CONGRESSIONAL TESTIMONY

Superfund and Transaction Costs - The Experiences of Insurers and Very Large Industrial Firms

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The author addresses the following questions: At how many hazardous-waste sites are various parties involved? How much have they spent at these sites? What proportion of their costs are transaction costs? Do transaction costs vary across sites and, if so, why?
Statement of
Lloyd S. Dixon
on Superfund and Transaction Costs

before the
Subcommittee on Investigations and Oversight
Committee on Public Works and Transportation
U.S. House of Representatives

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Mister Chairman and Members of the Subcommittee, thank you for inviting me to participate in your hearing on the Superfund program. My name is Lloyd Dixon, and I am an economist at RAND. Research on Superfund at RAND has been underway since 1988. I base my testimony today on a recently released report entitled Superfund and Transaction Costs: The Experiences of Insurers and Very Large Industrial Firms,\textsuperscript{2} which I co-authored with Jan Paul Acton.

Many critics of Superfund argue that its broad liability provisions shroud the program in litigiousness and generate steep transaction costs. Transaction costs are expenditures that do not contribute to the understanding or cleanup of a site. They are related to the apportionment of costs among parties and are essentially frictional in nature. Our research attempts to measure these transaction costs. We cannot give you the bottom line on transaction costs yet, but so far we have learned a great deal about two important sets of actors in the Superfund process: insurance companies and very large industrial firms.

Our research addresses the following questions:

- How many sites are these parties involved at?
- How much have they spent at these sites?
- What proportion of their costs are transaction costs?
- Do transaction costs vary across sites, and, if so, why?

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Our study is based on information collected from four insurance companies and five very large industrial firms. These firms are involved at a substantial number of sites. Because we are interested in the impact of Superfund on all inactive hazardous waste sites, not just those on the NPL, we include in our analysis both NPL and non-NPL sites.

First, I will present our findings for the insurance industry. Then I will turn to the experiences of the very large industrial firms.

Findings on the Insurance Industry

The involvement of the insurers in our study at inactive hazardous waste sites is substantial and growing:

- Between 1986 and 1989, pending claims that involve inactive hazardous waste sites rose from 650 per company to 2,200 per company.
- Over the same period, the average number of policyholders that had filed claims grew from 200 to 1,000 per company.
- Between 1986 and 1989, insurer spending rose from an annual average of $9 million per company to over $17 million per company.

To determine how this money was spent, we broke insurer outlays down into two categories: Indemnity payments and transaction costs. Indemnity payments are made to policyholders and are generally for site cleanup. Transaction costs, on the other hand, finance two main activities: defense of the policyholder in disputes with the government or other private parties over liability, and disputes with policyholders over whether a claim is covered under their insurance policies. Most of these policies were written before Superfund liability was ever envisioned, and coverage issues remain hotly contested.

We found that:

- Insurer transaction costs are high, averaging 88 percent of total expenditures through 1989.
• If the sampled firms are representative of the insurance industry as a whole, insurers spent $410 million on transaction costs in 1989. Using EPA's estimate that it costs between $25 million and $30 million to cleanup an NPL site, these transaction costs would pay for 15 site cleanups a year.

• Transaction costs are split roughly evenly between coverage disputes and defense of policyholders.

• There is no evidence of a substantial difference between the transaction cost shares for NPL and non-NPL sites.

• Transaction cost shares for closed claims were somewhat lower than for claims that were still open. As of 1989, insurers had closed approximately one-third of the claims that they had ever opened. And, the transaction cost share for closed claims was 69 percent.

What is the significance of these findings? Many observers of Superfund expected the costs incurred by insurers and the share of transaction costs in the total to be high. Our analysis confirms this expectation, and indicates that these high transaction costs are split roughly evenly between costs of defending their policyholders and disputes with policyholders over what the policies cover.

Findings for Very Large Industrial Firms

Now I will turn to the experiences of the five very large industrial firms who are potentially responsible parties, or PRPs, at many inactive hazardous waste sites. The involvement of these PRPs at inactive hazardous waste sites is also substantial and growing.

• These firms had each been contacted by the government or other private parties regarding cleanup at an average of 144 sites.

• Their annual outlays nearly tripled between 1984 and 1989, increasing from $2.6 million to $6.1 million per firm.

We divided PRP outlays into two categories: site investigation and remediation costs and transaction costs. The transaction costs of
the very large industrial firms are predominantly for legal counsel. We found that:

- Between 1984 and 1989, transaction costs averaged 21 percent of the total outlays.
- Transaction costs vary considerably across sites.
- Transaction cost shares are much lower at single-PRP sites than at sites where there are multiple PRPs. The share for single-PRP sites averaged 7 percent while that for multiple-PRP sites averaged 39 percent.
- Transaction cost shares depend strongly on the stage in the cleanup process to which the site has progressed. Sites further through the process have lower shares. The transaction cost share for sites where construction was complete averaged 16 percent.
- The difference in transaction-cost shares at NPL and non-NPL sites was small and not statistically significant.

What is the significance of these findings? First, contrary to what many had expected, transaction cost shares are not uniformly high for all participants in the Superfund process. Second, in situations such as single-PRP sites where liability is clearly defined, firms seem willing to pay and transaction cost shares are low. Third, transaction cost share appear to fall as a site moves through the remedial process. This illustrates that even sizeable transaction costs can be swamped by large remedial payments and raises an important policy question: when evaluating the transaction costs generated by Superfund, what is the most important measure—the overall level of transaction costs or the percent of transaction costs in total costs?

Concluding Comments

Two central questions arise in evaluating transaction costs in Superfund. First, what are the transaction costs TO DATE of the parties involved in the process? We have found some sizeable transaction costs, but the information presented today illuminates only two parts of the
picture, and we still need to determine what the transaction costs are of small and medium-sized PRPs and of federal, state, and local governments. Only when this information is available will we be able to calculate the total transaction costs of Superfund and determine how well the findings reported here characterize the total.

Second, and more important, what will transaction costs be when the dust settles and cleanup is complete at all the nation's inactive hazardous waste sites? We do not yet know. When the period covered by our analysis ended in 1989, cleanup was complete at only 5 percent of NFL sites and only one-third of the claims received by insurers had been closed. Consequently, the experience observed so far may not accurately represent what will happen in the future. Critical questions that must be answered include:

- Will insurance coverage issues be resolved, lowering the transaction costs of both insurers and PRPs?
- Are the sites and claims addressed so far representative, for example in terms of expected cleanup cost and the number of PRPs, of the many more yet to come?
- Will PRPs file more cost contribution lawsuits against non-participating PRPs as the cleanup at a site nears completion?
- Will insurers pursue their reinsurers as their own losses mount?

We need to know the answers to these questions before we can predict what the transaction costs of Superfund will ultimately be.