National Fish and Wildlife Foundation

Impact-Directed Environmental Accounts

Funding Approaches for Long-Term Management of Mitigation Sites

June 2013 In-Lieu Fee Mitigation
Training Webinar Series: Long-Term Funding

Primary Objective

A discussion of the issues around *funding* for long-term (or perpetual) management of compensatory mitigation projects

- Principles apply equally to ILF project sites, mitigation bank sites, and permittee-responsible project sites
- Addressed in the 2008 Rule by 33 C.F.R. §332.7(d)(2) and (3)
- §332.7(d)(2) requires a long-term management plan that:
  - describes the long-term management needs;
  - provides annual cost estimates for those needs; and
  - identifies the funding mechanism to be used to meet those needs
- §332.7(d)(3) provides a list of appropriate long-term funding mechanisms

Key Issues

- **Difference from "financial assurances"**
- **Importance of up-front planning and modeling**
- **Options for legal structure of funding mechanism**
- **How to size the initial amount of the fund:**
  - Cap Rate, investing, and spending
- **Ongoing operational rules of the fund**

Difference from Financial Assurances

- **33 C.F.R. §332.3(n) establishes requirements for "financial assurances" to ensure project completion.**
  - **Acceptable mechanisms are "performance bonds, escrow accounts, casualty insurance, letters of credit, legislative appropriations for government sponsored projects, or other appropriate instruments, subject to the approval of the district engineer"**
  - **However, these mechanisms are "phased out once the compensatory mitigation project has been determined by the district engineer to be successful in accordance with its performance standards."**
- **Thus financial assurances are by nature geared toward providing *short-term security* rather than long-term funding.**
- **The two different requirements present different sets of issues in terms of structure, reliability, etc.**

Importance of Up-Front Planning and Modeling

- Whatever long-term funding approach is selected, it will be expected to "perform" for an indefinite period of time, perhaps in perpetuity.
- Legal or regulatory options for returning to the payor for additional funds – if a long-term mechanism turns out to be insufficient – are likely limited as a practical matter.
  - Bankruptcy risk, dissolution risk, etc.
- The bottom line: **invest time at the outset to ensure the selected approach is appropriately funded, secure, and likely to endure over the long term.**

Legal Structures of Funding Mechanisms

- **Under §332.7(d)(3), appropriate funding mechanisms for long-term stewardship costs include:**
  - **"Non-wasting endowments";**
  - **Trusts;**
  - **Contractual arrangements with future responsible parties; and**
  - **Other appropriate financial instruments.**
- **Key goals of all of these mechanisms should be:**
  - **Ensure the funds are legally restricted to the purposes and property for which they were extracted, consistent with applicable law, regulation, and permitting documents**
  - **Ensure the mechanism is based on legal, financial, and operational principles that provide the mechanism with a strong statistical chance of persisting indefinitely**

Implications of Different Legal Structures

- Whatever structure is selected and approved for the long-term stewardship fund should be memorialized in appropriate documentation.
- IRT permitting agencies should consider the level of ongoing oversight rights they need to retain to ensure the funds are being managed and spent appropriately.
- Whether the funds are "being managed and spent appropriately" will likely be measured by reference to:
  - The underlying law pursuant to which the funds were extracted (i.e., CWA)
  - Accompanying regulations, policies, and guidance
  - The terms of the permit(s) that required the funds
  - "Background" law, e.g., contract law, trust law, fiduciary law, etc.
- Remember: the *legal and accounting* treatment of the funds matters!

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Sizing the Initial Amount of the Fund

- **For cash-funded mechanisms – such as escrows, trusts, and "endowments" – a critical issue is how to determine the initial amount of the fund.**
- **This determination can be separated into at least four separate steps:**
  - **Creating the long-term management plan**
  - **Breaking that plan down into specific annual tasks**
  - **Assigning an itemized cost to each task**
  - **Translating those year-over-year costs into an up-front funding need**
- **The first 3 steps are often accomplished through different types of "property analyses."**
- **The accuracy of both the work items and the estimated costs presented in a property analysis is critical to the accuracy of the up-front funding calculation.**

Understanding the Cap Rate:
How the Cap Rate Drives the Initial Amount of the Fund

- The relationship of the annual cash need for management tasks to the initial amount of the fund is often expressed in terms of a "capitalization rate," or Cap Rate.
- Specifically, the Cap Rate is the percentage of the fund necessary to be drawn each year to meet the annual cash need
- As a formula:
  - Cap Rate x Initial Amount = Annual Cash Need
- To solve for the Endowment Amount, the formula is:
  - Annual Cash Need ÷ Cap Rate = Initial Amount
- By selecting a particular Cap Rate, the initial amount can be calculated from the annual land management costs necessary for the project or property at issue.

Understanding the Cap Rate:
Consequences of Different Rates

- **Example: for a property requiring $20,000/ year for land management tasks, if a Cap Rate of 3.25% were applied, the calculation would be:**
  $20,000 ÷ 0.0325 = $615,385

- **Inherent in the calculation is that the lower the Cap Rate, the higher the necessary initial amount.**

- **Why does this matter?**

Annual Cash Need	Cap Rate	Initial Amount of Fund
$20,000	7%	$285,714
$20,000	5%	$400,000
$20,000	3%	$666,667
$20,000	1%	$2,000,000
$20,000	0.5%	$4,000,000

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Selecting the Cap Rate:
Relationship to Investment Strategy

- **The Cap Rate reflects the net amount of gain that the portfolio must realize each year (on average) to meet the cash requirement for management costs.**
- **"Net" in this sense is not only net of fees (investment manager and other administrative), but also net of inflation.**
- **Assuming administrative fees at 1% and inflation at 3.0%, the fund must be projected to return on average 4% annually *before* introduction of *any* Cap Rate.**
- **For example, a Cap Rate of 3.25% would require average "nominal" annual returns of 7.25% over time, and therefore an investment strategy that is tailored appropriately to this target.**

The Cap Rate and Investment Strategies

- In approving long-term stewardship funding mechanisms, IRT agencies make implicit or explicit determinations as to whether a particular Cap Rate is acceptable.
- Whatever Cap Rate is approved, IRT agencies should ensure that it is supported by a suitable underlying investment strategy.
- For example, Cap Rates in the range of 3-4% would require investment strategies expected to return, on average, 7-8% annually.
- In turn, target returns in the range of 7-8% (which align with the current return targets of many defined-benefit and endowment funds nationally) would necessitate **diversified asset allocations** within the corresponding investment portfolios.
- The characteristics of the portfolio, driven by the Cap Rate, should be reflected in a written **Investment Policy Statement** applicable to the portfolio.

Competing Interests in the Selection of a Cap Rate

- **Permitting agencies generally attempt to balance two primary competing factors in evaluating any proposed Cap Rate:**
  - **On one hand, applying a lower Cap Rate increases the statistical likelihood of successful funding in perpetuity;**
  - **On the other hand, allowing the use of a higher Cap Rate decreases the amount that must be paid up front, and thus is often advocated by payors (i.e., sponsors, bankers, permittees).**
- **These competing factors reflect the risk-reward calculus inherent in determining the appropriate initial amount to be funded into a long-term stewardship account.**

Cap Rate, Investing, and Spending

- Most Cap Rates will require diversified portfolios.
- Diversified portfolios are not “principal and interest” portfolios!
- References to “principal and income” or “non-wasting” or “historic dollar value” funds are obsolete.
- Not to worry - this is consistent with modern “prudent investor” and endowment law, such as the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”).
  - UPMIFA has been enacted in 49 of the 50 states (not PA)
  - UPMIFA incorporates a general standard of prudent spending measured against the purpose of the fund, and invites consideration of a wide array of other factors

Spending Plans and Ongoing Operational Rules

- **Common approach to spending allowed by agencies:**
  - **Presumption that the annual amount needed for work specified by the property analysis will be drawn or disbursed in advance each year to fund the necessary work**
  - **Requiring (or approving) an initial fund amount and an investment strategy that are designed to create a high statistical likelihood that the necessary annual spending will be sustainable over a very long period of time, potentially in perpetuity, without the availability of any additional "outside" funding**
  - **In this sense the long-term management funds are more analogous to defined-benefit plans (e.g., pensions) than true endowments**
- **Agencies may also require various "buffering mechanisms" or fail-safes in conjunction with the above approach.**

Spending Plans and Ongoing Operational Rules

- **Common buffering or fail-safe mechanisms:**
  - **Require several years' worth of initial annual funding in order to allow the long-term fund to mature.**
  - **Require certain minimum contingency line items in the property analysis. (Note: §332.7(d)(3) expressly allows the District Engineer to consider "contingencies" in the long-term funding mechanism.)**
  - **Do not allow incremental disbursement of funds for non-annual activities modeled in the property analysis (i.e., for periodic fencing, allow only the full draw in the year needed).**
  - **Retain ability to suspend or reduce disbursements in certain extreme circumstances, e.g., prolonged contraction in financial and investments markets.**
  - **Develop early consultation process with affected land managers to determine draws against the fund in "negative value" years or extreme investment climates.**

Key Questions for IRT Agencies

- **When considering funding mechanisms for long-term stewardship of mitigation projects:**
  - **Who is responsible for determining what long-term management activities are required on the property over time?**
  - **How will line-item costs be developed for those activities?**
  - **What is the agencies' risk tolerance for investment of funds, and therefore the "expected return" that drives a Cap Rate?**
  - **What are the general rules around annual disbursement of funds to long-term property managers?**
  - **What are the agencies' rights and responsibilities with respect to ongoing monitoring of the stewardship work, the funding mechanism, the long-term property manager, and if different the funds holder?**

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