Memorandum
October 30, 2006
Appendix A

SOLID WASTE
RATE REGULATION / FUEL COSTS

Managers for the solid waste collection companies have a fiduciary duty to maximize shareholder benefit. As fuel prices increase, companies pay more for fuel. Every additional dollar paid for higher fuel is a dollar less for the bottom line and shareholders.

We all know the price of fuel has increased in the last couple of years. However, that alone does not justify a rate increase. In analyzing rate increase filings, staff asks "Does the company need more revenue to recover expenses and earn a reasonable return on its investment?" or, in other words, "Should customers pay more for the service they receive?"

Solid Waste Company Cost Structure

Disposal fees represent the largest (approximately 30 percent to 50 percent of total cost) cost component for solid waste collection. Companies have no control over disposal fee costs. Local governments frequently own disposal facilities, set disposal fees and direct haulers operating within their jurisdiction to take waste to the local government facility. Disposal fees in western Washington are significantly higher than disposal fees in eastern Washington.

RCW 81.77.160 directs the commission to pass disposal fee increases directly through to customers with no earnings test or determination whether other factors have offset a company's need for additional revenue.

The Lurito-Gallagher methodology treats disposal fees the same as all other expenses. Companies earn a return on every dollar spent. Assume two companies have exactly the same operating characteristics, customer base and cost structures, except for disposal fees. Assume that one company is located in western Washington and pays relatively high disposal fees compared to the other company, which is located in eastern Washington. The company paying higher disposal fees will earn more profit.

The company has great incentive to control costs. The commission sets rates to recover reasonable expenses and provide the company an opportunity to earn a reasonable return. Every dollar that the company can save through managing risk, increasing productivity and decreasing expenses goes straight to its bottom line. Staff therefore believes that companies are operating efficiently.

Lurito-Gallagher Model
The commission uses the Lurito-Gallagher Model to determine revenue requirements and operating ratios for solid waste collection companies. The Lurito-Gallagher Model uses a turnover ratio methodology, refined to incorporate investment, capital structure and capital costs. All expenses, including disposal fees and fuel, earn a marginal return. The revenue requirement determines the rates customers must pay for their service. The relationship of expenses to revenue is expressed as an operating ratio.

Rate Case - Earnings Test
A rate case evaluates a company's operations to ensure the company recovers reasonable expenses and earns a fair return on investment. At the conclusion of a rate case, we have a high degree of confidence that the rates are fair, just, reasonable and sufficient.

Operating expenses, investment, capital structure, number of customers and other factors change almost immediately. Replacing an old collection truck with a new collection truck will increase depreciation expense. The new truck would likely be more fuel efficient, it should require less maintenance, it may require less labor (automatic lift) to operate and it may allow more efficient collection. The purchase would change the company's investment and capital structure. That means the company's revenue requirement and operating ratio will also change. Customer growth, both regulated and non-regulated, lowers average cost per customer. Mergers should lead to greater efficiency and cost savings to customers, and will likely change the company's capital structure. Investment and capital structure will change over time to reflect new investments. Any of the many variables can increase or decrease, and the only way to determine whether a company requires additional revenue is to perform an earnings test.

Single-Issue Ratemaking
A company may experience a significant change in a single expense soon after it completes a rate case. If there have been no significant changes in the company's other expenses, investment, capital structure, number of customers served, etc., it may be appropriate for staff to recommend the commission approve a single-item rate filing. However, staff needs to ensure there have been no changes in other factors that could offset the company's need for additional revenue. Staff needs to analyze single-item rate filings on a case-by-case basis.

Surcharge.
The current solid waste collection fuel surcharge methodology allows companies to recover that portion of increased fuel expense that exceeds one percent of gross revenues. Fuel cost is the product of units (gallons) multiplied by the unit price. The surcharge methodology addresses only changes in unit price, not changes in units purchased. The methodology adjusts the total fuel cost used in the company's last general rate case by the change in unit price. We use an index (Oil Price Information Service) to measure the change in unit price for both the current price and the fuel test period price.

The one percent threshold intends to reflect the uncertainty regarding the company's need for additional revenue and substitutes for an earnings test. The three companies that requested deferred accounting do not qualify for the current methodology because the additional total fuel costs do not exceed one percent of gross revenues:

Company	Fuel as % of Gross Revenue
Northwest	3.22%
SnoKing	3.66%
Seattle / South Sound	2.82%

Pass Through – Solid Waste Disposal Fee Increases.
Disposal fees vary between 30% and 50% of a solid waste collection company's total cost. RCW 81.77.160 requires the Commission to pass disposal fee changes straight through to the customer without an earnings test to determine whether other expenses or revenues and changed that offset the company's need for additional revenue. Staff only ensures that the rates reflect the appropriate amount of disposal fees.

Deferred Accounting / Balancing Accounts.
The commission has used the following deferred accounting or balancing accounts to remove uncertainty and balance the interests of the company and the customers:

Solid Waste - Deferred Accounting - Disposal Fees. In April 1997 through 1998, the commission approved a deferred accounting mechanism for disposal fees for solid waste collection companies in Whatcom County. A new disposal site began operations and started a price war with the only other disposal site. Disposal fees varied wildly, on a daily basis, for about two years. Deferred accounting ensured that customers benefited from price decreases and protected haulers from price increases by ensuring the haulers recovered all of their disposal costs. Staff monitored the companies' decisions to ensure companies paid the lowest prices.

Solid Waste – Deferred Accounting - Recyclable Commodity Credits. The commission established a deferred accounting mechanism for source separated recyclable commodities that haulers collected from residential customers. The program returns to customers the revenue received from the sale of the collected materials. The commission did not allow companies to retain any of the revenue. In 2002, the legislature authorized haulers to retain up to 30% of the revenue, subject to certain requirements.