

Exhibit: Notional Balancing Account

Background

In its May 16, 2022 Public Integrity Review of the refuse rate-setting process, the Controller's Office recommended the creation of a balancing account to regulate the profits earned from the rates by Recology Sunset Scavenger (RSS), Recology Golden Gate (RGG), and Recology San Francisco (RSF and, collectively, the SF Recology Companies). A balancing account would help ensure that rates "remain just and reasonable over time." It would also "be used to stabilize rates and protect ratepayers and Recology from extreme rate swings in anomalous years." This Public Integrity Review also recommended various reporting requirements in connection with the balancing account.

In the December 2022 settlement agreement between the SF Recology Companies and the City and County of San Francisco, the parties agreed to create a balancing account with an initial notional credit of \$25 million. This initial notional balance was decreased to account for below-target profits earned in Rate Year (RY) 2022 and for revenues foregone by RSS and RGG by applying a COLA on January 1, 2023 instead of on July 1, 2022, as originally scheduled. In addition, the December 2022 settlement agreement requires that the notional balance be adjusted for above- or below-target profits earned in RY 2023. Any notional balance remaining to the benefit of the ratepayers after accounting for profits earned during RY 2023 will be used to offset rate increases by equal amounts each rate year between RY 2025 and RY 2029. The December 2022 settlement agreement also requires the notional balance to be increased if certain properties, for which rental expenses have been paid by ratepayers, are no longer used to provide service to ratepayers.

The SF Recology Companies' Request for Changes to Refuse Rates, submitted March 7, 2023, proposes the ongoing use of a notional balancing account with some modifications, as described more fully in section 3, below. Beginning with periods regulated under the new Rate Order (i.e., beginning with profits earned in RY 2024), the notional balance would be adjusted for 100% of the difference between actual net profits or losses earned in a quarter, as reported in each quarterly rate report, during RY 2024 and after and the target profit that results from applying a 91% operating ratio to actual operating ratio-eligible expenses. Since the notional balance will be adjusted based on year-to-date results each quarter, the amount calculated for each quarter will replace the prior quarter amount until the annual amount of the notional balance is calculated.

After each rate year-end, the notional balance will be available to assist in long-term rate stabilization. If the notional balance due to actual profits earned in a rate year is above the target profit, 100% of that notional balance will be used to reduce rates charged in the second subsequent rate year. If the notional balance due to actual profits earned or losses incurred in a rate year is below the target profit, 100% of that notional balance will be used to increase rates charged in the second subsequent rate

year. For example, the notional balance due to actual profits earned (or losses incurred) in RY 2024 will be used to adjust rates for RY 2026.

The target profit for a rate year will be adjusted to account for any rate adjustments due to notional balances in the balancing account or any Zero Waste Incentives (ZWI) earned because the SF Recology Companies met ZWI goals. In other words, a balancing account-related adjustment to the rates, up or down, or ZWI funds earned by the SF Recology Companies does not change the target profit that would otherwise have been applied in the absence of any balancing account-related adjustments to the rates or any ZWI funds earned. For example, if rates were increased by \$1 million as a result of the notional balance of the balancing account in a prior rate year and the SF Recology Companies earned \$1 million in ZWI funds, the target profit for the year in which these activities occur would be increased by \$2 million.

The following table summarizes these concepts:

	Notional Balance	Impact to Future Rates	Adjustment to Target Profit
Actual profits above target profit, adjusted	positive balance	reduce rates	decrease target profit by positive balance amount
Actual profits or losses below target profit, adjusted	negative balance	increase rates	increase target profit by negative balance amount

Balancing account-related rate adjustments will be applied in addition to and at the same time as regularly scheduled rate changes or COLAs.

Sample Model

Rates are set with the expectation that the SF Recology Companies will earn profits using a 91% operating ratio on operating-ratio eligible expenses. Because the rates must be set using projected revenues and projected expenses, actual results will vary from projections. The notional balancing account is designed to keep the actual profits earned by the SF Recology Companies consistent with the target profit using a 91% operating ratio. In the periods regulated under the new Rate Order, the rate application proposes two balancing-account-related adjustments to the rates: (1) the notional balance accumulated under the provisions of the December 2022 settlement agreement, which will be used to reduce rates for RY 2025 – RY 2029, and (2) the notional balance accumulated as a result of actual profits earned or losses incurred above or below the target profit, beginning with RY 2024 and continuing into the future, adjusted for any use of these notional balance amounts, positive or negative.

The following table illustrates the mechanics of hypothetical rate adjustments assuming (1) a RY 2023 ending notional balance of \$5 million; (2) on-target profits earned in

RY 2024; (3) \$1 million in net profits earned above target in RY 2025; (4) \$1 million in net profits earned below target in RY 2026 (all numbers below in millions):

	RY 2024	RY 2025	RY 2026	RY 2027	RY 2028	RY 2029	RY 2030
Profits earned above or below target	0	1	-1				
Impact on revenue from ratepayers							
Dec 2022 settlement balancing account	0	-1	-1	-1	-1	-1	
RY 2024 profits			0				
RY 2025 profits				-1			
RY 2026 profits					1		
Total	0	-1	-1	-2	0	-1	
Impact on rates (rate adjustment)							
Dec 2022 settlement balancing account	0	-1	0	0	0	0	1
RY 2024 profits			0				
RY 2025 profits				-1	1		
RY 2026 profits					1	-1	
Total	0	-1	0	-1	2	-1	1

The "Impact on revenue from ratepayers" section illustrates the impact of these adjustments on the revenue required from ratepayers. A \$1 million downward adjustment to the rates in a rate year means that \$1 million less in revenue is required from ratepayers.

The "Impact on rates" section illustrates the mechanics of rate adjustments. Because the December 2022 settlement agreement requires a rate adjustment beginning in RY 2025 and continuing for five rate years, the RY 2025 rates will be adjusted lower. There is no further rate adjustment due to the December 2022 settlement agreement until RY 2030 because there is no change to the dollar amount of the adjustment in the intervening rate years. (The notional balance following the calculation of above- or below-target profits earned in RY 2023 will be applied equally across five rate years.) For RY 2030, the rates will be adjusted upward because the downward rate adjustment provided by December 2022 settlement agreement will have been fully realized. Similarly, for above- or below-target profits earned in RY 2025 and RY 2026, the adjustment applied in one rate year will be reversed in the following rate year because 100% of the notional balance will have been realized. For example, 100% of the notional balance resulting from above-target profits earned in RY 2025 will be used to reduce the RY 2027 rates.

Proposed Rate Order Text

The SF Recology Companies shall maintain a notional balancing account to be used for stabilizing the rates charged to ratepayers.

1. Calculation of Increases or Decreases

In Q4 of each rate year, beginning with Q4 RY 2024 and continuing until a subsequent Rate Order shall take effect, the SF Recology Companies shall increase or decrease the notional balance of the balancing account to account for an estimate of the actual profits earned or losses incurred year-to-date as described in this section. In Q1 of the following rate year, an adjustment will be made to the notional balance of the balancing account to account for the final actual profits earned or losses incurred for the prior rate year. The year-to-date increase or decrease shall be calculated by taking the difference between actual net profits earned or losses incurred during the year-to-date period reported in the quarterly rate report, as applicable, and (actual operating ratio-eligible expenses for the applicable year-to-date period divided by 91% operating ratio less actual operating ratio-eligible expenses) as illustrated below, where “expenses” means operating ratio-eligible expenses and “actual net profits” means actual net profits or losses based on actual costs and revenues reported in the quarterly or annual rate reports:

$$\textit{above/below target profit} = \textit{actual net profits} - \left[\frac{\textit{expenses}}{0.91} - \textit{expenses} \right]$$

The target profit shall be (1) increased by the amount of any negative notional balance applied to the rates in that rate year; (2) decreased by the amount of any positive notional balance applied to the rates in that rate year; and (3) increased by the amount of any ZWI funds earned because the SF Recology Companies met ZWI goals. These adjustments, if any, shall result in the adjusted target profit. The SF Recology Companies shall report all such adjustments as part of the reporting requirements described below.

Above- or below-target profit, as adjusted, shall be calculated separately for RSS and RGG, on the one hand, and for RSF, on the other. The results of these calculations shall be added to obtain a combined adjusted net above- or below-target profit.

A positive value of the combined adjusted net above- or below-target profit shall result in the SF Recology Companies increasing the notional balance of the balancing account in an amount equal to that positive value. A negative value of the combined adjusted net above- or below-target profit shall result in the SF Recology Companies decreasing the notional balance of the balancing account in an amount equal to that negative value, including below zero, if applicable.

2. Reporting

Each annual rate report shall include a schedule showing all adjustments to the notional balance of the balancing account during the period of the report and shall include beginning and ending notional balances. Since the notional balance shall be adjusted prior to the filing of the annual rate report, only the final amount will be reported.

With the submission of the SF Recology Companies' audited financial statements and annual rate report to the Refuse Rate Administrator, whichever occurs later, the SF Recology Companies shall submit a schedule of the activities in the balancing account over the same period. This schedule must be separately the subject of and accompanied by an Agreed Upon Procedures report issued by third-party auditors.

3. Use of Notional Balance

The notional balance of the balancing account as reported in the schedule filed concurrently with the SF Recology Companies' audited financial statements or annual rate report shall be applied to adjust rates in the second rate year subsequent to the rate year for which the notional balance is reported. If the notional balance at the end of a rate year is positive, 100% of that positive notional balance shall offset rates charged in the second subsequent rate year. The amount of the offset shall cause the notional balance of the balancing account to decrease by an equal amount. If the notional balance at the end of a rate year is negative, 100% of that negative notional balance shall increase rates charged in the second subsequent rate year. The amount of the increase shall cause the notional balance of the balancing account to increase by an equal amount.

The adjustment to the rates described in the preceding paragraph shall be applied in addition to and at the same time as regularly scheduled rate changes for COLAs or new rates set by the Rate Board. For RY 2025, the rate adjustment due to the notional balance in the balancing account at the conclusion of RY 2023, as provided in the December 2022 settlement agreement, shall occur at the same time as the October 1, 2024 rate adjustment provided by this Rate Order.