TO: HONORABLE CITY COUNCIL
ATTENTION: FINANCE COMMITTEE
FROM: CITY MANAGER
DEPARTMENT: PUBLIC WORKS
DATE: MAY 13, 2008
SUBJECT: APPROVAL OF THE PALO ALTO SANITATION COMPANY
COMPENSATION IN THE AMOUNT OF $10,960,234 FOR FISCAL
YEAR 2008-09

RECOMMENDATION
Staff requests that the Finance Committee recommend that the Council approve compensation to the Palo Alto Sanitation Company (PASCO) in the amount of $10,960,234 for Fiscal Year 2008-09 (FY 08-09). This recommendation, summarized below as Option 1, has been coordinated with the City Attorney’s Office and the City Auditor’s Office.

BACKGROUND
The current waste hauling and recycling contract with PASCO requires an annual review of compensation due PASCO for the upcoming fiscal year. This review is to be conducted as part of the Finance Committee’s annual review of the City budget for that fiscal year.

The contract provides that PASCO’s compensation in the upcoming year consists of forecasted allowable costs (such as labor and equipment), forecasted pass-through costs (such as taxes and regulatory fees), and profit. To calculate profit, the contract uses an “operating ratio” methodology. Specifically, the agreed-on operating ratio (“OR”) of 88% is applied to forecasted allowable cost with the result representing the forecast amount of profit to be earned in the upcoming year. (The “OR” is close to the reciprocal of a profit percentage, although the calculation is slightly different. Thus, if a company’s OR is 88%, it earns about a 12% profit. A 90% OR equates to about a 10% profit, while an 86% OR is equivalent to a 14% profit.)

As a general proposition, the contract provides that the forecasted allowable costs for the upcoming year are to be calculated by multiplying forecasted allowable costs for the current year by specified percentages of the change in the CPI, with the sum of those increased costs, plus profit, plus forecasted pass-through costs equaling the amount to be budgeted for PASCO compensation in the upcoming year. PASCO also retains revenues from recyclable materials, drop boxes, and disposition of vehicles as part of their compensation.

In most of the years since the contract began in 1999, PASCO’s compensation has been set through the simple, CPI-based adjustment of current year’s Forecasted Allowable Costs amount. However, the contract anticipated that, in some years, PASCO’s costs might increase (or decrease) significantly in relation to the annual CPI change. In cases where this discrepancy in costs is large enough so that PASCO profit would be expected to fall outside the 2% +/- target
range above or below the 88% OR (i.e., above 90% or below 86%), the contract requires the
parties to perform a cooperative, good faith review of the Forecasted Allowable Costs to
determine if an adjustment from the CPI change is needed.

An adjustment in PASCO’s compensation was made by the City Council, at staff’s
recommendation, last year. In May 2007, the City Manager’s Report stated in part:

“Due to significant on-going cost increases incurred by PASCO,
staff recommends a prospective adjustment to PASCO’s
compensation for 2007-08 and going forward. These cost
increases are based on the results of operations as detailed in
PASCO’s 2005-06 audited financial statements and the notion that
the cost increases are continuing in nature.” (Emphasis added.)

After a detailed review of PASCO’s financial records and meetings with PASCO representatives,
the staff recommended, and the Council approved, additional compensation in the amount of
$814,832 for FY 2007-08, attributed to specifically identified cost line items which had
increased sharply and were expected to continue. (CMR 245:07 is attached as Attachment A.)

DISCUSSION

As required by the contract, PASCO submitted its audited financial statements for FY 2006-07 in
September 2007 and its compensation adjustment application and review report (the
“Compensation Report”) by December 30, 2007. The financial statements showed that PASCO
had fallen short of the target OR range during FY 2006-07 due to a continuation of the higher
costs it experienced in FY 2005-06 and which had led the City Council last May to increase the
allowable costs budgeted for PASCO compensation in FY 2007-08. (The financial statements
showed that PASCO’s OR in FY 2006-07 was 95% -- meaning that its profit was approximately
5%.)

Therefore, the City engaged in a careful review of PASCO’s costs in FY 2006-07. At the City’s
request, PASCO also reported their costs for the first six months of the current year, FY 2007-08,
(Attachment B). Unlike the cost review conducted last year, however, staff found that the use of
the current year’s allowable costs as the baseline for setting Forecasted Allowable Costs for FY
2008-09 would not produce unfair results, precisely because of the City’s substantial increase in
PASCO’s compensation for the current year.

PASCO disagreed with this conclusion, arguing that because its actual OR in FY 2006-07 (95%)
was well outside the target range (86% - 90%) because of higher than expected costs in that year,
the City should for that reason increase Forecasted Allowable Costs for FY 2008-09 above the
level actually expected to be incurred so that it could be “made whole” for FY 2006-07.

City staff conducted a careful review of PASCO’s submissions and held approximately four
meetings with PASCO representatives during January through March of this year. No agreement
was reached. Therefore, as required by the contract, staff is submitting its proposal for PASCO
compensation (summarized as Option 1, Attachment C), as well as PASCO’s request
(summarized as Option 2, Attachment D).
OPTION 1: STAFF RECOMMENDATION ($10,960,234)

Staff calculated the FY 2008-09 compensation as follows:

1. Adjust the FY 2007-08 Forecasted Allowable Costs by a portion of the change in the CPI.
2. Determine the Profit by applying the 88% OR to the Forecasted Allowable Costs, as adjustment.
3. Add Forecasted Pass-Through Costs.

**STAFF CALCULATION**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2007-08 Forecasted Allowable Costs</td>
<td>$9,240,745</td>
</tr>
<tr>
<td>CPI Adjustment (3.11% on allowable costs and 3.8% on corporate expenses)</td>
<td>+ 290,736</td>
</tr>
<tr>
<td>FY 2008-09 Forecasted Allowable Costs</td>
<td>$9,531,481</td>
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<tr>
<td>Profit (88% OR)</td>
<td>1,299,747</td>
</tr>
<tr>
<td>Forecasted Pass-Through Costs</td>
<td>129,066</td>
</tr>
<tr>
<td><strong>Total for FY 2008-09 Compensation</strong></td>
<td><strong>$10,960,294</strong></td>
</tr>
</tbody>
</table>

OPTION 2: PASCO PROPOSAL ($12,048,749)

PASCO utilizes essentially the same methodology as the City, with one important difference. In determining the Forecasted Allowable Expenses for FY 2008-09, PASCO also begins with the Forecasted Allowable Expenses for FY 2007-08, but then includes an additional $950,474 which it attributes to costs incurred in FY 2006-07 that were not budgeted for and which prevented it from earning an adequate profit in that year.

**PASCO CALCULATION**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2007-08 Forecasted Allowable Costs</td>
<td>$9,240,745</td>
</tr>
<tr>
<td>Addition for Excess FY 2006-07 Costs</td>
<td>+ 950,474</td>
</tr>
<tr>
<td><strong>Total for FY 2006-07 Costs</strong></td>
<td><strong>$10,191,219</strong></td>
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<tr>
<td>CPI Adjustment (3.2% on allowable costs and adjusted line items; 3.8% on corporate expenses)</td>
<td>298,155</td>
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<tr>
<td>FY 2008-09 Forecasted Allowable Costs</td>
<td>$10,489,374</td>
</tr>
<tr>
<td>Profit (88% OR)</td>
<td>1,430,369</td>
</tr>
<tr>
<td>Forecasted Pass-Through Costs</td>
<td>129,006</td>
</tr>
<tr>
<td><strong>Total FY 2008-09 Compensation</strong></td>
<td><strong>$12,048,749</strong></td>
</tr>
</tbody>
</table>

Staff does not agree with PASCO’s approach for two reasons.
First, it is not supported by the contract language which contemplates a process in which the current allowable cost reimbursement level is carried forward from year to year with annual CPI adjustments, unless doing so would prevent PASCO from earning a profit within the Target OR Range. That outcome is to be avoided by a careful review of recent and current costs to see if they should be increased (or decreased) in the upcoming year so that application of the 88% OR to the adjusted costs can be expected to yield an OR in the coming year within the 86% - 90% range. The contract does not guarantee PASCO that it will earn an OR within that range in every year, with adjustments to a future year’s compensation being designed to compensate for a prior year’s actual results. An historical excursion outside the OR target range serves as a trigger for a detailed review of historical and current costs to determine if they need to be adjusted to get back on track in the upcoming year, not to “true up” historical shortfalls or overages.

Second, the significant increase in this year’s compensation allowed by the Council last May was not intended to “square the books” for the results of FY 2005-06. Instead, the results of FY 2005-06 were looked to, along with the best information available as to cost trends, to set the costs for FY 2007-08 at a realistic level.

After a careful review of the costs PASCO incurred during FY 2006-07 and the costs it has reported for the first six months of the current year, staff believes that adjusting the current year’s allowable costs by the CPI and setting total compensation for next year at $10,960,234 will allow PASCO to earn a profit within the contract’s OR Target Range.

The contract provides that, if the City staff and PASCO present different recommendations to the Council:

“The City Council shall consider staff’s proposal and alternatives to staff’s recommendations, if different from collector’s [i.e., PASCO’s] request and shall approve such amount of compensation as it reasonably deems appropriate, in a manner consistent with this Agreement, based on adjustment information submitted to it.”  
(Section 4.6.4)

**RESOURCE IMPACT**

There are sufficient funds in the Refuse Fund FY 2008-09 Proposed Budget to accommodate either Option 1 or Option 2. If the Council selects Option 1, the ending balance of the Rate Stabilization Reserve (RSR) as of June 30, 2009 is projected to be approximately $2.0 million. With Option 2, the projected RSR ending balance would be approximately $1.0 million. Under either option, the projected RSR ending balance falls below the minimum guideline range of $2.7 million. However, staff believes that the projected RSR under either option will be sufficient to meet its near-term needs and will continue to evaluate the RSR on an on-going basis.

**ENVIRONMENTAL REVIEW**

This report is not a project under the California Environmental Quality Act (CEQA) and an environmental review is not necessary.
ATTACHMENTS
Attachment A: CMR:245:07
Attachment B: PASCO’s Six Month Financial Analysis
Attachment C: Option 1 - Staff Recommendation
Attachment D: Option 2 - PASCO Proposal

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