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South Bayside Waste Management Authority
A Public Agency

ADMINISTRATION AND FINANCE

STAFF REPORT

To: SBWMA Board Members
From: Cliff Feldman, Recycling Programs Manager
Date: July 23, 2015 Board of Directors Meeting
Subject: Staff Update on 2016 Contractor Compensation Adjustment Applications

Recommendation

This staff report is for discussion purposes only and no formal action is requested of the Board of Directors.

Analysis

This staff report provides an update on the JPA's review of the annual compensation adjustment applications submitted by Recology San Mateo County (Recology) and South Bay Recycling (SBR).

Recology and SBR 2016 Compensation Adjustment Application Review Schedule

Table 1 provides the complete schedule to review the company's applications and approve the recommended collection rate adjustments for calendar (rate) year 2016.

Table 1 – 2015 Schedule

Due Date	Milestone
June 15, 2015	Recology 2016 Compensation Adjustment Application Submitted to Member Agencies and SBWMA
June 29, 2015	Member Agencies and SBWMA Comments Due to Recology
July 1, 2015	SBR 2016 Compensation Adjustment Application Submitted to SBWMA
July 24, 2015	Revised Recology 2016 Compensation Adjustment Application Submitted to Member Agencies and SBWMA
August 14, 2015	SBWMA issues to Member Agencies Draft Report Reviewing the 2016 Recology Compensation Adjustment Application
August 14, 2015	SBWMA Issues to Member Agencies the Draft Report Reviewing 2016 SBR Compensation Adjustment Application
August 28, 2015	Member Agencies Written Comments on SBWMA Draft Reports (Recology and SBR) Due to SBWMA
September 10, 2015	TAC Meeting: Staff Update and Discussion
September 17, 2015	SBWMA Final Reports (Recology and SBR) Issued to Member Agencies/Board of Directors
September 24, 2015	SBWMA Board Meeting: Consideration of Final Reports

Recology 2016 Compensation Application

Recology submitted its application for an adjustment to compensation for calendar year 2016 on June 15, 2015 as prescribed in the Franchise Agreements with the Member Agencies. The comments and questions on this application by the SBWMA and some Member Agencies were sent to Recology on June 29, 2015. A revised application based on comments and questions received will be issued by Recology on July 24, 2015.

The Recology 2016 Compensation Application submitted on June 15 notes that the company's total operating costs will increase slightly by $99,840 or by 0.2% from 2015 to 2016. The total contractor's compensation will decrease by $433,467 or by 0.8% due to the scheduled reduction in interest expense and lower Incentive/Disincentive payments. Per the SBWMA's preliminary review of the application, it does not appear these figures will change substantively when the company issues its revised compensation application. (Minor variances were noted in the SBWMA comments and questions submitted to Recology on June 29, 2015.) Table 2 below is a summary table (i.e., Table A found on page 6 in the Executive Summary) of Recology's total contractor's compensation adjustment including a change in Incentive/Disincentive payments from the application submitted on June 15, as noted in the SBWMA's comments to Recology's application submitted to the company and Member Agencies on June 29.

Table 2 (Table A from Executive Summary)

	Compensation - 2015	Compensation - 2016	Change	% Change
Total Annual Cost of Operations	**50,595,200**	**50,685,556**	**90,355**	**0.2%**
Profit	5,311,098	**5,320,583**	9,485	**0.2%**
Operating Ratio	90.5%	90.5%		
Total Operating Costs	**55,906,299**	**56,006,139**	**99,840**	**0.2%**
Total Contractor Pass-Through Costs	**1,563,993**	**1,261,767**	**(302,226)**	-19.3%
BASE CONTRACTOR'S COMPENSATION	**57,470,292**	**57,267,906**	**(202,386)**	**-0.4%**
Incentive / Disincentives	**253,210**	**26,604**	**(226,606)**	
TOTAL CONTRACTOR'S COMPENSATION	**$ 57,723,502**	**$ 57,294,510**	**$ (428,992)**	**-0.7%**

On July 8, 2015, the Board and TAC Members were sent a revision to the Memorandum of Understanding (MOU) with Recology establishing guidelines regarding future interest calculations on surplus revenue which was previously approved by the Board at the March 17, 2014 Board meeting. This revision clarifies that interest will not be charged to a Member Agency that pays Recology by September 30 the amount of any shortfall for the previous year as determined by the Board approved Revenue Reconciliation Report.

SBR 2016 Compensation Application

The SBR Compensation Application submitted on June 30, 2015 shows an overall 1.2% increase in compensation. SBR is paid on a fee per ton so the actual compensation paid will be based on the actual tons and mix of materials. The SBWMA has found a minor error and SBR has made this correction which is reflected in Table 3 on the next page.

Table 3
SBR 2016 Compensation Application - Summary of Fees 2015 to 2016

	2015	2016	% Increase
Cost per Ton Fees			
Transfer Station	$ 12.59	$ 12.84	2.0%
MRF (net residue)	$ 78.06	$ 79.76	2.2%
Transportation (cost / ton-mile)	$ 1.07	$ 1.081	0.6%
Transportation (cost / ton)	$ 18.19	$ 18.307	0.6%
Total Cost Estimate by LOB			
Transfer Station	$ 4,502,919	$ 4,591,441	2.0%
MRF (net residue)	$ 5,777,977	$ 5,903,812	2.2%
Transportation	$ 6,508,106	$ 6,548,766	0.6%
Total Operating Cost	**$ 16,789,002**	**$ 17,044,019**	**1.5%**
Pass-Through Costs			
Total Interest	$ 196,470	$ 164,898	-16.1%
Construction Management Cost			
Interim Ops			
Buyback Payment (estimate)	$ 888,000	$ 888,000	
Total Pass-Through Cost	**$ 1,084,470**	**$ 1,052,898**	-2.9%
Total Estimated Expense	**$ 17,873,472**	**$ 18,096,917**	**1.3%**

Background

The Franchise Agreements between the Member Agencies and Recology and the Shoreway Operations Agreement between SBR and SBWMA both prescribe the process for submittal and review of the company's applications for an annual adjustment to their compensation. The JPA is charged with performing a detailed review of the applications and providing a recommendation on the adjustment to compensation for the subsequent year for the Board's consideration at the Board meeting in September each year. In addition to the SBWMA reports providing a review of the respective contractor's compensation applications, the SBWMA also provides a report providing a projection of the base collection rate percentage adjustment needed to collect the revenues required for the next year to cover all collection costs including Recology services, disposal and processing expense at Shoreway, and agency fees paid to each Member Agency.

Fiscal Impact

There is an information item only and no fiscal impact is associated with this staff report.

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STAFF REPORT

To:	SBWMA Board Members
From:	Kevin McCarthy, Executive Director
	Marshall Moran, Finance Manager
Date:	July 23, 2015 Board of Director's Meeting
Subject:	Review of Unrestricted Cash Reserve Policy

Recommendation

This staff report is for discussion purposes only and no formal action is requested of the Board of Directors. The current cash reserve policy can be found in Attachment A.

Analysis

Current Policy Description

The current cash reserve policy encompasses three designated reserve accounts as follows:

- Rate Stabilization Reserve Account of up to a maximum of ten (10%) percent of budgeted operating expenses, exclusive of pass through expenses that are 100% offset by revenue from the same sources (e.g., Shoreway buyback payments to customers and door to door HHW collection expenses).
- Emergency Reserve Account of up to a maximum of ten (10%) percent of budgeted operating expenses, exclusive of pass through expenses that are 100% offset by revenue from the same sources. This reserve account shall be funded only after the Rate Stabilization Reserve is funded up to the maximum level.
- Equipment Replacement Reserve Account for replacement of the Shoreway MRF single stream processing equipment, inclusive of an annual CPI adjustment.

The Rate Stabilization Reserve estimated balance for FY1516 is approximately $4 million. The purpose of the reserve is to set aside funds to minimize Transfer Station rate increases resulting from significant one-time revenue shortfalls (e.g., commodity price decreases, loss of tipping fee revenues due to short or long-term closure of the Shoreway facility, etc.). Historically, this reserve has been used to address significant drops in commodity prices such as the market collapse in the fall of 2008. This collapse resulted in a $3.56 million drop in commodity revenue during FY09. Staff made a revenue transfer from this reserve of $1.7 million in FY09 and a $3 million revenue transfer for calendar year 2009 to primarily address this shortfall so that the bond covenant requirements could be met.

It should be noted that the Sunnyvale Smart Station which receives materials from the cities of Palo Alto, Sunnyvale and Mountain View does not maintain a rate stabilization fund; the cities individually must come up with any funds to pay for the type of rate impact scenarios noted above. We do not recommend following this model for our twelve Member Agencies.

The Emergency Reserve estimated balance for FY1516 is also approximately $4 million. The purpose of the fund is to address limited capital needs or significant one-time increases in Shoreway operating expenses associated with "damage by natural disasters, acts of war or terrorism, or other community emergency scenarios that are not covered by existing insurance policies." Notably, we currently do not have insurance coverage for damage from a seismic event, flood damage, and damage caused by an act of terrorism. Seismic insurance coverage is reviewed annually but has been declined by the Board due to the high cost (i.e., last quote was $450,000 per year with a 10 percent deductible).

We do maintain coverage for fire; natural gas explosion; a plane crashing into our property; and weather related damage from wind, lightening, or a severe storm.

The Equipment Replacement Reserve is a sinking fund that is funded annually and then drawn down as monies are needed for major MRF equipment capital repairs, and eventually for partial replacement of the single stream processing system within the Material Recovery Facility (MRF). The Equipment Replacement Reserve covers the expected equipment replacement costs after the assumed 12-year depreciable life of the single stream processing equipment installed in 2011 plus any "significant one-time equipment repair (wear parts) costs not covered in our Shoreway capital budget." Per the Operations Agreement with SBR, the SBWMA is responsible for any repair expenses to stationary equipment when the repair for a single item exceeds $10,000.

Staff Review of Current Policy
During recent Board discussions on the budget, a couple of questions have been raised about our current reserve policy, including:

- Have we considered establishing minimum fund balances as none currently exist?
- Is using the 10% of budgeted operating expense the right formula to use for calculating the reserve amounts for the rate stabilization account and emergency reserve accounts?
- Has the practice of funding to the maximum level resulted in being over reserved?

In reviewing other city and JPA reserve policies there is no clear consensus around establishing minimum reserve levels, though there does appear to be commonality around having flexibility in establishing reserve levels. Staff believes it would make sense for the JPA to establish clear minimum reserve balances (for the rate stabilization and emergency reserve) so sufficient funds are available for the stated purpose of each reserve category. Currently, the practice is to fund up to a maximum amount and Board practice has been to adopt budgets with an assumed full funding of each reserve account.

Staff did not undertake a review of the equipment replacement reserve as that is already reviewed and adjusted periodically to reflect an analysis of the MRF equipment condition and future replacement cost for major wear parts. This analysis was done as part of the Long Range Plan and recent FY1516 budget process.

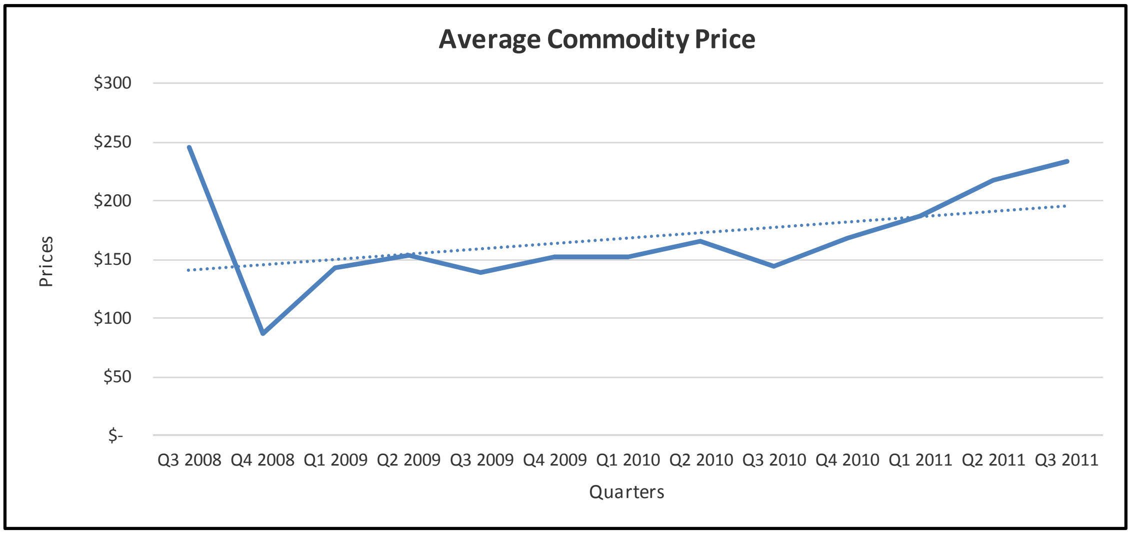
Staff reviewed the formula used for calculating the rate stabilization reserve and emergency reserve and found the following:

<u>Rate Stabilization Reserve</u>

- While the current formula of 10% of operating expense produces more than enough total dollars to cover past worst case commodity revenue shortfalls, a revised calculation should be used for determining a minimum and maximum amount to fund. This revised calculation should be based on comparing historical commodity revenue figures, both in terms of net commodity revenue and commodity prices per ton. The calculation would be updated each year depending upon market and budget conditions as necessary.

It is critical to understand, though, that the actual amount needed in the rate stabilization fund is affected by the JPA's adopted budget and how much money would be needed to be transferred from the fund to meet our bond covenant requirements (break-even test and debt coverage ratio of 1.4). The adopted FY1516 budget produces assumed financial results that barely meet the minimum bond covenant requirements so any significant commodity revenue shortfalls would require a transfer of funds.

The chart on the next page captures the cyclical nature of commodity prices. The 2008-2011 period captured in the chart was selected as this shows the biggest drop experienced in commodity prices in the fall of 2008, while also revealing how quickly commodity prices can recover from a historical drop.



Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011
$245	$86	$143	$154	$139	$152	$152	$166	$144	$168	$187	$217	$233

Table 1 below shows the change in net commodity revenue and price/ton change during this calamitous period of 2008/09 and through 2011. The $1.42 million drop in commodity revenue in 2009 vs. the historical average over a broader period of 2008-2014 is the single largest variance in commodity revenue the JPA has experienced. The same is true if you look at the variance in price per ton of $62/ton.

Table 1

Commodity Revenue Analysis for 2008-2011				
Calendar year:	2008	2009	2010	2011
Average Gross Price/Ton	$209	$147	$158	$206
Change from Prior Year ($/ton)		-$62	$11	$48
% Change		-30%	7%	31%
Assumed Gross Revenue	$13,678,071	$9,610,681	$10,298,032	$13,453,014
Variance to Average*	$2,127,545	($1,939,845)	($1,252,494)	$1,902,488
Revenue Share @ 27%	$2,193,119	$1,094,923	$1,280,508	$2,132,353
Buyback Payments	$800,000	$800,000	$800,000	$800,000
NET TO SBWMA	$10,684,952	$7,715,757	$8,217,524	$10,520,660
Variance to Average**	$1,553,108	($1,416,087)	($914,321)	$1,388,816
* 2008-2014 calendar year gross commodity revenue average = $11,550,526				
** 2008-2014 calendar year net commodity revenue average = $9,131,844				

Staff used the worst case scenarios, see items highlighted in orange in **Table 1** above, to model potential rate stabilization reserve scenarios as shown in **Table 2** on the next page. The reserve calculation figures shown for scenarios A and B could be used to establish a new minimum rate stabilization reserve fund amount of $1,416,072 and a maximum of $2,940,712. Staff would suggest a higher minimum given that the 2008 commodity price collapsed resulted in a FY0809 revenue transfer of $1.7 million.

Table 2

SBWMA Rate Stabilization Reserve Scenarios	FY1516 Adopted	Scenario A	Scenario B
Average Gross Commodity Price/Ton	$ 151	$ 121	$ 88
Commodity Price vs Budget $		$ (30)	**$ (62)**
Commodity Price vs Budget %		**-20%**	**-41%**
Gross Commodity Revenue	$ 9,630,366	$ 7,739,621	$ 5,651,073
Revenue Share	$ (1,064,410)	$ (589,737)	$ (25,829)
Buyback Payments to Public Customers	$ (897,939)	$ (897,939)	$ (897,939)
Net Commodity Revenue (1)	$ 7,668,017	$ 6,251,945	$ 4,727,305
Commodity Revenue Variance vs Budget		**$ (1,416,072)**	**$ (2,940,712)**
CASH RESERVE CALCULATIONS	**$ 4,033,671**	**$ 1,416,072**	**$ 2,940,712**
change compared to current cash reserve		*$ (2,617,599)*	*$ (1,092,959)*
Scenario A - based on worse case revenue reduction shown in Table 1.			
Scenario B - based on worse case price reduction price/ton shown in Table 1.			

Staff recommends that the reserves continue to be funded to the maximum levels unless the Board specifically determines that there are other rate and policy issues that would warrant funding less than the maximum.

Emergency Reserve

- Using a formula tied to operational expense makes logical sense as the most likely scenarios to be covered by this reserve fund relate to operational upsets caused by natural disasters. There is an open question related to whether the 10% of operational expense produces the maximum funds needed to address what staff believes is the mostly likely operational upset related to an earthquake, but staff believes a minimum fund balance amount can be more readily established.

Staff modeled what it believes is the most likely scenario of an earthquake impacting the transfer station operations. The northern half of the transfer station and the transfer station loading tunnels are part of the original 1980s construction and could be impacted by an earthquake. A preliminary engineering assessment conducted in 2013 concluded that the older portions of the transfer station building and tunnels were structurally sound but a much more detailed assessment would need to be completed to determine their seismic strength. As part of the adopted Long Range Plan and FY1516 budget, staff has funds available and will be evaluating these issues as they relate to the potential future installation of mixed waste processing equipment in the older portion of the transfer station; the significant loading associated with the new equipment has to be analyzed in the context of the existing transfer station building.

What staff was able to model were the operational costs impacts to SBR if the transfer station loading operations were impacted by an earthquake. Staff determined, with input from SBR, that if the transfer station tunnels were damaged and inoperable for a year that it would result in higher transfer trailer loading and transportation costs of $1.63 million. What we don't know yet would be the estimated capital costs to repair the transfer station building and loading tunnels.

Other Items

Staff would recommend one clean-up item in the current policy which is to add language defining "operating expense" so there is no future issues around calculating any reserve amounts tied to a percent of operating expense. The SBWMA has always defined operating expense for this purpose as all cash expenses including Shoreway operations, SBWMA program, interest expense and franchise fees. Non-cash expenses such as depreciation are excluded. This should be clarified in the reserve policy document.

Background

The current cash reserve policy was reviewed by the Board of Directors on March 27, 2014 and no suggested changes were made to the policy.

The policy was last revised per action at the May 23, 2013 Board Meeting to reflect more clarity in defining the purpose and use of each reserve account. Key changes were made to the reserve policy as follows:

- Maintained two previous reserve accounts (Rate Stabilization Reserve and Equipment Replacement Reserve) and replaced the Operating Reserve with an Emergency Reserve Account.
- Changed the priority order of the accounts so the Rate Stabilization Reserve is first in priority followed by the Emergency Reserve.
- Excluded certain operation expenses (i.e., Shoreway buyback payments to customers and door to door HHW collection expenses) in the calculation of the fund levels for each account (i.e., up to maximum of 10% of Operating Expenses) for the Rate Stabilization Reserve and the new Emergency Reserve.

The reserve policy was originally based on a review of reserve policies at our Member Agencies which the SBWMA tried to emulate as practical for our business. In 2013, the Board formed an adhoc subcommittee to review the policy. Staff also reviewed reserve policies in place at other solid waste JPAs (see Attachment B).

Fiscal Impact

There is no direct fiscal impact from maintaining the reserve policy other than its intended use if needed when an emergency occurs or commodity prices decline. A change in the reserve policy could have a one-time impact to tip fees at Shoreway if the reserves are increased or decreased. Alternatively, a reduction in designated reserve balances could be retained in the undesignated cash reserve balance for future use to fund capital projects at Shoreway as discussed in the recent Board approved Long Range Plan.

The table below shows the FY1314 audited reserve balances and adopted FY1415 and FY1516 adopted budget balances.

	ACTUAL FY1314	ADOPTED BUDGET FY1415	MID-YEAR BUDGET FY1415	ADOPTED BUDGET FY1516
UNRESTRICTED:				
RATE STABILIZATON (10% of expense)	$ 3,703,283	$ 3,906,648	$ 3,845,988	$ 4,033,671
EMERGENCY RESERVE (10% of total expense)	$ 3,703,283	$ 3,906,648	$ 3,845,988	$ 4,033,671
EQUIPMENT REPLACEMENT (ANNUAL)	$ 1,130,726	$ 1,542,328	$ 1,542,328	$ 1,499,514
UNDESIGNATED	$ 4,589,433	$ 2,530,236	$ 4,527,022	$ 3,175,018
TOTAL UNRESTRICTED GENERAL RESERVES	**$ 13,126,724**	**$ 11,885,859**	**$ 13,761,325**	**$ 12,741,874**
COMMITTED:				
BOND PRINCIPAL PAYMENT FUND	$ 1,004,167	$ 1,058,330	$ 1,058,330	$ 1,091,667
TOTAL GENERAL RESERVES	**$ 14,130,891**	**$ 12,944,189**	**$ 14,819,655**	**$ 13,833,541**
	$ 14,130,891	*$ 12,944,189*	*$ 14,819,655*	*$ 13,833,541*
SHOREWAY REMEDIATION PROJECT	**$ 1,289,283**	**$ 1,209,283**	**$ 1,209,283**	**$ 1,239,800**

Attachments:

Attachment A - Current Cash Reserve Policy
Attachment B - Summary of Other Solid Waste JPA Cash Reserve Policies

ATTACHMENT A

Current Reserve Policy

After meeting all debt service obligations of the SBWMA, the following designated reserve accounts shall be funded:

Rate Stabilization Reserve Account of up to a maximum of ten (10%) percent of budgeted operating expenses, exclusive of pass through expenses that are 100% offset by revenue from the same sources (e.g., Shoreway buyback payments to customers and door to door HHW collection expenses). These funds are available to help minimize Transfer Station rate increases resulting from significant one-time revenue shortfalls (e.g., commodity price decreases, loss of tipping fee revenues due to short or long-term closure of the Shoreway facility, etc.).

Emergency Reserve Account of up to a maximum of ten (10%) percent of budgeted operating expenses, exclusive of pass through expenses that are 100% offset by revenue from the same sources (e.g., Shoreway buyback payments to customers and door to door HHW collection expenses). This reserve account shall be funded only after the Rate Stabilization Reserve is funded up to the maximum level.

This fund is available to make limited capital repairs and reconstruct the Shoreway facility buildings and infrastructure that may be damaged by natural disasters, acts of war or terrorism, or other community emergency scenarios that are not covered by existing insurance policies. Such capital expenses would be those that could not be funded through an existing capital budget or those not reimbursable through insurance coverage. This fund is also available to cover significant one-time increases in operating expenditures associated with above said scenarios.

Equipment Replacement Reserve Account for a 12 year cost replacement schedule, inclusive of an annual CPI adjustment, for the Shoreway MRF single stream processing equipment. This reserve would also be available to fund any significant one-time unanticipated equipment repair (wear parts) costs not covered in our Shoreway capital budget.

Fund levels will be approved each year as part of the adoption of the fiscal year budget. During the budget process, projected net cash flow, reserve balances, and debt covenants are considered when budgeting Shoreway tip fees. Excess cash flow is minimized by adjusting tip fees to cover operating expenses and fund reserve balances.

It is important to note that the first two funds are basically static funds with minimal annual changes which are based on fluctuations in the annual operating budget. Ten percent is not added each year – this is the fixed limit. The third fund is a cumulative fund as cash is added each year to reach the total amount needed at the end of the twelve year replacement period.

If after all reserve levels are funded up to their maximum levels and tip fees are budgeted, surplus cash may be available. The adopted budget will include specific guidance on the use of such surplus cash with a goal of utilizing the monies for one-time expenditures, non-recurring costs, or funding an undesignated reserve account.

ATTACHMENT B

Summary of Other Reserve Policies

Sunnyvale SMaRT Station

1. Equipment replacement reserve based on replacement life of equipment plus CPI.
2. Don't have a specific operations reserve. The City of Sunnyvale maintains its own "Contingency Reserve" within its Solid Waste Fund. The reserve is set at 10% of operations expenses (i.e., their franchised haulers costs, disposal and processing costs and landfill closure costs).

Monterey Regional Waste Management District

1. 20% of cash operating expenses to address contingencies for unexpected expenses. The district runs all operations including a landfill, processing operations, HHW, etc.
2. Rae stabilization/Unfunded Mandates fund set at $200,000.
3. Facility Plan/Capital Outlay.

Salinas Valley Solid Waste Authority

1. Operating reserve at 15% of current year operating expenditures to provide sufficient reserves for emergencies, non-recurring expenditures, revenue shortfalls or major capital purchases that can't be accommodated through any current year savings.
2. Undesignated fund balance of 10% of current year operating expenditures (maintenance and operation expenditures only). If after annual audit, the undesignated fund balance exceeds 10%, the excess will be allocated to reserves in the following priority:
   i. Insurance retention reserves
   ii. Operating reserve
   iii. Capital projects reserve
3. Capital projects reserve for the purpose of funding future capital projects. After fulfilling all insurance and operating reserve requirements and undesignated funds above 10% will be allocated to the Capital projects reserve.