
PENALTY CAP PROGRAMS

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SUMMARY

What motivates companies to comply with environmental laws? No doubt there are many reasons, but clearly one of the most important is the desire to avoid costly sanctions for illegal conduct. Civil enforcement in the United States is built on the assumption that penalizing violators not only hastens their return to compliance, but helps deter noncompliance by others by establishing that it does not pay to pollute.

While fundamentally sound as theory, deterrence-based enforcement does face practical limits. It depends on frequent and effective compliance monitoring, which may in fact be limited by scarce resources and the inherent difficulty of detecting certain types of violations. While most enforcement actions in the United States are ultimately settled out of court, the negotiations that precede such agreements can be protracted and costly. The regulated industry often claims

-- rightly or wrongly -- that it did not understand the requirement in question. Deterrence obviously cannot work so long as companies assume they are exempt from the law. Finally, exclusive reliance on enforcement probably does not provide sufficient incentive for the regulated industry to cooperate in identifying and correcting problems.

1 PENALTY CAP PROGRAMS - POWER LIABILITY FOR SELF-CORRECTION WITH DEADLINES

The United States Environmental Protection Agency has attempted some useful experiments to overcome these barriers by inviting targeted companies to disclose and correct violations, while increasing the risk of enforcement for those not taking advantage of this opportunity. These "penalty cap" programs share several common features:

- a. The Agency notifies a group of regulated industry that they are, or may be, subject to specific environmental requirements. Usually this notice is personal, directed to the senior corporate manager with responsibility for compliance. It may also be accompanied by a concerted effort to help the companies targeted to understand the requirements, and advertise pollution prevention and other cost-effective options for compliance.
- b. Companies are given a time limited opportunity to disclose and correct violations, subject to a widely publicized and meaningful deadline.
- c. Participants that disclose violations within the deadline and commit to return to compliance receive a greatly reduced penalty. The penalty limits are advertised in advance, either through a fixed amount by reference to a known formula for recovering any economic benefit the violator may have gained from its noncompliance.

- d. Companies that do not take advantage of this time limited offer face a greater risk of future inspection and enforcement.

It may be useful to review EPA's practical experience with these experiments, before considering their broader applicability to enforcement.

2 CHEMICAL HAZARD REPORTING

Section 8 of the Toxic Substance Control Act (TSCA) requires companies that manufacture, process or distribute chemicals to inform EPA of any information that reasonably supports the conclusion that a mixture or substance presents a "substantial risk of injury to health or the environment." With over 1000 new chemical compounds introduced into American commerce every year, these requirements help inform the government about potential hazards of certain chemical products. The Agency uses information submitted under this law to regulate or limit the manufacture or use of a chemical, or require appropriate warning labels.

Almost 10 years ago, through the Toxic Substance Control Act Section 8(e) enforcement actions, the Agency discovered that these requirements were either misunderstood or ignored, or many companies were not submitting information on chemical risk as required. The apparent confusion and widespread noncompliance among the regulated community suggested that enforcement would be a time-consuming, expensive process. To encourage prompt reporting, the Agency decided instead to establish a limit on penalties for companies that agreed to conduct an audit and disclose any tests, studies or other data regarding chemical risks required to be reported under the Act. The program was announced through a federal register notice in February of 1991, and companies had 5 months to register for participation, and were required to report any data no later than February of 1992.

Penalties were "capped" (limited) at \$15,000 for any test or study about human health effects, and \$6,000 for animal studies (it is sometimes less clear that human health risks can be extrapolated from animal tests). Most importantly, the total liability for participating companies was limited to \$1 million, regardless of the number of reports ultimately submitted. Under federal law, companies could have been liable for \$25,000 for *each day each report* was submitted beyond the original deadline, with potential penalties reaching the tens of millions of dollars for large companies with multiple studies to report. The Agency chose to forego these high penalties in the interest of expediting compliance and obtaining this health data more quickly.

This incentive structure was clearly attractive to industry. One hundred and twenty-three companies registered to participate, and 90 companies located and submitted an astounding total of over 11,000 reports regarding potential chemical risk, and paid total penalties exceeding \$22 million. By contrast, the Agency had received an average of about 100 reports per year prior to the Toxic Substance Control Act "CAP" program. Most of the information received has been reviewed by the Agency, and much of it is now available to the general public.

3 MULTI-MEDIA COMPLIANCE AT "MINI-MILLS."

Mini-mills, generally defined as electric furnaces with associated rolling mills, are the fastest growing segment of steel production in the United States. Their operations are subject to multiple environmental requirements under the a number of Acts: CWA (discharges and spill prevention), EPCRA (reporting), CERCLA (reporting), RCRA (hazardous waste management and recordkeeping), TSCA (labeling and reporting) and CAA (emissions). In January of 1996,

EPA offered a new policy to substantially reduce penalties for any company willing to audit, disclose and correct violations but by the end of 1996, no mini-mills had taken advantage of this offer.

Given the environmental impact of that steel making process, EPA's Region 5 office (which covers the industrial Midwest) decided to target the industry with a combined program of compliance assistance, incentives and enforcement. All 25 mini-mills were contacted with letters which included attached materials outlining applicable requirements, and inviting companies to take advantage of the opportunity to audit and correct violations in exchange for reduced penalties. Significantly, these letters informed companies that EPA would conduct inspections in late 1997, and EPA later provided copies of its multimedia investigation manual and pollution prevention self-assessments to guide the industry's own audits. These efforts were supplemented with other forms of assistance to mini-mills, such as a workshop and publication of specific answers to questions about the applicability of specific environmental laws to steel making operations.

Of the 25 companies contacted, 12 companies identified violations including inadequate storm water prevention, improper storage of hazardous waste, failure to test for opacity limits, and violations of wastewater permits. In addition, of the 12 companies that self-disclosed violations, 10 voluntarily conducted and submitted environmental audits. Most of these violations were corrected by June of 1998, and the Agency was able to waive penalties altogether under its audit policy. In late 1997, EPA began the promised inspections of facilities that chose not to participate in the program, and has identified significant violations that are expected to lead to enforcement actions at several facilities.

4 ROCK CRUSHING OPERATIONS

Rock Crushing operations are subject to New Source Performance Standards under the Clean Air Act that limit emissions of particulate matter. EPA's Region 7 office found that most of these operations in the state of Missouri (where EPA itself administered the program, rather than the state) had not performed necessary tests to ensure that their emissions were in compliance with the Act. Many of these facilities were small, closely-held companies without environmental compliance staffs. The Region, in conjunction with the Missouri Limestone Producers Association, announced that for a limited three-month period, any company in violation of the requirements could voluntarily come forward under the program, come into compliance with the testing and reporting regulations, and pay a stipulated penalty substantially lower than would normally be assessed for such violations. Forty five companies participated in the program, reporting violations at 70 plants across the state of Missouri, and paying an average penalty of approximately \$20,000. All of the companies participating in the program have completed the necessary testing and reporting requirements. Region 8 and the Missouri Department of Natural Resources worked together to determine whether companies that failed to come forward under the program were subject to the requirements. For those companies that were subject and did not come forward, Region 2 pursued traditional enforcement actions, having recently settled the last of those actions for a penalty of approximately \$400,000. The Region 7 initiative is a good example of EPA, the state, and a trade association working together to bring an industry, heavily populated with small businesses, into compliance with environmental requirements.

5 DO PENALTY CAPS WORK ?

What lessons might be drawn from EPA's experience with these limited amnesty programs? At a minimum, they should eliminate any doubt about the powerful effect that even the threat of enforcement has in motivating companies to comply. When mini-mills were told they were being targeted for increased inspections but given a chance to disclose and correct first, at least half did so. Surprisingly, participation rates were even higher among family owned gravel-crushing operations. By way of comparison, no mini-mills had stepped forward to voluntarily disclose and correct under EPA's audit policy prior to being notified that they were possible targets for inspection. Even where a broader audience is targeted -- such as the tens of thousands of companies responsible for reporting chemical hazard assessments -- the response is striking. The 11,000 tests submitted under that initiative were greater than in the entire history of the program. The high level of participation in these efforts suggests that companies will respond rationally when given specific notice of requirements, a tangible limit on liability, and the pressure of a deadline for disclosure and correction.

These CAP initiatives reduce some of the practical impediments to deterrence-based enforcement. Businesses given specific notice of requirements are less able to argue that, "they just didn't understand." Companies that choose not to take advantage of a clear opportunity to self-correct are clearly in a less sympathetic position should their violations later be discovered through an enforcement action. The government obtains information about compliance at a much faster rate than could be obtained by relying on enforcement alone.

The benefits, of course, are not limited to the enforcement program, but extend to the regulated industry as well. Offering a limited opportunity to correct may provide a little breathing space for both government and regulated industries to better understand how a particular set of requirements applies to a specific sector. Companies that came forward under the mini-mill initiative were able to clarify that certain operations were not subject to potential "new source" permit standards, thereby avoiding wasting resources on unnecessary controls. And most significantly, companies can volunteer to comply without suffering the stigma of a hostile enforcement action.

6 SHOULD PENALTY CAP PROGRAMS BE EXPANDED?

The EPA faces new challenges as it considers expanding this approach. To be credible, the Agency must make good on its threat of follow up inspections and enforcement. The actions taken against gravel crushing operations helped illustrate the cost of recalcitrance, and agencies must anticipate the time and resources needed for such efforts. Interestingly, industries that do participate in voluntary initiatives often demand that action be taken against recalcitrant parties to ensure that the latter do not win an economic advantage by avoiding compliance costs.

EPA's initiative thus far have generally targeted requirements that do not require significant capital expenditures for compliance such as chemical use reporting. Whether the same level of response can be obtained for more expensive violations remains to be seen. The high cost of compliance with these programs might encourage some companies to resist making the necessary investments, forcing the Agency to litigate each case to conclusion. On the other hand, under EPA's penalty policies, the higher the cost to comply the higher the sanctions for avoiding these costs. CAP programs that make it more difficult to plead ignorance of the law and which include a credible threat of follow-up enforcement could make delay strategies much riskier.

Enforcement actions deter violations by increasing anxiety alone about the potential high cost of noncompliance. Incentive programs make constructive use of that concern by providing the opportunity to self-correct violations at a lower cost. Penalty cap programs that maintain a creative tension between anxiety and opportunity seem to have struck a responsive chord in the business community, and may offer the most realistic incentives to comply. If so, these programs may offer the greatest hope for compliance with the laws that protect our environment.

