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Mr. Mark Johnson
Executive Director and Secretary
Washington Utilities and Transportation Commission
P.O. Box 47250
Olympia, WA 98504-7250

Re: Docket TG-131255 Inquiry into methods for setting rates for solid waste collection companies

Dear Mr. Johnson:

Thank you for the opportunity to comment on Docket TG-131255: Inquiry into methods for setting rates for solid waste collection companies. The **Washington Refuse and Recycling Association's (WRRA)** comments are offered on behalf of the association. Our member companies may individually submit comments as well. We appreciate the ongoing work from the Commissioners and Staff of the Washington Utilities and Transportation Commission (WUTC) on this issue.

WRRA's comments supplement and elaborate upon a set of technical comments filed by the Berkeley Research Group (BRG). BRG is a global consulting firm with in-depth experience across a wide range of industries and markets. WRRA's comments primarily address policy and procedural considerations at a higher level while those provided by BRG address technical issues in detail and propose alternate models based on the work of Commission Staff. WRRA has worked closely with Dr. Cleve Tyler and Dr. Paul Driver from BRG in developing our response to the Commission's request for comments. Biographies for Dr. Tyler and Dr. Driver are included with BRG's comments.

History & Context:

The Lurito-Gallagher rate methodology (LG) has played an important role in Washington's excellent solid waste system for over thirty years. Under the LG, the Commission has ensured Washington's residents have access to essential public services at "just, fair,

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reasonable, and sufficient" rates. Meanwhile, Washington's regulated solid waste collection companies have earned a reasonable rate of return that allows for investment to grow and improve the regulated companies. Every day, Washington's regulated solid waste collection companies provide essential public health services in their communities in an environmentally and economically sustainable manner. During the LG's tenure, Washington has grown from no curbside recycling to a national leader. The municipal solid waste recycling rate for Washington in 2015 was 45.2% compared to the national rate of 34.7% (latest available data).[1] The LG has served its purpose and served it well.

In 2013, the Commission began its inquiry into solid waste rate methodology, though discussions on the issue began several years earlier. Since that time, Commission Staff has worked on the issue in several stages including: a workshop and comments in 2013, a study requested on behalf of the Commission from Bell & Associates in 2014, Staff's January 2019 Proposal and the October technical workshop. WRRA appreciates that the Commission has chosen a rulemaking as the forum for this inquiry. This process has allowed for collaboration and communication with both Commissioners and Staff on this multi-faceted issue. WRRA particularly appreciates the open dialogue with Assistant Director of Water and Transportation, Danny Kermode CPA, on this issue.

Recommendations:

WRRA has worked with Staff on this issue for years and both have benefitted from open communication and a strong working relationship. However, the methodology proposed in Staff's January 2019 report, as presented to WRRA, is unworkable for Washington's regulated solid waste collection companies. WRRA asks the Commission to address the following considerations:

- Staff's proposed methodology will not provide Washington's regulated solid waste collection companies with sufficient rates to obtain capital, earn a fair rate of return, and continue to provide Washington with an essential public health service.

- WRRA suggests the alternate model(s) discussed by BRG, which builds on Staff's initial proposal and is based on best practices, sound economic theory and strong research.

- WRRA requests that the Commission and Staff continue to work with WRRA and the industry to appropriately and fairly address taxation issues within any new rate model.

[1] Washington Recycling Rate Information from the Department of Ecology: https://ecology.wa.gov/Research-Data/Data-resources/Solid-waste-recycling-data . EPA National Recycling Statistics: https://www.epa.gov/facts-and-figures-about-materials-waste-and-recycling/national-overview-facts-and-figures-materials#NationalPicture.

- WRRA suggests that the Commission adhere to the existing procedural schedule, hold at least two more workshops and request several more sets of comments before adopting new rules and a new rate methodology in a detailed order.

I. Staff's proposed methodology will not provide regulated solid waste collection companies with sufficient rates to obtain capital and earn a fair rate of return.

WRRA's understanding is that the inquiry into solid rate waste methodology began and continues under a false assumption that solid waste collection companies are over earning. Since 1988, the LG has served as the rate-setting methodology for Washington's regulated solid waste collection industry. In that time, Washington has become a national leader on waste and recycling collection issues. Decades of history using the methodology has not exposed any obvious incidences of a company being unjustly enriched as a result.

WRRA challenges the assumption that solid waste collection companies are over earning under the LG and that profit margins should be reduced accordingly. Staff's January 2019 report calls for lower returns in part because the datasets in the LG are derived from a high inflationary period. This position misunderstands the relationship between profit margin and inflation. See the charts provided in BRG's comments labeled Tables 2-4 and 2-5. Furthermore, the Commission's own report from Bell & Associates in 2014 indicated that companies are under earning with the LG methodology. Washington's solid waste collection companies must earn a fair return on investment to continue providing essential public health services that they are required to do by law. When a fair return is not present, the public suffers because improvements and innovations in service delivery are simply not financially feasible.

a. BRG explains that Staff's proposal mischaracterizes the relationship between profit margins and inflation.

The most significant reason for the assertion that companies could be over earning relates to inflation and the data used in the original LG. BRG's comments address this issue in detail. WRRA will not duplicate that discussion but reiterates the conclusion. The LG used a sample of 198 regulated companies in seven different industries from 1968-1977. At that time, inflation was much higher than today. An article published in the Financial Services Review studied this issue in 1997 using the DuPont formulation:

> In summary, inflation had a negative relationship with stock returns and profit margins although the profit margin had a significant relationship with ROA [return on assets] and

> ROE [return on equity]. The point is, inflation had a negative relationship with the profit margin which will, in turn, reduce ROE and expected growth.[2]

BRG's comments challenge the assertion that higher inflation is naturally associated with higher margins and ROE. WRRA requests that the Commissioner's and Staff review BRG's discussion to help dispel the notion that solid waste collection companies are over earning under the LG and that any update to the eventual ratemaking model must produce lower profit margins.

b. Consultants hired by the Commission found that Washington's solid waste collection companies are under earning

In 2014, Bell & Associates submitted a final report and recommendations to assist the Commission in its inquiry into solid waste rate methodology and evaluation of the LG rate model. The report addressed some deficiencies of the LG methodology and identified two "material errors that cause revenue requirements to be lower than intended."[3] Bell & Associates directly addressed the assumption that solid waste companies are over earning, and found the opposite:

> The interpretation of these results is relatively straightforward. Based on equation (18), the operating margin, exclusive of a return on capital, is 6.2%, and the return on PP&E [plant, property, and equipment] is 6.02%. Allowing for the positive average residual of 0.044 (i.e., 4.4 percentage points) for the waste management sector, slightly higher operating margins or returns on PP&E would be reasonable.[4]

Bell & Associates tested a modified LG and found that sample company revenue requirements were up to 2.9% lower than recommended.[5] WRRA asks the Commissioners and Staff to consider the findings of the Bell & Associates report as it relates to the assumption that solid waste collection companies are over earning.

c. Washington's regulated solid waste collection companies are required by law to earn a fair return on investment that is not provided by the DuPont model.

The statutory mandate of the WUTC is to set just, fair, reasonable, and sufficient rates.[6] Washington Courts and the US Supreme Court have explained that the "sufficiency" requirement

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[2] Reilly, Frank K (1997) "The Impact of Inflation on ROE, Growth and Stock Prices," Financial Services Review, 6(1) 1-17, p 13

[3] ' Solid Waste Rate Setting Methodology" Report Submitted by Bell & Associates, Inc & Sound Resource Economics, December 19, 2014, Docket No UG 131255, p 1

[4] *Id* at 13

[5] *Id* at 5

[6] RCW 80 28 010- 02

for utility rates includes a fair interest return on investment.[7] Sufficient rates are rates that afford a fair return on investment. Washington Courts have articulated that rates must provide a reasonable return on investment. Sufficient rates are equally important as rates that are just, fair, and reasonable:

> Following this broad standard, then, the WUTC must in each rate case endeavor to not only assure fair prices and service to customers, but also to assure that regulated utilities earn enough to remain in business — each of which functions is as important in the eyes of the law as the other.[8]

No matter how rates are determined, they must "enable the company to operate successfully, to maintain financial integrity, to attract capital, and to compensate its investors for the risks assumed."[9]. Furthermore, "there is a constitutionally based floor below which a rate ceiling set by a regulatory agency will be reversed by the courts as confiscatory."[10] The Court in *Power v. WUTC* states what this means in terms of return:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties... The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[11]

The Commission has broad authority to determine rate methodology, but the end results are most important. Both Washington and federal courts have embraced an "end results" test.[12] Staff's proposed methodology does not allow Washington's solid waste collection companies to earn sufficient rates. Fair rates result in safe operations, innovation, investment, and the best possible service to the public. Unfair rates do not.

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[7] it was decided in that case to be the duty of the commission to the company to fix a rate which was sufficient (a rate that would afford a fair interest return on the investment) *Denney v Pacific Telephone & Telegraph Co 276 US 97 (1928)* citing *State ex rel Spokane v Kuykendall 119 Wash 107, 111 (1920)*

[8] *Power v UTC* 104 Wn 2d 798, 808, P 2d 319 (1985) citing *State ex rel PUD 1 v Department of Pub Serv*, 21 Wn 2d 201, 209, 150 P 2d 709 (1944)

[9] *Id* at 811 (quoting *Fed Power Comm n v Hope Nat Gas Co*, 320 U S 591, 605, 64 S Ct 281, 88 L Ed 333 (1944)

[10] *Id* at 812

[11] *Id* at 813 (quoting *Bluefield Water Works & Imp Co v Public Serv Comm'n*, 262 U S 679, 692, 67 L Ed 1176, 43 S Ct 675 (1923)

[12] *Id* at 812

II. Staff's proposed methodology is unworkable for Washington's regulated solid waste collection companies.

Overall, WRRA and BRG found merit in many components of the rate methodology proposed in the January 2019 Staff report. However, Staff's proposal will not result in sufficient rates for Washington's regulated solid waste companies without the improvements suggested by BRG. BRG's proposal was crafted using best practices and is supported by well-documented research.

WRRA defers to BRG's substantial and well-considered discussion on technical issues. WRRA's comments will not duplicate BRG's analysis, but we provide a brief "high-level" overview of key issues and conclusions:

- Both Staff and BRG's proposals develop a portfolio of comparable companies with risks similar to those faced by solid waste collection companies to provide a meaningful analysis for setting rates. BRG's proposal differs from Staff's on this point in two key respects, **data source** and **company selection**.

- **Data Source:** Staff's report used data from the Compustat database which is no longer updated. BRG's proposal pulls data from Capital IQ, a widely used data source that is expected to be available into the perceivable future.

- **Company Selection & Outlier Approach:** Staff and BRG's proposals both use similar criteria/definitions to select companies included in the dataset. Both proposals include methods for removing "outlier" companies with incomplete or incorrect data.
  - Staff's proposal uses a series of statistical tests to confirm a company's fitness for inclusion in the representative sample. Staff's approach to company selection and removing outliers introduces elements of subjectivity into what should be an objective process.
  - BRG's comments explain that Staff's proposal misapplies the selected filtering techniques. BRG proposes a method to trim outliers without introducing subjectivity using the Mahalanobis method, a standard statistical approach that is widely recognized as reliable.

- **Capital Structure:** Staff's proposal fixes predicted margins based on a theoretical proposition that relies on the Modigliani-Miller Theorem (MM) and does not include consideration of company's capital structure.
  - BRG's comments demonstrate that MM has not performed well under empirical testing over the last 60 years and thus Staff's proposal does not reflect real world results. BRG proposes that capital structure of transportation firms be included in the regression model itself which better reflects real world circumstances.

- **Regression Analysis:** Staff's proposal estimates its regression model using log 10 as opposed to natural log. BRG recommends natural log as it is a more commonly accepted and standard approach than log 10.

Any rate methodology adopted by the Commission should reflect the unique challenges of regulated solid waste collection companies. Both Commission Staff and BRG have identified concerns with the LG methodology. However, as discussed elsewhere in these comments, the LG has served Washington regulators, businesses, and citizens well for decades. While not perfect, the LG adequately addresses circumstances that distinguish solid waste collection companies from other regulated entities.

Solid waste collection companies face considerably more risk due to the variable nature of their capital deployment and faster turnover of assets than other regulated industries. This point was addressed by Dr. Lurito in testimony supporting the original LG:

> This relationship between risk and anticipated return applies not only to alternative forms of investment, but also to companies that exhibit different risk characteristics. As a result, the fair rate of return for a relatively risky company would be higher than for a less risky one. For example, the fair rate of return for a garbage hauling operation, if it could be directly measured, would potentially be higher than that for an electric or telephone utility.[13]

Furthermore, any model can provide a company an opportunity to earn up to a given authorized rate of return. However, due to many factors, few companies actually earn their full authorized return. Any new rate methodology for solid waste collection companies must adequately address issues related to higher risk than other regulated industries, capital structure, and fair taxation.

III. Any rate methodology considered by the Commission should address tax issues and treat all companies fairly.

The Tax Reform Act of 2017 decreased the corporate tax rate significantly, but made only minor revisions to individual tax rates, which are the rates applicable to many owners of closely held solid waste collection companies regulated by the Commission. Many closely held companies are "Flow-Thru Entities," either proprietorship, partnerships, certain limited liability companies or Subchapter S Corporations (S Corps). In this type of ownership, taxable profits flow directly to the owner for calculation of taxable income at the individual tax rate.

Staff's proposed model computes an overall return based on earnings before interest and income taxes. As a consequence of higher tax rates for S Corps, those companies will see

[13] *Consolidated Garbage Cases*, Docket TG 2016 et al , Testimony of Richard J Lurito and Kenneth F Gallagher (Oct 1987) at 23

reduced returns to the flow-thru entities compared to Subchapter C Corporations (C Corps) that pay taxes at the lower corporate rate. This places an unfair burden on flow-thru entities (typically smaller companies), which then have reduced revenue for investment in facilities and equipment. In summary, Staff's proposed model would favor companies organized as C Corps and will result in lower effective returns for flow-thru entities.

a. WRRA requests more information if the Commission adopts a rate methodology that does not address taxation issues.

If the Commission or Commission Staff believes that a mechanism to account for tax rate changes in the new rate methodology is unnecessary, WRRA poses the following questions:

1. The LG was recently updated to reflect changes in federal income tax rates. Why does the Commission now believe that changes in the federal income tax rates should not be addressed within a new rate methodology?
2. Is it the intended policy of the Commission to have federal tax policy become a crucial driver for the capital structure of Washington's regulated solid waste companies?[14]
3. How can the Commission determine sufficient rates of return if the proposed model fails to consider necessary components of the final return on equity?

b. WRRA requests continued work with the Commission and Staff on the issue.

The Commission has long recognized that federal income taxes are a cost of doing business and are proper expenses to include in the calculation of rates. WRRA requests that the Commissioner's and Commission Staff continue to work with WRRA on taxation issues. WRRA insists that any successful rate methodology must address tax issues and (a) include consideration of tax burdens in determining a company's revenue requirement and (b) treat all companies fairly.

IV. WRRA requests that the Commission continue the rulemaking, host at least two more workshops, and adopt a detailed order that articulates policy goals.

WRRA shares the Commission's goal to bring this rulemaking to a successful conclusion. However, after over six years of work, it is critical that the final resolution produces workable and enduring outcomes for both parties. WRRA requests that the Commission adhere to the currently discussed procedural schedule, including at least one more round of informal comments and at least two workshops. The procedural schedule stated at the October 8 technical

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For Washington's solid waste collection companies, return on equity is a crucial component final return measurement to shareholders The proposed DuPont Model does not account for any tax burden The model prescribes a rate of return based upon earnings before interest and taxes (EBIT) The mathematical steps to move from a prescribed return based on EBIT to a final ROE requires consideration of federal income tax rates as a necessary component Accordingly, the federal income tax rate is a key factor in determining ROE workshop included issuing a new CR-101 alongside new draft rules for informal comment and another workshop. WRRA requests at least two workshops before the Commission files CR-102 draft rules: a technical workshop between industry and Commission Staff to address BRG and Staff's models, and a workshop with Staff and Commissioners present to discuss procedural matters and remaining points of contention. Other workshops or hearings with targeted agendas may be warranted throughout the process.

Ultimately, WRRA believes the Commission should issue a detailed order alongside a new rule and model for solid waste rate methodology. To that end, WRRA recommends the Commission follow the model established several years ago in Docket TC-121328, which addressed a rule update for Passenger Transportation Companies. The order in Docket TC-121328 clearly articulated policy goals with supporting reasoning and provided detailed responses to comments.[15] Several legal practitioners that work with WRRA have reported that the detailed order has proved useful in "filling in gaps" and helped determine and establish future policy. To a lesser degree, the original order that established the LG in 1988's Consolidated Garbage Cases had a similar structure.[16] WRRA requests that the Commission ultimately adopt a detailed order alongside a final rule to provide guidance in future interpretation.

V. WRRA looks forward to continued work with the Commissioners and Commission Staff on key issues.

In conclusion, WRRA has agreed throughout this process that the underlying data sets for the LG, or any rate methodology, should be updated to reflect current market conditions and contain a mechanism to update that data in the future. If the Commission and WRRA are unable to reach consensus on a new model, the Commission should consider retaining the current LG methodology with an updated dataset. Much of the work produced by BRG can be adapted and inserted into the existing LG. This would provide the Commission and industry with a rate methodology that is familiar and has worked effectively for decades and reflects current market conditions.

WRRA welcomes the opportunity to work with Staff on these outstanding issues and the model(s) suggested by BRG. Open communication and a strong working relationship with Commission Staff has proved instrumental throughout this multiyear process. WRRA looks forward to continued work with Staff and the Commissioners to bring this rulemaking to a successful resolution for all parties involved. Washington's solid waste collection companies provide world class service every day in their communities. An updated rate methodology that allows for continued improvement, innovation, and investment at fair and sufficient prices will benefit everyone in Washington. The LG served both the Commission and the industry well for

[15] In the Matter of Amending and Adopting Rules in WAC 480-30 Relating to Passenger Transportation Companies, Docket TC-121328, General Order R-572 (Aug 21, 2013)
[16] *Consolidated Garbage Cases* TG-2016, 2017, 2018 et al, Final Commission Order (Jan 1988)

thirty years. WRRA hopes the new model will be equally successful. WRRA urges the Commission to take the time and consideration to get the rule done, but more importantly, get it "right."

Respectfully submitted,

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