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Honorable Mathy Stanislaus
Assistant Administrator
Office of Solid Waste & Emergency Response
U.S. Environmental Protection Agency
Washington, D.C. 20460-0001

Dear Mr. Stanislaus:

The Environmental Financial Advisory Board (EFAB) was asked by the Office of Solid Waste and Emergency Response to examine a series of important questions concerning financial assurance requirements for programs operating under the Resource Conservation and Recovery Act (RCRA). Previous EFAB reports have addressed the use of important individual financial assurance instruments -- the financial test/corporate guaranty, captive insurance, and commercial insurance. These earlier reports can be accessed at www.epa.gov/efinange/efabpub.htm. This latest report (enclosed) examines cost estimation practices and provides recommendations for improving the cost estimates that underpin the use of all financial assurance instruments.

EPA's charge to the Board regarding cost estimation first expresses a concern and then provides a specific direction:

Cost estimates can cover a variety of activities with different time frames. Estimates can also change substantially as a result of additional information, such as new data on the extent of contamination at a site. Because the cost of a mechanism can depend upon the cost estimate, there may be an incentive to underestimate costs.

EPA and its state government partners seek guidance on what can be done to improve the accuracy of cost estimates.

To respond to this charge, EFAB worked closely with EPA, state officials, and private sector parties to analyze the protocols, implementation practices, and regulatory contexts associated with conducting cost estimates under RCRA programs. The Board wishes to particularly note the invaluable assistance provided during this effort by EPA's financial assurance and cost estimation staff experts and the members of the Association of State and Territorial Solid Waste Management Officials.

The conclusions and recommendations contained in the enclosed report are the result of a process encompassing more than a year of intensive series of meetings, discussions, and deliberations. This process has only served to strengthen EFAB's opinion regarding the critical importance of good cost estimates. The Board shares the view expressed by many that the best financial assurance instrument is only as good the accuracy of the cost estimate that it secures.

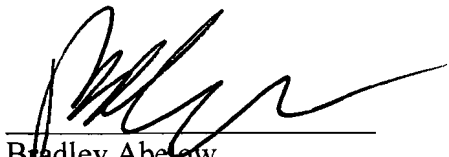
EFAB's most important conclusion is that the cost estimates for actions and activities under RCRA and Superfund programs are not uniformly accurate and up-to-date. To begin to address this concerns, the Board believes that EPA and its public and private partners need to improve cost estimation expertise and work by developing more standardized cost estimates; providing more education on best practices; and expanding existing coordinating mechanisms in cost-effective ways.

Some of the specific actions that the Board believes that EPA should take include:

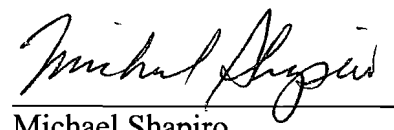
- Creating standard checklist templates that clarify definitions, ensure completeness, and streamline reviews;
- Creating a web-based platform to disclose and improve the state of knowledge regarding good cost estimation;
- Developing within EPA and the states a body of experts who know how to use these tools; and
- Committing Agency resources to translating information into best practices and providing improved ongoing training to regulators.

EFAB recognizes the importance of your Office's financial assurance responsibilities and appreciates the continuing opportunity to provide financial advice to you. We hope that you find our advice constructive and useful.

Sincerely,



Bradley Abelow
Chairman



Michael Shapiro
Designated Federal Officer

Enclosure

cc: Lisa P. Jackson, Administrator
Bob Perciasepe, Deputy Administrator
Barbara J. Bennett, Chief Financial Officer

Environmental Financial Advisory Board

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Improving Cost Estimation as a Financial Assurance Tool

This report has not been reviewed for approval by the U.S. Environmental Protection Agency; and hence, the views and opinions expressed in the report do not necessarily represent those of the Agency or any other agencies in the Federal Government.

December 2010

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Improving Cost Estimation as a Financial Assurance Tool

I. The Charge

The U.S. Environmental Protection Agency (EPA or Agency) has asked the Environmental Financial Advisory Board (Board) to examine a series of questions concerning the financial assurance requirements of the Resource Conservation and Recovery Act (RCRA). These requirements are also considered within the context of the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA or Superfund).¹ Thus far, the Board has answered questions regarding use of the financial test and insurance (both commercial and captive) as mechanisms to satisfy RCRA financial assurance obligations. This report provides recommendations for improving the cost estimates that underlie use of financial assurance instruments. While it is important to secure financial assurance of closure, post-closure, corrective action and remedial obligations through reliable financial instruments; the best financial instrument is only as good as the accuracy of the cost estimate it secures.

EPA's charge to the Board expresses a concern and then identifies the charge:

Cost estimates can cover a variety of activities with different time frames. Estimates can also change substantially as a result of additional information, such as new data on the extent of contamination at a site. Because the cost of a mechanism can depend upon the cost estimate, there may be an incentive to underestimate costs.

EPA and its state government partners seek guidance on what can be done to improve the accuracy of cost estimates.

The charge put to the Board is straightforward, but our efforts to develop workable approaches to improve cost estimates have been complex. The Board has deliberated for nearly two years, and has met several times with state regulators expert in cost estimating protocols, regulatory oversight, and implementation of cost estimation in the permitting and remedial project contexts. Some members of the Board are familiar with the cost estimating process as regulated parties or their insurers. EPA provided invaluable assistance in providing relevant literature on cost estimation and hands-on experience with the challenges posed in various regulatory contexts. The Board's series of meetings with members of the Association of State and Territorial Solid Waste Management

¹ Since the charge to the Board relates to environmental regulations, this report discusses cost estimation within the environmental programs designated above. Cost estimation of environmental liabilities is also an important component of other regulatory regimes, such as those governing financial reporting. While this report may be informative for those other programs, we note that different regulatory regimes produce different results and therefore emphasize that the conclusions in this report may not apply to other regulatory reporting programs.

Officials (ASTSWMO) proved to be particularly helpful as consensus positions on the difficulties of cost estimation and the path to improving accuracy began to emerge.

II. The Challenges in Cost Estimation

The Board identified both substantive and procedural causes for potential inaccuracy in cost estimates, whether performed to estimate costs of closure, post-closure care, or corrective action at RCRA facilities and response costs at Superfund sites. The following summary reflects the Board's knowledge from member experience, discussions with federal and state officials responsible for oversight of financial assurance obligations, and review of pertinent literature.²

Substantive Factors

Variability Among Like Units: Experience³ has shown a high variability among cost estimates for seemingly comparable facilities – clearly a red flag where the variability remains after subtracting for factors such as size, differing types of unit, or physical environment. There appear to be two main factors affecting reliability:

- Incomplete estimates: Upon scrutiny, the variability and resulting unreliability of many cost estimates reflect failure to include all appropriate costs (e.g., failure to include the cost of transportation to off-site disposal, the cost of certifying closure, or the cost of treatment before discharge of liquids). See, e.g., PRC Environmental Management, *Revised Draft Report on Analysis of Cost Estimates for Closure and Post-Closure Care* (hereafter *PRC Report*) (October 15, 1996), p. 13. Estimates may be incomplete because all elements of an anticipated action may not be included, or because the scope of the future project has been too narrowly defined. One study found what the authors believed to be underestimation varied by type of unit, ranging from 72.58 percent for waste piles to 16.14 percent for landfills. *Ibid.*, p. 17. The same report also saw variability according to whether a unit subject to an enforcement action incurred a penalty or not, with facilities incurring penalties tending to project lower costs than facilities where enforcement actions did not rise to the penalty phase. *Ibid.*, p. 21.
- Financial motivation to understate costs: Some reports posited a consistent motivation to low-ball cost estimates – both in terms of the completeness of the estimate and a consistent underestimation of costs that are included. See, e.g., EPA Inspector General, *Audit Report on RCRA Financial Assurance for Closure and Post-Closure* (hereafter *IG Report*) (2001-P-007, March 31, 2001), p. 45.

² Reports reviewed included:

- PRC Environmental Management, *Revised Draft Report on Analysis of Cost Estimates for Closure and Post-Closure Care* (October 15, 1996),
- EPA Inspector General, *Audit Report on RCRA Financial Assurance for Closure and Post-Closure* (2001-P-007, March 31, 2001), and
- ASTSWMO *Financial Assurance Review Paper* (April 21, 2003).

Importantly, these somewhat dated reports were supplemented by current information provided in direct discussions with state environmental division directors under the auspices of ASTSWMO.

³ See, e.g., the references in footnote 2 above.

The reports assumed there would be a tendency to choose the lower end of a range of potential costs as well as a tendency to “bundle” cost factors in a way that disguises missing elements. States found this particularly common for parties submitting their first estimate and small entities with relatively few facilities (and thus little interaction with regulatory experts who could educate them on good practices). One study found that estimates used to secure third-party funding (e.g., letters of credit, state mechanisms, trust funds and insurance) tended to be understated when compared to those of similar units using self assurance (e.g., surety bonds, the financial test and the corporate guarantee). *PRC Report*, p. 10-12. (but see *IG Report*, p. 45, recounting concerns that facilities using the financial test might find it easier if costs are underestimated).

Some states have attempted to improve the accuracy of cost estimates by requiring third-party verification of the estimates, but the ASTSWMO members with whom we conferred indicated third-party verification merely shifts the regulator’s burden of oversight from one entity to another. While the third party may have more experience to draw upon, this will not necessarily cure the underlying variability and inaccuracy of the cost estimate.

Reliability Over Time: Even estimates that originally reflect complete accounting of necessary activities and accurate estimates of each cost can become less reliable as time and circumstances at a site progress, or changes in science, technology or law overtake original estimates. Rules regarding when an estimate must be updated for more than inflation do not always exist, and where they do exist they may not be consistently followed. Estimates for corrective and remedial action are particularly challenging. Unlike RCRA closure/post-closure requirements, which are specific to individual units and largely fixed by regulation, corrective and remedial actions tend to address the impacts of activities that pre-dated proscriptive environmental standards. Corrective and remedial action estimates can be highly variable according to facility type, substances handled, availability of accurate records of disposal, knowledge of design and operating features, and the specifics of the industry sector. Because of insufficient knowledge of historic practices, cost estimates for corrective and remedial action tend to change over time as phases in the response process proceed, the site is more fully characterized and the extent of necessary cleanup becomes known. Estimates made during the remedial investigation stage will not be as accurate as those that can be formulated when the response action is in its design phase.

Procedural Factors:

Available Information: Although both EPA and the states oversee cost estimation of closure/post-closure and corrective/remedial action, there is no centralized database reflecting their experiences. Nor would there be an efficient way to search such a database if EPA were to gather the relevant federal and state experience in one place because the data are not arrayed in an accessible, standardized format. There is no “checklist” assuring that all tasks are comparably defined and separately itemized. Some states (Pennsylvania, for example) have detailed checklists to be filled out by regulated

parties. Others ask for broader categories of information, and still others allow regulated parties to develop ad hoc presentations of what they consider the relevant data. Without standardized definitions and presentation, there are inconsistencies and lack of transparency in treatment of discounting and use of contingency factors. These inconsistencies create the opportunity for inadequate cost estimates.

Resources: Constrained resources have impeded development of standardized approaches that could improve the body of knowledge on cost estimation. Standardized tools like CostPro and RACER are proprietary and may be outside state budgeting capacity. Moreover, tools like CostPro and RACER are just that -- tools, not a substitute for the professional judgment necessary to properly define the scope and essential elements of a particular future closure, post-closure maintenance regime or corrective action. These tools are not universally accurate, and in fact are embedded with assumptions that may or may not be applicable in any given case.

The limitations of these standardized tools are exacerbated in States with budget limitations, where resources may also be lacking to provide the kind of on-going training needed to continually improve regulators' expertise in cost estimation best practices. Moreover, where state budgets are limited, state regulators simply may not have the time to enter into extended negotiations necessary to flesh out accurate facility estimates.

III. Recommendations

Several themes emerged in the Board's deliberations:

- The need for more standardized cost estimates;
- The need for education on best practices; and
- The desire to improve the system with the least cost and bureaucracy possible.

The Board initially considered recommending creation of a team of experts who could research and identify best practices and procedures, and even serve in an advisory role on particularly challenging projects. As discussions progressed, state representatives identified an existing coordinating mechanism to serve as a practical substitute for an independent advisory board. The Board, in consultation with state regulators, determined that enhancing these informal consultations could improve the quality of cost estimates more expeditiously, with the least cost and bureaucracy and the most flexibility.

The Board's recommendations to EPA therefore focus on expanding existing coordinating mechanisms and taking advantage of web-based tools to improve cost estimating practices. Although the Board is not recommending creation of a team of experts, in part because of the cost involved, we cannot stress enough the need to develop within the process we are recommending continually improving expertise on this issue. The process we are recommending is intended to evolve the functional equivalent of a team of experts with in-depth knowledge of estimating best practices and increasing sophistication in recognizing the warning signs of insufficient cost projections.

Initiating Enhanced Dialogue

ASTSWMO/EPA Coordination: ASTSWMO members currently conduct informal information sessions to share best practices on cost estimation. In addition, there are monthly calls between states and EPA regional staff discussing programmatic issues, including trends in cost estimation. The Board recommends that EPA Headquarters participate the Regional monthly calls and make cost estimation trends and best practices part of the discussion. EPA Headquarters currently enjoys the benefit of longevity in staff highly experienced in financial assurance management and oversight, and the goal of the EPA/ASTSWMO coordination would be to transfer knowledge to new practitioners.⁴

Additional Coordination: To enhance EPA's usefulness to the states when participating in monthly calls, the Agency should solicit input from private sector RCRA and Superfund project owners and insurers. Those responsible for creating – and then following budgets to match – facility-specific cost estimates will have valuable information on best practices and data sources for cost information.

Creating Standardized Approaches to Documentation

Standardized template: All states with which the Board conferred expressed support for EPA's creation of more standardized approaches to cost estimation for closure, post-closure, corrective action and remedial action -- in particular for corrective action and remedial action where there are fewer prescriptive tasks than those set forth for RCRA closure and post-closure care. EPA's standardized approach should take the form of a template (or templates) to array the various components of a reliable cost estimate. It is likely that EPA will be able to create standardized checklists for specific industry sectors or regulated units (or groups of sectors with like characteristics).

The goal of a template is to improve consistency in the elements included as each facility performs its cost-estimation exercise. A checklist is a very straightforward way to assure that all potential costs are considered and accounted for with site-specific data. A standard template has the additional virtue of formatting the relevant data in a way that is predictable and thereby simplifies the review process. This kind of standard data array also facilitates input into an estimating tool like CostPro or RACER, if the regulator so chooses. The template is not CostPro or RACER methodology per se, but includes the data elements they incorporate.

The resulting document should include all critical elements, encourage maximum use of site-specific data, render any assumptions (as opposed to site-specific calculations) transparent, and in the end much better assure an estimate that is neither too low nor too high. The Board understands that some states already have projects underway to create

⁴ We note that coordination with ASTSWMO may not be sufficient to obtain information on a wide variety of corrective action or remediation sites, including mining sites. Because ASTSWMO members may have limited levels of expertise, EPA may need to seek broader coordination with state agencies or professional organizations with that kind of specialized expertise.

work sheets compatible with potential use of CostPro and RACER. EPA could build upon that work, and then make the worksheets broadly available.

It will be important to understand the benefits – and the limitations -- of these new templates. A template will encourage accurate unit data reflecting local third-party provider market conditions rather than mandate national assumptions (e.g., should incorporate the cost of local soil for liners, or current transportation costs in the region). Cost estimators must be aware, however, that these kinds of tools are necessary but not sufficient to improve the quality of cost estimates. Tools like worksheets, CostPro and RACER simply do not substitute for professional judgment. Estimations must properly reflect the scope of the future action and then tailor each item in the worksheet to the most accurate projection possible at the particular site in question. The worksheet will only be as good as the expertise of those completing and reviewing them. This is particularly the case with corrective action, where the variability in scope and potential tasks is more dramatic than with the relatively circumscribed closure/post-closure care.

Developing an On-Going Cost-Estimation “Body of Knowledge”

Documentation of trends: In the monthly Regional/state coordinating calls and the periodic discussions with RCRA and Superfund project owners and insurers, types of facilities or sectors in need of priority should be flagged. The information gleaned from both kinds of discussion should be documented in a publicly accessible web-based platform.

The usefulness and accuracy of this information repository should be strengthened over time by, for example, analyzing the accuracy of estimates vs. actual expenditures where such information is available – for example, at federally funded sites, removal actions and bankrupt sites where EPA gathers information on estimated vs. actual cost data. We know that EPA’s efforts to make Superfund “faster, fairer and more efficient” have refined understanding of standard remedial approaches and their costs at some kinds of sites, and the cost data compiled in the Superfund data base should be relatively current, specific and helpful to regulators encountering those types of sites. To the degree that these data can be accessed and searched in an efficient and meaningful way, they should prove to be very useful to the cost estimation body of knowledge.

EPA also should review its database on a routine basis for short-fall situations in order to isolate commonalities among types of facilities, sectors or ownership that could serve as a red flag. The results of such analysis could flag within the universe of current estimates those deserving extra scrutiny by federal or state regulators.

Formal training: EPA should incorporate the best practices and insights gained from its web site and routine discussions into cost estimating training provided to state agency personnel.

Clarifying When Estimates Must Be Updated

EPA should issue guidance clarifying the circumstances under which estimates should be adjusted to address factors other than inflation. Perhaps the best way to improve accuracy would be to require regularly scheduled reviews tailored to site-specific circumstances such as the nature of the risks posed (projects with higher risk might warrant more frequent reviews), the progression from one kind of activity to another different stage of response (upon completion of construction, it might be prudent to affirm the scope of monitoring required), or an unanticipated event that is expected to significantly modify the activities envisioned in the original estimate. Updates are particularly important for corrective action/remedial estimates; estimates generally become more reliable as time goes by and projects are refined. In no case should review occur less than every five years.

Ideally, the cost-estimation process should incentivize good behavior, e.g., facilities with good compliance and safety records or superior Environmental Management System procedures may be expected to have more reliable estimates, with corresponding ability to possibly narrow the scope of contingency factors. Because estimates for well-managed facilities are less likely to have errors of omission, contingency factors can be focused on specific elements known to have cyclical or other variability, such as the cost of fuel or other commodities. The guidance may also consider the way a facility's compliance record might factor into the frequency of estimate oversight.⁵ Well-managed facilities may also require less frequent review because their procedures (for example, use of ISO 14001 or other formal environmental management systems) are tailored to assure compliance and thus less likely to trigger unanticipated corrective action obligations.

IV. Conclusion

The Board shares the view expressed by EPA, the States interviewed, and the authors of the studies reviewed that cost estimates for closure, post-closure, corrective action and remedial action in the RCRA and Superfund programs are not uniformly accurate and up-to-date. Financial assurance for the costs of future action is only as useful as its accuracy and the adequacy of its scope. Underestimates put the taxpayer, communities and potentially other businesses in jeopardy in the event of owner default. Overestimates come at the cost of resources diverted from beneficial deployment to create jobs and improve operations.

The Board is encouraged by the initiatives we have seen from the States to better coordinate information and improve oversight of cost estimation accuracy. EPA can play a critical role in broadening and accelerating this process by:

- Infusing the state efforts with pertinent data from the Agency's files;

⁵ See, for example, the observation in the *PRC Report* regarding the relationship between penalty assessment and cost estimation accuracy. *PRC Report*, pp. 21, 26.

- Creating standard templates for cost estimation that clarify definitions, provide a checklist assuring complete coverage, and streamline the review process;
- Creating a web-based platform to disclose and perpetually improve the state of knowledge of good cost estimating, particularly with regard to how to define the proper scope of estimates;
- Developing within EPA and the states experts who know how to use these tools with precision ; and
- Using Agency knowledge and resources to provide and routinely improve the training to translate this wealth of information into best practices the regulators overseeing facility estimates can employ.

Finally, the Board reiterates its view that the best financial assurance mechanism available is meaningless if the estimate of how much will be spent is wrong. The importance of developing sound professional expertise in the cost estimation component of the Agency's financial assurance program cannot be overstated.

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Honorable Mathy Stanislaus
Assistant Administrator
Office of Solid Waste and Emergency Response
U.S. Environmental Protection Agency
Washington, D.C. 20460-0001

Dear Mr. Stanislaus:

At the request of the U.S. Environmental Protection Agency (the Agency), the Environmental Financial Advisory Board (the Board) was charged with examining questions concerning the financial assurance requirements established under the Resource Conservation and Recovery Act (RCRA). The financial assurance requirements established under RCRA programs are complex and multi-faceted. For this reason, in collaboration with the Agency, the Board approached the charge by addressing discrete, manageable pieces of inquiry into the various instruments available to satisfy the financial assurance requirements.

The Board provided its views on the *financial test, captive insurance* and *commercial insurance* in reports to the Agency on January 11, 2006, March 20, 2007, and February 25, 2010, respectively. These reports included recommendations that the Agency consider the requirement of independent credit ratings for various financial assurance instruments. For example, in the report on *commercial insurance*, the Board stated:

The regulatory agencies . . . readily admitted that they lacked the capacity to evaluate the financial strength of insurance carriers. The Board believes that this function may be best served by a nationally recognized statistical rating organization (NRSRO), such as AM Best, which specializes in objective third-party analysis of financial viability.

The Board notes that all members agree that there should be minimum requirements to evidence the financial strength of an insurer underwriting insurance for environmental financial assurance. The Board also agrees that a minimum acceptable rating from AM Best or a similar nationally

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). While the Dodd-Frank Act needs to be considered in its entirety, we direct you to Section 939: Removal of Statutory References to Credit Ratings and Section 939A: Review of Reliance on Ratings. We point out these provisions because they may have implications for the financial assurance requirements currently in effect, as well as implications for the recommendations made in the reports referenced above. We note that on August 10, 2010, in response to the Dodd-Frank Act, the Department of the Treasury, the Federal Reserve System and the Federal Deposit Insurance Corporation issued an advance notice of public rulemaking regarding alternatives to the use of credit ratings in the risk-based capital guidelines of the Federal banking agencies. We recommend that your Office work with the Office of the General Counsel to review the Dodd-Frank Act and monitor the rulemaking process to determine the application of Section 939 and 939A to the Agency's financial assurance requirements.

The Board appreciates the opportunity to provide financial advisory assistance to the Agency on issues of national importance. We hope that you find our recommendations constructive and useful.

Sincerely,



Bradley Abelow
Chairman



Michael Shapiro
Designated Federal Officer

Enclosure

cc: Lisa P. Jackson, Administrator
Bob Perciasepe, Deputy Administrator
Barbara J. Bennett, Chief Financial Officer



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

APR 08 2011

OFFICE OF
SOLID WASTE AND
EMERGENCY RESPONSE

Mr. Bradley Abelow
Chair
Environmental Financial Advisory Board
U. S. Environmental Protection Agency
1200 Pennsylvania Avenue NW (2731R)
Washington, D.C. 20460-0001

Dear Mr. Abelow:

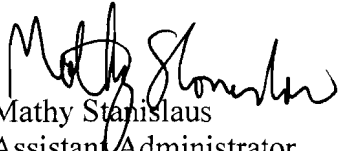
Thank you for the Environmental Financial Advisory's Board's (EFAB's) December 16, 2010, report on cost estimating, and its letter on the use of independent credit ratings for financial assurance instruments. The report on cost estimating is the product of more than a year of intensive meetings, discussions and deliberations. My staff and I want to thank the Board for all the work done on this important topic, and recognize the Board's consultations with a broad range of interested parties. EPA greatly appreciated the inclusion of the Association of State and Territorial Solid Waste Management Officials (ASTSWMO) and state staff in many of your discussions on this topic.

As noted in your transmittal letter, the cost estimating report is the last of four reports. The previous three reports investigated the topics of the financial test/corporate guarantee, captive insurance, and commercial insurance. In conjunction with the report's most important conclusion that "cost estimates for actions and activities under RCRA and Superfund programs are not uniformly accurate and up-to-date," the report makes several recommendations. EPA is considering the recommendations, and will be sharing them with ASTSWMO at its April 20 and 21, 2011 mid-year meeting whose theme is financial assurance. EPA will be exploring with ASTSMWO the best ways to implement these recommendations.

Your letter on the use of independent credit rating for financial assurance instruments notes provisions of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203. More specifically, you cited sections 939: *Removal of Statutory References to Credit Ratings* and 939A: *Review of Reliance on Ratings*. Your letter also recommended that our office work with the Office of General Counsel to review the act and monitor the ongoing rulemaking process of several other federal agencies to determine the application of Sections 939 and 939A to the agency's financial assurance requirements. We are currently working with the Office of General Counsel to determine the applicability of the Dodd-Frank Act to agency financial assurance requirements.

Again, thank you for providing the Board's findings and recommendations. EPA appreciates the Board's expertise and experience. The agency values the insights the Board has provided in answering our questions and concluding its work on our charge.

Sincerely,



Mathy Stanislaus
Assistant Administrator

cc: Michael Shapiro, EFAB Designated Federal Officer
Vanessa Bowie, U. S. EPA, OCFO

EPA-190-R-11-005