



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY  
WASHINGTON, D.C. 20460

MAY 10 2013

OFFICE OF  
THE ADMINISTRATOR

**DECISION MEMORANDUM**

**SUBJECT:** OIG Report 11-R-0700, American Recovery and Reinvestment Act Site Visit of Wastewater Treatment Plant-Phase II Improvement Project, City of Ottawa, Ill., September 23, 2011

**FROM:** Bob Perciasepe, Acting Administrator

A handwritten signature in black ink that reads "Bob Perciasepe".

**TO:** Arthur Elkins, Inspector General

Nancy Stoner, Assistant Administrator  
Office of Water

Susan Hedman, Region 5 Administrator

Congress passed the American Recovery and Reinvestment Act in February 2009 in response to the ongoing financial crisis facing the United States. According to the ARRA website, [www.recovery.gov](http://www.recovery.gov), the law had three immediate goals: create new jobs and save existing ones, spur economic activity and invest in long-term growth, and foster unprecedented levels of accountability and transparency in government spending.

The U.S. Environmental Protection Agency played a key role in implementing ARRA. Not only did the agency successfully distribute nearly \$6 billion in ARRA funds through its State Revolving Loan Funds, it did so within ARRA's aggressive requirement exclusive to the SRFs that these funds had to be placed in projects that were under "contract or construction" within one year of ARRA's passage. The EPA's distribution of ARRA funds to more than 3,300 projects in all 50 states is conservatively estimated to have created or saved 65,000 jobs.

Congress also included a requirement for all ARRA projects that "manufactured goods used in the project are produced in the United States," but did not define or elaborate on the intent of "produced in the United States." Implicitly, Congress recognized that in today's global economy not all components of a manufactured good will necessarily be "made in the USA" and that economic activity and long-term growth could be spurred by projects that use some foreign components, as Congress did not require that every component in an ARRA-funded project be "made in the USA."

In response, the EPA developed guidance for the recipients of the SRF funds to help them determine if a “manufactured good” was “produced in the United States.” The EPA’s guidance concluded that a manufactured good met that requirement if the good was “substantially transformed” in the U.S., a longstanding test used by the federal government. The EPA then provided a series of questions to help recipients determine whether their good had been “substantially transformed.”

In its review of the EPA’s approach, the Office of Inspector General agreed with the understanding that in today’s economy not all components of a U.S. manufactured good will necessarily originate in the U.S. and agreed with the EPA’s use of the concept of “substantial transformation” to help recipients determine if their “manufactured good” had been “produced in the United States.” The OIG disagreed, however, with the validity of one of the questions the EPA provided to help recipients determine whether their good had been “substantially transformed” and, as a result, questioned whether certain determinations made by recipients who relied on that question were appropriate.

There are two specific issues before me. The first issue is whether the EPA should find, as recommended in the referenced OIG site-visit report, that the wastewater treatment plant project at Ottawa, Ill., funded in part by the EPA under ARRA did not comply with ARRA’s Buy American provision. The second issue is whether the Office of Water must modify the substantial transformation questionnaire employed in its Buy American guidance, which was applied in Ottawa and elsewhere. The OIG recommends that OW modify its 2009 ARRA Buy American guidance to conform to what OIG believes is the appropriate test to achieve compliance with ARRA.

OW and Region 5 disagree with the OIG’s findings related to the Ottawa project and the OW guidance. They assert that the Ottawa project determination and the guidance on which it was based fully complied with ARRA, appropriately implemented the substantial transformation test for compliance with ARRA’s Buy American provision and were reasonable exercises of policy discretion.

### **Procedural Background**

This is the final agency decision pursuant to step 3 of the Internal Agency Audit Dispute Resolution Process, *EPA Manual 2750*, Part IIB.3.d. Beginning in March 2012, a series of meetings between the OIG and EPA attempted to resolve the disagreement but failed. The EPA then developed and sent to the OIG on December 15, 2012, a proposed compromise solution to the dispute, “Proposed Resolution to the Substantial Transformation Audit.” The OIG did not accept the proposed resolution. Pursuant to *EPA Manual 2750*, the OIG then elevated the disputed issue to the Office of the Chief Financial Officer where resolution was attempted in a February 28, 2013, meeting with the chief financial officer but again was not successful. The OIG and EPA then met with me on April 1, 2013, to “present the issue template for resolution.” *EPA Manual 2750, Part IIB.3.d*. The issue is now before me for decision.

### **Issue Background**

As indicated, Congress passed ARRA to create new jobs, save existing ones and spur economic activity. ARRA included a Buy American provision in section 1605 that requires, with limited exceptions, that funds awarded may be used for a project only if the “manufactured goods used in the project are produced in the United States.” Neither ARRA nor OMB guidance prescribed a particular test for determining whether a “manufactured good” was “produced” in the United States.

OW developed guidance for SRF program recipients and sub-recipients who would have to make difficult determinations regarding the origin of a wide range of manufactured goods to be used in SRF drinking-water and wastewater-treatment projects. The guidance states at the start that under section 1605, ARRA project procurement of manufactured goods produced in the U.S. “is the expected means of compliance.” OW adopted the concept of “substantial transformation” as a means of complying with ARRA’s Buy American provisions. OW issued its guidance, “Determining Whether ‘Substantial Transformation’ of Components into a ‘Manufactured Good’ Has Occurred in the U.S.” on October 22, 2009.

To help recipients determine whether a particular manufactured good was produced in the U.S., i.e., whether the good was substantially transformed in the U.S., the OW guidance instructed recipients to answer one of three questions, each intended to address a different type of good that might be used in SRF projects. The first question addressed situations in which all components of a good were manufactured in the U.S. and assembled into the final product in the U.S. The second question addressed situations in which important processing work was done in the U.S. prior to assembly. The third question, which addressed situations in which the most significant of the potentially transformative work in the U.S. is assembly of components into the manufactured good, is the only one at issue in this dispute.

The heart of this dispute is the appropriateness of the questions that OW developed to help recipients determine whether assembly in the U.S. of a product with any foreign components involved sufficient activity in the U.S. to conclude that it was “produced in the United States,” i.e., under OW’s test, whether assembly resulted in “substantial transformation” in the U.S. The guidance recommended asking whether the processes performed in the U.S. were “complex and meaningful” and whether they involved at least two of the following: substantial time, high cost, high-level skills, a number of different operations and substantial value added. The guidance stated that substantial transformation determinations are always case-by-case and that no good is substantially transformed through a simple combining or packaging operation. OW maintains that this test provided SRF recipients and sub-recipients with a practical, reasonable means of determining whether the character or use of the components would have been changed in the U.S. and would have been substantially transformed.

The OIG’s Ottawa site-visit report found that there was no evidence that the goods at issue – blowers and pumps for a wastewater treatment plant – had been substantially transformed. The OIG found that documentation was lacking to establish that the assembly process in the U.S. was complex and meaningful as required to qualify as substantial transformation. The site-visit report initially did not question the validity of the OW guidance. However, based on the OIG’s disagreement with the proposed management decision provided by Region 5, which relied upon the OW guidance, the OIG requested that OW modify its guidance.

The OIG, in its March 15, 2012, “Response to Region 5’s Proposed Management Decision on OIG Report No. 11-R-0700,” approved of the OW guidance’s use of the concept of substantial transformation but concluded that OW’s recommended test for determining whether assembled goods were substantially transformed in the U.S. was flawed. Throughout this process, the OIG and OW have disagreed on what OW was attempting to do in the third question, the one regarding assembly. The OIG has characterized that question and its subparts as creating an alternative and easier standard than the standard the OIG considered appropriate for concluding that manufactured goods were “substantially transformed.” OW asserts that its test properly focused on factors relevant to assembly of components to

determine whether a new and different article was produced. OW does not agree that it provided an easier path to compliance with the “substantial transformation” standard for assembled goods. The OIG recommended that OW change its test and adopt one that explicitly requires a physical transformation of the components of an assembled product and a “change in character or use” to constitute substantial transformation. The OIG then recommended that such modified guidance and new test be applied to the Ottawa project.

On August 07, 2012, at OW’s request, the EPA’s Office of General Counsel issued a legal opinion that concluded:

[T]he [s]ubstantial [t]ransformation [g]uidance ... is consistent with the Buy American provisions of the ARRA.... [It] provides a framework for recipients to analyze the concept of substantial transformation as a means of compliance with the Buy American provisions of the ARRA. The inquiries included in the [s]ubstantial [t]ransformation [g]uidance are based on relevant legal authority explaining the elements of substantial transformation in the circumstances of process and assembly.

## **Considerations**

### Undisputed Facts

- ARRA contains no definition of “produced in the United States” nor any guidance on how to determine whether a manufactured good was “produced in the United States.”
- OMB guidance on implementing ARRA does not prescribe a particular test for determining whether a manufactured good was “produced in the United States.”
- Neither ARRA nor OMB guidance required that all components of a manufactured good be “produced in the United States.”
- Given the absence of definitions or requirements, OW had discretion in choosing a means of securing and evaluating compliance with ARRA, including the obligation that manufactured goods be “produced in the United States.” OW chose “substantial transformation” as its test.
- The OIG agrees that OW’s decision to use the concept of “substantial transformation” to help recipients determine if their “manufactured good” had been “produced in the United States” was appropriate under ARRA.
- ARRA does not include any reference to “substantial transformation” and does not specify how agencies could define this term in implementing ARRA.
- Under both the agency’s and the OIG’s understanding of “substantial transformation,” manufactured goods with foreign components may permissibly be assembled in the U.S. such that the goods are “produced in the U.S.”
- The issue is how to determine when – on the spectrum from minimal assembly with a simple kit to complex, meaningful operations, such as heavy machining involving high-value labor and sophisticated equipment – a U.S.-based assembly process reaches a point where one can fairly say that the good is substantially transformed.
- OW’s guidance for assembled goods was designed to assist recipients in making that often-difficult judgment. The disagreement between the OIG and OW is over the validity of the methodology OW recommended in question 3 for determining whether assembly of a good in the U.S. resulted in its substantial transformation.
- Congress made quick expenditure for job creation an overarching “principle” in ARRA section 3(b) and a particular priority for the SRFs. Congress found it so important to “ensure that the [SRF] funds ... are used expeditiously to create jobs” that it directed that states would lose any

SRF funds – and, as a consequence, the local jobs they would generate – that were not under “contract or construction” within 12 months after ARRA’s enactment.

- Ninety-seven percent of the ARRA funds have been spent, and the vast majority of the projects were completed more than a year ago.

#### OIG Position

- OW made the correct choice to use the substantial transformation standard to determine whether goods are produced in the U.S., but, having made this choice, OW was required to apply what the OIG considers the sole, correct substantial transformation test under existing, non-ARRA precedents, regardless of whether the transformation involves assembly.
- In the OIG’s view the appropriate test is one that requires ultimate proof that a foreign component ultimately is truly transformed into a new and different article, i.e., changed in character or use. OW did not articulate its test in those terms but, rather, focused on such factors as cost, skill level, number of operations and value added in the domestic process.
- As a result, the OIG asserts that OW’s guidance did not achieve the ARRA goals to preserve and create jobs and promote economic recovery and resulted in SRF funds likely spent in violation of ARRA.
- The OIG recommends that the OW guidance be modified to use only the test for substantial transformation considered correct by OIG and that the revised guidance be applied to ARRA-funded SRF projects, including the Ottawa project.

#### Agency Position

- This is not a dispute about alleged violation of any legal requirement; it is a dispute over policy.
- In the absence of any legally mandated test for determining compliance with ARRA’s Buy American provision, OW had discretion to adopt the standard of "substantial transformation" and to recommend a reasonable, specific test for implementing that standard for assembled goods.
- The test OW chose was consistent with ARRA’s Buy American provisions and appropriate and practical for the ARRA-funded SRF grants. It was designed to ensure that assembled goods were produced in the U.S. based on reasonable, commonly used factors and that ARRA’s goals to expeditiously preserve and create jobs and promote economic recovery were met.
- The Civilian Agency Acquisition Council and the Defense Acquisitions Regulations Council, which include the Department of Defense, the General Services Administration and NASA, adopted for inclusion in the Federal Acquisition Regulations a different, seemingly less rigorous test for determining whether a good was “produced in the U.S.” for direct federal contracting under ARRA. This underscores the level of subjectivity and judgment that was involved in determining how best to implement that provision.

#### **Decision**

Based on the presentation and analysis of the issues in the attached copies of numerous documents prepared by the OIG, OW and OGC, I find that the EPA’s implementation of ARRA was consistent with ARRA’s goals and complied with its requirements. By choosing not to define the term “produced in the United States,” Congress effectively allowed implementing agencies to use their expertise to provide guidance to recipients of funds on how to determine whether a manufactured good met that requirement. The EPA appropriately used the standard of “substantial transformation” in its guidance and provided reasonable questions specifically designed to help recipients under its SRF programs apply that standard.



It is undisputed that a major goal of ARRA was to preserve and create jobs and promote economic recovery. In implementing ARRA, including its Buy American provisions, the EPA appropriately targeted job creation and preservation as a central priority. The success of the EPA's implementation of ARRA in its SRF programs is seen in the 65,000 jobs created or retained, according to the Council of Economic Advisors methodology, at more than 3,300 locations across the U.S.

As Congress understood in providing flexibility under ARRA, those jobs come not only from project components that are "made in the USA," but also from the use of manufactured goods that are "produced in the United States." The jobs required to produce manufactured goods in the U.S. for ARRA-funded projects were jobs created or saved in the U.S. For example, Kaeser Compressors, Inc., one of the manufacturers at issue in this case, opened a new 20,000 square-foot addition to their U.S. headquarters in Fredericksburg, Va., in 2009, the year ARRA was enacted. Once "produced in the United States," those manufactured goods spurred a series of U.S. jobs as they were transported to recipients of ARRA funds, used in the construction of new facilities or incorporated into existing facilities and then operated and maintained over their life spans. A reading of ARRA that would unnecessarily sacrifice the creation or preservation of these American jobs would have been inconsistent with ARRA's goals.

The OIG expressed concern that creation of American jobs was not adequately considered by OW in developing its policy. Congress found it so important to "ensure that the [SRF] funds ... are used expeditiously to create jobs" that it directed that states would lose any SRF funds – and the local jobs they would generate – that were not "under contract or construction" within one year. For the SRFs, Congress thus prioritized speed in the creation of jobs. To honor Congress' priority, the EPA developed its guidance to help recipients comply with ARRA's Buy American provision and manage their projects in the limited time Congress allowed. The agency further recognized congressional intent by noting that "Buy American provisions may properly increase demand for goods manufactured by domestic producers."

Because I find that the EPA's implementation of ARRA accomplished the law's goals consistent with its requirements, I find that OW is not required to modify its guidance as recommended by the OIG and that the Ottawa project complied with ARRA's Buy American provisions. Consequently, this decision resolves the OIG recommendation concerning the guidance and the alleged noncompliance on the Ottawa project.

Although not dispositive, I note that a retroactive change in the guidance, as recommended by OIG, would potentially require the review of more than 3,300 projects more than three years after all projects were statutorily required to be under "contract or construction." This could lead to contract disputes, litigation and economic hardship that would be harmful to states and funding recipients. The EPA generally should not reverse a carefully considered, reasonable position that has been fully implemented and relied upon by many recipients and sub-recipients, like the OW guidance, unless that is clearly shown to be necessary. That is not the case here; there was no failure to meet any legal requirement or congressional intent, but rather an after-the-fact disagreement about a policy choice.

OW requested an opinion from OGC concerning whether the analytical framework provided in the guidance is consistent with the requirements of ARRA's Buy American provision. OGC determined that the OW guidance is a legally supported framework for conducting the case-by-case assessments necessary to ensure compliance with those requirements. OGC concluded that the OW guidance

provided a test consistent with ARRA's Buy American provision and relevant legal authorities. My decision today relies on and is consistent with the OGC opinion.

ARRA afforded agencies discretion to establish a test for determining whether a good is produced in the U.S. because ARRA did not specify any particular test for making that determination. OW chose a reasonable means to exercise its discretion by developing practical guidance to assist recipients with the ARRA process. OW adopted the OMB guidance's concept that substantial transformation in the U.S. must result in "a new and different manufactured good distinct from the materials from which it was transformed." Recognizing this, it seems that the OW guidance's requirement to show transformation through multiple "complex and meaningful" factors – substantial time, cost, high skill, number of operations and substantial value added during U.S. processing – could in practice effectively amount to requiring a change in character or use.

The OIG has not demonstrated that OW was required to implement the substantial transformation test in the precise way preferred by OIG. Though expressing its own policy viewpoint, the OIG has not provided support for its contention that the EPA failed to comply with any applicable legal requirement. In fact, the extent of discretionary judgment involved in OW's policy choice is evidenced by the adoption in the Federal Acquisition Regulation of a different, seemingly less rigorous test for ARRA Buy American compliance. Nor has the OIG provided any analysis to demonstrate that more American jobs would have been expeditiously created or preserved if its preferred approach had been used rather than OW's. In addition, the OIG has not shown that there was any fraud, waste or abuse with respect to the explanation of the substantial transformation test in the OW guidance. In the final analysis, the EPA's implementation of the substantial transformation standard was designed to expeditiously create and preserve American jobs and spur economic recovery, as intended by Congress, and it accomplished those objectives.

Finally, I recognize that OW guidance's assembly test may, in practice, amount to requiring a change in character or use. Therefore, if ARRA's requirement for manufactured goods to be "produced in the United States" must be interpreted and applied in the future, it would be appropriate for the EPA to state explicitly that the factors in the "complex and meaningful" test would be applied to determine whether a change in character or use has occurred during the U.S. manufacturing process.

cc: Brenda Mallory  
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