Public Integrity Review

Preliminary Assessment:

Refuse Rate-Setting Process – Update Based on Additional Reviews and Meetings with Recology

CITY & COUNTY OF SAN FRANCISCO

Office of the Controller

May 16, 2022

Executive Summary

Executive Summary of the Assessment

Under the Refuse Collection and Disposal Initiative Ordinance approved by San Francisco voters in 1932, San Francisco Public Works (Public Works) administers the refuse rate process in the City and County of San Francisco (City) through a public hearing process. Public Works is tasked with issuing a rate order that approves just and reasonable rates for residential ratepayers. Rates are set for multiple years based on one year of projected revenues subject to rate setting and allowable costs. In 2017, approved rates included eligible costs for Residential and Commercial Uniform Ratepayers and allowable profit margin of 9 percent.

In an earlier assessment on April 14, 2021, we reviewed the current refuse rate process and recommended the development of mitigating controls to protect ratepayers from errors, omissions, and controllable and uncontrollable variances in the rate application and approval process. At that time, the City Attorney's Office had just announced the City's settlement with Recology San Francisco (RSF), Recology Golden Gate, and Recology Sunset Scavenger (collectively "the SF Companies" or "Recology"). As a result of that settlement, **Recology agreed to pay $101 million in restitution, interest, and penalties to ratepayers ($86.6 million in overcharges and $14.4 million in interest and penalties)** affected by the erroneous calculation of revenues in the 2017 Rate Application.

This assessment focuses on revenue and expense projections in past rate setting processes, allowable profit, and variances with actuals. Recology's actual profit margin was higher than the allowed 9 percent because its expenses were regularly lower than projected. **In rate years 2018 through 2021, Recology netted profits of $23.4 million over and above the allowed 9 percent profit margin.** These are actual profits even after Recology paid the $101 million settlement. Recology's revenues—and additional potential profitability—would have been greater if not for the reduction in Commercial Customer revenue in rate year 2020-21 due to the COVID-19 pandemic.

Executive Summary of the Assessment *(continued)*

Several factors complicated the tracking and accounting of variances between projections and actuals in rate years 2018 through 2021. First, in addition to the rate application error that resulted in the $101 million settlement, there were additional **errors in the 2017 Rate Application** such as costs inappropriately included in or excluded from the rate-setting calculation. These errors inflate or deflate projections used in rate-setting. Second, the **rate reporting includes disallowed, ineligible costs**. The inclusion of these ineligible costs masks the full extent to which actual profits were higher than the allowed 9 percent. Third, the rate year is July 1st through June 30th, but Recology's fiscal year is October 1st through September 30th. This difference made it difficult to compare and reconcile any discrepancies between Recology's audited financial statements and its rate reporting.

In addition to variances between projections and actuals, Recology's rate applications and rate orders have taken an **inconsistent approach to the acquisition and disposal of assets** paid by ratepayers. With ratepayer-funded equipment, ratepayers benefit from use of the asset after costs (including financing costs) are paid in full and are credited for their share of the sales proceeds when sold. This has not been true for the acquisition and disposal of real property used in the operations of the SF Companies. Instead, ratepayer-funded real property is owned by Recology Properties, another subsidiary of the parent company (Recology, Inc.), and associated rental costs were inconsistently charged to ratepayers. This is particularly relevant to Recology Properties' sale of real estate at 900 7th Street to Amazon for $200 million in December 2020 which was acquired with ratepayer funds but none of the proceeds of the sale of this asset accrued to the benefit of ratepayers.

Executive Summary of the Assessment *(continued)*

Recology and its legal counsel argue that the 9 percent profit margin allowed in the 2017 Rate Order is only a target and that Recology is entitled to keep profits above the allowed 9 percent profit margin. But for rates to remain **just and reasonable** over time, this assessment recommends the **creation of a balancing account** to remedy erroneous projections as a matter of course each year. To ensure just and reasonable rates over time, this assessment recommends:

(1) Recology **deposit the $23.4 million of profits over and above the allowed 9 percent profit margin in rate years 2018 through 2021**, and any subsequent value determined from review of prior periods or return on asset sales, into a **balancing account** or a comparable mechanism.

(2) This balancing account be utilized to offset future rate increases, including automatic cost of living adjustments scheduled to occur on July 1, 2022. **This balancing account could also be used to stabilize rates** and protect ratepayers and Recology from extreme rate swings in anomalous years.

(3) Recology's rate reports **accurately and timely identify when rates exceed (or fall below) the allowable target set by the applicable rate order** to ensure that the balancing account is promptly adjusted when profits exceed (or fall below) the allowed profit.

While the analysis and figures in this assessment pertain to rate years 2018 through 2021, many of the issues driving the above-target profit margin were present in previous rate years. Further, the analysis and figures exclude proceeds from the sale of real estate at 900 7th Street.

Assessment Summary

Assessment Summary – Overview

The Controller's Office (Controller) conducted this assessment of the rate-setting process in coordination with the City Attorney's Office (City Attorney). This assessment is based on findings from our joint Public Integrity investigation and is a follow-up to the previous assessment issued on April 14, 2021.

The ***previous assessment*** focused on how the City conducts the rate-setting process and revenue errors found in the 2017 rate application of the SF Companies. The previous assessment recommended improvements to the rate-setting and rate-reporting processes.

This assessment identifies areas for further review and makes additional recommendations to improve the rate-setting process for the collection of waste, compostable materials, and recyclables (refuse). To perform this assessment, we:

- Evaluated the **completeness and accuracy of quarterly and annual rate reports** for rate years ending 2018 through 2021, through discussion with the SF Companies and their counsel, and review of supporting documentation. We identified **potential errors, omissions, and controllable and uncontrollable variances** (between projections and actuals).
- Reviewed past rate orders, rate calculations, and associated supporting documentation from 1991 to the present to **identify historically noted issues and concerns, and past treatment of those items**.
- Identified areas for improvements in the rate-setting and rate-reporting processes **to increase transparency and better facilitate timely and effective monitoring** of implementation of goals and rates set in the rate-setting process, including traceability to audited financial statements.

Assessment Summary – Methodology

Our further assessment of the rate-setting and rate-reporting processes was initiated on November 16, 2021, when the Controller sent the SF Companies a letter with observations and requests for explanations with **supporting documentation related to expenses, revenues, and transparency and accountability** in the rate-reporting process. We then did the following:

- **Met with the SF Companies and their counsel (along with attendees from the City Attorney and Public Works) in 15 meetings** between January 4 and May 2, 2022, to discuss the issues raised in the Controller's November 16, 2021, letter.
- Reviewed (1) the 2017 Rate Application materials and projections; (2) quarterly and annual rate reports for rate years ending June 30, 2018, 2019, 2020, and 2021; and (3) **audited financial statements for the SF Companies and the Parent Company for fiscal years 2016 through 2021**.
- Reviewed the SF Companies' numerous responses to the November request related to real property (e.g., building and land), personal property (e.g., equipment and vehicles), corporate allocations (e.g., human resources and IT), payroll and related costs (e.g., pension and workers' compensation), and other items relevant or potentially relevant to refuse rates.
- **Reviewed materials from past rate-setting processes**, some dating back to 1991, including rate orders, rate calculations, rate reports, and supporting documentation.
- Conducted online research to **identify benchmarks** and practices in other jurisdictions for refuse rate setting and rate reporting.

Assessment Summary – Preliminary Findings

Our assessment identified the following additional concerns with the rate-setting and rate-reporting processes:

- The SF Companies' rate reporting for all four years following the 2017 Rate Application had errors and omissions, which ranged from **inclusion of ineligible expenses in the operating ratio eligible expenses** to inconsistent calculation of allowable profits in the annual rate reports.
- There were **significant variances in employee headcount and payroll-related expenses** when compared to the projections the SF Companies presented in the 2017 rate application process. These variances often led to profits exceeding targets.
- Allowable operating profits consistently exceeded the 9.0 percent stipulated in the 2017 Rate Order. **Even after taking into account the $101 million settlement paid to ratepayers, actual operating profits exceeded allowable profits by $23.4 million* for the period of rate years 2018 through 2021.**
- Significant intercompany charges to the SF Companies from the Parent Company make it challenging to determine the appropriateness of such expenses shown in the rate application, as well as in rate reporting. **These intercompany charges were often 30-60 percent of the SF Companies' expenses.**
- Failure by regulators to track and implement recommendations from previous rate application processes caused **historical issues and concerns to go unaddressed**.

* This figure was used throughout the assessment meetings with Recology. On April 15, 2022, Recology issued a disclosure for material misstatements that identified 29 line items. On May 11, 2022, in response to the Controller's draft report, Recology provided an additional adjustment that reduced the excess allowable profits figure to $19.0 million. The Controller did not have sufficient time to validate the new adjusted amount and will use the $23.4 million figure in this report.

Assessment Background

Federal Criminal Charges Alleging Public Corruption Prompted Joint Controller/City Attorney Investigation

In January 2020 former Public Works Director Mohammed Nuru was criminally charged with a scheme to defraud the City of his honest services by providing official action in exchange for bribes. In response to those criminal charges, the City Attorney and Controller launched a joint investigation into public corruption identified in the criminal complaint.

As part of that joint investigation, the Controller issued three preliminary assessments relevant to the SF Companies' interactions with the City:

- Gifts to Departments Through Non-City Organizations Lack Transparency and Create Pay-to-Play Risk *(September 24, 2020)*
- Refuse Rate-Setting Process Lacks Transparency and Timely Safeguards *(April 14, 2021)*
- San Francisco Department of the Environment's Relationship with Recology and Lack of Compliance with Ethics Rules *(April 8, 2022)*

Both Mr. Porter, former Vice President and Group Manager, San Francisco Group, and Mr. Giusti, former Government and Community Relations Manager, were charged with theft of honest services fraud and money laundering for bribing Mr. Nuru in exchange for official action. The criminal charges were based in part on payments of more than $1 million to Mr. Nuru through multiple non-profit organizations for city-sponsored events, like Giant Sweep and an annual Public Works/General Services Agency holiday party. Mr. Giusti pled guilty to theft of honest services fraud in July 2021 and is cooperating with the federal corruption probe.

Background on Recology Settlement With the City Attorney and United States Attorney's Office

On March 4, 2021, the City Attorney announced **a civil settlement with the SF Companies worth more than $101 million.** The settlement, approved by the Board of Supervisors and Mayor, required refunds to ratepayers based on errors in the SF Companies' 2017 rate application. The errors related to revenues collected by the SF Companies but earmarked for the Impound Account and Zero Waste Incentive Fund. These revenues were incorrectly counted as expenses, resulting in approval of a rate increase of 14 percent instead of 7 percent. The settlement also resulted in lower rates, effective April 1, 2021. In addition to more than $94 million in restitution with interest to ratepayers, the settlement required the SF Companies to pay a $7 million civil penalty.

The City's settlement with the SF Companies also **prohibits them from making any gift to any City employee or any contribution to a nonprofit at the behest of a City employee**. The stipulated injunction entered as part of the settlement and effective through June 30, 2025, further requires that the SF Companies: (1) disclose any contribution of $1,000 or more to any local non-profit; (2) comply with City law governing lobbyists; (3) report all contacts with City officials involved in rate-making; and (4) disclose material mistakes or errors in any rate-reporting document submitted to the City. Since the settlement, the SF Companies have disclosed material mistakes or errors in reports dated April 15, 2022, and May 2, 2022, posted on the Public Works website at https://sfpublicworks.org/refuserates.

On September 9, 2021, in a deferred prosecution agreement with the U.S. Attorney's Office, the SF Companies admitted to bribing Mr. Nuru and agreed to pay $36 million in criminal fines (offset by the $7 million in civil penalties paid to the City). The SF Companies admitted to funneling more than $150,000 a year to Public Works through non-city organizations "to obtain Nuru's official assistance with [their] business."

Background on Recology

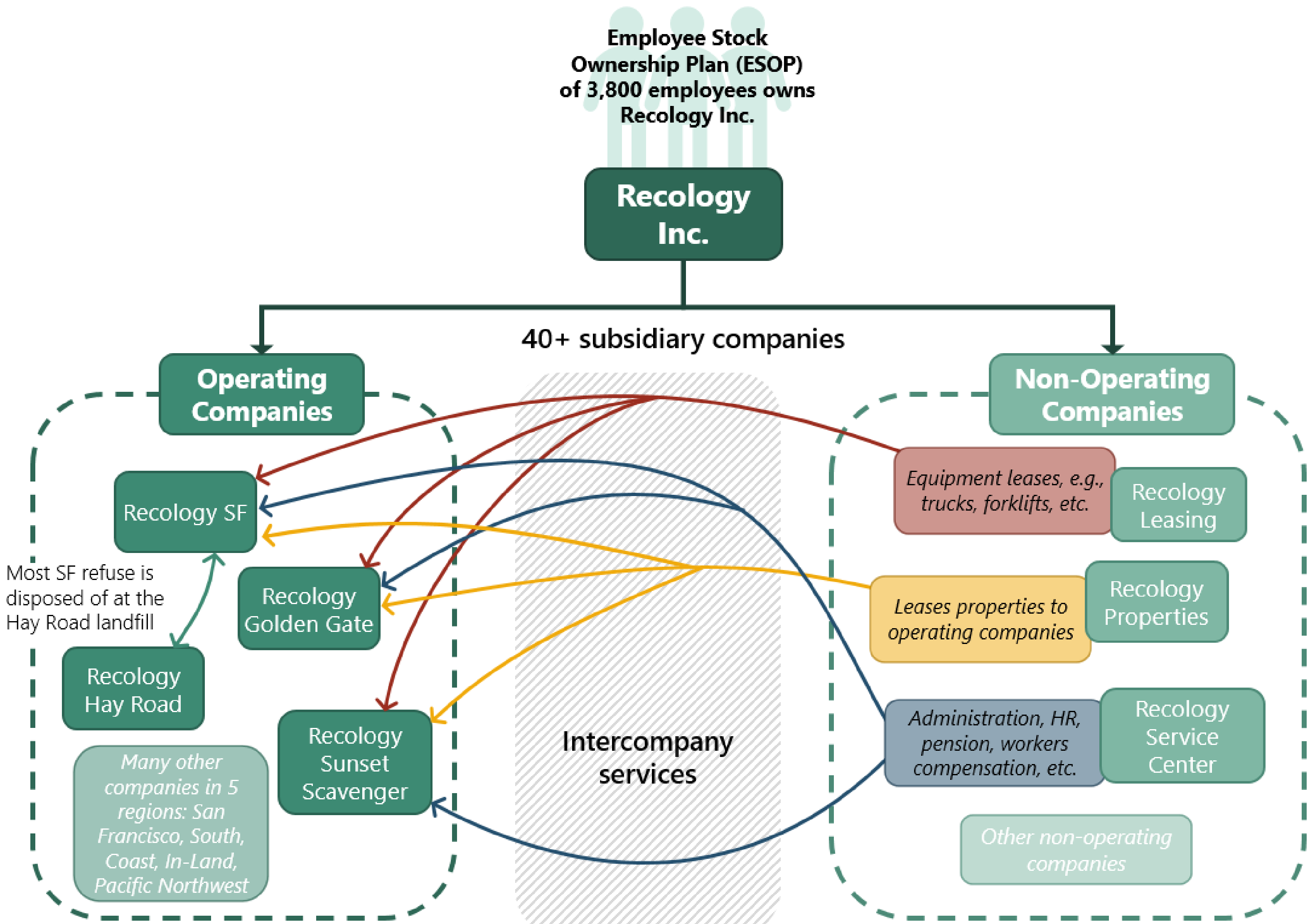
Recology Inc. (the Parent Company) is a privately held waste management company that provides refuse services to residential and commercial customers in San Francisco and other municipalities in multiple states, through over 40 subsidiaries. The Parent Company has three wholly-owned subsidiaries that operates in the City: Recology San Francisco, Recology Sunset Scavenger, and Recology Golden Gate. As defined above in Slide 3, these three local entities are collectively referred to in this assessment as "the **SF Companies**" or "**Recology.**"

The Parent Company is owned by an Employee Stock Ownership Plan (ESOP), which is a noncontributory plan that covers substantially all the employees of the Parent Company and its subsidiaries. The ESOP provides an ownership interest in the company. It is through that ownership interest that employees can obtain a supplemental retirement benefit.

The Parent Company and its subsidiaries provide various goods and services to the SF Companies, for which the SF Companies pay through intercompany charges from the Parent Company. The intercompany charges sometimes represent as much as **60 percent of the SF Companies' operating expenses**. These charges include allocations for insurance coverage and corporate fees from **Recology Service Center**, real property leases from **Recology Properties,** equipment leases from **Recology Leasing** (formerly Alta Leasing), and landfill disposal from **Recology Hay Road.**

See next slide for depiction of these intercompany charges.

Recology Corporate Structure



Background on Residential Refuse Collection

The City's Refuse Collection and Disposal Initiative Ordinance (the Refuse Ordinance), approved by San Francisco voters in 1932, created a regulatory process—and approved 97 permits, which never expire—for residential refuse collection in the City. Recology acquired all 97 permits which resulted in the City never engaging in a competitive procurement process.

- The City has no formal agreement with the SF Companies for residential refuse collection services.
- As **the major refuse collection companies merged into the SF Companies, they acquired all 97 permits and became the sole provider of residential refuse collection in the City.** Because the permits are perpetual, the SF Companies are not subject to a competitive bidding process for residential refuse collection.
- Other jurisdictions use various processes—including competitive bidding, negotiated agreements, and non-exclusive contracts—to select their refuse collection vendors.
- In contrast to residential rates, the Refuse Ordinance does not expressly authorize the Rate Board to set non-residential (commercial) refuse rates. Residential rates, however, have historically been set using consolidated eligible costs, which includes commercial and residential expenses. This approach sets the revenue requirement for Residential and Commercial Uniform Rates, and therefore commercial (non-negotiated) rate increases have mirrored residential rate increases.

Historical Review of Rate Applications

During the rate-setting process, the City must set rates that are "**just and reasonable**." City staff and external consultants review each rate application to validate changes and assess the **appropriateness and reasonableness of the stated expenses and profits**.

Issues raised in past rate applications

Year	Issues or Recommended Adjustments Noted by Public Works

1991	• Consultant Hilton Farnkopf and Hobson identify **several unresolved issues to be addressed before payments for land** should be passed through to ratepayers, including:
	  o Should the ratepayers reimburse the company for land previously acquired by the companies in the same manner or new acquisitions?
	  o How should land acquired and held for future use be valued?
	  o If the ratepayers compensate the companies for land they own or acquire, should the companies share in the proceeds from the sale of the land?
	  o Should the City have the right to select an option for each land acquisition?

1994	• SF Companies did not provide detailed information supporting their rate application with sufficient time for meaningful review by city staff.
1996	• Following analysis by Harvey Rose, **ESOP costs (then $3.7 million) should no longer be included in rate base.**
2001	• City agrees that financing portion of **lease costs should be eligible for operating ratio (OR) profits** based on Recology's testimony that most jurisdictions allow an OR on lease costs, including interest.
2006	• City determines that OR should not be allowed on **disposal fees (then $3.2 million)** and recommends lowering OR from 91.55% to 91.00% to preserve then-current allowed profit ratio. • Yano Accountancy finds that equipment **lease rates** charged by Alta Leasing, a Recology-affiliated company, were **significantly above market interest rates**, resulting in recommended savings of $6.5 million.
2013	• The City determined that **Brisbane license fee ($2.1M)** should be excluded from OR. • The City recommended increasing the lease term for stationary equipment from 7 to 10 years.
2017	• The City determined that **Intercompany processing expenses ($14.2M)** related to compostables, brush, processed fines, sheetrock, wood and concrete, and "out-of-county", should be excluded from OR.

Historical Review of Rate Reporting

The rate order requires the SF Companies to periodically provide rate reports. These rate reports are critical to the City's ability to **monitor** the performance of the SF Companies relative to operational and financial goals set in past rate proceedings. Past rate orders discuss the importance of relevant, accessible, and reconcilable financial information to increase **transparency to ratepayers**.

Past rate orders discuss the importance of rate reporting to monitoring performance and facilitating public review	
Year	**Relevant items noted in Controller's Office review of past rate orders**
1994	• SF Companies must report quarterly on deposits and expenditures from accounts and submit an annual report from their auditors.
2001	• SF Companies must provide "a report showing financial statements" to the City annually, no more than 90 days after the last day of the rate year.
2006	• Ratepayers and City seek greater transparency in how Recology operates, how various subsidiaries of the Parent Company relate to and do business with one another, and how rate dollars are expended. • Rate reports must include information on diversion levels, account balances, actual revenues, age and salvage value of trucks and containers, financial statements, pension fund status, etc. These are deemed critical to ensure **adequate monitoring of rate implementation** and achievement of diversion and other goals. • Rate reports due **within 90 days** of end of each quarter or rate year.
2013	• Rate reports due **within 60 days** of the end of each quarter or rate year. • Quarterly reports must include actual revenues and expenses (previously only required in annual reports). • Quarterly and annual reports must be posted on the Public Works website to **facilitate greater public review**.
2015 – The 2015 Landfill Disposal Agreement requires RSF to provide audited financial statements annually. However, RSF did not provide this information until the Controller requested it in May 2022.	
2017	• City states that financial information in quarterly and annual reports **does not reconcile** to information in rate application and that information in some of reports' tables is confusing. • City and SF Companies must work together to modify information in reports, identify missing or unnecessary data, and revise tables and format. Changes to be reflected in first quarterly report for rate year 2018.
2021 – As a result of City's settlement with SF Companies, their annual rate reports must disclose any material differences between actual operating ratio and projected operating ratio.	

Analysis & Findings:

Inconsistent Calculation of Operating Ratio and Allowable Profits

Operating Ratio – Definition

To set just and reasonable rates, Public Works uses a rate-setting formula that allows the SF Companies to obtain their costs plus a fair profit using an **operating ratio (OR).**

- The **OR** is applied to **OR-eligible expenses**—expenses on which the SF Companies are eligible to earn a profit. (The greater the OR-eligible expenses are, the higher the net revenue requirement, rate increase, and, ultimately, profit are).
- OR is generally expressed as a percentage. The formula to calculate OR requires dividing **[OR-eligible expenses] by [OR-eligible expenses plus allowed profit]**.
- A 91 percent OR results in an allowed profit margin on OR-eligible expenses of approximately 9 percent.

Operating Ratio – History and Excerpts on Intercompany Charges

The OR approved in past rate applications is summarized below, including details on resulting profitability and excerpts from rate orders regarding intercompany charges.

Year	OR (and ZWI*)	Profit Margin	Excerpts From Rate Orders Regarding Intercompany Charges
1990	90.50%	9.50%	"Regarding equipment leases, we [consultant] are requiring the operating companies to enter into formal equipment leases which specify that the assets involved become the property of the operating companies at the end of the lease period."
1991	91.55%	8.45%	"They [consultant] also noted that as yet no formal leases have been executed to assure that the operating companies receive ownership of the assets at the end of the lease. These leases should be formalized by the company on or before the effective date of this rate order."
1994	91.55%	8.45%	"To assure that profits are earned only once on intercompany expense, I am adjusting the calculation of profit on disposal charges paid by Sunset Scavenger to Sanitary Fill." "The Rate Board ordered that intercompany lease charges be treated as a non-profit [OR Ineligible] expense."
1996	91.55%	8.45%	No relevant excerpt located.
2001	91.55% (1.55% ZWI)	8.45% to 10.00%	No relevant excerpt located.
2006	91.00% (2.00% ZWI)	9.00% to 11.00%	"[Consultant] concludes that the interest rates on leases charged by Alta to the San Francisco Companies, while apparently based upon the 2001 Rate Application, appear to contain **excessive and double profit**."
2013	91.00% (2.00% ZWI)	9.00% to 11.00%	"Exclude certain corporate expenses from allocation to SF companies: reduce RSF allocation by $6,981."
2017	91.00% (2.00% ZWI)	9.00% to 11.00%	"However, RSF included $14,181,155 in intercompany processing expenses related to compostables, brush, processed fines, sheetrock, wood and concrete, and 'out-of-county' as eligible expenses."

* ZWI stands for Zero Waste Incentive, previously known as Diversion Incentive until 2013. In 1989, California AB 939 was passed which mandated a reduction of waste being disposed with diversion targets set at 1995 and 2000. The Diversion Incentive Account was established in 2001 which financially incentivized Recology to better assist the City meet AB 939 and historically has resulted in potential extra profit of approximately 2 percent.

Inconsistent Calculation of OR in Rate Reports versus Rate-Setting

Rate Reports: In the annual report, actual and projected OR are calculated using total sources (*see A below*) and total uses (*see C below*) across all customer classes. There does not appear to be a consistent definition for "Total Sources" and "Total Uses" in rate reporting. As a result, ratepayers cannot use this information to effectively monitor the implementation of the rate.

Table 11
Recology Sunset Scavenger and Recology Golden Gate
Statement of Operating Profits
July - June 2018

		2018 SF PW Approved	Crosswalk	2018 Actuals (Per Recology Reports)	Crosswalk	Dollar Variance	Percentage Variance
SOURCES	Commercial	$ 132,152,779	*See Table 6*	$ 154,804,031	See Table 6	$ 22,651,252	17%
	Residential	76,565,566	*See Table 6*	85,805,012	See Table 6	9,239,446	12%
	Apartment	61,144,917	*See Table 6*	67,688,952	See Table 6	6,544,035	11%
	Commercial Compactors	*29,073,624*	*See Table 6*	28,158,701	See Table 6	(914,923)	-3%
	Debris Box and Other	26,275,073	See Table 6	27,440,200	See Table 6	1,165,127	4%
	Contracts	5,895,493		-	NA	(5,895,493)	-100%
	Current Rate Payer Revenue	**$ 331,107,452**		**$ 363,896,896**		**$ 32,789,445**	**10%**
	Zero Waste Incentive Fund Rebate	$ 11,587,896	See Table 6	$ 11,587,896	See Table 6	$ -	0%
	ZWI Facility Improvements	3,247,570	See Table 6	3,247,570	See Table 6	-	0%
	Special Reserve Rebate	2,500,000	See Table 6	2,500,000	See Table 6	-	0%
	Applied Ratepayer Revenue from Prior Years	**$ 17,335,466**		**$ 17,335,466**		**$ -**	**0%**
A	**Total Sources**	**$ 348,442,917**		**$ 381,232,362**		**$ 32,789,445**	**9%**
USES	Impound Account (Not OR Eligible)	$ 19,692,816	See Table 6	$ 19,692,816	See Table 6	$ -	0%
	ZWI Funding (Not OR Eligible)	4,506,108	See Table 6	4,506,108	See Table 6	-	0%
	ZWI Approved Projects (Not OR Eligible)*	-		3,247,570			
	Processing (Not OR Eligible)	74,231,192	See Table 9	71,919,715	See Table 9	(2,311,477)	-3%
	Disposal (Not OR Eligible)	47,861,695	See Table 9	47,250,061	See Table 9	(611,633)	-1%
	Licensing (Not OR Eligible)	1,635,897	See Table 9	1,900,345	See Table 9	264,448	16%
B	OR Eligible Expenses	182,474,780	See Table 9	175,961,844	See Table 9	(6,512,937)	-4%
C	**Total Uses**	**$ 330,402,488**		**$ 324,478,459**		**$ (5,924,029)**	**-2%**
D = A less C	**NET PROFIT**	**$ 18,040,429**		**$ 56,753,903**		**$ 38,713,473**	**215%**
	OPERATING RATIO	**91.0%**		**75.6%**			

OR On Profit Eligible Expenses = 100% less (D) divided by (B plus D)

* Depreciation from fixed assets funded by approved ZWI projects are not included in expenses for rate setting purposes.

Source: Recology Rate Report for Rate Year Ended 2018. Notes in red added to show calculation methodology shown in Rate Report for Rate Year Ended 2021.

Inconsistent Calculation of OR in Rate Reports versus Rate-Setting

Rate-Setting: On the right is our recalculation of actual profit on allowable costs and achieved OR to be consistent with the 2017 Rate Application.

The actual profit calculated here is $3.25 million higher ($60.0 million versus $56.8 million) than the net profit stated in the rate report, as shown on the immediately preceding slide.

	2017 Rate Application	2018 Actual	
Total Expenses	306,203,564	297,031,966	A
Less: Non-OR Expenses			
Disposal Cost	(47,861,695)	(47,250,061)	B
Processing Cost	(74,231,192)	(71,919,715)	B
License Expenses	(1,635,897)	(1,900,345)	B
OR Eligible Operating Expenses	182,474,780	175,961,845	C = A + B
Allowable Profit on OR Eligible	18,046,956	17,402,820	D = (C/0.91) - C
Calculated OR Expenses PLUS PROFIT	200,521,736	193,364,665	E = C + D
Non OR Expenses			
Disposal Cost	47,861,695	47,250,061	
Processing Cost	74,231,192	71,919,715	
License Expenses	1,635,897	1,900,345	
Impound Account	19,692,820	19,692,820	
Total Non OR Expenses	143,421,604	140,762,941	F
Total Non-Rate Revenue	(32,170,566)	(27,440,200)	
Zero Waste Incentive (2% OR)	4,506,106	4,506,106	
Other Add-backs	3,641,871		
Total Non-Rate Revenue & Other	(24,022,589)	(22,934,094)	G
Net Revenue Requirement	319,920,751	311,193,512	H = E + F + G
Revenue Subject to Rate (As Reported)		353,792,161	I
Excess Profit		42,598,649	J = I - H
Allowable Profit		17,402,820	D (from above)
Calculated Profit		**60,001,469**	
Effective Operating Ratio		74.6%	
Profit Reported		**56,753,903**	
OR as Reported		75.6%	
Profit Calc. Vs. Profit Reported		**3,247,566**	
Difference in %		1.0%	

Inconsistent Calculation of OR in Rate Reports versus Rate-Setting

Preliminary Finding: Inconsistencies exist between the OR calculation used in the 2017 Rate Application process and the annual rate reports' methodology. Without a comprehensive, prescriptive list of OR eligible expenses, it is difficult to determine the appropriateness of OR calculations and actual profits.

The inconsistencies are due to:

- Differences in the revenue and eligible costs that should be included (and excluded) from the OR calculation, as well as the appropriateness and consistency in accounting basis (e.g., accrual versus cash basis accounting).
- No prescriptive list of revenues and eligible costs that are allowed (and not allowed) to be passed on to ratepayers that could be used in the rate-setting and OR calculation processes.
- No line-item details, nor breakdowns by customer classes, or other historical information.

As part of the rate-setting process, the City, with assistance from consultants, reviews the applicant's proposed rate schedules, revenue and expense forecasts, and assumptions and supporting documentation underlying the forecasts. For expenses, this includes determining whether the applicant may pass the cost to the ratepayers and may earn a profit on the cost.

Issued in 2002, Public Works Order No. 173,617 (Rate Adjustment Standardized Format) specifies the schedules to be included in rate applications, including Schedule D (Expense Summary and Financial Statements). However, Schedule D and its supplemental schedules do not adequately capture line-item detail of the various eligible cost categories or whether embedded line items may be passed on to ratepayers.

Inconsistencies between the OR calculations in the rate application and those in the rate reports indicate a lack of—and the need for—monitoring by the City. This need is further evidenced by Recology's disclosure of material errors on April 15th and May 2nd of 2022.

Eligible, Ineligible, and Disputed Costs

Through the rate application process, the City performs accounting and eligibility review of submitted costs to verify eligibility for ratepayer funding, appropriateness of future-looking cost projections, and accuracy of computations.

All Operating Costs				
	Ratepayer Allowable, Eligible Costs		Disputed Costs	Ineligible Costs
Categorized Through Rate Application	**OR-Eligible Costs**: Funded by ratepayers and a **fair profit* is allowed**. These costs generally involve risk or investment by Recology. * Profit calculated using the operating ratio, which is a rate-setting formula.	**Pass-through Costs**: Recovered from ratepayers, but **no profit is allowed**.	Various costs are noted as being disputed due to the actual cost line item or expenditure being different in scope from what was included in past Rate Applications.	Costs for which no compensation is allowed.
Examples in Past Rate Applications	• Labor costs, including pension, health insurance, and workers' compensation • Fuel costs • Financing portion (interest rates) of lease costs for property and equipment • Allocation of corporate charges from Parent Company, such as for human resources, finance, and environmental compliance	• Recyclable material processing costs • Trash disposal costs • Licensing and permit fees • Impound account	• Excess Directors and Officers' Insurance • Incorrect corporate allocations	• Lobbying and political contributions • Legal penalties and settlements • Financing costs on depreciation expenses

Notes:

Ratepayer allowable costs should be "just and reasonable." Examples include:

- Lease agreements, rental charges, labor costs, and purchases in general should reflect market rates.
- If items are leased, rented, or bought from affiliated companies, there should be no double profit.
- Intercompany charges and allocations should reflect the ratepayer-related operations only.
- Rebates and discounts, such as rebates for compressed natural gas vehicles through the California Energy Commission, should be pursued to reduce costs passed onto ratepayers and, if applicable, used to adjust lease expenses in subsequent rate applications.
- Line items for programs or projects approved to be OR-eligible or pass-through should be reasonable.

Analysis & Findings:

Significant Variances Exist Between Recology's 2017 Rate Application Projections and Its Actual Results

Significant Variances Between Projections and Actuals

Preliminary Finding: Projected costs in the 2017 Rate Application process often materially exceeded Recology's actual costs. These material variances raise fairness concerns and call into question mitigating controls that could correct both controllable and uncontrollable variances from projections used in the 2017 Rate Application process.

Our review of the SF Companies' annual reports reveal significant variances between projected and actual amounts for the biggest expense category, payroll and related expenses. For the four-year period of rate years 2018 through 2021, projections exceeded actuals by an average of $16.1 million (or 7.3 percent) annually. The reports also show an increase in the amount of intercompany corporate allocations to the SF Companies (disposal and recycling) from the Parent Company. Actual corporate allocations exceeded projections by an average of $1.2 million (or 11.7 percent) annually. Responses from Recology in subsequent follow-ups appear to explain the variances, as follows:

- **Payroll**: Multiple factors led to lower-than-projected payroll costs. **Controllable variances** included projections for staffing needs for a new program which were not incurred. **Uncontrollable variances** included the need for fewer operator driving hours due to the COVID-19 pandemic, and changes in foreign policy that reduced the market for recycled plastic.

- **Corporate Allocations:** Multiple factors led to higher-than-projected corporate allocation costs, including expenses for replacing a legacy billing system in rate year 2020 which was not included in the 2017 Rate Application; changes in generally accepted accounting principles (accounting rules; sales and acquisitions of subsidiaries; and changes in corporate allocation methodologies by the Parent Company.

Summary of Identified Errors, Omissions, and Controllable and Uncontrollable Variances

Summary of items that led to cost under-recovery or over-recovery

#	Categories of cost over-recoveries and under-recoveries	Net Impact ($)		
		Before 2017 Rate Application	After 2017 Rate Application	Annual Ongoing Impact*
1	Payroll and related expense **projections in 2017 Rate Application significantly exceed actuals**	-	69,927,737	32,585,800**
2	Tunnel Road rental costs should have been recovered by rate year 2006 but **erroneously included in 2017 Rate Application**	6,109,620	2,221,680	555,420
3	Annual approximate $25 million pension cost contributions in 2017 Rate Application **can be discontinued** based on updated funding projections	-	-	24,372,264
4	Property rental costs in 2017 Rate Application **can be discontinued** because property (900 7th Street) was sold in December 2020	-	2,680,345	882,530
5	Standard Directors and Officers Insurance (~$400,000/year) is in 2017 Rate Application but supplemental insurance (~$1.4 million/year) in excess of standard is not (but **erroneously included in actuals in rate reporting)**	-	1,434,217	1,547,520
6	Line items for actual payroll expenses not in 2017 Rate Application but **erroneously included in actuals in rate reporting**	-	824,211	-
7	Credit offset for Tunnel Road and Beatty rent **erroneously omitted from 2017 Rate Application**	-	960,000	-
8	Other rental costs **erroneously omitted from 2017 Rate Application**	-	(6,554,739)	-
	Total	**6,109,620**	**71,493,451**	**59,943,534**

* Includes projected cost-of-living allowance (COLA) as of July 1, 2022. No COLA adjustment for pension and intercompany rental costs. See next slide for breakdown.

** Represents payroll and related savings in rate year 2021: wages of $17.4 million, health insurance of $7.3 million, and worker's compensation of $5.5 million

Over-recoveries With Annual Ongoing Impact With COLA

#	Categories of cost over-recoveries and under-recoveries	Net Impact ($): Annual Ongoing Impact Without COLA	Net Impact ($): Including COLA on July 1, 2021 (1.56%)**	Net Impact ($): Including Projected COLA on July 1, 2022 (7.90%)***
	Summary of cost under-recovery or over-recovery items with ongoing impact			
1	Payroll and related expense **projections in 2017 Rate Application significantly exceed actuals**	30,200,000*	30,671,120	32,585,800
2	Tunnel Road rental costs should have been recovered by rate year 2006 but **erroneously included in 2017 Rate Application**	555,420	555,420	555,420
3	Annual approximate $25 million pension cost contributions included in 2017 Rate Application **can be discontinued** based on updated funding projections	24,372,264	24,372,264	24,372,264
4	Property rental costs in 2017 Rate Application that **can be discontinued** because property (900 7th Street) was sold in December 2020	882,530	882,530	882,530
5	Standard Directors and Officers Insurance (~$400,000/year) is in 2017 Rate Application but supplemental insurance (~$1.4 million/year) in excess of standard is not (but **erroneously included in actuals in rate reporting)**	1,434,217	1,456,591	1,547,520
	Total	**57,444,431**	**57,937,925**	**59,943,534**

* Represents payroll and related savings in rate year 2021: wages of $17.4 million, health insurance of $7.3 million, and worker's compensation of $5.5 million.
** Represents actual COLA adjustments of 1.56% per Public Works website. COLA adjustment not applied to pension and intercompany rental costs. We did not apply the weighted average approach stipulated in the rate calculation.
*** Represents projected COLA adjustments of 7.90% per U.S. Bureau of Labor Statistics. COLA adjustment not applied to pension and intercompany rental costs. We did not apply the weighted average approach stipulated in the rate calculation.

Variances from Projections in 2017 Rate Application Covering Rate Years Ending 2018-2021

Each of the adjustments below is an expense **projection that significantly exceeded actuals**, a result that could have been **prevented if a balancing account had been used**.

Expense line items with significant variances between projections and actuals over a four-year period		
#	**Adjustment**	**Amount**
1	Salary – Headcount Savings	$29,411,232
2	Health Insurance Savings	28,476,944
3	Workers' Compensation	12,039,561
	Total	**$69,927,737**

Analysis & Findings:

No Balancing Account Mechanism Exists to Curb Recology's Excess Profits

Although There is an Auto-Escalating Inflation/COLA Factor, No Balancing Account Mechanism Exists to Curb Excess Profits

Preliminary Finding: There is no automatic mechanism to correct rates when the SF Companies' actual profit exceeds 9 percent. Similarly, there is no automatic mechanism to correct rates when the SF Companies' profit falls below 9 percent. According to the SF Companies, even after they corrected for the revenue-related errors in the 2017 Rate Application (as agreed to in the civil settlement agreement with the City), actual operating profit exceeded projected allowable profit by $23.4 million during rate years 2018 through 2021. This excess profit could have been greater over those four years, but the SF Companies lost commercial (non-negotiated) revenues as a result of reduced commercial activity during the pandemic.

Issues anticipated in past rate orders demonstrate the myriad ways that a reconciliation process or balancing account could help correct for variances from projected profits. For example:

- In discussing a new residential can size (the "mini-can"), the 2006 Rate Order noted that if "projected subscription rate is not achieved, the Companies will have a windfall at the expense of the ratepayers."
- In discussing apartment migration and rate increase caps, the 2013 Rate Order noted that if a revenue windfall is realized, "one-half of the total potential excess revenue [should] be returned to the rate base in the annual COLA adjustment process."

Actual amounts that differ from projections often favor the SF Companies. These variances are further exacerbated by the automatic inflation-correcting mechanism, or COLA, dictated by the 2017 Rate Order.

Balancing Account Illustration Based on Rate Years 2018–2021

Use of a balancing account would ensure that actual profits are compared with projected profits and that rates are automatically adjusted yearly so they remain just and reasonable until the next rate-setting process. In this way, ratepayers would be reimbursed when a surplus exists and Recology would be compensated when a shortfall exists.

The table below shows the approximate costs that could have been accounted for if a balancing account had been used for rate years 2018 through 2021. For years in which actual profits exceeded projections, a surplus (or shortfall if actuals were lower) would have been calculated and rate adjustments would have occurred at set intervals (for example, annually during COLA adjustments or during the subsequent rate-setting processes).

	Rate Year 2018		Rate Year 2019		Rate Year 2020		Rate Year 2021	
	Projected	Actuals	Projected	Actuals	Projected	Actuals	Projected	Actuals
Profit	$25.9M	$44.2M	$27.1M	$41.1M	$24.6M	$33.0M	$28.7M	$11.3M
Balancing Account								
Surplus or (Shortfall)	$18.3M		$14.1M		$8.4M		($17.4M)	
Cumulative Balancing Account	$18.3M		$32.4M		$40.8M		$23.4M	

Analysis & Findings:

Recology's Real Property—and Related Gains or Losses—Are Treated Inconsistently

Real Property Used by the SF Companies Is Treated Inconsistently

Preliminary Finding: There is no agreed upon methodology for how to treat gains on real property purchased with ratepayer revenues.

The 1991 Rate Order included a request for proposal from the City and Recology to ensure fair and reasonable treatment of land due to a number of unresolved issues:

- Should the ratepayers reimburse the company for land previously acquired by the companies in the same manner as new acquisitions?
- How should land acquired and held for future use be valued?
- If the ratepayers compensate the companies for land they own or acquire, should the companies share in the proceeds from the sale of the land?
- Should the City have the right to select an option for each land acquisition?

The Parent Company/Recology Properties gained close to $200 million from the sale of 900 7th Street to Amazon. In contrast to the treatment of real property, gains to the SF Companies from the disposal of equipment assets (purchased via ratepayer revenue) were consistently credited to ratepayers on a proportionate basis.

Although there is no requirement for consistent reporting, SF Companies did not voluntarily report sales and acquisitions of real property, including historical cost basis, depreciation expenses, rental cost or even values associated with real property on a cash basis, GAAP accrual basis or otherwise. Furthermore, rate orders have not uniformly treated real property assets used by the SF Companies.

Real Property May Be Leased or Purchased via Ratepayer Revenue

The use of real property may come through one of three options. Like equipment, ratepayers should be entitled to the free use of the real property after rates have paid for the acquisition and financing, including for any improvements, costs. They should also proportionately share in the gain from the sale of such asset as ratepayers lose the benefit of the assets' use.

Real Property Leases and Ownership

	Reporting Method	**Effect on Ratepayers**	**Asset Disposal**
Cash-Purchased Asset	Cash-basis for rate setting and reporting purposes	Costs passed through to ratepayers in the first year only and excluded from rates thereafter. Year 1 $XX · Year 2 $0 · Year 3 $0	Ratepayers are credited their proportional share of the asset's disposal value REFUND
Financed		Principal and financing costs are passed through to the ratepayer throughout the financing term until it is paid in full. Year 1 $XX · Year 2 $XX · Year 3 $XX	
Third-Party Rental	Cash-basis presentation for expense reporting	Rental costs passed through to ratepayers throughout the term of the rental agreement. Year 1 $XX · Year 2 $XX · Year 3 $XX	Rental agreement ends and the property is transferred back to the owner. No credit due to ratepayers.

Analysis & Findings:

Lack of Follow-Through on Concerns Raised in the Rate-Setting Process

Issues and Concerns Raised in the Rate-Setting Process Are Often Left Unresolved

Preliminary Finding: Despite periodically raising concerns for three decades about inconsistencies in the presentation of data in the SF Companies' rate applications and rate reports, the City has not always tracked these concerns to ensure they are appropriately addressed and resolved.

Examples of unresolved issues include the following.

1) 1991: Questions about the treatment of gains on sales of land that the SF Companies purchased with ratepayer revenue, as noted by consultants.

2) 2006: Concerns about the lack of transparency in Recology's expenses and intercompany transactions, as raised by San Francisco ratepayers.

3) 2017: Concerns that financial data in quarterly and annual reports does not reconcile to the rate application and that information in some tables in these reports is confusing, as noted by the City.

Analysis & Findings:

Benchmarks

Benchmarks From Other Jurisdictions

Preliminary Finding: The City can facilitate greater transparency in its rate setting and rate reporting by learning from other jurisdictions.

1. The South Bayside Waste Management Authority (SBWMA) reviews Recology San Mateo County's refuse rate application and:

    a. Publishes expenses by line item and customer class and includes the breakdown in calculating rate increases.

    b. Uses an annual revenue reconciliation process and accompanying balancing account. Shows its reconciliation to audited financial statements in a public report.

2. The City of Pacifica (Pacifica) posts the audited financial statements of its refuse service provider, Recology of the Coast, on the same webpage with its staff reports of the applicant's refuse rate applications. This practice ensures the public has information needed to assess profitability and reasonableness of rates.

SBWMA Publishes Expenses by Line Item and Customer Class in Its Operating Ratio Calculation

Recology San Mateo County has a refuse franchise agreement with San Mateo County. The reviewing agency, SBWMA, publishes a table showing **expenses** broken down by **customer class**. Further, expenses are shown in several line items, including OR-eligible versus OR-ineligible pass-through costs.

Accessibility of this information enables customers to identify the portion of total expenses that is relevant to their service subscription and draw meaningful conclusions about their refuse service provider's spending.

Different customer classes

Expense items

Total SBWMA	Single Family Dwelling	MFD & Commercial	Member Agency Facilities	Compensation 2022
Annual Cost of Operations				
Direct Labor-Related Costs				
Wages for CBAs	10,718,642	8,856,048	241,381	19,816,071
Benefits for CBAs	5,054,145	3,892,121	111,187	9,057,453
Payroll Taxes	868,210	717,340	19,552	1,605,102
Workers Compensation Insurance	770,803	632,116	17,196	1,420,115
Total Direct Labor Related-Costs	17,411,800	14,097,625	389,316	31,898,740
Direct Fuel Costs	1,313,320	978,648	33,487	2,325,454
Other Direct Costs	1,603,185	1,290,332	57,694	2,951,211
Depreciation				
- Collection Vehicles	1,742,096	1,171,716	105,659	3,019,471
- Containers	841,011	300,467	-	1,141,479
Total Depreciation	2,583,108	1,472,183	105,659	4,160,950
Allocated Indirect Costs				
General and Administrative	5,454,276	3,763,345	257,260	9,474,882
Operations	1,088,976	759,888	52,117	1,900,981
Vehicle Maintenance	2,081,292	1,452,326	99,607	3,633,226
Container Maintenance	772,598	539,935	36,971	1,349,505
Total Allocated Indirect Costs	9,397,143	6,515,495	445,956	16,358,593
Total Allocated Indirect Depreciation Costs	65,130	45,604	3,450	114,184
Total Annual Cost of Operations	**32,373,684**	**24,399,887**	**1,035,562**	**57,809,133**
Profit	**3,398,343**	**2,561,314**	**108,705**	**6,068,362**
Operating Ratio				
Total Operating Costs	**35,772,027**	**26,961,201**	**1,144,267**	**63,877,495**
Contractor Pass-Through Costs				
Interest Expense	632,498	472,391	22,397	1,127,286
Contract Changes to Specific Agencies				229,874
Total Contractor Pass-Through Costs	**632,498**	**472,391**	**22,397**	**1,357,160**
BASE CONTRACTOR'S COMPENSATION	**36,404,524**	**27,433,592**	**1,166,665**	**65,234,655**
Other Adjustments				
Incentive / Disincentives	28,257	20,837	876	49,971
Total Other Adjustments	**28,257**	**20,837**	**876**	**49,971**
TOTAL CONTRACTOR'S COMPENSATION	**36,432,782**	**27,454,430**	**1,167,541**	**65,284,626**

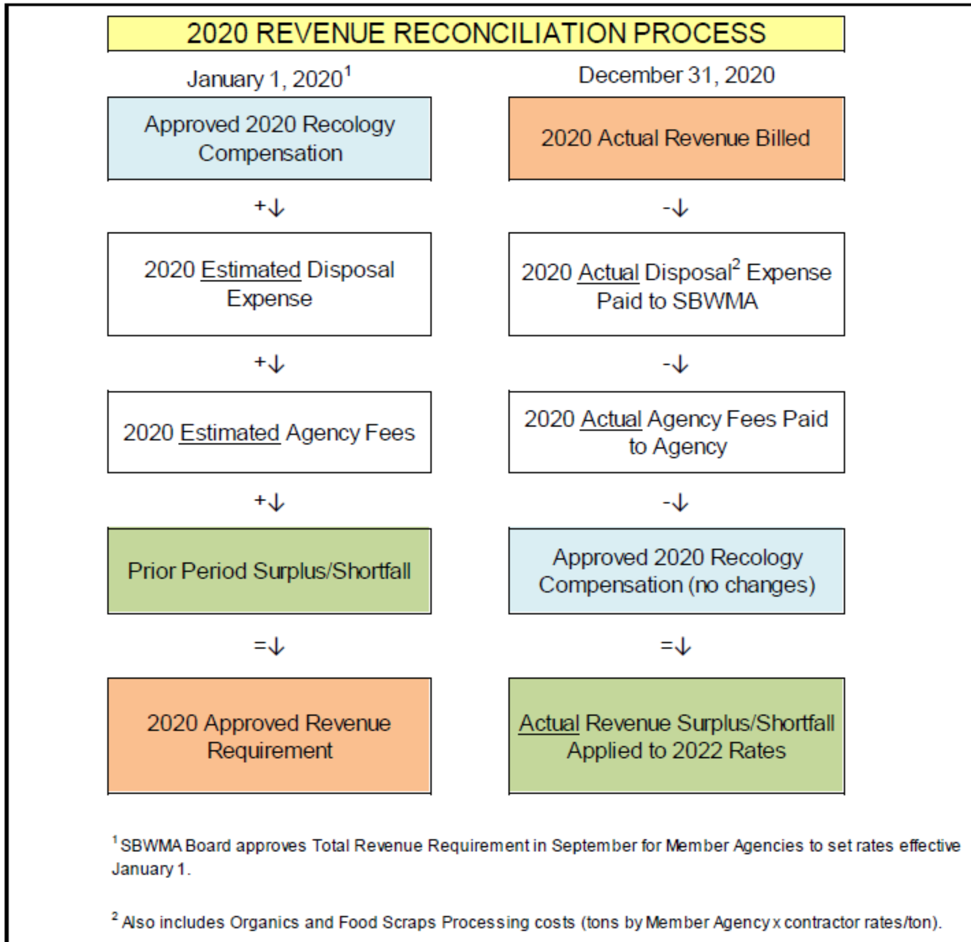
Source: Report dated September 23, 2021, and titled *SBWMA Final Report Reviewing the 2022 Recology San Mateo County Compensation Application*

SBWMA Reconciles Revenues Yearly

Excerpt from Recology San Mateo County's franchise agreement (Article 11, Contractor's Compensation and Rates):

After the conclusion of each Rate Year, SBWMA will conduct a revenue reconciliation process as provided in Section 11.03. The purpose of this procedure is to reconcile Net Revenues Billed by Contractor for a Rate Year with the approved Contractor's Compensation for that Rate Year. Adjustments to Contractor's Compensation will be made in a subsequent Rate Year to recover any excess revenue from Contractor or to compensate Contractor for a revenue shortfall.

On the right is an illustration of the annual revenue reconciliation process taken from Recology San Mateo County's *Rate Year 2022 Application*.



Source: Report dated September 23, 2021, and titled *SBWMA Final Report Reviewing the 2022 Recology San Mateo County Compensation Application* (page 39)

SBWMA Applies Revenue Surplus/Shortfall to Future Rate Years

Below is an illustration included in SBWMA's publicly available report showing the application of surplus/shortfall with interest in prior years to current year rate-setting using a **balancing mechanism**. This information is further shown as as a **supplementary schedule to the audited financial statements**.

	Compensation 2022	Belmont	Burlingame	East Palo Alto	Foster City	Hillsborough	Menlo Park	North Fair Oaks	Redwood City	San Carlos	San Mateo	West Bay	County Franchised Area
Annual Cost of Operations													
Direct Labor-Related Costs													
Wages for CBAs	$19,816,071	$1,305,979	$1,987,452	$828,339	$1,200,324	$643,409	$2,065,227	$653,762	$3,624,536	$1,790,916	$4,612,223	$342,868	$761,037
Benefits for CBAs	$9,057,453	$600,428	$895,119	$383,399	$547,922	$300,258	$932,136	$301,175	$1,660,444	$814,814	$2,107,475	$158,657	$355,625
Payroll Taxes	$1,605,102	$105,784	$160,984	$67,095	$97,226	$52,116	$167,283	$52,955	$293,587	$145,064	$373,590	$27,772	$61,644
Workers Compensation Insurance	$1,420,115	$93,644	$142,175	$59,487	$86,064	$46,067	$147,741	$46,844	$259,791	$128,315	$330,780	$24,587	$54,621
Total Direct Labor Related-Costs	$31,898,740	$2,105,835	$3,185,731	$1,338,320	$1,931,536	$1,041,850	$3,312,388	$1,054,735	$5,838,359	$2,879,109	$7,424,068	$553,884	$1,232,926
Direct Fuel Costs	$2,325,454	$123,032	$219,101	$103,261	$143,561	$83,996	$260,258	$76,756	$427,826	$221,811	$529,663	$43,057	$93,132
Other Direct Costs	$2,951,211	$189,544	$282,473	$127,880	$179,577	$101,098	$329,098	$95,060	$536,952	$277,252	$666,884	$52,310	$113,082
Depreciation													
- Collection Vehicles	$3,019,471	$196,817	$290,312	$130,338	$187,578	$111,875	$335,995	$94,287	$544,769	$284,647	$667,188	$55,161	$120,503
- Containers	$1,141,479	$77,090	$102,553	$52,636	$73,460	$37,043	$113,697	$36,566	$209,708	$105,767	$258,681	$22,873	$51,406
Total Depreciation	$4,160,950	273,907	392,865	182,974	261,038	148,918	449,692	130,853	754,477	390,414	925,869	78,034	171,909
Allocated Indirect Costs													
General and Administrative	$9,474,882	$591,068	$895,859	$476,497	$594,565	$225,154	$988,416	$288,789	$1,804,140	$917,873	$2,179,877	$151,461	$361,182
Operations	$1,900,981	$124,378	$186,538	$80,443	$121,302	$71,639	$211,689	$57,219	$337,742	$181,735	$418,063	$35,189	$75,045
Vehicle Maintenance	$3,633,226	$237,716	$356,517	$153,745	$231,836	$136,920	$404,589	$109,360	$645,506	$347,338	$799,016	$67,255	$143,429
Container Maintenance	$1,349,505	$86,058	$129,625	$65,445	$89,147	$34,335	$148,898	$40,573	$247,130	$126,208	$309,619	$22,162	$50,303
Total Allocated Indirect Costs	$16,358,593	$1,039,220	$1,568,540	$776,130	$1,036,850	$468,048	$1,753,592	$495,942	$3,034,518	$1,573,154	$3,706,574	$276,067	$629,959
Total Allocated Indirect Depreciation Costs	$114,184	$7,409	$11,716	$4,851	$7,246	$4,301	$12,856	$3,323	$20,229	$10,754	$24,940	$2,084	$4,476
Annual Implementation Cost Amortization	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Total Annual Cost of Operations	$57,809,133	**3,738,948**	**5,660,426**	**2,533,415**	**3,559,807**	**1,848,211**	**6,117,884**	**1,856,669**	**10,612,362**	**5,352,494**	**13,277,997**	**1,005,436**	**2,245,485**
Profit	$6,068,362	$392,486	$594,188	$265,939	$373,681	$194,011	$642,209	$194,899	$1,114,005	$561,864	$1,393,823	$105,543	$235,714
Operating Ratio	90.5%	90.5%	90.5%	90.5%	90.5%	90.5%	90.5%	90.5%	90.5%	90.5%	90.5%	90.5%	90.5%
Total Operating Cost	$63,877,495	$4,131,435	$6,254,614	$2,799,354	$3,933,489	$2,042,222	$6,760,093	$2,051,568	$11,726,367	$5,914,358	$14,671,820	$1,110,979	$2,481,198
Contractor Pass-Through Costs													
Interest Expense	$1,127,286	$73,679	$109,178	$49,263	$71,433	$36,791	$124,283	$35,721	$205,038	$106,275	$252,182	$19,870	$43,574
Contract Changes to Specific Agencies	$229,874	$14,868	$22,508	$10,074	$14,155	$7,349	$24,327	$7,383	$42,199	$21,284	$52,799	$3,998	$8,929
BASE CONTRACTOR'S COMPENSATION	**$65,234,655**	**$4,219,981**	**$6,386,300**	**$2,858,690**	**$4,019,077**	**$2,086,362**	**$6,908,703**	**$2,094,672**	**$11,973,604**	**$6,041,916**	**$14,976,801**	**$1,134,847**	**$2,533,702**
Incentives and Disincentives	$49,971	**$2,122**	**$7,156**	**$3,348**	**$2,968**	**$802**	**$4,486**	**$1,758**	**$10,712**	**$3,428**	**$11,699**	**$422**	**$1,071**
Total Contractor Adjustments	**$49,971**	**$2,122**	**$7,156**	**$3,348**	**$2,968**	**$802**	**$4,486**	**$1,758**	**$10,712**	**$3,428**	**$11,699**	**$422**	**$1,071**
TOTAL CONTRACTOR'S COMPENSATION	**$65,284,626**	**$4,222,103**	**$6,393,456**	**$2,862,038**	**$4,022,045**	**$2,087,164**	**$6,913,189**	**$2,096,430**	**$11,984,316**	**$6,045,345**	**$14,988,500**	**$1,135,268**	**$2,534,772**
Prior Year's Surplus/Shortfall to/from Recology													
Revenue Reconciliation 2020 (Surplus)/Shortfall	**($2,808,079)**	**$0**	**$0**	**($79,221)**	**($365,083)**	**($276,148)**	**$84,890**	**($414,481)**	**($1,047,452)**	**($738,906)**	**$308,256**	**($211,130)**	**($68,804)**
Interest on 2020 (Surplus)/Shortfall	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**
Sub-Total	**($2,808,079)**	**$0**	**$0**	**($79,221)**	**($365,083)**	**($276,148)**	**$84,890**	**($414,481)**	**($1,047,452)**	**($738,906)**	**$308,256**	**($211,130)**	**($68,804)**
TOTAL BALANCE TO CONTRACTOR 2022	**$62,476,547**	**$4,222,103**	**$6,393,456**	**$2,782,817**	**$3,656,962**	**$1,811,016**	**$6,998,079**	**$1,681,949**	**$10,936,864**	**$5,306,439**	**$15,296,756**	**$924,138**	**$2,465,968**
TOTAL BALANCE TO CONTRACTOR - 2021	**$60,820,252**	**$4,105,136**	**$6,417,246**	**$2,725,573**	**$3,812,974**	**$1,742,402**	**$6,584,783**	**$1,836,649**	**$11,583,121**	**$5,742,700**	**$13,247,715**	**$971,427**	**$2,050,526**
Change in Contractor's Compensation	**$1,656,295**	**$116,967**	**($23,790)**	**$57,244**	**($156,012)**	**$68,614**	**$413,296**	**($154,700)**	**($646,257)**	**($436,261)**	**$2,049,041**	**($47,289)**	**$415,442**
Percentage Change in Compensation	**2.72%**	**2.85%**	**-0.37%**	**2.10%**	**-4.09%**	**3.94%**	**6.28%**	**-8.42%**	**-5.58%**	**-7.60%**	**15.47%**	**-4.87%**	**20.26%**

Source: *SBWMA Final Report Reviewing the 2022 Recology San Mateo County Compensation Application, September 23, 2021*

Pacifica Publishes Audited Financial Statements

Recology of the Coast has a franchise agreement with Pacifica. Audited financial statements are published on Pacifica's website. The publication of audited financial statements enables ratepayers to reconcile them to rate-setting and rate-reporting materials, and to access information that could answer potential question or help to identify areas of concern, like significant profitability.

Recology of the Coast Franchise Agreement and Audits

Franchise Agreement 2013 (21Mb, large file may take awhile to download)

October 24, 2016 Council Staff Report - Recology of the Coast Five Year Extension Request

Audited Financial Statements 2020 and 2021

Audited Financial Statements 2019 and 2020

Audited Financial Statements 2018 and 2019

Audited Financial Statements 2017 and 2018

Audited Financial Statements 2016 and 2017

Source: City of Pacifica.

Recommendations

Recommendations

Given the findings of our preliminary assessment, we offer the following preliminary recommendations, which we may refine as the investigation and review continue and we consider the feedback we receive in the review process.

1. **To facilitate greater transparency, the City should assess and consider the following changes to the rate-setting and rate-reporting processes:**

   a. **Show Total Sources and Total Uses, then clearly detail how operating ratio eligible costs only include costs associated with ratepayers subject to rate setting and exclude ineligible costs, along with the associated profit margin on revenues subject to rate setting and the amount above or below the allowed, profit target.**

   b. **Develop and enforce consistent methodology for the calculation and presentation of the operating ratio and related expenses for the rate application, quarterly rate reports, and annual rate reports. This calculation should include a breakdown of profit by Recology Sunset Scavenger, Recology Golden Gate and Recology San Francisco, as well as total profitability for the SF Companies.**

   c. **Establish a process to re-baseline rate application projections at least annually as part of applying automatic escalators (i.e., COLA) and ensure that variance of actuals from original and re-baselined projections are calculated and explained in both the quarterly and annual reports.**

Recommendations *(continued)*

Recommendation 1

d. Develop clear language that must be used to disclose and articulate, before the rate-setting process, how revenues subject to rates will be calculated. Operating ratio eligible expenses and pass-through expenses should be defined, and the appropriate treatment of revenues and rebates that affect the required revenue calculation should be explained.

e. Require quarterly and annual reports to be submitted by Recology with an oath under penalty of perjury.

f. Require that expenses be shown by allocation according to customer class and service.

g. Include in quarterly and annual reports a schedule for owned and leased real property that includes address, historical purchase price, cumulative costs paid by ratepayers, and, for leased assets, annual proposed rental costs.

h. Include a separate schedule for all intercompany charges, including calculations for allocation percentages and information on the flow of expenses between companies.

i. Establish a process to, at least annually, benchmark San Francisco against other comparable jurisdictions, including but not limited to comparing rates by customer class and service type.

Recommendations *(continued)*

2. The City should require the SF Companies to establish a balancing account to true-up excess profit (or shortfall), and as part of that process:

   a. Recommend the SF Companies to establish the balancing account, or a comparable mechanism, before the beginning of the next rate year with a beginning balance of $23.4 million—the amount beyond allowable profit for rate years 2018 through 2021—which should be used to offset the upcoming COLA increase. Excess profits identified in prior periods could also be included in the balancing account.

   b. Develop a process to methodically check for errors and omissions in the rate calculation that should have otherwise been available during the rate-setting process, determine the impact of any mistakes on refuse rates, and true up differences with the balancing account.

   c. Require that the SF Companies request and receive approval from the City before substituting or swapping expenses within and among line items within a predetermined threshold. If an expenditure is made before being approved, such as expenditures for exigent circumstances, and later found to be ineligible, require that it be trued up with the balancing account.

Recommendations *(continued)*

3. The City should require the SF Companies to submit audited financial statements for each rate year and, in addition:

    a. Provide a schedule of reconciliation between audited financial statements and the annual rate reports.

    b. Align the rate year with the SF Companies' fiscal year to enable traceability and reconciliation.

    c. Require the balancing account be specifically included in the independent auditors' review of the annually audited financials statements, including a reconciliation that should be published as part of those statements.

4. The City should require the SF Companies to develop and document a consistent methodology to fairly charge ratepayers for real property and equipment, and ensure that:

    a. Recovery from ratepayers never exceeds the historical purchase price plus cost of capital used to purchase the property, including any capital improvements thereon.

    b. Upon sale of the property, a credit equivalent to the proportional gain is credited to the ratepayers.

Recommendations *(continued)*

5. The City should formally capture lessons learned from the rate-setting process and subsequent monitoring and ensure they are applied in future rate-setting, and should consider:

    a. Documenting publicly the adjustments resulting from the City's review of the rate application, including how the adjustment was derived, the impact on the rate calculation, and whether the adjustment item needs to be revisited in future rate-setting.

    b. Documenting publicly any significant issues or concerns with the overall rate-setting process, including whether there was timely access to accurate information from the SF Companies and whether public outreach to ratepayers was effective.

    c. Having an annual follow-up process to ensure that recommendations are implemented timely and that the results are published.

6. The City should require Recology to submit a new rate application that complies with the recommendations made in this assessment.