SHEARMAN & STERLING

Environmental Practice BRIEFING

WINTER 2003

Following are recent environmental developments that may be of interest to our colleagues, clients and other friends:

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Hong Kong
London
Mannheim
Menlo Park
Munich
New York
Paris
Rome
San Francisco
Singapore
Tokyo
Toronto
Washington, D.C.

United States Wetlands Developments

The Bush administration recently promulgated two statements regarding federal wetlands policy. The first is guidance relating to the mitigation of wetlands losses due to development. The second is guidance setting forth some limits on the federal government's jurisdiction over wetlands in the aftermath of a recent Supreme Court decision.

Wetlands Mitigation Guidelines

Wetlands, which are considered important natural resources, often are degraded or destroyed as a result of property development. In the United States, property development that affects wetlands is governed by Section 404 of the Clean Water Act (the "CWA"), which is administered by the Army Corps of Engineers (the "Corps"). Section 404(b)(1) of the CWA requires the Corps to issue a construction permit only if a permit applicant demonstrates that the proposed development activities minimize any harmful effects on wetlands. Specifically, the CWA requires the developer's permit application to demonstrate that adverse impacts to wetlands will be avoided to the extent practicable and that any unavoidable adverse impacts will be appropriately mitigated. In 1990, in an attempt to specify the actions that developers must take to limit wetlands degradation and destruction, the federal Environmental Protection Agency (the "EPA") and the Corps issued a memorandum of understanding setting out the so-called "no net loss" policy. The 1990 memorandum of understanding provides that, in most circumstances, an appropriate mitigation of adversely affected wetlands requires a 1:1 replacement of any wetlands acreage lost, either by restoring the wetlands that will be damaged by the subject development project or by creating new wetlands.

On December 27, 2002, the Bush administration released a plan of action consistent with administration efforts to rework the 1990 "no net loss" policy. The plan reaffirms the federal government's commitment to "no net loss of our nation's wetlands" and promotes recommendations set forth in a new guidance letter recently drafted by the Corps (the "2002 Letter").

In general, instead of relying on "acres lost" as the principal indicator of injury to wetlands, the 2002 Letter promotes a broader approach to assessing wetlands degradation and destruction. Under this approach, wetlands degradation and destruction is viewed through the lens of the entire wetlands ecosystem. Pursuant to the 2002 Letter, the Corps will evaluate the wetlands in question and determine which ecosystem functions will be lost to development. Based on such information and discussions with the applicant, the Corps will identify the most appropriate set of functional indicators for assessing the impact of the proposed development. The number of acres of wetlands to be restored or replaced will be based on the number of acres of wetlands needed to maintain the identified wetlands functions. While the new guidelines may permit a loss of absolute wetlands acreage in some cases, the EPA believes the value of the wetlands restored or replaced under the new policy will be equal to or greater than that produced by the procedure in place prior to the 2002 Letter.

Migratory Bird Rule

On January 10, 2003, the EPA and the Corps released a guidance memorandum (the "January 2003 Memorandum") setting forth the Bush administration's response to the January 2001 decision by the Supreme Court in *Solid Waste Agency of Northern Cook County v. Corps of Engineers.* In that case, often referred to as the *"SWANCC"* decision, the Court found that the Corps had exceeded its authority in asserting federal CWA jurisdiction over isolated, wholly intrastate wetlands "based on their use as habitat for migratory birds pursuant to . . . the 'Migratory Bird Rule'."

Until the *SWANCC* decision, the so called "Migratory Bird Rule" provided one basis for endowing the EPA with the authority to regulate wholly intrastate wetlands. Under the CWA, wetlands are protected from degradation and destruction by a prohibition against the deposition of dredge or fill material into "waters of the United States". Developers who seek to undertake such activities must demonstrate to the Corps that the proposal will minimize the harmful effects of the development on the water bodies in question. It has long been the EPA's position that "waters of the United States" include intrastate wetlands used in interstate commerce. Under the Migratory Bird Rule, wholly intrastate wetlands that are visited by migratory water fowl are deemed to be used in interstate commerce, making them subject to the CWA's wetlands regulations.

The *SWANCC* decision invalidated the Migratory Bird Rule as a sole basis for asserting CWA jurisdiction over isolated, wholly intrastate wetlands and in so doing raised the question of which "waters of the United States" are subject to the CWA.

The January 2003 Memorandum helps to answer this question. According to the memorandum, the *SWANCC* decision "squarely eliminates CWA jurisdiction" over isolated, wholly intrastate water bodies where the primary basis of that jurisdiction had been the water body's use as a habitat for birds that migrate across state lines. According to the January 2003 Memorandum, it remains uncertain as to whether the CWA grants the federal government jurisdiction over water bodies solely by reason of such water bodies being habitats for federally protected endangered or threatened species, being used by interstate or foreign travelers for recreational or other purposes, or containing fish or shellfish that could be taken and sold in interstate commerce. The *SWANCC* decision , according to the January 2003 Memorandum, does not change the EPA's and the Corps' determination that water bodies fall under the federal government's CWA jurisdiction if they are subject to the ebb and flow of the tide or are currently used or have been in the past used to transport interstate or foreign commerce. The January 2003 Memorandum emphasizes, however, that unless a specific water body falls precisely into a category now understood to be governed by the CWA, the determination of whether the CWA applies should be made on a case by case basis.

Developments in China

Two major Chinese environmental statutes were enacted in 2002: the Environmental Impact Assessment Law (the "EIAL") and the Clean Production Law (the "CPL"). Both new laws will take effect in 2003.

China requires environmental impact assessment reports for major construction projects under the 1989 Environmental Protection Law and related government guidance. The actual requirements under the 1989 law, however, are limited in scope. The EIAL is intended to be more substantive. Under the new law, environmental impact assessment investigations must be conducted prior to establishing new business or industrial zones, or developing natural resources in a way that will significantly affect the environment. The EIAL requires that reports of such investigations be reviewed first by independent, certified, environmental experts, chosen randomly from an approved list. Except in limited circumstances, once so reviewed the investigation reports are to be made public. Implementing regulations under the EIAL are to be

completed by June 2003 and will designate project-specific EIAL procedures. These regulations are expected to establish thresholds for local, provincial or national level governmental approvals. In anticipation of the EIAL's September 2003 effective date, China is training independent agencies and local environmental officials to conduct appropriate environmental assessments.

The CPL came into effect on January 1, 2003. Modeled after a similar German law, the CPL sets voluntary environmental production guidelines for industry. Implementing regulations are expected to encourage the adoption of more efficient manufacturing methods and a reduction in waste generation. While the CPL sets the groundwork for a system in which energy efficiency, the use of less polluting energy sources, the more efficient use of raw materials and expanded recycling efforts are favored, neither incentives (whether financial or otherwise) nor penalty provisions were incorporated into the CPL. Given the absence of such provisions, compliance with the CPL is currently voluntary.

FAS Statement 143: Accounting for the Retirement of Tangible, Long-Lived Assets

Under applicable disclosure and accounting requirements, costs associated with retiring tangible, long-lived assets (so called "asset retirement obligations") must be recognized and capitalized by entities responsible for such costs. Tangible, long-lived assets are physical assets—such as land, buildings and equipment—that take a comparatively long period (usually longer than a year) to be realized as cash, consumed, sold or otherwise divested.

In June 2001, the Financial Accounting Standards Board issued Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* ("FAS Statement 143"), which clarifies the public disclosure and accounting standards for such asset retirement obligations. Under FAS Statement 143, the fair value of an asset retirement obligation must be recognized and appropriately capitalized in the period in which the asset retirement obligation is incurred, or as soon thereafter as the fair value of the asset retirement obligation can be reasonably estimated. Prior to FAS Statement 143, it was unclear precisely which retirement events (i.e., which cash realization, consumption, sale or other divestiture events) and associated costs constituted asset retirement obligations that triggered disclosure and accounting obligations, when such disclosure and accounting obligations adhered to the entity, and exactly how to disclose and account for such asset retirement obligations. FAS Statement 143, which first becomes effective with regard to fiscal years beginning after June 15, 2002, attempts to clarify these issues.

For the purposes of FAS Statement 143, the retirement of a tangible, long-lived asset triggers disclosure and accounting obligations when that asset is *completely* removed from service by sale, abandonment or disposal. The anticipated costs of temporary closure of a long-lived asset (e.g., the "mothballing" of a production facility) do not trigger disclosure or accounting obligations under FAS Statement 143, nor do the costs of preparing a long-lived asset for alternate use by the same entity. The costs associated with legal obligations that arise in the context of the improper operation of a long-lived asset (e.g., the costs of remediating environmental contamination that occurs during mine closure as a result of noncompliance with safety procedures) also do not trigger disclosure and accounting obligations under FAS Statement 143. Costs associated with partial or staggered retirement (e.g., the costs of retiring one well in an oil field that continues to operate), and costs associated with retirement of a component of a business that is a tangible, long-lived asset (e.g., the costs of the decommissioning and disposal of a major piece of equipment) do, pursuant to FAS Statement 143, trigger disclosure and accounting obligations, and these costs must be recognized and capitalized.

For a given entity to have disclosure and accounting obligations associated with an asset retirement obligation under FAS Statement 143, the entity in question must have a present and largely unavoidable duty relating to the retirement event that requires some action at a discernible future date. In particular, FAS Statement 143 identifies three categories of asset retirement obligations that may arise during the normal operation of a tangible, long-lived asset: (a) obligations based on enforceable law or regulation; (b) obligations based on enforceable contracts; and (c) obligations based on promises that impose a reasonable expectation of performance by the promisor under the doctrine of promissory estoppel.

Japan's New "No Fault" Soil Contamination Law

On February 15, 2003, Japan's new Soil Contamination Control Law (the "SCCL") went into effect. The SCCL authorizes prefectural governors to assign investigation and remediation responsibilities to an owner of real property at which there is a potential risk of contamination. An owner must conduct an environmental investigation of the real property in one of two circumstances: (1) when a "registered factory" that is located on the real property ceases operations (a registered factory is one that is subject to the Water Pollution Prevention Law and that used, produced or disposed of certain designated contaminants); and (2) when a governor determines that there is a strong probability of soil contamination on the real property and that there is a probable risk to human health from such contamination. With respect to either triggering circumstance, the environmental investigation must include the laboratory analysis of soil samples and, if site-specific conditions warrant, soil gas samples and groundwater samples.

If an environmental investigation indicates the presence of contaminants in excess of regulatory limits, and if a governor determines that there is an actual risk of harm to human health, the governor can order the owner to clean up the impacted property. Significantly, the governor can order such owner to clean up the property even if the owner did not cause or contribute to the subject contamination. In the event a third party (i.e., not the owner of the property) actually caused the contamination, the governor has the option of ordering this third party to remediate the property if: (a) the third party can be identified; (b) it is reasonable to order the third party to clean up the property; and (c) the owner does not object to the third party conducting the remedial activities.

The SCCL provides criminal sanctions for its violation, including imprisonment of up to one year and a fine of up to approximately US$8,250 for the failure to comply with a governmental order to investigate and/or remediate a parcel of real property.

The prospect that an owner might be ordered to investigate and clean up contamination at his or her property that was caused by a third party (especially when such third party cannot be identified) introduces a "no fault" concept into the Japanese legal regime governing contaminated real property. The law makes the Japanese approach similar to the United States legal regime that, pursuant to the "Superfund" law, imposes liability based on an entity's status, rather than its activities.