



November 14, 2005

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VIA ELECTRONIC MAIL

Re: American Chemistry Council's Comments to the California DTSC on financial assurance

The American Chemistry Council (Council)¹ is pleased to submit our thoughts on financial assurance to the California Department of Toxic Substances Control (DTSC). Our members successfully provide financial assurance in a number of states for the closure and post-closure care of hazardous waste treatment, storage and disposal facilities (TSDFs). Our members utilize a variety of accepted mechanisms for financial assurance, including the financial test. The financial test is a critical tool in the financial assurance toolbox for companies in good economic standing. The appropriate use of this tool permits the companies able to pass the test to reinvest capital assets, thereby growing their businesses and ensuring strong capability to cover any environmental costs in the future.

Before we comment on the specific financial assurance issues raised by DTSC, we would like to note that we continue to be surprised by the recent attention generated by financial assurance, and more specifically, the use of the financial test. In the past year, both the Government Accountability Office (GAO) and the Environmental Protection Agency's (EPA's) Office of the Inspector General have issued reports on financial assurance. In addition, EPA has tasked its Environmental Financial Advisory Board (EFAB) with examining several issues relating to financial assurance, including the financial test and captive insurance. To date, even with all of these reports, there has been very little data demonstrating significant failures resulting from the use of the financial test. Yet, there continues to be a misperception that the current system,

¹ The Council represents the leading companies engaged in the business of chemistry. Council members apply the science of chemistry to make innovative products and services that make people's lives better, healthier and safer. The Council is committed to improved environmental, health and safety performance through Responsible Care®, common sense advocacy designed to address major public policy issues, and health and environmental research and product testing.

The business of chemistry is a \$520 billion a year enterprise and a key element of the nation's economy. It is one of the nation's largest exporters, accounting for 10 cents out of every dollar in U.S. exports. Chemical companies are among the largest investors in research and development. Safety and security have always been primary concerns of Council members, and they have intensified their efforts, working closely with government agencies to improve security and to defend against any threat to the nation's critical infrastructure.

which has been in place for twenty years, is fraught with weaknesses and vulnerabilities. Before changes to any financial assurance mechanisms are made, it is prudent that a thorough investigation and analysis take place to ensure that these changes are addressing *real* existing problems and that examines the impacts these changes may have on the regulated community. Altering and/or removing the use of the financial test could have unintended and significant consequences to both the regulated industries and the public.

Our comments will now focus on points raised in the DTSC discussion papers on the Resource Conservation and Recovery Act (RCRA) financial test and the post-closure period.

RCRA Financial Test

TSDFs should be required to provide financial assurance for closure and post-closure activities.

We agree with the premise that the owners/operators of TSDFs should be required to provide financial assurance to cover their closure and post-closure responsibilities. As both users and owners of TSDFs, we have a vested interest in assuring that waste facility owners have the financial capability to properly handle closure and post-closure. However, it should be noted that there are two types of TSDF owners – those that use the TSDF as a revenue source (commercial waste management companies and recyclers), and those that use the TSDF to manage their own waste created during a manufacturing process (such as with our members). This distinction is especially relevant when the former category of TSDF owners may be a small, single operating facility. Once that TSDF is closed, it stops generating revenue, making it critical that monies have been allocated and are available for closure and post-closure activities. On the other hand, for the latter category of TSDF owners, the TSDF activities themselves are rarely a source of revenue and these TSDF owners will typically continue to generate revenue through their primary manufacturing activities after closure of a TSDF. We encourage DTSC to fully analyze the risk posed by the two different types of TSDFs in providing sound financial assurance.

The Council cautions DTSC on against equating accounting scandals to weaknesses in the financial test requirements.

DTSC states that “the reliability of the audited financial statements is also an important factor in the level of risk posed to a regulatory agency inherent in the use of the financial test.” While this statement is true, it applies to every single company in the US economy – the companies with TSDFs as well as any company that provides third-party assurances. By focusing on fraud, the DTSC is overemphasizing the financial risk to the State due to a failure in the financial test as compared to any other financial assurance mechanism and all others risks facing the State. The forms of fraud generally cited are activities dealing with liability holding arrangements, dubious asset classification and other complex trading deals, which can for a time remain hidden by the complexity of the firm and its market. Moreover, the firms frequently cited tend to be financial institutions and not traditional manufacturing businesses. Firms subject to post-closure requirements typically have financial statements that could have been understood by the analysts of a generation ago. Furthermore, the accounting scandals that have received national attention

(Enron, Worldcom, etc.) are not likely to have involved corporations subject to financial assurance. As noted in the financial test discussion paper, the Sarbanes-Oxley Act was created to prevent these accounting scandals from occurring in the future.

The financial test is a critical financial assurance mechanism. The Council stresses that DTSC needs to gather specific information demonstrating whether any problem with the current financial test even exists, and until such information is developed, it is premature to assess any alternatives.

DTSC acknowledges that it has no evidence of failure in the financial test (for either Alternative I or Alternative II): "At first glance, simply leaving the financial test requirements as they now exist would make sense given that there have been no instances where DTSC had to perform closure, post-closure, or corrective action activities where a facility owner/operator using the financial test has failed." DTSC then surprisingly suggests several changes to the test, including eliminating it altogether. It is bad policy to make changes to programs that work. Little to no data exists to suggest a problem, and no evaluation was made to determine the existence or extent of a problem with the current program.

The financial test is an important financial assurance tool that allows financially strong entities to reinvest capital in an effort to continue growth, thereby further assuring the financial stability and wherewithal to cover any future environmental liabilities requiring financial assurance. This is particularly important for companies with TSDFs that are not a core business unit.

The financial test was developed to maximize the protection of the public while minimizing the cost to private industry. The goal of the test was to develop a means of determining the financial viability of a company posting financial assurance to pay for its closure, post-closure and corrective action costs through revenue generation. The conservatism built into the test minimizes the likelihood of a qualifying entity going bankrupt within 3 years of passing the financial test. Studies by EPA when the financial test was originally implemented in 1982 (April 7, 1982, 47 FR 15032), as well as more recent studies performed under contract with EPA (ICF, 1996, see <http://www.epa.gov/garbage/finance/famc>), indicate that the likelihood of a company passing the financial test and then going bankrupt within a year are extremely low. The predictive nature of the test is such that a company that may fail the test still has the financial ability to secure alternative financial assurance.

While having a second party available in the event of a failure by the first party might seem more protective than the current financial test, we caution DTSC on this assumption. In DTSC's workshop on October 17, the example of failure in financial assurance at the BKK landfill was cited. This case was an example of the State not collecting on an insurance policy, and not a failure of BKK to provide financial assurance or a failure in the financial test. Furthermore, the methods used to determine the creditworthiness of a third party would be similar to those currently applied by the financial test.

The DTSC should distinguish between the two alternative financial tests and fully evaluate the impact its recommended changes to either or both of these financial tests may have on the regulated community.

While the DTSC does mention the existence of a bond rating alternative (Alternative II), it was not factored into any of its analysis. The suggested modifications that the DTSC has made for the financial test do not include any discussion of the application of its recommendations to the two different alternatives. Furthermore, there has not been any evaluation to determine the impact that these changes may have on the regulated community. Yet, any requirement for greater liquidity and assets may inadvertently impact companies that reinvest capital. Thus, such changes should be fully evaluated prior to any potential changes.

The bond rating test (Alternative II) is a better predictor of bankruptcy than the Altman Z score.

In order for DTSC to fairly compare the Altman Z scoring model with the existing financial test, it is necessary to fully understand EPA's intent in creating the financial test in the first place. The RCRA Subtitle C financial test was originally created by the EPA to reduce private costs while not increasing social costs to an unacceptable level. Keeping dollars with firms, instead of spending it on bonds or insurance, ensures a stronger economy, more money for cleanups and ultimately a reduction in any cost to taxpayers.

There have been several studies, including one in 1996 by ICF² commissioned by EPA and more recently a 2004 doctoral thesis by Dr. Wendy Habegger,³ that show a very low misprediction rate for the Subtitle C Alternative I (ratio) financial test for firms going bankrupt. The 1996 ICF study showed misprediction rates from 0.33% to 0.667%. The Habegger study showed that only 7.82% of bankrupt firms between 1985 and 1999 would have passed the Alternative I test compared with 29.57% when using the Altman Z score model. This translates into the Subtitle C Alternative I test having a classification accuracy of bankrupt firms of over 92%. Thus, empirical studies indicate that the existing financial test is far superior in its ability to predict financial stability in a given firm than the Altman Z score alone.

Furthermore, according to the Habegger study, the bond rating financial test (Alternative II) classified bankrupt firms 100% of the time, unlike the Alternative I test or the Altman Z score. A company's bond rating is determined by an independent third party, which looks at a variety of economic data over a period of time, including the Altman Z score. The credit rating firms pride themselves on their objectivity and transparency, and thus conduct rigorous and comprehensive review of all of a company's financials. Reliance on the Altman Z score alone would be a step backward, not a step forward. The Council strongly urges the DTSC not to eliminate the use of the bond rating test, especially in light of this Habegger study data.

² "Subtitle C and D Financial Test Issue Paper – Performance of the Financial Test as a Predictor of Bankruptcy" by ICF Consulting, April 30, 1996. See <http://www.epa.gov/garbage/finance/famc/paper11.pdf>.

³ "An Investigation of Financial Assurance Mechanisms for Environmental Liabilities" by Wendy Habegger of Florida State University, presented to the Department of Finance, April 2004. See http://etd.lib.fsu.edu/theses/available/etd-04112005-121040/unrestricted/Dissertation_Habegger.pdf.

If the DTSC wishes to use the Altman Z score for the financial test, it should be used for those companies that do not have a bond rating. In addition, DTSC should be aware of several limitations in the Altman Z score model. Depending on the model used, an Altman Z score of greater than 2.675 indicates a low probability of bankruptcy, a score between 2.675 and 1.81 is inconclusive, and a score less than 1.81 indicates that a firm has a high probability of going bankrupt. By setting the requirement for passing the Altman Z score at 3.0, DTSC is eliminating the use of any financial test reliant on the Altman score by those companies with a score between 2.675 and 3.0, who all have a low probability of bankruptcy. In addition, the Altman Z score was developed based on a review of only 66 companies with assets ranging from \$1 million to \$25 million, and therefore did not analyze how larger firms (such as many of our member companies) utilize their working capital over business cycles. Finally, the Altman Z score only looks at one certain point in time. In contrast, a bond rating looks at the entire business cycle and is frequently updated based on a company's financial performance.

The DTSC should further evaluate its proposed changes to the financial test.

In addition to the Altman Z score, the financial test discussion paper contained several other potential changes to the financial test. We strongly caution the DTSC to fully analyze the impacts these changes may have on regulated industry. We are not opposed to raising the tangible net worth requirement from \$10 million to \$20 million to reflect inflation since 1982; however, we believe that a change should only be made if a detailed review and analysis indicates it is necessary. Similarly, the other two suggested changes should be thoroughly examined.

The Council urges DTSC to continue working with the accounting industry to resolve the negative assurance issue.

The complexities surrounding the negative assurance/agreed-upon procedure issue will continue to impact the companies that choose to utilize the financial test. It is critical that the DTSC and the accounting industry come to an agreement regarding an acceptable method to verify the numbers being reported for the financial test. Otherwise, it is likely that companies will not be able to use the financial test due to this technicality, heavily impacting capital investment. It also diverges from EPA's evaluation of what is appropriate under the regulatory requirements at issue.

Post-closure period

In the DTSC presentation and workshop held October 17, 2005, and in the State's discussion paper entitled "Postclosure Period," California indicated a concern about the timeframe for which financial assurance should be maintained for post-closure activities. The State suggests that for sites where waste will be left in place, post closure activities may continue in perpetuity. The DTSC discusses a "rolling thirty-year period" of post-closure financial assurance, since permits are renewed at a minimum of every 10 years, and require 30 years of post-closure activity (unless conditions have been met and further activity is no longer necessary). The DTSC states that the rolling thirty-year period of financial assurance will leave between 20 and 30 years

financial assurance should the permitted business go defunct, thereby causing the State to seek funding from those generators that have disposed of waste at the facility.

Council members frequently utilize the services of waste disposal facilities, and as such, it is important to us to make sure that these businesses are as financially strong as possible to assume their environmental responsibilities. Our members do not want to be held responsible for the actions of these TSDFs; however, as long as the Comprehensive Environmental Response, Liability and Compensation Act (CERCLA) liability clauses remain as they are, there is no way around this potential future liability. Regardless, we think that there are strong reasons that financial assurance should not be required for time periods greater than a generation (30 years).

The DTSC should consider the time value of money when determining how long funds will last should a TSDF in post-closure declare bankruptcy.

Financial assurance estimates are determined on a non-discounted basis with an annual inflation factor added. For instance, if post-closure care is estimated to cost \$10,000/year for a 30-year period, the TSDF would have to show that it can financially assure \$300,000. If the company goes bankrupt that first year, the State would conceivably have access to the full \$300,000. If that \$300,000 is put into an account that generates as low as 4% interest (not including inflation), the principal would last in perpetuity. Even if an inflation factor of 3% is included, a return on the investment of only 6.4% can provide almost 100 years of post-closure monitoring. In the DTSC example of a facility about to renew its permit going defunct with only 20 years of financial assurance left, that amount, which would have been adjusted for inflation over the past 10 years (assume 3%) would still provide for 66 years of post-closure monitoring if the principal returned only 6.4% interest. Even in these cases, post-closure care would likely be covered for longer than these estimates since the changes in post-closure activity (monitoring and other O&M) certainly will have become more efficient that far out into the future (and therefore not have increased in cost at a 3% annual rate).

While the examples above show that financial assurance may still run out at some point in the future, there is always the ability to hold responsible those generators that have utilized the services of the TSDF under the joint and several liability provisions of CERCLA. It should be a very rare case indeed that the cost of post-closure becomes the responsibility of the State.

It is unrealistic to look into the future of financial assurance beyond a generation. Much will change in the way risk is defined, the way land and resource use is qualified, and in monitoring and remediation technology and its application. Additionally, the DTSC must consider the economic impact of requiring financial assurance for long periods of time. If, as the DTSC states in their "Postclosure Period" discussion paper, the post-closure period for some sites will be in perpetuity, then would financial assurance be required in perpetuity? How would the value of the assurance be calculated, given that there's no known value to associate with perpetuity? More than ever our economy faces the challenges of global competition. We must manage the impact that regulations have on our economy with caution. We must be risk managers more than risk eliminators. A rolling thirty years for post-closure activities and financial assurance, on a site-specific basis, is a workable risk management mechanism.

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In closing, we strongly urge the DTSC to fully examine its assumptions and recommendations regarding financial assurance. We believe that the existing financial test has proven very capable of serving its designed purpose. Our members provided valuable information and recommendations within this letter that we hope the DTSC takes into account as it evaluates its current financial assurance requirements. If you have any further questions regarding the Council's comments, please contact Lorraine Krupa-Gershman at (703) 741-5219 or Lorraine_Gershman@americanchemistry.com . In the meantime, thank you in advance for your consideration of our comments.

Sincerely,



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