



CONSOLIDATION AND RECYCLING IN THE TWIN CITIES

**Consolidation's Impact on Price Increases For Waste and Recycling Services
and on the Need to Maintain Local Control Over Processing Capacity
for the Twin City Region's Recyclables**



Courtesy NREL

A REPORT TO THE ST. PAUL NEIGHBORHOOD ENERGY CONSORTIUM



July 2000

Acknowledgments

The generous assistance of Norm Shiferl and Michael Reed from Ramsey County, Bev Schomberg from Dakota County, Adam Frederick from Washington County, Don Kyser from the Minnesota Office of Environmental Assistance, and Mary Ayde from the Minnesota Waste Association in helping compile the data used in this report was invaluable, although they had no role or responsibility for the interpretations made of that data. Special mention is also due to the indispensable data base of information on the area's waste sector maintained by the Solid Waste Management Coordinating Board and its member counties.

Peter Anderson
Madison, Wisconsin



C O N F I D E N T I A L

Executive Summary

This report analyzes the impact of consolidation on the Twin Cities market for waste services and the ways in which that trend directly relates to Ramsey County's and St. Paul's decision whether to continue a public role in processing the area's recyclables after January 1, 2001, when the County's Rice Street Materials Recovery Facility, currently operated under contract with Waste Management, is scheduled to be shuttered.

Though the present waste market in the Twin Cities is currently competitive and two points of uncertainty exist that affect future predictions, Waste Management appears on track to complete a well-worn course it has traveled many times before. That path is one from which the company seems likely to soon emerge dominant in this market, be capable of quashing any problem-pricing competitors, and, if past conduct anticipates future behavior, may be expected to impose monopoly rents.

Were it not for this significant prospect of a regional garbage monopoly or cooperating duopoly, the decision whether to build a new public processing facility for the area's recyclables could be looked upon solely in terms of the traditional debate over privatization.

But, the looming threat of monopolization brings a whole new element into that controversy. For the only tool which the six counties in this region have to protect their residents and businesses from exorbitant trash bills is by ramping up recycling. In this way, they can divert material away from the waste stream and around the coming cartel's stranglehold over landfills. That is why the decision to retain public control over this escape hatch is so significant. Leave processing of recyclables in Waste Management's hands, and it would be probably not be prudent to expect the company to enthusiastically cooperate with an effort to expand the materials processed at its facility. For that would be contrary to its own interests.

With a regional \$400 million dollar waste tab, the Twin Cities can ill afford to leave itself open to the kinds of tipping fee increases — ranging upwards as high as 138% — that Waste Management may have flagged its willingness to impose on vulnerable regions.



Introduction

Since 1970, the key characteristic of the once fragmented solid waste industry has been an accelerating wave of consolidation and privatization across the United States. That pattern is being mirrored in the Twin Cities.

Against this backdrop, after offering recycling service for ten years, Ramsey County and St. Paul are now asking whether, in the future, they should play a role in supporting public operation of a materials recovery facility (MRF) to process the area's recyclables, or yield control of the field to the largest of those consolidators, Waste Management (WMI).

Broad overarching questions also arise out of these trends that directly intertwine with these issues for the County and City. They can be summarized as follows:

- ▶ BROAD QUESTION. Consolidation and privatization of recycling plants, just as with hauling and landfilling, play out against a broader framework which asks what this all means for competition. Will consolidation reduce competition to the point where monopoly prices are imposed on solid waste and recycling services? With a total bill for waste and recycling services in Ramsey County of upwards of \$90 million, every 10% price hike above the fair market rate translates into a \$9 million tax on its local governments, citizens and businesses. To calculate the regional impact, multiply that by a factor of 4×. And, with stakes as high as that, planning ahead is crucial if local decisions can lessen the monopolist's grip on the waste market. One key way to sidestep overcharges for waste disposal is to separate more recoverable material from the waste stream for recycling. But, to do that requires a processing facility willing to and capable of handling all of the new material that is being diverted from waste hauling.
- ▶ IMMEDIATE ISSUE. Ramsey County has provided a MRF to process the area's recyclables since 1990 when the private sector was less involved in recycling. However, today the County has questions about continuing some commitment in the face Waste Management's offer to provide all the area's processing. Viewed narrowly, this decision could be considered solely as a debate over privatization. However, a broader perspective is critical because *control over processing recyclables* carries with it the *ability to impede the expansion of recycling*. Ceding authority over processing recyclables to the consolidators may not only effect the ability of the County's municipalities to maintain quality, but also, could jettison the public sector's leverage to constrain monopoly power in the Twin Cities' waste industry. In the same manner, it could compromise their ability to work toward the proposed goal announced by Minnesota to eliminate land disposal of unprocessed waste by the year 2008.



C O N F I D E N T I A L

To understand how consolidation is interconnected with so many key issues facing Ramsey County requires first an understanding of the underlying structure of the industry and the consolidators who have transformed the garbage business from small local haulers into national, multibillion dollar corporations. Then those concepts can be applied to the situation in Ramsey County and the rest of the Twin Cities' region.

History of Consolidation and Its Impact on Prices

Beginning in Chicago and Houston as small companies with big dreams, Waste Management and Browning Ferris introduced consolidation to the fragmented waste industry in the years leading up to 1970. They brilliantly stroked the capital markets, convincing them to finance the “roll up” of local haulers across the country which were stitched together into national waste companies. As the decades passed, the small independents continued to be taken over at a rate of hundreds each year, year after year (see FIGURE 1 along side¹), with Waste Management winding up composed of 3,000 once independent haulers, just before it was taken over in turn.²

For a long time, the juggernaut seemed unstoppable. But, by the mid-1990’s, WMI and BFI had become hemmed in from several directions. On one side, investors downgraded the industry’s stock because of a series of major missteps that flattened earnings — landfill additions wildly exceeded demand, and product extensions into hazardous waste disposal and territory expansions in Europe misfired, all of which was followed by accounting chicanery intended to hide the carnage that was soon exposed.³

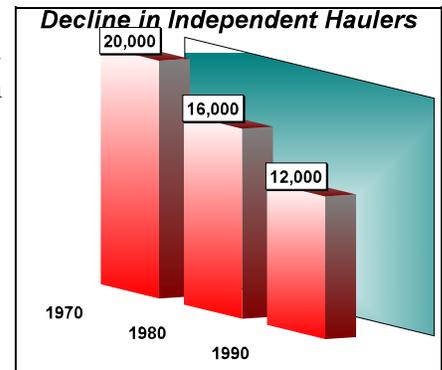


FIGURE 1

On the other, Justice Department regulators seemed to be breathing down their necks with a notice of a national investigation, following close on the heels of the devastating *Cumberland Farms* private class action antitrust lawsuit.⁴ Waste Management perceived that any attempt to pick up the pace of acquisitions, previously limited to the slow process of buying small private haulers, by merging with other large publicly-traded companies would be dead on arrival at the agency’s Anti-Trust Division. “You used to hear Waste Management say, ‘We can’t acquire this,

¹ *Waste Age* (May ‘97).

² Waste Management, SEC Form 10-K (Mar 30 ‘00), at Ex. 21.1.

³ J. Bailey, “Slump at Hazardous-Waste Dumps Raises Concerns: As Fat Profits Fizzle, Fund for Future Monitoring May Fail to Keep Pace,” *Wall Street Journal* (Aug 5 ‘94).

⁴ B. Richards, “Waste Haulers Face Charges of Nationwide Price Fixing,” *Wall Street Journal* (Feb 17 ‘88); S. Daniels and K. Paul, “Waste giants settle in antitrust probe,” *Waste News* (Feb 19 ‘96).



C O N F I D E N T I A L

we can't acquire that,' because of antitrust concerns,' says Melissa White, a waste-industry analyst at Piper Jaffray Inc. in Minneapolis and a former Waste Management finance officer.”⁵

John Drury, who had previously been deposed as president of BFI following concerns about his links to antitrust activity that were alleged in a national class action suit,⁶ led the industry back to the promised land. He used his connections with Sanders Morris Mundy, a private equity pool where he had wound up after being separated from BFI, to convince investors that the Justice Department would acquiesce to ramping up to take over other regional consolidators. The problem in the industry, he said, was that Waste Management and BFI “got diverted, and they took their eye off their really significant assets, and we're not going to do that. Our philosophy is keeping it simple and really focusing on collection and transfer and disposal, which is our power alley.”⁷ “Power alley” was a great turn of phrase. He had learned the art of the deal well.

From that point on until recently, the investors jumped back on board and consolidation advanced from taking over small independent operations to acquiring other publicly traded consolidators. This accelerated the race to the finish line dramatically (*see* TABLE 1 below⁸).

⁵ J. Bailey, USA Waste Is on a Mission to Expand in Trash Business; Highflying Hauler Dares to Pursue Acquisitions, Despite Antitrust Concerns,” *Wall Street Journal* (May 15 ‘98).

⁶ *Cumberland Farms v. BFI* (D.C.E.D.Pa., Case no. 87-3717), Plaintiffs’ Memorandum in Opposition to Defendants’ Motion for Summary Judgment (July 27 ‘90).

⁷ B. Brown, “USA Waste swallows the leader: No. 3 outfit snares WMI,” *Waste News* (Mar 16 ‘98).

⁸ Compiled from company Form 8-K’s filed with the Securities and Exchange Commission.

The rate of acquisitions accelerated to such an extent that, notwithstanding a bumpy journey, last year, Deutsche Bank analyst Mari Bari called investors' attention to the fact that, after the 30 years of accelerating acquisitions in the waste industry that followed, "[c]onsolidation could wind down by 2001" because there are now so "few large independents left (and those are generally not acquirable [due to liabilities])" (see FIGURE 2 along side).⁹ That is the consolidators' long hoped for "endgame" when they will have locked up in the hands of a few cooperating consolidators the control over solid waste in most major markets.

To predict the coming impact in the next two years of consolidation's endgame on price and recycling, it is necessary to address the institutional structure of a highly concentrated industry that, at the same time, has also become "vertically integrated" by combining disposal with hauling services. Those organizational structures, and the financing that is required to erect and maintain them, create the underlying economic forces that can be expected to drive the industry's future conduct.

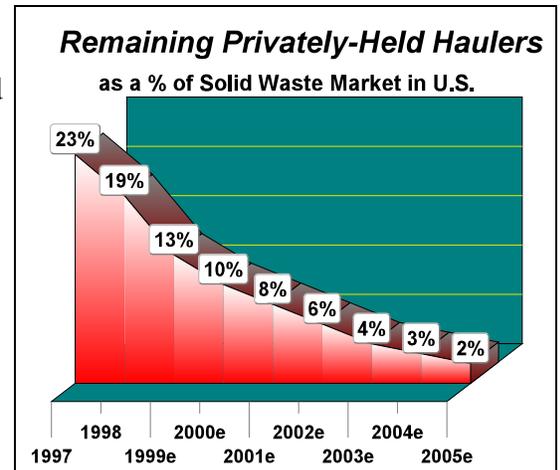


FIGURE 2

There will be intense economic pressures on the consolidators to exploit the landfill bottleneck with their newfound barriers to entry in order to both impose monopoly pricing and also to oppose any further diversion of recyclable or compostable material from the waste stream (described later at p. 13). Four leading sources of pressure include: the acquisition penalty that creates significant hurdles which consolidators need to overcome, investor pressures to earn outsized returns, a lack of native pricing power to meet those earnings expectations, and a consequent need to exploit the landfill bottleneck to meet the demands of their investors.

Whether the consolidators will have the power to sustain that market power derived from the landfill bottleneck will first depend upon whether they can resist the kinds of centrifugal forces that otherwise lead to chiseling by cartel members. Since the financiers of the waste industry have created powerful forces to clamp down on cheating among the oligopoly, this impediment ought to be overcome. The major wild card is recycling. Thus, the second make or break issue is whether the waste industry will be able to discourage recycling in order to prevent consumers from inoculating themselves against higher waste prices by diverting more from their trash cans into their blue bins. That turns out to be reason why the decision to build or forego a publicly-owned MRF is so critical to those wider issues. Much less likely to head off the endgame is the recent withdrawal of investor support for consolidation's completion.

⁹ Deutsche Bank, *The Environmental Quarterly: Good Times for Landfill Pricing* (May 24 '99), at p. 6.



C O N F I D E N T I A L

Acquisition Penalty

Consolidation, or the rapid roll up of local businesses into a national brand, is typically supported with claims of rationalizing a fragmented industry, achieving synergies, capturing economies of scale or accessing broader capital markets. Even though these can be real and there will be some industries in which some or all of these hypothesized benefits exist and can be captured, the first thing consolidation brings with it is a process that itself imposes substantial hurdle costs. Ultimately, this acquisition penalty must be overcome by even greater gains from the fruits of the acquisition in order to justify the buyouts in the first place. These costs consist of the following six downsides to acquisitions: premiums, surprise costs, cultural conflicts, management layers, loss of focus on operations and loss of entrepreneurial spirit:

- ▶ **PREMIUMS.** Typically, independent hauling companies land on the market when their founder retires and the children decide against entering the business. Accelerating consolidation generally requires the acquirer to pay substantial premiums over the straight market value of the acquired firms in order to convince a larger than normal number of owners to sell before their time. (For awhile when the acquiring company's stock is a high flyer, the consolidator can use his or her stock as a type of supercharged currency that may pay down the premium and even make the sale price seem cheap. But, with the hubris and overreaching this tends to create in executive suites and the fickleness of Wall Street favor, few stocks enjoy their day in the sun long enough to make this a sustainable strategy for overcoming the problem of overpaying for the acquisitions.)
- ▶ **SURPRISE COSTS.** In the early days of buccaneer style acquisitions, several deals were signed each day on airport tamaracks. But, even in the best of situations, due diligence may fail to uncover surprise costs in the acquired company from cooked books, undisclosed complications, long term liabilities and changing legal principles governing superfund cleanups that undermine the profitability projected by the buyer which was used to price the original offer. When the pace of consolidation accelerates, this problem is compounded.¹⁰
- ▶ **CULTURAL CONFLICTS.** Different companies have different corporate cultures and operating and accounting systems, and the task of merging many cultures in the process of rapid consolidation can lead to personnel tensions, miscues and abortive communications that create inefficiencies and lead to missed opportunities.

¹⁰ See WMI SEC Form 8-K (Aug 15 2000), at p.19. which states that WMI is a potentially responsible party in connection with 85 locations listed on the Superfund National Priorities List that may be expected to require remediation. "All of the sites ... were initially developed by others as land disposal facilities."



C O N F I D E N T I A L

- ▶ **ADDITIONAL MANAGEMENT LAYER.** An additional layer of management must be hired, trained, supervised and paid to control the far-flung operations. Also, that intervening level slows down and may becloud decision-making.
- ▶ **LOSS OF OPERATIONAL FOCUS.** Once a hauler “goes public” with an initial public offering in the equity’s markets to attract sufficient capital for acquisitions, all of the company’s energies tend to devolve on maintaining and increasing the value of the stock so that consolidation can continue. This financial focus is typically at the cost of operations. As the end of each quarter approaches, fundamentals such as fleet maintenance and customer relations critical to the business’s long term prospects get lost to expediency when that quarter’s earnings expectations or “whisper” numbers are not being met.
- ▶ **ENTREPRENEURIAL LOSS.** As local managers’ remuneration becomes detached from the full risks and rewards of ownership, entrepreneurial initiative is lessened at the local level where most of the operational decisions are made.

This leads to the question of how investors are convinced to bet that projected gains from this process will be greater than all of these losses.



C O N F I D E N T I A L

Investor Pressures

The traditional small business is financed with bank loans and by family-and-friends. Obviously, consolidators need to access wider capital markets to fund a nationwide buying spree. The private investment pools, public equity markets and bridge loans which back most waste industry acquisitions provide either the cash to pay for all those other companies or high and rising stock valuations that permit the acquirer for a time to use its own stock as a currency for buyouts. Except in a minority of the cases, junk bonds, lines of credit and internally generated funds have not played a major long term role. Banks will price their small business loans on the basis of the prime rate plus two or more percentage points, but equity markets and partners demand far more both to attract sufficient capital and compensate for the increased risk.

The second thing about consolidation, then, is that equity markets will only pay to roll up a locally-based industry into a few national companies if the acquirers can tell a convincing story that, in the end, the whole is substantially greater than the sum of its parts. Consolidation must be shown to produce above average rates of growth after netting any gains against those transaction costs. Moreover the measure of growth is not top line higher revenues, which consolidation does automatically bring, but instead growth in bottom line earnings per share (or similar measures of profitability like free cash flow as the industry repositions itself with investors from growth to value as a cash flow/stock repurchase story). Otherwise growth will come at the expense of dilution of earnings. Sooner or later, after too many one-time merger charges that can only temporarily disguise the reality of sagging earnings' reports, that will tank a company's stock.

This is an important distinction. Each year when the acquirer merges with the companies it has acquired, the profitability reflected on the bottom line of the new consolidated income statement — again after netting out the acquisition penalty — must be greater than the consolidator's earnings in the prior year. That is why equity markets impose substantially greater earnings expectations on consolidators than banks impose on local haulers. This course is an exceedingly hard row to hoe, which is one of the contributing reasons why, notwithstanding all of the glamour when takeovers are announced, that in 1999, 36% of mergers saw declines in the acquiring firms' post-merger stock price of 5% or more (net of changes in the S&P 500 Index), and only 30% better than 5%.¹¹

If the financial performance that follows fails to realize those promises, then there are enormous pressures on the consolidators to find other ways to generate outside gains or risk the certainty of being replaced by new management, as Messrs. Buntrock, Ranck, Drury and Proto — fallen leaders of old Waste Management, old Browning Ferris and new Waste Management —

¹¹ S. Lipin, "Merger Market Takes a New, Nasty Turn," Wall Street Journal (May 2 '00). Cf. P. Ghemawat, "The Dubious Logic of Global Megamergers," *Harvard Business Review* (July/Aug '00), p. 65.



C O N F I D E N T I A L

can attest to. This, in turn, leads to the question of what sorts of enhanced profitability consolidation will actually create that can be tapped to meet investors' demands.

No Enhanced Profitability

In that regard, the third thing to understand in the case of solid waste is that the industry is intrinsically incapable of producing the kinds of enhanced profitability to both exceed the hurdle costs which roll-ups impose and go on to meet the higher growth expectations demanded by the wider capital markets which finance the buyouts. Garbage is a stodgy albeit steady cash generator in low tech business with no brand name value that has no national economies of scale.

- ▶ **LOW TECH.** The basic industry's operations are rudimentary and low tech that do not involve skill, resource or technological barriers or the sale of luxury products or services which can sometimes sustain premium pricing. Waste industry wunderkind, 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."¹²
- ▶ **NO BRAND NAME.** There is no brand name value from going national that helps sell its collection service to customers over a reputable local independent. Mr. Drury also acknowledged that "as much as big waste companies like to think they have a valuable brand name, customers buy [waste services] on price."
- ▶ **NO SCALE EFFICIENCIES.** There are no economies of scale a consolidator can reap such as to justify transforming an industry from a local into a national business, nonetheless scale efficiencies that are great enough to first offset the cost's consolidation imposes and then go on to realize the outsized profitability the equity markets demand.
 - *Commercial Market.* In the containerized commercial front or rear end loader market which usually is the leading edge of market entry, internal operating scale efficiencies can be achieved with ten to 12 trucks, representing upwards of 3,000-5,000 commercial accounts. This provides sufficient mass to fully utilize backup trucks, swing drivers, maintenance staff and a sales force, and also have sufficient breadth to be sustainable

¹²

B. Brown, "Huizenda: The more things change..." *Waste News* (May 3 '99).



C O N F I D E N T I A L

and capable of expanding. Greater route densities in the field do affect productivity of the commercial collection vehicle, because that reduces the time otherwise wasted traveling between stops. But, first, that is a local consideration with little to do for national consolidation. Second, because most of a collection vehicle's time is spent at the stop (not between stops) or away from the route entirely, time saved between stops while on the route does not shave 10% or more of costs until a hauler controls 60% of the territory. That would raise blatant monopolization concerns. Third, even on a local plane, the relationship between the hauler's aggregate size and densities in a particular part of town is only indirect.¹³

- *Franchised Residential Market.* In a strictly economic sense, there are no scale efficiencies at all for franchised collection beyond professional qualifications and credibility, to the extent that the contract with the locality to provide service can collateralize a loan. The impediment to free entry arises because a packer truck (with a preventive maintenance program) has a useful life of eight years, while franchise contracts typically only guarantee five years, sometimes with squishy options to renew. If, to be prudent, a small hauler calculates his bid based upon a five-year amortization of his fleet, the contract will be awarded to someone else who amortizes his fleet more aggressively over eight, because his competitor's fixed costs will be lower. If, on the other hand, that small hauler bids based upon an eight-year amortization to insure a low bid that can take the franchise away from a consolidator, he or she risks being whipsawed when the contract comes up for renewal. For the consolidators' have shown themselves ready to use discriminatory pricing to low-ball bid whatever it takes to get its franchise back. Because of this, a successful small bidder needs to have a large enough existing fleet to reabsorb the vehicles once used for the franchise in the event his or her renewal effort at the end of the contract is not successful.

For all of these reasons, it is true that there can be efficiencies gained which generate greater profitability when moving from a small local hauler with just a few trucks to a dominant local hauler *within a metropolitan region*. These arise by spreading overheads, fully utilizing equipment and staff, increasing route densities and having enough activity to switch vehicles into and out of accounts as they are won and lost. But, there are none when moving from a metro region to a national arena, and national reach is what the waste industry

¹³ P. Anderson, "How Greater Route Densities Impact Collection Efficiency," *MSW Management* (Sep/Oct '99).



C O N F I D E N T I A L

consolidation is all about. “The reality of this business is that it’s local,” boasted Thomas Van Weelden, CEO of fourth ranked and decentralized Allied, when he acquired second tier BFI which operated centrally —

“There’s no great synergy in running businesses in Chicago and Indiana, let alone in the Northeast from here ... We have never bought off on the philosophy that you can make grand decisions from a corporate headquarters.”¹⁴

This means that the consolidators will be forced to find other ways to exploit their assets in order to earn above market rates of return. That raises the question of precisely where the waste consolidators can look to satisfy the financial markets.

Source of Higher Margins

To provide the growth in earnings which the financial markets demand, the consolidators in this intrinsically low margin waste industry have historically relied upon a combination of artificial, contrived and illegal expedients to inflate actual earnings. Most of the earnings’ updraft had been generated by legitimate accounting anomalies available for mergers in which there are such things pooling of interests and recording the new company’s whole year revenues for end-of-year acquisitions, as well as by overly aggressive and potentially illegitimate accounting gimmicks that misstate items such as depreciation and future liabilities.¹⁵

Some may be incredulous that multi-billion dollar corporations can be built on a tissue of accounting fictions, but experts concede that the opportunity for mischief in recording “serial” acquisitions in almost any of the roll-up consolidation industries is next to impossible to sort out.¹⁶ This would not, it may be noted, be the first time that little more than a good story and accounting games have restructured an entire industry based upon an illusion. The wave of conglomerate mergers in the 1960’s that was supposed to capture synergies among unrelated

¹⁴ M. Malloy, “Allied Waste Industries: Letting Them Grow,” *Waste Age* (Aug. ‘98), p. 28.

¹⁵ A. Briloff, “Recycled Accounting: It Enhances Waste Management’s Earnings,” *Barrons* (Aug 6 ‘90); “Burying Trash in Big Holes — On the Balance Sheet,” *Business Week* (May 11 ‘92); Gabriella Stern, “Polluted Numbers: Audit Report Shows How Far Chambers Would Go for Profits,” *Wall Street Journal* (Oct 21 ‘92); Deutsche Morgan Grenfell, *The Solid Waste Industry* (Oct ‘97), at p. 11;

¹⁶ R. Abelson, “Gorging on a Diet of Deals,” *New York Times* (Jul 5 ‘98), at D10.



C O N F I D E N T I A L

businesses were in fact erected on accounting legerdemain and wound up unraveling in the seventies and eighties.¹⁷

Profits were also augmented by threats and direct collusion among the consolidators to fix prices that was even messier stuff of limited durability. The story of reputed mobster Harold Kaufman who testified before a New York State legislative committee that Browning Ferris Industries had knowingly used the Giantello crime family to run its New Jersey operations, was retold — to the dismay of the consolidators’ and investment bankers’ board rooms — on a television docudrama in 1986. Similar the stories that wound up in courtroom testimony of Diane Cone, a former waitress at Denny’s Restaurant in Kansas City, who signed up for a sales job with Waste Management as a step-up in her career, or another saleswoman she met at WMI, Sandra Blackman. They testified that they would pick up how prices were fixed when they mistakenly tried to win business and make commissions by taking away a customer from a competitor who was a member of the cartel. Ms. Blackman told how she asked her manager for a bid price to compete against BFI for a big customer of BFI which was being handed a 35% price increase. “I was told to double — double the 35%. It was almost laughable to call people back.”¹⁸

Investor alerts, exposés in *Barron’s*, the *New York Times*, the *Wall Street Journal* and *Business Week*, criminal charges, SEC investigations and private class action securities and antitrust law suits have effectively eliminated or severely restricted those options.¹⁹ The only remaining avenue going forward for consolidators to now generate the requisite returns demanded by Wall Street was to find a route that would be more discrete and create a lower profile with stockholders, regulators and prosecutors.

It was in the middle of all this turmoil that a tactic fell in their lap ten years ago from an unlikely source that, as Waste Management cleverly anticipated, exploited the unintended consequences that flowed out of government regulations intended to protect the environment. By integrating vertically to lock down disposal along with hauling, they could fence out competitors because a new barrier to entry into the market for landfills was erected by the Environmental Protection Agency’s groundwater protection rules for landfills.

¹⁷ B. Malkiel, *A Random Walk Down Wall Street*.

¹⁸ *Cumberland Farms v. BFI*, (D.C.E.D.Pa., Case No. 87-3717), Exhibit 113.

¹⁹ Deutsche Morgan Grenfell, *The Solid Waste Industry* (Oct ‘97), at p. 11. See also footnote nos. [14](#), [15](#), [16](#) and [17](#).

When 20,000 unlicensed dumps dotted the landscapes in 1970 at the time the march toward of consolidation began, this had not been possible.²⁰ That is what explained the earlier risky reliance on the, then, only available tools — collusion and deception. Ironically, however, it was the enactment in 1991 of EPA’s first national standards for land disposal that also created perfectly legal barriers to entry with enormous implications for market power.

Those standards led to lengthy and contentious licensing proceedings (rarely less than three years and sometimes, in the seminal case of Eagle Mountain, more than ten), and substantial permitting and construction expenditures (increasing the minimum investment to enter the business from a half million dollars for a few trucks to \$50 million and more, a significant part of which is incurred and at risk before approvals can be assured).²¹ Now there are only slightly more than 2,000 licensed facilities (*see* FIGURE 3), and the environmental regulations can be seen to have erected overwhelming barriers to entry in a text book case of the law of unintended consequences.

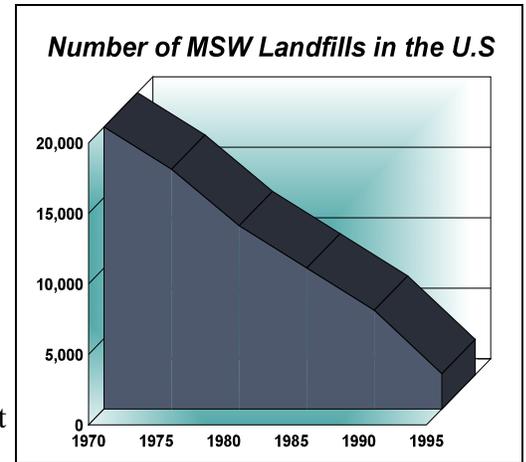


FIGURE 3

Not only are there barriers to entry into the associated landfill business, but also landfills are bottlenecks in the waste industry in the sense that a new entrant cannot compete without access to disposal. When the vertically integrated consolidators together control all of the landfills in a region, they can use discrete signaling to fix prices and then “price squeeze” any new entrant that might be attracted to the high profitability being earned by the cartel.

It is true that a few hundred thousand dollars to buy a few compacting trucks is all it takes to startup in the garbage business. It is also true that the waste business tends to attract especially feisty entrepreneurs who enjoy a good fight with the large corporations.

But, if all the disposal sites in an area fall under the control of an oligopoly, it can become impossible for even the most scrappy new hauler to break in and compete. When it comes time to off-load as his or her packers top out, the competitor will have to queue at one of the cartel’s landfills. There he or she will be susceptible to price squeezes by being overcharged, sent for a very long wait at the scale house or have his loads given a white glove inspection and turned away for carting proscribed materiel. “We don’t fear competition on the street,” Jerry Antonacci, president of New York City hauler, Crown Waste Corp., pointed out —

²⁰ *Waste Age* (Jan ‘96).

²¹ W. Wiley, “Judges give boost to rail-haul landfill,” *Waste News* (Aug 9 ‘99).



C O N F I D E N T I A L

“Our fear for the future is the dumps. The public 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.”²²

With disposal making up as much as 40%-60% of hauling charges, price squeezes put erstwhile competitors out of business.

Thus, this first led the national firms in the last decade to move toward what generically is called “vertical integration,” but in the waste industry is referred to as a “hub and spoke” strategy. That is where they couple all of their hauling operations in an area with their own disposal facility. This is pursued to such a degree that they usually swap out of, or withdraw from, collecting garbage in towns where they do not control their own disposal capacity. Integration, or hub and spoke, provides the vehicle to price squeeze. But that only works in locales where there is no competitively priced, publicly-owned landfill, because a public facility provides a relief value for non-vertically integrated independents.

Closely related to the hub and spoke strategy is the consolidators’ “internalization policy.” This simply means that they will dispose of their trucks’ waste at their own landfill even if that

entails driving more than an hour, or in some places like Southern California two hours, past a competitors’ or a public entity’s facility to get to their own.

In a competitive market, this practice would not seem to make any sense. Even in less extreme cases than Southern California, such as in markets with more than one disposal site, but in which the consolidator only has one of the landfills, the irrationality of internalization on free market precepts is evident. In those more typical types of cases, approximately one-half of the consolidator’s collection vehicles will, at any given time, be on routes that are closer to a competitor’s facility. Yet, internalization dictates traveling further to get to one’s own site, and that

unnecessary time away from the truck’s route to offload is expensive. In general, the dominant integrated companies would need to be charging other integrated haulers the equivalent of at least \$5/ton to \$10/ton above market rates (or about 25%-50% of total charges) for the savings from avoiding monopoly tip fees to offset that wasted drive time (see FIGURE 4).²³

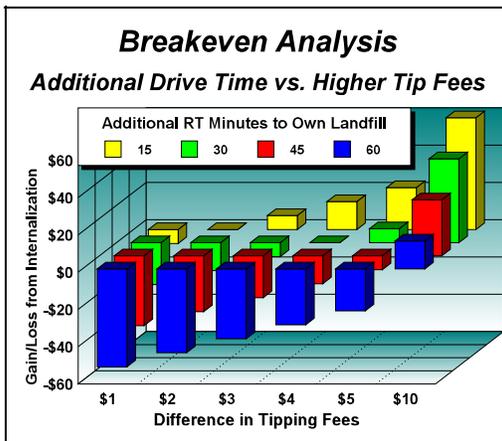


FIGURE 4

²² Phillip Lentz, “Small, New York hauler feels pinch: Mob-controlled cartels gone, but influx of national firms hurts Crown Waste,” *Waste News* (Aug 3 ‘98).

²³ Based upon internal studies that assumes the fully loaded cost per effective vehicle hour of \$60. The chart in the text displays the breakeven point for different added drive times needed to internalize loads. As (continued...)

The additional drive costs that consolidators are absorbing in order to increase their internalization rates from 50% to 75% is a measure of market distortions due to market power or the search for market power. Internalization would seem to be related to what is termed “linked oligopolies,” or the need to retain control in up and downstream markets in order to protect market power. It has come to serve different purposes depending upon the structural organization of the industry in each part of the country.

- ▶ **REGIONS WITH UNDER-CAPACITY.** In regions where disposal capacity is tight, internalization enables each consolidator to pocket the premiums being imposed on tip fees, instead of paying it to a competitor.
- ▶ **REGIONS WITH OVER-CAPACITY.** In other areas where the consolidators dramatically overbuilt a new generation of mega-landfills that led to overcapacity, internalization insured that each consolidator maxed out inflows to its own sites to help amortize the enormous investments that financed those facilities.
- ▶ **REGIONS WITH PUBLIC CAPACITY.** Internalization also became another handle to lever market power by a “supply squeeze” of publicly-owned landfills which, if they remain uncontrolled, would act as a relief valve against its opposite, the price squeeze described earlier (*see p. 13*). Since most publicly-owned landfills were built as a public service in an earlier time when there still remained a vibrant independent hauler market, they were sized to serve the independents’ loads as well as those from city-owned collection vehicles. As the independents were taken over by the consolidators, and the consolidators shifted those independents’ waste loads from public sites to their own facilities, the public landfill sector has been increasingly starved for supply with which to amortize their debt without recourse to taxation. Coupled with municipalities’ greater fiscal conservatism and apprehension over landfill’s long term liability, many wound up selling their operations to the national firms or just phasing out of the

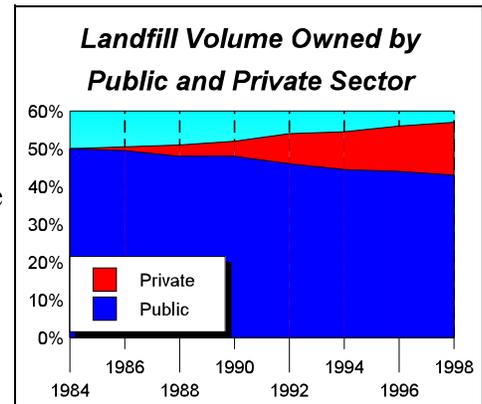


FIGURE 5



C O N F I D E N T I A L

business.²⁴ FIGURE 5 shows the shift in landfill control away from the public to the private sector.²⁵ In this way, market by market, the noose has become tighter.

An illustration of the magnitude of the kinds of price increases contemplated when endgame is achieved is shown in the series of landfill tipping fee increases that Waste Management imposed in the Northeast. This happened after its combination with Eastern Environmental Services was approved by the Justice Department in 1999, and Waste Management thought — prematurely it turned out — that the merger had eliminated effective competition. Although it subsequently developed that Waste’s ambitions were ahead of the facts on-the-ground, the tipping fee increases ranged from 40% to 138% in that region, for an unweighted average of 89%.²⁶

Although this clearly lays out a path to market power to meet investor expectations, that road is littered with oligopolies that, even once established, have come unraveled from either internal centrifugal forces or external threats of substitution or new technologies. Thus, the long term condition of the waste market will be defined by its resilience to sustain market power over the long term, not by its ability to grasp that brass ring tomorrow.

Curbed Centrifugal Forces

“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices,” observed Adam Smith more than 200 years ago. As the *Wall Street Journal* commented in a 1998 profile of then high-flying USA Waste, “[f]ew industries in the in the 1970s and ‘80s were hit by as many civil and criminal antitrust actions as the waste business.”²⁷

The structure of the waste industry generally tends to greater *relative* stability for covert price fixing than most industries. This is because its organizational attributes favor collusion and enforcement of pricing agreements. Those factors which industrial organization theorists have identified, and which exist in the waste industry, include —

²⁴ E. Lowe, “Competitors aim to trash area landfills,” *The Post-Crescent* (Apr 16 ‘00).

²⁵ Environmental Industries Association, *Solid Waste Disposal Trends 1999 Update*.

²⁶ USDOJ Press Release, “Justice Department Settles Merger Lawsuit with Waste Management and Eastern Environmental Services (Dec 31 ‘98). B. Brown, “WMI raises tip fees,” *Waste News* (Mar 1 ‘99).

²⁷ J. Bailey, “USA Waste Is on a Mission to Expand in Trash Business,” *Wall Street Journal* (May 15 ‘98).



C O N F I D E N T I A L

- ✓ A small number of sellers,
- ✓ High concentration ratios,
- ✓ A homogeneous service,
- ✓ High barriers to entry,
- ✓ Ease of detection of chiselers,
- ✓ Similar cost structures and
- ✓ Low price elasticities.²⁸

Nonetheless, all oligopolies, even those with substantial barriers to new entrants and favorable collusive structures like the waste industry, suffer from inherent instability due to persistent chiseling as each participant is under what game theorists refer to as the “prisoners dilemma” type pressure to defect.²⁹ A well-recognized example of this is seen in the problems that OPEC, the Mideast oil cartel, has experienced enforcing price discipline. All this is compounded by strict antitrust laws in the U.S. that create significant criminal and treble damage liability against collusion that can be documented in restraint of trade.³⁰ Consequently, prudence would require that price fixing and enforcement against chiseling has to be accomplished by signaling and other oblique maneuvering that is unlikely to be uncovered in a trial. These are cumbersome tools to rely upon on over the long haul.

In the case of oligopolies which are consolidators, however, a new type of enforcer that tends to evade exposure has entered the scene which can override centrifugal forces. They are the institutional investors and equity pool managers who have financed the waste combinations, and without whom, the national giants would unravel. Thus, they have the portfolio to serve as enforcers, and, since they are not themselves competitors in the waste market, they have so far been able to navigate around the Sherman Act’s bar against collusion among direct competitors. But their footprints have writ deep in the waste industry scene.

The financiers have acted to dethrone executives who pursued market share over profit margins. Piper Jaffray’s Melissa White flew to Houston to visit BFI just as Allied Waste Industries’ unsuccessful 1998 takeover bid was received. “Talking with J. Gregory Muldoon, BFI Chief Operating Officer, she said she was surprised by ‘a lack of a sense of urgency to do

²⁸ F. M. Scherer and D. Ross, *Industrial Market Structure and Economic Performance* (Houghton Mifflin, 1990), at pp. 227-293.

²⁹ D. Hofstadter, “Metamagical Themas: Computer Tournaments of the Prisoner’s Dilemma Suggest How Cooperation Evolves,” *Scientific American* (May ‘85), at p. 16. The prisoner’s dilemma is part of the annals of game theory. It postulates two suspects accused of a crime being grilled in separate rooms by the police who do not yet have enough evidence to charge them with a crime unless one or the other confesses. Each one has to decide whether to cop a plea, knowing at the same time that if either both or just the other does so, he will go down.

³⁰ The Sherman Act, as amended, 15 USC §1.



C O N F I D E N T I A L

anything’ to raise its share price.’” Reminiscent of the French Revolution’s Madame Lafarge, Ms. White went on to tell a *Wall Street Journal* reporter that “[h]e seemed like a man who is expecting to be sitting in the same chair three years from now.” BFI yielded to a second buy out an offer from Allied a few months later.

Also, the large investment houses have also threatened retaliation against second tier consolidators who were suspected to have been lowering prices in order to gain share and become one of the top drawer firms. Goldman Sachs, one of the investment advisors for many of the deals, reported to its institutional investors about its efforts to keep things on track when word trickled out that Republic had dropped tipping fees at some of its landfills. “One of the concerns” their analyst reported —

“is the impact of R[epublic’s] targeted price cuts on the industry’s competitive environment. ... The ... company’s adamant position that its own pricing growth will remain in the 2% range ... for the foreseeable future, lead us to believe that there will not be a detrimental impact on the industry. To verify this, we will be paying particularly close attention to R[epublic’s] price growth in coming quarters. If the company is pressuring prices more generally, it is certain to show up here first as a drop in price growth and a ram up in volume growth.”³¹

But, the fact that they will be positioned to charge monopoly prices — with barriers to entry to keep new competition at bay and an industry structure to implicitly raise and enforce price hikes— still does not mean that the waste consolidators can sustain their coming cartel. Consumers can shift to substitutes or new technologies that meet the same need. In the early 1980’s, OPEC found to its dismay that tripling crude oil prices only convinced the industrialized world to evade the impact of those price hikes by conserving energy. It is sometimes thought that garbage pickup is a necessity that is immune from substitution, but OPEC at one time erroneously thought energy was too. In matters of solid waste, recycling symbolizes the oil industry’s vulnerability to conservation.

Recycling Threat

Whether the consolidators will ultimately sustain market power in order to follow the path laid out by those institutional forces is a distinct issue from whether they can form a cartel. That ability to exploit the consumer can be crippled if people respond to higher disposal prices by diverting more. While some diversion strategies may currently be more costly than disposal when landfilling is priced in the \$20-40/ton range as it is, more and more recycling strategies will make economic sense with each ratchet upwards in tip fees. But, economics can be stymied if there is a physical bottleneck that impedes implementation.

³¹ Alan Pavese, “RSG, AW, WMI: It’s Bad, But It’s Not THAT Bad (Part I of 2) (Goldman Sachs) (Aug 31 ‘99).



C O N F I D E N T I A L

The cities' residents and their stores, restaurants and offices may envision a way to separate more of their waste stream for recycling to avoid price hikes for trash hauling. But once collected, the recyclables need to be processed. That is the function of material recovery, and for organics, composting, facilities. The resolution of who controls the levers of diversion in each local market will play a key role in determining whether the coming oligopoly is undermined by dramatic increases in recycling, as is detailed in its relationship to the Twin Cities market later at p. 35.

Market Turmoil

Following new Waste Management's July 6, 1999 announcement of an unexpected major earnings shortfall in the wake of its problems combining USA Waste and old WMI, the waste industry sector went into a tailspin on the stock market. Waste's stock plummeted from a high of \$60 to a low of \$13 per share; and Allied, from \$20 to \$5 a share. In the space of a few months, the market capitalization of Waste Management lost an incredible \$29 billion, and Allied, almost \$4 billion. During that market swoon described in more detail later at p. 37, the question arose whether the impending monopoly is falling apart at the seams.

As a general proposition, the threat of a waste cartel would greatly diminish if the capital markets lose faith in the industry sector, as it clearly did in the days following the WMI announcement last July. For the consolidators must have either capital infusions or high stock valuations to complete the acquisitions and especially the mega-mergers necessary to reach the endgame. In that sense, it needs to be recognized that the industry's long term strategy could be aborted were Wall Street to cut off its oxygen supply just short of the finish line.

However, the market has many different strata like the thermal layers in the sea. While the bloom may go off an industry's rose in the mind of the general investor, lower down there are bottom fishers, distressed-firm artists and value funds constantly always on the prowl for unrecognized worth in the dross of the ocean floor as a means of achieving above average returns. After this last bloodbath, they reemerged to bankroll an industry rebound. Most recently, their efforts, combined with the first quarter is seemingly reassuring earnings reports, succeeded in establishing a market bottom for the waste giants that had been elusive for the past half year, and began to slowly drag the sector back to the surface (about which more later at p. 37).

This all suggests that there is no way to reliably determine whether there will continue to be capital backing to complete the final acquisitions needed to lock down market power in most areas through these ebbs and flows of the waste industry's fortunes. But, with the cash generation from aggressive asset sales as WMI and Allied divest non-core and foreign subsidiaries (*see* p. 39), and the ability to use the cash generated to buy back stock and boost share price, investors could easily be fooled yet again. In attempting to assign a probability to the investors' resilience, it ought to be borne in mind that Waste Management has had near death experiences with the market several times before, only to spring back again and again. Prediction here, then, is like



C O N F I D E N T I A L

betting on whether Charlie Brown will attempt to kick Lucy's football yet one more time. Certainly, Charlie may wise up some day, but it is certainly difficult discerning when that point will be reached.

Impact of Consolidation on Public MRF Decision

The prior section of this report provides a background for the economic forces that are operating on the consolidators nationally, and which create intense pressures to exploit market power. That power derives from control over not only landfills which create barriers to entry but also MRFs which could be an avenue for customers to escape. This section examines how those broader factors interact with the facts on the ground in the Twin Cities metropolitan area.³² It shows why it may be prudent for Ramsey County to continue its presence in the processing of recyclables in order to maintain competition in the waste industry and achieve the state's environmental objectives.

Consolidation in the Twin Cities

The experience in the Twin Cities metropolitan area parallels the growing consolidation trends nationally. Increasingly, ownership of landfills and MRFs are falling into the hands of a two- or three-firm oligopoly. Control in the disposal market can be exploited to price squeeze any new competitor which attempts to cash in on high hauling rates collusively set by price signaling among a cartel (*see* p. 14). Coordinated control over MRFs by the consolidators can provide them with an insurance policy to reduce the risk that customers might seek to evade exorbitant trash hauling prices by diverting their garbage away from the waste stream. The strong role played by incineration and processing in this region as an alternative to landfilling, while crucial in other particulars, does not affect the competitive landscape.

LANDFILLS. The year 1997 was a watershed for the Twin Cities. It was then that USA Waste, a major up-and-coming regional consolidator, took over Kramer and Elk River, the last independent landfills in the area. Then, too, in 1998, USA Waste went on to combine with and Waste Management, eliminating competition between the two major players in the area's landfill market. Today, new Waste Management, Allied Waste Industries (successor to Browning Ferris) and Superior Services effectively control all of the significant landfill capacity currently used by the metro area. FIGURE 6 along side shows

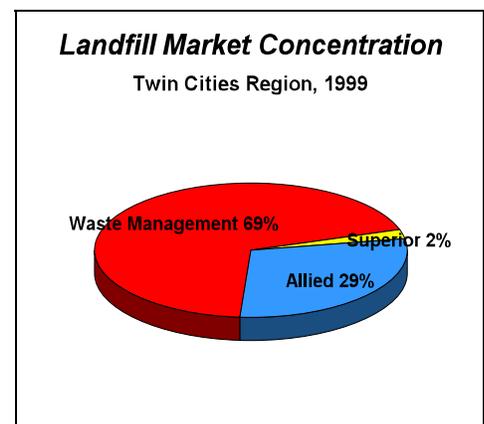


FIGURE 6

³²

Anoka, Carver, Dakota, Hennepin, Ramsey and Washington Counties.

that Waste Management controls 69% of the landfill capacity used by Twin Cities' haulers, Allied/BFI, 24% and Superior, 2%.³³

Related to these trends, in the market for hauling MSW and recyclables in the Twin Cities metro region the consolidators' 1995 19% market share has increased to 48% in 1999, or by 153%. Independents have dropped by 40% from 72% to 43% and the public sector has remained stable at 9%, (see FIGURE 7 along side).³⁴

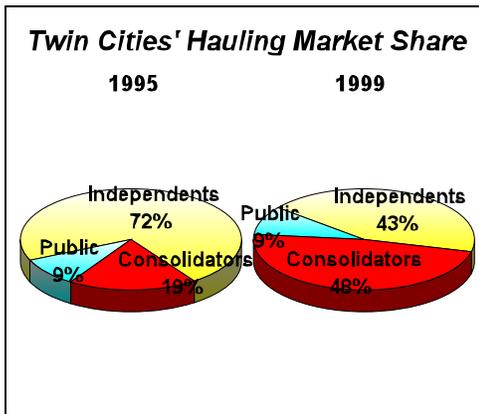


FIGURE 7

But, the actual competitive picture indicates even greater effective market concentration, because there is some size threshold below which a small hauler is too weak to grow by taking customers away from a consolidator charging exorbitant rates. Obviously, the ability of a very small hauler to take customers from a monopoly pricing waste giant is also a function of the individual's mettle. But, as a general proposition, recognizing that there is no single number that applies in all cases, a general threshold can be figured with reference to the economies

of scale and financial durability of haulers in those parts of the market where new entry usually occurs.

Entry into the waste industry is generally either through the construction roll-off or containerized commercial front or rear end loader markets because it has the lower capital requirements and barriers. In that arena, or in subscription residential collection which exists in some locales such as St. Paul, ten to 12 trucks is a reasonable threshold before a hauler can have the potential to impact the competitive market. For with less than that number, a hauler cannot optimize the use of swing drivers, backup vehicles or a maintenance staff, and would have substantial difficulties ever getting enough time when he or she is not driving or repairing one of the trucks to go out and find many new customers beyond a small niche (see p. 10). Sweat equity may substitute for profitability while the seeds for growth are patiently sown, but no amount of sweat can enable an entrepreneur who has to either drive a route or serve as a swing driver with the time to change into a suit and act as a salesman to lure customers away from consolidators which are charging premium rates.

³³ 1999 Metropolitan County Certification Annual Reports.

³⁴ Vehicles registered for the collection of municipal solid waste with the six counties in the Twin Cities metropolitan area were examined and used as a proxy for market share. The 1999 registrations were first adjusted for the takeovers by WMI of Aagard, Quality Waste, Mendota Heights, AW and Best later in the year. Also, trucks nominally registered for MSW collection, but could be determined were actually used for construction roll-off collection or self hauling were excluded.

In 1999, there were 137 different independents hauling garbage companies in the metro region with an average of less than four vehicles. Only nine of them, however, have 10 or more trucks (only three with 20 or more), leaving 69% of the trucks owned by independent haulers with companies that have fewer than ten vehicles. Subtract out the haulers with fleets less than 10 trucks and the consolidators' market share rises to 55%, the public's to 11%, and the independents' falls to 34%. Without access to their own landfills or to any landfill outside of the control of the consolidators, all the independents will become vulnerable to price squeezes.

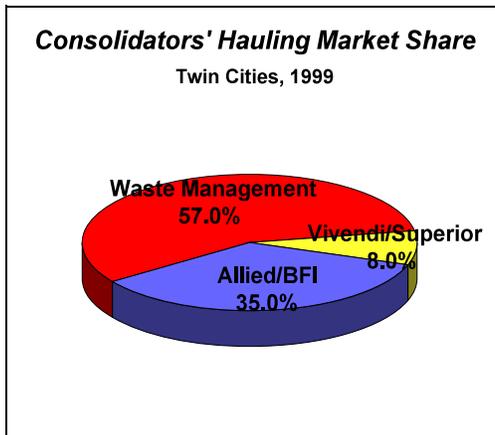


FIGURE 8

Among the consolidators themselves, in 1999 WMI had a 57% share in the region's hauling market, Allied/BFI, 35% and Superior, 8% (see FIGURE 8). In 1995, the breakdown had been WMI, 58%, BFI, 40% and United (an earlier regional consolidator that wound up part of WMI), 2%. Waste Management has been and remains the leading consolidator in the area. As discussed later, for this and reasons relating to Allied's short-lived disposal capacity, Waste Management is likely to inherit Allied/BFI's share in an asset swap in the near future (see p. 30). That would only leave Superior, as the only other vertically integrated hauler, in a position to resist a price squeeze and keep competition alive.

None of this growth in the consolidators' share is surprising. Typically, the consolidators' control of an area's landfills is the soil in which monopolization grows because it makes it possible for a two- or three-firm cartel to cooperate and fence out new competitors through their domination of the bottleneck landfills. Although the trap has not yet been sprung, absent serious antitrust enforcement the handwriting is on the wall for the future of the independent haulers.

COMBUSTION. In the Twin Cities, however, the situation becomes more complicated because the area also contains extensive waste-to-energy (WTE) and refuse-derived-fuel (RDF) capacity that accept discarded municipal waste from anyone, including haulers who are subjected to price squeezes at the consolidators' landfills. Indeed, in 1999 these facilities captured almost twice as much as landfilling of the Twin Cities area's waste. Moreover, that burn/processing capacity is owned by the Hennepin Energy

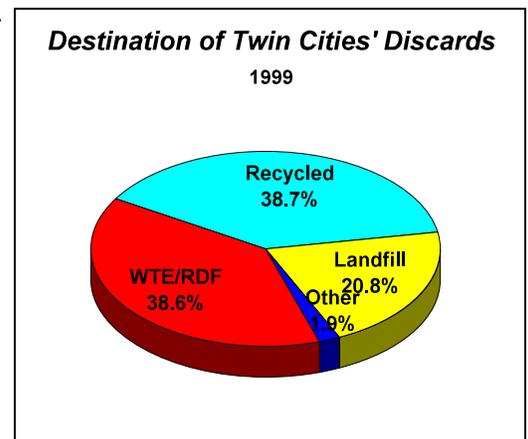


FIGURE 9



C O N F I D E N T I A L

Recovery Company (HERC) and Northern States Power Company (NSP) which are outside of the control of the waste consolidators (see FIGURE 9 above).³⁵

However, combustion is to a large extent not relevant to an analysis of competition where free market forces operate (except insofar as these facilities create a ceiling setting the maximum monopoly rents that can be imposed equal to the how much more expensive incineration is than landfilling). This is because these facilities cost about twice as much landfilling and that means they can only remain a market force through subsidization, the purpose of which is to *maintain minimum inflows* for disposal, not to *protect competition* for collection. The limit on how much taxpayers will accept being assessed to pay for that subsidy restricts the influence of these facilities on the future competitive landscape.

In general, incineration and RDF cost in the range of \$60-\$70/ton before subsidies, which is more than twice as much as land filling that, at large sites, actually costs in the \$18-\$23/ton range.³⁶ At that kind of premium, burning would offer independents scant shelter from the storm. For even blatant discriminatory pricing charged to squeeze competitors at a consolidator's landfill will not impose as great a premium on a small independent hauler as would be dependence on expensive incineration or processing. At one time, cities with combustion contracts mandated waste flows to their WTE facility that negated any advantage a vertically integrated hauler otherwise would have over independents, but these "flow control" laws were overturned by the Supreme Court in 1994 in *Carbone v. Clarkstown*.

To maintain inflows to the Twin Cities' more expensive incinerators and RDF plants in a post-*Carbone* world, Washington and Ramsey County are subsidizing gate fees. Set at about \$39/ton, the incentive seems structured to be sufficiently competitive with landfill tip fees, once transfer costs of reaching the lowest cost landfill sites are factored in, *to attract the minimum volumes* required by the counties' put-or-pay contracts with HERC and NSP.

Consequently, while combustion has come to define disposal for much of the residential waste sector acting through extra-market forces, landfills dominate the commercial stream where market factors control.

Since consolidators with large landfills can still make a profit charging themselves less than \$20 per ton for disposal, and since the transfer cost of reaching those types of facilities costs little more than \$10/ton, the \$39/ton subsidy at 30% or more greater than landfilling and does not succeed in leveling the playing field between existing independent haulers and integrated consolidators in order to preclude price squeezes. For new entrants, in view of the fact that the

³⁵ 1999 Metropolitan County Certification Annual Reports.

³⁶ Chartwell, *Solid Waste Digest Reports* (1999).



C O N F I D E N T I A L

put-or-pay contracts are already being met, there is the further issue of whether independents can expect the taxpayers to foot more subsidies to extend the \$39/ton fee for their additional loads.

INDEPENDENTS' BEHAVIOR. In the near future, assuming Allied/BFI departs and Waste Management consolidates its position (*see* p. 30), the existing independents will not be an impediment to monopoly pricing. As noted, only nine of the 137 have ten or more licensed trucks, and only three 20 or more. Of those nine independents who might impact the market price, were any one of them to aggressively price compete, Waste Management could put them in a vice. On one side the consolidator, which is the low-cost producer, could roil the challenger with a targeted price war. On the other side — an offer to buy them out — a pattern of conduct which has characterized the waste industry.

Wall Street refers to haulers on the margin who do not cooperate with a cartel as “problem pricing entities” and frequently reports on progress to remove these entities from the market, such as the case of Mid-American Waste, “which had been in financial trouble for years, had been pricing low in order to maximize cash flow throughout the Midwest and several other markets.

“Mid-American was acquired by USA Waste in [1997] and pricing was improved immediately throughout these markets. The Laidlaw U.S. operations, which were acquired by Allied Waste in [that year], had not experienced price increases in the majority of its markets for two to three years, and Allied is now raising pricing aggressively in these markets. Similarly, USA is aggressively raising prices in the Laidlaw Canadian operations it acquired in early 1997.”³⁷

For this reason, in the end only cooperative independents are like to remain. Thus, the future of competition will ultimately turn less on the existing independents than on whether potential new entrants (or owners of acquired firms after their non-compete clauses or payout terms expire) calculate that they can break into the market and hedge the risk of a price squeeze by leaning on subsidized rates at the WTE or RDF plants. Because if they can, then a consolidator's strategy of buying out problem pricers should ultimately fail in the face of a continuing flood of new entrants until the price drops to or below its marginal cost.

Here is what a potential new competitor attracted by the profitability flowing from a cartel's high carting charges will consider. Against the hoped for benefits to be garnered by forcing his or her way in to share the monopoly profits, there are personal and business risks. Among them are the risks of making good on personal guarantees if the startup fails, a recognition that the cartel's interests cannot accept any new entry and survive, that they are going

³⁷ Duetsche Morgan Grenfell, *The Solid Waste Industry* (Oct '97), at. 14.



C O N F I D E N T I A L

up against the low-cost producer, that the consolidators have both the inclination and capacity to predate and the incinerator subsidy is a weak reed to lean on.

- ▶ *Personal Guarantee.* Since loan officers value rolling stock at 50% or less of its purchase price and at least six months working capital is needed at startup, in order to fully collateralize a bank loan a new hauler entering the Twin Cities market will be required to put up his own house, retirement savings, first born and a personal guarantee as collateral. This is not an act taken lightly.
- ▶ *Cartel's Interest.* An individual exploring the risk factors will understand that if the cartel permits one new entrant to share in the monopoly profits, it will only invite further entry until the premium prices are undercut by an oversupply of hauling services from all that new entry, even if the first new hauler cooperates and does not deliberately drop prices. Note, though, that this consideration does not necessarily apply to existing small independent haulers inside the market but outside of the cartel so long as they do not break price ranks. Indeed, cartels often prefer to leave existing independents alone — so long as the fringe players price follow — because their presence tends to deflect antitrust concerns.
- ▶ *Low-Cost Producers.* Knowing that the cartel will virulently seek to oppose new haulers, the new entrant will calculate whether he or she can survive a retaliatory price war with the majors. In this regard, the consolidators' landfills are the equivalent of the "low-cost producers," even with the burn subsidies at HERC and Newport, notwithstanding the fact that, up to this point, it has not been in their interest to drop their prices to bare bones' levels. It is the low-cost producers who win any price war because they can at least break even while the upstart is hemorrhaging losses.
- ▶ *Predation.* Then, too, the consolidators operate across many markets. That gives them the capacity, which they have been known to exploit, to use "predatory pricing." This tactic involves charging below costs in competitive markets in order to destroy competition that is offset by premium pricing in less competitive markets. Also on the minds of new entrants will be the widely reported instructions of a BFI district manager in Vermont who had once told his salesman to threaten Kelco Disposal, a recalcitrant competing independent hauler, "If you have to drop your prices, drop your prices and croak him, put him under ... put him out of business. Do whatever it takes. Squish him like a bug." While such blatant episodes in the Twin Cities have not been reported, the consolidators' apparent split pricing — with their nearby landfills charging \$65-\$70/ton gate fees with taxes, 115% higher than their far away sites at \$26-37/ton — is a warning flag of what may come. This disparity suggests



C O N F I D E N T I A L

predacious tendencies because the size of the near and far sites are both large enough to have similar scale economies, leaving the unanswered question of the underlying justification for such extremely high tip fees at Pine Bend and Burnsville. Even if they were pricing the near-in sites on an incremental basis — that is at the higher rate that would arise when the next landfill comes on line because the nearby sites have limited lives — that would only be in the \$35-45/ton range to recognize the longer transfer haul costs.

- ▶ *Weak Reed.* Beyond the fact that there is substantial doubt that an interloper could survive a protracted price war even if the new entrant has recourse to the subsidized combustion rate to avoid a landfill price squeeze, there are questions about whether that subsidy or capacity will be available in the future. On the one hand, the Twin Cities Solid Waste Management Coordinating Board commissioned a study to investigate expanding this capacity in order to meet the state’s proposed goal of eliminating landfilling unprocessed waste by 2008.³⁸ On the other hand, the subsidized \$39/ton tip fee at the three WTE/RDF facilities— ranging from a public subsidy of \$21/ton for Elk River, \$19/ton at HERC and \$28/ton at Newport — is estimated to have cost the taxpayers in the Twin Cities region approximately \$30 per household each year.³⁹ What is important for new entrants is that this level of subsidization is both extremely costly to the public and is presently bringing in more volumes than required by the put-or pay contracts that are the primary reason the subsidies exist. Moreover, in 1999, HERC received more loads than it had the capacity to handle and the incinerator wound up turning away 67,604 tons that had to be landfilled at WMI and BFI sites.⁴⁰ With each new county board every two years legally free to make its own decision in response to political winds regardless of prior boards’ non-contractual commitments, there is some significant degree of uncertainty whether the counties will always be willing to extend the subsidy and expand the capacity to accommodate them. Indeed, the issue continues to come up at meetings, such as the comment made by a member of the Ramsey/Washington County Resource Recovery Project:

38 Barlow Group, *Regional System Technical Evaluation* (Mar 13 ‘00), at p. 40.

39 Minnesota Office of Environmental Assistance.

40 SCORE reports.



C O N F I D E N T I A L

“[T]he more waste we receive, the more it costs the Counties. She stressed the Project should look for more aggressive ways to *decrease* the waste stream and lower the tonnage.”⁴¹

Without that subsidy, the combustion alternative would cost upwards of \$60/ton if it is available at all and make a new entrant unable to compete against the consolidators which control the landfills.

Taken together and absent outside intervention, the likelihood of competitive conditions for new entry being maintained in the future after endgame appears on the face of things to be small. The consolidators’ control over landfills appear likely to then make the risks of new entry failing too great.

As to the role of outside forces, the balance could be tipped toward making the rewards greater than the risks if the consolidators come to perceive that the United States Department of Justice and Minnesota Attorney Generals Office are monitoring the situation, and also whether the agencies have dedicated the resources to prosecute violations of the antitrust law in tough cases that are far less glamorous than the Internet and where the underlying conspiracy can be effected without express communication among just two or three large firms with shared roots. To date, this has not been the case. Quite the contrary.

CONSOLIDATORS’ CONDUCT. With the question of future new entry after the endgame probably relegated to the margins of probability, the better question for predicting competitive conditions is what will define the relationship among the vertically integrated consolidators themselves. Currently, the short term market behavior of Waste Management, Allied/BFI and Superior is one of competition for dominant market share. Some may view this as testament to the fact that they have eschewed their alleged past collusive practices, forsaken the market power latent in their control over bottleneck landfills that they need to meet investor expectations, and reneged on the promises that they have made to the capital markets to maximize profit, instead of pursuing gains in market share.

Others will counter that would be unrealistically optimistic. But, how then to explain the current competitive mode? The reason may have more to do with short term tactics than long term strategy. Beginning in 1997, pressure from Wall Street to improve earnings had led to a new era of uniquely cooperative relations among the once competitive integrated national and regional firms— old WMI, old BFI, old Allied, new Allied, Republic, former USA Waste, former American Disposal, Casella, Superior, former United Waste and Waste Connections. First, they are reported to have met, examined each other books to evaluate which of them was dominant in a particular market. Then they proceeded to swap local assets and abandon the field where they

⁴¹ Ramsey/Washington County Resource Recovery Project, Minutes of June 22, 2000, Meeting, at p. 3 (comments of Commissioner Wiessner, emphasis added).



C O N F I D E N T I A L

where they were not the primary, or sometimes the secondary, major player to the one which was and *visa-versa*.⁴²

In this way, although to the non-initiate it may seem odd that a major hauler would just pick up its marbles and walk from a major market, their abandonment of large (as well as small) cities has become the norm. For example, like a merry-go-round, BFI handed over its St. Louis assets to Allied who later turned around and passed them off to Superior, and the company gave Phoenix and Columbus to Superior who soon handed them over to Allied; Allied gave up its Boston business to BFI (before their merger), its Milwaukee territory to Superior, and Cincinnati to Republic; and BFI also transferred Chicago to Allied (again before their merger), and Phoenix and San Diego to USA Waste.⁴³ Whatever the intent, this game of musical chairs has had the effect of facilitating price signaling by reducing the number of oligopoly members in each locale based upon an apparent tacit agreement that the number one firm keeps, and the others leave, town.

In the Twin Cities area, the handwriting seems to be on the wall. If the past history of waste industry of almost 200 asset swaps is any guide, BFI may not be long for this market. It only has 35% of the consolidator's 48%-55% share of the collection market and only 24% of the current landfill market. Most important, its only landfill, Pine Bend, can accommodate barely more than five remaining years of operating life and has no expansion potential, while Waste Management's Lake Mills landfill, over the border in Iowa, after proposed expansions, will essentially have infinite capacity.⁴⁴ It would be an extremely rare situation for a consolidator to remain in a market where it does not have a hub as well as spokes. In this view, today's competitive pricing could be alternatively seen as an effort to pump up each company's books to fetch a better price in the coming exchange using agreed upon formulas for valuation, not as an indication of longer term competitive conduct.

The consolidators' own recent comments to the Wall Street analysts are consistent with an expectation that they will be pursuing higher profit margins rather than greater market share in the future:

- “[New Waste Management CEO John] Drury said he is hoping that, with some weaker companies gone from the industry in recent years and continuing

⁴² See, e.g., *Waste News*' issues for Jun 2, Jun 16, Jul 7, Aug 18, Oct 13, Nov 3 and Dec 12 '99; Nov 23 and Dec 21, 1998; and Feb 15 '99, Mar 3 and Apr 12 '99.

⁴³ *Waste News*, June 16 and Nov 3 '97; Aug 2 and Dec 21 '98; and Aug 9 '99. In one sense, some of these asset swaps were nominally driven by divestitures required by the Justice Department to approve mergers. However, the consolidators often anticipated the amount of divestitures that be required and offered up non-strategic assets to Justice for spin offs.

⁴⁴ Chartwell, *Solid Waste Digest Reports* (1999).



C O N F I D E N T I A L

consolidation, disposal prices can be increased without losing customers. The disposal glut for most of the 1990s caused dumping prices to plunge, cutting into industry profits.”⁴⁵

- “[Analysts at Goldman Sachs] believe pricing for both WMI and the industry are likely to be headed upward. The company’s senior management team and each of the five area managers repeatedly addressed the intention to develop better pricing in their markets. Area managers characterized many of the former-WMX markets as underpriced, and stated a desire to be price leaders in their regions.”⁴⁶
- “Likely the greatest impact of the merger of the second [BFI] and third [Allied] trash haulers is more favorable pricing nationwide, analysts predicted.
“Allied CEO and President Thomas Van Weelden, like Waste Management CEO John Drury, focuses on margins and cash flow, said D. Cotton Swindell, an analyst for BT Alex Brown in Baltimore.
“BFI’s market share emphasis is less important to Van Weelden than returns, and Van Weelden possesses a greater willingness to raise prices to achieve his goal, Swindell said. ‘That helps the industry in general,’ he said.”
“The Allied-BFI combination will reduce competition in many markets, thus eliminating a driver that kept prices down, said Stacy Gray, an analyst for First Analysis Securities Corp. in Chicago. ‘That should prove positive in terms of pricing,’ Gray said.”⁴⁷

That would then leave just Superior as the only other vertically integrated company on the local scene whose market conduct is uncertain. Although it only has an 8% hauling market share and 2% disposal share, it is in a position, if it exercises its potential, to be a significant competitive force. Superior’s 7 Mile Creek landfill across the border in Wisconsin has essentially infinite capacity (though its Forest Road landfill in Wright County adjoining the metro area presently seems to have too many local restrictions to make it a Twin Cities’ market factor).

Historically, prior to being acquired in 1999, Superior seemed to have flagged its intentions to cooperate with cartel pricing. “[Peter] Rudd [vice-president of Superior Services] also predicts that the [USA Waste/WMI]merger will add stability to the nature of competition,” according to one trade journal.

⁴⁵ J. Bailey, “Waste Management to Buy East Coast Hauler,” *Wall Street Journal* (Aug 18 '98)

⁴⁶ Goldman Sach, “Waste Management Inc.,” *Investment Research* (Part 1 of 2) (Aug 10 '98).

⁴⁷ B. Brown, “WMI, Allied firmly grasp market control,” *Waste News* (Mar 15 '99).



C O N F I D E N T I A L

“He says in some cases, ‘local [Waste Management] operation’s activities were somewhat unpredictable.’ He expects ‘more rational pricing and a more disciplined approach to producing earnings’ under the new leadership.”⁴⁸

Then, last year Superior was purchased by a major French conglomerate, Vivendi SA. Superior CEO Bill Dietrich, who was left in charge, assured the industry that “[w]e expect no changes at the operating level [and] will continue to operate our business as usual...”⁴⁹ But, Vivendi is a \$39.7 billion company, and, realistically, it is in a position to assert and have the staying power to persist with any market strategy it chooses should its strategic interests diverge from WMI’s and Allied’s, regardless of whatever assurances Vivendi’s CEO Jean-Marie Messler provided Mr. Dietrich at its Superior subsidiary.⁵⁰

The parent’s strategic thinking, along with Suez Lyonnaise des Eaux SA, had envisioned a new energy, water and waste management market offering one-stop shopping for large industrial firms that have far flung, worldwide operations.⁵¹

Presumably, Superior’s small footprint with operations in just twelve states centered on the Midwest will be too small to, by itself, justify a trans-Atlantic expansion strategy. Vivendi may choose to expand its U.S. waste operations one of two ways. One is by dropping the price for service, but the other is on increasing the price for acquisition targets, which is an especially fertile area in regions where likely antitrust objections bar WMI or Allied from acting.

Until, as we expect, BFI exits the Twin Cities in an asset swap, it will not be possible to reliably make any definitive predictions about Superior’s conduct, because Vivendi has no track record here and has not yet flagged whether it will override the U.S. subsidiary’s prior signal to pursue profitability over share.

However, as to the longer term, it is necessary to evaluate, first, the durability of Vivendi’s position, and second, the longer term interests of the French company. The track record for trans-Atlantic territory extensions has been uniformly abysmal. The bleak experience of WMI and BFI

⁴⁸ B. Wolpin, “A Strong Current of Change,” *World Wastes* (Apr ‘98), at p. 27.

⁴⁹ M. Lasoff, “From Players to Partners: Len Enriquez of Onyx-North American and Bill Dietrich of Superior Services Inc discuss their companies’ future in the wake of acquisition,” *Waste Age* (Aug ‘99), at p. 41.

⁵⁰ N. Deogun, “Vivendi, Canal Plus May Make Bid for Seagram Through Stock Swap,” *Wall Street Journal* (Jun 14 ‘00).

⁵¹ T. Kamm, “Suez Lyonnaise to Launch \$4.1 Billion Nalco Bid,” *Wall Street Journal* (Jun 28 ‘99); T. Kamm, “Suez Lyonnaise Chief Hails Deal for Nalco as Major Strategic Step,” *Wall Street Journal* (Jun 29 ‘99). At this writing, Suez Lyonnaise’s U.S. presence is limited to a recent acquisition of a producer of water treatment chemicals.



C O N F I D E N T I A L

abroad has been well documented.⁵² Moreover, by the same token, prior foreign expansion in the U.S. by British-based Costain, UK's Attwoods, and Canadian Laidlaw, have also failed. This suggests that the whole new layer of obstacles involved in managing such an enterprise with dramatically different national cultures from across the ocean may just be insurmountable. That implication appears especially well taken in an industry where scale economies are regional at best, the service is a commodity without any brand name value in marketing and local landfill regulations are a minefield of future liabilities.

On top of these complications that afflict trans-Atlantic expansion in the waste industry, Vivendi is following a wide-ranging diversification strategy that also includes telephones, a media group and cable television that is reminiscent of the conglomerates that combined unrelated businesses in the U.S. in the 1970's. Those are the same ones that wound up being spun off in the eighties. Investors decided that they preferred to buy stock in firms that were "pure play" companies so that they could control the diversification in their portfolios. In this way they could match their needs rather than being forced to follow the opportunistic buying sprees of the conglomerate's executive. Also, analysts found it difficult to price a company with many different, unrelated businesses, and wound up applying a "conglomerate discount" that makes the company worth more split apart than kept together.

Moreover, the focus of Vivendi's diversification into new areas appears, invidiously, to be in the higher growth telecommunications business that the solid waste sector, absent pervasive market power, cannot match.⁵³ Related to that is the fact that the company's buying spree to expand in the fast growing communications sector has left it cash strapped. There appears to be a very distinct probability that Vivendi will spin or sell off its environment division (which includes waste systems), following a planned listing of the division on the New York Stock Exchange this summer, in order to finance more telecommunications' targets.⁵⁴ That could leave Superior in play with a new owner not presently known whose intentions are not predictable.

If past experience is any guide, Vivendi's position may be short lived. If it does remain in the waste business, the company might retrench to servicing multinational industrial customers instead of commercial customers which was the strategic reason for coming to America. Alternatively, it could fall under the control of one of the other regional or national U.S. consolidators and follow the course they have laid out to sell out to a bigger fish, swap out of secondary markets, and, in those markets where there are no longer a competitive publicly-owned

⁵² J. Aquino, "Yanks Abroad: U.S. Solid Waste Firms International Experience," *Waste Age* (Apr '98), at p. 84.

⁵³ A. Galun, "Vivendi's reach crosses global boundaries," *The Business Journal* (Jul 2 '99).

⁵⁴ A. Barrett, "From Water Utility to Media Giant: Merger Plans With Seagram Put Vivendi CEO Messier in International Spotlight," *Wall Street Journal* (Jun 15 '00).

landfills to prevent squeezes, impose monopoly price hikes. Lastly, it might wind up on track to be taken over by one of the waste giants if antitrust regulators remain on the sidelines.

Even though Superior does create uncertainty as to the short term pricing picture in the Twin Cities, the MRF decision is one that extends 15 years or more. That is a time frame that is sufficiently long enough that one would be able to more reliably predict it will be off the scene as a wild card. It is that long term horizon line which relates to the MRF decision, for, once the public or the private sector drives stakes for the MRF and attains the sunk investment, that position will be extremely difficult to upend.

Endgame — when all of the structural conditions come together to create market power — is normally considered to arise when the one or two consolidators control all of the landfills and cooperate on pricing. Here the landfills are already controlled by three consolidators. One of them is expected to be preparing to swap out of the region and may be temporarily fighting for market share in order to wrangle the best buyout price. When (or if) Allied does that, and Superior confirms that it will continue its past stated policy of pricing for margins not share, the endgame will have arrived in the Twin Cities.

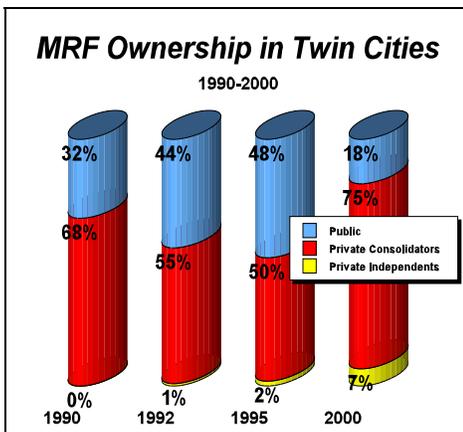


FIGURE 11

All this makes the decision of MRF ownership — the vessel through which the community can avoid monopoly waste fees — extremely important.

MATERIAL RECOVERY FACILITIES. Currently, the consolidators' have become increasingly dominant in the market for processing recyclables. However, the situation tomorrow is in flux, and the public sector that controls the residential recycle stream in Ramsey County is in a stronger position to dominate

the future world than the consolidators which are in a weakened state.

Current Market. In tandem with the growing consolidation in the waste market, consolidation has also been building in the U.S. market for processing recyclables. MRF industry's consolidators, Waste Management, BFI/Allied and most recently Casella (which acquired KTI and FCR last year), have increased their market share of MRFs (based on

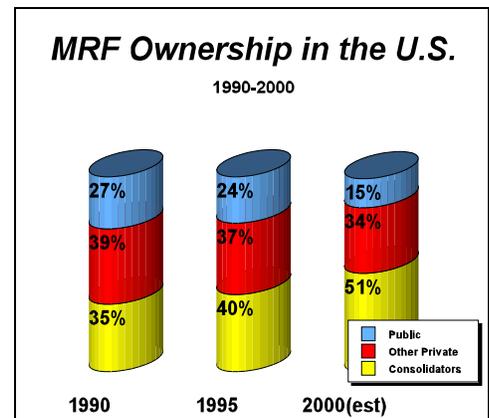


FIGURE 10



C O N F I D E N T I A L

throughputs) from 35% in 1990 to 51% in 2000 (est.), while the public sector's involvement has declined from 27% to 15% (see FIGURE 10).⁵⁵

Today in the Twin Cities, the trend has generally been the same. As shown in the next graph below, the consolidators' market share of processing capacity in the Twin Cities, after declining for a number of years has in the last half of the 1990's increased by half to reach 75% today (see FIGURE 11).⁵⁶

This would seem to speak to the consolidators' interest in also controlling the processing of recyclables. For a time there was reportedly some internal vacillation inside Waste Management that led it to consider spinning MRFs off, because of the stomach churning impact on earnings caused by the roller coaster scrap commodities market in which MRFs operate. But, just recently, WMI formally "ended long-running industry speculation by deciding to keep operating its massive recycling operations." Floor prices and options trading are said to be devices it intends to use to hedge against commodity price swings.⁵⁷

The consolidator's growing appreciation of the value of MRFs to their market power does not mean, however, that a publicly-owned MRF in Ramsey County would not be able to compete in the marketplace. For, at the same time that the consolidators' concentration ratio today raises concern, the fact that a number of the key players are in the midst of decisions to exit the processing market creates an open-ended future.

Future Market. In addition to Ramsey County's consideration to close its Rice Street MRF that is operated by Waste Management (as the successor to SuperCycle), Allied/BFI may be considering bowing out of the area in favor of Waste Management as part of another set of asset swaps. Waste Management, in turn, may be about to shutter its St. Louis Park facility. Even though, WMI states that it intends to replace both that and Rice Street with a new, large single line MRF, it would not appear likely that the company could go forward on a "merchant plant" basis in which it has no long term contracted flows, but rather receives only whatever loads arrive on any given day. Like a publicly-owned facility, it will have to first sign up users before risking the investment. In doing so, it will also have to overcome resistance to single stream processing from some of the area's major communities.⁵⁸

55 Government Advisory Associates data base.

56 Government Advisory Associates data base.

57 J. Johnson, "Waste giant sticks with recycling," Waste News (July 10 '00).

58 According to engineering consultants for the St. Paul Neighborhood Energy Consortium which manages the city's residential recycling program:

(continued...)



C O N F I D E N T I A L

The type of major facility that Waste Management describes would probably cost in the order of \$15 million.⁵⁹ Clearly, a company with \$13 billion in annual revenues could, even in its current weakened state, finance the construction of a \$15 million facility if it focused its resources on the Twin Cities. However, the limitation of being a national company is that it is not possible to focus all of its resources in every market in which it operates at the same time. This is especially the case with a company as such as Waste Management which has become Wall Street's favorite whipping boy.

The company's financial travails has been on a roller coaster since 1991, but the most recent downturn was precipitated last summer when, just short of two weeks less than a year of having consummated the USA Waste takeover of Waste Management, "[o]n July 6, 1999," according to its annual report —

“the Company announced that it had lowered its expected earnings per share for the three months ended June 30, 1999. On July 29, 1999, the Company announced a further reduction in its expected earnings for that period. On August 3, 1999, the Company announced a further reduction in its expected earnings for that period and that its reported operating income for the three months ended March 31, 1999 may have included certain unusual pretax income items. More than 20 lawsuits that purport to be based on one or more of these announcements were filed against the Company and certain of its officers and directors” —

58

(...continued)

“Significant technical concerns remain with both the design and operational efficiency of single stream (both fibers and containers together) commingled recycling processing facilities. Sorting technologies for single stream have improved during the last few years, but as a rule these facilities continue to have higher operating costs and higher residual rates than the more ubiquitous two stream commingled plants. In fact there is a significant risk that single-stream processing facilities can be outright failures, resulting in white elephant facilities, much like most of the mixed waste processing facilities that were designed in the late 80's.

“While it is self-evident that recyclables collected in a two-stream manner can be delivered to a processed by a single stream facility, it is likely that tip fees will remain higher than they would at a two-stream facility. Overall, there are no single-stream facilities operating as part of the top tier of high recovery programs in any of the larger metropolitan areas of the United States.”

59

WMI's description of the facility it claims to envision is similar to the single line MRF that was constructed in Phoenix in 1998. That facility in the Arizona desert cost \$12 million two years ago. B. Barber, “Phoenix's New MRF: A Singular Sensation,” *Waste Age* (Nov '98). Bringing those costs forward to 2001 and adjusting for Minnesota winter heating requirements and snow loadings would suggest an installed price of approximately \$15 million.



C O N F I D E N T I A L

for alleged insider trading in view of the sale from their own stakes in the company immediately prior to these announcements.⁶⁰

The investors' response was swift and unforgiving. Waste Management's stock which shortly before had risen to \$60 was pummeled to \$14 in the space of a few weeks and later sagged as low as \$13 a share. Wall Street darlings, Drury and Proto, had once been viewed as USA Waste's miracle workers riding on a white horse to rescue the languishing and rudderless Waste Management of 1997. At their pinnacle, they had doubled the stock valuation and forced a lawsuit with industry architect and WMI co-founder Dean Buntrock whom they had deposed for wounding the company allegedly with cooked books. But now amidst the ashes, it was their turn to be told by the Board of Directors to clear out their desks, and later to be ignominiously sued themselves by their own company for allegedly looting corporate assets for unjust personal enrichment spelled out in a mind numbing complaint detailing allegations of rampant self dealing.⁶¹

Makeover artist Robert "Steve" Miller was rotated back in as acting-CEO from his position on the board — where previously he had engineered the merger with USA Waste — to restore the company's credibility with investors. For months after that fateful July announcement, the company had been unable to explain July's nearly \$300 million shortfall in predicted revenues. The shortfall was especially inexplicable because, just one year before, an exhaustive audit had led to a \$3.54 billion writeoff to clean the books once and for all in preparation for the merger with USA Waste. This time more than 1,000 outside auditors that cost more than a million dollars a week were brought in to scour the books in each district office to find out once and for all what was going on. "The Company had," they found according to the annual report—

"experienced significant difficulty in the integration and conversion of information and accounting systems subsequent to the WM Holdings Merger, including certain financial systems and its billing systems. As a result of these systems and process issues, and other issues raised during the 1999 accounting review, certain charges and adjustments were recorded, [totaling] \$1,762,517,000 ..."

The report seems to have sugar coated the reality, and the detailed auditor's report has never been released. But those in the industry had long seen clearly what was going on. The core business was not producing any real earnings' gains, for one thing. For another, the artificial earnings uplift previously provided by recording the revenues from acquired firms currently and

⁶⁰ Here and the description that follows of Waste Management's financial troubles are quoted from the company's Form 10-K (Mar 31 '00), known as its Annual Report, filed with the Securities and Exchange Commission.

⁶¹ *Waste Management v. Paolino et al.*, D.C. Delaware (Complaint filed Dec 29 '99), Case No. 99-CV-930. J. Bailey, "Waste Management Sues on Acquisition: Overpayment and Fraud, Benefits to Ex-Leaders of Firm are Alleged," *Wall Street Journal* (Dec 31 '99).



C O N F I D E N T I A L

on a whole-year basis, while pooling or deferring the acquisition premiums more than 30 years, was being washed out by the “law of large numbers.” That just means after so many mega-mergers the sheer size of the waste giant had gotten too large for pooling accounting of the much more modest acquisitions that followed to register on the radar screen.⁶²

The moment of truth arrived when each quarter’s earnings reports came due. As the end of March, June, September or December approached, corporate headquarters is said to have exhorted its district offices to produce more earnings to assuage Wall Street. Essential maintenance was said to have been foregone, charges for dumpster pickup unilaterally hiked, depreciation expenses fudged, obsolete facilities kept afloat to avoid closure costs and much more that the local bookkeepers could devise to appease unrealistic demands.⁶³ It all resembled nothing so much as Mao’s Great Leap Forward — villagers exhorted to produce 10,000 pounds of iron with their bare hands wound up melting down their cooking pots and then multiplying the useless puddle of slag by 1,000 with their abacuses.

With the writedowns necessary to implement the outside auditor’s report, Waste Management was not even able to maintain “coverages” required to maintain its lines of credit, typically a bare minimum requirement that the revenue stream be adequate after expenses to pay two times the interest charges on debt, or have the loans be called. Indeed, “absent waivers,” admitted the company in its annual report—

“the Company would not have been in compliance as of September 30, 1999 with certain financial covenants as required by its four bank credit facilities... Additionally, the [waivers] contain the necessary provisions for the Company to proceed with its strategy of divesting of its WM International operations and domestic non-core assets. ...However, the Company anticipates that its cash flows from operations for the year 2000 will likely not be sufficient for the Company to maintain compliance with certain of the financial ratios ... However, there can be no assurance that, in the event the Company actually violates its agreements, that ... waivers or amendments will be obtained. Failure to obtain such waivers or amendments would have an adverse effect on the Company’s financial condition, results of operations and cash flows. During the last six months of 1999, the Company experienced a decline in its public credit ratings which curtailed its

⁶² M. Bari and B. Shim, *Waste Management: Getting Focused on the Long Term, Big Picture Cash Flow Story* (Deutsche Bank, Apr 22 ‘99), at pp. 2-3. S. Daniels, “Redefining Success: New creed at WMX, BFI, Internal Growth,” *Waste News* (Feb 27 ‘97).

⁶³ J. Bailey, “Trash Hauler WMX Gets Carried Away with Expansion: ‘Nonrecurring Charges Have Become Recurring Headache for Company,’” *Wall Street Journal* (Jan 30 ‘97); R. Melcher and G. McWilliams, “Can Waste Management Climb Out of the Muck,” *Business Week* (Mar 23 ‘98), at p. 39-40; B. Brown, “WMI refigures financial stats,” *Waste News* (Mar 2 ‘98)



C O N F I D E N T I A L

access to the commercial paper market. All outstanding commercial paper was redeemed by March 1, 2000. The Company does not expect that it will be in a position to reissue commercial paper in the foreseeable future. Additionally, as a result of a decline in its credit ratings, the Company expects to incur substantially higher costs of financing for the foreseeable future as compared to prior years should it attempt any capital market activity.”

What does all that mean? It simply relates that the audit found the company actually had losses instead of gains, and without profits, the banks and others which had extended credit were entitled by their agreements to call in their loans before the situation worsened further to the point those interest payments might go unpaid. In this case, it seems that they were able to convince the creditors to give them more time by agreeing to sell off non-core assets and use all of the proceeds to pay back the outstanding loans. But, in the year 2000, the company states that it expects to be in the same situation all over again with inadequate coverages and no assurances that it will get a second set of waivers. Certainly they would not seem to easily expect any further waivers if they did not fulfill the promises of austerity made to win last year’s reprieve.

As part of all this, the WMI Board of Directors committed in a new strategic plan to buy more time from its creditors to “[d]ispose of the Company's non-strategic and under-performing assets, including the Company's WM International operations, its non-core assets and up to 10% of its [North American] assets.”

Waste Management is suffering from what appears to be financial distress and has had to commit to its creditors to limit capital investments to those which are clearly strategic and essential to its core operations today. It would seem unlikely that the company is in any position to incur a \$15 million investment such as a Twin Cities’ MRF, which is unrelated to hauling and dumping garbage, as a “merchant” facility absent contracts to insure that recycle flows will materialize at its new MRF’s door with which to amortize the debt. While the Twin Cities MRF is an important link in tightening the noose around the region, it involves a chess move three turns later in the game. When brushing up against what seems to look like insolvency, a corporation has little leeway to indulge in forward looking thinking beyond the current quarter. Indeed, the big money backers are now said to be demanding monthly instead of just quarterly reports, and the company’s ability to finance core investments even with contractually guaranteed inflows may be hostage to each upcoming quarter’s earnings reports.

Recent upbeat analysts’ reports and upticks in its stock price do not seem to alter this assessment. Most recently, on May 10, 1999, the companies’ shares finally appeared to have firmed up a bottom, at least for the moment, after analysts received an advance peak at expected quarterly earnings reports from the waste sector and upgraded their sector ratings from hold to



C O N F I D E N T I A L

buy. Waste Management's has since been testing the \$20 level, and Allied's, \$10 a share, up from a bottom of \$13 and \$5 per share, respectively.⁶⁴

If anything, however, one thing is demonstrably clear. None of the analysts in the environmental services sector have shown sufficient knowledge to make predictions that have any value. On May 24, 1999, was just a little over a month before the fateful 6th of July when Waste Management announced its unprecedented earnings shortfall that led to an industry meltdown. Mari Bari with Deutsche Bank, the most respected analyst in this industry group, not content to regurgitate management claims finished her own independent review of Waste Management's books. Nonetheless, even the astute and diligent Ms. Bari missed the coming \$1.76 billion writedown, having concluded that "WMI's fundamentals [are] attractive and [we] believe that the stock [then at \$54] is still cheap."⁶⁵ Three months and \$29 billion of lost stock valuation later, Ms. Bari decided to move over to analyzing the fast food industry instead. Therefore, notwithstanding the recent small bump up in its stock, Waste Management's financial situation seems bleak.

Were the County to become involved with processing recyclables, contracts with communities in that market may be desirable to reduce uncertainty depending upon how large a facility for how wide a market was envisioned. If it were to act alone, the City would not need to be concerned with such contracts, although, by themselves, their facility would not achieve all the available economies of scale.

The County would be in a better position to make any needed deals, especially once each municipality in the county region recognizes the urgent need it has to act jointly to control the area's recycling destiny in order to diminish the growing market power of the waste consolidators.

Were they to do so, the county has residential recycle flows controlled by its municipalities that is several times greater than the 150 tons per day generally considered necessary to achieve economies of scale in MRF operation. For that reason, neither would the public facility need to fear having a higher cost profile than a Waste Management mega-MRF.

Recycling

⁶⁴ C. Williams, "Tales of the Tape: Solid Waste Cos Must Prove Mgmt Mettle," *Wall Street Journal Interactive* (Jan 28 '00); A Gynn, "Waste stock prices surge," *Waste News* (May 15 '00). "Salomon Upgrades Waste Management to Outperform from Hold," *Dow Jones Newswires* (May 11 '00). Other analysts, having been burned too many times in the past, hedged their bets. Deutsche Bank, *Waste Management: Has the Great Weight Been Lifted*, (May 11 '00).

⁶⁵ Deutsche Bank, *Good Times for Landfill Pricing* (May 24 '00), at p. 71.



C O N F I D E N T I A L

As noted earlier, a community can escape from a waste cartel's grip by expanding its recycling program. Retaining public control over the capability to expand recycling, then, is an effective response to divert so much of the waste stream as to lessen the bottleneck character of landfills without which the cartel cannot retain market power to bar new entry.

Expansion. To illustrate how this might pertain in this case, currently the Twin Cities metropolitan region reports that it recovered 49% of the municipal waste stream in 1997.⁶⁶ A recent waste composition study for the Twin Cities metropolitan area found that, after diverting separated recyclables, 11.5% of the waste stream was food matter and another 11.1% was residential mixed paper (RMP).⁶⁷ Typically yard debris is already diverted from the organic fraction of Minnesota's waste but food matter is almost not at all. Some programs are collecting separated RMP, but a brief examination of the quantity of RMP per household successfully captured in Minnesota against other states' programs with more aggressive promotion suggests that recovery rates might be doubled or, in some cases, tripled, as the residual remaining in the waste stream implies may be possible.

Wet/dry collection systems are increasingly found to be an effective strategy for diverting the remaining organic component after yard debris is eliminated, and RMP, which is routinely a partial component of recycle programs, is enjoying more and more reliable markets.

Together, perhaps another 15-17% of the material presently landfilled or processed — or 22% of the material currently recycled directly — might be readily added to the volume diverted for recycling or composting, if the region decides it wants to either minimize monopoly pricing or meet the state's goals for 2008, so long as it retains the power to do so. That is more than 260,000 additional tons removed from the 650,000-700,000 landfilled each year and it would leave barely more than one-quarter for landfilling or processing

Additionally, diverting the food matter along with the yard debris has wider implications than its simple volume suggests. The environmental nuisance and damage from land disposal of municipal solid waste derives largely from decomposition of the organic fraction of solid waste. That is what creates odors, greenhouse and carcinogenic gas emissions, and toxic and hazardous groundwater leachate. Though Subtitle D landfills have extensive barrier, extraction, removal and monitoring systems, all of that protective casing has a limited life, while the waste loadings are an environmental threat for as much as one-thousand years.⁶⁸

⁶⁶ *Regional/Ramsey County Solid Waste Master Plan 1998-2017* (Jan 9 '99), at p. 4.

⁶⁷ R.W. Beck, *MSW Composition Study for the Solid Waste Management Coordinating Board* (Mar '00), at p. 4-7.

⁶⁸ FEDERAL REGISTER, February 5, 1981, at pp. 11128-11129; May 26, 1981, pp. 28314-28328; July 26, 1982, at pp. 32284-32285; and August 30, 1988, Vol.53, No.168.



C O N F I D E N T I A L

Subtract organics and the inert residual remaining for disposal is of another environmental character entirely, and one that is far more benign. In addition to the environmental benefits — which are a whole critical class of considerations separate and apart from a competitive market analysis — that also has significant implications for the barriers to entry that currently exist for landfilling. Essentially, the bulk of the costs and complexity incurred currently are to putatively isolate the decomposing wastes. Remove that biological element and the task remaining for land disposal of inerts is greatly simplified. That means more players can readily enter the disposal arena.

Current landfill tip fees average \$30/ton. It is in the \$40 to \$60/ton zone that it is thought by observers more components of material currently discarded could economically be recycled or composted.

If at all possible, then, it is in the region's interests to aggressively investigate the feasibility of expanded diversion efforts for a competitive market standpoint alone. The 2008 goal to eliminate landfilling of unprocessed waste is a whole other ground in support of retaining public control over recycling's choke hold.⁶⁹ But, the current drifts to privatization of recycle processing may foreclose implementation of any feasibility plan which the area develops to control the area's MRF in order to insure both competition and attainment of the 2008 objective.

Control. As explained in detail earlier (*see p. 6 ff*), the economic imperatives operating on the consolidators in the waste industry run in opposition to expanded recovery. It would not be reasonable to expect a consolidator to act directly opposed to its own interests.

For that reason, if Waste Management were to control the only significant MRF in the region, as it proposes to do, one could not expect them to facilitate the addition of such diversion programs as food composting. Indeed, wet/dry systems are already said to be against their corporate policy. Compounding this expected bias in general will be the company's new corporate policy concerning any recycling which is not as profitable as its waste hauling operations. As a condition of keeping recycling and not spinning it off, *Waste News* reported that management stated it "will keep a keen eye on market conditions and cut back collection efforts when necessary.

⁶⁹ "Policy initiative one: Eliminate the landfilling of unprocessed MSW. The technology, methods and practices are available today to eliminate the landfilling of unprocessed MSW. The state, with assistance from stakeholders and its citizens, should take the necessary steps to assure that unprocessed MSW will not be disposed of in Minnesota landfills by the year 2008. Minnesota Office of Environmental Assistance, *Solid Waste Policy Report* (Jan '00), at p. 7).



C O N F I D E N T I A L

“You’ll see a renewed focus on turning the spigot off when prices go down,’ [Steve Ragiel] said. ... Waste Management’s recycling division also will be expected to deliver bottom-line results, Ragiel said.”⁷⁰

To make wet/dry work economically, it is desirable to have a fleet of dual, two compartment trucks, with recyclables collected in one compartment and wet waste in the other on the same truck, that can unload at one site. Should Waste Management have the only MRF in town, it would be able to obstruct implementation of wet/dry by refusing to accommodate composting along a side its container and fiber separation lines. Were the collection vehicle 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. That would make the apparent cost to compost food waste uneconomic.

On the other hand, the cost to preserve public control over processing recyclables has been estimated to only be a capital expense of \$4.9 million, with an annual debt service cost of approximately \$550,000.⁷¹ That amount is infinitesimally minor relative to the magnitude of overcharges that the county’s residents and businesses could be subjected to were there no escape route from a monopoly power for waste services in the area.

⁷⁰ J. Johnson, “Waste giant sticks with recycling,” *Waste News* (July 10 ‘00).

⁷¹ Resource Recycling Systems, *An Evaluation of Recycling Options for the Neighborhood Energy Center* (Jun ‘00), at APPENDIX B, at p. 4.



Conclusions

This analysis of the market for waste services suggests the strong probability that Waste Management may emerge dominant in the short term in the Twin Cities region, notwithstanding the existence of some uncertainty due to the unpredictable behavior of Vivendi subsidiary, Superior Services, and the vicissitudes of continued backing from investors. Past experience strongly suggests that domination of a local market by Waste Management may lead to significant price increases.

To some this conclusion may seem at variance with the fact that the Twin Cities market currently is competitive. The best way to look at the reason for the seeming contradiction is to understand that until the endgame is completed, market power does not arise. Price inflation is not something that builds slowly, heralding its coming arrival with an uptick or swell on the price curve. Rather, pricing behavior is something like the super-saturated solution of sugar that remains liquid until the last granule turns it solid. Waste Management's aborted attempt to raise tip fees in the Northeast in advance of achieving total control illustrates this fact. That characteristic of the market also means that the Twin Cities does not have the luxury to wait-and-see what happens. After the lockdown occurs, the options to restore competition will be extremely limited and unwieldy.

Previously, Ramsey County and St. Paul have viewed their decision whether to renew or establish a public role in providing MRF services in traditional privatization terms. The imminent existence of a waste monopoly in the private sector turns all those considerations on their head. For the primary purpose of privatization is to realize the advantages flowing out of competition that do not always exist to the same extent in publicly-run functions. But, in those distinct market segments where competition may soon disappear, not only will that benefit be lost, but also, exorbitant pricing will probably be imposed.

Moreover, when it comes to the particular issue of whether to maintain the county's role in providing a facility to process recyclables, continuing public involvement actually is the better way of achieving privatization's objectives because that facility is the vehicle through increased diversion with which to circumvent monopoly power and protect competition.

The County and the City would be well put to weigh this factor in their consideration of the issue. Just a $\frac{6}{10}$ th of a 1% undue increase in waste fees would exceed the estimated \$550,000 carrying charges for a \$4.9 million facility to continue its role in providing processing services for the area. Any realistic assessment of the actual far higher overcharges for waste services which seem likely would simply dwarf the dollars associated with the cost



C O N F I D E N T I A L

to maintain a public MRF. Indeed, the same considerations pertain for the other counties in the region, as well. ■