FEATURE ARTICLE

PERSPECTIVES ON THE U.S. ENVIRONMENTAL PROTECTION AGENCY'S TREATMENT OF ABILITY-TO-PAY CASES

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During the current financial crisis, increasingly large numbers of firms, municipalities, and individuals are likely to seek reductions in environmental civil penalties and/or moneys demanded for "superfund" cleanups based on their limited financial capabilities. "Superfund" is the name given to the environmental program established to address abandoned hazardous waste sites. It is also the name of the fund established by the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). (*See*, http://www.epa.gov/superfund/about.htm).

Since the mid-1980s, the U.S. Environmental Protection Agency (EPA) has made its ability-to-pay software available for public use. EPA's "ABEL," "MUNIPAY," and "INDIPAY" models can be downloaded from EPA's web site. ABEL is designed for use by businesses, including C-corporations, S-corporations, and partnerships; MUNIPAY, for use by cities, counties, and regional treatment authorities; and INDIPAY, for use by individuals.

When a company or a municipal entity has a real ability-to-pay problem and not just an aversion to paying fines or remediation costs, its counsel needs to understand the use and limitations of these models and to make analytically well grounded arguments about EPA's modeling assumptions and interpretation of results. Since EPA presents itself as reasonable and not arbitrary, the burden is on counsel to highlight aspects of the government's approach that, arguably, do not fit this description.

The purpose of this article is to illuminate certain relevant issues related to ABEL and MUNIPAY. The space limitations of this article preclude an adequate discussion of INDIPAY.

ABEL

EPA uses ABEL as a screening device to test the validity of businesses' claims of inability-to-pay. ABEL is used to analyze three to five years of federal tax return data to produce two types of results: (1) a series of financial ratios reflecting the liquidity, solvency, general financial health, and possible additional debt capacity of a company and (2) a probabilistic forecast of its near-term cash flows.

ABEL's probabilistic forecasts focus on how much money the firm may be able to generate during the next three to five years. It does this by assuming that past and future cash flows will be similar, a very critical assumption that is not always true. In a typical case, if ABEL shows that the business has at least a 70 percent probability of being able to pay the desired amount of money over the selected time period, EPA considers the firm to have adequate financial capability.

However, in a typical case, if the model indicates less than a 70 percent probability that the company will be able to pay the desired amount of money, EPA or its outside consultants may seek additional financial information to help shape regulators' judgments about what the company could do to generate sufficient funds. The alternatives include paring operating expenses and thereby generating additional cash flow, selling off non-essential assets, refinancing debt, calling in loans to shareholders, reducing the salaries and benefits of officers, and drawing upon the resources of a parent or affiliated companies.

Depending on the specifics of each case, the implicit definition of ability-to-pay that EPA chooses to

implement is variable and will depend on the amount of financial distress that EPA is willing to impose. In various policy pronouncements, EPA has stated that, as a general matter, it does not intend to drive businesses into bankruptcy merely to pay penalties or remediation expenses. However, EPA policy allows for such an outcome if the company refuses to comply with pollution control requirements, cannot afford to do so, or has exhibited conduct that EPA considers egregious.

ABEL calculations submitted on behalf of a company are sometimes sufficient to convince EPA that there is a real limitation to what a firm can afford to pay. On that basis, EPA has been willing to forego or significantly reduce its demand for payment. However, in other cases, EPA and its outside consultants effectively have pushed back and have tried to impose compliance or remediation costs that to the claimants seemed harsh.

When using ABEL, issues to be consider.ed are examined below.

Absence of Clear Guidance

From 1986 through 2003, EPA periodically updated and made publicly available its "ABEL User's Manual." That manual provided helpful guidance on how to use the model and how EPA interprets its case-specific results. Because no version of the manual is readily available, a first-time user now must depend on the "help menu" embedded in the current version of ABEL. That aid leaves certain very important questions unanswered.

For example, the "help menu" fails to explain: (1) the rationale behind ABEL's standard assumption of a zero reinvestment rate, meaning that all future depreciation expenses are treated as "available" for paying penalties and cleanup costs; (2) the extent to which it is reasonable to include projected future incremental pollution control costs in an ABEL analysis; and (3) the circumstances under which some types of superfund expenditures are tax-deductible or non-tax-deductible, and either capitalized or expensed.

In this context, it is particularly noteworthy that the "helpline" identified in the "help menu" accepts questions *only* from government employees, which leaves private parties to sift these and other issues on their own.

The Critical Reinvestment Rate Assumption

Without providing any explanation and without distinguishing between civil penalty and superfund-related contexts, the "help menu" asserts that ABEL uses a standard assumption of a zero reinvestment rate.

According to the 2003 version of the "ABEL User's Manual," ABEL uses this standard value:

> based on the assumption that a firm required to pay environmental expenditures should not be constrained from meeting those obligations by the need to replace machinery and equipment. Because ABEL forecasts only five years into the future, the firm is not permanently prevented from replacing such assets; a five-year period of reduced investment should not jeopardize the long-run solvency of most firms. In addition, the firm could continue to reinvest by reducing other expense items, like salaries or marketing expenses.

The manual does not provide analytical support for its bold assertion that "a five-year period of reduced investment in plant and equipment should not jeopardize the long-run solvency of most firms."

Even if that statement were true, financially distressed firms tend not to be like *most firms*. Such firms frequently are capital-intensive companies that have underinvested in plant and equipment for several years and that may have to undertake very substantial near-term investments to remain competitive or even viable.

The standard assumption of a zero reinvestment rate for five years is not conservative. It is very aggressive. The difference between using zero and 1.0 (*i.e.*, 100 percent) as the reinvestment rate can be the difference between being able to pay a substantial amount of money and being able to pay nothing at all.

When one is dealing with EPA on ability-to-pay issues, this is obviously an aspect of ABEL that bears close scrutiny and thoughtful analysis. To have the best chance of being persuasive, counsel needs to articulate a solid rebuttal based on the actual implications of the firm not being able to reinvest its depreciation expenses for the next five years.

Here is a related issue. In 1992, EPA published its "Supplement to the ABEL User's Manual: Superfund ABEL." According to that document, as of 1992 at least, in ABEL calculations related to superfund claims, EPA did use a standard value of 1.0 as the reinvestment rate. The supplement stated:

> This standard value is based on the assumption that a firm contributing to the remediation costs at a superfund site may be making more than a one-time payment. Therefore, by allowing for reinvestment, the model seeks to maintain the financial strength of the firm into the future.

The same rationale would seem to be reasonable today both in superfund and non-superfund-related cases involving multi-year payments.

Future Incremental Compliance Costs

In ABEL calculations related to civil penalties, the user may enter future incremental environmental expenditures into the model. In some cases, entry of such data has the effect of reducing the probability that projected cash flows will be adequate to demonstrate ability-to-pay. This makes sense because these future costs were not reflected in past cash flows.

Neither the ABEL "help menu" nor the 2003 user's manual provides any indication that EPA may limit the future incremental compliance costs to only those associated with the statute (*i.e.*, the Clean Air Act) that was allegedly violated. However, in one case EPA staff did exactly that. Similarly, neither source illuminates whether these incremental costs should include all such costs that will be incurred in the next year or in all future years covered by the cash flow analysis. This situation provides EPA flexibility that some might consider an unfair advantage in settlement negotiations.

Tax Treatment of Superfund-Related Costs

In ability-to-pay modeling in which superfund costs are an issue, the user must indicate whether the relevant superfund costs are tax-deductible or non-tax-deductible, and either depreciable or non-depreciable.

The 2003 "ABEL User's Manual" provided an almost two-page discourse on the appropriate tax treatment of superfund expenditures in certain situations. The write-up recognized many different situations that, at that time, appeared to have very different tax implications. However, that write-up was based on just one Internal Revenue Service (IRS) ruling, one IRS private letter ruling that cannot be cited as a binding precedent, and one time-limited IRS revenue procedure.

Given that six years have past since the manual was last revised, it is probable that if EPA were to update this write-up, it would be able to provide better guidance concerning the appropriate tax treatment of superfund-related expenses in ABEL.

As the model is currently structured, the user has no way of knowing how to deal with *multiple* superfund-related costs in ABEL, some of which may be tax-deductible and some of which may not; some which may be either expensed or capitalized. ABEL only allows for the following limited input data related to superfund costs: one entry for remedial expenses and one entry for tax treatment. This is inadequate. Also, the "help menu" and manual are silent about how a firm is supposed to deal with ability-to-pay issues in ABEL when the entity is involved at multiple superfund sites. At best, treatment of superfund-related expenses in ABEL is crude and incomplete.

Irrelevance of ABEL in Certain Contexts

As stated earlier, the key assumption in ABEL is that past cash flows will be indicative of future cash flows. In situations where past and future flows almost certainly will be dramatically different, ABEL analyses may be highly misleading.

Consider, for example, what would happen to a domestic automotive parts manufacturer if General Motors, Chrysler, and Ford were suddenly to go out of business. If the parts manufacturer had been profitable in the years preceding the ABEL analysis because of its sales to one or more of these companies, it probably will face a radically different financial future than one predicated on projections of past cash flows.

Rather than run ABEL, the manufacturer would be wise to base its ability-to-pay analysis and arguments on the available facts and trends, reasonably predictable financial scenarios, and standard measures of financial distress, including recent or near-term layoffs, difficulty in satisfying existing bond covenants, and inability to obtain loans adequate to meet working capital requirements.

An Example

In one case, EPA and a company agreed to participate in alternative dispute resolution (ADR) to try to resolve an ongoing standoff over ability-to-pay. Well in advance of the ADR session, the company submitted its ABEL analysis to EPA. During the meeting, EPA provided the company an analysis prepared by EPA's consultants. That analysis deviated from the ABEL methodology and relied instead on a statistical comparison of five years of the company's *audited financial statements* (as opposed to its tax returns), with the company's *unaudited financial statement* for the most recently concluded year.

By showing that unaudited total pre-tax costs as a percentage of net sales appeared to be higher in the most recent year than in the previous five years' audited financial statements, the government argued that the company could cut its costs and pay a high civil penalty. EPA staff did not apply the ABEL model at all and chose to disregard the company's ABEL analysis. That analysis incorporated the model's standard values and approach. It also indicated that the company had zero ability-to-pay.

The company then did what it considered to be rational. It settled for what it projected its litigation costs would be if the case went to trial and arranged a payment schedule for that amount of money, spread over a multi-year period, with a small upfront payment.

The settlement was for less money than the government had wanted but for more than the company felt it could afford without undergoing financial hardship. The fairness of EPA's tactics aside, that kind of outcome may be exactly what EPA hopes to accomplish in certain cases.

MUNIPAY

MUNIPAY's approach to assessing the financial capability of a municipal entity is discussed in the *MUNIPAY User's Manual*, which EPA last updated in 1999, as well as in the current model's "help menu."

MUNIPAY provides two sets of analyses, a "demographic analysis" and an "affordability analysis."

The demographic analysis uses population and income data to compare indicators for governmental units of interest, such as the county, the state, and the nation as a whole. According to the manual:

> The demographic analysis does not give the user a specific conclusion on the municipality's demographics, but provides a better understanding of long-term changes in the community's resource base.

Since MUNIPAY's demographic analysis focuses on data for the years 1990 and 2000, it is not very useful.

For the purposes of developing an affordability analysis for a city or county, the first source of funds the model considers is the unreserved portion of the municipal entity's general fund.

Municipalities, counties, and nonprofit entities produce financial reports based on the principles of fund accounting. This type of financial reporting is concerned with account-ability rather than profitability, and focuses on the adequacy of fund balances to provide for current and future delivery of services. Most, but not all, municipal entities maintain a balance in their general fund accounts that is not restricted to any specific future use and is described as the "unreserved portion of the General Fund."

As a default assumption, according to the "help menu," MUNIPAY assumes that the unreserved portion of the general fund should never be allowed to comprise less than five percent of annual budgeted or anticipated general fund expenditures and net transfers out to other funds, such as "enterprise funds," such as for a water treatment authority. MUNIPAY assumes that any money in excess of that limit is available to pay compliance costs, civil penalties, and/or superfund remediation expenses.

In performing ability-to-pay calculations, the model also assesses the municipal entity's current debt burden, its ability to take on additional debt, and its taxing capacity for the environmental expenditures at issue. Therefore, the affordability analysis requires various parameters and threshold criteria for which MUNIPAY provides default values. These criteria include a maximum debt service ratio, a maximum overall net debt to property value ratio, and a maximum property tax increase on a median home as a percentage of median household income. The user needs to be able to defend any deviations from the default values.

In calculating ability-to-pay, MUNIPAY allows the user to set a priority among the possible uses of avail-

able funds, with the default assumption being that pollution control requirements should be met first, then superfund remedial costs, then penalties, and then any other needs.

In the case of a municipal utility, the model looks initially to various aspects of the relevant enterprise fund, including its current assets and current liabilities, annual debt payments, operating revenues and expenses, and anticipated expenses plus net transfers.

As with ABEL, EPA uses MUNIPAY only as a screening device. EPA is free to look more deeply into cases that indicate financial capability problems and to perform additional analyses that might lead to very different conclusions.

From the point of view of the municipal entity, the main problems with MUNIPAY's affordability analysis is that it is very static and fails to take into account both existing legal constraints and trends in general fund balances, tax revenues, and expenditure levels over a multi-year period.

When using MUNIPAY, there are several issues to consider, addressed below.

Default Rate for the Unreserved Balance

According to the 2002 pronouncement of the Government Financial Officers Association (GFOA) titled "Appropriate Level of Unreserved Fund Balance in the General Fund,"

> GFOA recommends at minimum, that general-purpose governments, regardless of their size, maintain unreserved balances in their general fund of no less than [five] to 15 percent of regular general fund operating expenditures, or no less than one to two months of regular general fund expenditures.

Therefore, MUNIPAY's default assumption conflicts with the recommendation of this well-respected professional association of state and municipal financial professionals.

Raising the minimum unreserved balance assumption from five to ten percent or higher in MUNIPAY would greatly affect ability-to-pay results in some specific cases.

Impediments Not Considered in MUNIPAY

MUNIPAY does not consider that a municipal entity may face a very difficult budgetary situation as well as legal requirements to pay unfunded mandates over which it has no control, such as to build bridges and state courthouses, to incur costs on behalf of other governmental entities, and to satisfy court judgments. As a result, a municipality may need to draw heavily upon the unreserved balance in its general fund. Additionally, one state has legally required each of its counties to maintain 25 percent of its annual budgeted general fund expenditures as a minimum reserve balance.

Various other anomalies exist in various states and counties. Sometimes additional debt cannot be issued except by a positive vote of the electorate. Sometimes fund accounts included in the general fund are not legally available to pay superfund costs, so the apparent unreserved balance is overstated for present purposes. Sometimes fund balances that are included in a municipality's financial statements as part of its general fund are actually restricted for special purposes.

Need for a Dynamic Analysis

Because MUNIPAY only uses certain data for one year, it may oversimplify financial issues and miss important trends. For example, the unreserved portion of the general fund may decline in the next year due to multiple factors, revenues may diminish due to declining business activity and declining home values, and future debt capacity may already be pledged to statutorily-specified purposes. MUNIPAY would be challenged to deal with such issues.

An Example

In one case, it would have been misleading and counterproductive to perform the MUNIPAY analysis. There was no officially designated "unreserved balance" in the general fund. The unused balance that was carried forward from one year to the next had declined at a dramatic rate in the previous two years. During the same period, county revenues, which had been propped up by a major but potentially unreliable source of funding, had remained virtually unchanged, while county expenses had significantly increased. Financial matters had been cushioned by tapping the county's general fund as well as its "Rainy Day Fund." As of the date of the analysis, the latter fund was essentially depleted.

The analysis submitted to EPA consisted of a demographic analysis, commentary on the county's

financial statements for the most recent three years, a projection of its financial statements for the next year, analysis of its currently available funds, analyses of the potential for increased revenue from the county income tax and from property taxes (essentially nil), and an assessment of the potential for increased debt financing. In addition, the submission included a list of the capital projects competing for the county's limited amount of remaining debt capacity. The projected unused balance in the general fund at the end of the next year was not much greater than MUNIPAY's assumed minimum unreserved balance.

EPA settled the case for a figure approximately $1 million lower than what it had sought in superfund cost recovery. But even that figure was higher than what the county thought it should pay, given its projected financial outlook.

Conclusion and Implications

Counsel seeking to use EPA's tools for assessing ability-to-pay for businesses, municipalities, and nonprofit entities should proceed with caution. EPA's models can be helpful in some circumstances for achieving reasonable settlements. However, they embody some complicated assumptions, should not be taken at face value, and are not necessarily used by EPA in a consistently objective manner. In order to refute unreasonable assumptions and arguments, counsel should be armed with appropriate analytical support.

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