

SPECIAL REVIEW
SOUTHEASTERN PUBLIC SERVICE AUTHORITY

OCTOBER 2008

APA

**Auditor of
Public Accounts**

COMMONWEALTH OF VIRGINIA

FINDINGS AND RECOMMENDATIONS

In collecting and analyzing such data and information, the Auditor of Public Accounts shall assess Southeastern Public Service Authority's financial stability and performance, compare SPSA's operations with similar public and private entities, and make such recommendations as he may deem relevant to the purposes of this study.

The above is a direct quote from the Joint Resolution authorizing this review. Fundamental to accomplishing this charge is a comparison of SPSA's actual performance against its financial and operational plans both short and long-term. SPSA has never completed a comprehensive financial and operational plan with which to conduct such a review.

Overview

We believe that many of the actual and perceived problems with SPSA's operations come from the lack of a clear business focus and direction, which a comprehensive financial and operational plan would demonstrate. Although SPSA faces an uncertain long-term future, financial and operational planning would provide the governing body and management a framework with which to begin addressing SPSA's future direction and aid in making long-term decisions.

Further, we believe that management has made a number of debt financing decisions, and taken revenue setting and generation actions and other actions without a long-term vision of their consequences or effects on the operating viability of the authority. For example, should SPSA terminate as an entity, the governing body and management need to have available the long-term funding to monitor and maintain all landfills and other such facilities after SPSA closes them for a lack of space. However, SPSA has not adequately assessed these future obligations nor funded them.

Our review, therefore, focused on SPSA's governance, planning, operations, and financial position. There are a number of areas we believe require both management and Board attention. A vast majority of these areas focus on fundamental policy and management practices.

Historically, SPSA has used bond proceeds as a primary source of short and long-term capital funding. This ability to easily access the capital markets has allowed management and the Board to have sufficient funds to operate and expand and not forced the authority to always consider operational and financial best practices.

Fundamental Policy and Strategy

SPSA has undertaken activities that are generally contrary to best practice for a going-concern entity. Below are some examples that we further explain in this report.

- Not adequately developing and implementing a strategic plan
- Consuming assets before paying off the related debt
- Operating and pricing programs and services without calculating their associated costs

- Setting fees without knowledge of their customers' other options
- Not reassessing business decisions as conditions change
- Not adequately funding future liabilities

SPSA practices and decisions have created skepticism and raised questions among member communities and other stakeholders. The activities have brought additional attention and scrutiny on SPSA's operations and practices. Special arrangements with certain member communities, private haulers, and out-of-area haulers have caused negative public perception and tension.

The current SPSA Board has begun addressing a number of the issues above and needs to continue to address fundamental policy and management issues concerning governance, planning, operations, and finance. Foremost, management and the Board need to determine SPSA's future and whether it will continue its operations past 2018 when the member community contracts expire. This decision is critical for SPSA when deciding how to best operate the authority in the ensuing years.

In order to continue operations, SPSA will have to demonstrate how it adds value to the member communities within the region and meets their needs more efficiently and effectively than other options. SPSA has to show that a combined solid waste management approach better serves the region. In general, SPSA has to demonstrate the necessity of its operations to the region by showing the region its plans for operations and financial management beyond a current budget or operating cycle.

Governance

In order to best operate the authority, SPSA must first address the governance of the authority. The participating localities rely on the Board to provide oversight to SPSA and its management. Without adequate governance and management, SPSA will not be able to adequately operate and plan for the future.

Member localities need to re-examine their processes and procedures for determining the qualifications and level of commitment they expect of board members. The appointing bodies need to collectively set qualification criteria and ensure that Board members understand their responsibilities and have the background and time to devote to active governance of SPSA.

Appointing bodies should consider as a qualification an individual's business experiences with a large organization. Also in the immediate future, appointing bodies should consider finding members who will have the time and effort to help draft and implement a long-term direction for SPSA.

The Board will need to establish its working relationship with management before addressing the SPSA's other concerns. Management and the Board should work together to develop and document the Board and management's responsibilities, respectively, to ensure each party knows their responsibilities. These policies should be specific with clear definition of each parties' roles and responsibilities.

Management and the Board should also determine what SPSA, industry-specific, and governance training the Board should receive. Required training would help the Board enhance its fiscal, budgetary, management, and industry-specific knowledge. This training should also inform the members of their duties and responsibilities.

Planning

As we discuss later, SPSA lacks a detailed, thought-out plan to implement its mission and determine exactly what businesses the authority should remain in or enter. Specifically, we believe that management and the Board have not determined

- its future,
- what businesses to be in, and
- how best to focus and operate its core businesses.

Completion of a specific strategic operating plan is a fundamental organizational issue that management and the Board must address to determine SPSA's directions and goals and how they intend to reach these goals. SPSA's uncertain future also adds to this lack of direction since the organization is currently waiting on the planning district's study to determine its future. In order to continue operations, SPSA will have to demonstrate its value.

Adequately planning for the future is imperative for SPSA. Management and the Board should first set a course for the authority's future, including its future after 2018, since SPSA will have responsibilities to monitor and maintain its closed landfills.

Planning should also include deciding which services and programs SPSA offers that add value to the member communities. Adding value means offering programs or services that benefit their members more than a competitor could, typically by operating efficiently and effectively. Also the plan needs to balance competing demands for keeping low disposal (tipping) fees, competition from private organizations, and realistic assumptions about future resources such as available landfill space and associated costs. Planning needs to balance long-term, future costs versus immediate savings. Keeping tipping fees low to increase revenues and solid waste supply in turn reduces the life of the landfill as it fills up quicker and creates a long-term liability for monitoring and closing it.

Management and the Board can then build a business operating plan to define their core businesses based on a preliminary analysis and plan; this will help SPSA concentrate on how best to operate these core programs. During this process, management and the Board should evaluate and modify when necessary their organizational structure and their current operating processes. SPSA should also describe the organization's structure and how processes will occur under this structure, including administrative, to support the overall strategic plan. This plan will ensure that disposing of waste in an environmentally-sensitive manner remains the authority's priority, while operating efficiently and effectively.

Comparing to Other Entities and Setting Targets

Without comparing its operations to other entities and setting performance targets, an organization has difficulty assessing its performance. In the past, SPSA hired a consultant to compare its operations to other entities; however, this does not occur on a frequent, regular basis and does not encompass the entire operations. As a result, SPSA has difficulty benchmarking itself to other similar organizations to aid in determining how it is functioning in the various programs and services.

As part of the strategic planning process, SPSA should consider establishing performance measures and compare these key factors to parts of other comparable entities. This would allow them to determine whether they are progressing towards meeting their strategic goals. This process would also help SPSA improve its efficiency and effectiveness by pointing out areas for improvement.

Assessing Current Operations and Previous Business Decisions

Management makes decisions on current and future operations based on what they anticipate happening in the future. However, they must monitor these decisions to make sure the decision continues to be appropriate by periodically reassessing the current operating environment. In addition, management must determine whether future operating plans will have an impact on current operations and business decisions.

SPSA does not appear to have continually reevaluated its previous decisions in a current environment and determined the impact on its environment before making future decisions. For example, management and the Board do not appear to have adequately reevaluated its decision to take responsibility for the waste-to-energy facility, including the financial and operational impacts. Also, SPSA does not appear to have taken into account the potential effects on solid waste under flow control and has not subsequently reevaluated the landfill's useful life.

SPSA does not have an established process for periodically reassessing its operating environment and operating plans. In order to properly manage an organization, management and the Board should evaluate its operations and make sure that the entity and its components are operating in an appropriate manner and that the organization should continue operating in all aspects.

Costs

Currently, management and the Board have limited cost accounting information related to its operational programs and services, as well as capital project costs. SPSA does not allocate its costs and revenues to individual operations and as a result, cannot tell which areas are financially self-supporting and which areas require internal subsidies. Without this knowledge, management and the Board cannot fully assess the authority's operations to make informed decisions. With more reliable and readily available cost information, SPSA could better determine whether it wants to internally subsidize any programs or services and continue all of its programs.

Setting Fees

SPSA should further consider its operations and the industry before setting fees. Management and the Board should first set policy decisions regarding internally subsidizing programs and determine when to discontinue programs. In addition, SPSA should also evaluate its private solid waste disposal customers' other options before setting fees to make sure the authority is maximizing its resources. In addition, SPSA should also consider how much revenue it will need for funding future operations, debt service, and capital projects before setting rates. SPSA does not appear to have had an adequate assessment and development process to determine the ideal tipping rate to fund these policy decisions.

In addition, SPSA needs to adequately assess whether its current tipping fees will fully fund its current debt service requirements and operating costs. Furthermore, SPSA should fully develop their capital project budget by determining how they are going to fund any remaining capital projects for the next ten years, the new debt repayment plan, and the associated impact on tipping fees. By doing this, management and the Board can make any necessary changes to the capital project budget or fees.

Debt

Overall, SPSA does not have internal plans and policies for funding capital projects, debt issuance, and determining the impact of debt on the authority. If SPSA does not address this problem soon, it could face a significant problem in repaying all of the authority's current and future outstanding debt and make it difficult for SPSA to get adequate buy-in from the current member localities if SPSA wants to continue operations past 2018.

SPSA needs to establish adequate debt policies to provide sufficient guidance and limits for management, staff, and the Board. First, SPSA should determine whether SPSA should issue any more debt, especially considering its possible closure after 2018. Once management and the Board have decided this, they should work together to establish written restrictions on the issuance of debt, including what projects or purposes debt can fund and limitations on the maturity of the debt issued, along with policies limiting debt service and the amount of debt outstanding.

Future Obligations

Regardless of whether SPSA continues its operations beyond 2018, SPSA has a legal obligation to set aside funding today to meet its future obligation to monitor and maintain its landfills. Only within the last several years has SPSA begun funding this obligation. SPSA needs to make a reasonable and realistic estimate of this long-term commitment and take appropriate steps to fund this liability with sources other than debt.

In addition, member communities may have additional future obligations after 2018. If the localities do not use SPSA after 2018, the authority may still have outstanding debt service requirements. Management and the Board currently do not know who will have to fund any potential outstanding debt and interest. Both believe that the localities will have to pay any outstanding liabilities, but are not currently sure how to determine each locality's percentage.

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BACKGROUND

The Southeastern Public Service Authority (SPSA) provides municipal solid waste disposal to eight member localities in the Hampton Roads planning district. The following are SPSA's member communities.

- Chesapeake
- Franklin
- Isle of Wight
- Norfolk
- Portsmouth
- Southampton
- Suffolk
- Virginia Beach

Originally, the member communities established the Southeastern Water Authority of Virginia in 1973 pursuant to the Virginia Water and Sewer Authorities Act with the purpose of creating a regional water supply system; however, in 1976 the localities changed the organization to the Southeastern Public Service Authority to establish an organization to dispose of the municipalities' solid waste. Four communities secured bond anticipation notes to provide SPSA its original operating funds of \$3,000,000. Between 1978 and 1988, SPSA constructed and opened the main infrastructure components, including the transfer stations, regional landfill, and the refuse derived fuel plant.

SPSA signed thirty-year contracts with the eight localities; Virginia Beach's contract was effective as of 1984. The remaining seven localities' contracts were effective on the completion of the entire waste-to-energy facility. All member contracts expire in 2018. Under these contracts, the eight municipalities agreed to deliver to SPSA at least 95 percent of all of the disposable solid waste generated within, collected by, or otherwise under the control of the contracting community. SPSA agreed to provide at least one delivery point within each community where the locality could drop-off its solid waste. The municipalities, with the exception of Suffolk and Virginia Beach, agreed to pay the tipping rate established by SPSA. Suffolk and Virginia Beach established different special arrangements with SPSA, which we discuss later in this report.

The Hampton Roads Planning District Commission (HRPDC) is currently evaluating and drafting a special study on the region's solid waste disposal options after 2018. HRPDC anticipates releasing this report in late 2008.

Current Operations

SPSA serves approximately 1.1 million individuals within its eight member municipalities. In order to meet their needs, SPSA operates a number of services and programs for its members and other entities. These services and programs include basic solid waste disposal, recycling, waste-to-energy, household hazardous waste disposal, proprietary waste, and tire disposal. Seven member localities pay SPSA a tipping fee for each ton of disposable solid waste delivered to SPSA. The regional landfill host locality, Suffolk, does not pay a tipping fee as negotiated in their member

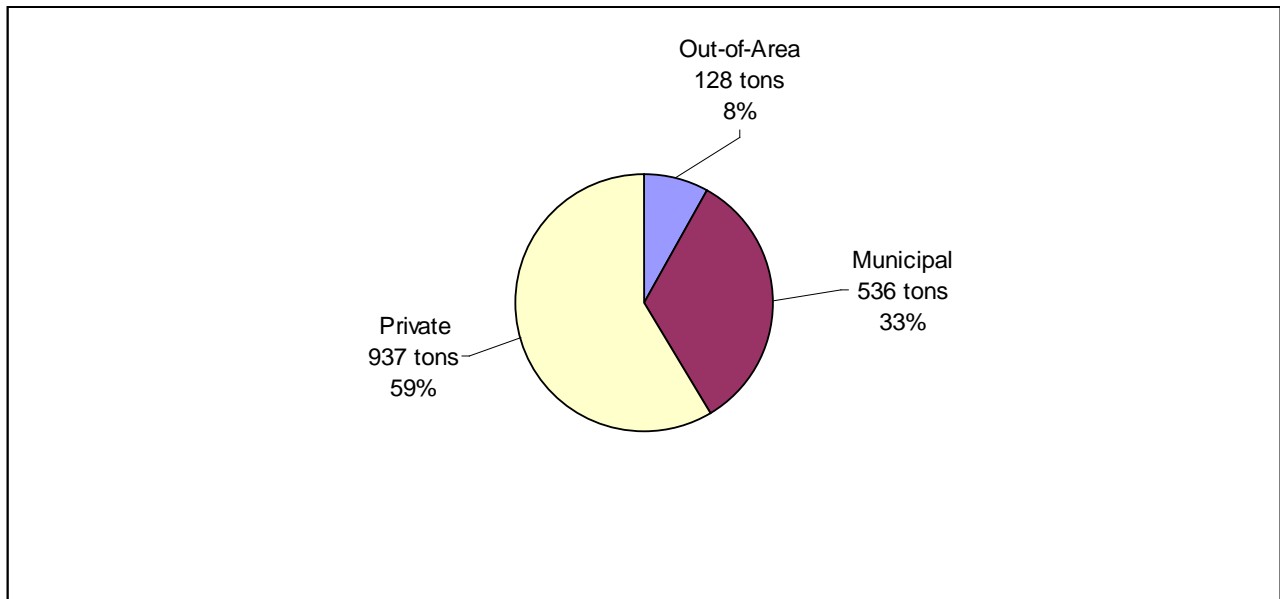
agreement. Private disposal haulers also discard solid waste at the tipping stations and regional landfill and pay a different tipping fee set by the Board.

During fiscal year 2007, SPSA received and handled over 1.6 million tons of waste and the refuse derived fuel plant processed over .5 million tons of burnable solid waste. The graph below shows the waste SPSA received during fiscal year 2007 by source.

Graph 1

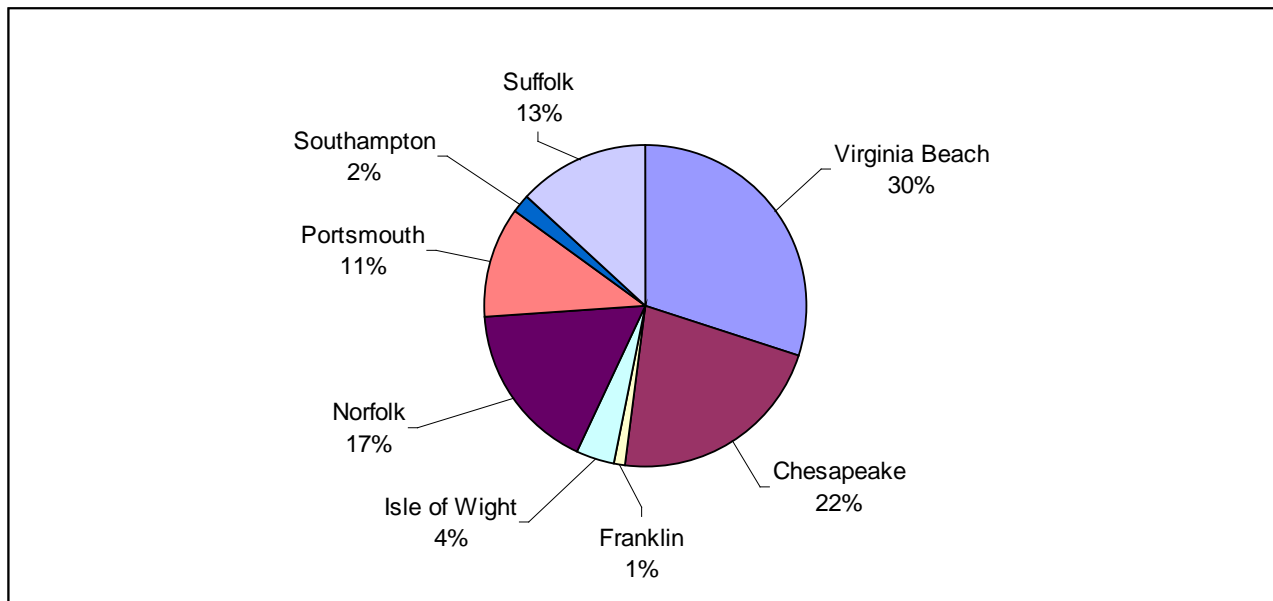
Fiscal Year 2007 Waste Received by Source

(tons received in thousands)



Even though the local municipalities originally created SPSA, the local private haulers provided the largest portion of SPSA's solid waste during fiscal year 2007. Municipal waste in the graph represents the amount of solid waste from the eight member localities. These members only provided a third of the total solid waste SPSA received. The graph below shows the municipal waste SPSA received during fiscal year 2007 by member locality.

Fiscal Year 2007 Municipal Solid Waste Received by Locality



Together, Virginia Beach and Chesapeake provide SPSA with over half of its municipal solid waste received, while Isle of Wight, Southampton, and Franklin provide less than ten percent. The 13 percent of solid waste Suffolk contributes provides no disposal tipping fee revenues to SPSA since the locality does not pay a tipping fee.

During fiscal year 2007, SPSA received approximately \$81.5 million in operating revenue. Table 3 summarizes the sources and amount of operating revenue for fiscal year 2007.

Table 3

Operating Revenue by Source for Fiscal Year 2007

| | |
|--------------------------------|----------------------------|
| Disposal (Tipping) Fees | \$57,391,969 |
| Sale of Electricity | 7,548,610 |
| Sale of Steam | 7,146,848 |
| Recycling | 4,135,458 |
| Proprietary Waste | 2,330,721 |
| Household Hazardous Waste | 753,942 |
| Bi-Metal Sales | 712,718 |
| Compost and Mulch | 621,232 |
| Tire Waste Program | 573,795 |
| Methane Gas | 224,372 |
| Other | 76,470 |
| Total Operating Revenue | <u>\$81,516,135</u> |

Disposal (tipping) fees account for approximately 70 percent of the operating revenue, while the sale of electricity and steam together account for about 18 percent. The table below summarizes the tipping fees by source for fiscal year 2007.

Table 4

Disposal Tipping Fee by Source for Fiscal Year 2007

| <u>Disposal (Tipping) Fee</u> | <u>2007</u> |
|----------------------------------|---------------------|
| Municipal Tipping Fees | \$31,833,837 |
| Commercial Contract Tipping Fees | 13,171,093 |
| Other Tipping Fees | <u>12,387,039</u> |
| Total Disposal (Tipping) Fees | <u>\$57,391,969</u> |

Member community tipping fees account for about 55 percent of the total disposal tipping fees for fiscal year 2007, even though the municipalities only provide one-third of the waste.

Overview of the Capital Infrastructure

Currently, the SPSA capital infrastructure includes nine local transfer stations located throughout the member communities and a centralized, regional landfill in Suffolk. In addition, SPSA operates a refuse derived fuel (RDF) facility and a power plant in Portsmouth, collectively referred to as the waste-to-energy facility. In this facility, SPSA burns solid waste to create steam and electricity to sell under contracts to the Norfolk Naval Shipyard and American Electric Power.

Member localities use transfer stations as a drop-off point for solid waste. At the transfer station, SPSA combines several smaller loads from traditional collection vehicles into a larger trailer to transport the waste to the regional landfill. SPSA operates these transfer stations primarily in urban areas with limited temporary holding spots for waste. Transfer stations can reduce overall transportation costs through economies of scale by consolidating several small loads of waste into one large load hauled to the RDF plant or landfill.

Member localities and private haulers collect their own solid waste and deposit collections at the local transfer station; SPSA is then responsible for the solid waste once the member communities, private haulers, and other entities drop the waste at the local transfer station. SPSA sorts the waste into processable and non-processable waste and loads the sorted waste into larger trucks. The authority delivers processable waste to the RDF plant for burning and non-processable waste to the regional landfill.

SPSA's waste-to-energy facilities convert solid waste to electricity and steam. At the RDF plant, SPSA sorts and separates waste and then shreds burnable (or processable) waste into small particles to burn at the power plant. The power plant burns the processable waste in boilers, which turn turbine generators to produce electricity and steam.

The Suffolk Regional Landfill has six cells; a cell is an independent storage component of a landfill which stores solid waste permanently. Typically, trucks deliver solid waste and dispose of it

in a portion of a cell, where SPSA continually compacts the waste with heavy equipment and spread a daily cover over the waste.

SPSA first began accepting waste in the regional landfill in 1985 and by October 2006, had filled the regional landfill's first five constructed cells (Cells I- V). SPSA is currently using Cell VI for their disposal needs. Management now anticipates filling-up this cell by February 2012 and has begun the process of planning for an additional cell, referred to as Cell VII.

COMPARISON WITH OTHER PUBLIC ENTITIES

Different Structures and Operational Aspects

In Virginia, like most other states, solid waste management is a local responsibility with state and federal oversight. Some localities chose to take a regional approach and work with other communities in their area to gain economies of scale and improve operations, while others work individually within their own locality.

Many governments across the United States established solid waste authorities to deal with their municipality or region's solid waste disposal needs. Authorities have unique disposal needs related to geographic location, legal requirements, and citizens' needs. These entities also operate and dispose of trash in a variety of different ways.

Governance

Generally, solid waste authorities have a board of directors that meet periodically to provide oversight and governance over the entities' operations. Board structures and organizations differ by authority, including board membership. Authorities may have all elected officials, such as city council members, mayors, or members of the board of supervisors, that serve as representatives. Others structure their board with non-elected locality employees who are familiar with local government operations and/or knowledgeable of solid waste disposal, such as city managers, public works officials, environmental services representatives, and county administrators. Some authorities have a mix of elected and non-elected members, as well as general members of the community, representatives from other entities affected by the actions of the authority, and those from the solid waste industry.

Authorities also differ on how they determine how many members should serve on the board from each locality or geographic area. For authorities with multiple member communities, the authority's by-laws may specify equal representation from each locality regardless of their population size. Others may determine the number of board members per locality based on the population of each locality, giving more votes to larger communities.

Types of Service

Waste authorities generally provide an array of services including residential and business waste collection, recycling, yard waste, and household hazardous waste disposal. In order to provide these services waste authorities operate transfer stations, convenience centers, waste-to-energy facilities, and landfills. Authorities have to decide which programs to offer, as well as the different level of service for each program. For example, recycling programs may offer customer drop-off points or provide each individual household with a recycling bin for periodic pick-up. Higher levels of service typically increase costs so that authorities have to ensure they have the appropriate balance of service and costs for their customers.

Authorities, like SPSA, also own waste-to-energy facilities where the facilities turn waste into energy, which the organization then sells to others. These facilities help municipalities divert waste from their landfill to prolong the life of the landfill.

Contracting Services

Like other aspects of government, public solid waste entities can provide services in-house, contract with a private company to provide such services, or utilize a combination of contracting and in-house services. This decision leads to different organizational structures and consequences, both financial and operational. The waste industry is a highly capital industry with landfills and heavy equipment. Those entities that contract with private companies can generally reduce their initial start-up costs and/or debt issuances because the contractor may provide all of the capital resources. As a result of using private contractors, public solid waste entities may more evenly distribute the cost of services over the contract, instead of having to fund major capital projects.

Funding Streams

Funding for solid waste disposal comes from a variety of different sources and funding streams. Common sources of funding for solid waste authorities may include user fees, tipping fees, assessment fees, electricity and steam sales, interest income, or funds from the municipality's General Fund. Authorities may structure their funding streams to use one revenue source or they may blend their structure to use multiple funding sources. Some localities fund solid waste disposal through special assessments designed to recover the estimated cost of providing service, while others use general funds generated from property taxes. Another charge method includes a single tipping fee that covers the costs of most of the services offered. Other localities use a method based on customer usage and demand where the authority charges a separate rate for each type of service, such as recycling or yard waste, and allows the consumer to choose in which programs to participate. Waste authorities also may charge a flat user fee for each participating residential or commercial member.

Comparing Authorities

Central and Tidewater Virginia

Two other public solid waste authorities in SPSA's general geographic region are the Virginia Peninsula Public Service Authority (VPPSA) and the Central Virginia Waste Management Authority (CVWMA). VPPSA serves the following communities: the cities of Hampton, Poquoson, and Williamsburg, and the counties of Essex, James City, King and Queen, King William, Mathews, Middlesex, and York. CVWMA serves the following communities: the cities of Colonial Heights, Hopewell, Petersburg, and Richmond, the town of Ashland, and the counties of Charles City, Chesterfield, Goochland, Hanover, Henrico, New Kent, Powhatan, and Prince George.

However, VPPSA and CVWMA are structured and operate in a different manner than SPSA. These two authorities primarily coordinate solid waste disposal in their regions by contracting or coordinating services with vendors from the private solid waste management industry. Since both entities contract with private vendors, they do not own any landfills and do not process a significant

amount of waste. Instead, they negotiated contracts with private landfills so their member communities could dispose of their solid waste at a set tipping fee. For example, under VPPSA, the localities are responsible for the transportation of waste to the landfill, while VPPSA pays the landfill's tipping fee and seeks reimbursement from the localities. The table below shows their basic operating and financial information compared to SPSA.

Table 5

Fiscal Year 2007 Financial and Operational Data for VPPSA, CVWMA, and SPSA

| | <u>VPPSA</u> | <u>CVWMA</u> | <u>SPSA</u> |
|------------------------------|-------------------|--------------------|----------------------|
| General information: | | | |
| Number of employees | 65 | 12 | 486 |
| Population of area served | 500,000 | 1,045,000 | 1,125,783 |
| Tipping Fee | \$25 | \$32 | \$104/\$28 |
| Financial information: | | | |
| Current assets | \$4,140,758 | \$ 4,398,129 | \$ 11,243,524 |
| Current liabilities | \$1,791,050 | \$ 1,537,338 | \$ 36,718,639 |
| Total assets | \$7,591,664 | \$ 4,469,955 | \$252,833,287 |
| Total debt | \$3,315,000 | \$ - | \$241,032,806 |
| Debt service for fiscal year | \$ 741,892 | \$ - | \$ 31,662,189 |
| Operating revenue | \$6,990,749 | \$12,484,272 | \$ 81,516,135 |
| Operating expenses | <u>6,802,853</u> | <u>12,512,725</u> | <u>70,762,255</u> |
| Net operating income | <u>\$ 187,896</u> | <u>\$ (28,453)</u> | <u>\$ 10,753,880</u> |

Source: 2007 Annual Financial Statements and respective authorities' internal documents

SPSA has two primary tipping rates, one for the private haulers and one for the member communities. VPPSA and CVWMA only have one tipping rate, which is for the member communities.

Since VPPSA and CVWMA operate in a different manner, their structure and basic financial information differs greatly from SPSA. VPPSA and CVWMA have far fewer employees, assets, liabilities, debt, revenues and expenses than SPSA because of the different manner in which they provide services to their member localities. They use fewer employees because their employees primarily perform administrative and contract management duties, with some VPPSA employees operating the convenience drop-off centers, composting facility, and other recycling operations. VPPSA has little long-term debt, while CVWMA has no long-term debt since the private industry is responsible for procuring and maintaining most of the capital assets. Both entities have less operating revenue and expenses because the localities perform many of their own solid waste disposal services.

SPSA has a much larger municipal tipping fee partly because their fee funds more services than the VPPSA or CVWMA tipping fee. Under SPSA management, the tipping fee provides operating revenue to fund most of their operations including the transfer stations, transportation between the transfer stations and the regional landfill, the regional landfill, the and the waste-to-energy facility. Under VPPSA and CVWMA, the tipping fee covers the amount that the private landfills charge the authorities to dispose of their trash at the landfill.

Other Public Solid Waste Disposal Authorities

We also selected two other authorities to compare to SPSA based on a number of factors, including population served, annual waste processed, geographic location, and overall operations. These other two authorities selected are: the Solid Waste Authority of Central Ohio (SWACO) and the Solid Waste Authority of Palm Beach, Florida (SWA).

SWACO and SWA each serve one locality and provide most of their own services, like SPSA, instead of contracting with the private sector. One of the authorities, SWA, also owns a waste-to-energy facility; however, management recently decided to contract with an outside vendor to operate the facility.

The table below compares basic information about SPSA with other public waste disposal entities.

Table 6

Comparison of Operating Information for SPSA and Other Public Waste Disposal Entities

| | <u>SWACO</u> | <u>SWA</u> | <u>SPSA</u> |
|-------------------------------|--------------|------------|-------------|
| Number of employees | 110 | 436 | 486 |
| Population of area served | 1,180,000 | 1,300,000 | 1,100,000 |
| Number of landfills | 1 | 2 | 1 |
| Number of transfer stations | 3 | 5 | 9 |
| Annual waste processed (tons) | 880,000 | 1,783,000 | 1,482,000 |
| Tipping fee | \$46.50 | \$28 | \$104/\$28 |

*All data taken from 2007 financial statements for each entity. Operational statistics are approximate.

SPSA has the highest tipping fee of any of the three entities mentioned in the table above and is more than three times SWA’s tipping fee. Tipping fees may differ for several reasons, including how management operates the authority and what level of services the authority provides. Another factor, as already mentioned, is that these entities receive different funding streams and pay for their programs in different manners. For example, SWA’s primary revenue source (67 percent of operating revenue) is a special assessment on property owners’ annual property tax bill. These assessment fees cover the cost of residential trash disposal and a portion of commercial disposal

combined with the commercial tipping fee. On the other hand, SPSA raises most of its revenues from tipping fees.

SPSA also has two different tipping rates, while the other entities have the same tipping rate for localities and private haulers. In SWACO's case, this causes a higher tipping fee than SPSA's private contract rate, but less than the municipal rate.

SPSA employs fifty more employees than the Solid Waste Authority of Palm Beach and 376 more employees than the Solid Waste Authority of Central Ohio. However, differences in service levels, programs, and facilities make it difficult to compare the staffing levels. For example, although SPSA employs a significant amount of employees more than the other authorities, almost 40 percent of SPSA's employees work in the waste-to-energy facility; the only other facility that owns a waste-to-energy facility in Table 7 is Palm Beach County, which contracts with a private vendor to operate their waste-to-energy facility. Therefore, Palm Beach's staffing numbers do not include the waste-to-energy information. Excluding the waste-to-energy divisions, SPSA has approximately 296 employees.

The table below compares financial information about SPSA with other public waste disposal entities.

Table 7

Comparison of Financial Information for SPSA and Other Public Waste Disposal Entities

| | <u>SWACO</u> <u>Ohio</u> | <u>SWA</u> <u>Florida</u> | <u>SPSA</u> |
|---------------------------------|-----------------------------|------------------------------|----------------------|
| Financials: | | | |
| Current assets | \$ 27,759,908 | \$213,759,165 | \$ 11,243,524 |
| Current liabilities | \$ 38,088,609 | \$ 57,911,393 | \$ 36,718,639 |
| Total assets | \$112,483,640 | \$596,627,023 | \$252,833,287 |
| Total debt | \$110,564,279 | \$236,412,229 | \$241,032,806 |
| Debt service for fiscal year | \$ 11,747,950 | \$ 39,471,941 | \$ 31,662,189 |
| | | | |
| Operating revenue | \$ 37,467,217 | \$194,543,522 | \$ 81,516,135 |
| Operating expenses | <u>28,100,875</u> | <u>145,317,626</u> | <u>70,762,255</u> |
| Net operating income | <u>\$ 9,366,342</u> | <u>\$ 49,225,896</u> | <u>\$ 10,753,880</u> |
| Net income | \$ 4,475,627 | \$ 63,981,807 | \$ 1,771,738 |
| Statistical Information: | | | |
| Net working capital | \$(10,328,701) | \$155,847,772 | \$(24,475,115) |
| Current ratio | .73 | 3.69 | .31 |
| Debt per person | \$ 93.70 | \$ 181.86 | \$ 219.12 |
| Debt service coverage | - | 2.19 | 0.31 |
| Total debt ratio | 0.98 | 0.40 | 0.95 |

*All data taken from 2007 financial statements for each entity. Operational statistics are approximate

The most noteworthy difference in the financial information above is the amount of debt SPSA has outstanding, especially considering the size of the organization. The other two organizations have less debt than SPSA. SWA is a much larger organization but still has less debt than SPSA; specifically, SWA has \$5 million less in debt but has almost \$344 million more in total assets and \$113 million more in operating revenue than SPSA.

SPSA's current liabilities primarily consisted of current year maturities of bonds payable. The ratio of current assets to current liabilities is an indicator of an entity's ability to meet short-term obligations. As you can see from the table, SPSA's current assets are roughly one-third of their current liabilities, signaling potential difficulty in meeting short-term obligations. In addition to SPSA's higher amount of short-range debt, they also have a larger amount of total debt. Throughout SPSA's existence, they have primarily relied on debt financing for capital assets. Since SPSA has owned and operated the equipment making up the waste disposal system, this has contributed to the large amount of debt on hand.

Private Entities

There are a number of private options for waste disposal services. Companies such as Waste Management, Allied Waste, and BFI Waste Services operate on a national scale. These companies have a large amount of resources and can achieve lower costs due to their large-scale operations. These companies provide services ranging from residential and commercial waste disposal to recycling and waste-to-energy operations. The waste disposal industry is highly competitive and continues to grow as national economic development and population increase.

During our review, we requested financial and operational information from similar private entities. However, these entities considered this proprietary information and as a result, we did not receive sufficient information to compare SPSA to other private entities.

GOVERNANCE

Background

Board of Directors

SPSA has a Board of Directors (Board) consisting of one representative and one alternate from each of the member cities and counties. As of July 2008, six of the eight localities appointed a local elected official to serve as the locality's board member. The Virginia Beach and Portsmouth representatives are the only non-elected board members. The localities also appoint an alternate to the Board; alternates often work in the locality's public works or city administrator's office.

Board Responsibilities

Following is a listing of Board responsibilities taken from the Code of Virginia, SPSA's articles of incorporation, and past Board actions.

- Appoint and annually evaluate the Executive Director
- Oversee and approve all operations, contracts and other operational activities
- Set organizational policy
- Approve and monitor annual operating and capital budgets
- Authorize the issuance of debt

No Board member exercises any greater authority over SPSA than that delegated to the Board as a whole. The Board chairperson is primarily responsible for conducting the meetings.

The Board has the same authority over SPSA's operation that locally elected officials have over the locality. The Code of Virginia structures the Board of Directors so that these authorities operate very much like a Board of Directors in a commercial enterprise.

As such, the direction and actions of SPSA is highly dependent on the guidance the Board provides the Executive Director. The Code of Virginia states that "The board members may appoint a chief administrative or executive officer who shall serve at the pleasure of the board members. He shall execute and enforce the orders and resolutions adopted by the board members and perform such duties as may be delegated to him by the board members."

Executive Director

Since its creation, SPSA has had three Executive Directors; in July 2008, the Board appointed the current Executive Director. The Executive Director acts as the Chief Executive Officer of SPSA and has responsibility for implementing the Board's directions and serves at the pleasure of the Board.

The Executive Director has operational responsibilities for managing operations, employing staff, monitoring and maintaining financial operations, negotiating contracts and any other duties

assigned by the Board. The Board sets the level of reporting and approval of activities and operations that the Executive Director must follow.

Organization Activities and Structure

The Virginia Water and Sewer Authority Act and SPSA's articles of incorporation and bylaws do not set any specific restrictions on how SPSA will conduct its activities, undertake its business, or organize its operations. The law appears to have allowed this organizational flexibility so that authorities could meet the needs of their service areas. An organization's activity and structure is therefore the responsibility of the Board.

SPSA Board Responsibilities and Understanding

With such broad responsibilities, the Board needs to clearly understand its duties, have resources to undertake these responsibilities and have access to resources necessary to fulfill its oversight and monitoring duties. To obtain an understanding of the information and resources available to the Board, we reviewed Board documents, minutes and conducted interviews with current and former Board members.

Governance Observation 1

Typically, Board members are officials who also serve on their respective local governing bodies and have little or no background or industry specific information or expertise on SPSA's operations or business practices. Some governing bodies tend to appoint newer and less experienced officials to the Board. Board members also realize that they are heavily dependent on the Executive Director and SPSA staff for providing them information and analysis for decision making; however, most members do not have the knowledge base to question the analysis or ask for additional information.

Board Responsibilities

To provide new Board members with some orientation to SPSA, SPSA management developed a Board manual with basic background information about SPSA and the Board. We could not determine if Board members participated in the development and review of the manual. Additionally, we could not determine if SPSA held an orientation to discuss SPSA operations and the manual's written duties with new members.

Below is a summary of the duties set forth in the manual.

- Appointing and annually evaluating the Executive Director,
- Attending Board meetings and special retreats as scheduled,
- Setting organizational policy,
- Approving and monitoring annual operating and capital budgets,
- Developing and understanding the mission statement,
- Serving on Board committees, as appointed,

- Becoming informed and educated as to the agency and the solid waste management industry in general,
- Being familiar with the agency's Bylaws and Articles of Incorporation,
- Actively participating in special activities sponsored by the agency,
- Staying well-informed about agency business by reading minutes of the Board meetings, financial statements, and other materials,
- Functioning as a goodwill ambassador and spokesperson for the agency and its programs,
- Acting as a sounding board for their community relative to the activities of the agency,
- Supporting the programs and services of the agency and speak out in its behalf,
- Supporting and encouraging meaningful regional cooperation among all members of the agency,
- Establishing a strategic plan for the agency, and
- Monitoring progress in meeting strategic goals.

Governance Observation 2

Many of the members were not entirely aware of all of these responsibilities and did not recall receiving a list of these responsibilities. In addition, by not explicitly making the Board's and the Executive Director's responsibilities well known, each party is unsure of what the other party should do and who should manage the organization and take the initiative to make strategic decisions. Confusion between the roles of the Board and the Executive Director frequently resulted in a lack of guidance to management and oversight for the entity.

Board Resources

The Board has two additional resources to help provide additional information on SPSA and the solid waste industry. With the help of SPSA management, the Board created the Business Advisory Committee (BAC) in fiscal year 2008 to help determine how SPSA can meet their mission and most effectively continue regional waste management in the future. This committee includes Board-nominated members of the solid waste industry and private citizens who are residents or work in SPSA member communities and do not hold elective offices in these localities. Since its formation, the BAC has only presented information to the Board once, concerning searching for a suitable location for a new public landfill after filling Cell VII.

In addition, SPSA also created the Intergovernmental Coordinating Committee (ICC) to respond to Board requests for additional analysis or information. This committee is comprised generally of public works officials from the SPSA member communities. The ICC has historically assessed the budget and offered their insight to the Board.

Governance Observation 3

Boards employ management and therefore there must be a degree of trust in management's ability to analyze situations and make recommendations for Board action. Governance best practices also recognize that Boards may from time to time need external objective resources to review management's recommendations or provide a non-organizational perspective to an issue. The SPSA Board has not provided themselves with access to sufficient external objective resources.

Inherent Board Conflicts

During discussions, many Board members mentioned that their first responsibility was to their locality by ensuring low tipping rates for municipalities and that the locality was satisfied with the service. This creates an inherent conflict where Board members sometimes must choose between long-term plans for SPSA and the short-term goal of keeping tipping fees low. If this is the Board's first priority and the Board primarily focuses on this goal, then the viability and success of the authority suffers.

If an organization focuses more on the short-term rather than the long-term, then it jeopardizes its operational and financial future. Instead of fully developing and focusing on the long-term and strategic plan, the organization takes care of current operational and financial concerns. This can cause management to defer critical decisions and not look at the "big picture" on how to operate. If this happens for a long period of time, then the organization may not develop or may lose a competitive advantage to ensure that the organization will remain viable and competitive in the future.

Governance Observation 4

The Board frequently focused on low tipping fees and maintaining these lower fees appears to have affected many of the Board's decisions. By setting low rates and concentrating on funding most capital costs with debt, the Board did succeed in the short-term. However, focusing on low rates and short-term results coupled with a lack of effective long-term planning has had a negative organizational and financial impact on SPSA.

Board Qualifications

A Board's ability and willingness to provide governance to an organization has a significant impact on the organization's overall performance. Each individual member's commitment to the Board is vital to both the Board and the organization's overall success. As such, Board members must be willing to devote both the time and effort required to meet their responsibilities.

These responsibilities include, but are not limited to, gaining industry-specific knowledge, keeping abreast of their current business environment, and thoroughly reviewing and questioning the organization's financial, operational, and performance data and reports. Board members also need to have an adequate understanding of business operations and finances, as well as the judgment to ensure they appropriately apply their knowledge. In addition, members need to consider both the short and long-term implications of their decisions.

Governance Observation 5

Generally, localities appoint elected officials to the Board without informing the official of the actual commitment required to serve on a Board responsible for proper guidance and oversight. Board members frequently have multiple commitments to their own locality and are unable to provide much time to the Board beyond the mandatory monthly meetings. Additionally, the member localities did not provide guidance about the necessary qualifications of Board members when they created the SPSA. Without requiring board members to have a background in business or the industry, Board members do not always have the ability to properly supervise management's decisions or business practices.

PLANNING

Introduction

Planning in some form provides the basis for assessing if an organization is performing as expected. Planning documents in government and business take various forms and titles. Many governmental units which provide service for a fee typically have business plans; financial and operations budgets; performance measures, including financial reports and key analysis; and finally some type of long-term or strategic plan. All of these documents should set the direction of the organization and help provide a framework for assessing business risk, evaluating new business or services opportunities, and converting the governing body's objectives or goals into an operating plan that management and staff can use.

Planning documents allow organizations to focus on their core business components and evaluate opportunities within the framework of their business. These documents also provide a vital communication tool with outside parties in understanding the business, its risk, and the direction of an organization. Most businesses cannot obtain sources of capital whether through sale of stocks or loans without a business plan. The business plan provides a communication tool to investors to understand how an organization identifies and addresses its market and whether an organization is realistic about its prospects.

As we discussed earlier, the Virginia Water and Sewer Authority Act and SPSA's articles of incorporation and bylaws do not set any specific restrictions on how SPSA will conduct its activities, undertake its business, or organize its operations. The law appears to have allowed this organizational flexibility so that authorities could meet the needs of their service areas. Organization activity and structure is therefore the responsibility of the Board through its delegation of authority to the Executive Director. Therefore, this flexibility further necessitates the need for sound planning.

General Best Practices for Planning

In order to have some reference point to evaluate SPSA's planning efforts; we compiled a general list of practices normally followed in developing plans for business and other types of organizations. While there are numerous books, articles, training courses, and consultants that describe the process for planning, in general we found the traits of a good plan described in the following paragraph.

An organization's strategic plan sets the entity's mission, priorities, goals, and objectives. This plan describes the purpose for the organization's existence. In order to achieve its strategic plan, an organization should establish a functional operating plan. An appropriate operating plan will direct management and employees by setting-up the organization's structure and describe how processes will occur under this structure. This plan should describe the most efficient and effective way for the organization to operate, as well as allow management and employees to implement daily operating processes. Operating plans must also have sufficient detail to describe how each individual business unit should operate.

Using this general guideline and other materials as best practices, we have examined SPSA's planning process since 1999 involving both the Board and management. Although budgeting for operations and capital are an integral part of the planning process, we do not discuss our review of those issues here. We do discuss how they fit into the planning process, but have separate, detailed discussions of these issues, as they were specific mandates of the study.

Internal Strategic and Long-term Planning Attempts

Throughout the last ten years, management and the Board have periodically considered the authority's future. In 1999, management and the Board discussed the term of the existing contracts and the original fifty-year life that the Water and Waste Authorities Act allowed for any authority created under the Act. With SPSA's creation in 1973, it would expire in 2023. As a result, the Board lobbied for an amendment to state law allowing SPSA to have an unlimited life; this legislation passed in 2000. SPSA's reason for extending the life of the authority was to provide some sense of continuity for the participating localities to continue their contract beyond 2018. However, the Board did not continue with its plan to request that the localities extend their commitment to SPSA and this remains an open issue today.

In 2000 and 2001, management and staff met frequently to discuss revenue ideas and on-going operational concerns. The Board requested that management search for new revenue ideas to meet the Board's desire to increase other revenues and decrease the tipping fees. However, this discussion did not address the long-term direction or how these new activities would affect SPSA's long-term business.

Management's three main revenue generation ideas were document destruction, increasing construction and demolition debris collections, and medical waste disposal. SPSA implemented a program for document destruction and reduced tipping fees for construction and demolition debris to increase volume. Neither idea produced the significant revenue that management anticipated. Management researched the medical waste industry but later determined the local market was too competitive.

In January 2002, the Board met with an outside strategic plan facilitator to develop a strategic plan and establish a five year plan. They identified their core businesses as follows:

- Operate and manage a regional landfill
- Generate power: waste-to-energy
- Dispose of proprietary waste
- Dispose of specialty waste
- Operate recycling programs
- Provide solid waste collection services
- Be an advocate for public solid waste management

During this process, the Board also established goals for the end of the five year plan (2009), which were:

- Become a national model for environmentally responsible integrated waste management
- Provide excellence in solid waste management and services
- Offer new services for SPSA
- Have long-term financial security for SPSA
- Provide life after 2018 for SPSA
- Increase awareness and credibility of SPSA

This was a noteworthy attempt at further developing SPSA as an organization. However, SPSA did not fully develop plans for these goals and did not follow through.

In 2003, management and the Board once again began addressing the member contracts; the Board created a sub-committee of four alternate Board members and SPSA staff to discuss and negotiate a new contract with community members. The sub-committee presented a proposed contract to the Board in October 2004 and developed a plan to share the proposed contract with member communities. Before further discussions on new contracts, the Board requested an additional financial-related meeting, which the Board held in January 2005.

During this meeting, consultants and other outside professionals presented reports about the financial condition of the authority, the condition and potential closing of the waste-to-energy system, and private hauler and out-of-state waste. One consultant's report showed that the most significant way to reduce tipping fees was accepting more waste into SPSA from non-member sources. Shortly thereafter, in March 2005, the Board adopted a resolution to accept waste from New York. However, the Board still did not fully address and resolve the scheduled end to the member use and support contracts. Instead, they again focused on generating additional revenue.

In September 2006, the Board met again to focus on the long-term future of SPSA. As a result of this meeting, the Board established the following long-term goals:

- SPSA will be a viable, effective regional choice for solid waste management
- SPSA will operate in a business-like manner
- All activities must be evaluated with a return component
- Member communities are free agents post-2018
- Eliminate open-ended commitment for Member communities
- Pay off all debt and unfunded liabilities by 2018

- Continuity of service to Member communities until 2018
- Provide only those services Member communities are willing to pay for
- Obtain lowest cost for Member communities/price transparency
- Provide choices consistent with a deregulated environment
- Continue to maintain assets to retain/embrace value (need to balance with new debt liabilities)
- The long-term goals remain in place

At that time, management and the Board did not develop a formal plan for meeting those goals and measuring their performance. Therefore, SPSA does not know their progress towards these goals.

In September 2007, the Board met again to address whether SPSA would exist after 2018. As a result of this meeting, the Board agreed to request that each community advise SPSA whether the locality would continue using SPSA's services after 2018. However, within two months, the Board decided to wait for the Hampton Roads Planning District Commission (HRPDC) to complete its study. Even though the Board originally planned to address SPSA's future, they once again deferred this discussion and decision.

During all of these strategic planning and management discussions, both the Board and management planned to address long-term issues and set a course of action for the organization. However, they did not follow-through and fully develop ideas, concepts, and strategies, but instead kept changing their course or decided to instead focus on a short-term problem. Without adequate focus on the long-term, the organization cannot plan and set its future and the goals it should be working towards.

Planning Observation 1

SPSA's mission is to dispose of waste and the organization plans to accomplish this by disposing of waste in an environmentally-sensitive manner, minimizing damage for current and future generations and reusing waste whenever possible, turning it into a useful product. Management and the Board have not completed an appropriate operating plan as to how the authority will achieve its mission and its supporting goals.

Revenue Generation Ideas

Over the past few years, SPSA has researched or inquired about a number of new ways to expand their organization and generate more revenues; Board members and management have hoped this will reduce the dependency on municipal tipping fees to allow the authority to reduce these fees for the communities. Below are some of SPSA's revenue generation ideas.

- Operating Other Landfills- In 2004, SPSA considered operating two landfills for other municipalities, Wake County, North Carolina and Page County, Virginia. Page County was having financial and operational problems. The Board declined both opportunities because they were outside of the service area.

- Document Destruction- SPSA entered into the document destruction business with an investment of around \$30,000. However, two years later, SPSA exited the business because of growing competition and the amount of senior management resources it required.
- Medical Waste Collection and Disposal- The authority researched the medical waste management business and negotiated with a local business owner to purchase the company. SPSA later decided not to enter the business, as a larger business came into the area and took a large portion of the market share.
- Black Bear Landfill- In 2004, SPSA discussed the possibility of providing port facilities and waste to a potential North Carolina landfill developer. However, the developer did not develop the landfill.
- Covanta and New York Waste- SPSA later discussed the possibility of entering into a contract to accept New York waste at the waste-to-energy facility; however, SPSA announced it abandoned this idea in October 2006.

These ideas have contributed to the organization's lack of focus on its core businesses, further improving its existing programs, and concentrating on controlling cost and improving effectiveness. These ideas have a cost associated with their implementation and if not part of a sound business strategy and plans, they can also divert resources with little or no gain.

Planning Observation 2

Management and the Board do not always focus on assessing and responding to its current core business environment and developing strategies and competitive advantages to improve its current operations. Instead, management and the Board are devoting their time and resources on other business ventures and not on SPSA's current core business environment and its future direction.

Future of SPSA After 2018

As noted above, SPSA has an uncertain future after 2018. Management has tried unsuccessfully to get the localities to agree to a new member contract. Past discussions led to contract term disagreements and localities now appear to be waiting on the completion of the upcoming HRPDC study. After encouraging member communities to make a decision for several years, management and the Board also appear to have dropped their efforts and are reluctantly waiting for the HRPDC study. Therefore, management is waiting for an outside entity to decide its future instead of deciding whether to continue operations and trying to get its member communities and key stakeholders to agree with the decision. As a result, SPSA has a lack of long-term direction because of the organization's uncertainty. In order to continue operations, SPSA will have to demonstrate its viability including taking the time now to ensure it adds value to the region and meets their needs more efficiently and effectively than another organization could, instead of waiting for an outside HRPDC consultant to plan their future.

Although organizations are not certain of their future, an entity's management generally assesses its operating environment and makes a decision based on the anticipated future. SPSA has

a much greater uncertainty about its future and continuity and this has forced management to have a lack of direction for the organization, making it difficult to make the best business decisions.

Upper management has appeared to operate the organization based on its believed future; for entities with a limited future, managers typically try to prepare the organization for its closure, while limiting losses for its owners. If an entity expects to continue operations, managers instead pursue the goal of trying to carry on the business by developing a strategic plan and meeting its customers' future needs. This leads management to operate the organization in a different manner. For example, if SPSA continues past 2018, then management and the Board would need to start planning for a new landfill or other solid waste disposal option now to ensure on-going operation after filling Cell VII. Otherwise, without planning for the future, SPSA may not have the capacity to continue operations even if the study recommends SPSA continue.

Planning Observation 3

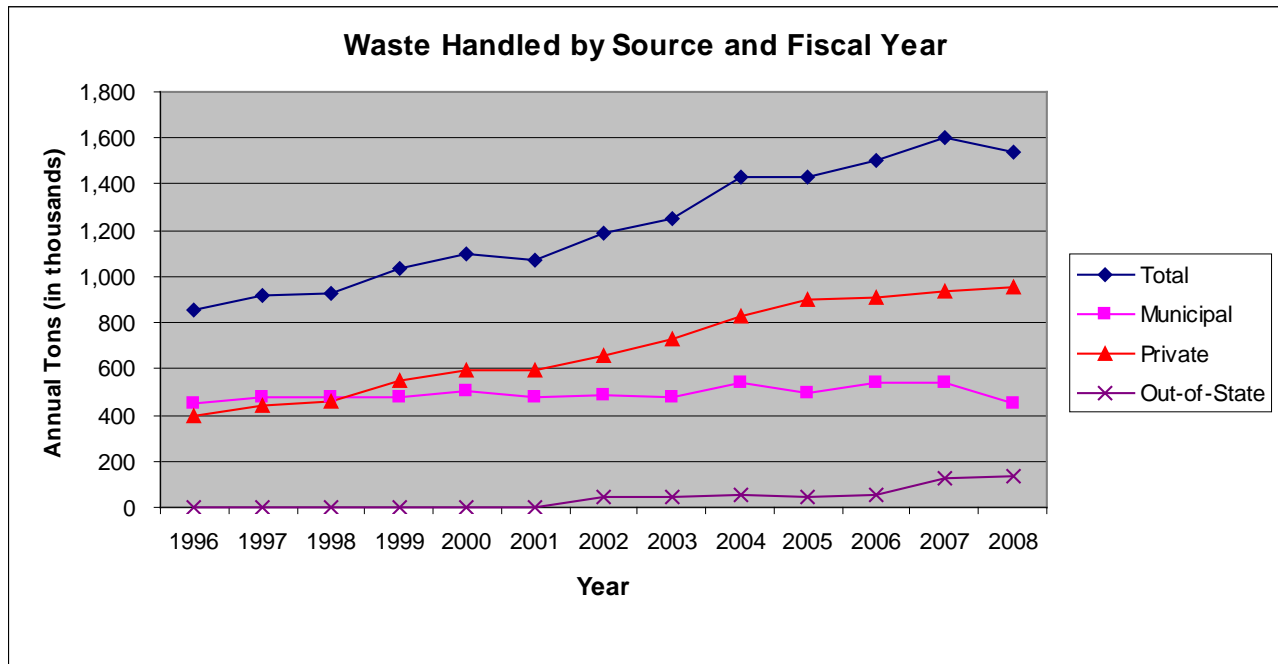
Management and the Board have not established a detailed strategic plan, set all of their long-term goals, or assessed the viability of the organization after the use and support contracts expire in 2018. In addition, we believe that management and the Board have not determined which businesses they should be in and how best to operate those businesses. Management and the Board should establish a strategic operating plan which includes identifying core business units and determines how each business unit and the administrative section will support the overall strategic plan. This plan would ensure that disposing of waste in an environmentally-sensitive manner remains the authority's priority, while operating efficiently and effectively.

OPERATIONS

Current Waste Stream

Over the last twelve years, the annual waste handled by SPSA has generally increased with a slight decline from fiscal year 2007 to 2008. However, the source of this waste has changed. In 1996, the member localities contributed approximately 53 percent of the total waste, while the private haulers contributed about 47 percent. This has changed fairly dramatically since then and the member communities now contribute only 29 percent of the total, while the private haulers contribute 62 percent, and out-of-area waste totals nine percent. The private haulers and out-of-area waste now accounts for over two-thirds of the waste handled by SPSA. The following graph shows the annual waste hauled by source and fiscal year since 1996.

Graph 8



Later in this section, we will discuss some of the reasons for the shift in the source of SPSA's solid waste.

Locality Contracts

As previously mentioned, six of the eight member communities entered into substantially similar contracts with SPSA. The contracts with the local communities require the localities to deliver at least 95 percent of disposable solid waste produced or collected in the applicable locality to SPSA. These member localities then pay a set tipping fee for each ton of solid waste disposed of with SPSA.

Two members, Suffolk and Virginia Beach, have different arrangements with SPSA. In exchange for hosting the regional landfill, Suffolk does not pay a tipping fee for municipal solid

waste. The contract also required SPSA to make modifications to the primary road leading to the landfill to allow for safer and less obstructive access to the landfill site. In order to construct the final cell in the landfill, the Suffolk City Council approved a resolution which will require SPSA to build and operate two more transfer stations for Suffolk, at an estimated cost of \$22.5 million.

Virginia Beach's contract sets maximum tipping fee for their municipal solid waste that ends in 2015. This maximum tipping fee is currently \$53.88, compared to the current \$104 member municipal tipping fee. Under this arrangement, SPSA can also deliver up to 300,000 tons of ash from the waste-to-energy facility to Virginia Beach's landfill, while SPSA pays the annual operating and indirect costs for Virginia Beach's landfill. SPSA also had to purchase and operate Virginia Beach's transfer station and build an additional transfer station for the city. In 1997, SPSA also paid \$5 million to expand Virginia Beach's landfill so it could hold more ash.

However, for the last ten years SPSA has not utilized its option in the contract and has only delivered ash to its own regional landfill. Management cites a consultant's report as the reason for this decision; this report states that SPSA would minimize its costs by delivering all of the ash to one landfill, either the regional landfill or the Virginia Beach landfill. Management chose to deliver the ash to the Suffolk landfill, while still paying for operating costs at the Virginia Beach landfill. SPSA did not formally reassess this decision until fiscal year 2008, when management became more concerned about filling up the currently used landfill cell before having a chance to open the next one. As a result, SPSA started delivering ash to the Virginia Beach landfill on July 2, 2008 to save landfill space in the regional landfill.

The SPSA municipal tipping fee did not exceed the Virginia Beach maximum tipping fee until 1995 and as a result, did not have an impact on the amount that Virginia Beach paid for disposal and SPSA received until that time; however, when the tipping fee exceeded the negotiated maximum amount, the contract protected Virginia Beach from further increases. In fiscal year 2008, the maximum negotiated tipping fee saved Virginia Beach almost \$6.8 million in tipping fee payments to SPSA.

In addition, SPSA had to pay almost \$7 million in operating and indirect costs for the Virginia Beach landfill during fiscal years 2004 through 2008. In total, this contract cost SPSA approximately \$17 million in landfill operating and indirect costs and forgone tipping fees during fiscal years 2004 through 2008.

Operations Observation 1

As the tipping fees continue to increase, SPSA's opportunity cost will decrease as the contract will cost more in lost tipping fees. On the other hand, the value of Virginia Beach's tipping fee cap will increase to the city, due to the increasing spread between the two tipping fees.

The special arrangements with Suffolk and Virginia Beach have a significant impact on SPSA. Not only has SPSA forgone tipping revenues from these localities, but many in the public have a negative perception of these arrangements. Other communities perceive these agreements as an inequity, especially since SPSA only recently began delivering ash to Virginia Beach to

use their side of the agreement. Others do not believe that Virginia Beach and Suffolk have the same commitment and point of view for SPSA's decisions since raising tipping fees would have little impact on their locality. This creates tension among the remaining member communities.

Flow Control and Private Haulers

When SPSA originally began operating, the Hampton Roads district used "flow control." Flow control is a legal provision where localities or states could mandate where to process and dispose of solid waste. Under flow control, facilities could have a monopoly in municipal solid waste disposal.

Since the Hampton Roads district used flow control, SPSA originally had a government monopoly and assumed this monopoly would continue and as such operated under this financial model. However, SPSA later lost control of the waste when the courts decided these government monopolies were unlawful. In 1994, the United States Supreme Court ruled in the "Carbone decision" that state or local laws that mandate where to process and dispose of waste violated the United States Commerce Clause.

Since SPSA originally built its organization based on the premise that flow control would continue, the organization's leaders made many key decisions under this premise; as a result, SPSA assumed that it would continue to receive all private haulers' waste at the rate set by SPSA that was equal to the member communities' rates. Instead, under the Carbone decision, the industry changed SPSA's environment; the private haulers had more options for waste disposal, as they were no longer required to take their waste to SPSA. Many private haulers looked for more economical means of disposal and chose to take their waste to privately owned transfer stations within the Hampton Roads area. In fiscal year 1993, before the Carbone decision, SPSA received a total of 958,020 tons of private area waste, which was the highest amount SPSA received. However, by 1996, two years after the decision, private area waste decreased by approximately 11 percent, or 104,702 tons, to a total of 853,318 tons.

By delivering their waste to other transfer stations and landfills, private haulers showed that they had other, more economical disposal solutions and therefore, had more bargaining power with SPSA for lower rates. As a result, SPSA lowered its tipping fees for private haulers to attract more business from these private haulers.

In 2001, SPSA entered into solid waste disposal contracts with the six largest private haulers to compensate for the loss in waste and associated revenue. These contracts required the private haulers to deliver all of their waste in the area to SPSA and required them to pay tip fees which escalate every year. This rate started at \$28 per ton in 2001, and rose to a high of \$42 per ton in 2006. Subsequently, in February 2006, the parties negotiated new contracts with the private haulers with a tipping fee of \$28 per ton.

Setting Tipping Fees

SPSA generally reassesses and sets its municipal tipping fees annually. These tipping fees are not necessarily market rates; instead, management and the Board have historically set these rates based on anticipated cash flow needs to fund current operations and debt service requirements.

Member contracts require the localities, except Suffolk and Virginia Beach, to pay the tipping fee approved by the Board.

As of July 2008, the tipping fee is \$104 per ton of disposable solid waste, while in July, 2006, the tipping fee was \$57 a ton. From July, 2006 to July, 2007, SPSA increased the tipping fee by \$43 a ton, or an increase of over 75 percent.

In contrast, SPSA generally charges external private haulers a negotiated price or a different tipping fee that management and the Board try to set based on market prices. Historically, SPSA management and the Board have wanted the additional revenue from these private vendors so they were willing to set lower rates for them to encourage them to use their facilities, instead of disposing of their collected solid waste at a private landfill.

In order to encourage the private haulers to continue to bring their waste to SPSA, the organization lowered its tipping fee for the private contract haulers below the municipal tipping fee in May, 1995. At this time, SPSA negotiated private contract rates that were \$36 a ton less than the municipal rate.

The table below compares the tipping fee by fiscal year for the various main providers of solid waste to SPSA.

Table 9

Tipping Fees by Source and Year (\$ per ton)

| <u>Timeframe</u> | <u>Municipal</u> | <u>Private</u> | Processable <u>Private Contract</u> | <u>Out-of-Area</u> |
|------------------|------------------|----------------|--|--------------------|
| July, 1989 | 26.5 | 26.5 | n/a | n/a |
| July, 1990 | 29 | 33 | n/a | n/a |
| July, 1991 | 29.5 | 35.25 | n/a | n/a |
| July, 1992 | 26.5 | 36 | n/a | n/a |
| July, 1993-1994 | 34 | 41 | n/a | n/a |
| May, 1995 | 61 | 41 | 25 | n/a |
| July, 1995 | 48.2 | 48.2 | 25 | n/a |
| July, 1996 | 45 | 45 | 25 | n/a |
| July, 1997-1999 | 48.5 | 48.5 | 25 | n/a |
| July, 2000 | 53.5 | 50.5 | 18.36 | n/a |
| July, 2001 | 57 | 54 | 23 | n/a |
| July, 2002 | 55 | 55 | 55 | n/a |
| July, 2003 | 49 | 49 | 57 | 13 |
| July, 2004 | 46 | 58 | 58 | 13.28 |
| July, 2005 | 51.98 | 59 | 42 | 17 |
| July, 2006 | 57 | 57 | 28 | 16 |
| January, 2007 | 75 | 60 | 28 | 16 |
| July, 2007 | 100 | 60 | 28 | 16 |
| July, 2008 | 104 | 60 | 28 | 40 |

The private rate is the amount that the general private haulers pay per ton, while those haulers that negotiated a contract rate with SPSA pay a different fee considered a processable private contract rate. The rates show that the July 2008 rates have the largest difference between the contract rate and the municipal rate. Many member localities have expressed their concerns over the dramatic difference between the two rates.

Operations Observation 2

Individual locality tipping rates are subsidizing the special rates for Suffolk, Virginia Beach, the private haulers, and out-of-area operations.

Out-of-Area Waste

In fiscal year 2002, SPSA began accepting out-of-area waste at \$13 a ton and received over 44 thousand tons of out-of-area waste. Since then, SPSA has received 458 thousand additional tons of out-of-area waste at their regional landfill. SPSA management indicated that they accepted the out of area waste to compensate for a shortage of materials for the RDF plant. The following table shows the tipping fees for of out-of-area waste from 2003 through 2008 with the corresponding number of tons received by fiscal year.

Table 10

Out-of-Area Tipping Fee and Tons of Waste by Fiscal Year
(in thousands)

| | <u>Tons</u> | <u>Tipping Fee</u> |
|------|-------------|--------------------|
| 2003 | 42 | \$13.00 |
| 2004 | 58 | \$13.28 |
| 2005 | 42 | \$17.00 |
| 2006 | 55 | \$16.00 |
| 2007 | 128 | \$16.00 |
| 2008 | 133 | \$40.00 |

Management and the Board began accepting this solid waste in order to increase their revenues and cash flows to fund expenses. However, they did not perform an adequate assessment of their environmental and operating and other costs before setting these rates. In addition, at the time that management was setting their rates, SPSA had not performed a review of their landfill costs to ensure that the out-of-area tipping fee was greater than the cost incurred per ton of solid waste disposed for these additional tons of waste. Management did not know the cost of day-to-day operations, landfill closing costs, and the costs to construct a new landfill.

When originally setting the out-of-area tipping fees, management simply inquired about what the out-of-area haulers would be willing to pay. SPSA did not perform due diligence when setting this rate to ensure they were getting a fair market rate. Management did not know these potential customers' other options and the associated cost for each option.

Operations Observation 3

By not knowing how much their landfill costs are and how much the costs are for their out-of-area customers' other options, management does not have enough information to appropriately set a tipping fee. Management should compare the out-of-area haulers other options to SPSA and take this assessment, as well as the cost assessment, into account before setting an out-of-area waste fee.

Future of Flow Control

In April 2007, the United States Supreme Court decided that in certain situations municipal governments could adopt flow control to ensure disposal of solid waste into a publicly owned solid waste management facility. Since then, SPSA has worked with member communities to assess the viability of flow control in their area and determine how much the current tipping fee would decrease.

In order to reenact flow control, SPSA has to terminate current private hauler contracts; under these contracts, SPSA had to provide the other party with 12 months advance written notice. In January, 2008, the Board voted to terminate the contracts effective January 31, 2009 in anticipation of flow control. As of July 2008, six of the eight member communities approved flow control for their municipality. Suffolk and Virginia Beach have not voted for flow control in their jurisdictions.

Currently, SPSA is developing contract proposals to present to the private haulers that include an initial tipping fee of \$40 per ton, which will increase by \$10 per ton each year until the commercial tipping fee equals the municipal tipping fee. Under flow control, SPSA anticipates an eventual tipping fee of \$80 a ton for both private haulers and member communities. As previously mentioned, commercial haulers currently pay \$28 per ton, while member communities pay \$104 a ton. In addition, SPSA will stop receiving out-of-area waste because management believes it will no longer need the additional revenues. SPSA has estimated the savings shown in the following table for each municipality.

Table 11

Management Estimated Locality Savings for Flow Control by Municipality

| | Actual Fiscal Year <u>2007 Tons</u> | Estimated First <u>Year Savings</u> | Total Savings <u>(2009-2018)</u> |
|----------------|--|--|-------------------------------------|
| Chesapeake | 111,437 | \$ 5,510,600 | \$ 58,979,000 |
| Franklin | 4,896 | 242,100 | 2,591,000 |
| Isle of Wight | 19,956 | 986,800 | 10,562,000 |
| Norfolk | 86,285 | 4,266,900 | 45,667,000 |
| Portsmouth | 55,019 | 2,720,700 | 29,119,000 |
| Southampton | 12,290 | 607,800 | 6,505,000 |
| Virginia Beach | <u>147,819</u> | <u>922,990</u> | <u>37,706,000</u> |
| Total | <u>437,702</u> | <u>\$15,257,890</u> | <u>\$191,129,000</u> |

Under flow control, the solid waste industry environment in Hampton Roads could expect to return to the way it was when SPSA first opened and structured its organization. However, many in the area have expressed concern over whether flow control will once again function as it originally did.

For example, private haulers will not have to take recycling or construction, demolition and other materials to SPSA. As a result, upon pick-up, haulers could consider more solid waste as recyclable or as waste that requires sorting to separate the recyclable material. Therefore, materials could then go to a private facility and any remaining waste could go to a private landfill.

Private haulers and other stakeholders have suggested “economic flow control” to avoid a decline in the waste stream. This involves a waste generation fee allowing the communities to set flat rate charges for individual businesses based on projections of solid waste generated. This would charge the end users directly and allow SPSA to avoid increasing the tipping fee and subsequently keep more waste within the area because the final tipping fee would remain competitive.

Landfill

Management estimates that the current capacity of the Suffolk Regional Landfill will last through February 2012. SPSA evaluated several alternatives to determine what the authority should do with its solid waste after 2012. These alternatives included expanding the current landfill with a new cell, building a new landfill, and hauling the solid waste to private landfills in the general geographic area. After performing these evaluations, management and the Board decided that expanding the current landfill was the most economical choice. As a result, SPSA is currently in the process of expanding the regional landfill in Suffolk by building Cell VII. Based on internal projections, this landfill addition should have a useful life through 2018.

Since SPSA anticipates Cell VII lasting through 2018, management and the Board believe that the current landfill will provide them with a disposal area through the end of the current member use and support contracts.

Operations Observation 4

Management did not fully consider all of the factors that would affect the useful life of the new cell. Specifically, SPSA did not evaluate the impact of flow control on the amount of solid waste disposed with SPSA and reevaluate the original estimated life of the new landfill cell and modify it as necessary. Such an analysis would allow SPSA to determine whether the regional landfill has the capacity through the end of the member use and support contracts.

A significant change in flow control could affect the amount of solid waste SPSA will landfill. A significant change in the amount of solid waste placed in the landfill will affect the useful life of the landfill. However, SPSA did not attempt to factor in and project the change in quantities received from the private haulers when estimating the useful life of Cell VII. Therefore, the

current landfill and Cell VI may not meet SPSA's disposal needs through the end of the current member use and support contracts.

Operations Observation 5

Not having a business focus in determining how SPSA should operate to fulfill its mission has impacted the setting of tipping fees and also resulted in not properly considering the capacity of the landfill. Clearly, SPSA has a focus on revenue and not the entire cost of operations. Increasing volume does generate more revenue; however, there are no discussions of who should pay and how much, coupled with the longer term cost to the organization of having to maintain an old landfill and replace it.

Waste-to-Energy

Obtaining the Power Plant

From 1988 through 1999, SPSA sold processed refuse derived fuel to the Navy to burn in the power plant. The Navy originally constructed and owned the power plant, which SPSA operated for the Navy under a cost-reimbursement contract. However, in the late 1990s, the Federal Government directed the Navy to divest of non-core, non-mission critical activities and wanted lower cost steam and electricity. As a result, SPSA and the Navy began preliminary discussions on potential ways to continue operating the power plant.

In 1999, under a modified contract, the Navy gave SPSA all of the power plant's assets for \$1. Under this agreement, SPSA maintains the facility and must provide a contract set amount of steam to the Navy through 2018. If management and the Board issue debt to improve or maintain the facility, SPSA must make all related debt service payments.

Before entering this new agreement with the Navy in 1999, a consultant performed a study on SPSA's alternatives. This consultant recommended that SPSA perform an additional on-site assessment and appraisal of the power plant to determine what improvements, both capital and operational, were necessary to ensure that management and the Board made an informed decision. If this additional assessment had positive results, the consultant recommended SPSA gain ownership of the facility to prolong the regional landfill's capacity. At that time, the consultant projected that SPSA would fill the existing landfill's cells by 2000, the new cell (Cell V) by 2010, and would need to construct Cell VI, which it would fill in 2017.

Shortly thereafter, SPSA hired another consultant to perform the suggested on-site assessment of the power plant. This consultant reviewed the power plant and provided SPSA with a summary of the various components of the plant, their estimated replacement intervals, and current condition. Based on this assessment, management believed that most of the items included in the assessment were general maintenance items with the exception of a few capital improvement projects. The consultants estimated the cost of the power plant's annual capital projects between \$900,000 and \$1,000,000.

Based on these consultants' analyses and SPSA's own assessment, SPSA assumed ownership and operations for the power plant. Since acquiring the power plant in 1999, management estimates that SPSA has spent over \$46.2 million in capital improvement projects for the waste-to-energy facility, with approximately \$38.8 million funded with bond proceeds.

Current Operations

During fiscal year 2007, the RDF plant received 597,659 tons of waste and produced 528,981 tons of RDF. However, the power plant historically has had problems operating to capacity. As a result, the plant did not produce as much electricity in fiscal year 2007, causing a \$3 million decrease in electricity revenues from the previous year. During 2007, the boilers in the power plant were down approximately 26 percent of the time, of which ten percent represented scheduled maintenance, 14 percent unscheduled, and one percent due to a lack of RDF to burn. Whenever the boilers are not operating, the facility cannot produce steam and electricity for sale. According to SPSA consultants, R.W. Beck, the amount of unscheduled downtime was high, even for a system of similar age. Several of these problems appear to be the result of equipment failure and operator error, which may be a result of the high turnover of personnel at the power plant.

Impact of the Waste-to-Energy Facility on the Amount of Capital Projects and Debt

Until recently, SPSA management and the Board did not reassess their waste-to-energy operating environment to determine whether it added value to their organization, helped them meet their strategic mission, and ultimately whether SPSA should be the one operating the facility. Specifically, management has had trouble recruiting and retaining qualified employees at the power plant to ensure that they have the expertise to efficiently operate the plant. As a result, the boilers and other equipment in the power plant are down more than should be expected, causing the plant to run inefficiently and ultimately costing SPSA lost steam and electricity revenues.

Board members and management also have limited outside knowledge and background on the waste-to-energy operating environment and the expertise needed to properly oversee the facilities. However, this business accounts for a large portion of SPSA's costs and efforts; in fiscal year 2009, waste-to-energy operations are budgeted for over \$27 million of the \$102 million operating budget and \$13 million of the \$26 million capital budget. This lack of expertise has an impact on the organization's options for the waste-to-energy facility.

Management also did not continue to compare their operations and the environment to the consultants' assumptions, which the consultants used to develop their recommendations. SPSA later relied on these assumptions and recommendations to help them determine whether the authority should assume ownership of the power plant.

In 1999, the consultant assessed the current operating environment and made certain assumptions about continued operations of the facility, the entire organization, and the solid waste industry. Some of these projections or assumptions did not come true; for example, the consultant's estimated useful life of the landfill was much greater than the actual useful life of the landfill. In addition, the actual annual capital project and maintenance expenses were much greater than the consultant's estimated annual capital project and maintenance expenses. As mentioned previously,

the consultant originally anticipated about \$1 million of capital expenses annually. However, the organization spent significantly more than that annually. The table below shows the estimated capital project costs and projected bond issuance by fiscal year for the RDF and power plants.

Table 12

Budgeted Capital Project Expenses, Projected Bond Issuance, and Cash Funding for RDF and Power Plants for Fiscal Years 1999-2008

| | <u>RDF</u> | <u>Power Plant</u> | <u>Total</u> | <u>Projected Bond Issuance</u> | <u>Budgeted Cash Funding</u> |
|-------|---------------------|---------------------|---------------------|--------------------------------|------------------------------|
| 1999 | \$ 120,000 | \$ - | \$ 120,000 | \$ 120,000 | \$ - |
| 2000 | 321,300 | 1,585,400 | 1,906,700 | 1,906,700 | - |
| 2001 | 857,100 | 1,030,000 | 1,887,100 | 1,887,100 | - |
| 2002 | 1,309,976 | 2,883,210 | 4,193,186 | 4,193,186 | - |
| 2003 | 2,490,060 | 2,036,000 | 4,526,060 | 4,526,060 | - |
| 2004 | 2,243,450 | 3,152,000 | 5,395,450 | 5,395,450 | - |
| 2005 | 2,708,000 | 3,281,146 | 5,989,146 | 5,989,146 | - |
| 2006 | 1,839,000 | 3,409,700 | 5,248,700 | 5,218,700 | 30,000 |
| 2007 | 2,670,918 | 4,783,006 | 7,453,924 | 7,453,924 | - |
| 2008 | <u>2,039,100</u> | <u>7,482,663</u> | <u>9,521,763</u> | <u>2,194,000</u> | <u>7,327,763</u> |
| Total | <u>\$16,598,904</u> | <u>\$29,643,125</u> | <u>\$46,242,029</u> | <u>\$38,884,266</u> | <u>\$7,357,763</u> |

As shown in the table, the budgeted capital project expenses far exceeded the \$1 million annually originally projected by the consultant. Due to the large capital requirements and the lack of internal funding available, SPSA later planned to issue debt for \$38.8 million, or 84 percent, of the budgeted capital expenses for the RDF and power plants. These unexpected capital expenses had a significant impact on SPSA's financial conditions and operations and management and the Board reacted by deferring these expenses and issuing more debt. As a result, the RDF and power plant's capital projects account for a significant amount of SPSA's debt issuance.

Operations Observation 6

Even though some of the consultants' projections were not accurate, management did not appear to continue to critically re-evaluate their situation, environment, assumptions, and decisions to determine how the waste-to-energy facility should operate and who should operate it. SPSA manages the facility internally at significant operating and capital expense costs. For example, in 2009, management and the Board estimate spending \$27.5 million in operating costs and \$13.7 million on capital projects.

Operations Observation 7

One factor in not reassessing the information is the difficulty in obtaining reliable cost allocation information for expenses and bond data. For example, management was unable to provide us with actual capital project expenses by fiscal year for the RDF and power plant by fiscal year. As a result, management and the Board would also not know how much funds they spent and how much debt the entity incurred to operate the RDF and power plant facilities. Without this information readily available, management and the Board cannot make an informed decision about the future of the facilities. If SPSA staff collected this information in the future, they could provide decision makers with all of the necessary information needed to make an informed decision.

SPSA is now considering selling the waste-to-energy system under the Public-Private Education Facilities and Infrastructure Act of 2002. Interested private companies submitted proposals addressing how the company would operate and receive solid waste. As of August 2008, four companies have submitted bids to purchase the waste-to-energy facility from SPSA. If SPSA sells the facility, the Board anticipates using the proceeds of the sale to retire a portion of the debt outstanding.

If SPSA does not sell the waste-to-energy facility, then management intends to continue to operate the facility. We prepared the following table to show a scenario of potential costs and revenues (or avoided costs) over the next five years if SPSA continues to operate the facility. This scenario is for illustrative purposes to show the potential impact to SPSA.

Table 13

Potential Impact of Waste-to-Energy Facility

| | <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>2013</u> |
|---|---------------------|---------------------|---------------------|---------------------|---------------------|
| Revenues or avoided costs: | | | | | |
| Steam sales (1) | \$7,260,743 | \$7,260,743 | \$7,260,743 | \$7,260,743 | \$7,260,743 |
| Electrical sales (1) | 13,300,000 | 13,300,000 | 13,300,000 | 13,300,000 | 13,300,000 |
| Proprietary waste (1) | 2,200,000 | 2,200,000 | 2,200,000 | 2,200,000 | 2,200,000 |
| Non-ferrous recovery sales RDF plant (1) | <u>250,000</u> | <u>250,000</u> | <u>250,000</u> | <u>250,000</u> | <u>250,000</u> |
| Total revenues | 23,010,743 | 23,010,743 | 23,010,743 | 23,010,743 | 23,010,743 |
| Avoided landfill (2) | <u>4,395,000</u> | <u>4,395,000</u> | <u>4,395,000</u> | <u>4,395,000</u> | <u>4,395,000</u> |
| Total revenues and avoided costs | <u>27,405,743</u> | <u>27,405,743</u> | <u>27,405,743</u> | <u>27,405,743</u> | <u>27,405,743</u> |
| Expenses: | | | | | |
| Capital projects | | | | | |
| Power plant (3) | 10,820,000 | 8,381,900 | 7,077,000 | 9,411,000 | 7,024,500 |
| RDF plant (3) | <u>2,899,000</u> | <u>2,995,000</u> | <u>2,230,440</u> | <u>2,180,000</u> | <u>2,240,000</u> |
| Total capital project expenses | 13,719,000 | 11,376,900 | 9,307,440 | 11,591,000 | 9,264,500 |
| Operating expenses (1) | <u>27,507,140</u> | <u>27,507,140</u> | <u>27,507,140</u> | <u>27,507,140</u> | <u>27,507,140</u> |
| Total expenses | <u>\$41,226,140</u> | <u>\$38,884,040</u> | <u>\$36,814,580</u> | <u>\$39,098,140</u> | <u>\$36,771,640</u> |
| Potential loss (Revenues and avoided costs less expenses) | (13,820,397) | (11,478,297) | (9,408,837) | (11,692,397) | (9,365,897) |

Assumptions:

- (1) Fiscal year 2009 Annual Budget- General Operating (2009 budgeted amounts used for all five years)
- (2) Number of RDF tons processed multiplied by a SPSA consultant's calculated avoided landfill cost per ton. Avoided landfill calculation is intended to represent the potential cost of dumping the solid waste in the regional landfill.
- (3) Fiscal year 2009 Annual Budget- General Operating and five-year capital

Our illustrative example shows that operating and capital project expenses will exceed revenues and avoided landfill costs between \$9 million and \$14 million annually, totaling \$55.7 million over the next five years. Under this scenario, continuing to operate the waste-to-energy system could have a significant negative financial impact on SPSA.

Operations Observation 8

SPSA has not performed their own detailed analysis for operating the waste-to-energy facility to avoid having to further increase the tipping fee, issue more debt, or cut costs and/or programs in another area. Such an assessment and evaluation for alternatives could include leasing the facility, contracting with a private vendor to operate the plant, selling the facility, modifying operations or production, or reducing capital and/or operating costs. Management has not identified all of their potentially viable options and assessed each one, including determining the potential costs and revenues associated with each option. This assessment should include opportunity costs and avoided costs, as well as non-monetary factors, such as the impact on the environment.

Reassessing Decisions and the Operating Environment

Operations Observation 9

SPSA does not have a thought-out and established process for periodically reassessing its operating environment and previous decisions. In order to properly manage an organization, management and the Board should evaluate its operations and make sure that the entity and its components are operating in an appropriate manner and that the organization should continue operations unchanged.

SPSA also does not have an adequate process for tracking and allocating costs to individual capital projects and operational costs to programs and facilities. As mentioned previously, SPSA does not currently have a readily available method for identifying and allocating its actual costs for capital or operations by program or facility. SPSA does not allocate its costs and revenues to individual operations and as a result, cannot tell which areas are financially independent and which areas require internal subsidies. Without this knowledge, management and the Board cannot assess its operations to make informed decisions.

FINANCIAL POSITION

Over the past five years, SPSA has operated with a positive operating income but overall has reported a net deficit. During fiscal year 2007, SPSA earned \$81.5 million in operating revenue and incurred \$70.6 million in operating expenses for a total operating income of \$10.7 million. However, after non-operating expenses and revenues, including interest expense, SPSA had a net deficit of \$1.7 million. Total debt service for fiscal year 2007 was \$31.6 million and exceeded total operating income by \$20.9 million.

For fiscal year 2007, SPSA's total liabilities exceeded total assets by \$22.8 million. SPSA has a large capital infrastructure and capital assets accounts for approximately 70 percent, or \$177.5 million, of the total \$252.8 million in assets. The long-term debt for SPSA totaled \$219.9 million as of June 30, 2007 with an additional \$21 million in short-term bonds payable due during the following fiscal year. Long and short-term bonds payable exceeded capital assets, net of depreciation, by \$63.4 million.

During fiscal year 2007, SPSA used \$1.3 million more cash than it generated during the year. Principal payments on bonds payable and interest paid totaled \$32.8 million and exceeded net cash provided by operating activities by \$7.5 million. The following table shows that the principal payments on bonds payable and the interest paid exceeds the net cash provided by operating activities for the past five fiscal years. We added the proceeds from the issuance of bonds payable to show that it is a significant source of cash for the year.

Table 14

Select Cash Flow Comparison for Fiscal Years 2003 through 2007

| | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> |
|--|---------------------|---------------------|---------------------|---------------------|---------------------|
| Net cash provided by operating activities | \$26,923,914 | \$22,433,804 | \$21,368,045 | \$23,099,699 | \$25,226,123 |
| Principal payments on bonds payable | (58,465,000) | (56,945,000) | (15,625,000) | (20,760,000) | (20,250,000) |
| Interest payments | <u>(12,999,839)</u> | <u>(14,232,768)</u> | <u>(11,507,620)</u> | <u>(11,757,574)</u> | <u>(12,530,764)</u> |
| Sub-total | (44,540,925) | (48,743,964) | (5,764,575) | (9,417,875) | (7,554,641) |
| Proceeds from issuance of bonds payable | <u>59,903,608</u> | <u>57,790,000</u> | <u>15,360,000</u> | <u>17,740,000</u> | <u>21,320,000</u> |
| Total | <u>\$15,362,683</u> | <u>\$ 9,046,036</u> | <u>\$ 9,595,425</u> | <u>\$ 8,322,125</u> | <u>\$13,765,359</u> |

This table illustrates that their net cash provided by operating activities cannot fund their principal and interest payments.

The Balance Sheet, Statement of Revenues, Expenses, and Changes in Net Deficit, and the Statement of Cash Flows for fiscal year 2007 are included in Appendix A of this report.

Revenues

During fiscal year 2007, 70 percent, or \$57 million, of SPSA's total operating revenue of \$81.5 million came from municipal and commercial tipping fees. Steam and electrical sales comprised almost 18 percent, or \$14.5 million, of the authority's total operating revenue. SPSA's three largest customers are municipal member communities: Virginia Beach, Norfolk, and Chesapeake; these three customers account for almost 36 percent of the authority's total operating revenues. The table below shows SPSA's ten largest customers during fiscal year 2007.

Table 15

Fiscal Year 2007 Top Ten Revenues by Customer

| <u>Customer</u> | <u>2007</u> |
|-----------------------------------|---------------------|
| City of Virginia Beach | \$11,577,326 |
| City of Norfolk | 9,219,958 |
| City of Chesapeake | 8,476,775 |
| Waste Industries Inc. | 6,316,443 |
| Waste Management of Hampton Roads | 5,648,071 |
| City of Portsmouth | 3,667,807 |
| Bay Disposal | 3,008,175 |
| Chesapeake Waste Solutions | 2,285,863 |
| Tidewater Fibre | 2,009,922 |
| County of Isle of Wight | <u>1,424,751</u> |
| Total | <u>\$53,635,091</u> |

Debt and Capital Projects

Historical Use of Debt

Since its inception, SPSA has relied on debt from the issuance of long-term revenue bonds as its primary source of financing capital projects. SPSA initially funded equipment, transfer stations, and the landfill with bond issues totaling \$133.8 million in 1984, and an additional \$20 million in 1985. Even after the authority's initial start-up, SPSA has continued to primarily fund its capital projects by issuing debt.

As of June 30, 2007, SPSA had a total of \$244 million in bonds outstanding. Over the past eight years, SPSA has issued over \$200 million in debt and has paid over \$250 million in debt service. The table below shows the amount of debt issued, outstanding, and the annual debt service payments for fiscal years 2000 through 2008.

Table 16

Total Debt Issued, Outstanding, and Annual Debt Service Payments
For Fiscal Years 2000-2008

| Year | Beginning of Fiscal Year Debt Outstanding | Debt Issued | Debt Service Payments |
|------|---|--------------|--------------------------|
| 2001 | \$244,930,000 | \$20,510,000 | \$22,957,566 |
| 2002 | 254,785,000 | 3,400,000 | 24,339,047 |
| 2003 | 246,430,000 | 24,105,000 | 36,218,966 |
| 2004 | 247,070,000 | 15,290,000 | 26,391,062 |
| 2005 | 247,915,000 | 15,360,000 | 27,540,783 |
| 2006 | 247,650,000 | 17,740,000 | 32,232,893 |
| 2007 | 244,630,000 | 21,320,000 | 32,704,016 |

As shown in the table below, as of fiscal year 2008, SPSA has to repay about \$314 million in debt service payments by 2018. Currently, SPSA has a total of \$234 million in debt outstanding and plans to issue \$26 million in additional debt during fiscal year 2009.

Table 17

Debt Repayment Schedule

| Year | Principal | Interest | Total Payment | Total Outstanding Debt |
|-------|----------------------|---------------------|----------------------|---------------------------|
| 2008 | \$21,115,000 | \$10,547,189 | \$31,662,189 | \$234,275,000 |
| 2009 | 23,580,000 | 10,539,284 | 34,119,284 | 210,695,000 |
| 2010 | 28,865,000 | 9,768,868 | 38,633,868 | 181,830,000 |
| 2011 | 39,770,000 | 8,387,706 | 48,157,706 | 142,060,000 |
| 2012 | 30,720,000 | 6,710,637 | 37,430,637 | 111,340,000 |
| 2013 | 34,130,000 | 5,179,861 | 39,309,861 | 77,210,000 |
| 2014 | 24,140,000 | 3,494,966 | 27,634,966 | 53,070,000 |
| 2015 | 18,750,000 | 2,260,109 | 21,010,109 | 34,320,000 |
| 2016 | 25,285,000 | 1,323,391 | 26,608,391 | 9,035,000 |
| 2017 | <u>9,035,000</u> | <u>465,406</u> | <u>9,500,406</u> | - |
| Total | <u>\$255,390,000</u> | <u>\$58,677,417</u> | <u>\$314,067,417</u> | |

Of the 2009 total operating budget, 40 percent, or almost \$41 million of the total \$102 million, is budgeted for debt service payments. Budgeted debt service payments account for the largest line item on the authority's budget and equal about 63 percent of the budgeted tipping fee revenue for fiscal year 2009. According to the authority's fiscal year 2007 financial statements, debt service payments exceed operating income by \$20.9 million.

By having such a large amount of debt outstanding and significant debt service requirements, SPSA will have to continue to contribute a considerable amount of its resources to paying off its debt. This becomes increasingly difficult if the operating cash flows do not exceed the debt service requirements. Issuing additional debt will increase the burden making it more difficult to meet debt service requirements.

Financial Position Observation 1

Although SPSA is aware of the amount of debt outstanding and has raised their municipal tipping fee rates, management and the Board have not developed a detailed plan on how they intend to repay their currently outstanding debt and new issuances over the next ten years. Specifically, SPSA raised the tipping fee to \$104 and later plans to lower the fee to \$80 a ton under flow control; however, the authority has not performed a detailed analysis of how much additional revenue this will generate or how much additional revenue the organization will need to repay their debt and fund current operations and closure costs. In addition, SPSA does not know how much additional revenue they will need to fund future debt issuances, as mentioned below.

Financial Position Observation 2

SPSA does not have a policy directing a periodic analysis to drive the tipping fees. This lack of analysis may have contributed to the constant changes in the tipping fees since the organization does not fully calculate the impact before modifying rate structures.

Current Impact of Debt on Tipping Rates

The table below compares the tipping fee for the past five fiscal years.

Table 18

Municipal Tipping Fee Rates for the Past Five Fiscal Years

| <u>Timeframe</u> | <u>Tip Fee</u> |
|------------------|----------------|
| July 2008 | \$104.00 |
| July 2007 | \$100.00 |
| January 2007 | \$ 75.00 |
| July 2006 | \$ 57.00 |
| July 2005 | \$ 51.98 |
| July 2004 | \$ 46.00 |
| July 2003 | \$ 49.00 |

When SPSA increased the tipping fee to \$57 in July 2006, SPSA began trying to set aside funds to pay for current year closure costs. However, at this time, management did not believe that

the revenues from the \$57 tipping fee would fully fund current operating expenses and annual debt service payments.

Beginning in January 2007, the Board decided to raise the tipping fee to fund annual requirements for debt service and operating costs and additional current and future costs. The Board set the use of excess revenue as follows: 1) fund current year closure and post-closure requirements, 2) fund the reserve and contingency fund with 20 percent of the excess revenues, and 3) debt management. Under debt management, SPSA anticipates cash funding more capital projects with excess revenues. For example, SPSA management anticipated funding the majority of future anticipated capital improvements through current year operating revenues in fiscal year 2009. In addition, the SPSA Board determined that SPSA will not issue debt which requires debt service after 2018 and that the life of a bond will not exceed 75 percent of the life of the assets paid for by the bond proceeds.

As a result of these new financial policies, SPSA substantially raised the tipping fee from fiscal year 2007 to 2008. In fiscal year 2008, management planned to put \$2.5 million in the closure and post-closure fund, \$2.35 million into the reserve and contingency fund, and cash fund \$7 million in capital projects. However, for fiscal year 2009, SPSA budgeted less for these items with only \$1.5 million in closure and post-closure, \$1.5 million in reserve and contingency, and no cash to fund the \$26 million in projected capital expenses for the fiscal year. Therefore, SPSA was not able to continue the pay-as-you-go method for more than one fiscal year. Originally, during Board discussions, SPSA estimated that about \$15 million of the \$18 to \$20 million capital outlay budget could be cash funded. Management stated that an anticipated decrease in revenue caused by a projected decrease in waste caused SPSA to not have sufficient revenues to cash fund capital projects.

When SPSA first decided to implement these new fiscal policies, management and the Board understood that to fund these decisions, the tipping fee would have to substantially increase. As a result, SPSA increased its tipping fee from fiscal year 2007 to 2008 to \$100, which is an increase of \$43 or 75 percent. This is the largest total increase in tipping fees for the member communities.

Financial Position Observation 3

SPSA does not appear to have an adequate assessment and development process to determine the optimal tipping rate to fund their policy decisions. Instead, the Board was aware of the need to raise additional revenues but SPSA did not perform a detailed analysis to calculate an appropriate estimated amount needed and the subsequent associated tipping fee rate.

Five-Year Capital Project Budget

SPSA developed a five-year capital project budget. Between 2008 and 2013, SPSA is considering approximately \$134.5 million in capital projects and improvements, including \$11.6 million in expenses for Cell VII construction. During fiscal year 2008, SPSA budgeted \$16.6 million in capital projects and improvements and planned to fund \$6.9 million of these expenses with current operating revenues and the remaining \$9.6 million with bond proceeds. In fiscal year

2009, management plans to fund \$26 million in capital projects, all of which the authority will fund by issuing debt. Management anticipates using approximately half of these funds, or \$13 million, on improvements or replacements to the RDF and power plants. The table below summarizes the capital project budget for fiscal years 2009 through 2013.

Table 19

Budgeted Capital Project Expenses for Fiscal Years 2009 through 2013

| | <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>2013</u> |
|------------------------------------|---------------------|---------------------|---------------------|---------------------|--------------------|
| RDF and power plant | \$13,126,000 | \$12,320,900 | \$9,307,400 | \$12,931,000 | \$9,264,500 |
| Landfill and transfer stations | 9,442,595 | 8,156,850 | 5,027,000 | 16,263,300 | - |
| Other waste and recycling programs | 978,956 | 9,336,798 | 820,600 | 180,400 | - |
| Other | <u>2,508,000</u> | <u>2,726,350</u> | <u>2,753,700</u> | <u>2,795,400</u> | <u>-</u> |
| Total | <u>\$26,055,551</u> | <u>\$32,540,898</u> | <u>\$17,908,700</u> | <u>\$32,170,100</u> | <u>\$9,264,500</u> |

In general, SPSA has not projected how much debt the organization will issue to fund future projects. Even though management and the Board have developed a capital project budget for the next five years, SPSA has not adequately planned its capital budget. Specifically, management has only determined how much will be funded through debt issuance and cash for the current fiscal year's budget (2009). SPSA and the Board have not developed a financial plan for funding the remaining four years of the capital project budget. As a result, the organization does not know how much these projects will impact rates, cash availability, and debt outstanding. In addition, SPSA cannot develop a reliable debt repayment plan since it may significantly change if SPSA issues debt to fund future projects.

Financial Position Observation 4

By not developing a formal financing plan, the Board has more difficulties measuring the success of the new financial policies, including cash funding more projects. SPSA has not developed a funding plan for the entire five-year capital project, including details on how much debt the organization will issue, the debt repayment plan for the new and existing debt, and the revenue which will repay the debt.

The following tables are illustrative examples of how much new debt issuances could potentially impact SPSA's debt outstanding and repayment amounts.

Table 20

Potential Impact of New Debt Issuance
For Funding Capital Projects with All Debt

| <u>Year</u> | <u>Current Debt Service</u> | New Capital Projects | |
|-------------|---------------------------------|--|---|
| | | <u>Debt Financing At 100 Percent</u> | <u>Adjusted Annual Debt Service</u> |
| 2008 | \$ 31,662,189 | \$ 16,605,663 | \$ 34,216,588 |
| 2009 | 31,620,382 | 26,055,551 | 38,382,951 |
| 2010 | 52,922,204 | 32,540,898 | 65,258,749 |
| 2011 | 44,235,306 | 17,908,700 | 59,630,045 |
| 2012 | 31,267,238 | 32,170,100 | 53,153,407 |
| 2013 | 39,309,861 | 9,264,500 | 62,657,133 |
| 2014 | 27,634,966 | 9,264,500 | 52,806,831 |
| 2015 | 21,010,109 | - | 45,067,091 |
| 2016 | 26,608,391 | - | 49,550,490 |
| 2017 | <u>9,500,406</u> | <u>-</u> | <u>31,327,623</u> |
| Total | <u>\$315,771,052</u> | <u>\$143,809,912</u> | <u>\$492,050,908</u> |

Table 21

Potential Impact of New Debt Issuance
For Funding Capital Projects with Fifty Percent Debt

| <u>Year</u> | <u>Current Debt Service</u> | <u>New Capital Projects</u> | Debt Financing | |
|-------------|---------------------------------|---------------------------------|----------------------|---|
| | | | <u>at 50 Percent</u> | <u>Adjusted Annual Debt Service</u> |
| 2008 | \$ 31,662,189 | \$ 16,605,663 | \$ 8,302,832 | \$ 32,939,389 |
| 2009 | 31,620,382 | 26,055,551 | 13,027,776 | 35,001,667 |
| 2010 | 52,922,204 | 32,540,898 | 16,270,449 | 59,090,476 |
| 2011 | 44,235,306 | 17,908,700 | 8,954,350 | 51,932,675 |
| 2012 | 31,267,238 | 32,170,100 | 16,085,050 | 42,210,322 |
| 2013 | 39,309,861 | 9,264,500 | 4,632,250 | 50,983,497 |
| 2014 | 27,634,966 | 9,264,500 | 4,632,250 | 40,220,898 |
| 2015 | 21,010,109 | - | - | 33,038,600 |
| 2016 | 26,608,391 | - | - | 38,079,441 |
| 2017 | <u>9,500,406</u> | <u>-</u> | <u>-</u> | <u>20,414,014</u> |
| Total | <u>\$315,771,052</u> | <u>\$143,809,912</u> | <u>\$71,904,957</u> | <u>\$403,910,979</u> |

Assumptions:

- (1) SPSA will not issue any debt in the last three years of operation
- (2) New capital project amounts for fiscal years 2008-2013 came from the capital project budget and amount for 2014 equals the 2013 amount.
- (3) Average interest rates from Series 16 (Coupon of 5.1 percent - 5.08 percent) and Series 17 (5.6409 percent - 5.710 percent) for a rate of 5.3827 percent for the new debt service
- (4) SPSA will pay all new debt issuances off by 2017.
- (5) Estimated adjusted debt service amounts based on annual principal payments rather than semi-annual or quarterly payments

Under the first illustrative example, SPSA could spend an additional \$176 million on debt service payments between now and the end of the member use and support contracts. This would have a significant impact on the future repayment schedule for the organization and could make it difficult to make debt repayments without significant increases in the tipping fees.

Financial Position Observation 5

SPSA has not developed plans for funding capital projects and the impact on the authority. By establishing these plans, the organization will not further defer the potential problem of repaying all of the authority's current and future outstanding debt.

Debt Issuance Policies and Practices

As mentioned earlier in the report, SPSA adopted new fiscal policies in 2007. These policies provide limited guidance on debt issuance and management. Specifically, these policies do not allow SPSA to issue debt with a term that exceeds the life of the current use and support agreements. In addition, they direct SPSA not to issue debt with terms greater than 75 percent of the averaged estimated life of the assets the bonds will finance. Before management and the Board created these new policies, SPSA routinely issued debt with maturity terms greater than the expected life of the assets the proceeds financed. As a result, SPSA continued to pay debt service for assets that were no longer in use.

These limited policies still do not address all of SPSA's current debt issues. SPSA does not have adequate debt policies that provide sufficient guidance and limits for management, staff, and the Board. The authority does not have sufficient written restrictions on the issuance of debt, including what projects or purposes debt can fund and limitations on the maturity of the debt issued. In addition, SPSA also does not have adequate policies limiting debt service and the amount of debt outstanding, such as a total dollar amount, market value limitation, or expenditure limitation. Also, SPSA does not perform an analysis to consider the impact additional debt service will have on tipping revenues before issuing debt.

Financial Position Observation 6

Management and the Board have not established sufficient policies to ensure they perform adequate due diligence before issuing debt.

The new policies also do not address the lack of oversight on debt issuance and capital project expenses. For example, the authority's budgeted capital projects do not agree with the actual projects funded through the use of bond proceeds. As a result, it does not appear that management is ensuring that bond proceeds spent on projects are the amounts approved by the Board and included in the original budget. During our review, we noticed that SPSA spent funds on capital projects not included in the Board approved budget. Instead, management transferred the funds from a project included in the budget to a project not included in the original budget without notifying the Board. As a result, management spent capital project funds on projects not approved by the Board.

The authority also did not provide sufficiently detailed bond records for several issuances showing how management actually spent the bond proceeds. As a result, SPSA cannot demonstrate that they did not use bond proceeds to fund operating expenses, as believed by several stakeholders. Without adequate documentation supporting how SPSA used the funds, management and the Board also do not know the true capital costs for specific projects or facilities. In general, SPSA management and the Board do not have sufficient, readily available information pertaining to capital projects and their funding. As already mentioned, SPSA could not easily provide the total capital project costs and funding for the RDF and power plant facilities.

SPSA also plans to continue to issue debt for what many would consider a general operating cost and to fund repayment through operating cash. For example, in the fiscal year 2009 capital budget, SPSA included almost \$1.3 million in tipping floor resurfacing, repairing, or upgrading funded through bond issuances. By doing this, SPSA is causing its debt to increase in size for replacement or maintenance projects which most organizations fund through operating budgets.



Commonwealth of Virginia

Walter J. Kucharski, Auditor

**Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218**

September 10, 2008

The Honorable Timothy M. Kaine
Governor of Virginia
State Capital
Richmond, Virginia

The Honorable M. Kirkland Cox
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

We have audited the Southeastern Public Service Authority's (SPSA) governance, planning, operations, and financial position and are pleased to submit our report entitled "Southeastern Public Service Authority." We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Our objectives for the audit of the Southeastern Public Service Authority were to:

- Assess financial stability and performance, including viability of future operations;
- Evaluate internal management of its financial position;
- Compare operations with similar external entities;
- Evaluate the Board's involvement in the management of the authority; and
- Make recommendations to improve operations.

Exit Conference and Report Distribution

We discussed this report with management and the Board's Chairman on October 8, 2008. Management's response has been included at the end of this report.

This report is intended for the information and use of the Governor and General Assembly, management, the Board, and the citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

Regional Office
723 Woodlake Drive, Chesapeake, VA 23320
phone: (757) 420-4700 fax: (757) 424-4133
www.spsa.com

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EXECUTIVE DIRECTOR
Rowland L. Taylor
SPSA

October 15, 2008

Mr. Walter Kucharski
Auditor of Public Accounts
101 N. 14th Street, 8th Floor
Post Office Box 1295
Richmond, Virginia 23218

Dear Mr. Kucharski:

This letter is written as a portion of the response to your report relating to the Southeastern Public Service Authority of Virginia (SPSA) located in Chesapeake, Virginia (House Joint Resolution 89 / Senate Joint Resolution 65).

SPSA's responses to the "Findings and Recommendations" section of your report are attached herewith.

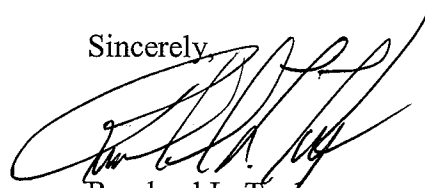
We appreciate you, Brandy Mikell and Brandon Halsey meeting with SPSA representatives on October 8, 2008 in an exit conference. We feel that changes made to the report at that time and incorporated herein reflect changes that SPSA feels are important to the report.

I would like to point out that while this response has had electronic means of presentation to the SPSA Board, no formal meeting has been held at which the responses were discussed among the members. Limited input has been offered under the tight response time required. The Board's next regularly scheduled meeting is November 12, 2008.

As you will note in the response, SPSA agrees with many of the findings and recommendations and provides some minor responses to some. It can be assured that your report will be carefully considered by SPSA and implementation will occur as directed by the Board.

With kindest regards, I am

Sincerely,



Rowland L. Taylor
Executive Director

P.O. Box 1346
Chesapeake, VA 23320-1346

Response to the APA's Report by SPSA

When SPSA was first established to provide disposal for the eight communities' solid waste there were no "private" options to meet the needs of the communities. The communities needed to close their own landfills and needed somewhere to continue to take their solid waste for disposal. Over the years since SPSA's beginning, private options have become available and in 1994 with the "Carbone" Supreme Court decision that ruled that "flow control" (requiring waste within a certain area to only be disposed of at a designated location by a locality) of the waste generated within an area was unconstitutional. This completely changed how SPSA was going to have to do business in the future but the business model previously used by SPSA continued and it was not capable of making the adjustments necessary in order for SPSA to survive in a world where competition was now readily available. Debt continued to be issued for many items which could have been funded through normal operations but would have required the communities to have paid a higher tipping fee to cover the expenses. Higher tipping fees were not viewed as a favorable option; so borrowing for capital expenses continued.

Until 1995 seven of the eight communities paid the same tipping fee. After 1995 there were only 6 communities which paid the same tipping fee; one paid its established "cap" on its tipping fee and one continued to pay no tipping fee since this was a requirement for being the "host" community for the regional landfill.

The tipping fees received from seven of the eight municipalities are still the largest sources of revenue for SPSA. However, the communities bring in only some 34% of the waste that is disposed of through the SPSA system. This means that "shortages" in revenue which cannot be made up through cuts in operating budgets must be placed on the municipal tipping fee which is a small portion of the total waste stream. This means that local municipal taxes or fees must increase (or expenses decrease in other parts of the local budgets) to cover the increases in local tipping fees. And, the emphasis to not increase tipping fees in the past to cover current operating and future costs and borrow capital funds to keep SPSA going has exacerbated the higher debt position the Board now finds itself.

Addressing this will require some rather drastic operational and policy actions by the Board over the next several months. The Board is committed to do that which will make SPSA a viable entity now and into the future.

SPSA agrees with many of the findings and recommendations in the report but does wish to note that policy changes have, in recent years, been adopted to provide greater guidance to staff. While policies are in place there have been instances where it has been very difficult to continue to consistently fund many of the future needs within the system operational requirements and maintaining a reasonable municipal tipping fee. SPSA will continue to focus on achieving its policies and operating as the solid waste management system of choice in the region.

Now to the Findings and Recommendations section of the report of the Auditor of Public Accounts. Please note that SPSA comments are provided in bold and italics and underlined.

FINDINGS AND RECOMMENDATIONS

In collecting and analyzing such data and information, the Auditor of Public Accounts shall assess Southeastern Public Service Authority's financial stability and performance, compare SPSA's operations with similar public and private entities, and make such recommendations as he may deem relevant to the purposes of this study.

The above is a direct quote from the Joint Resolution authorizing this review. Fundamental to accomplishing this charge is a comparison of SPSA's actual performance against its financial and operational plans both short and long-term. SPSA has never completed a comprehensive financial and operational plan with which to conduct such a review.

Overview

We believe that many of the actual and perceived problems with SPSA's operations come from the lack of a clear business focus and direction, which a comprehensive financial and operational plan would demonstrate. Although SPSA faces an uncertain long-term future, financial and operational planning would provide the governing body and management a framework with which to begin addressing SPSA's future direction and aid in making long-term decisions.

SPSA agrees with this finding. There have been some Board policy changes over the last several years that are providing staff with a better framework under which to operate. These policies are attached to this response.

Further, we believe that management has made a number of debt financing decisions, and taken revenue setting and generation actions and other actions without a long-term vision of their consequences or effects on the operating viability of the authority. For example, should SPSA terminate as an entity, the governing body and management need to have available the long-term funding to monitor and maintain all landfills and other such facilities after SPSA closes them for a lack of space. However, SPSA has not adequately assessed these future obligations nor funded them.

SPSA would agree with this finding.

Our review, therefore, focused on SPSA's governance, planning, operations, and financial position. There are a number of areas we believe require both management and Board attention. A vast majority of these areas focus on fundamental policy and management practices.

Historically, SPSA has used bond proceeds as a primary source of short and long-term capital funding. This ability to easily access the capital markets has allowed management and the Board to have sufficient funds to operate and expand and not forced the authority to always consider operational and financial best practices.

Fundamental Policy and Strategy

SPSA has undertaken activities that are generally contrary to best practice for a going-concern entity. Below are some examples that we further explain in this report.

- Not adequately developing and implementing a strategic plan
- Consuming assets before paying off the related debt
- Operating and pricing programs and services without calculating their associated costs
- Setting fees without knowledge of their customers' other options
- Not reassessing business decisions as conditions change
- Not adequately funding future liabilities

SPSA has the following comments to make regarding the above noted items.

- **Not adequately developing and implementing a strategic plan**

SPSA has developed several plans to assist in managing its operations. Each year a “retreat” has been held which had specific outcomes outlined. It is safe to say though that continued development and, most importantly, the implementation of those plans did not reach the full intent and purposed that can now be looked back as was needed to negate some of the current financial impact those decisions have had.

- **Consuming assets before paying off the related debt**

SPSA, during its early years, did have instances where the term of the bonds were actually longer than the expected life of some of the equipment that was purchased and put into service. This has been changed by the Board of Directors. The Board now requires that no borrowing can be for a period longer than 75% of the expected life of the item being purchased.

- **Operating and pricing programs and services without calculating their associated costs**

SPSA does not possess or use a “cost accounting” computed based software package that distributes all costs to a particular cost center. This has been due to the cost and implementation of such software and associated hardware. However, SPSA has had studies done by 3rd party consultants who have looked at the various cost centers and have made reports

regarding same. In some instances these reports have lead to the cancellation of certain programs which were not felt to provide adequate revenue above costs.

- Setting fees without knowledge of their customers' other options

SPSA has a high percentage of knowing what options are out in the area. However, SPSA is not set up under state law to make quick changes to its pricing structure in order to be competitive with options that may exists from the private sector. A good example of this is the cost of disposal of Commercial Demolition Debris (CDD) waste. With a lowering of the private tipping fee well below that of SPSA, a shortage in tons received for disposal has occurred in the current 2008-2009 budget.

- Not reassessing business decisions as conditions change

While reassessing decisions is a constant activity for SPSA, a formalized practice to insure its completion has not been followed through in all instances.

- Not adequately funding future liabilities

Again, with one of the top priorities of the Board and member communities being "keep tipping fees as low as possible", sufficient revenue has not been generated that would provided the funds needed to fund future liabilities such as landfill closure.

SPSA practices and decisions have created skepticism and raised questions among member communities and other stakeholders. The activities have brought additional attention and scrutiny on SPSA's operations and practices. Special arrangements with certain member communities, private haulers, and out-of-area haulers have caused negative public perception and tension.

SPSA agrees with the statements noted in the above paragraph.

The current SPSA Board has begun addressing a number of the issues above and needs to continue to address fundamental policy and management issues concerning governance, planning, operations, and finance. Foremost, management and the Board need to determine SPSA's future and whether it will continue its operations past 2018 when the member community contracts expire. This decision is critical for SPSA when deciding how to best operate the authority in the ensuing years.

In order to continue operations, SPSA will have to demonstrate how it adds value to the member communities within the region and meets their needs more efficiently and effectively than other options. SPSA has to show that a combined solid waste management approach better serves the region. In general, SPSA has to demonstrate the

necessity of its operations to the region by showing the region its plans for operations and financial management beyond a current budget or operating cycle.

SPSA agrees with the statements noted in the above paragraphs. It should be added that SPSA's future as an organization rests completely in the hands of its member localities. Until the localities determine if they wish to work together after 2018, "SPSA" does not know if it will need to exist. A study is currently being done by the HRPDC/CAO's that will provide some suggested answers to this very important question. The report is to be presented to the HRPDC and SPSA Boards on November 19, 2008.

Governance

In order to best operate the authority, SPSA must first address the governance of the authority. The participating localities rely on the Board to provide oversight to SPSA and its management. Without adequate governance and management, SPSA will not be able to adequately operate and plan for the future.

Member localities need to re-examine their processes and procedures for determining the qualifications and level of commitment they expect of board members. The appointing bodies need to collectively set qualification criteria and ensure that Board members understand their responsibilities and have the background and time to devote to active governance of SPSA.

Appointing bodies should consider as a qualification an individual's business experiences with a large organization. Also in the immediate future, appointing bodies should consider finding members who will have the time and effort to help draft and implement a long-term direction for SPSA.

The Board will need to establish its working relationship with management before addressing the SPSA's other concerns. Management and the Board should work together to develop and document the Board and management's responsibilities, respectively, to ensure each party knows their responsibilities. These policies should be specific with clear definition of each party's roles and responsibilities.

Management and the Board should also determine what SPSA, industry-specific, and governance training the Board should receive. Required training would help the Board enhance its fiscal, budgetary, management, and industry-specific knowledge. This training should also inform the members of their duties and responsibilities.

SPSA feels that this is a "municipality" decision which will have to be determined solely by the representatives of the member municipalities. Several good points are presented by the Report; namely, "qualification's" "responsibilities" and "... have the background and time to devote to active governance." It is imperative that the Board insures that decisions that impact the operations and business of "SPSA"

are not negatively influenced by what an individual community believes would be in its sole best interest.

Planning

As we discuss later, SPSA lacks a detailed, thought-out plan to implement its mission and determine exactly what businesses the authority should remain in or enter. Specifically, we believe that management and the Board have not determined

- its future,
- what businesses to be in, and
- how best to focus and operate its core businesses.

Completion of a specific strategic operating plan is a fundamental organizational issue that management and the Board must address to determine SPSA's directions and goals and how they intend to reach these goals. SPSA's uncertain future also adds to this lack of direction since the organization is currently waiting on the planning district's study to determine its future. In order to continue operations, SPSA will have to demonstrate its value.

Adequately planning for the future is imperative for SPSA. Management and the Board should first set a course for the authority's future, including its future after 2018, since SPSA will have responsibilities to monitor and maintain its closed landfills.

Planning should also include deciding which services and programs SPSA offers that add value to the member communities. Adding value means offering programs or services that benefit their members more than a competitor could, typically by operating efficiently and effectively. Also the plan needs to balance competing demands for keeping low disposal (tipping) fees, competition from private organizations, and realistic assumptions about future resources such as available landfill space and associated costs. Planning needs to balance long-term, future costs versus immediate savings. Keeping tipping fees low to increase revenues and solid waste supply in turn reduces the life of the landfill as it fills up quicker and creates a long-term liability for monitoring and closing it.

Management and the Board can then build a business operating plan to define their core businesses based on a preliminary analysis and plan; this will help SPSA concentrate on how best to operate these core programs. During this process, management and the Board should evaluate and modify when necessary their organizational structure and their current operating processes. SPSA should also describe the organization's structure and how processes will occur under this structure, including administrative, to support the overall strategic plan. This plan will ensure that disposing of waste in an environmentally-sensitive manner remains the authority's priority, while operating efficiently and effectively.

SPSA agrees with the content of this section. It should be noted that planning exercises have been held annually and many useful items have been forthcoming and are in place today which will address some of these findings. To reiterate, SPSA does not have the final say so regarding its future after 2018...the communities SPSA serves controls this future.

Comparing to Other Entities and Setting Targets

Without comparing its operations to other entities and setting performance targets, an organization has difficulty assessing its performance. In the past, SPSA hired a consultant to compare its operations to other entities; however, this does not occur on a frequent, regular basis and does not encompass the entire operations. As a result, SPSA has difficulty benchmarking itself to other similar organizations to aid in determining how it is functioning in the various programs and services.

As part of the strategic planning process, SPSA should consider establishing performance measures and compare these key factors to parts of other comparable entities. This would allow them to determine whether they are progressing towards meeting their strategic goals. This process would also help SPSA improve its efficiency and effectiveness by pointing out areas for improvement.

SPSA agrees that there are no other organizations that compare exactly to the SPSA organization. However, there are “parts” of some entities with which SPSA could compare itself to insure that it maintains a suitable comparability. Comparison reports have been done in the past but have not been on a continued annual bases due to cost.

Assessing Current Operations and Previous Business Decisions

Management makes decisions on current and future operations based on what they anticipate happening in the future. However, they must monitor these decisions to make sure the decision continues to be appropriate by periodically reassessing the current operating environment. In addition, management must determine whether future operating plans will have an impact on current operations and business decisions.

SPSA does not appear to have continually reevaluated its previous decisions in a current environment and determined the impact on its environment before making future decisions. For example, management and the Board do not appear to have adequately reevaluated its decision to take responsibility for the waste-to-energy facility, including the financial and operational impacts. Also, SPSA does not appear to have taken into account the potential effects on solid waste under flow control and has not subsequently reevaluated the landfill's useful life.

SPSA does not have an established process for periodically reassessing its operating environment and operating plans. In order to properly manage an organization, management and the Board should evaluate its operations and make sure that the entity

and its components are operating in an appropriate manner and that the organization should continue operating in all aspects.

SPSA feels that many decisions have been made with the primary factors being how to deal with short-term situations...how does SPSA make revenue meet anticipated expenditures.

There are other factors that were considered in the WTE takeover beyond those noted here but SPSA does feel that a more in-depth review and look may have averted many of the issues where we now find ourselves.

Costs

Currently, management and the Board have limited cost accounting information related to its operational programs and services, as well as capital project costs. SPSA does not allocate its costs and revenues to individual operations and as a result, cannot tell which areas are financially self-supporting and which areas require internal subsidies. Without this knowledge, management and the Board cannot fully assess the authority's operations to make informed decisions. With more reliable and readily available cost information, SPSA could better determine whether it wants to internally subsidize any programs or services and continue all of its programs.

SPSA agrees with these findings and recommendations.

Setting Fees

SPSA should further consider its operations and the industry before setting fees. Management and the Board should first set policy decisions regarding internally subsidizing programs and determine when to discontinue programs. In addition, SPSA should also evaluate its private solid waste disposal customers' other options before setting fees to make sure the authority is maximizing its resources. In addition, SPSA should also consider how much revenue it will need for funding future operations, debt service, and capital projects before setting rates. SPSA does not appear to have had an adequate assessment and development process to determine the ideal tipping rate to fund these policy decisions.

In addition, SPSA needs to adequately assess whether its current tipping fees will fully fund its current debt service requirements and operating costs. Furthermore, SPSA should fully develop their capital project budget by determining how they are going to fund any remaining capital projects for the next ten years, the new debt repayment plan, and the associated impact on tipping fees. By doing this, management and the Board can make any necessary changes to the capital project budget or fees.

SPSA agrees with these findings and recommendations.

Debt

Overall, SPSA does not have internal plans and policies for funding capital projects, debt issuance, and determining the impact of debt on the authority. If SPSA does not address this problem soon, it could face a significant problem in repaying all of the authority's current and future outstanding debt and make it difficult for SPSA to get adequate buy-in from the current member localities if SPSA wants to continue operations past 2018.

SPSA needs to establish adequate debt policies to provide sufficient guidance and limits for management, staff, and the Board. First, SPSA should determine whether SPSA should issue any more debt, especially considering its possible closure after 2018. Once management and the Board have decided this, they should work together to establish written restrictions on the issuance of debt, including what projects or purposes debt can fund and limitations on the maturity of the debt issued, along with policies limiting debt service and the amount of debt outstanding.

SPSA agrees with the findings and recommendations.

Future Obligations

Regardless of whether SPSA continues its operations beyond 2018, SPSA has a legal obligation to set aside funding today to meet its future obligation to monitor and maintain its landfills. Only within the last several years has SPSA begun funding this obligation. SPSA needs to make a reasonable and realistic estimate of this long-term commitment and take appropriate steps to fund this liability with sources other than debt.

In addition, member communities may have additional future obligations after 2018. If the localities do not use SPSA after 2018, the authority may still have outstanding debt service requirements. Management and the Board currently do not know who will have to fund any potential outstanding debt and interest. Both believe that the localities will have to pay any outstanding liabilities, but are not currently sure how to determine each locality's percentage.

SPSA agrees with the first paragraph. As to the second paragraph, SPSA along with legal counsel understand that there is no way for SPSA to charge any fees except the tipping fee. If there is no tipping fee after 2018 then there is no income. Therefore, all debt must be paid off prior to the termination of the use and support agreements. Under the example noted above as to what "moral obligation" the communities have to the retirement of any debt that SPSA "could potentially have" would rest solely with each municipality. The decision would not be SPSA's.

As to the chart on page 34 of the report relating to the Waste To Energy Plant SPSA would offer the following.

SPSA does not agree with the presentation of the Waste-to-Energy Facility financial information on Table 13. The analysis fails to include an allocation of tipping fee revenue for waste that is disposed of at the Facility. A reasonable allocation of tipping fee revenue, if included in the analysis, reverses the bottom line result. Specifically, tipping fees of approximately \$28.0 million per year should be credited to the Facility and were excluded in the APA's analysis. All other things being equal in the analysis, this correction would indicate that the Facility revenues exceed expenses by over \$15.0 million per year.

APA's COMMENTS ON SPSA RESPONSE

With regards to SPSA's response on page 56 concerning table 13 of the report, we do not fully agree with their calculation. Our calculation in table 13 does include an amount for avoided landfill costs to show the landfill savings of not taking the solid waste directly to the landfill.

Appendix A

Southeastern Public Service Authority of Virginia
Enterprise Fund
Balance Sheet
As of June 30, 2007

Assets

Current assets:

| | |
|---|-------------------|
| Cash and cash equivalents | \$ 2,354,830 |
| Accounts receivable: | |
| Authority members | 3,422,630 |
| Other customers | 4,351,918 |
| Allowance for doubtful accounts | (112,800) |
| Insurance proceeds receivable | 366,207 |
| Prepaid expenses | 855,616 |
| Current portion of net investment in direct financing lease | - |
| Accrued interest receivable | <u>5,123</u> |
| Total current assets | <u>11,243,524</u> |

Noncurrent assets:

Restricted assets:

| | |
|-----------------------------|-------------------|
| Investments | 55,371,370 |
| Accrued interest receivable | <u>267,992</u> |
| Total restricted assets | <u>55,639,362</u> |

| | |
|---|--------------------|
| Maintenance parts | 2,791,598 |
| Capital assets, net of accumulated depreciation and depletion | 177,563,384 |
| Intangible assets, net of accumulated amortization | 4,938,660 |
| Debt issue costs, net | <u>656,759</u> |
| Total noncurrent assets | <u>241,589,763</u> |

| | |
|--------------|-----------------------------|
| Total assets | <u><u>\$252,833,287</u></u> |
|--------------|-----------------------------|

Liabilities and Net Deficit

Liabilities:

Current Liabilities, payable from current assets:

| | |
|--|------------------|
| Accounts payable | 2,408,182 |
| Accrued expenses | 4,019,697 |
| Line of credit | 1,500,000 |
| Landfill closure and post-closure care liability - current portion | <u>2,000,000</u> |
| Total current liabilities, payable from current assets | <u>9,927,879</u> |

Southeastern Public Service Authority of Virginia
 Enterprise Fund
 Balance Sheet (continued)
 As of June 30, 2007

| | |
|---|----------------------|
| <u>Current Liabilities, payable from restricted assets:</u> | |
| Accounts payable | \$ 1,809,960 |
| Current maturities of bonds payable | 21,115,000 |
| Accrued interest on revenue bonds | <u>3,865,800</u> |
| Total current liabilities, payable from restricted assets | <u>26,790,760</u> |
| Total current liabilities | <u>36,718,639</u> |
| <u>Noncurrent liabilities:</u> | |
| Long-term debt: | |
| Bonds payable | <u>219,917,806</u> |
| Total long-term debt | <u>219,917,806</u> |
| Landfill closure and post-closure care liability - noncurrent | <u>19,000,245</u> |
| Total noncurrent liabilities | <u>238,918,051</u> |
| Total liabilities | <u>275,636,690</u> |
| <u>Net deficit:</u> | |
| Invested in capital assets, net of related debt | (34,771,625) |
| Restricted for debt service | 16,501,028 |
| Restricted for other purposes | 4,769,900 |
| Unrestricted | <u>(9,302,706)</u> |
| Total net deficit | <u>(22,803,403)</u> |
| Total liabilities and net deficit | <u>\$252,833,287</u> |

Southeastern Public Service Authority of Virginia
Enterprise Fund
Statements of Revenues, Expenses, and Changes in Net Deficit
Year Ended June 30, 2007

Operating Revenue:

Charges for services, net of bad debt expense of \$3,177 in 2007 \$81,516,135

Operating Expenses:

| | |
|---|-------------------|
| Compensation and related payroll costs | 27,346,203 |
| Payment for temporary services | 488,128 |
| Depreciation, depletion and amortization of intangibles | 18,430,007 |
| Postage, printing, and supplies | 609,290 |
| Rent and utilities | 2,029,966 |
| Equipment fuel | 2,139,994 |
| Routing maintenance and vehicle operations | 13,132,898 |
| Non-routing maintenance and repairs | 3,454,694 |
| Insurance | 1,795,933 |
| Virginia Beach Ash Disposal Agreement costs | 2,298,992 |
| Aluminum recycling | 44,382 |
| Legal and professional services | 2,195,253 |
| Bad debts | 3,177 |
| Landfill closure and post-closure care cost accrual | (3,841,207) |
| Swap waste expense | - |
| Proprietary waste expense | 450,386 |
| Other | <u>184,159</u> |
| Total operating expenses | <u>70,762,255</u> |

Operating income (loss) 10,753,880

Non-operating revenue (expense):

| | |
|--|-------------|
| Net gain (loss) on disposal of capital assets | 145,828 |
| Write down of long-lived assets | (1,376,951) |
| Net increase (decrease) in fair value of investments | 41,476 |

Interest expense:

| | |
|---|---------------------|
| Interest on long-term debt | (12,454,016) |
| Amortization of loss on defeasance | (1,727,956) |
| Amortization of bond issue costs, discounts and premiums, net | <u>159,252</u> |
| Total interest expense | <u>(14,022,720)</u> |

Southeastern Public Service Authority of Virginia
Enterprise Fund
Statements of Revenues, Expenses, and Changes in Net Deficit (continued)
Year Ended June 30, 2007

| | |
|----------------------------------|-----------------------|
| <u>Other revenue:</u> | |
| Insurance recoveries | \$ 15,948 |
| Interest income | 2,427,495 |
| Other | <u>243,306</u> |
| Total other revenue | <u>2,686,749</u> |
| Total non-operating expense, net | <u>(12,525,618)</u> |
| Change in net deficit | (1,771,738) |
| <u>Total net deficit:</u> | |
| Beginning of year | <u>(21,031,665)</u> |
| End of year | <u>\$(22,803,403)</u> |

Southeastern Public Service Authority of Virginia
Statement of Cash Flows
Year Ended June 30, 2007

| | 2007 |
|--|---------------------|
| <u>Cash flows from operating activities:</u> | |
| Receipts from customers | \$80,876,301 |
| Payments to suppliers for operations | (29,402,348) |
| Payments to employees for compensation | <u>(26,247,830)</u> |
| Net cash provided by operating activities | 25,226,123 |
| <u>Cash flows from capital and related financing activities:</u> | |
| Purchases of capital assets | (8,751,966) |
| Proceeds from sale of capital assets | 1,110,106 |
| Proceeds from insurance recoveries | 15,948 |
| Payments received under direct financing lease | 92,066 |
| Proceeds from issuance of notes payable | 15,000,000 |
| Principal payments on notes payable | (15,000,000) |
| Proceeds from issuance of bonds payable | 21,320,000 |
| Principal payments on bonds payable | (20,250,000) |
| Proceeds from bond premium, net of payment of debt issue costs | (174,504) |
| Interest paid | (12,530,764) |
| Other income | <u>243,306</u> |
| Net cash used in capital and related financing activities | <u>(18,925,808)</u> |
| Cash flows from noncapital financing activities - proceeds from line of credit | <u>1,500,000</u> |
| <u>Cash flows from investing activities:</u> | |
| Proceeds from maturity and sale of investments | 68,576,892 |
| Payments for investments purchases | (80,120,149) |
| Interest and dividends received from investments | <u>2,344,620</u> |
| Net cash provided by (used in) investing activities | <u>(9,198,637)</u> |
| Increase (decrease) in cash and cash equivalents | (1,398,322) |
| Cash and cash equivalents at beginning of year | <u>3,753,152</u> |
| Cash and cash equivalents at end of year | <u>\$ 2,354,830</u> |

Southeastern Public Service Authority of Virginia
Statement of Cash Flows (continued)
Year Ended June 30, 2007

| | |
|---|---------------------|
| Reconciliation of operating income (loss) to net cash provided by operating activities: | |
| Operating income (loss) | \$10,753,880 |
| Adjustments to reconcile operating income to net cash provided by operating activities: | |
| Depreciation, depletion and amortization of intangibles | 18,430,007 |
| Accrual of insurance premium rebate | (281,703) |
| Provision for bad debts | 3,177 |
| Landfill closure and post-closure care cost accrual | (3,841,207) |
| Changes in operating assets and liabilities: | |
| Accounts receivable | (639,832) |
| Maintenance parts | (157,290) |
| Prepaid expenses | (162,665) |
| Accounts payable - operations | 661,632 |
| Accrued expenses | 1,586,501 |
| Accounts payable - restricted | 750,166 |
| Landfill Closure and post-closure care liability settlement | <u>(1,876,543)</u> |
| Net cash provided by operating activities | <u>\$25,226,123</u> |
| Noncash transactions - increase in fair value of investments | \$ 93,745 |

Appendix B

Net Working Capital = Current Assets less Current Liabilities

Current Ratio= $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Debt per Person= $\frac{\text{Total Debt}}{\text{Population of Area Served}}$

Appendix C

HOUSE JOINT RESOLUTION NUMBER 89

Directing the Auditor of Public Accounts to collect, receive, and analyze data and information relating to the operation and finances of the Southeastern Public Service Authority of Virginia. Report.

WHEREAS, historically, solid waste had been handled in southeastern Virginia by the individual localities, with each city or county either collecting and disposing of waste within its borders or transporting the waste to a neighboring locality for disposal; and

WHEREAS, in 1973 local communities realized the need for a regional water supply system and created the Southeastern Water Authority of Virginia, and in 1976 the local municipalities also realized the need for regional management of their solid waste and agreed to establish the Southeastern Public Service Authority of Virginia (SPSA); and

WHEREAS, upon its establishment, SPSA's responsibilities included the development of a regional solid waste disposal system that included a resource recovery operation; and

WHEREAS, SPSA's mission is to dispose of waste "in an environmentally sensitive manner, minimizing damage for current and future generations and reusing waste whenever possible, turning it into a useful product"; and

WHEREAS, in 1977 the General Assembly authorized bonding authority for SPSA for the purpose of providing acquisition, financing, construction, operation, and maintenance of a water system and a garbage and refuse collection and disposal system; and

WHEREAS, in 1978 initial funding for SPSA's operation in the amount of \$3 million was provided through bond anticipation notes secured by four local communities; and

WHEREAS, during the mid-to-late 1980s, facilities were constructed with funding provided through several bond issues and staff was hired to operate its facilities; and

WHEREAS, SPSA's member localities, which include the Cities of Chesapeake, Franklin, Norfolk, Portsmouth, Suffolk, and Virginia Beach, and the Counties of Isle of Wight and Southampton, have entered into Use and Support Agreements with SPSA that require the delivery of substantially all of the waste generated within the member localities' boundaries, and these agreements will expire in 2018; now, therefore, be it.

RESOLVED by the House of Delegates, the Senate concurring, that the Auditor of Public Accounts be directed to collect, receive, and analyze data and information relating to the operation and finances of the Southeastern Public Service Authority of Virginia.

In collecting and analyzing such data and information, the Auditor of Public Accounts shall assess SPSA's financial stability and performance, compare SPSA's operations with similar public and private entities, and make such recommendations as he may deem relevant to the purposes of this study.

Technical assistance shall be provided by the staffs of the House Committee on Appropriations and the Senate Committee on Finance. All agencies of the Commonwealth shall provide assistance to the Auditor of Public Accounts in collecting the data and information, upon request.

The Auditor of Public Accounts shall submit to the Division of Legislative Automated Systems an executive summary and the data and information collected, including any recommendations, on the Southeastern Public Service Authority of Virginia no later than the first day of the 2009 Regular Session of the General Assembly. The executive summary and data and information, including any recommendations of the Auditor of Public Accounts, shall be submitted for publication as a report document as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents and reports and shall be posted on the General Assembly's website.

OBSERVATIONS

Governance Observations

Governance Observation 1

Typically, Board members are officials who also serve on their respective local governing bodies and have little or no background or industry specific information or expertise on SPSA's operations or business practices. Some governing bodies tend to appoint newer and less experienced officials to the Board. Board members also realize that they are heavily dependent on the Executive Director and SPSA staff for providing them information and analysis for decision making; however, most members do not have the knowledge base to question the analysis or ask for additional information.

Governance Observation 2

Many of the members were not entirely aware of all of these responsibilities and did not recall receiving a list of these responsibilities. In addition, by not explicitly making the Board's and the Executive Director's responsibilities well known, each party is unsure of what the other party should do and who should manage the organization and take the initiative to make strategic decisions. Confusion between the roles of the Board and the Executive Director frequently resulted in a lack of guidance to management and oversight for the entity.

Governance Observation 3

Boards employ management and therefore there must be a degree of trust in management's ability to analyze situations and make recommendations for Board action. Governance best practices also recognize that Boards may from time to time need external objective resources to review management's recommendations or provide a non-organizational perspective to an issue. The SPSA Board has not provided themselves with access to sufficient external objective resources.

Governance Observation 4

The Board frequently focused on low tipping fees and maintaining these lower fees appears to have affected many of the Board's decisions. By setting low rates and concentrating on funding most capital costs with debt, the Board did succeed in the short-term. However, focusing on low rates and short-term results coupled with a lack of effective long-term planning has had a negative organizational and financial impact on SPSA.

Governance Observation 5

Generally, localities appoint elected officials to the Board without informing the official of the actual commitment required to serve on a Board responsible for proper guidance and oversight. Board members frequently have multiple commitments to their own locality and are unable to provide much time to the Board beyond the mandatory monthly meetings. Additionally, the member localities did not provide guidance about the necessary qualifications of Board members when they created the SPSA. Without requiring board members to have a background in business or the industry, Board members do not always have the ability to properly supervise management's decisions or business practices.

Planning Observations

Planning Observation 1

SPSA's mission is to dispose of waste and the organization plans to accomplish this by disposing of waste in an environmentally-sensitive manner, minimizing damage for current and future generations and reusing waste whenever possible, turning it into a useful product. Management and the Board have not completed an appropriate operating plan as to how the authority will achieve its mission and its supporting goals.

Planning Observation 2

Management and the Board do not always focus on assessing and responding to its current core business environment and developing strategies and competitive advantages to improve its current operations. Instead, management and the Board are devoting their time and resources on other business ventures and not on SPSA's current core business environment and its future direction.

Planning Observation 3

Management and the Board have not established a detailed strategic plan, set all of their long-term goals, or assessed the viability of the organization after the use and support contracts expire in 2018. In addition, we believe that management and the Board have not determined which businesses they should be in and how best to operate those businesses. Management and the Board should establish a strategic operating plan which includes identifying core business units and determines how each business unit and the administrative section will support the overall strategic plan. This plan would ensure that disposing of waste in an environmentally-sensitive manner remains the authority's priority, while operating efficiently and effectively.

Operations Observations

Operations Observation 1

As the tipping fees continue to increase, SPSA's opportunity cost will decrease as the contract will cost more in lost tipping fees. On the other hand, the value of Virginia Beach's tipping fee cap will increase to the city, due to the increasing spread between the two tipping fees.

The special arrangements with Suffolk and Virginia Beach have a significant impact on SPSA. Not only has SPSA forgone tipping revenues from these localities, but many in the public have a negative perception of these arrangements. Other communities perceive these agreements as an inequity, especially since SPSA only recently began delivering ash to Virginia Beach to use their side of the agreement. Others do not believe that Virginia Beach and Suffolk have the same commitment and point of view for SPSA's decisions since raising tipping fees would have little impact on their locality. This creates tension among the remaining member communities.

Operations Observation 2

Individual locality tipping rates are subsidizing the special rates for Suffolk, Virginia Beach, the private haulers, and out-of-area operations.

Operations Observation 3

By not knowing how much their landfill costs are and how much the costs are for their out-of-area customers' other options, management does not have enough information to appropriately set a tipping fee. Management should compare the out-of-area haulers other options to SPSA and take this assessment, as well as the cost assessment, into account before setting an out-of-area waste fee.

Operations Observation 4

Management did not fully consider all of the factors that would affect the useful life of the new cell. Specifically, SPSA did not evaluate the impact of flow control on the amount of solid waste disposed with SPSA and reevaluate the original estimated life of the new landfill cell and modify it as necessary. Such an analysis would allow SPSA to determine whether the regional landfill has the capacity through the end of the member use and support contracts.

A significant change in flow control could affect the amount of solid waste SPSA will landfill. A significant change in the amount of solid waste placed in the landfill will affect the useful life of the landfill. However, SPSA did not attempt to factor in and project the change in quantities received from the

private haulers when estimating the useful life of Cell VII. Therefore, the current landfill and Cell VI may not meet SPSA's disposal needs through the end of the current member use and support contracts.

Operations Observation 5

Not having a business focus in determining how SPSA should operate to fulfill its mission has impacted the setting of tipping fees and also resulted in not properly considering the capacity of the landfill. Clearly, SPSA has a focus on revenue and not the entire cost of operations. Increasing volume does generate more revenue; however, there are no discussions of who should pay and how much, coupled with the longer term cost to the organization of having to maintain an old landfill and replace it.

Operations Observation 6

Even though some of the consultants' projections were not accurate, management did not appear to continue to critically re-evaluate their situation, environment, assumptions, and decisions to determine how the waste-to-energy facility should operate and who should operate it. SPSA manages the facility internally at significant operating and capital expense costs. For example, in 2009, management and the Board estimate spending \$27.5 million in operating costs and \$13.7 million on capital projects.

Operations Observation 7

One factor in not reassessing the information is the difficulty in obtaining reliable cost allocation information for expenses and bond data. For example, management was unable to provide us with actual capital project expenses by fiscal year for the RDF and power plant by fiscal year. As a result, management and the Board would also not know how much funds they spent and how much debt the entity incurred to operate the RDF and power plant facilities. Without this information readily available, management and the Board cannot make an informed decision about the future of the facilities. If SPSA staff collected this information in the future, they could provide decision makers with all of the necessary information needed to make an informed decision.

SPSA is now considering selling the waste-to-energy system under the Public-Private Education Facilities and Infrastructure Act of 2002. Interested private companies submitted proposals addressing how the company would operate and receive solid waste. As of August 2008, four companies have submitted bids to purchase the waste-to-energy facility from SPSA. If SPSA sells the facility, the Board anticipates using the proceeds of the sale to retire a portion of the debt outstanding.

If SPSA does not sell the waste-to-energy facility, then management intends to continue to operate the facility. We prepared the following table to show a scenario of potential costs and revenues (or avoided costs) over the next five years if SPSA continues to operate the facility. This scenario is for illustrative purposes to show the potential impact to SPSA.

Operations Observation 8

SPSA has not performed their own detailed analysis for operating the waste-to-energy facility to avoid having to further increase the tipping fee, issue more debt, or cut costs and/or programs in another area. Such an assessment and evaluation for alternatives could include leasing the facility, contracting with a private vendor to operate the plant, selling the facility, modifying operations or production, or reducing capital and/or operating costs. Management has not identified all of their potentially viable options and assessed each one, including determining the potential costs and revenues associated with each option. This assessment should include opportunity costs and avoided costs, as well as non-monetary factors, such as the impact on the environment.

Operations Observation 9

SPSA does not have a thought-out and established process for periodically reassessing its operating environment and previous decisions. In order to properly manage an organization, management and the Board should evaluate its operations and make sure that the entity and its components are operating in an appropriate manner and that the organization should continue operations unchanged.

SPSA also does not have an adequate process for tracking and allocating costs to individual capital projects and operational costs to programs and facilities. As mentioned previously, SPSA does not currently have a readily available method for identifying and allocating its actual costs for capital or operations by program or facility. SPSA does not allocate its costs and revenues to individual operations and as a result, cannot tell which areas are financially independent and which areas require internal subsidies. Without this knowledge, management and the Board cannot assess its operations to make informed decisions.

Financial Position Observations

Financial Position Observation 1

Although SPSA is aware of the amount of debt outstanding and has raised their municipal tipping fee rates, management and the Board have not

developed a detailed plan on how they intend to repay their currently outstanding debt and new issuances over the next ten years. Specifically, SPSA raised the tipping fee to \$104 and later plans to lower the fee to \$80 a ton under flow control; however, the authority has not performed a detailed analysis of how much additional revenue this will generate or how much additional revenue the organization will need to repay their debt and fund current operations and closure costs. In addition, SPSA does not know how much additional revenue they will need to fund future debt issuances, as mentioned below.

Financial Position Observation 2

SPSA does not have a policy directing a periodic analysis to drive the tipping fees. This lack of analysis may have contributed to the constant changes in the tipping fees since the organization does not fully calculate the impact before modifying rate structures.

Financial Position Observation 3

SPSA does not appear to have an adequate assessment and development process to determine the optimal tipping rate to fund their policy decisions. Instead, the Board was aware of the need to raise additional revenues but SPSA did not perform a detailed analysis to calculate an appropriate estimated amount needed and the subsequent associated tipping fee rate.

Financial Position Observation 4

By not developing a formal financing plan, the Board has more difficulties measuring the success of the new financial policies, including cash funding more projects. SPSA has not developed a funding plan for the entire five-year capital project, including details on how much debt the organization will issue, the debt repayment plan for the new and existing debt, and the revenue which will repay the debt.

Financial Position Observation 5

SPSA has not developed plans for funding capital projects and the impact on the authority. By establishing these plans, the organization will not further defer the potential problem of repaying all of the authority's current and future outstanding debt.

Financial Position Observation 6

Management and the Board have not established sufficient policies to ensure they perform adequate due diligence before issuing debt.

RESPONSIBLE OFFICIALS

Southeastern Public Service Authority

Rowland Taylor
Executive Director

Board Members

Donald Williams
Chairman

Ray A. Smith
Vice-Chairman

Michael Barrett
Leroy Bennett
James Brown
Bryan L. Collins
Dallas O. Jones
Barry W. Cheatham

