ARNOLD & PORTER LLP

CLIENT ADVISORY

EPA's Environmental Financial Advisory Board Recommends Changes in Financial Assurance Requirements[1]

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EPA's Environmental Financial Advisory Board ("EFAB") has recommended key changes in existing financial assurance requirements. These recommendations, set forth in a recently-released January 11, 2006 letter to EPA Administrator Stephen Johnson, include requiring companies to obtain a strong bond rating from a credit agency such as Standard & Poor's or Moody's in order to demonstrate the financial capacity to clean up polluted sites, if a company seeks to satisfy financial assurance requirements through reliance on its own balance sheet, rather than through coverage provided by a third party or in some other way.

These recommendations affect or are of interest to owners and operators of RCRA-regulated waste facilities, both hazardous and nonhazardous, and underground storage tanks. Because the recommendations signal EPA's growing attention to financial assurance issues generally, they are relevant to owners and operators of facilities or operations permitted under other environmental statutes requiring financial assurance. In addition, generators of wastes sent to such facilities should take heed because their due diligence with respect to such facilities may need to be enhanced to take account of the EFAB concerns expressed in its recommendations.

WHAT IS EFAB?

EFAB is a federally chartered advisory committee formed in 1989. Its membership is drawn from government and the private sector, including the finance and banking communities and regulated industry. It provides advice to EPA's Administrator on a range of financial issues. It convenes semi-annually in open meetings. Its initial financial assurance recommendations come in response to an agency request that it examine and address a number of questions about the current financial assurance regulations, including how to improve the financial test and corporate guarantee. EFAB's January 11 letter indicates that additional

1 This Client Advisory updates an article entitled "Avoiding a Financial Fiasco" by Jeff Bromme that was published in the May 1, 2005 issue of *Waste Age*. Mr. Bromme is a partner in Arnold & Porter LLC's Environmental Practice Group.

recommendations regarding financial assurance will be forthcoming.

CURRENT FINANCIAL ASSURANCE REQUIREMENTS

EFAB's letter suggests that its recommendations will apply to financial assurance requirements for Subtitle C facilities (hazardous waste), Subtitle D facilities (municipal solid waste) and Subtitle I (underground storage tanks). For purpose of explaining its recommendation, however, it "worked from the hazardous waste regulations," and so, as context for EFAB's recommendations, a very brief description of RCRA's Subtitle C financial assurance regime is necessary.

Under Subtitle C, EPA (and through authorization, the states) must condition operation of hazardous waste facilities upon the owner or operator's demonstration of financial ability to fund the ultimate closure of the facility and post-closure care. EPA's rules for RCRA-permitted facilities allow the owner or operator to establish financial assurance by selecting from several options—trust fund, surety bond guaranteeing payment into trust fund, surety bond guaranteeing performance of closure and/or post-closure care, letter of credit, insurance (or some combination of these) or corporate guarantee. **EFAB's initial recommendations focus exclusively on beefing up the corporate guarantee requirements.**

Under current EPA regulations, the corporate guarantee method of providing financial assurance requires that an affected company demonstrate that it meets one of two tests. First, if the company satisfies two of three specified financial ratios and meets certain other net worth requirements, it would be in compliance with the financial assurance rules. Alternatively, if it carries a bond rating of BBB to AAA issued by Standard and Poor's or Baaa to Aaa issued by Moody's and meets certain other net worth requirements, the company would be in compliance.

EFAB'S RECOMMENDED CHANGES

Although EFAB admits that it has no data indicating that this two-option financial test is not working, and although it also noted that industry opposes changes without such data, EFAB nevertheless has recommended a significant change. The bond rating requirement would apply to both alternative corporate guarantee tests, and not just to the second. In all cases, a company would have to establish the designated bond rating if it were to self-insure for cleanup. If ratings from Standard and Poor's or Moody's are not available, then companies could meet their obligations by receiving "an independent third-party assessment of their credit position using methodologies currently employed by the credit rating services and other financial institutions."

EFAB gave several reasons for its recommendations. First, since credit ratings are used by commercial markets to determine what debt obligations a company can safely carry, these same ratings should be used by regulators, who "should view themselves as potential creditors with respect to the financial assurance requirements." Second, requiring credit ratings would ease the burden that some regulators feel in assessing a company's financial condition using the option that focuses on compliance with financial ratios. As EFAB delicately put it, some state and federal officials "have limited staff capacity to undertake reviews of complex financial documents and to make sophisticated judgments," since their staffs generally deal with matters of "public health and the environment," rather than "financial regulation or oversight." Third, EFAB considered the "methodologies" used by credit rating agencies to be "a reliable assessment of credit quality." EFAB concluded that the first corporate guarantee test—focusing on three financial ratios—"does not provide the same level of scrutiny offered by a credit rating," but that strengthening it could result in a new test that was too complicated to implement. Relying on credit ratings would be preferable, in EFAB's view.

EPA'S INCREASING FOCUS ON FINANCIAL ASSURANCE ISSUES

EFAB's recommendations are likely to carry significant weight with the agency. They are the product of EFAB's lengthy and detailed consideration of financial assurance issues, dating back at least to June 2004, when EFAB hosted a workshop in New York to discuss financial assurance issues such as the financial test for self-insurance and corporate guarantees, corporate sibling guarantees, insurance ratings and capitalization requirements, and captive insurance.

As evidenced in its mandate to EFAB, EPA has shown growing interest in financial assurance issues over the past several years.

- About a year ago, on February 22, 2005, EPA announced that enforcement of financial assurance requirements would be a new, national priority. The agency said it would shift resources into identifying and penalizing violators.
- In April 2003, EPA featured financial assurance requirements in an Enforcement Alert. EPA stated that it was "stepping up its enforcement" of financial assurance requirements.
- Earlier still, on March 20, 2001, the EPA Inspector General had issued a report noting several concerns with the current financial assurance regulatory structure, including concerns about coverage provided by captive insurance companies and the methods and assumptions used in estimating closure and post-closure costs. Later that same year, EPA requested public comments regarding captive insurance and applying uniform ratings governing the eligibility of insurance companies to provide financial assurance.

Several developments help to explain the agency's intensifying focus on financial assurance. These include the fact that some closed facilities are nearing the end of the 30-year period for which closure and post-closure costs were calculated. The contamination may still exist, but the financial assurance coverage will have been calculated on the assumption that costs would extend for only 30 years. If the owner/operator disappears from the scene at that point, the financial assurance designed as a backstop may be inadequate to ensure continued care.

Likewise, the collapse of both Reliance Insurance Company and Frontier Insurance Company in the early part of this decade shook federal and state regulators. In the period 2000-2001 both providers effectively ceased being able to provide financial assurance coverage. They were major providers of financial assurance coverage, and their demise severely strained operations at a number of companies.

The EFAB letter also refers to concerns that "pensions and other financial obligations may impair the financial capabilities of the potentially responsible parties, as well as the companies that may provide third-party assurance."

The initial EFAB recommendations announced this month may energize EPA into proposing changes to its financial assurance regulations, even as the agency continues with its heightened enforcement of existing regulations.

WHAT COMPANIES SHOULD DO NOW

In view of recent EPA activity in this area, there are several steps a regulated company should take:

First, a company relying on third-party providers of coverage should conduct due diligence to assure themselves that third-party providers of coverage are strong and not likely to become insolvent. There is very limited time to obtain replacement coverage if a provider collapses.

Second, a company should confirm that their closure and post-closure estimates are current and realistic. Even properly calculated estimates may draw unwanted attention if they are unrealistically low.

Third, companies should determine whether they can satisfy the existing corporate guarantee test. If so, the company can avoid the premium and collateral costs associated with posting bonds or providing insurance. These costs can be substantial.

Fourth, if a company cannot meet the corporate guarantee test, it should make certain that its bonds, insurance policies or other coverage instruments are current and that they provide coverage for the full closure and post-closure estimates. Failure to keep coverage amounts current may now draw greater scrutiny than in the past.

Fifth, in some cases, spreading coverage among several providers may be advisable, rather than putting all facilities with a single provider. And companies should shop around regularly for better pricing. Not only does this provide assurance that costs are as low as possible, it will build important relationships with alternative providers who may be called upon if existing providers fail or their capacity to issue coverage contracts.

Sixth, if a company discovers that it is violating financial assurance requirements, or has done so in the recent past, consideration should be given to voluntary disclosure of these facts to EPA. Penalties can be reduced if a company self-reports.

Finally, companies should engage with regulators in the rulemaking process. Important changes may be coming to the world of financial assurance. Affected companies should not miss the opportunity to provide their valuable input to EPA through comments and meetings, informal and otherwise.

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