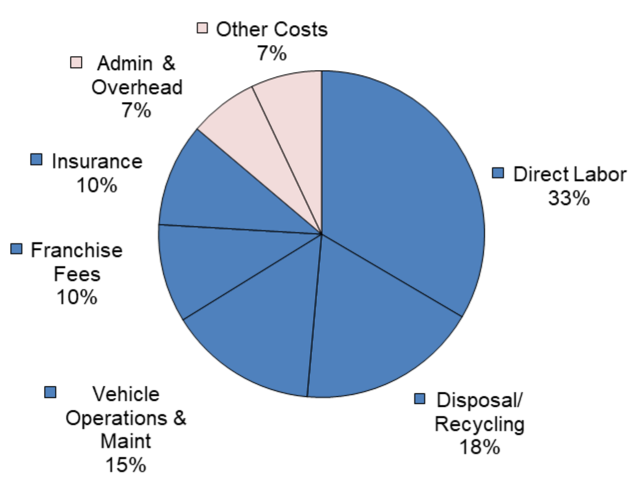
FINANCIAL OVERVIEW

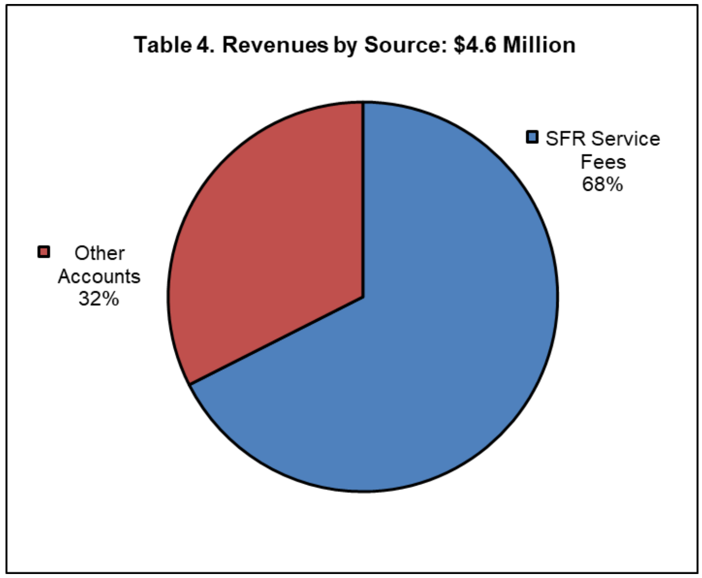
While detailed financial and service information is provided in the MCD rate request application (Appendix A), the following summarizes their actual costs, revenues and account information for 2017 (the last completed fiscal year for which there are audited financial statements) for all areas serviced by them.

Costs by Type. Total expenses for 2017 (after deducting for non-allowable and limited costs as discussed later in this report) were $4.6 million. As reflected in Table 3, five cost areas accounted for over 85% of total costs:

- Direct labor for collection: 33%
- Disposal and recycling: 18%
- Vehicle operations and maintenance (including depreciation): 15%
- Franchise fees: 10%
- Insurance: 10%

Table 3. Costs By Type: $4.6 Million



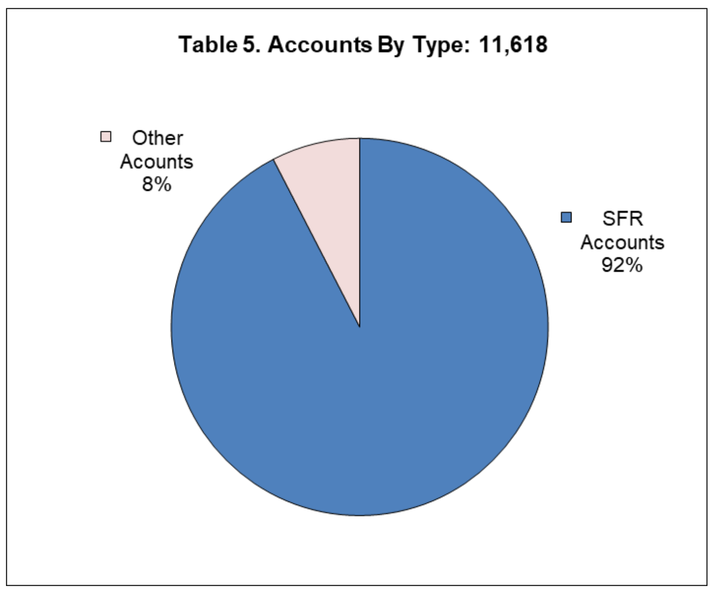


Revenues by Source. Total revenues in 2017 were $4.6 million. As reflected in Table 4, over two-thirds of MCD's revenues come from single-family residential (SFR) accounts.

Services to multi-family residential and non-residential customers account for 32% of their revenues, with less than 1% from other revenues.

It should be noted that revenues and expenses in 2017 were virtually the same. This means that MCD earned no profit in 2017. As discussed below, this compares with the target of 8% profit on "allowable" costs under the *Rate Manual.*

Restoring MCD to this target from 2017 accounts for about 30% of the proposed rate increase.



Service Accounts by Type. While single-family residences account for 68% of revenues, they represent 92% of total accounts (Table 5).

This reflects the fact that per account, multi-family and non-residential customers generate more solid waste than single-family residential customers (and thus more revenue per account).

RATE-SETTING PROCESS

Under the *Rate Manual*, the rate-setting process follows a three-year cycle:

- ***Base Year.*** The first year of the cycle—the *Base Year*—requires a comprehensive, detailed analysis of revenues, expenses and operating data. This information is evaluated in the context of agreed upon factors in the franchise agreements in determining fair and reasonable rates.

- ***Two Interim Years.*** In both the second and third years, MCD is eligible for *Interim Year* rate adjustments that address three key change factors: changes in the consumer price index for "controllable" operating costs; changes in "pass-through costs" (primarily landfill tipping fees, which MCD does not control: they are set by the County Board of Supervisors); and an adjustment to cover increased franchise fees.

The rate review for the two *Interim Years* requires less information and preparation time than the *Base Year* review, while still providing fair and reasonable rate adjustments.

RATE SETTING METHODOLOGY

Are the Costs Reasonable?

The first step in the rate review process is to determine if costs are reasonable. There are three analytical techniques that can be used in assessing this:

- Detailed review of costs and service responsibilities over time.
- Evaluation of external cost factors, such as general increases in the cost of living (as measured by the consumer price index).
- Comparisons of rates with other communities.

Each of these was considered in preparing this report, summarized as follows.

Detailed Cost Review

In its rate application (Appendix A), MCD provides detailed financial data for five years:

- Audited results for the two prior years (2016 and 2017).
- Estimated results for the current year (2018, which is still in progress).
- Projected costs for the Base Year (2019).
- Estimated costs for the following year (2020).

Additionally, for virtually all line items, MCD provided supplemental detail upon request to support cost increases from 2017 to 2019. A detailed response from MCD on key issues is provided in Appendix B.

Table 6 below provides actual costs for 2017 (most recent audit results) compared with \cost projections for 2019.

While there are significant cost increases in several categories, they are reasonable given the cost drivers facing MCD; and in the case of MRF costs, this is an acceptable increase due to higher processing costs and lower revenues combined with the lack of other viable alternatives.

The Short Story. The key drivers behind the proposed rate increase for 2019 can be summarized by four cost factors over the past two years:

- 7.5% for direct labor
- 5.5% for recycling via MRF operations.
- 3.5% for vehicle operations and maintenance.
- 2.7% for all other cost increases and pass-through costs.

As reflected above, cost factors account for about 80% of the rate increase. The remaining balance is due to restoring MCD to an 8% operating target on allowable cost (compared with a loss of $21,529 in 2017), offset by modest increases in the revenue base from 2017.

Table 6. Detailed Cost Review: 2017 vs 2019

	2017	2019	Increase	
	Actual	Proposed	Amount	Percent
Direct Labor	1,550,238	1,910,261	360,023	23%
Adminstrative Costs	315,481	259,345	(56,136)	-18%
Other Expenses				
Depreciation on Bldgs & Equip	2,061	14,448	12,387	601%
Depreciation on Trucks & Containers	182,827	194,149	11,322	6%
Gas and Oil	310,503	436,926	126,423	41%
Office Expense	92,526	113,848	21,322	23%
Operating Supplies	14,165	17,423	3,258	23%
Insurance: Health Care	229,654	325,234	95,580	42%
Insurance: Liability and Other	244,056	162,104	(81,952)	-34%
Outside Services: Food/Green Waste	250,825	260,866	10,041	4%
Outside Services: Truck Repairs	6,009	14,953	8,944	149%
Outside Services: Temporary Labor	3,197	24,039	20,842	652%
Truck Repairs	132,851	163,564	30,713	23%
All Other Costs	206,814	211,655	4,841	2%
Total Allowable Costs	3,541,207	4,108,815	567,608	16%
Pass-Through Costs				
Tipping Fees: Landfill	535,426	502,894	(32,532)	-6%
Tipping Fees: MRF	46,429	310,687	264,258	569%
Franchise Fees	450,588	479,619	29,031	6%
Interest, Related Party (1)	35,904	54,143	18,239	51%
Transportation, Related Party	4,400	3,996	(404)	-9%
Facility Rent, Related Party	20,288	96,323	76,035	375%
Total Pass-Through Costs	1,093,035	1,447,662	354,627	32%
Total Costs	$4,634,242	$5,556,477	$922,235	20%

The following describes the basis for each for major cost areas and significant changes.

Allowable Costs

- **Direct Labor.** This reflects a two-year increase of 23%. As discussed above, during an in-depth review in 2018, Waste Connections found that hours for MCD were under reported by about 14%, with corresponding over-reporting for MBG. This was due to organizational changes that more efficiently pooled staff between the two companies, However, time keeping records did not accurately reflect the "borrowing" of MBG staff. The balance of the cost increase over two years is about 9%, which is consistent with increases experienced by SCSS from 2017 to 2019 in providing cost of living increases of about 2% per year plus an across the board increase of 5% for retention and attraction. Given the tight labor market, this portion of the direct labor cost increase is reasonable.

As reflected below in other cost categories, this revised cost accounting drives other major costs that are allocated between companies based on direct labor hours, such as group health insurance, truck operating expenses, fuel and other operating expenses.

- **Administrative Costs.** This is a combination of corporate overhead (which is limited to increases in the consumer price index) and office salaries. This reflects a net decrease of $56,000 (18%) from 2017.

- **Depreciation: Buildings and Equipment**. This increase results from the MCD share (22%) of yard repaving costs of $346,222, amortized over twenty-five years, offset by other minor reductions.

- **Gas and Oil.** This cost increase reflects two factors: cost increases in diesel and the increased allocation for fuel use based on revised direct labor costs. Given the volatility in diesel and CNG costs (both up and down), cost per gallon assumptions are reasonable for 2019. Moreover, given the revised direct labor allocation, the overall projection for 2019 appears reasonable.

- **Office Expense and Operating Supplies.** These are both up by 23%, reflecting the revised direct labor cost allocation.

- **Insurance: Health Care.** These costs are projected to increase from 2017 by about 5% annually. Given increases in health care costs, this is a reasonable assumption for 2019 costs. However, this cost increases by more than 10% due to the increase in direct labor allocations.

- **Insurance: Liability and Other.** Projected costs have decreased significantly from 2017, which reflects favorably on MCD's risk management efforts.

- **Truck Repairs: Outside Services and In-House.** As summarized below, the rate application requests an increase of $39,000 (28%) in this cost category:

Table 7. Truck Repair Costs: 2017 vs 2019

	Actual 2017	Proposed 2019	Increase Amount	Increase Percent
Outside Services	6,009	14,953	8,944	149%
In-House	132,581	163,564	30,983	23%
Total	$140,607	$178,517	$39,927	28%

This is due to two factors: an increase in allocated costs based on direct labor combined with a more proactive approach to vehicle maintenance, which MCD believes is necessary in meeting safety concerns. Along with other efforts, this focus on safety appears to be working, as reflected by the significant reduction in insurance costs.

- **Outside Services: Temporary Labor.** The cost increases in this category were incurred for dispatch and container cleaning in backfilling for vacancies. While costs in this category may decrease in the future if vacancies are filled, any decreases will be offset by increases in direct labor costs.

- **All Other Allowable Costs.** While there are ups and downs in individual line items, in total these reflect modest annual increases of 1%.

Pass-Through Costs

- **Tipping Fees: Landfill.** No rate increases are reflected in the rate application. The projected costs for 2019 reflect a modest decrease from 2017 of 6%.

- **Tipping Fees: MRF (Related Party).** This cost category reflects a significant cost increase from 2017. As summarized below, this is driven by a rate increase from $10.17 per ton to $67.50 per ton by a separate company that is controlled by Waste Connections (Cold Canyon Processing Facility):

Table 8. MRF Costs: 2017 vs 2019

	Actual 2017	Proposed 2019	Increase Amount	Increase Percent
Tonnage	4,556	4,603	47	1.0%
Cost per Ton	10.17	67.50	57.33	563.7%
Annual Cost	$46,335	$310,703	$264,368	570.6%

Waste Connections believes that its MRF rates are not subject to regulatory review and that its basis for setting these rates is proprietary and not subject to disclosure under the Franchise Agreements. That said, MCD offers the following explanation for this cost increase:

Competitive Rates. The following information was provided by MCD in comparing their proposed rate with other communities:

Table 9. MRF Rates Survey

			Per Ton Pricing				
Facility	Location	Distance (Miles)	Processing	Reload (If SLO)	Transport from SLO	Revenue Sharing	All-In Cost
Cold Canyon Processing Facility	San Luis Obispo	0	$67.50	$0.00	$0.00	No	$67.50
Monterey Regional Waste Facility (1)	Monterey	144	50.00	10.00	45.00	No	105.00
Burrtec (2)	West Valley	215	57.50	10.00	45.00	No	112.50
Mid Valley Disposal	Fresno	140	67.50	10.00	40.00	No	117.50
Gold Coast Recycling	Ventura	162	77.44	10.00	40.00	No	127.44
Mid-State (3)	Templeton	23	78.00	10.00	25.00	No	113.00
Tajiguas Landfill	Santa Barbara	112	160.00	10.00	30.00	No	200.00
Recology	Pier 96 (Bay Area)	214	190.00	10.00	45.00	Unknown	245.00

1. Expected rate in 90 days.
2. Eliminated revenue share
3. Unable to handle SLO County volume

In short, MCD believes its pricing is far lower than that otherwise available to north coastal communities; and even if loading and transportation costs are excluded, Waste Connections' MRF costs are very competitive.

In reviewing these costs, it is important to note that while MCD is responsible under the Franchise Agreements for separately collecting co-mingled recyclables and delivering them to a recycling facility that will accept them for processing, it is not required to operate such a facility. As such, the $67.50 rate, while a significate increase, is more cost-effective for MCD than other alternatives.

Given increased costs and lower market prices, the increased rate for 2019 reflects the same operating margin as 2017. Subject to several key caveats, this may be true.

1. It is clear that market realities have significantly impacted the net cost of recycling. As discussed by the President of the Boston Group in Appendix C, this is largely due to the collapse of markets in China, which affects both costs and revenues: the quality of the recycled product needs to be higher (resulting in higher costs); and the price of recycled products is significantly lower.

2. It reasonable for operating margins for recycling to be higher than they are for collection services like those provided under the Franchise Agreements. As discussed below under Rate-Setting Methodology, MCD is allowed an operating profit margin of 8% for "non-pass through costs." In essence, this recognizes that while there are risks in effectively managing costs, there are minimal revenue risks, since rates are guaranteed and service is required. However, with recycling costs, revenues are highly volatile depending on the market. Thus, there is both cost and revenue risk.

   A complex econometric model developed the firm of Sound Resource Economics (located in Tacoma Washington: Neal Johnson, PhD, Principal) indicates that 16% is an appropriate operating profit margin for utilities where costs and revenues are at risk. Setting aside the math and assumptions behind this conclusion, it intuitively makes sense that operating margins should be higher where both costs and revenues are at risk, versus where just costs are. Placed in context for MCD collection services, which have an 8% operating margin for cost risks, an added margin for revenue risks (especially in a volatile market) makes sense.

3. Based on a non-disclosure agreement, MCD shared with me very high-level data showing that based on projected higher costs and lower revenues from 2017, that the operating margin between 2017 and 2019 remained the same.

4. While I was not provided with the underlying detail for the high-level cost and revenue data provided to me, I can conclude that based on market forces that are driving higher costs and lower revenues, and a reasonable operating margin in excess of 8%, that a significant increase in recycling costs is reasonable. The question is: how much?

Answering this question clearly is made difficult by the fact that the *Rate Manual* did not foresee this situation (in fact, it thought there would be net revenues offsetting rate requirements). More appropriately addressing this cost issue is a key factor in my recommendation to update the *Rate Manual*.

That said, given the higher costs and lower revenues undoubtedly faced by the MRF combined with the lack of more cost-effective options, the proposed rate of $67.50 is acceptable.

Provided in Appendix D is additional information from Waste Connections about its MRF operations.

- **Franchise Fees**. This reflects a modest two-year increase of 6% based on customer growth.

- **Interest (Related Party).** Interest is an allowable cost under the *Rate Manual.* In this case, interest costs are assessed internally by Waste Connections based on a methodology that considers its corporate costs of borrowing and financed assets. Accordingly, this is treated as a "pass-through" cost. MCD's auditors have provided a written opinion on the reasonableness of the methodology; and I have reviewed the calculations underlying the projected costs in accordance with this methodology. Based on this, I believe the projected interest costs for 2019 are reasonable.

  It should be noted that MCD believes there is a case for treating this interest as a non-related party allowable expense since there is no internal mark-up on the interest; however, they chose not to press the matter at this time. This is another issue that should be addressed as part of a *Rate Manual* update and future rate applications.

- **Transportation (Related Party).** These costs have decreased modestly.

- **Facility Rent (Related Party).** This increase is based on an updated assessment of the market value of MCD's share of the yard and office facilities. Based on reviewing a recent independent market value assessment and Waste Connections methodology for allocating MCD's share of these costs (which reflect the revised allocation of direct labor costs), I believe that the cost increase is reasonable.

Trends in External Cost Drivers

The most common external "benchmark" for evaluating cost trends is the consumer price index. Over the past two years, the U.S. CPI-U increased by 4.4%. Excluding the cost drivers discussed above, all other costs increased by 2% over the last two years (about 1% annually).

It should be noted that MCD believes that operating on the central coast of California presents higher cost pressures than the national CPI suggests, which leads to lower margins in interim years and higher base rate increases. They would like to address this concern in the *Rate Manual* update and future rate applications.

Rates in Comparable Communities

Lastly, reasonableness of rates (and underlying costs) can also be evaluated by comparing rates with comparable communities. However, survey results between "comparable" communities need to be carefully weighed, because every community is different. In short, making a true "apples-to-apples" comparison is easier said than done.

Nonetheless, surveys are useful assessment tools—but they are not perfect, and they should not drive rate increases. Typical reasons why solid waste rates may be different include:

- Franchise fees and AB 939 fee surcharges.
- Landfill costs (tipping fees).
- Service levels (frequency, quality).
- Labor market.
- Operator efficiency and effectiveness.
- Voluntary versus mandatory service.
- Direct services provided to the franchising agency at no cost, such as free trash container pick-up at city facilities, on streets and in parks.
- Revenue collection procedures: Does the hauler or the franchising agency bill for service? And what are the procedures for collecting delinquent accounts?
- Services included in the base fee (recycling, green waste, containers, pick-up away from curb).
- Different rates structures.
- Land use and density (lower densities will typically result in higher service costs).
- Mix of residential and non-residential accounts, and how costs and rates are allocated between customer types. This factor is particularly relevant to MCD, where commercial revenues that often help offset residential rates, make up only 32% of revenues.
- Distance from collection areas to disposal sites. This is also a key cost factor for MCD.

With these caveats, the following summarizes single family residential rates for other cities in the Central Coast area compared with the proposed rates for MCD. As reflected below, even with the proposed rate increases, Cambria and Cayucos will have among the lowest rates of the agencies surveyed.

Table 10. Single Family Residential Rate Survey

Single Family Residential Monthly Trash Rates			
	Container Size (Gallons)		
	30-40	60-70	90-101
Atascadero	$26.49	$41.56	$52.18
Morro Bay	17.91	35.81	53.72
Paso Robles	32.33	42.41	46.81
San Luis Obispo	16.48	32.97	49.45
Santa Maria	na	30.69	34.81
San Miguel	28.23	44.48	61.06
Templeton	28.72	41.15	45.67
Requested: Mission Country Disposal Service Area			
Cambria	24.72	37.94	46.15
Cayucos	19.77	23.36	26.98

Summary: Are the costs reasonable? Based on the results of the three separate cost-review techniques—trend review, external factor review and rate comparisons—the proposed cost assumptions for 2019 are reasonable.

What Is a Reasonable Return on these Costs?

After assessing if costs are reasonable, the next step is to determine a reasonable rate of return on these costs. The rate-setting method formally adopted by Cambria and Cayucos in their Franchise Agreements with MCD includes clear criteria for making this assessment. It begins by organizing costs into three main categories, which will be treated differently in determining a reasonable "operating profit ratio:"

Allowable Costs (Operations and Maintenance)

- Direct collection labor
- Vehicle maintenance and repairs
- Insurance
- Fuel
- Depreciation
- Billing and collection

Pass-Through Costs

- Tipping fees
- Franchise fees
- Payments to affiliated companies (such as facility rent, interest and trucking charges)

Excluded and Limited Costs

- Charitable and political contributions
- Entertainment
- Income taxes
- Non-IRS approved profit-sharing plans
- Fines and penalties
- Limits on corporate overhead

After organizing costs into these three categories, determining "operating profit ratios" and overall revenue requirements is straightforward:

- The target is an 8% operating profit ratio on "allowable costs."

- Pass-through costs may be fully recovered through rates but no profit is allowed on these costs.

- No revenues are allowed for any excluded or limited costs.

In the case of MCD, about 75% of their costs are subject to the 8% operating profit ratio; and 25% are pass-through costs that may be fully recovered from rates, but no profit is allowed. No recovery is allowed for excluded costs.

Preparing the Rate Request Application

Detailed "spreadsheet" templates for preparing the rate request application—including assembling the required information and making the needed calculations—are provided in the *Rate Manual*. MCD has prepared their rate increase application in accordance with these requirements (Appendix A); and the financial information provided in the application for 2016 and 2017 ties to its audited financial statements.

Rate Request Summary

The following summarizes the calculations that support the requested and recommended rate increases:

Table 11. Rate Increase Summary

Rate Setting Factors	Cambria	Cayucos
Allowable Costs	$4,108,815	$4,108,816
Allowable Profit (8% Operating Ratio)	357,287	357,287
Pass-Through Costs		
Tipping Fees: Landfill	502,894	502,894
Tippping Fees: MRF	310,687	310,687
Franchise Fees	479,619	479,619
Related Party Costs	154,462	154,462
Total Pass-Through Costs	1,447,662	1,447,662
Allowed Revenue Requirements	5,913,764	5,913,765
Revenue without Rate Increase	4,778,462	4,778,463
Revenue Requirement Shortfall	1,135,302	1,135,302
Rate Base Revenue	4,772,485	4,772,486
% Change in Revenue Requirement	23.79%	23.79%
Allowed Revenue Increase *	25.31%	26.43%

**Adjusted for franchise fees of 10% in Cambria and 6.0% in Cayucos*

As reflected above, all the rate setting factors are the same for Cambria and Cayucos, except for the final adjustment for Franchise Fees: 6% in Cambria and 10% in Cayucos. (Increased Franchise Fees are due on added revenues from a rate increase: this final adjustment accounts for this.)

Implementation

The following summarizes key implementation concepts in the adopted rate-setting model:

- The "8%" operating profit ratio is a target; in the interest of rate stability, adjustments are only made if the calculated operating profit ratio falls outside of 10% to 6%.

- There is no provision for retroactivity: requested rate increases are "prospective" for the year to come; there is no provision for looking back. This means that any past shortfalls from the target operating profit cannot be recaptured.

- On the other hand, if past ratios have been stronger than this target, then the revenue base is re-set in the *Base Year* review.

- As discussed above, detailed *Base Year* reviews are prepared every three years; *Interim Year* reviews to account for focused changes in the consumer price and tipping fees are prepared in the two "in-between" years.

- Special rate increases for extraordinary circumstances *may* be considered.

The result of this process is a proposed rate increase of 25.31%.in Cambria and 26.43% in Cayucos.

IMPACT OF CAMBRIA INCREASING FRANCHISE FEE FROM 6% TO 10%

The Board has expressed interest in considering an increase in the Franchise Fee from its current rate of 6% to 10.0% (which is the prevailing Franchise Fee throughout the County).

There would be two rate impacts resulting from this change:

- Even if no rate increase from MCD was being considered, an increase of 4.44% would be needed to increase the Franchise Fee from 6% to 10%. (The increase is slightly more than the 4% rate difference to account for the additional Franchise Fees that will be required to paid from the added revenues.)

- With a Franchise Fee of 10.0%, the allowable rate increase for 2019 would also be higher: 24.63% (like Cayucos) rather than 25.31%.

Since these two percentage rate increase factors are compounded rather than additive, the allowed rate increase or Cambria at a 10% Franchise Fee is 32.05%: (1.0444 x 1.2463)-1.
The following chart summarizes the different rate impacts of the recommendation based on the current rate of 6% and the rate impact if the Franchise Fee is increased to 10.0% in single family residential accounts.

Table 12. Sample Rate Increase with Franchise Fee at 10%

Current Rate: 32-Gallon Container	$19.73
Revised Rate: Franchise Fee Increase (4.44%)	20.61
Revised Rate: MCD Rate Increase (26.43%)	26.05
Difference	6.32
Percent Increase	32.05%

The following summarizes this rate increase for single family residential customers:

Table 13. Cambria SFR Rates: 6% vs 10% Franchise Fee

Container Size	Current Charge	6% Franchise Fee 25.31% Rate Increase		10.0% Franchise Fee 32.05% Rate Increase	
		Proposed	Increase	Proposed	Increase
32 Gallons	$19.73	$24.72	$4.99	$26.05	$6.32
64 Gallons	30.28	37.94	7.66	39.98	9.70
96 Gallons	36.83	46.15	9.32	48.63	11.80

COORDINATION WITH OTHER AGENCIES

MCD has submitted similar rate requests to the County, which regulates rates in other areas served by MCD. The County is likely to act on the requested rate increases within the same time frame as the two agencies covered in this report. Based on discussions with County staff, they are planning to rely on the findings in this report in making their recommendations to the Board of Supervisors.

SUMMARY

Based on the rate-setting policies and procedures formally adopted by Cambria and Cayucos in their Franchise Agreements, this report concludes that:

- MCD has submitted the required documentation required under its Franchise Agreements with the two agencies.
- This results in a recommended rate increase of 25.31% for Cambria and 26.43% for Cayucos.
- If Cambria decides to increase its Franchise Fee from the current rate of 6% to 10%, a rate increase of 32.05% is recommended.

ATTACHMENTS

Appendix A: Base Year Rate Request Application from South County Sanitary Service
Appendix B: Follow-Up Information provided by Mission Country Disposal
Appendix C: Boston Group Outlook on Recycling Costs
Appendix D: Cold Canyon Processing Facility Background

Appendix A

BASE YEAR RATE REQUEST APPLICATION

Base Year Application Summary

- Cambria Community Services District
- Cayucos Sanitary District

Supporting Schedules

- Financial Information: Cost and Revenue Requirements Summary
- Revenue Offset Summary
- Cost Summary for Base Year
- Base Year Revenue Offset Summary
- Operating Information