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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

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

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.

> "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."

That said, however, it does not follow that such 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.

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 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."

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 look at waste history 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.”

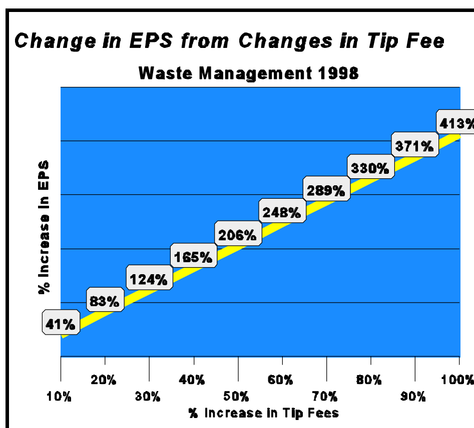

FIGURE 1

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 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 aggregating inefficient small haulers, 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.

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 has to go somewhere to offload when his or her trucks top out, those engineered landfills also became a bottleneck in the waste business. “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 shows how Waste Management's profitability, reflected in its earnings per share (EPS), soars when market power enables the company to be able to increase the tip fees at its landfills. Just a 10% increase in disposal charges above fair market rates flows right to the bottom line, and its profits jump 41%.

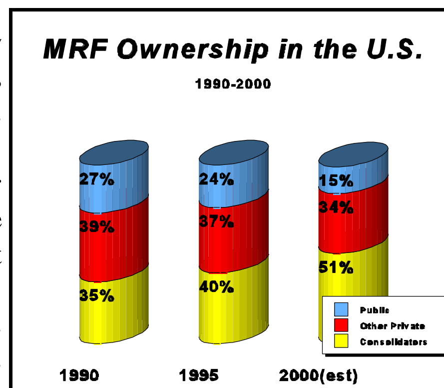

FIGURE 2

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 raised 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. Beneficiaries are hardly likely to want to divert more waste flows from their landfills

Only two threats keep consolidators on the edge of their seats. One is the possibility of antitrust enforcement--not currently high on the Justice Department and Federal Trade Commission list of commitments— and independent recycling.

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. 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 disposal. Reduce disposal to that minor a fraction of the pie and the leverage that currently derives from control over landfills evaporates.

How, then, will the consolidators try to prevent that from happening? Taking control over processing capacity would seem to be the simplest method. If the vertically integrated haulers also lock up control of an area's MRFs— just as they almost have for landfills — then they can exploit that gatekeeper power.

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 a consolidator 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 could increase from 40-60 minutes to a 1½ - 2 hours, killing its economics.

Then, too, if consolidators control all of the MRFs in a region, they have the opportunity to increased prices 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. 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 replies that it serves the needs of its customers and, if its 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.

While the political fallout from cutting the current generation of recycling services could unleash a backlash, it is an entirely different matter when one turns to the recovery of new materials. In much of the US, local recycling programs are beginning to report slow deterioration in their recovery fractions. Most are just trying and would be happy if they could hang onto what they have got. Consequently, there's little incentive for recyclers of any stripe to dive into new programs.

Waste Management 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 some suggest that 20%-30% of resident-separated materials will not be sorted out for market at these high speed, heavily automated MRFs. Instead they will be hauled to the landfill as rejects. 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, lose value, and may not be self sustaining.

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' are finding it expedient to choose lower cost options over the maintenance of high service levels.

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 don't take action to insure a competitive marketplace for materials recovery. ❐

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.

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