

IWM Fund and Rates Overview

Source: FY 2005-06 Funds Management Report to Council

Note: The information presented in this overview is from Environmental Services' Annual Funds Management Report for Fiscal Year 2005-06. The data in the report was current as of January 2006.

INTEGRATED WASTE MANAGEMENT FUND (FUND 423)

Purpose of the Fund

The Integrated Waste Management Fund (Fund 423) was established by the San José City Council to segregate Integrated Waste Management (IWM) related revenue and costs from the General Fund, providing a vehicle to improve both management control and policy oversight by clearly delineating revenues and costs. The IWM Fund provides the means for clear analysis of the need and timing for future rate increases; the ability to minimize year-to-year rate fluctuation by the judicious use of any reserves that the Fund may accumulate; and increased responsiveness and adaptability to meet customer needs and comply with ever-changing environmental regulations.

The IWM Fund supports activities related to the performance of Environmental Services' core service, to manage recycling and garbage services. As contributor to the Environment and Utility Services City Service Area, these services are designed to protect public health, safety, and the environment and to maximize diversion from landfills by promoting reuse and recycling of solid waste.

The IWM Fund was established on December 13, 1994, by the adoption of Ordinance No. 24746. The activities covered, which were previously supported within the General Fund, encompass the garbage and recycling services and the billing operation related to those services for the City of San José.

Prior to the implementation of Recycle Plus in July 1993, garbage and recycling rates were adjusted almost every year. In the 12 years since the Recycle Plus program began, services to City residents have been enhanced periodically, including the introduction of commingled recycling, the 20-gallon mini garbage cart option, and yard trimmings cart service in 2002. Even with these service improvements, Recycle Plus rates are still below the county-wide average. Cost recovery is at approximately 97%, based on rates approved in June 2004.

Major Challenges

Currently, the major challenges for the IWM Fund are to bring the residential program to cost recovery, while securing new garbage, recycling, yard trimmings and street sweeping service providers and effectively addressing the potential impacts on customer rates associated with these new service providers.

Revenues and expenditures in the IWM Fund are subject to fluctuations in local economic conditions. Efficiencies are continually being sought for the IWM Fund, including contract renegotiations during the term of the 1993 service contracts; major cost-savings with the 2002 service contract procurement; and providing for extensions to the current Recycle Plus contracts without additional contractor compensation (above routine cost of living adjustments). Despite these efficiencies, expenditures have continued to outpace revenues due to increasing population growth, cost of living adjustments, increases in labor and other operating costs, shifting of costs from the General Fund, and decreasing commercial AB939 revenues.

In future years, the City will be challenged to keep the IWM Fund healthy while developing programs which will enable the City to achieve the Zero Waste goal included in the United Nations Urban Environmental Accords, co-sponsored by the City in 2005.

SOURCES AND USES OF IWM FUND

Figures 1 and 2 below show the budgeted sources and uses of funds for FY 2005-06.

Figure 1

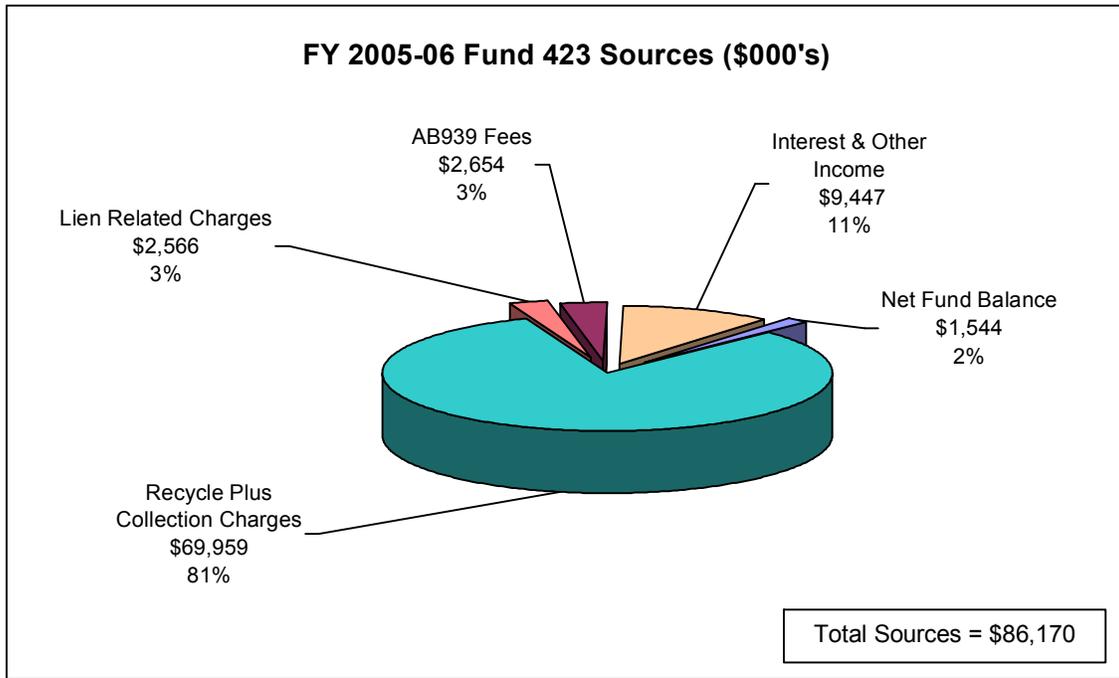
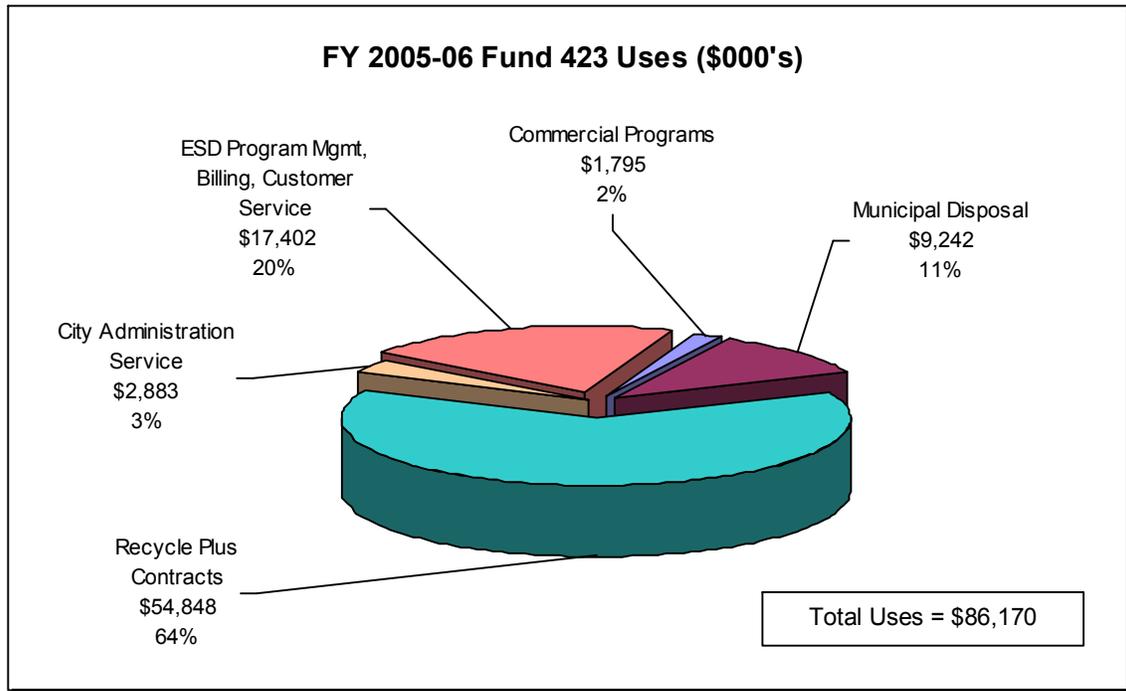


Figure 2



IWM Fund Revenues

The IWM Fund’s revenue sources include residential Recycle Plus charges; AB939 fees from residents, commercial businesses, and landfills; lien-related charges; and other related sources. These revenues are allocated to pay for the services provided by the IWM Program. Revenues from commercial garbage Franchise Fees and the Disposal Facility Tax accrue to the General Fund.

Financial incentives are used to encourage recycling in both the residential and commercial sectors. Rates and fees that contribute to the IWM Fund are strategically based on the volume of garbage disposed of by residents and businesses. For example, the City currently charges double for a 64-gallon garbage cart compared to the 32-gallon size (as do most other cities in the Bay Area with “pay as you throw” systems). This system was implemented in 1993 and is considered a major factor in driving residential diversion rates above the 50% level, along with education.

Residential Recycle Plus Charges

Service rates for single-family and multi-family dwellings are established through rate resolutions adopted by Council. In June 2004, Council approved a rate increase of 9% for single-family customers and 9% for multi-family properties effective August 1, 2004. This rate increase brought the basic single-family rate for 32-gallon garbage cart service to \$18.30. With the 9% increase in multi-family rates, the new rate for a 3-cubic yard bin serviced once per week (one of the most common multi-family service levels) is \$150.67.

With the new rates, Recycle Plus revenue for FY 2004-05 was \$67.1 million, which brought the program to 97% cost recovery.

The public hearing and adoption of Recycle Plus rate increases in FY 2005-06 was deferred by Council in June to August 2005 and then to February 2006. The 5% rate increase adopted by for single-family residents on February 28, 2006 is to cover increasing costs and prepare for any cost impacts associated with securing new Recycle Plus service providers.

Other IWM Fund Revenue

Other IWM Fund revenue sources not detailed in this overview include AB939 fees set for commercial garbage collection and paid by the garbage generator, lien-related charges, and interest earned by the fund.

IWM Fund Expenditures

The IWM Fund supports the contractual, technical, and administrative costs for waste management related services provided by the City's garbage, recycling and yard trimmings/street sweeping contractors, ESD program management, and other City departments.

Non-Contractual Expenditures

This category includes personal services from the IWM Program and related programs within the department, as well as personal services from other City departments who provide administrative, legislative, and financial services that support waste management activities. Non-contractual expenditures also include the IWM Fund's share of the FY 2005-06 implementation costs for the Consolidated Utility Billing System.

Contractual Expenditures

Contractual expenditures in the IWM Fund include:

- Recycle Plus contractor payments are made to GreenTeam of San José and Norcal Waste Systems of San José for residential garbage and recyclables collection. Payments for residential street sweeping and yard trimmings collection/processing are made to GreenWaste Recovery, Inc. and Norcal Waste Systems of San José. Contractual increases are based on service recipient growth and yearly cost of living adjustments. In the case of Norcal Waste Systems, additional payments for increased labor costs retroactive to FY 2002-03 are also included through FY 2006-07.
- The City has a 34-year Disposal Agreement with International Disposal Corporation (IDC), a subsidiary of BFI/Allied Waste. This agreement provides for disposal at Newby Island Landfill of the residential garbage collected by Recycle Plus contractors. It also provides for low-cost disposal of city waste collected by City staff or by GreenTeam and other contractors collecting from City facilities and from other City property, events, and operations. Residential

disposal costs are charged to the IWM Fund, while City waste disposal is charged to the General Fund.

- Residential disposal costs are based on a per-ton base rate, which is adjusted annually to reflect changes in: economic indices; disposal surcharges paid to the State, County, and City on a per-ton basis; and regulatory costs. The regulatory costs are based on annual claims filed by IDC, showing expenditures made to comply with changes in regulations or their enforcement since 1985, when IDC submitted its proposal. Regulatory costs have become significant, now that the older parts of Newby Island have been filled and all waste is being disposed of in areas that must be engineered to meet stricter environmental regulations.

Other Expenditures

Other expenditures in the IWM Fund include:

- General and administrative expenditures include outreach to residents and businesses, contractor evaluation, market development, office space lease, non-personal costs, and overhead transfers to the General Fund. Overhead transfers to the General Fund are salary-driven and are projected to increase at the rate of 2% per year.
- To address the City's budget shortfall over the last two fiscal years, funding for several solid waste related activities that had previously been General Fund expenses were transferred to the IWM Fund. These expenses have an ongoing impact of \$800,000 annually and include: LIRA (low income rate assistance), Neighborhood Cleanup support costs, and appropriate civic yard trimmings collection costs.

FUND GOALS AND GUIDELINES

Key goals of the IWM Fund include ensuring the financial integrity of the Fund and providing the resources necessary to meet program obligations and service levels. Factors that impact the stability of the Fund are the contingency reserve, cost recovery of programs, contractors' cost of living adjustments, and diversion.

Contingency Reserves

Responsible financial management practices include the setting aside of funds to serve as a contingency reserve. This reserve serves as both an operating contingency and a rate stabilization reserve. The operating contingency provides a safeguard against contract terminations due to such factors as contractor default, voluntary withdrawal, or failure to perform. This reserve can also serve as a rate stabilization fund. The rate stabilization reserve will protect the ratepayers in the event of unanticipated revenue shortfalls or expenditure increases. The current practice, as agreed with the City Manager's Office, is to maintain a minimum ending fund balance equal to approximately one month's operating expenditures for the Recycle Plus and disposal contracts.

A new fund balance goal of \$5.3 million, without the C-UBS reserve, was established during the rate strategy discussions in the FY 2005-06 budget process. A \$2.3 million reserve was set up for C-UBS in FY 2004-05. This reserve will be used annually to assist in offsetting rate increases as a result of C-UBS costs. Currently, a \$1.5 million contingency reserve has been established for general use by the Fund. The Recycle Plus rate strategy will be set to meet this fund balance goal in the out year projections for the IWM Fund. In addition, a number of other factors impact the stability of the Fund:

Even with a 9% rate increase in FY 2004-05, fund balance is decreasing by 18% when comparing FY 2004-05 levels to FY 2005-06. This decrease is due to expenditures continuing to outpace revenues due to increasing population growth, cost of living adjustments, and decreasing commercial AB939 revenues. A revised rate strategy will be presented to Council during the FY 2006-07 budget process. This strategy will include the repayment of C-UBS commercial paper loans and funding for contractor transition.

Cost Recovery of Recycle Plus Program

As stated in the FY 2005-06 Budget, the key goal for the Fund is revenue restructuring to achieve cost recovery for the single-family and multi-family garbage and recycling programs. Continual analysis is conducted considering elements such as contractual obligations, program changes, and the current economic climate to determine the impact on the Fund in future years and incorporate them into future projections. An updated rate strategy will be brought forward for Council consideration during the FY 2006-07 budget process. The goal to achieve cost recovery in the IWM Fund is in alignment with Council policy that programs be self-supporting.

Cost of Living Adjustment

Recycle Plus contract costs are tied to a Refuse Rate Index, which was designed specifically to annually adjust collection costs up or down based on cost of living changes that would affect the contractors' cost of collection. It is based on annual changes in certain national indices that are directly applicable to the major costs incurred by the collector. National indices that are included are: average hourly earnings for service producing industries from the Monthly Labor Review; diesel fuel index; vehicle replacement index for complete vehicles produced on purchased chassis; vehicle maintenance for parts and attachments for industrial work trucks; and the Consumer Price Index for all urban consumers. It is weighted based on the contractors' actual cost breakdown in the following categories: average hourly earnings; diesel fuel or alternative fuel; vehicle replacement; vehicle maintenance; and all other costs. Historically, the Refuse Rate Index has increased contractor costs by about 3% each year. However, the recent volatility of diesel fuel indicates that costs may increase 5% to 7% over the next couple of years.

Landfill Diversion

Increases in diversion can also increase the costs of the Recycle Plus contracts through the payment of incentives that encourage maximum recovery of materials and decrease residential revenues as well as revenue from commercial and landfill AB939 fees.

RATE SETTING

San José's rates rank below the county-wide average based on annual surveys of Santa Clara County cities and other cities in Northern California with comparable size and types of garbage and recycling systems. San José's current single-family service rate of \$18.30 for 32-gallon garbage service is well below the county-wide average of \$20.74 per month. The proposed increase of 5% currently scheduled for Council consideration in February 2006, will bring the 32-gallon rate to \$19.20, which is still below the county-wide average.

Similarly, multi-family rates also have remained far lower than the county-wide average. The rate for a 3-cubic yard bin serviced once per week (one of the most common multi-family service levels) is currently \$150.67 – far lower than the county-wide average of \$200.20 per month, based on a July 2005 survey prepared by the City of Santa Clara. A proposed increase of 2% will bring this rate to \$153.68 per month, still well-below the county-wide average.

Rate History and Methodology

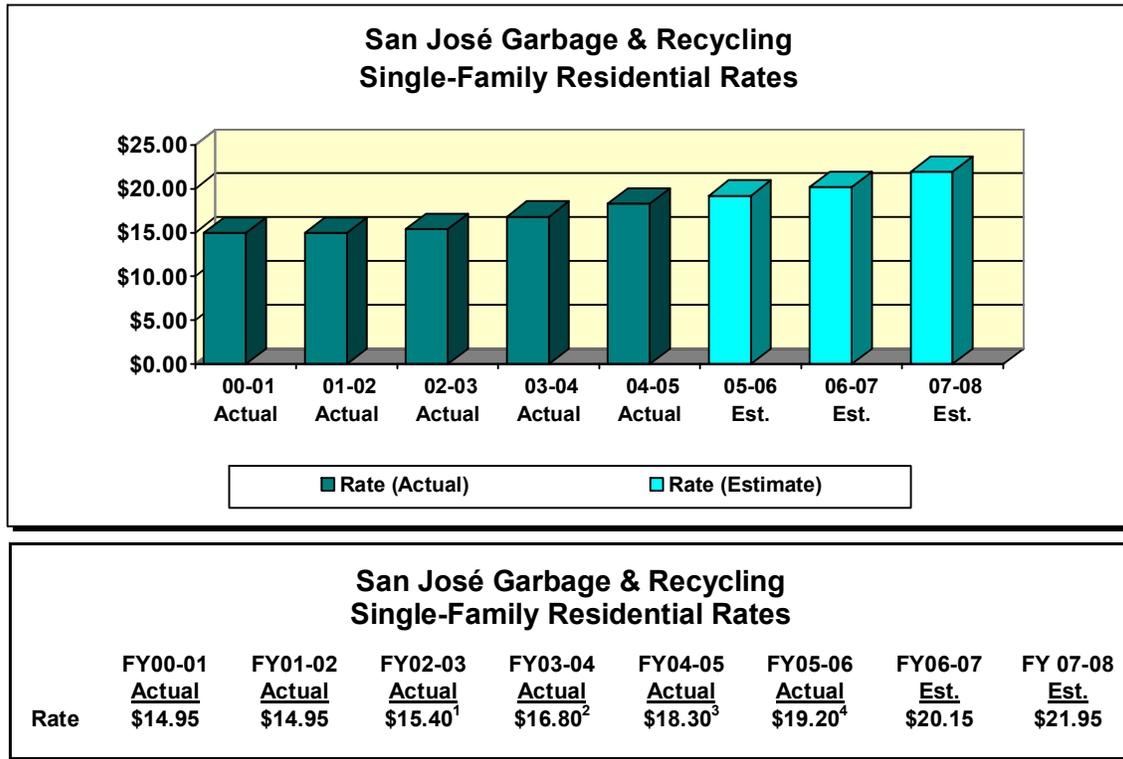
As part of the FY 1997-98 budget and rate-setting process, Council directed staff to recommend a rate structure that would achieve cost recovery status within the IWM Fund by FY 2001-02 for both the residential and commercial sectors. In order to maintain the integrity of the Fund and move closer toward the Council-directed cost recovery goal, the 32-gallon single-family rate was increased by 7%, from \$13.95 per month to \$14.95.

Adoption of the FY 1997-98 rates was the only increase to take effect from the 5-year strategy recommended by staff. Due to subsequent revenue losses and escalating costs over the last several years, Council has authorized rate increases in Fiscal Years 2002-03, 2003-04 and 2004-05 to bring the cost for 32-gallon garbage service from \$14.95 to \$18.30 per month.

In June 2005, approval of the FY 2005-06 rate increase was deferred to August 2005 and then to February 2006. The proposed single-family rate increase would bring the cost for 32-gallon garbage service to \$19.20 per month. Proposed multi-family rate increase for a 3-cubic yard bin serviced once per week would be \$153.68 per month.

Figure 3 below shows San José's garbage and recycling rate history from FY 2000-01 through the projected rate for FY 2007-08.

Figure 3



¹ Effective February 1, 2003.

² Effective July 1, 2003.

³ Effective August 1, 2004.

⁴ Proposed; Council action scheduled for February 2006

Figure 3 shows the FY 2005-06 rate increases adopted by Council in February 2006, with updated out-year estimates. The rate strategy will be reviewed during the FY 2006-07 budget process based on the most current information on program costs and updated revenue and expenditure projections. A major consideration in the rate strategy review will be the results of the Recycle Plus Request for Proposals and the budgetary impacts of the new contract(s). As mentioned previously, Norcal's garbage, recycling, yard trimmings, and street sweeping agreements will terminate on June 30, 2006, and new contractors must be selected.

It is important to recognize that any analysis of rate changes for a particular program within the IWM Fund must take into account resulting effects on each of the other programs and the fund balance. For example, if residential rates are held at their current level, either the fund balance would decline over time, or revenue that currently flows to the General Fund would need to be shifted back into the Fund to cover increasing costs.