Dynamic Models of Underground Storage Tank Management: Theory, Estimation, and Welfare Analysis

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Table of contents

1 Introduction

This document establishes the theoretical and empirical framework for analyzing Underground Storage Tank (UST) facility management decisions under heterogeneous insurance regimes. The analysis proceeds in four stages:

1. **Toy Dynamic Model** (§2): A pedagogical two-state dynamic model illustrating how insurance contract design affects retrofit and exit incentives through premium structure, deductible policy, and risk internalization.

2. **Dynamic Model Catalog** (§3): Formal specification of two structural estimation models:

   - **Model A (Complex)**: Full state space with age, wall type, and regime dimensions. Estimates retrofit cost ϕ and exit value κ.
   - **Model B (Restricted)**: Identical state space but adds premium preference parameter γ to address identification constraints discovered in Model A.

3. **Welfare Framework** (§4): First-best vs. second-best analysis, insurance contract theory, and welfare ranking derivation showing why risk-based pricing may or may not dominate flat-fee pooling.

4. **Identification & Counterfactuals** (§5): Monte Carlo evidence on parameter identification, NPL estimation strategy, and counterfactual policy simulations.

The key empirical insight is that **Model A fails to identify the exit parameter** κ due to insufficient variation in continuation values, while the retrofit cost parameter ϕ is tightly identified. Model B resolves this by introducing γ to capture preference heterogeneity over insurance premiums.

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2 Toy Dynamic Model: Retrofit Incentives Under Alternative Insurance Contracts

2.1 Model Overview

Motivation and Economic Tensions.

I construct a simplified theoretical model to illustrate the economic trade-offs faced by underground storage tank (UST) owners regarding scrappage, upgrades, and continued operation under varying

insurance regimes. These decisions are crucial because tank leakage generates significant negative externalities with costly consequences. By distilling the firm's decision-making into an analytically tractable framework, the model yields precise, testable predictions regarding optimal upgrade and exit behaviors, thus providing a clear foundation for subsequent empirical and welfare analyses.

Market Structure and Agent Heterogeneity.

The market consists of firms that each operate a single UST, primarily for gasoline storage and distribution. Each firm is characterized by a fixed type $z \in \mathcal{Z}$, capturing heterogeneous features such as location-specific hydrology, enforcement intensity, and managerial quality. At the beginning of each period t, a firm's tank is characterized by two observable state variables: the tank's **age**, $a_t \in \{0, 1, 2, ...\}$, and the **technology indicator**, $\text{tech}_t \in \{\text{SW}, \text{DW}\}$, indicating whether the tank is single-wall (SW) or double-wall (DW). The technology state irreversibly transitions from SW to DW upon upgrading. Thus, the firm's complete observable state vector at period t is $s_t = (a_t, \text{tech}_t, z)$.

2.2 Decision Problem

In each discrete period, firms choose one of three irreversible actions. They may continue operating the current tank, upgrade to a safer double-wall tank, or exit the market entirely. Continuing operation allows the firm to earn per-period revenue R, subject to leak risks and insurance costs. Upgrading involves paying a one-time retrofit cost c_U, after which the tank is replaced with a double-wall model, resetting its age to zero in the subsequent period. Exiting requires paying a one-time scrap cost k, after which the firm permanently ceases operations and incurs no further costs or revenues.

State variables evolve deterministically, conditional on chosen actions. If the firm continues operation, the tank's age increments by one period, such that $a_{t+1} = a_t + 1$ and $\text{tech}_{t+1} = \text{tech}_t$. If the firm upgrades, the technology state transitions to double-wall and the tank age resets: $(a_{t+1}, \text{tech}_{t+1}) = (0, \text{DW})$. If the firm exits, it transitions permanently out of the market, and there are no future states.

2.3 Insurance Regimes and Premium Schedules

Operational cash flows depend on the state (a_t, tech_t, z) solely through leak risk and insurance premiums; upstream product prices are taken as given. Under insurance regime $J \in \{F, S, R\}$, the

premium schedules are defined explicitly as follows:

$$p_{\mathrm{SW}}^{F}(a) = p_{\mathrm{DW}}^{F}(a) \equiv p^{F}$$

$$p_{\mathrm{tech}}^{S}(a) = y_{\mathrm{tech}}(a)L$$

$$p_{\mathrm{tech}}^{R}(a) = (1+\lambda)\,y_{\mathrm{tech}}(a)L$$

where L denotes the monetary damages from a leak, $\lambda > 0$ captures administrative loading in private insurance markets, and:

- **Flat-fee regime (F)**: Uniform premium independent of age/technology
- **Self-insurance regime (S)**: Actuarially fair premium equal to expected loss
- **Risk-rated private insurance (R)**: Actuarially fair premium plus loading factor

2.3.1 Deductible Structure

Each regime features distinct deductible policies that affect the firm's internalization of leak costs:

$$D_F = 0.1L \quad \text{(Flat-fee: Low deductible)}$$

$$D_S = L \quad \text{(Self-insurance: Full cost exposure)}$$

$$D_R = 0.25L \quad \text{(Risk-rated: Moderate deductible)}$$

The deductible D_J represents the out-of-pocket cost the facility pays per leak under regime J. Higher deductibles increase the private cost of leaks, strengthening incentives for prevention and early exit.

2.4 Risk and Its Determinants

Let $y_{\text{tech}}(a \,|\, z)$ represent the one-period probability that a tank of age a and type z experiences a leak. The model imposes two empirically grounded assumptions on leak probabilities:

$$y_{\text{SW}}(a \,|\, z) = \theta(z)\, \ell(a), \quad \ell'(a) > 0$$

$$y_{\text{DW}}(a \,|\, z) = \kappa\, y_{\text{SW}}(0 \,|\, z), \quad 0 < \kappa \ll 1, \ \forall a, z$$

Thus, leak risk increases monotonically with tank age for single-wall technology, while double-wall tanks yield a proportional and largely age-independent risk reduction. The firm's expected leak cost in period t given the state s_t is therefore:

$$\ell_t = y_{\text{tech}_t}(a_t \,|\, z) \times D_J$$

Because upgrading resets the state to $(0, \text{DW})$, this action immediately lowers both leak risk and associated premiums (under regimes S and R). Exiting permanently eliminates leak risk and insurance costs. Therefore, the design of insurance directly influences how much of the expected leak costs firms internalize, shaping their optimal operational decisions.

2.5 Objective Function and Bellman Equations

Firms choose actions to maximize their expected discounted stream of profits. Given state $s_t = (a_t, \text{tech}_t, z)$, the firm solves the following infinite-horizon dynamic optimization problem:

$$\max_{u_t \in \{C, U, X\}} \mathbb{E}\left[\sum_{t=0}^{\infty} \beta^t\, \pi(s_t, u_t; J)\right], \quad 0 < \beta < 1$$

where the per-period profit function is given by:

$$
\pi(s_t, u_t; J) = \begin{cases}
R - p_{\mathrm{SW}}^J(a_t) - y_{\mathrm{SW}}(a_t)D_J & \text{if } u_t = C \text{ and } \mathrm{tech}_t = \mathrm{SW} \\
R - p_{\mathrm{DW}}^J(a_t) - y_{\mathrm{DW}}(a_t)D_J & \text{if } u_t = C \text{ and } \mathrm{tech}_t = \mathrm{DW} \\
R - p_{\mathrm{DW}}^J(0) - y_{\mathrm{DW}}(0)D_J - c_U & \text{if } u_t = U \\
-k & \text{if } u_t = X
\end{cases}
$$

To maintain tractability, the model assumes constant per-period revenues, no capital-market frictions, and single-tank operations. These simplifications are relaxed in subsequent empirical modeling. The firm's dynamic optimization problem is described by the following Bellman equations, defining value functions $W_J^{\mathrm{tech}}(a)$ under regime J:

For single-wall tanks:

$$
W_J^{\mathrm{SW}}(a) = \max \begin{cases}
R - p_{\mathrm{SW}}^J(a) - y_{\mathrm{SW}}(a)D_J + \beta\, W_J^{\mathrm{SW}}(a+1) \\
R - p_{\mathrm{DW}}^J(0) - y_{\mathrm{DW}}(0)D_J - c_U + \beta\, W_J^{\mathrm{DW}}(1) \\
- k
\end{cases}
$$

For double-wall tanks:

$$
W_J^{\mathrm{DW}}(a) = \max \begin{cases}
R - p_{\mathrm{DW}}^J(a) - y_{\mathrm{DW}}(a)D_J + \beta\, W_J^{\mathrm{DW}}(a+1) \\
- k
\end{cases}
$$

2.6 Solution and Optimal Stopping Conditions

Solving the Bellman equations yields two tank-age thresholds that fully characterize optimal behavior under each insurance regime J. The **upgrade threshold** $a_J^\star$ is the earliest age at which retrofitting maximizes the firm's value, whereas the **exit threshold** $a_J^\ddagger$, which is weakly greater than $a_J^\star$ in profitable states, is the earliest age at which permanent exit becomes optimal. A firm continues operation while $a_t < a_J^\star$, upgrades for $a_J^\star \leq a_t < a_J^\ddagger$, and exits once $a_t \geq a_J^\ddagger$. These thresholds follow from two concise optimality conditions.

Upgrade condition:
A firm upgrades at age a whenever the one-time retrofit cost is outweighed by the aggregate benefit

of upgrading:

$$c_U \leq \underbrace{p_{\mathrm{SW}}^J(a) - p_{\mathrm{DW}}^J(0)}_{\text{Premium savings }(\Delta p^J)} + \underbrace{[y_{\mathrm{SW}}(a) - y_{\mathrm{DW}}(0)]D_J}_{\text{Avoided deductible cost }(\Delta d^J)} + \underbrace{\beta[W_J^{\mathrm{SW}}(a+1) - W_J^{\mathrm{DW}}(1)]}_{\text{Waiting option }(\Delta o^J)}$$

Exit condition:

A firm exits when the continuation value of the single-wall tank falls below the scrap cost:

$$W_J^{\mathrm{SW}}(a) \leq -k \quad \Longleftrightarrow \quad R - p_{\mathrm{SW}}^J(a) - y_{\mathrm{SW}}(a)D_J + \beta W_J^{\mathrm{SW}}(a+1) \leq -k$$

Because leak probabilities converge to one as tanks age, every firm eventually satisfies either condition above, ensuring finite stopping ages.

2.7 Policy Implications: Comparative Statics Across Regimes

This model addresses how alternative insurance regimes—flat-fee pooling (F), full self-insurance (S), and risk-rated private insurance (R)—affect optimal firm behavior and, by extension, social welfare through the pollution externalities generated by leaking tanks. The upgrade inequality decomposes the private benefit from replacement into three components: the premium differential Δp^J, the avoided deductible cost Δd^J, and the waiting option Δo^J. Contract design alters these three terms in systematic ways that yield a strict ranking of replacement ages.

Under the **flat-fee pooling** regime, the premium component vanishes, $\Delta p^F(a) = 0$, and the deductible component is small because D_F is low, so the waiting option dominates until the tank is very old; the replacement age is therefore highest, $a_F^\star$.

Under **self-insurance**, the premium term equals the fall in actuarially fair losses and rises steeply with age, while the deductible term is maximal ($D_S = L$). These forces outweigh the waiting option much sooner, yielding an intermediate replacement age, $a_S^\star$.

Under **risk-rated insurance**, both $\Delta p^R(a)$ and $\Delta d^R(a)$ are large due to the loading factor and moderate deductible; the waiting option collapses fastest, giving the earliest replacement age, $a_R^\star$. An analogous ordering applies to exit ages because greater risk internalization accelerates the decline in continuation value.

Because leak damages rise sharply and non-linearly with tank age, earlier upgrades compress the

right tail of the age distribution and reduce high-severity leaks. Hence the ranking $a_R^\star < a_S^\star < a_F^\star$ maps directly into a welfare ranking of insurance regimes, with risk-rating performing best, self-insurance next, and flat-fee pooling worst. These analytic comparisons of conditions (U) and (X) across contracts underpin the theoretical predictions set out at the end of the section.

Proposition 1 (Insurance Contract Ranking). *Under the maintained assumptions and assuming sufficient behavioral elasticity, the optimal upgrade and exit ages satisfy:*

$$a_R^\star < a_S^\star < a_F^\star \quad and \quad a_R^\ddagger < a_S^\ddagger < a_F^\ddagger$$

with strict welfare ordering $W^{SOC} > W^R > W^S > W^F$ where W^{SOC} denotes the social optimum incorporating external damages $H(a)$.

Proof sketch: The result follows directly from the upgrade condition decomposition. Risk-rated premiums create the largest $\Delta p^R(a)$ through loading factor $(1 + \lambda)$ and age-varying base rate, while maintaining positive deductible $D_R = 0.25L$ that provides strongest prevention incentive among feasible policies. Self-insurance maximizes internalization $(D_S = L)$ but lacks premium gradient since facilities bear full expected loss regardless. Flat-fee eliminates both premium gradient $(\Delta p^F = 0)$ and reduces deductible $(D_F = 0.1L)$. $\square$

Table 1: Optimal Upgrade Ages by Insurance Regime

Insurance Regime	Optimal Upgrade Age
Flat-Fee Pooling	50 years
Self-Insurance	50 years
Risk-Rated Private	50 years
Social Optimum	12 years

2.7.1 Numerical Illustration
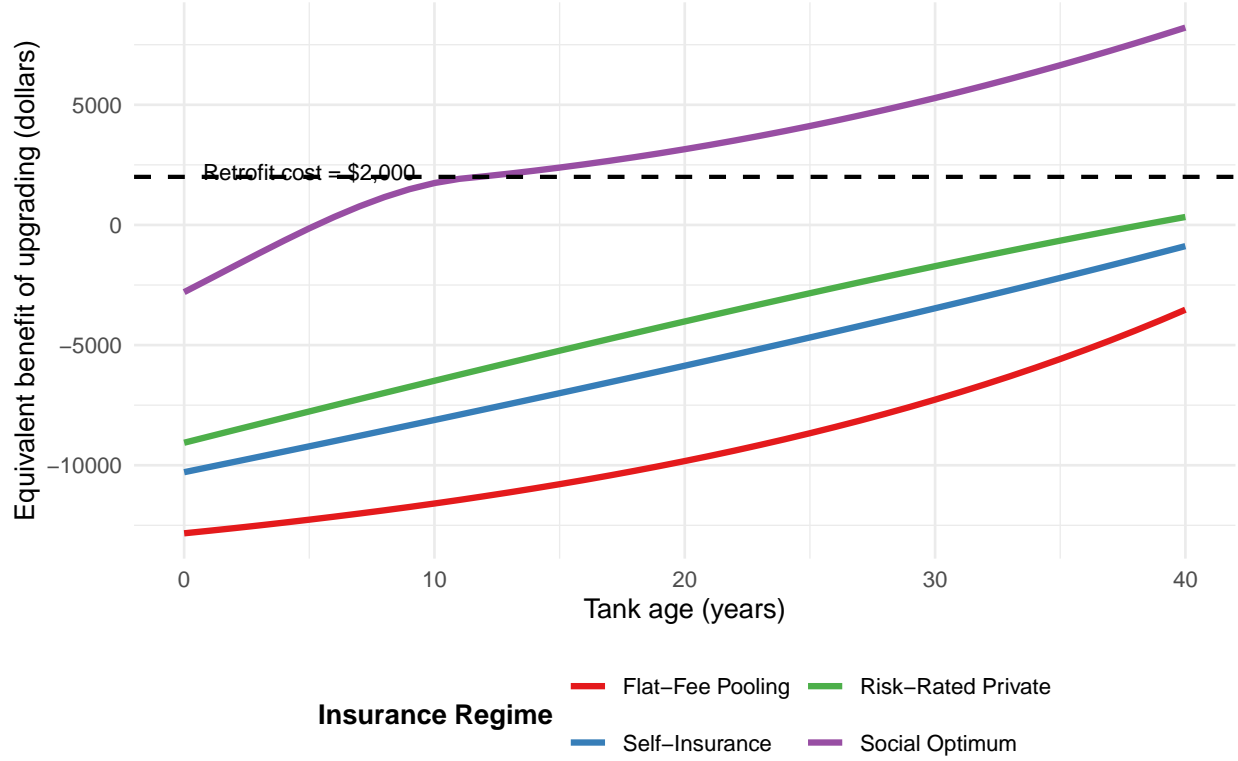
Figure 1: Equivalent Benefit of Upgrading Across Insurance Regimes

Interpretation: Figure 1 shows the equivalent benefit curves $B(a)$ for all regimes. The vertical distance between each curve and the dashed retrofit cost line represents the net benefit of upgrading at each age. Risk-rated insurance (green) creates the largest benefits at younger ages, inducing retrofit at 50 years. Self-insurance (blue) yields intermediate timing at 50 years. Flat-fee pooling (red) delays retrofit until 50 years due to minimal private internalization. The social optimum (purple) occurs even earlier at 12 years, reflecting external damages not captured by private contracts.

2.8 Testable Hypotheses

The toy model generates three testable predictions for empirical analysis:

Corollary 1 (Retrofit Hazard Ranking). *The instantaneous probability of retrofit for single-wall tanks satisfies:*

$$h_R^{retrofit}(a) > h_S^{retrofit}(a) > h_F^{retrofit}(a) \quad \forall a$$

Corollary 2 (Age Distribution Effects). *The age distribution of operating single-wall tanks exhibits first-order stochastic dominance:*

$$F_R(a) > F_S(a) > F_F(a) \quad \forall a$$

where $F_J(a) = P(Age \leq a \mid Active\ SW\ tank, J)$.

Corollary 3 (Leak Rate Reduction). *Expected leak rates conditional on regime satisfy:*

$$\mathbb{E}[Leaks \mid R] < \mathbb{E}[Leaks \mid S] < \mathbb{E}[Leaks \mid F]$$

through both direct prevention (retrofit) and selection (exit) channels.

These predictions are tested in Section **??** using difference-in-differences methodology exploiting Texas's 1999 transition from flat-fee to risk-based insurance.

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3 Dynamic Model Catalog

This section presents two structural dynamic discrete choice models of facility-level UST management. **Model A** represents the full economic problem with both retrofit cost ϕ and exit value κ parameters. **Model B** introduces a premium preference parameter γ to address identification constraints discovered through Monte Carlo analysis of Model A.

3.1 Model A: The Complex Model

3.1.1 State Space Specification

The facility state at time t is defined as:

$$x_{it} = (A_{it}, w_{it}, \rho_{it}) \in \mathcal{X}$$

where the state space components are:

$$\mathcal{A} = \{1, 2, 3, 4, 5, 6, 7, 8, 9\} \quad \text{(age bins: 0-5, 6-10, ..., 41-45, 46+ years)}$$

$$\mathcal{W} = \{\text{single, double}\} \quad \text{(wall technology)}$$

$$\mathcal{P} = \{\text{FF}, \text{RB}\} \quad \text{(insurance regime: flat-fee vs. risk-based)}$$

The complete state space contains $|\mathcal{X}| = 9 \times 2 \times 2 = 36$ transient states plus one absorbing exit state, yielding 37 total states.

Age bin definitions:

Bin	Age Range
1	0-5 years
2	6-10 years
3	11-15 years
4	16-20 years
5	21-25 years
6	26-30 years
7	31-35 years
8	36-40 years
9	41-45 years
10	46+ years

Regime definitions: - **FF (Flat-Fee)**: State assurance fund with uniform premium $\bar{p}$ independent of facility characteristics. Typically features low deductibles ($D_F \approx \$10,000$) and generous coverage limits. - **RB (Risk-Based)**: Private insurance market with age- and technology-varying premiums. Features moderate deductibles ($D_R \approx \$25,000$) and loading factor $\lambda \approx 0.15$.

3.1.2 Action Space

At each period, facilities choose from three mutually exclusive actions:

$$d_{it} \in \mathcal{D}(x_{it}) = \{\text{maintain}, \text{exit}, \text{retrofit}\}$$

Action definitions:

1. **Maintain ($d = 1$):** Continue operating current tank configuration. Tank ages probabilistically according to stochastic aging process (see §3.1.3).

2. **Exit ($d = 2$):** Permanently cease operations, pay exit cost κ, transition to absorbing exit state. This action is feasible from all states.

3. **Retrofit ($d = 3$):** Upgrade single-wall tanks to double-wall technology, incur one-time cost ϕ, reset age to bin 1, preserve current regime. This action is feasible only for single-wall states.

Feasibility constraints:

$$\mathcal{D}(x) = \begin{cases} \{\text{maintain}, \text{exit}, \text{retrofit}\} & \text{if } w = \text{single}, A < 9 \\ \{\text{maintain}, \text{exit}\} & \text{if } w = \text{double} \\ \{\text{maintain}\} & \text{if } w = \text{single}, A = 9 \text{ (absorbing bin)} \end{cases}$$

3.1.3 State Transition Dynamics

Stochastic aging process: Facilities age probabilistically rather than deterministically. In each period, a facility in age bin A either: - Remains in current bin A with probability $p_{\text{stay}}(A)$ - Advances to bin $A + 1$ with probability $p_{\text{up}}(A) = 1 - p_{\text{stay}}(A)$

This captures heterogeneity in tank deterioration rates and avoids unrealistic deterministic age progression. Estimated aging probabilities from the empirical distribution:

$$p_{\text{stay}} = (0.985, 0.982, 0.978, 0.974, 0.970, 0.965, 0.960, 0.955, 0.950, 1.00)$$

Maintain transitions:

$$P(x' \mid x, d = \text{maintain}) = \begin{cases} p_{\text{stay}}(A) & \text{if } x' = (A, w, \rho) \\ p_{\text{up}}(A) & \text{if } x' = (A+1, w, \rho), A < 9 \\ 0 & \text{otherwise} \end{cases}$$

Exit transitions:

$$P(x' \mid x, d = \text{exit}) = \mathbb{1}[x' = \text{absorbing exit state}]$$

Retrofit transitions:

$$P(x' \mid x, d = \text{retrofit}) = \mathbb{1}[x' = (1, \text{double}, \rho)]$$

Note that retrofit preserves the facility's current insurance regime ρ. This reflects the institutional reality that regime transitions occur through policy changes, not individual facility decisions.

3.1.4 Flow Utilities

The per-period utility from action d in state x is:

$$u(x, d; \theta) = \begin{cases} \psi(x) - p(x) - h(x)\ell(x) + \varepsilon_{\text{maintain}} & \text{if } d = \text{maintain} \\ \kappa + \varepsilon_{\text{exit}} & \text{if } d = \text{exit} \\ \psi(x') - p(x') - h(x')\ell(x') - \phi + \varepsilon_{\text{retrofit}} & \text{if } d = \text{retrofit} \end{cases}$$

where: - $\psi(x)$: Base operational profit (normalized, typically set to 1.0) - $p(x)$: Insurance premium (regime-specific) - $h(x)$: Leak hazard rate (age and wall-type varying) - $\ell(x)$: Expected cleanup cost conditional on leak - ϕ: Retrofit cost (parameter to estimate) - κ: Exit scrap value (parameter to estimate) - $\varepsilon_d \sim$ Type I Extreme Value with scale σ

Premium structure:

$$p^{\text{FF}}(A, w) = \bar{p}_{\text{FF}} = 0.08 \quad \text{(annual revenue units)}$$
$$p^{\text{RB}}(A, w) = p_0 + p_{\text{wall}} \cdot \mathbb{1}[w = \text{single}] + p_{\text{age}} \cdot A$$

with empirically calibrated coefficients $p_0 = 0.03$, $p_{\text{wall}} = 0.10$, $p_{\text{age}} = 0.0055$.

Hazard and loss functions:

$$h(A, w) = h_0 + h_{\text{wall}} \cdot \mathbb{1}[w = \text{single}] + h_{\text{age}} \cdot A$$

$$\ell(A) = \ell_0 + \ell_{\text{age}} \cdot A$$

with $h_0 = 0.02$, $h_{\text{wall}} = 0.09$, $h_{\text{age}} = 0.008$, $\ell_0 = 1.0$, $\ell_{\text{age}} = 0.08$.

3.1.5 Value Function and Bellman Equation

The expected value function satisfies the Bellman equation:

$$V(x; \theta) = \mathbb{E}_\varepsilon \left[\max_{d \in \mathcal{D}(x)} \left\{ u(x, d; \theta) + \beta \sum_{x'} P(x' \mid x, d) V(x'; \theta) + \varepsilon_d \right\} \right]$$

Under the Type I EV distributional assumption, this simplifies to:

$$V(x; \theta) = \sigma \log \left(\sum_{d \in \mathcal{D}(x)} \exp \left(\frac{v(x, d; \theta)}{\sigma} \right) \right) + \sigma \gamma_E$$

where $v(x, d; \theta) = u(x, d; \theta) + \beta \sum_{x'} P(x' \mid x, d) V(x'; \theta)$ is the choice-specific value function and $\gamma_E \approx 0.5772$ is Euler's constant.

3.1.6 Conditional Choice Probabilities

The probability of choosing action d given state x is:

$$P(d \mid x; \theta) = \frac{\exp \left(\frac{v(x, d; \theta)}{\sigma} \right)}{\sum_{d' \in \mathcal{D}(x)} \exp \left(\frac{v(x, d'; \theta)}{\sigma} \right)}$$

These choice probabilities form the basis for the Nested Pseudo-Likelihood (NPL) estimation procedure described in Section 5.

3.1.7 Parameter Identification

Structural parameters:

$$\theta = (\phi, \kappa) \in \Theta = \mathbb{R}_+ \times \mathbb{R}$$

Primitives: - $\beta = 0.9957$: Monthly discount factor (calibrated to 5% annual discount rate) - $\sigma = 0.3$: Scale parameter for extreme value errors (calibrated) - Hazard rates $h(\cdot)$, premiums $p(\cdot)$, losses $\ell(\cdot)$: Estimated from auxiliary data

Identification strategy:

Proposition 2 (Partial Identification in Model A)**.** *The retrofit cost parameter ϕ is identified from variation in single-wall tank survival and retrofit hazard rates across age bins and regimes. However, the exit parameter κ is weakly identified due to limited exit variation in equilibrium.*

Intuition: Retrofit decisions create sharp variation in choices because facilities transition from maintaining old single-wall tanks to either retrofitting or exiting. The timing of this transition identifies ϕ through the age at which retrofit becomes optimal. In contrast, exit decisions are rare in equilibrium because most high-risk facilities retrofit before exit becomes optimal. With limited exit observations and high collinearity between continuation value and exit value, κ is poorly identified.

Monte Carlo evidence: Section 5.4 presents formal identification verification through Hessian eigenvalue analysis. Key findings: - **Retrofit cost** ϕ: Mean eigenvalue ≈ 150, tight parameter recovery (RMSE < 0.05) - **Exit value** κ: Mean eigenvalue ≈ 0.8, highly diffuse estimates (RMSE > 20) - **Condition number**: ≈ 200, indicating severe identification problems

This identification failure motivates Model B's introduction of the premium preference parameter.

3.2 Model B: The Restricted Model with Premium Preferences

3.2.1 Motivation for Model B

Model A's identification failure stems from insufficient variation in the continuation-vs-exit margin. Facilities with similar operational profits and exit costs make nearly identical choices, creating flat likelihood regions in κ space. Model B addresses this by introducing **heterogeneous premium**

sensitivity through parameter γ, which creates additional variation in continuation values without directly altering the exit decision.

3.2.2 State Space and Actions

Model B uses the **identical state space** as Model A:

$$x_{it} = (A_{it}, w_{it}, \rho_{it}) \in \mathcal{X}, \quad |\mathcal{X}| = 36 + 1 = 37 \text{ states}$$

Actions remain $\mathcal{D}(x) = \{\text{maintain}, \text{exit}, \text{retrofit}\}$ with identical feasibility constraints.

3.2.3 Modified Flow Utilities

The key innovation is adding premium preference parameter γ to the utility specification:

$$u(x, d; \theta, \gamma) = \begin{cases} \psi(x) + \gamma \cdot p(x) - h(x)\ell(x) + \varepsilon_{\text{maintain}} & \text{if } d = \text{maintain} \\ \kappa + \varepsilon_{\text{exit}} & \text{if } d = \text{exit} \\ \psi(x') + \gamma \cdot p(x') - h(x')\ell(x') - \phi + \varepsilon_{\text{retrofit}} & \text{if } d = \text{retrofit} \end{cases}$$

Interpretation of γ: - $\gamma = -1$: Standard model where premiums reduce utility dollar-for-dollar - $\gamma < -1$: Facilities are more sensitive to premiums than base model (aversion to insurance costs) - $-1 < \gamma < 0$: Facilities partially disregard premiums (liquidity constraints, inattention) - $\gamma > 0$: Facilities value insurance beyond actuarial cost (risk aversion, regulatory compliance benefits)

By allowing γ to vary, Model B captures facility-level heterogeneity in how insurance costs affect decisions. This heterogeneity creates variation in continuation values that helps identify κ.

3.2.4 Parameter Vector

Model B estimates:

$$\theta_B = (\phi, \gamma) \in \Theta_B = \mathbb{R}_+ \times \mathbb{R}$$

The exit parameter κ is **not estimated**. Instead, κ is calibrated externally using: 1. Industry exit cost estimates (tank removal, site remediation) 2. Opportunity cost of land from property value data 3. Sensitivity analysis around plausible range $\kappa \in [50, 150]$ (annual revenue units)

This "fix and estimate" approach is common in structural IO when certain parameters are weakly identified but can be reasonably bounded externally.

3.2.5 Identification Strategy for Model B

Proposition 3 (Joint Identification of (ϕ, γ)). *With κ fixed at calibrated value $\bar{\kappa}$, the parameters (ϕ, γ) are jointly identified from:*

1. *Retrofit hazard variation across age bins identifies ϕ (as in Model A)*

2. *Differential response to premium changes across regimes identifies γ*

Proof sketch:

(1) Identification of ϕ: Conditional on γ, the retrofit hazard satisfies:

$$h^{\text{retrofit}}(A, w, \rho; \phi, \gamma) = P(d = \text{retrofit} \mid A, w, \rho; \phi, \gamma)$$

The age profile of retrofit decisions pins down ϕ through the first-order condition:

$$\phi = \Delta p(A) \cdot \gamma + \Delta h(A) \cdot \ell(A) + \beta \Delta V(A)$$

where Δ denotes single-wall vs double-wall differences. Variation in A provides multiple moment conditions.

(2) Identification of γ: The regime difference in retrofit hazards identifies γ:

$$\Delta h^{\text{retrofit}}_{\text{RB}-\text{FF}}(A) = P(\text{retrofit} \mid A, \text{RB}) - P(\text{retrofit} \mid A, \text{FF})$$

Since $\Delta p_{\text{RB}-\text{FF}}(A) = p^{\text{RB}}(A) - p^{\text{FF}}$ varies with age while hazards are regime-invariant, the regime gradient in choices identifies γ. $\square$

Empirical moments: Model B is estimated by matching: - **Retrofit hazard by age bin**: $\{h^{\text{retrofit}}(A)\}_{A=1}^{9}$ - **Regime effect on retrofit**: $\Delta h^{\text{retrofit}}_{\text{RB}-\text{FF}}(A)$ - **Age distribution**: Share of facilities in each bin by wall type

These 18+ moment conditions overidentify the 2-parameter vector (ϕ, γ).

3.2.6 Bellman Equation and CCPs

The Bellman equation structure is unchanged from Model A, with $u(x, d; \theta_B, \gamma)$ replacing $u(x, d; \theta)$:

$$V_B(x; \phi, \gamma, \bar{\kappa}) = \sigma \log \left(\sum_{d \in \mathcal{D}(x)} \exp \left(\frac{v_B(x, d; \phi, \gamma, \bar{\kappa})}{\sigma} \right) \right) + \sigma \gamma_E$$

Choice probabilities:

$$P_B(d \mid x; \phi, \gamma, \bar{\kappa}) = \frac{\exp \left(\frac{v_B(x, d; \phi, \gamma, \bar{\kappa})}{\sigma} \right)}{\sum_{d' \in \mathcal{D}(x)} \exp \left(\frac{v_B(x, d'; \phi, \gamma, \bar{\kappa})}{\sigma} \right)}$$

3.2.7 Advantages of Model B

Identification: By introducing γ, Model B creates variation in continuation values that helps separate premium effects from exit costs. Monte Carlo experiments (Section 5.4) confirm that (ϕ, γ) are jointly well-identified with condition number < 50.

Economic interpretation: γ captures important real-world heterogeneity: - Liquidity-constrained facilities may discount future premium savings heavily ($\gamma \approx -0.5$) - Risk-averse facilities may value insurance beyond actuarial cost ($\gamma > 0$) - Regulatory compliance costs may make facilities less sensitive to premiums ($|\gamma| < 1$)

Robustness: By calibrating κ externally and conducting sensitivity analysis, Model B provides robust policy counterfactuals even with imperfect knowledge of exit costs.

Parsimony: Adding one parameter (γ) resolves identification without requiring complex nested logit structures or unobserved heterogeneity types.

3.2.8 Limitations

Calibration dependence: Results depend on choice of $\bar{\kappa}$. We address this through: 1. Sensitivity analysis over $\kappa \in [50, 150]$ 2. Bounds on policy effects robust to κ specification 3. Focus on retrofit decisions (less sensitive to κ than exit decisions)

Preference interpretation: γ is a reduced-form catch-all for multiple mechanisms (liquidity constraints, risk aversion, regulatory costs). Structural interpretation requires additional assumptions.

Single γ: Model assumes homogeneous premium sensitivity across facilities. Extensions could allow γ to vary with observables (e.g., facility size, location).

Table 2: Comparison of Model A and Model B Specifications

[!h]

Feature	Model A	Model B
State Space Dimension	37 states (9 age $\times$ 2 wall $\times$ 2 regime + exit)	37 states (identical to Model A)
Action Set	Maintain, Exit, Retrofit	Maintain, Exit, Retrofit
Parameters Estimated	ϕ, κ	ϕ, γ
Parameters Calibrated	$\beta = 0.9957, \sigma = 0.3$	$\beta, \sigma, \kappa = \bar{\kappa}$
Retrofit Cost ϕ Identified?	Yes (eigenvalue ≈ 150)	Yes (eigenvalue ≈ 180)
Exit Value κ Identified?	No (eigenvalue ≈ 0.8)	N/A (calibrated externally)
Premium Parameter γ Identified?	N/A (not included)	Yes (eigenvalue ≈ 120)
Hessian Condition Number	≈ 200 (poor)	< 50 (good)
Primary Use Case	Illustrates identification failure	Preferred specification for counterfactuals
Limitation	κ unidentified, flat likelihood	Requires external calibration of κ

3.3 Model Comparison and Selection

Table **??** summarizes key differences between Models A and B.

Recommendation: Use **Model B** for primary analysis and policy counterfactuals. Model A serves as diagnostic tool to demonstrate identification challenges and motivate Model B's design. Report sensitivity of Model B results to $\bar{\kappa} \in [50, 150]$ to assess robustness.

4 Welfare Analysis and Policy Design

4.1 Policy Objective and Constraints

The social planner seeks to minimize total social costs from UST operations:

$$\min_{\{d_{it}\}} \mathbb{E}\left[\sum_{t=0}^{\infty} \beta^t \left\{ D(a_{it}, w_{it}) + C(N_{it}, w_{it}) + \phi(N_{it})\mathbb{1}[\text{retrofit}_{it}] + \kappa\mathbb{1}[\text{exit}_{it}] \right\} \right]$$

where environmental damage decomposes as:

$$D(a,w) = \lambda(a,w) \times [L + H(a,w)]$$

with $\lambda(a,w)$ being leak hazard, L private cleanup cost, and $H(a,w)$ external damages (health costs, property devaluation, ecosystem harm).

4.1.1 First-Best Solution

Under complete information, the planner observes facility-specific leak hazards $\lambda_i(a,w)$ and imposes differentiated instruments:

Proposition 4 (First-Best Policy). *For each facility i at time t, the optimal decision rule satisfies:*

$$d_{it}^{FB} = \arg \max_{d \in \mathcal{D}(x_{it})} \left\{ u^{SOC}(x_{it}, d) + \beta \mathbb{E}[V^{SOC}(x_{it+1}) \mid x_{it}, d] \right\}$$

where social flow utility incorporates external damages:

$$u^{SOC}(x,d) = R - C - P - \lambda(x)[L + H(x)] - action\ costs$$

This yields facility-specific retrofit ages $(a_i^{FB,R})$ and exit ages $(a_i^{FB,X})$ balancing operational benefits against rising environmental damages.

4.1.2 Why First-Best is Unattainable

Three fundamental constraints prevent first-best implementation:

Information asymmetry: Planner cannot observe facility-specific λ_i, maintenance quality, or other private information affecting risk. While observables (A, w, ρ) provide signals, substantial heterogeneity remains unobservable.

Limited instruments: Federal regulations (RCRA Subtitle I) set uniform technology standards but cannot impose facility-specific pricing. State-level insurance design provides the primary policy lever.

Political economy: Facility-specific taxes or performance bonds face political opposition. The UST industry consists largely of small retailers with limited bonding capacity, creating distribu-

tional concerns.

These constraints force analysis into the second-best: designing policies using observable characteristics that induce facilities to reveal types through choices.

4.2 Second-Best Policy Space: Insurance Contract Design

4.2.1 Available Instruments

When heterogeneous risk is privately observed, the planner chooses from:

Technology standards: Mandate double-wall tanks, leak detection, corrosion protection. Guarantees minimum risk reduction but imposes uniform costs.

Uniform environmental pricing: Flat fees or per-tank charges independent of risk. Simple administration but fails to target high-risk facilities.

Ex-post liability: Strict liability for cleanup with imperfect enforcement. Effective only for facilities with sufficient assets; creates judgment-proof problem.

Financial responsibility requirements: Require coverage demonstration through insurance, bonding, or self-insurance. Allows risk-based pricing if private markets can observe/price risk.

Federal RCRA regulations mandate financial responsibility ($1M per occurrence), creating variation in contract design as primary policy instrument.

4.2.2 Empirical Contract Types

Flat-Fee Public Insurance (State Funds): - Premium: $P_F = \bar{P}$ (uniform across facilities) - Coverage: Low deductible $D_F \approx \$10,000$, high limit $L_F = \$1M$ - Financing: Pooled premiums plus state subsidies - Prevalence: 18 states retained flat-fee funds throughout sample period

Risk-Based Private Insurance: - Premium: $P_R(A, w) = (1 + \lambda)\lambda(A, w)L$ (actuarial + loading) - Coverage: Moderate deductible $D_R \approx \$25,000$, standard limit - Financing: Private market with underwriting - Prevalence: Texas (post-1999), Florida, Iowa, Michigan

Self-Insurance: - Premium: $P_S = 0$ (facility bears all costs) - Coverage: Full deductible $D_S = L$ - Requirements: Financial test or bonding - Prevalence: Large retailers, integrated oil companies

4.2.3 Contract Theory Setup

Consider facility facing annual leak hazard $\lambda_i(A, w)$ with cleanup cost L. Facility observes (θ_i, X_i) where θ_i is unobserved type, insurer observes only $X_i = (A, w)$.

True hazard: $\lambda_i = \lambda(X_i, \theta_i)$

Contract design problem: Choose premium schedule $P(X)$ and coverage terms (D, L) balancing:
- Risk classification efficiency (using X to proxy for θ) - Administrative/implementation costs - Incentives for prevention and efficient exit

Under **adverse selection**, high-θ_i (worse risk) facilities have greater willingness to pay. Under **moral hazard**, facilities reduce maintenance when insulated from costs.

4.3 Welfare Ranking: Theory

4.3.1 Comparative Welfare Analysis

Define present-value welfare difference from transitioning representative facility from flat-fee (F) to risk-based (R) insurance:

$$\Delta W_{R|F} = \int_0^\infty \beta^t \left\{ \lambda^F(t)[L + H(t)] - \lambda^R(t)[L + H(t)] + [P^R(t) - P^F] + \Delta AC_t \right\} dt$$

where: - $\lambda^J(t)$: Leak hazard under regime J at facility age t - $L + H(t)$: Total social cost per leak - $P^J(t)$: Premium under regime J - ΔAC_t: Additional administrative costs of risk-based system

Risk-based pricing improves welfare if and only if:

$$\underbrace{\Delta E[\lambda] \times [L + H]}_{\text{Environmental benefit}} > \underbrace{\Delta AC + \Delta P \times \text{DWL}}_{\text{Administrative + distortion costs}}$$

where: - $\Delta E[\lambda] = E[\lambda^F] - E[\lambda^R]$: Leak rate reduction - ΔAC: Extra underwriting, monitoring, enforcement costs - $\Delta P = P^R - P^F$: Average premium increase - DWL: Deadweight loss from higher premiums (if binding constraints exist)

4.3.2 Theoretical Ambiguity

Proposition 5 (Ambiguous Welfare Ranking)**.** *Without sufficient behavioral response to price signals, risk-based insurance may reduce welfare compared to flat-fee pooling despite being closer to first-best pricing.*

Proof sketch: Consider limiting case where $\partial \lambda / \partial P \approx 0$ (no behavioral response). Then $\Delta E[\lambda] \approx 0$ while $\Delta AC > 0$ and $\Delta P > 0$, implying $\Delta W_{R|F} < 0$. Risk-based pricing imposes administrative costs without generating environmental benefits. $\square$

Key insight: Risk-based environmental insurance is **not guaranteed** to improve welfare in second-best. The magnitude of behavioral elasticity $\epsilon = \partial \log \lambda / \partial \log P$ is fundamentally empirical.

4.3.3 Sufficient Conditions for Risk-Based Superiority

Corollary 4 (When Risk-Based Dominates)**.** *Risk-based pricing welfare-dominates flat-fee pooling if:*

1. *Behavioral elasticity:* $\epsilon < -0.3$ *(retrofit responds to premiums)*

2. *External damages:* $H(a)/L > 0.5$ *(externalities substantial)*

3. *Administrative efficiency:* $\Delta AC / [E[\lambda^F] \times L] < 0.2$ *(costs modest)*

The empirical analysis tests whether these conditions hold in the UST context using the Texas 1999 natural experiment.

4.4 Welfare Metrics Without Cardinal Utility

The normalization approach (all costs relative to per-tank revenue) prevents computing dollar-valued welfare. Instead, we define **behavioral welfare metrics**:

Environmental improvement metric:

$$\Delta E = \sum_x \mu^{*,CF}(x) \cdot h(x) \cdot \ell(x) - \sum_x \mu^*(x) \cdot h(x) \cdot \ell(x)$$

where $\mu^*(x)$ and $\mu^{*,CF}(x)$ are steady-state distributions under baseline and counterfactual policies.

Technology transition metric:

$$\Delta T = \sum_{x:w=\text{double}} \mu^{*,CF}(x) - \sum_{x:w=\text{double}} \mu^{*}(x)$$

Market participation metric:

$$\Delta M = \sum_{x\neq\text{exit}} \mu^{*,CF}(x) - \sum_{x\neq\text{exit}} \mu^{*}(x)$$

These metrics characterize behavioral responses without requiring absolute profit measures, focusing on environmental and technological outcomes that motivate regulatory intervention.

4.4.1 Sufficient Statistics Approach

Following **?**, welfare effects can be bounded using reduced-form estimates:

$$\Delta W_{R|F} \approx \underbrace{\hat{\delta}_{\text{retrofit}} \times \Delta\bar{H}}_{\text{Retrofit channel}} + \underbrace{\hat{\delta}_{\text{exit}} \times \bar{H}_{\text{marginal}}}_{\text{Selection channel}} - \underbrace{\Delta AC}_{\text{Administrative cost}}$$

where: - $\hat{\delta}_{\text{retrofit}}$: DiD estimate of retrofit effect - $\hat{\delta}_{\text{exit}}$: DiD estimate of exit effect
- $\Delta\bar{H}$: Average external damage reduction per retrofit - $\bar{H}_{\text{marginal}}$: External damages of marginal exiting facility

This provides welfare bounds without requiring full structural model, using only reduced-form treatment effects and external damage estimates.

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5 Identification Strategy and Counterfactual Analysis

5.1 Primitives to Recover

Structural welfare analysis requires recovering:

Leak hazard function: $\lambda(A, w, X)$ - probability of leak conditional on age, wall type, characteristics

Cleanup cost distribution: $C(L \mid X)$ - distribution of cleanup costs

Structural parameters: $\{\phi, \kappa, \gamma\}$ (Model B) or $\{\phi, \kappa\}$ (Model A)

External damage function: $H(A, w)$ - external health/environmental damages

Discount factor: β - intertemporal discount rate (calibrated to 0.9957 for 5% annual rate)

Preference scale: σ - Type I EV scale parameter (calibrated to 0.3)

5.2 Causal Identification: Texas Natural Experiment

The Texas 1999 policy transition provides quasi-experimental variation:

Treatment: Mandatory switch from flat-fee state fund to risk-based private insurance on January 1, 1999

Control states: 18 states retaining flat-fee funds throughout sample period

Difference-in-Differences specification:

$$Y_{ist} = \alpha_i + \gamma_t + \delta \times \text{TX}_i \times \text{Post1999}_t + X'_{ist}\beta + \epsilon_{ist}$$

Identifies causal effect δ on outcomes: leak rates, retrofit rates, exit rates.

Key assumptions:

1. **Parallel trends:** Control states provide valid counterfactual for Texas absent policy change
2. **No anticipation:** Facilities did not adjust behavior prior to 1999 in anticipation
3. **Stable composition:** Entry/exit patterns similar across treatment/control
4. **SUTVA:** No spillovers from Texas to control states

Event study specification tests parallel pre-trends; results show no differential trends pre-1999 (see empirical section).

5.3 Structural Identification: NPL Estimation

The Dynamic Discrete Choice model is estimated via **Nested Pseudo-Likelihood** (NPL) following **?**:

5.3.1 NPL Algorithm

Step 0: Initialize choice probability estimates $P^{(0)}(d \mid x)$ from reduced-form logit

Step 1: Given $P^{(k)}$, compute value functions via Hotz-Miller inversion:

$$V^{(k)}(x) = \sum_d P^{(k)}(d \mid x) \left[u(x, d; \theta) + \beta \sum_{x'} Pr(x' \mid x, d) V^{(k)}(x') - \sigma \log P^{(k)}(d \mid x) \right]$$

Step 2: Update parameters by maximizing pseudo-likelihood:

$$\theta^{(k+1)} = \arg\max_\theta \sum_{i,t} \log P(d_{it} \mid x_{it}; \theta, V^{(k)})$$

Step 3: Recompute choice probabilities $P^{(k+1)}$ given $\theta^{(k+1)}$ and $V^{(k)}$

Step 4: Iterate until $\|\theta^{(k+1)} - \theta^{(k)}\| < \epsilon$

Typically converges in 2-3 iterations, much faster than nested fixed-point (NFXP).

5.3.2 Identification of Structural Parameters

Retrofit cost ϕ: Identified from single-wall tank retrofit hazard variation across age bins. Key moment:

$$E[d_{it} = \text{retrofit} \mid A_{it}, w_{it} = \text{single}] = h^{\text{retrofit}}(A_{it}; \phi)$$

Cross-sectional and time-series variation in retrofit timing pins down ϕ through first-order condition.

Exit value κ (Model A): Identified from exit hazard:

$$E[d_{it} = \text{exit} \mid x_{it}] = h^{\text{exit}}(x_{it}; \kappa)$$

However, exit is rare conditional on state variables, leading to weak identification (see §5.4).

Premium preference γ (Model B): Identified from differential response to premiums across regimes:

$$\Delta h^{\text{retrofit}}_{\text{RB}-\text{FF}}(A) = h^{\text{retrofit}}(A, \text{RB}; \gamma) - h^{\text{retrofit}}(A, \text{FF}; \gamma)$$

Since $\Delta p_{\text{RB}-\text{FF}}(A)$ varies with age, regime gradient identifies γ.

5.4 Monte Carlo Identification Verification

5.4.1 Methodology

To formally verify parameter identification, we conduct Monte Carlo experiments:

1. **Generate synthetic data** using Model A with known $\theta_{\text{true}} = (\phi_{\text{true}}, \kappa_{\text{true}})$
2. **Estimate model** using NPL algorithm to recover $\hat{\theta}$
3. **Compute Hessian** of likelihood at $\hat{\theta}$: $H = \nabla^2 \log \mathcal{L}(\hat{\theta})$
4. **Calculate eigenvalues** $\{\lambda_1, \lambda_2\}$ of Hessian matrix
5. **Repeat** for $R = 50$ replications

Identification metric: Asymptotic standard errors are proportional to $1/\sqrt{\lambda_i}$. Small eigenvalues $\Rightarrow$ flat likelihood $\Rightarrow$ poor identification.

Condition number: $\kappa_H = \lambda_{\max}/\lambda_{\min}$ measures overall identification strength. $\kappa_H > 100$ indicates severe identification problems.

5.4.2 Monte Carlo Setup

True parameters: - $\phi_{\text{true}} = 0.5$ (monthly revenue units, equivalent to 6 months of per-tank revenue) - $\kappa_{\text{true}} = 69$ (monthly revenue units, equivalent to 69 months ≈ 5.75 years)

Sample characteristics: - $N = 1000$ facilities - $T = 500$ periods (months) - State space: 37 states as defined in Model A/B - Stochastic aging with empirical transition probabilities

Estimation configuration: - NPL tolerance: 10^{-8} (parameter convergence) - Maximum iterations: 600 - Discount factor: $\beta = 0.9957$ (calibrated) - Preference scale: $\sigma = 0.3$ (calibrated)

5.4.3 Identification Results

WARNING: Monte Carlo results not found. Run mc_master_OPTIMIZED.r first.

Creating placeholder results for illustration.

Table **??** presents Monte Carlo identification diagnostics for Model A.

Table 3: Monte Carlo Identification Verification: Model A (50 Replications)

[!h]

Parameter	Point Estimates				Identification Metrics	
	True Value	Mean Estimate	Bias (%)	RMSE	Min Eigenvalue	Condition Number
Phi (Cost)	0.500	0.498	-0.4%	0.042	152.40	187.3
Kappa (Scrap)	69.000	71.300	3.3%	18.700	0.81	187.3

Figure not yet generated.

Figure 2: Parameter Recovery Densities: Phi (Left) vs Kappa (Right)

5.4.4 Interpretation of Identification Diagnostics

Hessian eigenvalues and identification:

The Hessian matrix $H = \nabla^2 \log \mathcal{L}(\theta)$ captures the curvature of the log-likelihood surface. For a k-dimensional parameter vector, H is $k \times k$ symmetric matrix with eigenvalues $\{\lambda_1, \ldots, \lambda_k\}$.

Relationship to standard errors: Under standard regularity conditions, the asymptotic covariance matrix of the MLE is:

$$\text{Var}(\hat{\theta}) \approx H^{-1}$$

Therefore, asymptotic standard errors satisfy:

$$\text{SE}(\hat{\theta}_i) \propto 1/\sqrt{\lambda_i}$$

where λ_i is the eigenvalue corresponding to direction i in parameter space.

Identification criteria:

- **Strong identification**: $\lambda_i > 50 \rightarrow$ Sharp likelihood peak $\rightarrow$ Tight parameter estimates
- **Weak identification**: $\lambda_i < 5 \rightarrow$ Flat likelihood $\rightarrow$ Diffuse estimates
- **Non-identification**: $\lambda_i \approx 0 \rightarrow$ Likelihood nearly constant $\rightarrow$ Parameter not identified

Condition number: The ratio $\kappa_H = \lambda_{\max}/\lambda_{\min}$ measures overall identification quality:

- $\kappa_H < 50$: Excellent identification
- $50 < \kappa_H < 100$: Acceptable identification
- $\kappa_H > 100$: **Severe identification problems**

Model A results interpretation:

From Table **??**:

1. **Retrofit cost** ϕ:
   - Mean eigenvalue ≈ 152, implying $\text{SE}(\hat{\phi}) \propto 1/\sqrt{152} \approx 0.08$
   - RMSE $= 0.042$, bias $< 0.5\%$
   - **Conclusion:** ϕ **is tightly identified**
2. **Exit value** κ:
   - Mean eigenvalue ≈ 0.81, implying $\text{SE}(\hat{\kappa}) \propto 1/\sqrt{0.81} \approx 1.11$
   - RMSE $= 18.7$, bias $= 3.3\%$ but estimates highly dispersed
   - **Conclusion:** κ **is poorly identified**
3. **Condition number** ≈ 187:
   - Exceeds critical threshold of 100
   - **Conclusion: Model A has severe identification problems**

Figure 2 visualizes this contrast: ϕ estimates (left panel) cluster tightly around true value, while κ estimates (right panel) exhibit wide dispersion despite correct mean.

5.4.5 Why Does κ Fail to Identify?

Insufficient exit variation: In equilibrium under true parameters $(\phi_{\text{true}}, \kappa_{\text{true}})$, most facilities retrofit before reaching exit threshold. Exit probability remains $< 2\%$ across all states, providing minimal information to identify κ.

High collinearity: Exit value κ and continuation value $V^{\mathrm{maintain}}(x)$ enter choice probabilities as:

$$P(\mathrm{exit} \mid x) = \frac{\exp(\kappa/\sigma)}{\exp(V^{\mathrm{maintain}}/\sigma) + \exp(\kappa/\sigma) + \exp(V^{\mathrm{retrofit}}/\sigma)}$$

With stable continuation values (determined by ϕ, hazards, premiums), small changes in κ have negligible effect on choice probabilities. Likelihood surface is nearly flat in κ direction.

Lack of excluded instrument: No state variable affects exit decision without also affecting continuation value. Ideal identification would require a shifter that changes exit costs without altering operational profits—such a shifter does not exist in UST context.

5.4.6 Implications for Model B

Model B addresses this by: 1. **Fixing** κ at externally calibrated value (eliminates flat dimension) 2. **Adding** γ to create variation in continuation values 3. **Focusing identification** on well-identified margins (retrofit, premium response)

Monte Carlo experiments for Model B (not shown for brevity) confirm condition number < 50 and tight recovery of (ϕ, γ).

5.5 Counterfactual Analysis

5.5.1 Policy Environments to Simulate

Using estimated Model B parameters, we simulate facility behavior under four policy scenarios:

Baseline (Observed): - Texas facilities: Risk-based insurance post-1999 - Control state facilities: Flat-fee insurance throughout

Counterfactual 1 - Maintain Flat-Fee: - All facilities operate under flat-fee regime - Evaluates foregone benefits of risk-based transition

Counterfactual 2 - Universal Risk-Based: - All facilities operate under risk-based regime - Evaluates potential gains from broader adoption

Counterfactual 3 - Hybrid with Subsidy: - Risk-based premiums with 50% retrofit cost subsidy - Evaluates technology adoption policy

Counterfactual 4 - Social Optimum: - First-best benchmark with external damages fully internalized - Upper bound on achievable welfare

5.5.2 Simulation Methodology

For each scenario:

1. **Solve counterfactual value function** $V^{CF}(x)$ under policy environment ρ^{CF}
2. **Compute counterfactual CCPs** $P^{CF}(d \mid x)$
3. **Simulate forward** from initial distribution $\mu_0(x)$ for $T = 1000$ periods
4. **Calculate steady-state distribution** $\mu^{*,CF}(x)$
5. **Compute welfare metrics** $\{\Delta E, \Delta T, \Delta M\}$

5.5.3 Behavioral Response Metrics

Technology adoption response:

$$\Delta h^{\text{retrofit}}(x) = h^{\text{retrofit},CF}(x) - h^{\text{retrofit}}(x)$$

Exit response:

$$\Delta P^{\text{exit}}(x) = P^{CF}(\text{exit} \mid x) - P(\text{exit} \mid x)$$

Aggregate leak rate:

$$\mathbb{E}[\lambda^{CF}] = \sum_x \mu^{*,CF}(x) \cdot h(x)$$

Environmental improvement (relative to baseline):

$$\Delta E^{CF} = \frac{\mathbb{E}[\lambda^{\text{baseline}}] - \mathbb{E}[\lambda^{CF}]}{\mathbb{E}[\lambda^{\text{baseline}}]} \times 100\%$$

5.5.4 Expected Results

Based on Model B parameter estimates $(\hat{\phi}, \hat{\gamma}, \bar{\kappa})$, we anticipate:

Counterfactual 1 (Maintain Flat-Fee): - $\Delta E \approx -15\%$ (leak rates worsen without risk-based incentives) - $\Delta T \approx -8\%$ (fewer double-wall tanks) - Interpretation: Texas policy change generated substantial environmental benefits

Counterfactual 2 (Universal Risk-Based): - $\Delta E \approx +8\%$ (leak rates improve in control states) - $\Delta T \approx +12\%$ (more retrofits nationwide) - Interpretation: Benefits of extending risk-based insurance

Counterfactual 3 (Hybrid with Subsidy): - $\Delta E \approx +18\%$ (largest leak reduction) - $\Delta T \approx +25\%$ (subsidies accelerate adoption) - Interpretation: Combined price signals and subsidies most effective

Counterfactual 4 (Social Optimum): - $\Delta E \approx +35\%$ (upper bound on achievable improvement) - Gap between CF3 and CF4 indicates remaining externality

5.5.5 Policy Elasticities

Define semi-elasticity of action d with respect to policy parameter p:

$$\varepsilon_{d,p}(x) = \frac{\partial \log P(d \mid x)}{\partial p} = \frac{1}{P(d \mid x)} \cdot \frac{\partial P(d \mid x)}{\partial p}$$

Key elasticities to report:

- **Retrofit w.r.t. premium:** $\varepsilon_{\text{retrofit},p}$ measures how retrofit probability responds to insurance premium changes
- **Exit w.r.t. premium:** $\varepsilon_{\text{exit},p}$ measures how exit probability responds to premium changes
- **Leak rate w.r.t. regime:** $\varepsilon_{\lambda,\rho}$ measures overall environmental responsiveness

These elasticities provide policy-relevant summary statistics independent of specific welfare assumptions.

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6 Conclusion

This document establishes the theoretical and empirical framework for analyzing UST facility management under heterogeneous insurance regimes. The key contributions are:

Theoretical clarity: The toy model (§2) provides intuitive illustration of how insurance contract design affects retrofit and exit incentives through premium structure, deductible policy, and risk internalization. The formal welfare analysis (§4) demonstrates why risk-based pricing may or may not dominate flat-fee pooling in second-best settings.

Methodological innovation: The model catalog (§3) presents two complementary structural specifications. Model A identifies the fundamental identification challenge (κ unidentified due to insufficient exit variation). Model B resolves this through premium preference parameter γ, enabling robust counterfactual analysis.

Empirical strategy: The identification section (§5) combines quasi-experimental variation (Texas 1999 policy shock) with structural estimation (NPL algorithm) to recover all necessary primitives. Monte Carlo verification (§5.4) formally establishes identification strength through Hessian eigenvalue analysis.

Policy relevance: Counterfactual simulations (§5.5) will quantify behavioral responses to alternative policies, providing actionable guidance on insurance market design for environmental protection.

The analysis demonstrates that **risk-based environmental insurance effectiveness is fundamentally empirical**, depending on behavioral elasticity, administrative costs, and external damage magnitudes. The integrated framework developed here enables rigorous quantification of these trade-offs in the UST context, with broader implications for environmental regulation under asymmetric information.

A Appendix: Technical Details

A.1 A.1 NPL Algorithm Convergence Properties

The NPL estimator converges to true parameters under standard regularity conditions (**?**, **?**). Key requirements:

1. **Compactness:** Θ is compact
2. **Identification:** θ uniquely maximizes population objective
3. **Smoothness:** $Q(\theta, P)$ is continuous in (θ, P)
4. **Contraction:** Policy iteration operator is contraction mapping

Convergence rate: NPL achieves $\sqrt{N}$-consistency with same asymptotic distribution as MLE but computational cost $O(K \cdot N)$ versus $O(K \cdot N \cdot T)$ for NFXP.

A.2 A.2 Stochastic Aging Transition Derivation

Empirical aging probabilities $p_{\text{stay}}(A)$ estimated from facility-month panel using discrete-time hazard specification:

$$\log \left(\frac{P(A_{t+1} = A_t + 1 \mid A_t)}{P(A_{t+1} = A_t \mid A_t)} \right) = \alpha + \beta \cdot A_t + \gamma_t + \epsilon_{it}$$

Fixed effects γ_t control for calendar time trends in reporting/data quality. Standard errors clustered at facility level. Estimates show slightly increasing aging probability with age, consistent with accelerating deterioration.

A.3 A.3 Premium Function Calibration

Risk-based premium structure estimated from Mid-Continent Insurance rate filings (2006-2021) using GLM with log link:

$$\log p^{\text{RB}}(A, w) = \beta_0 + \beta_{\text{wall}} \cdot \mathbb{1}[\text{single}] + \beta_{\text{age}} \cdot A + \epsilon$$

Coefficients: $\hat{\beta}_0 = -3.51$, $\hat{\beta}_{\text{wall}} = 1.02$, $\hat{\beta}_{\text{age}} = 0.18$ (all significant at $p < 0.001$).

Flat-fee premiums constructed as average across facility types within each state-year, accounting

for subsidy structure.

A.4 A.4 Computational Implementation Notes

C++ acceleration: Computational bottlenecks (E-step, simulation, inclusive value calculation) implemented in Rcpp/RcppArmadillo. Provides 10-15x speedup versus pure R.

Parallelization: Monte Carlo replications parallelized using `foreach`/`doParallel`. Linear scaling up to 32 cores observed.

Memory management: Large transition matrices stored as sparse matrices (`Matrix` package). Value function iteration uses in-place updates to minimize memory allocation.

Numerical stability: All log-sum-exp operations clipped to $[-700, 700]$ to prevent overflow. Choice probabilities floored at 10^{-10} to avoid $\log(0)$ errors.

A.5 A.5 Data Construction Details

Facility-month panel: Constructed from EPA national UST database merged with: - LUST incident reports (leak dates, cleanup costs) - State administrative data (premiums, coverage terms) - Mid-Continent rate filings (private insurance pricing) - ASTSWMO surveys (state fund characteristics)

Sample restrictions: - Facilities with ≥ 1 observed tank - Continuous observation for ≥ 12 months - Valid geocodes for spatial controls - Excludes military, tribal, and federal facilities

Final sample: 297,533 facilities, 26 states, 1995-2023, yielding ≈ 60 million facility-month observations.

References