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October 10, 2000

**Via Hand Delivery**

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**Via Facsimile 505/827-1544**  
**and Via Federal Express**

James Bearzi  
New Mexico Environment Department  
Harold Runnels Building  
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P.O. Box 26110  
Santa Fe, New Mexico 87502-6110

Re: Financial Assurance

Dear Mike and James:

This letter is a response to correspondence dated August 16, 2000, relating to the financial assurance provided by Sparton Technology, Inc. in March 2000. Questions were raised about the date of letters related to the corporate guaranty, and the content of the letter from Sparton Technology, Inc.'s outside accountant, Ernst & Young. Enclosed with this letter is a new original letter from Dick Langley, as well as a revised letter from Ernst & Young, containing language that I have been advised orally by Mike Hebert is acceptable to both of you.

The second question raised was why in its 10-Q, filed with the Securities and Exchange Commission, Sparton reserved a greater amount of money in connection with response costs at the Coors Road Facility than the estimate for conducting corrective actions set forth in the financial assurance submission. The 10-Q listed the reserve as \$9,417,000. The combined capital and operating and maintenance costs described in the financial assurance submission totaled \$4,623,910.

As discussed below, that difference reflects two entirely different methodologies for estimating costs and a different planning horizon.

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ERM-Southwest, Inc. ("ERM"), which prepared the financial assurance estimates, did so on the basis that they were to reflect the minimum costs that would be paid by the state to a third party to complete work known to be currently specified by the Consent Decree. In making those estimates, ERM focused on what was known at the time the financial assurance package was submitted and estimated the cost of completing the tasks it identified as known, as the minimum amount necessary based on either published reference standards or quotes from qualified companies. In other words, ERM looked at the financial assurance process as iterative, that it is to be a snapshot of what was known to have to be completed at the time it was submitted. That figure would be revised annually, decreasing because of work finished and potentially increasing costs if a year's worth of new data identified additional tasks.

Sparton's accounting estimate was based on the cost of all response activities that it was probable (as opposed to known) Sparton Technology would conduct in response to the plume, whether or not currently specified in the Consent Decree. That number, which ERM was not involved in developing, was based upon standards described in FASB Statement No. 5, Accounting for Contingencies, FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss-An Interpretation of FASB Statement No. 5, and the American Institute of Certified Public Accountant's Statement of Position 96-1, Environmental Remediation Liabilities. Those documents require a company such as Sparton Technology to accrue response costs based on an identification of those activities that are "probable," and to estimate the cost of those response activities based on a range of what appears to be "reasonable." In selecting a cost out of that range, Sparton Technology could have used the minimum for a task to be completed, but was not required to do so and in almost all cases did not. In other words, in making an estimate for accounting purposes, which is the number that is reflected in the 10-Q, Sparton Technology did not limit itself to those response activities known, at the time the estimate was made, that the state would be specifically required by the Consent Decree to undertake and did not use a minimum cost for any such response activity based upon either reference standards or actual quotes.

Unlike the financial assurance estimates, which are revised annually, Sparton Technology, for a variety of reasons, did not want to continually update its accounting estimate. Therefore, it chose to estimate for financial reporting purposes a number that included probable response activities that might never be undertaken or the need for which would not be known for several years, the cost of which was the minimum amount Sparton thought it would cost to accomplish a task, but not the minimum amount that it would cost to have a third party finish a task. Using this approach does not mean that all of the estimated costs will with absolute certainty be incurred, rather in the event that they are, they will not adversely effect Sparton's future earnings.

Finally, the estimate found in the 10-Q was based upon conditions existing as of the end of Sparton's fiscal year for 1999--June 30, 1999, modified for expenditures through December 31,

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2000. The financial assurance submission, on the other hand, was based on work left to be performed as of March 3, 2000.

In short, the two numbers serve different purposes and were independently arrived at by different estimators using different guidelines. It is not surprising that the totals are different.

Set forth below by category of costs is an explanation of where and why the differences exist.

## **CAPITAL COSTS**

### **Permits**

Sparton's accounting estimate included \$63,000 for obtaining permits, an amount that was not included in the financial assurance estimate. Of this total \$37,200 was the cost for obtaining an NPDES permit, a task not currently specified by the Consent Decree, but one that would be a response to the plume. The remaining amounts represent estimates made for accounting purposes of work that had been substantially completed by March of 2000.

### **Infiltration Gallery**

Sparton's accounting estimate included \$266,805 for replacement of the infiltration gallery, representing the minimum of what Sparton thought it would cost it, but not what it would cost the state to hire a third party to complete a task that was thought to be probable. ERM, based on its independent engineering evaluation of the operation of the infiltration gallery through March 2000, concluded that it was more likely than not that the infiltration gallery would last during the life of the off-site containment well, and chose not to include this amount in the financial assurance submission.

### **Source Containment**

Sparton's accounting estimate for activities related to source containment was \$114,500 higher than ERM's independent estimate submitted as part of the financial assurance package. ERM's estimate was based upon what would meet the known requirements of the Consent Decree. For instance, ERM's estimate did not include a building for the air stripper, something that in ERM's experience often is not constructed and was not required by the Consent Decree, and ERM also assumed lower installation costs based upon either published reference standards or quotes. Sparton chose to include the cost of the building in its accounting estimate and also elected, as it is allowed to do under the accounting standards, to use a higher figure for the cost of installation, representing the minimum it would cost Sparton, as opposed to the minimum it would cost to complete the task.

### **Landscape and Additional Fencing**

Sparton's accounting estimate included \$35,000 for landscaping and new fencing required by the city that ERM did not include in the financial assurance submission because neither task was considered to be required by the Consent Decree, even though such work was a response to the plume.

### **Chromium Treatment**

Sparton's accounting estimate included \$100,000 for the installation of an off-site chromium treatment system. At the time of preparing its accounting estimate, Sparton was aware, as were the regulatory authorities, of the possible need to address the presence of chromium in the groundwater and opted to include a figure to cover that task, because at the time the estimate was made it was considered probable that such a treatment mechanism could be required.<sup>1</sup> At the time ERM submitted the financial assurance package in March of 2000, the chromium data at the off-site containment well was consistent with chromium treatment not being needed then, if not for at least another year. EPA and NMED were in agreement with this conclusion, recognizing that if such treatment became necessary it would be included in an updated financial assurance package. Subsequent data has required a rethinking of how quickly chromium treatment will be needed, and the financial assurance estimates will be updated in the next submission, as contemplated under the regulations, to include this task.

### **Off-Site Pump House and SVE Equipment**

Sparton's accounting estimate overstated what ended up being the actual cost for the off-site pump house, and also included projected costs for the SVE equipment other than the minimum amounts determined by ERM based upon reference standards or actual quotes that it would cost the state to have such work done.

## **OPERATION AND MAINTENANCE COSTS**

### **Reporting**

The Consent Decree contemplates numerous reports being generated by Sparton Technology during remedial activities. Sparton in its accounting estimate included costs not only for the preparation of the specific reports required, but monies for conducting analysis, thought to be

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<sup>1</sup> For financial reporting purposes Sparton did not want to have to increase its reserve if this probability became a reality.

probable, although not known to be required, to determine how to minimize the cost of future responses to the plume, and amounts for addressing differences of opinion that might arise in connection with conclusions reached in submitted reports, but not now known to be required by the Consent Decree. ERM, on the other hand, only included the cost of preparing the reports currently known to be called for by the Consent Decree, and with a current assumption that there would be no disagreement about the conclusions reached, which would undoubtedly be the case if EPA or the state took over this project after calling upon the corporate guaranty. Finally, ERM in developing its estimated costs used rates charged by qualified consultants, which rates are lower than those charged by the most well respected firms, such as Papadopoulos & Associates. An additional level of effort was also assumed because Sparton lacks in-house expertise in these areas. Finally, many of the reports Sparton would be required to file, the state would not be required to prepare and file as it would be directly involved in the work. These differences in approach resulted in Sparton's accounting estimate being \$2,525,573 higher than what ERM estimated in the financial assurance submission.

#### **Re-working of Wells**

Sparton assumed in its accounting estimate that there was a probability that the monitor wells would have to be re-worked. ERM made an independent engineering evaluation that those wells would not require any major maintenance during the life of the off-site remedial activities. Additionally, in selecting a cost for re-working the wells, Sparton chose a number higher than the minimum that the task might cost if done for the state by a third party. This difference in outlook resulted in a \$748,299 difference between the two estimates.

#### **Chromium Treatment**

As already discussed, Sparton and ERM, using different standards, reached different conclusions about the need to include, at least initially, an estimate for chromium treatment. Because Sparton viewed such a response activity as probable, it was also required to estimate an operation and maintenance cost. In choosing a figure within a range thought to be reasonable, but not the minimal amount the state could pay a third party. Sparton's approach required it to include \$570,000 in its accounting estimate that was not included in the financial assurance package.

#### **Environmental Impairment Liability Insurance**

Sparton is not directly required to provide environmental impairment liability insurance under the Consent Decree. Sparton is nevertheless required by the city of Albuquerque to obtain

such coverage and has included in its accounting estimate \$210,000 for the cost of such a policy during the life of the remedial activities.<sup>2</sup>

### **Project Management**

Sparton's accounting estimate was higher than ERM's financial assurance estimate for project management by \$184,600. The difference falls in two categories. First, Sparton assumed that those involved in project management for Sparton Technology would be doing significant work not currently known to be called for by the Consent Decree, although in response to the plume, in order to adequately advise Sparton Technology management on the status of remediation and options available to the company. Additionally, Sparton's estimates were based upon using a firm with higher billing rates than the referenced standard labor rates for qualified firms that the state would hire, and assumed an additional level of effort because Sparton lacks in-house expertise in these areas.

### **Easements and Leases**

Sparton's accounting estimate assumed a longer life for off-site remediation, based on a standard of what is probable. ERM, on the other hand, did not base its estimates on what might be probable, but what was more likely than not based on information available in March 2000, and concluded that a shorter period of time was justified. This difference in outlook resulted in Sparton's estimate being \$44,200 greater than ERM's estimate.

In summary, the two estimates serve very different purposes. Financial assurance is an annual estimate of completing known, at the time of submittal, work that the state would be required to complete under the Consent Decree. The accounting estimate reflects all probable costs of responding to the plume under the Consent Decree in the context of advising investors concerned about future earnings and liabilities.

Additionally, the financial assurance estimate will be updated annually to take into account changed conditions. The accounting estimate was made with an intent that it would not require revision. Because the financial assurance estimate is more easily re-worked than Sparton's accounting estimate, it reflects what is known for a given year. For example, next year's financial assurance package will include chromium treatment costs. At some point in the future, the cost of

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<sup>2</sup> ERM also understood that if the state took over this project it would not be obligated to obtain such coverage; another reason for not including this amount in the financial assurance estimate.

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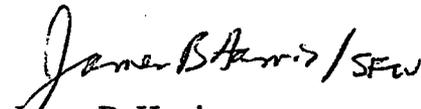
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replacing the infiltration gallery may also be included, if new data make such work a known task.

One estimate reflects what is known work, at each annual submission, that is required to be completed under the Consent Decree. The other reflects all costs that will probably be incurred in responding to the plume under the Consent Decree in the context of advising investors concerned about future earnings and liabilities. Both are appropriate estimates based on the different approaches required to be followed for each analysis.

I trust the foregoing explains the differences. If you would care to discuss them in more detail, please do not hesitate to contact me so that a meeting can be arranged.

Yours very truly,

  
James B. Harris

JBH/tks

Encls.

cc: R. Jan Appel, Esq.

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