

Attachment C



HF&H CONSULTANTS, LLC

Managing Tomorrow's Resources Today

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November 27, 2023

Ursula Syrova
Environmental Programs Manager
Public Works
10300 Torre Avenue
Cupertino, CA 95014

Subject: Review of Recology South Bay Rate Period Four Contractor's Compensation Application

Reference Number: S7018

Dear Ursula Syrova:

HF&H Consultants, LLC's (HF&H) is pleased to present our findings and recommendations to the City of Cupertino (City) from our review of Recology South Bay's (Recology) Rate Period Four (RP 4) Contractor's Compensation Application (Application), which was submitted on August 1, 2023. This report presents our findings and recommendations and is organized into the following three sections:

- I. Summary and Recommendations
- II. Background
- III. HF&H Analysis

It should be noted that this report is based solely on our review of Recology's Application prepared in accordance with the methodology prescribed in its franchise agreement (Agreement) with the City.

I. SUMMARY AND RECOMMENDATIONS

A. Review of Recology's RP 4 Rate Application (for rates effective 2/1/24)

Recology's Application calculated a revenue requirement of \$20,505,312 to provide current franchised services for RP 4 (see Table 1).

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Table 1: Recology's RP 4 Rate Application

	Proposed RY4	Adjustments	HF&H RP4
Labor-related Costs	\$ 5,256,746	\$ -	\$ 5,256,746
Vehicle-related Costs (excluding fuel)	794,980	-	794,980
Fuel Costs	543,089	-	543,089
Other Costs	482,240	-	482,240
Direct Depreciation	905,853	-	905,853
Allocated Costs	3,362,188	(44,126)	3,318,063
Allocated Costs (Depreciation and Start-Up)	35,311	-	35,311
Total Cost of Operations	\$ 11,380,408	\$ (44,126)	\$ 11,336,282
Application of 5% Cap			\$ (909,320)
Total Cost of Operations with Cap			\$ 10,426,962
Profit (assuming operating ratio of .725)	\$ 4,316,706	\$ (361,652)	\$ 3,955,055
Solid Waste Disposal Costs	\$ 795,729	\$ 13,380	\$ 809,109
Recyclable Materials Processing Costs	242,966	26,021	268,987
Residential Organic Materials Processing Costs	739,034	93,445	832,479
Commercial Organic Materials Processing Costs	805,697	37,726	843,423
C&D Processing Costs	116,781	(4,213)	112,568
Reusable Materials Handling Costs	-	-	-
Interest Expense	326,655	-	326,655
Direct Lease Costs	-	-	-
Allocated Lease Costs	180,000	-	180,000
Total Pass Through Costs	\$ 3,206,862	\$ 166,359	\$ 3,373,221
Solid Waste Fund Operations Fee	\$ 1,601,336	\$ 34,360	\$ 1,635,697
Rate Application Review Costs	-	85,000	85,000
Total Reimbursements to City	\$ 1,601,336	\$ 119,360	\$ 1,720,697
Total Calculated Costs	\$ 20,505,312	\$ (1,029,378)	\$ 19,475,934
Other Adjustments (City Payments)			
Calculated Costs	\$ 20,505,312	\$ (120,058)	\$ 19,475,934
Revenue	\$ 18,530,975	\$ 14,862	\$ 18,545,837
Surplus / (Shortfall)	\$ (1,974,338)		\$ (930,098)
Required Percentage Increase / Decrease	10.65%		5.02%

Note: Numbers may not sum exactly due to rounding.

Based on our recommended adjustments to the Application, we have determined that a total revenue requirement of \$19,475,934 is appropriate and consistent with the rate setting methodology described in the Agreement. These adjustments result in a 5.02% overall rate increase to provide the services currently

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required in the Agreement. The City may apply a different rate increase by sector or use City funds in order to generate the overall 5.02% rate increase. HF&H's adjustments to Recology's Application are described in more detail in Section III.C below. We have reviewed our findings with Recology, and Recology agrees with the proposed rate adjustment unless otherwise noted in this letter report.

II. BACKGROUND

A. General

The Agreement with Recology for recyclable materials, organic materials, and solid waste collection, recyclable materials and organic materials processing services, and transport for disposal commenced in February 2021. In accordance with Article 8.2.B of the Agreement, Recology's maximum rates for RP 1-3 were determined at the start of the Agreement. In accordance with Article 8.2.C of the Agreement, Recology's compensation shall be adjusted annually in subsequent rate periods, beginning with RP 4 through the remaining term of the Agreement, including any extension periods. The adjustments to Recology's compensation shall be determined using one of two methodologies: (i) an index-based adjustment or (ii) a cost-based adjustment (detailed rate review).

In RP 4, rates shall be adjusted using the cost-based methodology as described in Exhibit E2 of the Agreement. The cost-based methodology involves review of Recology's actual cost of operations and operational statistics (staffing levels, routes, route hours, customers, and their service levels, etc.) to determine the actual allowable total annual cost of operations for the most-recently completed rate period to forecast Recology's allowable costs for RP 4.

The intent of performing the cost-based adjustment is to examine the actual costs to serve the City's ratepayers, instead of relying on Recology's proposed costs from the proposal process. This methodology takes into consideration the impacts of changes in inflation, deflation, number of customers, and the service levels of each customer to determine Recology's allowable compensation.

Additionally, because the rates for RP 1-3 were set at the start of the Agreement, the City wishes to use this rate adjustment process to reconcile any significant cost areas that Recology was compensated for, but did not incur, or that the City incorporated into the projected Solid Waste Fund Operations Fee that the City did not yet incur costs for, and integrate the impact in this year's rate adjustment.

III. HF&H ANALYSIS

A. Scope of Work

Our approach to this engagement was to work objectively to follow the compensation adjustment terms of the Agreement between Recology and the City. When performing the procedures described in the Agreement for the cost-based adjustment, we relied on Recology's audited financial statements, current year-to-date financial results of operations data, copies of transactions, reports of operations, and other information provided by Recology, Recology's proposal to the City, and industry standards.

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The results of our review and our findings were documented by the HF&H staff that performed the engagement and were consequently objectively reviewed by our Engagement Manager. This documentation and subsequent HF&H adjustments were made available to Recology and the City for review. While taking direction from the City, we worked cooperatively with Recology in an open and transparent manner to ensure that Recology understood our procedures and preliminary findings. In this capacity, the City and Recology had the opportunity to correct any misunderstandings and understand the reasons for any adjustments to the Application that we recommended.

HF&H staff performed this review based upon procedures agreed upon by the City and HF&H, as documented in our proposal, and the agreement between the City and Recology. These procedures included the following activities:

- We reviewed the Application to ensure its completeness and compliance with the methodology described in the Agreement.
- We reviewed the Application for mathematical accuracy and internal consistency. We also checked that the summary schedules agreed to the supporting schedules and worksheets.
- We verified Recology correctly calculated their RP 4 compensation using the allowable expenses and the correct percentage changes in CPI in accordance with the Agreement.
- We reviewed the Application by performing: a review of revenue; a verification of solid waste tonnage and disposal expenses; a review of organic material tonnage and processing expenses; and a review of recyclable commodity revenue and processing costs.
- We compared actual RP 2 costs to projections and inquired about any significant unexplainable variances.
- We verified that the estimated RP 3 gross receipts were correctly calculated according to the methodology per the Agreement.
- We reviewed the costs to process multi-family and commercial solid waste, which did not occur during RP 1-3, and discussed with the City options to integrate these funds in the rate adjustment process.
- We reviewed the updated Solid Waste Fund Operations Fee with the City to integrate into the rate application.
- We met with the City and Recology to review the recommended adjustments to the Application described herein.
- We prepared a written draft and final report to document our findings and recommendations to share at the Council meeting.

B. Limitations

Our review was substantially different in scope than an examination in accordance with Generally Accepted Auditing Standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion. Such a review was conducted, and an opinion expressed by Recology's independent accountants BFBA, LLP.

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Our conclusions are based on the review of Recology's projections of its financial results of operations. Actual results of operations will usually differ from projections because events and circumstances frequently do not occur as expected, and the difference may be significant.

C. Review of RP 4 Application (February 1, 2024 – January 31, 2025)

The City engaged HF&H to perform a review of Recology's Application submitted in accordance with Section 8.2.C of the Agreement. Recology submitted the Application on August 1, 2023. HF&H's procedures included the following steps:

Step 1: Verification of the Mathematical Accuracy

HF&H reviewed Recology's Application to determine completeness, mathematical accuracy, reasonableness, and logical consistency of the assumptions supporting the projected revenues and expenses. This included:

- Verification that all cost indices used to project expenses conformed to Exhibit E2 of the Agreement;
- Verification of the mathematical accuracy of Recology's compensation adjustment calculations; and,
- Verification of the consistency and integrity of the spreadsheets housing calculations.

HF&H found that Recology's application was mathematically correct and used the correct indices. No adjustments required.

Step 2: Determine Current Cost Components

As required by Exhibit E2.2.A.1 of the Agreement, we found that Recology did correctly use the actual expenses incurred for RP 2 (Labor-related, Vehicle-related costs, fuel, etc.) as the starting point for calculating their RP 4 allowable compensation. However, Recology did not exclude all non-allowable costs as detailed in Exhibit E2.2.A.2. HF&H adjusted allocated costs to remove non-allowable costs related to legal services, citations, and tax penalties. The dollar effect of this adjustment is included with Step 3 F below.

Step 3: Adjust Specific Cost Component

A. Labor-Related Costs

Section 2.A.3.a of Exhibit E2 states that the projected labor-related costs for the coming rate period shall be calculated by (i) multiplying the allowed labor-related cost, both direct and allocated, for the most recently completed Rate Period by one plus the Annual Percentage Change in the CPI-U, and (ii) multiplying the result of step one once more by one plus the Annual Percentage Change in the CPI-U. We reviewed and verified the reasonableness of Recology's actual RP 2 labor-related expenses and inquired about any large variances from projected RP 2 costs, noting no unexplainable variances. Adjustments were made pursuant to the 5% cap on total annual operating costs as further described in Step 3 H below.

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B. Vehicle-Related Costs (excluding fuel and depreciation costs)

Section 2.A.3.b. of Exhibit E2 states that projected vehicle-related costs for the coming rate year shall equal the allowable vehicle-related costs (i) multiplied by one plus the percentage change in the Motor Vehicle Index and (ii) multiplying the result of step one by the same percentage change used in step one. Adjustments were made pursuant to the 5% cap on total annual operating costs as further described in Step 3 H below.

C. Fuel Costs

Section 2.A.3.c of Exhibit E2 states that projected fuel costs for the coming rate year shall equal the allowable fuel costs (i) multiplied by one plus the percentage change in the Fuel Index and (ii) multiplying the result of step one by the same percentage change used in step one. We reviewed and verified the reasonableness of Recology's actual RP 2 fuel expenses and inquired about any large variances from projected RP 2 costs, noting no unexplainable variances. Adjustments were made pursuant to the 5% cap on total annual operating costs as further described in Step 3 H below.

D. Other Costs

Section 2.A.3.d of Exhibit E2 states that projected other costs for the coming rate year shall equal the allowable other costs (i) multiplied by one plus the percentage change in the CPI-U and (ii) multiplying the result of step one by the same percentage change used in step one. Adjustments were made pursuant to the 5% cap on total annual operating costs as further described in Step 3 H below.

E. Depreciation

Section 2.A.3.e of Exhibit E2 states that direct depreciation shall be fixed at \$905,853 per year for vehicles, containers, and facilities. Recology's application correctly included depreciation at \$905,853. No adjustment recommended.

F. Allocated Costs – Labor, Vehicle, Fuel, and Other Costs

Section 2.A.3.f of Exhibit E2 states that allocated costs for labor, vehicle, fuel, other, and depreciation shall equal the allowable allocated costs (i) multiplied by one plus the percentage change in the CPI-U and (ii) multiplying the result of step one by the same percentage change used in step one. However, Section 2.A.1.a through f of Exhibit E2 indicates the various indices applied by expense category apply to both direct and allocated expenses. In other words, instead of applying the CPI-U to the total allocated costs, allocated labor costs will be increased by the ECI, allocated vehicle costs will be increased by the Motor Vehicle Index, allocated fuel costs will be increased by the Fuel Index, allocated depreciation will be held flat, and other costs will be increased by the CPI-U. As such, HF&H recalculated the allocated costs for RP 4 by applying the individual labor, fuel, vehicle, and other indices to the allocated cost categories. Allocated depreciation was held flat, the Fuel Index was less than the CPI-U, and non-allowable costs were removed from allocated costs. As such, HF&H recommends a decrease of \$44,126 to reflect the net impact of non-allowable costs from Step 2 and the multiple indices on allocated costs.

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G. Allocated Costs – Depreciation and Start-Up Costs

Section 2.A.3.g of Exhibit E2 states that Allocated Depreciation and Start-Up Costs shall be \$35,311 per year and are not annually adjusted. Recology's Application correctly included Allocated Depreciation and Start-Up Costs of \$35,311. No adjustment recommended.

H. Total Cost of Operations

Section 2.A.3.h of Exhibit E2 states that the total of Sections A – G above shall be subject to the 5% cap as described in Section 1 of Exhibit E2. For the coming rate period, total forecasted annual cost of operations for RP 4 may not be more than a 5% increase to the total annual cost of operations for the then-current rate period (RP 3). HF&H calculated the 5% cap based on the RP 3 total annual cost of operations, which was calculated per the index methodology in Exhibit E1. HF&H noted that the sum of Sections A – G was above the 5% cap. HF&H adjusted the total forecasted annual cost of operations for RP 4 to meet the 5% cap and recommends a \$909,320 decrease in total cost of operations (exclusive of prior adjustments from Steps 2 and 3).

I. Profit

We found that Recology correctly calculated its allowable profit by applying an 72.5% operating ratio (approximately an 27.5% profit) to its allowable operating costs; however, due to the calculated adjustments described above, we recommend a \$361,652 decrease to Recology's profit.

J. Pass-Through Costs Disposal and Processing Costs – All Material Streams

Solid Waste Disposal

Section 2.A.3.C.4 of Exhibit E2 states the projected cost to process solid waste disposal shall be calculated based on the total tons of materials processed during the most recently completed 12-month rate period multiplied by the allowable per-ton disposal fee.

The per-ton disposal fee adjusts every July 1. Because the City's rate period is from February – January, the disposal fee adjusts in the middle of the rate period. Recology proposed a methodology to account for these timing differences: a weighted average based on the current rate and the most recent rate increase. The per-ton disposal fee is known for February 2024 through June 2024 (\$47.59). The July 2024 – January 2025 rate is the current per-ton disposal fee increased by July 1, 2023 rate increase ($\$47.59 \times 1.022 = \50.67). The weighted average was calculated as follows: $((\$47.59 \times 5) + (\$50.67 \times 7)) / 12 = \48.22 . HF&H reviewed this calculation for reasonableness and agrees with Recology's proposed methodology.

However, Recology's proposed RP 4 disposal costs did not take into consideration the first amendment to the disposal agreement. The amendment states the tipping fee for the disposal and/or recycling of Municipal Solid Waste at Newby Island as of July 1, 2024, shall be the amount adjusted pursuant to Section 5.2 and 5.4 of this Agreement plus an additional \$2.00 per-ton to the adjustable portion of the tipping fee. As a result, HF&H recommends an increase of \$2.00 per-ton to July 2024 Newby Island's tipping fee, which

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modified the weighted average calculation and yielded a per-ton disposal rate of \$49.39. HF&H revised the application to use this per-ton rate and noted the net impact of \$13,380 in Table 2 below.

Recycling Processing

Section 2.A.3.C.1 of Exhibit E2 states the projected cost to process recyclable materials shall be calculated based on the total tons of materials processed during the most recently completed 12-month rate period multiplied by the allowable per-ton processing fee. The City's recycling processor is GreenWaste; however, the processing agreement is between Recology and GreenWaste, not the City and GreenWaste, and therefore the details of the processing agreement are not available for HF&H to review. HF&H received communications from GreenWaste stating the increase for RP 4 to be about \$1.25 per ton. Recology's calculation of the allowable per-ton processing fee reflected the processing expense incurred during the most recently completed 12-month rate period (RP 2) divided by tons collected in RP 2 (\$31.01). This rate was increased by \$1.25 twice to calculate the RP 4 per ton rate of \$33.51.

Recology further explained that the processing charge at GreenWaste has four tiers that change throughout the year. The tiers are based on contamination and include seasonal wet material; it is not a set rate throughout the year. Therefore, a full 12 months should be considered for any comparative analysis. Because we are in the middle of RP 3, a full 12 months at the current processing tiers are unavailable and an average of the available months in RP 3 (February 2023 – September 2023) would not capture the full scale of seasonal material. Therefore, Recology provided the RP 2 average rate per ton and increased it by \$1.25 twice to capture this seasonality.

HF&H reviewed Recology's proposed methodology for RP 4 and deemed it reasonable. The RP 4 rate of \$33.51 will be used as in the RP 4 cost-based rate adjustment methodology. Therefore, no adjustment required to the per ton recycling processing rate.

Organic Materials Processing

Section 2.A.3.C.2 through 3 of Exhibit E2 describes the projected cost to process organic materials shall be calculated based on the total tons of materials processed during the most recently completed 12-month rate period (i) multiplied by one plus the percentage change in the CPI-U and (ii) multiplying the result of step one by the same percentage change used in step one. No adjustment required to the per-ton organic materials rate.

Construction and Demolition Processing

Section 2.A.3.C.4 of Exhibit E2 describes the projected cost to process construction and demolition (C&D) materials shall be calculated based on the total tons of materials processed during the most recently completed 12-month rate period multiplied by the allowable per-ton processing fee. Because the disposal agreement for solid waste is inclusive of C&D materials, and the first amendment only applies to solid waste, the weighted average per-ton rate for C&D is \$48.22. Therefore, no adjustment required to the per-ton C&D rate.

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Tonnage Adjustment

The tonnage information submitted by Recology for RP 4 did not tie to the City's monthly reports. HF&H inquired with Recology, who acknowledged the tonnage was submitted in error and that it should align with the City's monthly reports. HF&H corrected the tonnage in the application to agree with the tonnage as presented in the City's monthly reports.

Table 2 below summarizes the tonnage adjustments related to both per-ton calculation corrections and tonnage corrections noted above.

Table 2: HF&H Adjustment to Tons

Material	Proposed RP4 Tons	HF&H RP4 Tons	Impact on Revenue Requirement
Solid Waste	16,502	16,382	\$ 13,380
Recyclable Materials	7,251	8,026	26,021
Organic Residential	7,424	8,362	93,445
Organic Commercial	5,944	6,222	37,726
C&D	2,422	2,334	(4,213)
Total	39,542	41,328	\$ 166,359

K. Interest Expense

Section 2.C.5 of Exhibit E2 states interest expense shall be fixed at \$326,655 and is not annually adjusted. Recology's Application correctly included an interest expense of \$326,655. No adjustment recommended.

L. Direct and Allocated Lease Costs

Section 2.C.6 of Exhibit E2 states Direct Lease Costs shall be fixed at \$0, until RP 10, and is not annually adjusted. Section 2.C.7 of Exhibit E2 states Allocated Lease Costs shall be fixed at \$180,00 and is not annually adjusted over the term of the Agreement. Recology's Application correctly included Direct and Allocated Lease Costs at \$180,000. No adjustment recommended.

M. City Fees / Reimbursements

Solid Waste Fund Operations Fee: The Solid Waste Fund Operations Fee (SWFOFee) payment for the coming Rate Period shall equal the total Solid Waste Fund Operations Fee paid to the City in the most-recently completed 12-month period multiplied by one plus the Annual Percentage Change in the CPI-U, or such other amount as is determined by the City in accordance with Section 7.2. Recology's application included the RP 2 SWFOFee amount. HF&H worked with the City to determine the projected SWFOFee amount required in RP 4 and recommends an increase of \$34,360 for a total SWFOFee of \$1,635,697.

Rate Application Review Cost: Section 2.E.4 of Exhibit E1 states Recology is required to pay City to reimburse City for City's costs, including consulting and legal fees, associated with determination of Rates for the coming Rate Period. Recology did not include the cost of the rate application review in costs reimbursed to the City. HF&H recommends including \$85,000.

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Step 4: Other Adjustments

Section 2.F states that from time to time, it may be necessary to make other adjustments to the compensation calculation, either as mutually agreed or as required under various provisions on the Agreement.

The City plans to use reserves or other funding sources to reduce the RP 4 rate impact on customers. HF&H's report is reflective of the overall rate increase before the City's use of funds.

Step 5: Determine Projected Gross Receipts

Section 3 states that the projected gross receipts at then-current rates shall reflect projected annual gross receipts from all customers. On-call services and special charges shall be based on the prior 12 months of billing activity. Recology based its gross receipts on current subscription and rate revenue for one month in RP 3, multiplied by 12 months to annualize, and added annual debris box and compactors revenue from February 2022 – January 2023 inflated by 5%. HF&H reviewed the reasonableness of Recology's method of calculating projected gross receipts and performed our own build-up of rate revenue based on actual RP 2 revenue and the predetermined rate increases in RP 3. HF&H recommends the following adjustment to the projected gross receipts:

Miscellaneous service and recycling revenue were not included in Recology's calculation. HF&H recommend a \$14,862 increase to Recology's projected gross receipts to account for miscellaneous revenue attributable to the City.

Step 6: Adjusted Revenue Requirement

The following table summarizes Recology's requested revenue requirement of \$20,505,312 to provide current franchised services for RP 4 and HF&H's adjusted Application. Based on our recommended adjustments to the Application described in this report, we have determined that a total revenue requirement of \$19,475,934 (a decrease of \$1,029,378 from Recology's Application) is appropriate and a recommended 5.02% overall rate increase is consistent with the rate-setting methodology described in the Agreement. The City may apply a different rate increase by customer sector or use City funds in order to generate the overall 5.02% rate increase.

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Table 3: HF&H Adjusted Rate Application

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Labor-related Costs	\$ 5,256,746	\$ -	\$ 5,256,746
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Other Adjustments (City Payments)			
Calculated Costs	\$ 20,505,312	\$ (120,058)	\$ 19,475,934
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Surplus / (Shortfall)	\$ (1,974,338)		\$ (930,098)
Required Percentage Increase / Decrease	10.65%		5.02%

Note: Numbers may not sum exactly due to rounding.



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We would like to express our appreciation to Recology's management and staff for their assistance. In addition, we express our appreciation to you for your assistance and guidance during the course of the review. Should you have any questions, please contact Dave Hilton directly at (925) 977-6964 or dhilton@hfh-consultants.com.

Sincerely,
HF&H CONSULTANTS, LLC

A handwritten signature in black ink, appearing to read 'Rob C. Hilton'.

Rob C. Hilton
President

A handwritten signature in black ink, appearing to read 'Dave Hilton'.

Dave Hilton
Project Manager