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The Impact of Waste Industry Consolidation on Recycling

by

Peter Anderson, Joan Edwards, Michael Garfield, Judi Gregory, Gary Liss, Eric Lombardi and Peter Montague

After months of rumors that the waste giant's material recovery facilities were on the auction block, Waste Management's recycling chief, Steve Ragiel, told audiences last summer that the company has recommitted itself to recycling and wants to be a partner in future recycling activities —

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> "There has been a fair amount of discussion and rumor about the future of recycling [at Waste Management]. It's a service our customers want and it's a core part of our business. ... A very clear decision was made that we will be in recycling collection and processing for the long term."[1]

Certainly, it should be acknowledged that Steve Ragiel is an eminently responsible individual. That said, however, it does not follow that his fine *personal* intentions define the *institutional* role that the waste giant will play in recycling's future. Here's why that larger canvas needs to be examined.

To attract the kinds of massive capital infusions and financial leverage needed to consolidate the once fragmented waste industry, companies like Waste Management have had to issue stock and become publicly-traded firms. As such, they answer to their investors' immediate financial interests or they will be out pounding the pavement looking for another job. Just ask once high-flying CEOs, Messrs. Buntrock, Ranke, Rooney, Drury or Proto, who failed to produce promised profitability and were unceremoniously heaved over the side.

Thus, in the final analysis it makes little to no difference how committed Mr. Ragiel is to recycling, notwithstanding our deep appreciation for his best efforts. The question for those looking for private partners to help sustain and widen recovery efforts is —

> *What are the fundamental financial interests of waste industry consolidators like Waste Management (or Allied, Republic or any of the regional consolidators), and how do they support or conflict with the goals of recycling?*

For it seems wholly inappropriate to ask new Waste Management CEO Maurie Myers to violate his fiduciary responsibilities to the company's stockholders if the expansion of recycling threatens waste industry profitability.

Thus, the answer to the defining question might be better found in what Waste Management is telling Wall Street. While Mr. Ragiel assured recyclers at the Paper Recycling 2000 conference in

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1 Jim Johnson, "Waste giant sticks with recycling," *Waste News* (Jul 7 '00).

Atlanta that Waste Management had recommitted to its recovery efforts, the company's financial officers had earlier been briefing Wall Street analysts like those from Morgan Stanley Dean Witter with the real story. Out of those briefings, the investment house reported —

> "For nearly a decade, recycling has decimated aggregate volume growth in the traditional waste management business ... [R]ecycling has long been the enemy of the solid waste industry, stealing volumes otherwise headed for landfills ... [R]ecycling has reached a saturation point in the U.S. and should therefore not be nearly as large a threat to solid-waste companies going forward as it has been over the past decade. ... [L]ess recycling should lead to accelerating disposal volumes, which in turn should lead to pricing leverage for landfill operators."[2]

Why, though, would recycling be a threat to profitability? To find out, look at the pressures consolidators are under from Wall Street and the private equity pools that stepped into the breach when the public markets fled in the last meltdown of the waste sector in 1999.

A short walk down the garbage industry's memory lane shows why the interests of vertically integrated consolidators — though not those of local haulers — diverged from recyclers a decade ago. As diversion of waste away from landfills began to reach significant levels, the lever for racking in the kind of premium profits that lures investors became wobbly.

For, absent those levers, at its core the waste industry is actually a low-tech, low margin business without any scale economies past the local level. That sort of industry is simply not capable of meeting their investors' expectations. Just ask the protagonists themselves:

> Allied CEO, Thomas Van Weelden, has defined the operating philosophy that prevails when he successfully took over BFI, four times old Allied's size: "'The reality of this business is that it's local. There's no great synergy in running businesses in Chicago and Indiana, let alone in the Northeast, from here .... These markets are extremely unique, with their peculiarities in the labor force, the type of equipment, the climate...We have never bought off on the philosophy that you can make grand decisions from a corporate headquarters.'"

> John Drury, commented as he reached the pinnacle of success when his third ranked company took over first ranked Waste Management: "I was always surprised when Waste changed its name to WMX Technologies, because there is no significant technology in this industry."

> Waste Management and later Republic co-founder Wayne Huizenga reflected at the close of the century that "we still pick up the waste pretty much as we did in the '70's."

So how, then, have the national waste companies competed for capital in the big leagues with advanced technology firms that make outsize profits? At the very beginning when they were just

2 Morgan Stanley Dean Witter, *Environmental Services*, "Solid-Waste Pricing Debate Intensifies," March 2, 1998.

aggregating inefficient small haulers with a couple of trucks into regional operations, real synergies were often captured by the acquisitions. These sometimes did generate extra profits over the prior run rate that had determined the purchase price. But, as time went on, the little fish remaining in the pond became a minor piece of the action, and most of the capital went into stitching together national, and for a while, international conglomerates. By then, there were no more economies to capture: just dead weight to absorb. The consolidators became relegated to satisfying Wall Street's thirst for high margin businesses with legitimate but thoroughly deceptive accounting anomalies that are permissible when a corporation continues merging and acquiring other firms, and, allegedly, with collusion and accounting fraud.

But, exposure in the financial press and hefty judgments in criminal and civil court cases slammed the door on those options by the beginning of the 1990's. That left the consolidators — whose ill-fated, grandiose diversification efforts had compounded the problem — in a precarious situation. Ironically, had it not been for the Environmental Protection Agency (EPA), the consolidators probably would have been broken up into pieces by takeover artists years ago.

Historically, when 20,000 unlicenced open dumps littered the landscape, access to disposal was not a constraint on competition. But, in 1991, the "Subtitle D" landfill regulations promulgated by EPA erected very high barriers to entry into the disposal market for the first time. The process effectively required $25 million to $100 million to be put at risk just to seek an operating permit in a proceeding that can consume 10 years or more to complete.

Since the independent hauler who might threaten the waste oligopoly has to go somewhere to offload when his or her trucks top out, those engineered landfills also became a bottleneck in the waste business. Once the vertically integrated firms lock up control over disposal in an area, new upstarts become subjected to price squeezes at the dump until they can no longer compete.

> "We don't fear competition on the street, said [Jerry] Antonacci [of Crown Waste Corp., NYC]. 'Our fear for the future is the dumps. The public[ly traded] companies control the dumps, and if they want to raise the price to $70 a ton, they can — with a snap of their fingers — put everyone out of business.'"

This is precisely what the consolidators, after decades of mergers and acquisitions, are finally poised to pull off in many parts of the country that do not have publicly-owned landfills serving as safety valves. As that goal crystalizes, market power — the ability to impose above-market pricing free from competitive threats — is created. That can finally make it possible to meet investor expectations from their core operations. It might be useful to show graphically the power that these forces impose on the managers at the trash companies.

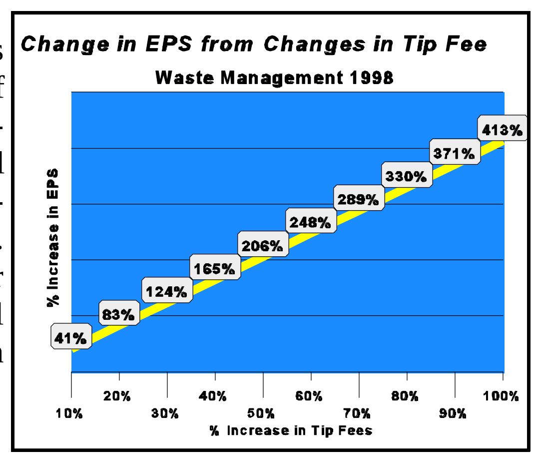

FIGURE 1

FIGURE 1 shows how Waste Management's profitability, reflected in its earnings per share (EPS), soars when market power enables the company to be able to pump up the tip fees at its landfills.[3] Just a 10% increase in disposal charges above fair market rates flows right to the bottom line, and its profits jump 41%.

A real life episode is especially illuminating of how this can play out. In 1998, after Waste Management had acquired Eastern Environmental, a major regional waste hauler in the Northeast, the company thought it had attained control of that market and jacked up tip fees by an average of 89% in vulnerable areas. Although it turned out that the company's perception of market control was premature in that particular instance, the graph illustrates that an across-the-board 89% tip fee increase converts into a *370%* updraft in profits. That kind of windfall can be expected to dampen the recycling enthusiasm of anyone who occupies the executive suites in Houston or Scottsdale. They are hardly likely to want to divert more waste flows from their landfills that generate premium profits merely because recycling might advance the broader public good. That is not meant to be critical or judgmental. It is just the facts about how our economy operates.

Only two threats to the coming endgame keep the consolidators on the edge of their seats. One is the possibility of antitrust enforcement. However, preoccupied with their gargantuan cases against Microsoft and America-On-Line, Justice Department and Federal Trade Commission regulators have not had the time to devote significant resources to the mundane garbage industry. The other threat — one that remains stirring restively on the table — is independent recycling.

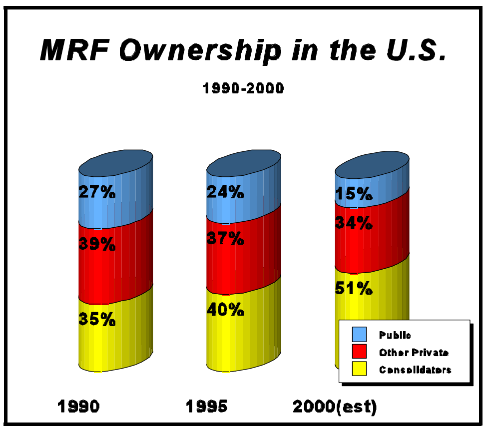

FIGURE 2

Why recycling? Because as the price of landfilling rises, the economic incentive mounts for factories, stores and public works departments to search out alternatives to disposal instead of setting out their discards in dumpsters. This mirrors the same way energy consumers turned to conservation in response to the oil embargo in the early 1980's to avoid gas prices that had tripled at the pump.

Were recycling to expand to aggressively capture residential mixed paper like Seattle, and were cities to follow and expand upon San Francisco's demonstration of wet/dry composting programs, less than 25% of the waste stream would be left for Waste Management's landfills. Reduce disposal to that minor a fraction of the pie and the leverage that currently derives from control over landfills evaporates in the morning mist.

How, then, will the consolidators try to prevent that from happening? Taking control over processing capacity would seem to be the simplest thing that would come to mind for the garbage companies. If the vertically integrated haulers also lock up control of an area's MRFs— just as they

[3] Calculated from WMI's 1998 income statement in its Form 10-K.

almost have for landfills — then they can exploit that gatekeeper power. They could claim, as an example, that it is not economic for a city to expand into residential mixed paper. This even though it is well known by insiders that three-quarters of mixed paper is actually very valuable near-office paper quality, despite most people perceiving it to be unmarketable low-grade paper. Think $75/ton for that office-like fraction netting against $20/ton additional sort cost.

Similarly, they will have no use for wet/dry collection at their sorting facilities. That rejection would make composting economically impossible to pursue. For, in the end, separate collection of decompostibles may need to be done using a fleet of dual two compartment trucks, with recyclables collected in one compartment and wet discards in the other on the same truck that can unload at one location. Should Waste Management have the only MRF in town, and refuse to expand into composting at the same site, the collection vehicle would be required to go to two separate sites to queue, scale in and tip. The total time to offload would increase from 40-60 minutes to a 1½ - 2 hours, killing its economics.

Then, too, when the consolidators control all of the MRFs in a region, the price for processing can be increased above market rates, making recycling look less attractive than it would be with true competition. In all this, the interests of the consolidators that span the continent are very different from local trash haulers who are not vertically integrated into disposal. Absent the transformation into publicly traded firms which pursue control over landfills to lock down sky high profit margins, the home town firm can be perfectly happy with the additional profits rolling out a second fleet of trucks on the routes for expanded recycling. As such, local, independent haulers, especially those with healthy recycling operations, can represent a constructive alternative for communities looking for waste services from companies whose economic incentives are not hostile to recycling.

Do the facts on the ground bear this out? In the last decade, the consolidators' involvement in MRF processing on a weight-adjusted basis has grown from a third to more than half as shown in FIGURE 2.[4] This has occurred as the importance of consolidators' control over processing has become increasingly self-evident. Today, across wide swaths of the country, Waste Management, now with 112 MRFs in its quiver, is the only processing game in town.

Waste Management has never challenged any of these facts. What they have replied is that they must serve their customers and, if their customers want recycling, that is what the company will happily provide. There is an element of truth to this, and that ought to be acknowledged. But what that defense misses is the key difference between *continuing* the programs that now exist and *expanding* them to the next level.

It is certainly correct that the political fallout from frontally assaulting the current generation of recycling services could unleash a backlash that would trim any monopolist's sails. Nevertheless, it is an entirely different matter when one turns to the recovery of new materials. In much of the U.S., local recycling programs are beginning to report slow deterioration in their recovery fractions. Most

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4 Government Advisory Associates data base.

are just trying and would be happy if they could hang onto what they have got. Consequently, little of the negative reaction that would greet a refusal to keep collecting today's palette of recyclables is likely if a waste company finds a thousand-and-one good sounding reasons why expanding programs is not practical.

Worse still, this last line of defense is also wobbly, even if we look past the occasional horror stories that crop up from time to time and focus on corporate policy. BFI has thrown glass off the truck in dozens of towns by offering as corporate policy two-tier service, with seductively lower fees for cities that "choose" non-glass programs.

For Waste Management's part, Steve Ragiel told reporters after a meeting with company brass where he convinced management to back down from a planned announcement to jettison much of the recycling division: "[y]ou'll see a renewed focus on turning the spigot off when prices go down." This seemed to be indicating that his company will damp down on its collection efforts in response to price dips in the future, hardly a prescription for maintaining public support for these programs.

Waste Management also says it is about to become heavily invested in a massive conversion to capital-intensive single-stream processing. They say the changeover is to improve efficiency, but any improvement in cost seems likely to come directly at the expense of recycling. Early indications suggest that 20%-30% (and some say more) of the recyclables that were carefully separated by residents will not be sorted out for market at these high speed, heavily automated MRFs. Instead they will be hauled to the landfill as rejects. Successful 35% recovery programs as measured on the truck would succumb to an anemic 25% recovery at the MRF; once soaring 50% programs become pedestrian 35% efforts. In addition, half the newsprint and glass — the vast majority of the material that is recovered — looks like it is winding up being down-cycled to markets that waste resources, loose value and may not be self sustaining. All this could eventually push recycling down a slippery slope to oblivion.

Short-term cost pressures on municipalities led many to see BFI's lower price for non-glass pickup as worth the loss in recovery. Similarly, the "cost" advantage of these mega-MRFs may make it hard for independent MRFs to compete on price and remain in business as a safety valve for recyclers when those dedicated processors' strength lies in recovery. For increasingly — and doubly so if American hits an economic downturn — municipalities' mantra is "cost, cost and cost."

The only other thing that Waste Management has pointed at to justify epaulets as top gun recyclers is their cooperation with local or producer-sponsored recovery programs of used computers and other items banned from or unwanted in landfills. But, these programs, though worthy, are pursued for reasons of hazards management, not diversion.

Computers are projected to be less than 1% of the discarded waste stream, of which presumably less than half would actually be diverted from the landfill by those programs. Recycling computers makes sense for monopolists and environmentalists alike because it keeps the *toxics* like lead, mercury and cadmium that are in the console out of the ground where they might both poison drinking water and trigger expensive cleanup costs. However, though the company does deserve credit for those things it does well, in the big picture these programs have almost nothing to do with increasing aggregate *recovery* that would upset their monopoly applecart. Expand recycling and that would spell the end of the consolidators' empire that they have been clawing and scrapping to capture for thirty years. The consolidators simply cannot afford to let that happen, and recyclers need to understand this irreducible fact. Again, that is not to say the waste companies are doing anything wrong for which they warrant being criticized. They are following their legitimate interests as they are entitled to do. Just as we do. Unfortunately, their interests are not the same interests as ours. In fact, they are diametrically opposed.

If we do not come to understand the financial facts of life and pursue partners with common or at least overlapping interests instead, we are deeply concerned that recyclers will come to have an exceedingly difficult time achieving their objectives. Indeed, after a dozen years of our own struggles, a trajectory is now in sight to gain 75% or more of the way to zero waste. We could let that golden opportunity slip through our fingers if we permit those with opposing interests to define the feasibility of following that bright and shining path. ❒

Peter Anderson is executive director of the Center for a Competitive Waste Industry, Madison, WI; Joan Edwards is president of J. Edwards & Associates, Los Angeles, CA; Michael Garfield is director of the Ecology Center, Ann Arbor, MI; Judi Gregory is president of Global Waste Recycling, West Covina, CA; Gary Liss is a member of the Executive Committee of the Independent Recyclers Council of the California Resource Recovery Association; Eric Lombardi is executive director of Eco-Cycle, Denver, CO; and Peter Montague is director of the Environmental Research Foundation, Annapolis, MD.

To read the shorter version of this report excerpted in the June 2000 issue of* MSW Management *magazine, click on the BACK button and select "Consolidation and Recycling — Magazine Excerpt."