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WASHINGTON, D.C. 20460

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CHIEF FINANCIAL OFFICER

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Dear Sir/Madam:

Enclosed are two copies of the Environmental Financial Advisory Board's (an EPA Federal Advisory Committee), report titled, "*Financial Assurance in RCRA Programs*" for your records. If you have any questions, please call me at 202-564-5186.

Sincerely,

Vanessa Y. Bowie, Director  
Environmental Finance Staff

Enclosures

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**UNITED STATES ENVIRONMENTAL PROTECTION AGENCY  
ENVIRONMENTAL FINANCIAL ADVISORY BOARD**

JAN 11 2006

Honorable Stephen L. Johnson, Administrator  
United States Environmental Protection Agency  
1200 Pennsylvania Avenue, NW  
Washington, DC 20460

Re: EFAB initial findings concerning use of the financial test and corporate guarantees to meet financial assurance requirements under RCRA programs

Dear Administrator Johnson:

At the request of the Agency, the Environmental Financial Advisory Board (EFAB or Board) has convened a workgroup to address a number of questions concerning the financial assurance requirements for Office of Solid Waste and Emergency Response programs. These requirements address closure, post-closure, corrective action and other aspects of the Subtitle C (hazardous waste), Subtitle D (solid waste) and Subtitle I (underground storage tank) programs. The goal of the financial assurance requirements is to ensure that an obligated party has the financial capacity to meet its obligations. A range of mechanisms are available to regulated entities to meet these requirements including: (1) trust funds; (2) satisfying the corporate financial test; (3) corporate guarantees provided by a corporate parent, sibling corporation, or other firm with a substantial business relationship that does meet the financial test; (4) insurance; (5) letters of credit; and (6) third-party sureties (payment or performance bonds).

Pursuant to the specific charge developed by the Agency, the EFAB workgroup has reviewed various reports and documents, met with Agency staff and state officials responsible for administering the RCRA programs, held a 2-day workshop in New York City, met with representatives of regulated entities, and held numerous meetings as well as telephone conferences of the subcommittee. Early on, it became apparent to the subcommittee that in light of the complex and multi-faceted nature of the financial assurance requirements and the issues concerning them, that we should break the work down into more manageable pieces and focus sequentially on them. In this letter we provide our initial analysis and response concerning the use of the financial test and corporate guarantees. The financial test mechanism relies on an evaluation of the financial viability of the regulated entity; the regulated community prefers this method since all other mechanisms require an additional cost. As we complete our review of the other mechanisms, we will apprise you of our responses to the questions posed by the Agency along with our findings.

## Commendation of Agency

At the outset, we want to commend the Agency's leadership for the initiative it has taken to assess the efficacy of the financial assurance requirements, to consider improvements and to contemplate where they might be extended to other activities regulated by the Agency. The RCRA Subtitle C, D and I programs have been in place for 20 to 25 years; the Agency acts responsibly when it reviews critical aspects of the programs to assess how well they have worked, to identify any problems that need to be addressed, and to assess whether changes or foreseeable trends in the external environment indicate the need for program adjustments or improvements. We understand that there are other related efforts underway that may offer additional insights that would need to be taken into account in making decisions concerning the financial assurance requirements. We appreciate the interest in the project as well as the cooperation we have consistently received from Agency staff at all levels.

Substantial private and public monies have been expended to date to remediate past waste disposal problems and those expenditures are expected to continue. In light of concerns about the public's confidence in corporate financial disclosures, there is a need for prudence in assessing the public exposure to future unfunded waste sites. This situation is exacerbated by 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 Current Financial Tests

The financial assurance regulations for hazardous waste facilities, municipal solid waste facilities, and underground storage tanks are contained in different parts of the Code of Federal Regulations. The financial tests vary for costs associated with closure and post-closure and for costs associated with liability coverage, but both rely on the same basic financial concepts. We have worked from the hazardous waste regulations which provide, in 40 CFR Parts 264 and 265, subpart H, for closure/post-closure costs, that in order to demonstrate financial assurance, an owner or operator must meet one of the following two options:

### Alternative I:

(A) Two of the following three ratios:

A ratio of total liabilities to net worth of less than 2.0;

A ratio of the sum of net income plus depreciation, depletion, and amortization to total liabilities of greater than 0.1; and

A ratio of current assets to current liabilities of greater than 1.5; and

(B) Net working capital and tangible net worth each at least six times the sum of current closure and post-closure care cost estimates being covered by the test; and

(C) Tangible net worth of at least \$10 million; and

(D) Assets in the United States amounting to at least 90 percent of total assets or at least six times the sum of the current closure and post-closure care cost estimates being covered by the test.

**Alternative II:**

- (A) A current rating for the owner or operator's most recent bond issuance of AAA, AA, A or BBB as issued by Standard and Poor's or Aaa, Aa, A or Baa as issued by Moody's;
- (B) Tangible net worth at least six times the sum of current closure and post-closure care cost estimates being covered by the test; and
- (C) Tangible net worth of at least \$10 million; and
- (D) Assets in the United States amounting to at least 90 percent of total assets or at least six times the sum of the current closure and post-closure care cost estimates being covered by the test.

In 1991, EPA proposed revisions to the financial test for hazardous waste facilities (50 FR 30201, July 1, 1991). The proposed revisions, which to date have not been the subject of final action by the Agency, would change the financial test requirements by requiring compliance with one of two ratios under Alternative I, and modifying the remaining ratio requirements to specifically ensure coverage of the closure and post-closure costs and have minimum net worth/working capital remaining. The goal of the 1991 revisions was to address the following concerns: 1) that the test was less predictive of potential bankruptcies; and 2) some large financially sound companies were not allowed to use the financial test. The revisions did not propose any changes to Alternative II.

**Agency Questions**

In its charge to the Board, the Agency posed the following concerning the financial test and corporate guarantee:

EPA and its state government partners seek general advice on how to improve the financial test and corporate guarantee. Specific questions that have arisen include:

- What are the strengths and pitfalls of the financial test and corporate guarantee?
- Should EPA adopt the financial test proposed in 1991 for hazardous waste, or have advancements in financial analysis provided better potential tests in the meantime?
- What, if any, new or different financial tests or protections might be appropriate?

**Observations**

The Board would offer the following general observations from its review to date of the financial test and corporate guarantees to provide some context for our responses and recommendations:

- The GAO reports that there has been no systematic collection of data with regard to the efficacy of the test. While initiatives are underway at the state and federal levels to commence such collection, it has been difficult for the Board to define the exact nature of any problems with the test in the absence of such information. Thus, our recommendations are based not on specific failures of the financial test, but on our knowledge of prudent financial practices and the availability of existing expertise in the financial services sector.
- The EPA Inspector General reports that some states have placed restrictions on the use of the financial test and/or the corporate guarantee. The Board has limited information on the application or scope of such restrictive use. States are concerned that they do not have expertise on their staffs to review the financial documentation and assess compliance with the financial test. This is particularly important since some state regulators have primary responsibility for the enforcement of many financial assurance requirements.
- The state concerns highlight the fact that oversight of the financial assurance requirements rests with federal and state officials whose responsibilities involve the protection of public health and the environment—and normally do not involve financial regulation or oversight. In some instances, state and federal officials have limited staff capacity to undertake reviews of complex financial documents and to make sophisticated judgments.
- Regulated entities—primarily large public companies—that utilize the test do not believe it is appropriate to change the existing test without sound evidence showing that the test has not achieved its intended purpose and that changes are necessary to assure that the risks presented by its use are not appreciably larger—or less acceptable—than when the test was adopted. Members of the regulated community also warn that any proposal to modify the test would cause disruption among the regulated community in meeting their requirements under the test.
- We note that we have seen very little information concerning the utilization of the financial test by small entities, and particularly those without a bond rating. If the small company is private, it is not subject to the same financial disclosure requirements imposed on public companies, and the issues with respect to use of the financial test may be different from those for publicly owned companies.
- The use of the financial test can be affected by the nature of the business of the regulated entity. Some regulated entities are primarily in the waste transport, storage and disposal business while for others such activities represent a relatively small part of their overall business operations.

- Finally, because the financial test requirements are relative to the estimated closure and post-closure costs, confidence in the integrity and relative accuracy of those estimates is integral to whether the financial test provides adequate assurance. And, to the extent the financial test is being used with reference to projected remediation costs, the timing of the imposition of the financial assurance requirement as well as the determination of the amount to be secured have to be carefully considered in tandem with the structure of the financial test itself.

## **Findings and Recommendations**

The Board has found that many regulated parties rely on their credit ratings to use the financial test for meeting their financial assurance requirements. We believe that the use of independent credit analysis, i.e., credit ratings, is a cost-effective mechanism for demonstrating financial assurance and should continue to be an alternative for those companies that have investment-grade ratings on their debt. Many of the large public companies that are obligated to provide financial assurance are participants in the debt markets and carry ratings on their bonds.

We believe that the investment grade credit quality benchmark of Alternative II is an important threshold that should be required in Alternative I. The Agency and its state counterparts should view themselves as potential creditors with respect to the financial assurance requirements. Requiring credit substitution in the absence of investment grade credit quality is a common practice in the financial services industry, and we recommend that such a standard apply to Alternative I as it does for Alternative II.

We find that credit ratings help address the limited capacity for undertaking extensive credit analysis by state regulatory bodies. We do caution, however, on the definition of the ratings that may be used to demonstrate financial assurance: the requirement currently is the "most recent rating." Many companies issued secured debt (with collateral or mortgage pledge) that would carry a higher rating as a result of that securitization. The requirement should be based on the "senior unsecured" or "senior implied" rating which is a statement of fundamental credit quality without regard to a specific pledge of assets. The rating should also be current, reviewed at least within the past 24 months.

We find that the methodologies used by the credit rating agencies are a reliable assessment of credit quality. They are comprehensive, historical and dynamic, in that they address both financial performance and financial position to assess market dynamics; incorporate liquidity; address reinvestment; and consider the overall performance of the industry in which the regulated party operates. The ratings incorporate trends, reviewing financial performance and business operations over time for signs of credit deterioration.

We believe that the current Alternative I test does not provide the same level of scrutiny offered by a credit rating. On balance, we recognize that a test that affords that level of scrutiny may be deemed to be too complicated for codification, and may impose administrative complexities on the regulated parties. The Board recognizes that the Agency seeks to have the test fulfill a least-cost criterion. Inevitably, there will be a tension between this goal and the goal of transparency with a "comprehensive" test. There is a real risk that additional comprehensiveness of a test will come at the expense of a test that is much more complex, difficult to understand and administer—and that marginal gains in reduction of risk have to be weighed against those potential costs.

Thus, the Board recommends that the Agency consider that all companies using the Alternative I test to meet their obligations receive an independent third-party assessment of their credit position using methodologies currently employed by the credit rating services and other financial institutions, which is already being done for the companies using Alternative II. We believe that parties are already disadvantaged in their ability to use the financial tests due to the limitations on its acceptance in some states. Using an independent third party will relieve the states of the administrative burden of reviewing financial statements (along with concerns about their capacity to adequately undertake such review); such a third party would also be able to render an opinion as to whether the party met an investment grade standard of credit quality. While the third-party review is more costly than the simplicity of the existing Alternative I test, it is less costly than purchasing third-party instruments and seems to address the current concerns better than the 1991 proposal.

### Next Steps

The Agency has also posed the following questions to the Board:

- Should EPA continue to allow corporate siblings to guarantee the obligations of another subsidiary, or should guarantees only be allowed for parents and higher level companies?
- Does the current level of disclosure of cleanup obligations in financial statements provide sufficiently reliable information for use of a financial test?

The Agency has also posed questions with respect to insurance and other third-party credit mechanisms. The Board does not feel that it has adequate information at this time to make a recommendation with respect to the corporate guarantee or the cost estimation elements of the financial test, but has developed a plan to address these issues. We look forward to providing further communication to you in this regard in the near future.

If the Agency decides at some point to go forward with changes to the financial test, the Board would be pleased to work with the Agency to develop specific proposed changes. We would also note that the Board has identified looking at the financial assurance requirements of other federal agencies as a potential source of ideas for an enhanced financial test. If the Agency believes it would be desirable for the Board to do so, it will add this to its work schedule.

We will, of course, be pleased to respond to any questions you or the Agency may have concerning this initial report, and we look forward to continuing to work with the Agency as this project continues into its next stage.

Sincerely,



A. Stanley Meiburg  
Executive Director

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