



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
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OFFICE OF
ENFORCEMENT AND
COMPLIANCE ASSURANCE

MEMORANDUM

SUBJECT: Guidance for Determining Whether a Project is Profitable, When to Accept Profitable Projects as Supplemental Environmental Projects, and How to Value Such Projects

FROM: John Peter Suarez
Assistant Administrator

A handwritten signature in blue ink, appearing to read "John Peter Suarez", written over a circular stamp.

TO: Regional Counsel
Regional Enforcement Division Directors
Regional Media Division Directors

This memorandum advises enforcement personnel of a change in the Supplemental Environmental Projects (SEP) Policy. This change will allow for the acceptance, under certain circumstances, of SEPs that may ultimately be profitable to a defendant/respondent. Under the existing SEP Policy, profitable projects are not generally permitted as SEPs. However, after further consideration, the Office of Enforcement and Compliance Assurance (OECA) has determined that, in some instances, a project's environmental or public health benefits may outweigh its potential profitability to the alleged violator, such that the project may be allowed as a SEP. In addition, the positive returns for some projects may be so speculative or remote that a business may not decide to undertake the project independent of the enforcement settlement.

The attached guidance document describes the background and rationale for this decision and sets forth issues to consider for evaluating whether to accept a profitable project as a SEP as well as how to value such a SEP and establish the appropriate mitigation credit. Specifically, the guidance includes:

- Acceptance of projects as SEPs that are expected to become profitable after five years is appropriate if the project is consistent with the criteria described in the guidance;
- An exception for small businesses and small communities. For these entities, projects that are expected to become profitable after three years may be accepted as SEPs if the projects are consistent with the criteria described in the guidance;
- A five to fifteen year period for evaluating the profitability of a proposed project;

- A recommended process for valuation of a profitable project using the PROJECT Model; and
- A recommended mitigation credit of no more than 80% for profitable pollution prevention SEPs, and not more than 60% for all other profitable SEPs.

The decision to permit profitable SEPs under certain circumstances was reached after considering numerous comments and suggestions from Regional and Headquarters enforcement and program personnel. These considerations are described further in the Background section of the attached guidance.

If you have questions about this guidance, the SEP policy, or specific SEPs, please do not hesitate to contact me or the Agency's SEP contacts, Melissa Raack and Beth Cavalier. Melissa can be reached at (202) 564-7039, and Beth can be reached at (202) 564-3271. For questions concerning the PROJECT model, please contact Jonathan Libber at (202) 564- 6102 or the Financial Issues Helpline at (888) ECONSPT ((888) 326-6778). For questions about SEPs at Superfund sites, please contact Michael Northridge at (202) 564-4263. For questions about SEPs at federal facilities, please contact Melanie Garvey at (202) 564-2579 or Bernadette Rappold at (202) 564-4387.

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Attachment

**Guidance for Determining Whether a Project is Profitable,
When to Accept Profitable Projects as
Supplemental Environmental Projects,
and
How to Value Such Projects**

The purpose of this guidance is to modify that portion of the May 1998 Supplemental Environmental Projects (SEP) Policy, which states that profitable projects are generally unacceptable as SEPs.¹ The Office of Enforcement and Compliance Assurance (OECA) has determined that, in some instances, projects that are potentially or ultimately profitable to an alleged violator may be allowable as a Supplemental Environmental Project. OECA believes that in cases where a project's environmental or public health benefits outweigh its potential profitability to the alleged violator, the project may be acceptable as a SEP.

This guidance document describes the background and rationale for this decision and also provides criteria for evaluating if a project is likely to be profitable and whether to accept a profitable project as a SEP. In addition, the document provides guidelines for determining the value² of such a SEP and the appropriate mitigation credit.

Background

On August 22, 2001, the Office of Inspector General (OIG) issued an audit report, *Final Report on Region 6 Supplemental Environmental Projects*; Report No. 2001-P-00014, addressing the implementation of SEPs. This report criticized the Agency for approving projects that were ultimately profitable to the defendant/respondent in light of the current Policy's prohibition on such projects. In its response to the OIG, OECA committed to review this issue and provide guidance to the Regions. Following this review, and after extensive discussion with the Regions, other Headquarters offices, and the Department of Justice, OECA concluded that some projects that are ultimately profitable to the defendant/respondent may in fact have significant environmental or public health benefits (*e.g.*, pollution prevention projects). OECA also recognizes that some companies may not elect to pursue certain projects because of the speculative nature of the returns or the untested technology involved. Based on these considerations, OECA believes it is appropriate, under certain circumstances, to allow a proposed SEP, even though that SEP might eventually become profitable to the defendant/respondent.

¹ Conforming changes to the SEP Policy that reflect this guidance are underway.

² The SEP Policy uses the PROJECT model to calculate the value of a SEP. PROJECT generates the net cost of a project over time. For purposes of determining the monetary value of a SEP, OECA uses the PROJECT generated net cost, therefore, the net cost over time is considered the monetary "value" of the SEP.

Potentially profitable projects present a challenge to enforcement personnel who must determine the appropriate value of the project. A profitable project is one that results in no net cost to the alleged violator. This raises the question of how to determine the value of such a project and subsequently the associated mitigation credit. This guidance provides some background on this issue, describes the circumstances under which a profitable project may be acceptable as a SEP, and provides guidance for determining the value and mitigation credit that can be given.

1. Profitable Projects and the Project Period

Projects for which the net annual costs (*i.e.*, annual costs minus annual savings) reflect a savings are most likely to be profitable to the defendant/respondent at some point. To determine whether a project is profitable, the PROJECT financial model evaluates the project costs and savings for a specified period of time referred to as the “number of credited years” or the “project period.” If the PROJECT model returns a negative value, this indicates that the proposed project will provide a positive return over that period of time and should be considered “profitable” for the alleged violator.

Thus, the determination of whether a proposed SEP is profitable depends greatly on the project period, which is the length of time for which the project costs are considered. The OIG report noted the lack of guidance on this issue and recommended that OECA clarify the project period to be considered when determining the value of a SEP. The OIG recommended that the useful life of capital equipment (generally considered to be fifteen years) may be the appropriate period for determining SEP value (and for considering profitability). Under this scenario, projects that were profitable within the first fifteen years would be unacceptable as SEPs. The OIG made no recommendation regarding the appropriate project period for projects where no costs are incurred for capital equipment.

After soliciting Regional comments on the OIG recommendation, OECA rejected the OIG’s recommendation as impractical. The SEP Policy states that “at a minimum, the defendant/respondent must be required to implement the project for the same number of years used in the PROJECT model calculation.” (See page 14, paragraph 2.). Based on this language, under the OIG recommendation, defendants/respondents would be required to implement SEPs for fifteen years; consent decrees and administrative settlements would, therefore, have to remain open and be monitored for fifteen years, creating a significant administrative burden. In addition, imposing a complete ban on all SEPs that would likely be profitable within a fifteen year window would likely result in the elimination of many pollution prevention SEPs, which are more likely to be profitable to a defendant/respondent.

To balance competing concerns in this area, OECA proposed prohibiting as SEPs projects that are profitable to the defendant/respondent within the first five years of implementation. OECA further proposed the careful evaluation of projects that become profitable between five and fifteen years to ensure that the benefits to public health or the environment warrant giving the

defendant/respondent SEP credit. If the Region determines that it does, the project can be accepted as a SEP.

OECA proposed a five-year project period as the minimum time period for determining the acceptability of proposed, potentially profitable projects, because a five-year cycle is commonly used in the financial world for evaluating businesses' financial stability and for evaluating potential investments and other business activities. Because businesses commonly use a "five-year plan" for financial planning, OECA has also adopted this five-year period in its ability to pay analysis computer models.

Some of the Regional enforcement and pollution prevention personnel that reviewed the draft guidance commented that the proposed five-year limit for profitable projects might not be appropriate in all circumstances. Based on their experience, they felt that a five-year planning period was not always feasible, especially for small businesses. According to the Regions, because a five-year cost/benefit analysis may be burdensome for a small business, many small businesses will not opt to implement a project that was profitable in less than five years without the inducement of an enforcement settlement and the incentives that the SEP Policy provides. The Regions cited many factors, such as institutional barriers, opportunity costs of capital, emphasis on shareholder returns, and a lack of recognition of potential profits from resource conservation and efficiency, as reasons why smaller companies may not commit to a project that would be profitable in five, or less, years. The Regions commented that technical assistance agencies report that new technologies are resisted by companies receiving assistance, even when potential exists for great payback.

After considering the Regional comments and concerns and upon further discussion with OECA's financial experts, OECA has determined that approval as SEPs of projects that become profitable within five years is not appropriate. We believe that a shorter project period for limiting profitability would be inappropriate for larger, more sophisticated companies, which have the resources to implement a project that would not be profitable for five or more years. Thus, not only would these companies be reducing their civil penalties, but the SEP that provided the mitigation would be profitable in less than five years. This would seriously undermine the deterrent value of the settlements in those cases.

However, we understand the Regions' concern that a five-year project period may eliminate some otherwise acceptable projects especially for small businesses. Therefore, we have adopted a different approach for small businesses and small communities.³ For entities

³ To maintain consistency with the SEP Policy, which uses the Clean Air Act's definition of a small business stationary source (see CAA § 507(c)(1)(A)), "small business" is defined under this guidance to be a business that is owned by a person or another entity that employs 100 or fewer individuals. Small businesses could be sole proprietorships, individuals, privately held corporations, farmers, landowners, partnerships, and others. A small community is one comprised of fewer than 2,500 persons.

meeting the definition of a small business or a small community, a three-year project period may be used for determining the acceptability of a profitable project.

2. When to Accept a Proposed Profitable Project as a SEP

SEPs mitigate civil penalties in an enforcement action and reflect the Agency's use of its enforcement discretion. All proposed projects, including ultimately profitable projects found to be acceptable under this guidance, should meet the factors and conditions outlined in the SEP Policy. However, because a profitable project accepted as a SEP will provide benefits to the alleged violator as well as to public health or the environment, OECA believes that such projects should meet a higher standard, or "high hurdle," for acceptance. This "high hurdle" can be met if the project demonstrates attributes such as:

- (1) a high degree of innovation (*e.g.*, projects that use new technologies or processes not commonly in use by the industry or sector) with the potential for widespread application;
- (2) technology that is transferable to other facilities or industries, and the defendant/respondent will share information about the technology;
- (3) extraordinary environmental benefits that are quantifiable (*e.g.*, project will result in measurable reductions in air pollutant emissions or measurable improvement in water quality);
- (4) exceptional environmental or public health benefits to an Environmental Justice community; and/or
- (5) a high degree of economic risk for the alleged violator.

OECA believes it is inappropriate for SEPs that are profitable (as determined in Step 6, see below) to receive the maximum allowable mitigation credit. When considering the percent of mitigation credit to give, Regions should consider how well the project meets the "high hurdle" criteria as well as the length of time before the project becomes profitable and the degree of profit.⁴ Regions may wish to provide a lower percent of mitigation credit for projects that become profitable earlier on or show a significant profit. Projects that are only slightly profitable may receive a higher mitigation percent. OECA recommends a maximum upper mitigation percentage of 80% for profitable pollution prevention SEPs, and a maximum upper mitigation percentage of 60% for all other profitable SEPs.

⁴ This can be determined by running PROJECT using varying project periods between five and fifteen years.

3. Using the PROJECT Model to Calculate the Value of Such SEPs for Purposes of Penalty Mitigation

Section E of the SEP policy (see pages 12-17) describes the steps that Regions should take in calculating the value of a SEP. The policy recommends that use of the PROJECT model and describes the three types of cost information that may be associated with a SEP and that are entered into the PROJECT model. These three types of costs are: (1) capital costs, which are costs associated with equipment, buildings, etc.; (2) one-time, nondepreciable costs, such as the purchase of land or the removal of contaminated materials; and (3) annual costs and savings (also called “annual recurring costs”). Annual costs include operation and maintenance expenditures, lease payments, and insurance premiums. Annual savings may include items, such as reduced energy costs, reduced cost of raw materials, and reduced waste disposal costs resulting from the implementation of the project.

The PROJECT model requires input of data concerning the annual recurring costs of a SEP and the number of years that these costs will be credited. This data is entered into the annual recurring costs and number of credited years (also known as the “project period”) fields of the PROJECT model and, along with the cost information described above, is important in determining whether a SEP is profitable.⁵

In most cases, the value of a SEP as generated by the PROJECT model is the value on which any mitigation percentage will be based. A SEP that is profitable will generate a negative or zero value. A mitigation percent applied to such a value will result in zero credit. Therefore, we have developed a two-tier approach to assist the Regions in determining an appropriate value and mitigation credit for a profitable SEP.

The approach described in the steps below and in Attachment A should be used in evaluating any SEP for which there is a negative value entered into the annual recurring costs field of the PROJECT model. Annual recurring costs are determined by adding the annual costs to the alleged violator and subtracting any annual savings or profits that the alleged violator may realize as a result of performing the SEP. If the result of this calculation is a negative number,⁶ then a negative entry will be made in the annual recurring costs field of PROJECT. SEPs with a negative annual recurring cost are more likely to result in a zero or negative PROJECT value, indicating that the SEP may be profitable, and this guidance should therefore be applied.⁷

⁵ For the purposes of this discussion, SEPs that result in a zero or negative PROJECT result, indicating cost savings to the defendant/respondent, will be considered “profitable.”

⁶ A negative number indicates an annual return rather than cost to the violator.

⁷ Regions should be alert to other factors that could produce a profit for a violator. For instance, a violator may produce a new product line or business as a result of the SEP, which could ultimately result in increased revenues for the violator. Such factors should also be

4. Using PROJECT to Determine the Value of Profitable Projects

Step 1 - Collect information from defendant/respondent on costs of the project as well as any savings due to efficiencies, substitution of raw materials, re-use of waste products, etc.⁸

- If the cost entry for annual expenses is a negative number (indicating the project may return at least some savings to the defendant), proceed to Step 2.

- If the cost entry for annual expenses is positive, set the number of years in the annual expense category to the number of years that violator will be required to implement the project. Run PROJECT to determine the value of the SEP. This is the current process and will continue to apply for most SEPs.

Step 2 - Run PROJECT Model using five (5) years as the project period.⁹

Step 3 - If the PROJECT Model returns a negative value using the five-year project period, this indicates that there is a positive return for the defendant. A positive return at this step indicates that the SEP will be profitable within the first five years and the proposed SEP should be rejected.

Step 4 - If the PROJECT Model returns a positive value, indicating that there is a net cost to the defendant during the first five years, then the proposed SEP should be run through PROJECT again, this time using fifteen (15) years as the project period. This second PROJECT run is done to see if the proposed SEP will become profitable between five and fifteen years.

Step 5 - If the PROJECT Model still returns a positive value, indicating a net cost to the defendant, the SEP can be approved providing it meets all other requirements of the SEP Policy (e.g., nexus, etc.)

Step 6 - If the PROJECT Model returns a negative value, indicating that the defendant will be making a profit at some point during the fifteen-year project period, the Region should carefully consider the project's benefits to public health or the environment as described above. If the benefits are significant despite the profit to the defendant/respondent, the proposed SEP may be

considered as well when determining the acceptability of a proposed project and/or the appropriate mitigation percentage to apply.

⁸ The defendant/respondent should submit this information in writing, and the information should be kept in the case file as part of the record.

⁹ For a small business or small community, a project period of three (3) years may be used. The second-tier project period of fifteen (15) years will be used for all proposed SEPs, including those proposed by small businesses and small communities.

approved, however, the percent of mitigation credit given should reflect the fact that the defendant/respondent receives a financial benefit.

Step 7 - Determine the mitigation percentage: it is inappropriate for SEPs that are profitable (as determined in Step 6) to receive the maximum allowable mitigation credit. When considering the percent of mitigation credit to give, Regions should consider how well the project meets the “high hurdle” criteria as well as the length of time before the project becomes profitable.¹⁰ Regions may wish to give a lower percent mitigation credit for projects that become profitable earlier. OECA recommends a maximum mitigation credit of 80% for pollution prevention SEPs, and a maximum mitigation credit of 60% for all other SEPs.

Step 8 - The percent mitigation should be applied against the SEP’s value as determined by the PROJECT model. This requires the litigation team to enter information about the SEP, including the number of years credited into PROJECT. While the SEP Policy calls for entering the same number of years as the defendant/respondent is obligated to implement the SEP, this will generally not work for profitable SEPs, because the cost of performing the SEP decreases over time as the defendant/respondent recoups expenditures and approaches the profitability point. If, for example, a defendant/respondent is only obligated to implement the SEP for two years, but the SEP will become profitable at some point between five and fifteen years, using a two-year project period would likely place too high a value on the project and result in too high penalty mitigation. The overriding goal should be to use a timeframe that reflects the real cost of the SEP to the defendant/respondent but that takes into account that the SEP will become profitable in the near future. Therefore, we recommend using the value as determined by PROJECT using a five-year project period.¹¹ This is the value generated in Step 2 above.

Step 9 - Maintain written justification for selection or rejection of the proposed project(s) and the rationale behind the selected mitigation percentage for the case file. As part of the justification, the case file should include copies of the relevant PROJECT model runs conducted on each proposed SEP.

¹⁰ This can be determined by running PROJECT using varying project periods between five and fifteen years.

¹¹ It may also be the case that a defendant/respondent is committed to perform the SEP for more years than it will take for the project to become profitable. If a project is not profitable during the first five years, but becomes profitable later, the PROJECT-generated value will decrease over time and eventually become negative at the point at which the project becomes profitable. For the purposes of penalty mitigation, one cannot assign a percentage mitigation to a negative value. Therefore, we recommend using the PROJECT-generated value for a five-year project period as the value of the SEP for mitigation purposes for projects that will be profitable, unless another period more appropriately captures the costs, as well as the profitability, to the defendant/respondent.

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Attachment A

Process Flowchart for Determining Whether a Project is Profitable,
When to Accept Profitable Projects as Supplemental Environmental Projects
and
How to Value Such Projects

