NEBRASKA DEPARTMENT OF ENVIRONMENTAL QUALITY

ENVIRONMENTAL GUIDANCE DOCUMENT

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GUIDANCE DOCUMENT FOR THE LOCAL GOVERNMENT FINANCIAL TEST

BACKGROUND

In finalizing the federal regulations for landfills, Environmental Protection Agency (EPA) concluded that an exemption to the financial responsibility requirements is not appropriate for Municipal Solid Waste Landfills (MSWLF's) owned or operated by local governments. Although many local governments, like the Federal and State governments, are permanent entities that act to secure the well-being of their citizens, substantial variations exists among local governments in terms of size, financial capacity, and functions performed. Furthermore, although local governments are unlikely to abandon their MSWLF's even in the unlikely event of bankruptcy, relative to Federal and State governments they are generally:

(1) more limited in terms of financial resources and less flexible in their annual budgets, thereby making reallocation of a substantial amount of funds for a specific purpose in a given year more difficult;

(2) less able to obtain their traditional sources of financing (i.e., bond issues, taxes, and intergovernmental transfers) quickly enough to ensure funding in a timely manner; and

(3) more prone to fiscal emergencies than Federal and State governments.

In addition, although local governments are generally able to pay all their obligations eventually, they have many competing financial needs. Conflicting financial and political demands may cause some local governments to delay required activities at MSWLF's, thereby jeopardizing protection of human health and the environment.

Despite the conclusion that exempting all local governments from financial assurance requirements would be inappropriate, some local governments possess sufficient financial capacity and fiscal responsibility to demonstrate that their resources are adequate to meet their financial assurance obligations without use of third-party mechanisms (i.e. trust funds, letters of credit, and surety bonds). Therefore, a local government financial test and local government financial guarantee is allowed for use by local governments to reduce the regulatory burden of financial assurance requirements.

The test's financial ratios and bond rating criterion are intended to ensure that a local government is financially capable of meeting its assured obligations, similar to the financial measures comprising a corporate financial test. The public notice requirement ensures that the local governments using the test are committed to planning for the assured obligations and meeting them in a timely manner.

Local governments can use the test to assure all costs for which they pass the test, even if these costs are less than the total costs of closure and/or post-closure care. In addition, a local government guarantee is available with the financial test specifically for use by local governments.

For a financial test to accurately describe a local government's financial condition the financial data must be verifiable and have common standards and accounting practices for analysis. For that reason only financial statements using generally accepted accounting principles (GAAP) for governments can be used as a basis for evaluation. Since GAAP accounting is not mandatory in Nebraska and many local governments use a cash basis of measurement rather than an accrual basis, which GAAP requires, the financial test has prevented many local governments from having access to the financial test as a viable mechanism.

Only general purpose local governments (e.g. municipality, county) are eligible to utilize the local government financial test. Enterprise funds, joint ventures, agencies, coalitions, etc. are not able to use the financial test as a separate government entity. However, the local government partners in a joint venture, or the primary government that is associated with the enterprise fund, or the counties and/or municipalities that are part of an agency or coalition through an interlocal agreement are eligible to provide a local government guarantee for financial assurance. See Guidance Document for Local Government Guarantee.

LOCAL GOVERNMENT FINANCIAL TEST

The general criteria for using the local government financial test are as follows:

GENERAL CRITERIA

(a) Prepare financial statements in conformity with GAAP for governments,

(b) Not currently in default on any outstanding general obligation debt,

(c) All outstanding general obligation bonds are rated investment grade (Baa, A, Aa, or Aaa issued by Moody's or BBB, A, AA, or AAA issued by Standard and Poor's),

(d) No operating deficit equal to 5% or more in each of the past two years (two consecutive years in a row) (Deficit is referring to a negative value when taking total annual revenues minus total annual expenditures),

(e) No adverse or qualified opinion from an independent certified public accountant that audits the local government's financial statements. Qualified opinions will be evaluated on a case-by-case basis.

The specific criteria used to pass the test once the local government has determined it meets <u>all</u> of the above general criteria consists of a financial component, a public notice component, a record keeping and reporting component, and a costs assured calculation component:

FINANCIAL COMPONENT

Alternative A: Bond Rating Requirement

(a) The local government's outstanding general obligation bonds must have a current investment grade bond rating. Alternative A must be used if there are any outstanding and rated general obligation bonds. Those local governments with "unrated" bonds may use the financial ratio alternative. Revenue bonds or other types of collaterized, insured, or guaranteed bonds may not be used for this test.

Alternative B: Financial Ratio Requirement

(a) Alternative B may be used if a local government has no outstanding rated general obligation bonds. Alternative B requires satisfying the following ratio tests using the primary government funds, such as the General Fund, Special Revenue Funds, Debt Service Fund, Enterprise funds, and Internal Service Funds, as the basis for the tests.

(1) A ratio of cash plus marketable securities to total expenditures greater than or equal to .05 (liquidity ratio).

(2) A ratio of annual debt service to total expenditures of less than or equal to 0.20 (debt service ratio).

DEFINITIONS

The following definitions are applicable in using the financial ratio requirement:

(a) Liquidity - The degree to which an entity has available cash, or other assets that can quickly be converted to cash, available to meet its current or upcoming expenses. Liquidity is essential to meet current obligations or execute transactions, and can provide an important cushion to protect funds intended for upcoming expenses against unexpected or emergency costs that arise on short notice. Liquidity is an extremely important factor in maintaining solvency.

(b) Total expenditures – All expenditures excluding capital expenditures and debt repayment.

(c) Total revenue - Revenue from all taxes and fees, but does not include the proceeds of borrowing or from asset sales. It excludes revenue from trust and agency funds (funds managed by local governments on behalf of a specific third party as opposed to the general public).

(d) Debt service - The amount of principal and interest due on a loan in a given time period, typically the current year. Annual debt service shall include the annual scheduled principal and interest payment for all notes, debt, and capital leases having any due dates extending one year or longer from the financial statement date.

(e) Debt service ratio - Possessing only low to moderate debt service is important for a local government so that it may retain flexibility in meeting its obligations. Even if a local government currently has high liquidity and can meet its current obligations, it may have difficulty in obtaining funds to meet longer term obligations. High debt service significantly reduces the resources available to fund current operating expenses, the flexibility to fund unexpected needs, and the ability to obtain additional loans or issue any additional debt. If a local government is overly burdened by debt service payments they may have greater difficulty paying for assured activities in a timely fashion.

(f) Cash plus marketable securities – All of the cash plus marketable securities held by the local government on the last day of the fiscal year, excluding cash and marketable securities designated to satisfy past obligations such as pensions.

(g) Capital expenditures - Long-term expenditures that are amortized over a period of time to acquire capital assets, construction of infrastructure, and perform projects with long-term economic benefits.

PUBLIC NOTICE COMPONENT

Because local government spending is carefully planned in advance by the annual budget a local government demonstration (by means of a financial test) of current financial strength and health may not ensure that future closure and post-closure care will be funded in a timely manner unless it can also demonstrate its commitment to funding these obligations by public notice of their ability and willingness to pay.

In each year that the financial test is used, the assured costs must be identified in the comprehensive annual financial report. Disclosures should include:

- the type of requirements (closure, post-closure, and/or remedial action);
- the source of the requirements (Nebraska Administrative Code (Title 132-Integrated Solid Waste Management Regulations, the Nebraska Environmental Protection Act, and the Integrated Solid Waste Management Act);
- the name of the specific facility covered;
- the corresponding cost estimates;
- the amount of closure, post-closure, or remedial action liability recognized at the balance sheet date;
- The estimated remaining costs not yet recognized;
- The estimated landfill capacity and useful life in years; and
- The financial assurance method being used.

The comprehensive annual financial disclosures will most likely be included in the financial section as a footnote to the annual financial statements and must conform to Government Accounting Standards Board Statement # 18.

RECORDKEEPING AND REPORTING COMPONENT

In addition to preparing an annual financial report in compliance with GAAP for governments the following three items must be submitted to NDEQ annually:

(1) Chief financial officer (CFO) letter- A draft example of a CFO letter is included in this packet. The CFO letter should list all current cost estimates covered by the financial test; providing evidence that

the local government passed the financial component (i.e., evidence of its bond rating or a demonstration showing that the local government's annual financial data meet the specific measures required by the test), certification of meeting the general criteria of the financial test described above, and a calculation of the amount of total costs which may be assured by this method.

(2) Year-end financial statements for the latest fiscal year - Included in the annual financial report should be the unqualified opinion from the independent certified public accountant and the required note to financial statements or other required annual notice documentation as required in the Public Notice Component.

(3) Independent Accountant’s Special Report - This should confirm that the data used in the CFO letter to pass the test were taken directly, or appropriately derived from, the audited year-end financial statements. This special report must state that, in connection with that examination, no matters came to the accountant's attention that caused him to believe that the data in the CFO letter should be adjusted. A draft example of an Independent Accountant’s Special Report is included in this packet.

The above items must be submitted within specific time frames and be updated annually:

(a) The above 3 items must be submitted and approved prior to initial receipt of waste or the effective date, whichever is later for a new facility.

(b) The above 3 items must be submitted annually within 180 days of the close of the local government's fiscal year.

- Included in the submittal should be evidence that the costs are updated annually for inflation.

- If a local government can no longer satisfy all of the financial test criteria it must obtain alternative financial assurance within 210 days of the close of the fiscal year.

COSTS ASSURED CALCULATION COMPONENT

To maximize the availability of the local government financial test to financially sound local governments while, at the same time, assure that the costs that a local government seeks to assure are reasonable relative to its size. The relative financial strength measure is a ratio calculated by dividing the "assured costs" (the closure and/or post-closure costs as identified in the cost estimates plus any other environmental obligations assured through a financial test) by the local government's total annual revenue. (See the definition of total annual revenues). Passing values would be those vales less than or equal to 0.43. A threshold of 0.43 means that to pass the measure, a local government's assured costs may not be more than 43 percent of total annual revenue.

(a) Assured costs/annual total revenue must be less than or equal to 0.43.

(b) Any environmental obligation exceeding the percent of revenues limitation must be assured by alternative means.