Mitigation Banking and Reputational Risk

Writing in *The New Yorker* about the London Interbank Offered Rate (LIBOR) scandal, James Surowiecki observed that "for decades, regulators and people in the financial industry assumed that banks' desire to protect their reputations would keep them honest. If banks submitted false LIBOR estimates, the argument went, the market would inevitably find out, and people would stop trusting them, with dire consequences for their businesses." Markets, Surowiecki notes, "need a basic level of trust" to function well. Obviously, there are great differences between LIBOR and wetland mitigation banking; the former is largely self-regulating and the latter depends on government regulation for the existence of the market. But the market for wetland mitigation credits is no different with respect to trust, and it would behoove the wetland mitigation banking industry to learn one of the lessons of the LIBOR debacle: a market cannot thrive if there is no confidence in the underlying numbers.

A key number underlying the wetland mitigation banking industry is the amount of credits that a bank site generates. Credits are determined, in part, by assessing the baseline conditions of the site and developing a detailed mitigation plan with performance standards. The ecological lift, the anticipated environmental gain from meeting the performance standards, is quantified in a number of credits that can be bought and sold. A recent study by Craig Denisoff and David Urban found that almost all mitigation banks (98.3%) that were permitted to sell credits had met or were meeting their performance standards. Denisoff and Urban did caution, however, that some performance standards "may not always represent the best or most updated wetland restoration approaches." The saga involving the Highlands Ranch Mitigation Bank in north Florida illustrates this point and underscores how a lack of confidence in the credit determination (in terms of process and substance) can damage the reputation of the entire wetland mitigation banking industry.

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In 2008, Highlands Ranch, a Delaware limited liability company that is part of the Carlyle Group, purchased an 1,800-acre parcel in Clay County. The area, bordered by a state forest to the east and a titanium mine to the west, was in pine production. The Florida Department of Environment Protection (DEP) identified the area as a desirable acquisition for the Florida Forever program. In addition, the Critical Lands and Water Identification Project, a geographic information systems database of conservation priorities, placed the area in its Priority 1 category.

In January 2009, Highlands Ranch applied to the St. Johns River Water Management District for a state permit to establish a 1,575.5-acre mitigation bank. The proposed bank area consisted of 552 acres of wetlands (224 acres of which were described as hydric pine plantation) and 1,023.5 acres of uplands. The mitigation plan included: an end to pine production; the removal of a trail road, pine beddings, and furrows; the installation of water crossings; the planting of canopy species; and a conservation easement. Highlands Ranch requested 688 credits under the Uniform Mitigation Assessment Methodology (UMAM).

The water management district granted the permit, but for far fewer credits: 193.56. A main area of disagreement was the extent to which enhancement activities on uplands should be recognized. The water management district assumed that uplands within 500 feet of a wetland provided greater benefits to the wetland than more distant uplands; accordingly, those uplands more than 500 feet from wetlands did not produce as many credits under UMAM. Highlands Ranch disagreed, contending that the uplands should not be divided into separate categories.

Highlands Ranch also disputed how the district applied a "preservation adjustment factor," which assesses the preservation value of a mitigation area from a range of zero (no value) to one (optimal value) in one-tenth increments. Unless an area receives a score of one, application of this factor will reduce the number of overall credits. Highlands Ranch suggested a preservation adjustment factor should not be applied in this case. Alternatively, it stated that if the factor were to be applied to the uplands, the score should be high because the likely use of the property, if not a mitigation bank, was a landfill.

Highlands Ranch challenged the district's credit determination before an administrative law judge. In a March 2010 hearing, Highlands Ranch reduced the number of credits it sought to 425. Nevertheless, the administrative law judge rejected Highlands Ranch's approach with respect to uplands, reasoning that: "Because most of the value of this site comes from the wetlands, with the uplands providing supplemental value, preservation of the uplands cannot be worth more than the wetlands they are protecting."

The judge found the district's use of the preservation adjustment factor to be reasonable and rejected as speculative the threat of the landfill. The judge's final order was entered in July 2010, and Highlands Ranch sought no further judicial review. Instead, it went to the Florida Legislature.

Highlands Ranch was unsuccessful in that forum as well. The 2011 Florida Legislature declined to rewrite the state's mitigation banking rules to allow for more credits for upland enhancement and preservation. The company, however, had one more option.

An applicant can always request an agency to reconsider its decision. Of course, an agency is exceedingly unlikely to do so when the matter has been reviewed (and the agency's decision has been affirmed) by a judge. So Highlands Ranch tweaked its application and requested that the Florida DEP, rather than the water management district, review the matter and award more credits. In December 2011, the DEP agreed to consider the application pursuant to an operating agreement with the district, explaining that the move was justified because its review "would be more efficient or effective."

Yet there remained one more roadblock for Highlands Ranch. Connie Bersok, a well-respected and experienced DEP regulator who had responsibility for reviewing the mitigation bank's application, objected to increasing the number of credits for upland activities. In a May 9, 2012, status memo, she noted that granting this level of credits was a departure from past practice. She stated:

> As a result, this permit would be expected to result in a net loss of wetland function, contrary to environmental resource permitting rules . . . . I further expressed my concern that other pending and permitted mitigation banks would want the same treatment and applications of this approach, including the high credit assessment, which would only further increase the net loss of wetland function.

In this memo she formally expressed her "objection to the intended agency action and refusal to recommend this permit for issuance."

Two days later, the DEP suspended Connie Bersok pending an inspector general investigation. Accused of leaking information and being absent without leave, she was reinstated after a June 2012 inspector general report found no basis for the concerns.

In July, at the Ramsar Convention Conference of the Parties in Romania, I was discussing biodiversity offsets over lunch with a delegate from South Africa, who was familiar with the controversy. You know your industry has a problem when a South African policymaker in Bucharest is expressing concerns about what is going on in Florida.

The Highlands Ranch case calls into doubt what the credits represent. I would expect that fellow mitigation bankers are not enthused about these upland-derived credits flooding the market. And I would not be surprised if, as Connie Bersok suggested, other mitigation banks seek similar treatment. That could, of course, further erode support for mitigation banking as the preferred means to offset impacts to aquatic resources.

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In August 2012, the DEP issued the mitigation bank permit for a potential 425 credits. Connie Bersok did not sign the permit; her division supervisor, who took over the permit application during her suspension, did.

So, at this point, it appears that Highlands Ranch has received what it wanted. On the face of it, Highlands Ranch was merely exercising its rights for a review of an agency decision. There is nothing inherently wrong with seeking judicial review, a legislative fix, or an agency reconsideration. But the outcome is not good for the mitigation banking industry in general.

First, the DEP's suspension of Connie Bersok, which the inspector general found to be unwarranted, sends a terrible message to regulators who have the responsibility to ensure that the rules are applied fairly, consistently, and for the benefit of the public. The impression that the DEP leadership has created is that regulators who exercise their best professional judgment will be punished. The episode also has the potential to besmirch the mitigation banking industry. The adverse publicity went well beyond Florida.

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It is interesting (and hopeful) to note the U.S. Army Corps of Engineers' (the Corps') position on Highlands Ranch Mitigation Bank. While the Jacksonville District uses UMAM in determining credit allocations for mitigation banks, its online training module notes that the Corps "has more restrictions compared to the state in the amount of wetland and upland preservation credit given." Thus, according to RIBITS, the Corps' mitigation banking database, Highlands Ranch Mitigation Bank is approved for no more than 70.37 credits, and the credits will be released in three phases. It is nice to see that there are still some numbers in which one can have confidence. ■

- Royal C. Gardner