Financial Assurances for Mitigation Project Success

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What is Financial Assurance for Mitigation Success?

- Mechanism for ensuring resources are available to provide required mitigation if the responsible party proves unable or unwilling to do so
- Long-standing practice in other contexts
  - Construction
  - Mining reclamation
  - Hazardous waste facilities
- Endowments to provide any needed funds for long-term management of mitigation projects is different (although it can employ similar types of assurance forms, e.g. escrow accounts)

Why Financial Assurance in Mitigation Context?

- Compensatory mitigation projects are complex and implementation and results are uncertain
- Organizations can fail or walk away
  - Bankruptcy
  - Dissolution
- Allows for sale of mitigation bank credits before mitigation project success is demonstrated
  - Facilitates the economic viability of commercial mitigation banking

What is to be Assured in Mitigation Context?

- 33 CFR 332.3(n)(1) Provisions:
  - "The district engineer shall require sufficient financial assurances *to ensure a high level of confidence that the compensatory mitigation project will be successfully completed, in accordance with applicable performance standards*." [italics added]
  - Alternative mechanisms allowed (e.g. a formal documented commitment by government or public authority) if they provide a high level of confidence for mitigation success

When Must Assurances be Posted?

- Permittee-Responsible Projects
  - "If financial assurances are required, the DA permit must include a special condition requiring the financial assurances be in place prior to commencing the permitted activity." [CFR 332.3(n)(3)].
- Mitigation Bank Projects
  - Banking instruments may allow for an initial debiting of some share of potential bank credits when bank instrument and plan are approved, site is secured, and appropriate financial assurances have been posted [CFR 332.8(m)].
  - In practice, assurances for bank credit capacity sometimes required upfront, and sometimes in a phased manner
- ILF Programs
  - Can provide assurances by increasing credit prices and setting aside the added funds to cover contingencies [CFR 332.8(m)(5)]

When can Assurances be Released?

- Financial assurances phased out once the project has been determined to be successful according to its performance standards [CFR 332.3(n)(4)]
  - Permit or instrument must specify the conditions under which the financial assurances may be released
  - Assurances can be phased-out in stages as certain project milestones or interim performance standards are met
- The financial assurance must ensure that the district engineer will receive notice at least 120 days prior to any termination or revocation [CFR 332.3(n)(5)]

Determining the Dollar Amount of Financial Assurances

- Assurance amounts must be determined by the DE in consultation with project sponsor and reflect:
  - Size and complexity of project
  - Degree of completion of project
  - Likelihood of success
  - Past performance of project sponsor
  - Other factors that the DE deems appropriate [CFR 332.2 (n)(2)]

Determining the Dollar Amount of Financial Assurance - continued

- Based on full cost of providing required mitigation
- Could include component costs for:
  - Land
  - Planning, design, and engineering
  - Construction & planting
  - Monitoring & maintenance
  - Reasonably foreseeable remedial work
  - Contingencies
  - Legal & administrative

Issues in Determining Amount of Financial Assurance

- Assurance amounts should reflect where replacement mitigation work would proceed
- On-site Replacement: replacement might proceed at the project site if there are no potential problems/questions regarding:
  - Quality of the site and surrounding landscape
  - Site ownership/access/protection issues
  - Willingness of a suitable third-party entity to complete work at the site

Determining Assurance Amounts for On-site Replacement Work

- Full Cost Basis: Costs to fully complete work and meet performance standards at the bank/project site
- Components: If site is high-quality and secure, no need to include land costs in assurance amounts
- Source: Normally, banker/permittee would be expected to provide component cost estimates; Other sources that might provide a check on banker’s estimates might include
  - Corps in-house engineering estimates
  - Independent third party estimates
  - Current ILF & bank credit prices in same service area

Determining Assurance Amounts for Off-site Replacement Work

- Full Cost Basis: Costs to complete mitigation work at some alternative site by a third party (might include an established ILF program in the same area)
- Components: For off-site replacement, need to include costs of securing the land
- Source: Could be based on estimates by the third party who agrees to complete work at the alternative site

Determining the Dollar Amount of Financial Assurance

- Factors to consider
  - Quality of the source data
  - Completeness of cost accounting
  - Possible need to reevaluate for escalating costs
- Possibility of noncompliance/project failure
  - Past performance of responsible party
  - Site quality
  - Progress toward meeting performance standards

Implementing Assurances: Miscellaneous Receipts Statute

- 31 USC 3302(b). Requires that money collected by Federal agencies be placed into the U.S. Treasury upon receipt.
- Once deposited into the Treasury it is lost to the federal agency unless that amount in provided to the agency in a new Congressional appropriation.
- Upshot: Corps should not directly receive financial assurance payouts because that money will not be available to secure replacement mitigation.

Implications of Miscellaneous Receipts Statute

- Financial assurances must be payable directly to a 3rd party designee of the Corps who agrees to complete mitigation work, or to a standby trust
- Standby Trust [CFR 332.3(n)(6)]:
  - "Financial assurances must be payable at the direction of the DE to his designee or to a standby trust agreement. When a standby trust is used (e.g., with performance bonds or letters of credit) all amounts paid by the financial assurance provider shall be deposited directly into the standby trust for distribution by the trustee in accordance with the DE's instructions."

Standby Trust Agreement

- Independent third party trustee with fiduciary responsibility to the beneficiary (DE)
- DE does not directly access the funds; rather, the DE has decision authority over how and to whom the funds are to be disbursed to ensure completion of mitigation requirements
- Relationship established through a valid document, but not funded until assurances are called
- When assurances called, funds are paid into this Standby Trust and distributed for completion of mitigation according to DE directions

Allowable Forms of Assurances

- Performance bonds
- Letters of credit
- Escrow accounts
- Casualty Insurance
- Other appropriate instruments, subject to DE approval

Performance Bond

- Contract in sum certain (penal sum) between project sponsor & surety (e.g., insurance company) whereby surety guarantees to the Corps performance of sponsor's mitigation requirements or payment of penal sum.
- Sponsor pays approx 2 -5 % of penal sum to the surety and also enters into an indemnity agreement with surety that includes collateral
- Issues: Limited availability without high collateral; limits on coverage and term; potential for performance disputes

Letter of Credit

- Provides for the extension of the credit of a financial institution (issuer), on behalf of the sponsor, to the Corps as beneficiary for payment for the sponsor's obligations up to a stated dollar amount
- Sponsor pays 0.5 – 1.5% of letter amount to issuer and also enters into loan agreement with surety that typically requires collateral
- Issues: Limited availability without high collateral; limits on term; provides funds but not performance

Cash in Escrow Account

- Sponsor deposits entire amount of required assurance into an escrow account at a legal or financial institution that serves as escrow agent.
- Corps authorized to direct disbursement through escrow agent based upon specified conditions.
- Issues: High opportunity costs; provides funds but not performance

Casualty Insurance

- Information presented here is associated with a prospective insurance product that has been proposed in connection with several mitigation banks
- Contract between project sponsor (policyholder) whose mitigation responsibilities are being insured & insurer for claims made against the policy by the Corps up to a specified cost cap for default on sponsor's obligations
- Sponsor pays insurer one-time premium of 5-10% of cost cap for the period over which sponsor is required to meet success criteria, and agrees to deductible of 100% of insurer costs for a claim (that insurer knows may never be recovered)

Casualty Insurance--continued

- Only the Corps can make a claim where trigger is Corps determination of sponsor default.
- Policy says insurer will satisfy a claim in any way directed by the Corps.
- This could be cash payment to a Corps designee; Alternatively, Corps could direct insurer to develop & implement replacement mitigation, or to purchase credits from an existing mitigation bank or ILF program
- Issues: Untested in mitigation context

Credit Sales Revenue Held in Escrow Until Success Met

- Sponsor may be unable to secure conventional assurances due to cost or availability
- With this option, sponsor is allowed to sell limited credits w/o posting assurances upfront
- Instead, revenue from credit sales goes directly to Escrow and is not released to sponsor until project milestones/success criteria are met
- Issues: Provides for funds but not performance

Regulator Considerations for Choice of Financial Assurance Form

- Normally, Sponsor will propose an assurance form in consideration of availability & terms
- Regulator considerations for evaluating proposed assurance forms include:
  - Future solvency of surety/financial institution
  - Ease of access to funds & performance considerations
  - Life of assurance form & renewal issues
  - District experience/administrative requirements
  - Opportunity costs to sponsors

Concluding Remarks

- Few hard and fast rules for establishing financial assurances for mitigation project success; all relevant issues in establishing assurances must be considered in the context of all other factors that go into finalizing mitigation projects
- Assurances are meant to limit the risk that mitigation projects will not meet success criteria; however, assurances can not completely eliminate that risk
- Regulators should consult and secure the help of District Counsel and other Corps staff with relevant experience in establishing assurances