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STATEMENT OF
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RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

ON THE DEFENSE PRODUCTION ACT

Mr. Chairman and Members of the Committee:

We appreciate this opportunity to comment on extending titles I and III of the Defense Production Act (DPA) beyond their current March 31, 1983, expiration date and using the act's title III authorities to provide financial and other assistance to private industry for the production of nonfuel minerals and materials needed for national defense. Title III, together with title I priorities and allocations, facilitates the production of goods and services necessary for national defense.

While we agree with extending title I and III authorities, we believe that the Congress should consider amending title III to assure that the economic benefits and costs, as well as the national security implications, of each title III proposal are properly addressed. Further, the Congress should consider amending the act to provide the Congress with ample opportunity to review each title III proposal. I will comment further on these issues after briefly summarizing why we believe that the act's authorities should be extended and GAO's involvement with title III over the past 2 years.

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EXTENSION OF THE DPA

The act, originally intended to terminate in ~~1982~~ 1952, has been extended by a series of amendments ranging from 30 days to 2 years and has never lapsed for longer than a day or two. The current importance of this act is reflected in this committee's report which accompanied the 1981 extension. It states that:

> "The Defense Production Act is the sole statutory vehicle for insuring that the nation's industrial base is kept in a state of readiness in peacetime so that new programs may be initiated and standby programs may be expanded in the event of mobilization."

In January 1983, the Department of Defense stated that the act "is a statutory cornerstone of our country's national security."

At the October 8, 1982, request of the former Chairman of the Subcommittee on Economic Stabilization, House Committee on Banking, Finance and Urban Afairs, GAO has just completed an evaluation of the effects of a lapse in the DPA, focusing on the priorities and allocations provisions of title I. GAO found that a lapse of DPA could result in (1) difficulty in acquiring desired products, (2) schedule or delivery delays, (3) cost growth, (4) problems in administering and enforcing DPA authorities and regulations, and (5) contractual problems.

It would appear that the loss of title I and III authorities could have a widespread impact on the way Defense satisfies its procurement and readiness responsibilities. Thus, we recommend that the Congress extend their expiration date.

CHRONOLOGY OF RECENT GAO INVOLVEMENT IN TITLE III

Our views on the need to couple amendments to title III with extension of the act's authorities are based on work we have done over the past 2 years, including that accomplished in response to your request that we testify here today.

--First, following an October 7, 1981, letter from Senator Proxmire to the Director of the Office of Management and Budget stating that he intended to ask GAO to review any title III proposal, we have regularly monitored executive branch activity relating to title III.

--Second, we issued a report[1] on the need to weigh the benefits and costs of domestic mining against other mitigating alternatives, including stockpiling and the development of substitutes, to determine the most effective approach to assuring our national security and economic well-being.

--Third, we provided comments on a bill entitled the Defense Industrial Base Revitalization Act questioning the viability of certain contemplated title III proposals to either reduce long-term national vulnerability in strategic and critical mineral markets or improve the ability of domestic producers to compete at home or abroad.

--Finally, in response to your testimony request, we evaluated, to the extent that time permitted, an August 1982 Federal Emergency Management Agency (FEMA) proposal for using title III to help meet the National Defense Stockpile cobalt goal. At your request, we limited our review

[1]"Actions Needed to Promote a Stable Supply of Strategic and Critical Minerals and Materials," GAO/EMD-82-69, June 3, 1982.

primarily to the most cost-effective means of meeting this goal.

ECONOMIC AND NATIONAL SECURITY BENEFITS AND COSTS SHOULD BE CONSIDERED

Certainly, we support a well-designed, cost-effective Federal program to improve the readiness of this Nation's industrial base and to prepare for national defense mobilization. Title III authorizes a variety of alternatives to stockpiling, including loans, loan guarantees, purchases, commitments to purchase, and floor price guarantees (price supports) to expand our productive capacity and supply.

Title III was used with varying degrees of success during the Korean conflict and the aftermath arms buildup, but has been used infrequently since then. The Department of Defense has been authorized $50 million in fiscal year 1983 and has requested an additional $200 million in fiscal year 1984 for title III purchases and purchase commitments of metals, minerals, and materials.

Over the past 2 years, the executive branch has discussed the possible use of title III to expand domestic production of cobalt, titanium, aluminum ore (refactory bauxite), and natural rubber (guayule). We believe that a proper analysis of these proposals' economic and national security benefits and costs would show that, at least for some strategic and critical minerals, title III authorities may not be the most effective alternative for promoting long-term national defense.

The only recent executive branch analysis pertains to FEMA's cobalt proposal. We believe that the analysis raises important issues concerning which economic and national security benefits and costs should be considered. However, due to the time constraint in responding to this committee's request, it has not been possible for us to either draft a formal report or obtain FEMA's comments on our present assessment.

Analysis Of FEMA's Title III
Cobalt Proposal

In his April 5, 1982, program plan and report to the Congress required by the National Materials and Minerals Policy, Research and Development Act of 1980 (P.L. 96-479), the President stated that an analysis was ongoing to determine whether circumstances exist under which the use of Defense Production Act incentives would be more cost effective than stockpile purchases. The first such analysis was performed by FEMA to identify the most economical investment alternative for providing a level of cobalt availability equivalent to a strategic stockpile of 85.4 million pounds.

In an August 1982 report, FEMA recommended that using title III to stimulate domestic cobalt production would be a more cost-effective alternative to meeting the stockpile goal than purchasing the cobalt on the open market. FEMA proposed a 5-year Federal floor price guarantee to stimulate 10 million pounds of domestic production annually, supplemented by open market stockpile purchases of 14.2 million pounds over a 10-year period. This option was recommended over stockpile purchases on the open market of 44.6 million pounds over a 10-year period with no domestic production.

The basis for FEMA's recommendation was a cost comparison which concluded, in part, that cumulative Federal expenditures would be substantially less under its proposed option. However, the results of such an analysis are only as valid as the data, assumptions, and methodology used. We question the results of FEMA's analysis and resulting recommendation based on what we regard as deficiencies in each of these areas.

Data

For example, the FEMA data base reflects a 11 percent discrepancy in the amount of cobalt in the stockpile. It does not take into account 5.4 million pounds of cobalt acquired under a July 10, 1981, contract. One result of this oversight is a significant increase in the cost of the stockpile-only option (between $136 million and $198 million).

Assumptions

Further, there appears to be no reasoned basis for FEMA's projected cobalt price. Studies by both Commerce and Interior in 1981 projected a price of $18 a pound or less through 1990, the time frame of the FEMA analysis. Yet, FEMA's nondisruption stockpile-only option assumes a price increasing to over $36 a pound, or more than double the Commerce and Interior projections. This pricing assumption added an additional $274 million to the cost of the stockpile-only option.

FEMA's price assumption also appears unrelated to historical or existing market conditions. The price of cobalt fell from its record producer high of $25 a pound in February 1979 to $12.50 a pound in February 1982 and commodity analysts were projecting that its short-term price would continue to decline. Since the FEMA analysis was completed, the dealer price of cobalt has declined to below $6 a pound. FEMA's divergence in its pricing assumption from both historical and existing market conditions has a major impact on the results of its cost analysis.

FEMA's recommended option also assumes that Federal price guarantees and related expenditures will end after 5 years. However, this assumption would be valid only if FEMA's projected price for cobalt is accepted.

Under a federally guaranteed floor price program, participating producers would be paid the difference between the guaranteed price and the market price. As long as the market price of cobalt remains below domestic production costs, Federal subsidies will be required to maintain domestic capacity. Therefore, Federal price guarantees may have to be continued far beyond the 5 years envisioned by FEMA and may have to be increased as the grade or quality of ore deceases.

For example, FEMA's analysis includes a minimum floor price of $15 a pound. At today's market price of roughly $6 a pound, a Federal subsidy of $9 a pound would be required. If the floor price increases to the $25 a pound also included in FEMA's analysis, the Federal subsidy would increase to $19 a pound. Thus, if the market price of cobalt remains at $6 a pound, the floor price guarantee would cost the Federal Government between $450 million and $950 million over the 5-year program. Yet, this subsidy would result in no increase in the amount of cobalt in the stockpile since, under FEMA's recommended option, the 14.2 million pounds to be acquired for the stockpile would be purchased at additional cost on the open market.

Conversely, a contract at today's market price to acquire all the cobalt still needed to meet the stockpile goal would cost $235 million. Filling the cobalt stockpile goal now would also eliminate any potential future stockpile deficit if domestic production ends once the Federal price guarantee program is terminated. Thus, FEMA's recommended title III option could incur not only greater Federal expenditures over the life of the price guarantee program but also future costs not applicable to the stockpile-only option.

Methodology

Finally, FEMA's methodology raises questions concerning important, but nonquantifiable, costs or risks that should be taken into account in reaching a sound conclusion on the national security issues associated with any title III proposal. The FEMA proposal apparently accords no weight to the national security consideration of the United States having only limited, marginally economic domestic cobalt reserves that could be extracted under any known mining technology. Based on a 1981 Bureau of Mines appraisal of domestic cobalt availability,[2] a Federal floor price guarantee of $15 a pound would assure domestic production of 10 million pounds per year for only 10 years. Another 9 years of domestic production may be possible at $25 a pound. The Bureau's appraisal concludes that

> "U.S. production would provide only short-term relief from the Nation's dependence on imports and will not significantly alter the structure of dependence over the long-run."

Given the physical limitations of domestic cobalt reserves, it would seem prudent to retain this in-the-ground stockpile for periods of actual national emergency instead of selling it on the

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[2]Department of the Interior, "Cobalt Availability-Domestic," Bureau of Mines Information Circular 8843, 1981.

open market during peacetime as FEMA recommends. FEMA's analysis does not acknowledge the potential costs and national security risks associated with the peacetime depletion of our limited cobalt reserves and the resulting potential increase in long-term U.S. vulnerability to supply disruptions.

In a September 1982 study[3] of Federal policy options relating to cobalt, the Congressional Budget Office states that, if domestic cobalt is reserved for national emergencies,

> "the protection afforded by stockpile cobalt extends beyond the mandatory three years, since domestic ore bodies could be brought on-line within that time and greatly extend the years of protection afforded by the stockpile."

Such potential "protection" would be significantly compromised, if not lost, under FEMA's recommended option.

Besides the physical security they afford, domestic reserves also provide a degree of economic protection from contingencies that might cause sharp price increases. Once the leverage afforded by domestic reserves has been eliminated, the Federal Government may have to pay a substantially higher price for foreign supplies.

TITLE III SHOULD BE AMENDED

Given the preceeding assessment, we believe that FEMA's analysis does not provide all the information necessary to (1) identify the most economical investment alternative to meet the

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[3]Congressional Budget Office, "Cobalt: Policy Options for a Strategic Mineral," September 1982.

stated stockpile goal and (2) understand national security considerations relating to depleting our limited domestic cobalt reserves. Further, the decline in the market price of cobalt since FEMA's analysis was published makes FEMA's recommended option even less attractive.

Title III does not now require that economic and national security benefits and costs be considered prior to Federal funding of loans, loan guarantees, purchases, commitments to purchase, or floor price guarantees. We believe that the Congress should consider amending the act to require that these benefits and costs are properly addressed and to give the Congress ample opportunity to review each proposal and associated benefits and costs before entering into any commitment to provide financial or other assistance under title III.

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Let me conclude by recapping the most essential points in my testimony.

--First, we agree with extending title I and III authorities of the Defense Production Act relating to nonfuel minerals and materials, but believe that amendments to title III are needed.

--Second, while we foresee instances where the use of title III authorities may be needed to stimulate domestic production of strategic and critical minerals and materials, our work indictes that title III authorities may not always be the most effective alternative for promoting national security. Therefore, we believe that the Congress should consider amending title III to assure that the economic and national security benefits and costs of each title III proposal are properly considered.

--Third, since the results of any such analysis are only as valid as the data, assumptions, and methodology used, we believe that the Congress should also consider amending the act to give the Congress ample opportunity to review each title III proposal prior to entering into any commitment to provide financial or other assistance.

Mr. Chairman, that concludes my statement. I welcome any questions the committee may have.