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November 6, 2018

Ms. Karineh Samkian
Environmental Program Analyst
Public Works Department, City of San Pablo
13831 San Pablo Avenue, Building 3
San Pablo, CA 94806

Subject: Final Report on Review of Richmond Sanitary Services' 2019 Rate Applications for San Pablo, Pinole and Hercules

Dear Ms. Samkian:

R3 Consulting Group, Inc. (R3) was engaged by the City of San Pablo (City) on behalf of the City and the cities of Pinole and Hercules (collectively referred to as the "Jurisdictions") to review Richmond Sanitary Service's (RSS's), rate adjustment applications (Rate Applications) to each of the Jurisdictions for 2019 Base Year Rate Change (effective January 1, 2019). This letter report presents the results of our review.

Background

RSS has an exclusive franchise agreement (Agreement) with each of the Jurisdictions for the collection of solid waste, recyclables and organics. Under the terms of the Agreements, the year 2019 shall be a "Base Year" for rate review and adjustments. RSS may initiate a Base Year request to adjust the rates authorized under the Agreements by providing written notice no later than 180 days prior to the January anniversary date for the adjustment of rates. Notice must therefore, be given by July 1, 2018 for adjustment to the maximum permitted Base Year rates for calendar year 2019. RSS's Rate Applications to each of the Jurisdictions are dated June 28, 2018, with modified Rate Applications dated July 5, 2018 reflecting "some minor adjustments in projected labor costs". The Agreements provide that *"The Contractor's Rate Application shall be supported by sufficient financial operational information as determined by the City."*

Rate Adjustment Requests & Recommendations

RSS's requested 2019 rate adjustments are as follows:

Pinole	- 2.49%
Hercules	+ 6.35%
San Pablo	+ 5.78%

Based on our review, we recommend the following 2019 rate adjustments, which have been reduced from RSS's original rate applications:

Pinole	- 3.67%
Hercules	+ 5.34%
San Pablo	+ 4.36%

It should be noted that rates in Pinole are proposed to decrease while rates in Hercules and San Pablo are proposed to increase. This is due to the fact that Pinole has seen greater growth in its commercial sector compared to San Pablo and Hercules and that this growth has driven an increase in rate revenues as compared to allocated RSS expenses. As a component of this review, R3 reviewed and confirmed the basis and mathematical accuracy of those allocations.

The above preliminary adjustments are based on handling the following items as noted below:

- An operating ratio (used to calculate profit) of 88%;
- Limiting bonus pay expenses at the average of the last three years expenses (escalated for 2019 and consistent with prior methodology);
- Disallowing lobbying expenses;
- Correcting 2019 revenue projections at current rates; and
- Correction to franchise fee calculations.

R3 has briefed RSS regarding the basis and calculations for these adjustments, and RSS has confirmed their acceptance of these adjustments as presented in this report.

Review Methodology

The Agreements do not specify a methodology for adjusting Base Year rates, including how to handle a number of relevant items including:

- The level of profit;
- Expenses not subject to profit (i.e., pass-through expenses that are allowable but not subject to profit. Pass-through expenses may include solid waste disposal and recyclable material processing costs, franchise and other fees and other certain expenses); and
- Non-allowable expenses (e.g., fines and penalties, charitable or political donations, income taxes, employee free services, etc.).

The lack of a clear methodology for preparing the Base Year Rate Application was first noted during Hercules 2007 Base Year Rate review process. For purposes of structuring its Rate Application, RSS used rate application forms from Contra Costa County's Rate Adjustment Guidelines (Guidelines) for its 2019 Rate Applications, as well as its 2007 and 2012 Rate Applications to the City of Hercules. In conducting this review R3 applied methodologies consistent with past practice, as proposed to the Jurisdictions and RSS at the outset of the review.

Profit Level

The Agreements do not specify a target profit level (operating ratio) for RSS, although the City of Hercules increased RSS's profit from a 90 percent operating ratio (11.1% profit) to an 88 percent operating ratio (13.6% profit) in 2007 at RSS's request. RSS based that request *"on its ability to control costs by meeting internal productivity goals which have resulted in labor costs escalating at a lesser rate than the union contract increases."* RSS set its profit level to an 88% operating ratio in each of its Rate Applications to each of the Jurisdictions. RSS reported that 88% operating ratios were accepted by each jurisdiction. For purposes of this review R3 applied the 88% operating ratio to calculate RSS's profit for each of the Jurisdictions.

Non-Allowable Costs

As noted above, the Agreements do not address non-allowable costs, although doing so is common industry practice. As an example, Contra Costa County's Rate Setting Manual specifies that the following costs are not allowed for rate setting, and as a result will not be passed on to the ratepayers:

- Amortization of franchise purchases;
- Charitable and political contributions;
- Fines and penalties;
- Income taxes;
- Interest expenses; and
- Other costs on a case-by-case basis.

As part of the 2012 Base Year rate review for the City of Hercules, R3 identified the certain expenses allocated to the City that we recommended be disallowed based on common industry practice, including fines and penalties, charitable contributions, lobbyist fees, property damage and other expenses. In 2013 the Hercules City Council ultimately adopted rates that included adjustments for fines and penalties, lobbyist fees, and other expenses.

For this review, RSS reported that it did not make adjustments to its 2017 reported expenses, or its 2018 or 2019 projected expenses to account for non-allowable costs. For the purposes of the review of the 2019 Rate applications, R3 applied past practice with respect to non-allowable costs for the Jurisdictions, resulting in disallowance of fines/other penalties, lobbyist fees, and limitations on staff bonuses.

Revenue Adjustments

RSS calculated its residential revenues by multiplying the number of current customers at each service level (i.e., cart size) by the associated monthly rates. While this provides a good projection of residential monthly base rate revenues it does not account for residential revenues associated with extra services, fees or other residential revenue not accounted for in the monthly base rate revenue. We requested that RSS provide an accounting of residential revenue associated with special services, extra services, and/or charges or fees not included in the monthly base rate revenue, and applied those revenues to the revenue calculations in the rate application.

Franchise Fee Adjustments

R3 reviewed RSS's calculations of franchise fees in the rate applications, and made adjustments consistent with the descriptions for franchise fees (and other Jurisdiction payments) as noted below.

City of Pinole

The 2nd Amendment; Section 7 (Franchise Fee) states that franchise fees shall be calculated as follows: *"For calendar year 2012 and thereafter an amount of 10% of gross revenues."* Gross Revenues are defined within the Amendment as: "all actual monies remitted to RSS by customers excluding any pass-through fees such as the IRRF Fee and AB 939 Fee as determined in accordance with Generally Accepted Accounting Principles." Pinole's franchise fees exclude light industrial rate revenue, and also include a \$6,000 annual "blight" payment.

City of San Pablo

The 2013 Amendment; Section 5 states that franchise fees shall be calculated as follows: *"...in an amount equal to the percent (10%) of gross revenues."* The Amendment also specifies that "For purposes of calculating gross revenues, Contractor shall not deduct the amount of franchise fee payments or any other business expense." San Pablo's franchise fees further include \$35,000 for a voucher program and annual "blight" payments.

City of Hercules

In 2013 the City of Hercules set its franchise fee in the amount of 10% on gross revenues not including light industrial rate revenues.

We calculated 2019 franchise fees for the Jurisdictions according to the methods reported above, which resulted in slight reduction to the proposed rate adjustments.

Limitations

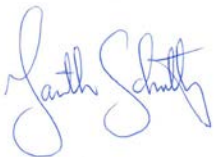
The level of review conducted for this engagement was limited in accordance with the available project budget, and per our proposal to the Jurisdictions to conduct this review. Of note is that this review was conducted simultaneously for all three Jurisdictions and included a general application of prior practice to all Jurisdictions. Because of the limited nature of this review, prior differences in approach by Jurisdiction were not continued, and RSS's rate applications to each Jurisdiction were treated identically. Overall, our review focused on ensuring that the Rate Applications were consistent with general past practice, that they were mathematically accurate, and that adjustments were made that were consistent with the City of Hercules' 2012 Base Year Rate review. While we conducted a variance analysis and requested that RSS provide an explanation of significant variances, we did not conduct a more detailed review, or make adjustments to RSS's 2018 and 2019 expense projections, except as otherwise noted above.

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We appreciate the opportunity to be of service to the City and the Jurisdictions. Should you have any questions regarding this submittal, please contact me by phone at (510) 292-0853 or by email at gschultz@r3cgi.com.

Sincerely,

R3 CONSULTING GROUP



Garth Schultz | Principal