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Environmental Insurance as a FASB Fix



Insured Fixed-Price Cleanups (IFCs) provide the most certain, most accurate, and often the lowest-cost means of addressing the Financial Accounting Standards Board's (FASB's) recent pronouncement with respect to environmental Asset Retirement Obligations (AROs).

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Environmental

FASB Interpretation No. 47 (FIN 47) was issued last March to remove a widely perceived loophole with regard to environmental and other AROs. FIN 47 makes clear that companies must typically expense for AROs even before the assets' retirement and despite uncertainties as to the timing and/or method of cleanup or other settlement. Examples given are: (i) an asbestos-contaminated factory cannot simply be "mothballed" without adequate reserves to cover the eventual cost of removing the asbestos; and (ii) reserves must be established today for the eventual disposal of still-in-use, creosote-soaked utility poles.

As stated by the *Wall Street Journal*:

The issue seems technical, but the response ... has been one of shock. That is because FASB's guidance is likely to require these companies to immediately expense hundreds of millions of dollars to record the cumulative effects of the accounting change on their income statements....

Wall Street Journal, "Getting Rid of Factories Is about To Get Tougher," at C3 (March 18, 2005).

As mentioned above and explained more fully below, IFCs are typically the most certain and most accurate—and often also the lowest-cost—means to address AROs. At one site, an IFC lowered a company's costs to \$5M from an estimated \$15M-\$20M. Half of this reduction came from the efficiencies and incentives inherent in the IFC itself; half came from the IFC's enabling of grants and tax incremental financing facilitated by the hosting municipality. Thus, companies and municipalities as well should consider the use of IFCs to address environmental AROs and to get Brownfields redeveloped.

Background of FIN 47

FIN 47 provides FASB's clarification of its 2002-issued Financial Accounting Statement 143 (FAS 143). Titled *Accounting for Asset Retirement Obligations*, FAS 143 applies to "legal obligations associated with the retirement of long-lived assets...." In a nutshell, it tells companies that they must reserve for environmental and other liabilities associated with the eventual retirement of manufacturing facilities or parts thereof.

The following key provision of FAS 143, however, has been widely seen as a loophole:

An entity shall recognize the fair value of a liability for an asset retirement obligation in the period in which it is incurred *if* a reasonable estimate of the fair value can be made.

FAS 143, at ¶ 3 (emphasis added).

Until now, numerous entities have seized upon the word "if" to defer recognition of obligations until it is probable the assets will be retired "as of a *specified* date using a *specified* method or when the asset is *actually* retired." FIN 47, at 1 (emphasis added).

FIN 47 was written to close this perceived timing and uncertainty loophole and require that most environmental and other AROs be immediately expensed. It cites as examples items as remote and uncertain as the eventual disposal of utility poles, kiln bricks, and other assets now in active use. While FIN 47 is not limited to *environmental* AROs, its likely focus in the environmental arena is underscored by the fact that all four of its "illustrative examples" concern environmental obligations. (The first two were the utility poles and the kiln bricks; the third and fourth concerned asbestos-contaminated factories still in use. FIN 47, App. A.)

The Relationship between IFCs and FIN 47

The following excerpt shows a possible causal connection between IFCs and FIN 47:

An [ARO] would be reasonably estimable [and thus must be expensed] if ... an active market exists for the transfer of the obligation....

FIN 47, at 2.

An active market for the transfer of environmental AROs has emerged over the past decade and now clearly exists. There are now almost 20 remediation contractors (Contractors) and a smaller number of Brownfield redevelopers (Developers) who will, for an insured and/or otherwise guaranteed fixed-price, accept transfer of environmental AROs. AIG, Ace, XL, Zurich, and a number of other insurers (Insurers) have provided the financial backing necessary for this market. FIN 47 makes clear that industrial and other entities in most cases *must* estimate and reserve for environmental AROs where an IFC or other market exists for their transfer. Finally, where additional capital is required (particularly to go beyond cleanup and to redevelopment), companies may turn to various well-heeled and experienced environmental investor/developers. In appropriate circumstances, these entities also offer sale-leaseback options.

The Mechanics of an IFC

The mechanics of an IFC are fairly simple. Under the traditional cleanup model, a Contractor is hired to perform the cleanup but the risk of cost overruns is borne largely if not entirely by the site owner or other entity(ies) originally responsible for the cleanup (Owner). Under an IFC, the Contractor guarantees a fixed price to cover *all* environmental regulatory costs, regardless of whether those costs increase due to unknown pollutants, regulatory changes, or other causes. The guarantee is typically backed not only by the Contractor's own indemnification but also by a site-specific insurance policy. Thus, the Contractor and Insurer assume the risk of overruns *before* the Owner, and the Owner need pay nothing more unless all three of the protections set forth below were to fail.

IFCs provide Owners with three protections against cost increases:

- *Commutation Account.* The estimated cleanup costs are placed in an escrow, commutation, or similar account that is typically (though not always) held by the Insurer. The funds are paid to the Contractor *only* as it accomplishes the cleanup. The Insurer is financially motivated to monitor the cleanup closely and pay out the funds only as earned because, as shown below, the Insurer provides the second layer of protection in the event the cleanup account is depleted.
- *Insurance Policy.* An insurance policy that typically doubles the amount of the estimated cleanup costs. Thus, if the cleanup is estimated to cost \$10M, the policy ensures that the Contractor has at least \$20M of outside funding to complete it.
- *Contractor Indemnity.* An indemnity from a Contractor who has two enormous financial incentives to complete the cleanup at or below the estimated cost: (1) the Contractor receives or shares with the Owner whatever remains in the Account following governmental sign-off on the cleanup; and (2) the Contractor is required to cover any costs above the amounts not provided by the Cleanup Account and the insurance. The value of this indemnity depends, of course, on the financials of the Contractor, but several have both assets and revenues of several hundred million dollars.

Three Specific Advantages of an IFC

IFCs will virtually always bring two, and sometimes three, specific advantages to addressing an environmental ARO: greater cost certainty; more accurate cost estimates; and (often) lower costs.

Greater Cost Certainty

While IFCs do not provide Owners absolute protection against further cost increases, in almost all circumstances they provide the most protection (and thus the most certainty) available. At least to the author's knowledge, IFCs have protected Owners from *any* cost increases at every one of the hundreds of sites where they have been applied. Particularly when judged against an historical record where non-IFC cleanups almost typically involve "change orders" requiring more dollars, Owners are in almost all cases assured that IFCs provide greater certainty than conventional approaches.

More Accurate Cost Estimates

IFCs also provide more accurate cost estimates. This is because they reflect strong incentives forcing bidding Contractors toward the true costs. A bidding Contractor who artificially underestimates ARO costs would risk assuming liabilities with insufficient funds to cover them. A bidder who artificially overestimates would, at least in a competitive process, risk losing the competition and thus wasting the time and costs involved in bidding. Because of these market incentives, an Owner that has obtained a cost estimate through IFC bidding is almost certainly in the best position to argue that it has reserved enough while also assuring itself that it has not reserved too much.

Lower-Cost Solution

Finally, though counter-intuitive, IFCs very often cost *less* than conventional cleanups. This is due to the many cost advantages that IFCs offer Contractors: IFCs require fewer administrative costs; they allow greater flexibility of resource use; they improve Contractors' long-term planning abilities; and they often reflect

leveraging of otherwise unavailable regulatory benefits/advantages, both formal (e.g., an otherwise unavailable Brownfield program) and informal (e.g., a responsible party with a "new face"). Although no hard data on these cost reductions is available, one can reliably state that fixed-price liability transfers are frequently 10-20 percent lower than conventional estimates:

- In one example about which I have written previously, a conventionally estimated \$15-\$20M cleanup was completed for \$10M, half of which came from outside funding (as discussed below), thus reducing the company's costs to \$5M. Today the site is being developed into tax-generating commercial and residential properties. See "Insured Fixed-Price Cleanups as a Means To Quantify Costs and Obtain Funds To Clean Up Contaminated Sites: The Kenosha Model," Int'l Risk Mgmt. Inst. (April 2003).
- In another, a cleanup estimated at \$25M was completed for \$15M, and today the property consists of soccer fields and open space. *A Tale of Two Sites: How Insured Fixed-Price Cleanups Expedite Protections, Reduce Costs, and Help the SEC, the EPA, and the Public*, 45 Chem. Waste Litig. Rptr. 907 (May 2003), reprinted with permission by the American Bar Association's Science & Technology Newsletter (Vol. 3, No. 2, p. 17, August 2003), and in the National Association of Attorneys General's National Environmental Enforcement Journal, Vol. 18, No. 8, p. 3 (Sept. 2003).

IFCs Also Facilitate the Obtaining of Outside Funding

In addition to the increased efficiencies, market incentives, and other cost-reducing mechanisms discussed above, IFCs may also facilitate the availability of outside funding. This is particularly true when Owners and municipalities work together for their mutual benefit.

In the first example referenced above, fully half (\$5M) of that \$10M IFC was paid for with Brownfield grants and tax incremental financing (TIF). IFCs enable Brownfield grants because they give grantors greater assurances that their funds will actually lead to a cleanup. And IFCs facilitate TIFs because they provide bond issuers the greatest certainty of the cleanup costs. IFCs can also promote site's developability (and thus tax revenues) following cleanup, because the cost guarantees can run to future owners as well as past.

Further information on this example and how IFCs facilitate outside funding can be found in the April 2003 IRMI.com article, "Insured Fixed-Price Contracts as a Means To Quantify Costs and Obtain Funds To Clean Up Contaminated Sites: The Kenosha Model."

Conclusion

IFCs are by now well-tested. They have been used at one state and three federal Superfund Sites; at two of the largest Brownfield redevelopments in the United States; and at over 100 other sites. IFCs require no statutory or regulatory changes, and they are generally favored by regulators because in most cases they add a responsible party (the Contractor), add financial resources (the policy), and expedite cleanups all while remaining fully subject to government direction and requirements.

Not until FIN 47, however, has the connection between AROs and IFCs been so clear. FIN 47 makes clear that, beginning this year, companies must reserve for AROs despite uncertainties as to the time or method of settlement. IFCs enable the transfer of environmental AROs despite these uncertainties, and IFCs are almost always the most certain and most accurate—and often also the lowest-cost—means to meet this requirement. Thus, companies (and hosting municipalities) should consider the use of IFCs to address environmental AROs and to get Brownfields redeveloped.

**Author's Note: As IRMI's new Commentator in the area of environmental risk management, this is my first in a series of quarterly articles. I would very much welcome comments on this article as well as suggestions for future topics. MOH*

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