

Texas Commission on Environmental Quality

Interoffice Memorandum

To: Commissioners' Work Session **Date:** September 28, 2011
Thru: Stephanie Bergeron Perdue, Deputy Director, Office of Legal Services *SBP*
From: Kathleen C. Decker, Director, Litigation Division *KCD*
Subject: Implementation of HB 2694 - Adoption of SEP Policy
Issue: Consideration of proposed Supplemental Environmental Project (SEP) Policy required by HB 2694

Background and Current Practice

Prior to the passage of HB 2694 in the 82nd Legislature, Texas Water Code § 7.067 prohibited the use of SEPs to assist bringing respondents into compliance with environmental laws or remediating the harm caused by those violations. HB 2694 creates an exception to this prohibition by authorizing the Commission to exercise discretion in approving a SEP that would bring a respondent into compliance with environmental laws or that is required to remediate the environmental harm caused by the respondent's alleged violation provided the respondent is a local government (hereinafter referred to as a "compliance SEP"). A local government is defined as a school district, county, municipality, junior college district, river authority, water district or other special district or other political subdivision created under the constitution or a statute of this state.

HB 2694 was effective on September 1, 2011.

HB 2694 directs the agency to develop a policy to prevent local governments from systematically avoiding compliance through the use of SEPs which includes a requirement for an assessment of (1) the respondent's financial ability to pay the administrative penalty; (2) the ability of the respondent to remediate the harm or come into compliance; and (3) the need for corrective action.

The Executive Director (ED) is seeking guidance from the Commission regarding the review process and what, in addition to the above, should be included in assessing whether a local government is systematically avoiding compliance through the use of compliance SEPs.

Discussion: Currently, all respondents, including local governments (as defined in HB 2694), may apply for a reduction in the penalty (up to 100%) alleging an inability to pay under 30 Tex. Admin. Code § 70.8. Importantly, when an analysis is conducted under this format the ability to pay compliance costs is assumed. The evaluation only determines whether the respondent is capable of paying all or part of the penalty.

Additionally, under the provisions of Tex. Water Code § 7.034, the Commission may allow a municipally owned utility, a water supply or sewer service corporation, or a district to defer the payment of all or part of an administrative penalty on the condition that the entity complies with all provisions for corrective action in a commission order to address the violation. In determining whether a deferral is appropriate under this statute, the ability to pay compliance costs is again, assumed. Other considerations such as other essential health and safety services are also taken into consideration during this more restrictive type of review.

Some stakeholders and members of the public have requested more flexibility in the process for allowing a regulated entity to participate in a SEP. With the new compliance SEP, both the costs of compliance and the ability to pay the administrative penalty will be evaluated. However, whether the financial assessment is conducted under the auspices of 30 Tex. Admin. Code § 70.8, Tex. Water Code § 7.034 or under the newly legislated Texas Water Code § 7.067(a-1), the local government respondent will always be required to come into compliance with environmental laws unless the violations have already been corrected.¹

Question No. 1 – Should all local governments be subject to financial review before they may utilize a compliance SEP to bring them into compliance or remediate the harm caused by the violation(s)?

Option A: Yes. The Sunset Advisory Commission commented in its January 2011 report that statutory prohibitions could prevent TCEQ from using SEPs as an appropriate tool to ensure compliance and remediation of the violation, particularly if the violator is a governmental entity with limited resources to perform corrective action for the violation. Given this comment it could be implied that a financial component was intended as criteria for participation in a compliance SEP.

Pro: A financial component ensures that the legislative intent to bring local governments with limited financial resources into compliance with environmental laws and remediate the harm caused by violations of these laws through

¹ The commission has authority to defer or offset penalties on the condition that corrective actions are performed based on the authority in Sections 5.102, 7.002, 7.051, 7.058, and 7.073 of the Water Code.

participation in a compliance SEP will prevent those local governments with the requisite financial means from delaying projects necessary to accomplish these goals.

Con: Review of financial capabilities delays the enforcement process.

Option B: No. A financial review will not be required before a local government respondent may participate in a compliance SEP.

Pro: All local governments will be able to participate in the compliance SEP program without regard to financial capability.

Con: Local governments will not have any incentive to comply with environmental laws until the violation(s) are discovered and formal enforcement action is initiated by the TCEQ.

Question No. 2 – If all local government respondents must be reviewed for financial ability to pay under Tex. Water Code § 7.067 (a-2), how extensive of a review should be performed?

Discussion: Staff request Commission consideration of proposed screening criteria designed for the financial inability to pay review process, which could limit the volume of requests for a review of financial inability to pay as well as reduce the time required for the review of documentation specific to a compliance SEP. The screening criteria would be used to efficiently evaluate respondents at either end of the financial spectrum, meaning local governments that have significant financial ability would be excluded from participating in a compliance SEP while local governments that clearly do not have adequate financial ability would qualify for a compliance SEP. If the screening criteria is used in this manner, it is planned that a full MUNIPAY review would still be conducted for all local governments that fall in the middle of the spectrum. ²

Staff propose that if one or more of the following screening criteria are met then no further review be required to assess the local government respondent's ability to pay the administrative penalty and remediate the harm or come into compliance:

² Local governments are generally reviewed using a MUNIPAY analysis when they have audited financial statements and operate within a finite geographic area that allows for demographic analysis. MUNIPAY is a computer program used to evaluate the economic and financial condition of the entity. It performs two separate sets of analyses: a demographic comparison, and an affordability calculation. The affordability analysis involves calculations for the amount of currently available funds and then, if necessary, the amount of funds available through financing.

Screening No. 1 (this screens out the financially capable).

- (1) Bond Rating³: If Moody's, then higher than Ba; if Standard & Poor or Fitch, then higher than BB (see Attachment "A"); or
 - (2) Uses a Financial Test to demonstrate financial assurance for any TCEQ program; or
 - (3) Unrestricted Reserves General Funds & Enterprise Funds less penalty amount/Operating Expense > 16.6% (2 months)⁴
- and
- Utility Rates, if applicable < 1% of Median Household Income (Water or Sewer annualized); 2% of Median Household Income (combined Water & Sewer annualized)

Screening No. 2 (this screens out the financially incapable).

- (1) Bond Rating: If Moody's, then Ba or below; if Standard & Poor or Fitch, then BB or below; or
 - (2) Unrestricted Reserves General Funds & Enterprise Funds less penalty amount/Operating Expense < 16.6% (2 months)
- and
- Utility Rates, if applicable > 1% of Median Household Income (Water or Sewer annualized); 2% of Median Household Income (combined Water & Sewer annualized)
- (3) If Local Government does not have financial statements and both of the following apply:
Utility Rates, if applicable > 1% of Median Household Income (Water or Sewer annualized); 2% of Median Household Income (combined Water & Sewer annualized)
and Compliance Costs > 1% of Total Revenue

³ In investment, the bond credit rating assesses the credit worthiness of a corporation's or government debt issues. It is analogous to credit ratings for individuals. The credit rating is a financial indicator to potential investors of debt securities such as bonds. These are assigned by credit rating agencies such as Moody's, Standard & Poor's and Fitch that have letter designations (such as AAA, B, CC) which represent the quality of a bond. Bond ratings below BBB/Baa are considered not to be investment grade and are colloquially called junk bonds.

⁴ 16.6% is a measure of how much cushion the local government has in reserves to cover operating expenses and the penalty. It is equivalent to 60 days (2 months) of operating expenses + penalty.

Option A: Use screens. If one or more of the criteria are met in Screening No. 1 then the local government respondent will not qualify to perform a compliance SEP to direct penalty dollars to address its own compliance issues. If one or more of the criteria are met in Screening No. 2 then the respondent qualifies to perform a compliance SEP to direct penalty dollars to address its own compliance issues.

Pros:

1. The financial review process is expedited which results in more timely enforcement and corrective actions being implemented earlier.
2. Less impact on limited Office of Administrative Services/Financial Division resources.

Con: The Financial Division will not review and consider the same level of financial information to assess a local government's ability to pay through MUNIPAY.

Option B: Don't use screen. Even if one or more of the criteria in Screening No. 1 or 2 are met, a MUNIPAY review will be conducted on the local government respondent. Screening criteria will not be used as indicia of financial capability.

Pro: The Financial Division will perform a thorough MUNIPAY financial analysis on all local government respondents.

Con: The financial review process for many local government respondents will be more time intensive, which may result in longer enforcement timelines for these entities.

Question No. 3 –What should be reviewed in determining whether a local government respondent has “systematically avoided compliance through the use of SEPs”?

Since this type of SEP allows local governments to undertake corrective action to come into compliance, a threshold question for determining whether a local government respondent is systematically avoiding compliance is whether corrective action is necessary. If corrective action is necessary, then the next step would be to concurrently review the ability to pay the penalty and the ability to remediate the harm or come into compliance.

The new Subsection 7.067(a-2) of the Texas Water Code allows the commission to consider additional criteria when determining whether or not a respondent has systematically avoided compliance through the use of SEPs, such as:

Option A: The local government respondent has been the subject of two or more prior enforcement orders with the penalty offset by a SEP in order to assist a respondent into compliance or remediate the environmental harm caused by the violations during the five year period preceding the enforcement action that is the basis for the compliance SEP application. Historically, since local governments have not been able to perform SEP's to address their own compliance issues until the passage of HB 2694, this may not be relevant until and if new enforcement actions are initiated against a respondent in the future.

Pro: This option sets objective numeric criteria to evaluate whether a local government is over-using the compliance SEP option.

Con: This option does not allow for case-by-case flexibility if a local government truly needs this type of SEP to come into compliance.

Option B: The local government respondent failed to complete a previously approved SEP, meaning it did not spend the required offset amount or perform the subject project.

Pro: Past performance is often an indicator of future performance as well as an indication of the local government's diligence to adhere to the SEP program requirements.

Cons:

1. The failure may have been due to financial constraints.
2. The past performance may have been under a different government administration which may not have focused on adherence to the responsibilities and time frames of the SEP project.

Option C: An investigation shows evidence that the local government respondent delayed compliance to qualify for this type of SEP.

Pro: Serves as a disincentive for local governments to delay compliance for this reason.

Con: The local government may still have serious financial constraints that would benefit from a compliance SEP.

Option D: Combination of Options: _____.

Question No. 4 – HB 2694 becomes effective September 1, 2011. In terms of timing in the enforcement process, which local government respondents are eligible to apply to perform a compliance SEP under the exception of Tex. Water Code § 7.067 (a-1)?

Option A: Any local government respondent with an enforcement action pending on September 1, 2011, may apply to perform a compliance SEP under the exception of Tex. Water Code § 7.067 (a-1).

Pro: Of the three options, this one would allow the most local government respondents to immediately participate in compliance SEPs.

Con: On cases that are somewhat advanced in the enforcement process, this will result in duplicate work and delay in the enforcement process as documents are changed to account for the compliance SEP option.

Option B: Any local government respondent with an enforcement action initiated by the issuance of a Notice of Enforcement on or after September 1, 2011, may apply to perform a SEP under the exception contained in Tex. Water Code § 7.067 (a-1).

Pro: This option would allow immediate participation but without duplication of work involved with ongoing enforcement cases.

Con: This option does not allow as much immediate local government participation as Option A.

Option C: Any local government respondent with an enforcement action that has violations that occurred on or after September 1, 2011, may apply to perform a SEP under the exception contained in Tex. Water Code § 7.067 (a-1).

Pros:

1. This approach is consistent with the applicability clause relating to penalty policy in HB 2694.

2. This would allow for a slower phase-in of the program so that experience from individual cases could be applied to other compliance SEPs in the future.

Con: Local government respondents may want to participate in compliance SEPs with current pending enforcement.

Attachment "A"

<u>Moody's</u>	<u>Standard & Poor's</u>	<u>Fitch</u>	Credit worthiness
Aaa	AAA	AAA	An obligor has EXTREMELY STRONG capacity to meet its financial commitments.
Aa1	AA+	AA+	An obligor has VERY STRONG capacity to meet its financial commitments. It differs from the highest rated obligors only in small degree.
Aa2	AA	AA	
Aa3	AA-	AA-	
A1	A+	A+	An obligor has STRONG capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories.
A2	A	A	
A3	A-	A-	
Baa1	BBB+	BBB+	An obligor has ADEQUATE capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.
Baa2	BBB	BBB	
Baa3	BBB-	BBB-	
Ba1	BB+	BB+	An obligor is LESS VULNERABLE in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitments.
Ba2	BB	BB	
Ba3	BB-	BB-	
B1	B+	B+	An obligor is MORE VULNERABLE than the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
B2	B	B	
B3	B-	B-	
Caa	CCC	CCC	An obligor is CURRENTLY VULNERABLE, and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments.
Ca	CC	CC	An obligor is CURRENTLY HIGHLY-VULNERABLE.
	C	C	The obligor is CURRENTLY HIGHLY-VULNERABLE to nonpayment. May be used where a bankruptcy petition has been filed.
C	D	D	An obligor has failed to pay one or more of its financial obligations (rated or unrated) when it became due.
e, p	pr	Expected	Preliminary ratings may be assigned to obligations pending receipt of final documentation and legal opinions. The final rating may differ from the preliminary rating.
WR			Rating withdrawn for reasons including: debt maturity, calls, puts, conversions, etc., or business reasons (e.g. change in the size of a debt issue), or the issuer defaults.
unsolicited	unsolicited		This rating was initiated by the ratings agency and not requested by the issuer.
	SD	RD	This rating is assigned when the agency believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner.
NR	NR	NR	No rating has been requested, or there is insufficient information on which to base a rating.