



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

MAR 11 1977

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The Honorable Howard W. Cannon
Chairman, Subcommittee on
National Stockpile and
Naval Petroleum Reserves
Committee on Armed Services
United States Senate

Dear Mr. Chairman:

This is in response to your August 26, 1976, letter asking us to examine Israel's purchase of excess industrial diamonds from the strategic and critical materials stockpile. You said that the sale was noncompetitive and included the highest quality stones in the stockpile. You were concerned about three points:

1. Was a negotiated sale proper considering the public law and congressional intent?
2. Was the sale properly negotiated and did the United States receive fair market value for the stones?
3. Were the diamonds used or simply resold at a profit?

Over a 1-year period beginning on July 22, 1975, the United States sold 300,000 carats of industrial diamonds to Israel for \$9.1 million. The sale was part of a disposal of 4,961,000 carats authorized by the Congress in 1971.

In our opinion, the sale did not violate the applicable disposal law, nor did it appear to violate the congressional intent underlying that law. The stones Israel purchased were generally large and of higher quality than those offered and sold in comparable sealed bid sales. The prices the United States received were reasonable in comparison to sealed bid sales. The diamonds were resold by Israel, but we do not know how they were ultimately used.

LCD-77-414

SCOPE

We made our review principally at the General Services Administration's Federal Preparedness Agency, Washington, D.C. We interviewed officials within the Office of Stockpile Disposal and reviewed applicable legislation, policies, reports, correspondence, and other records. We coordinated our audit with General Services internal auditors.

We did not obtain formal written comments but discussed our findings with the Stockpile Disposal officials.

USE OF NEGOTIATED SALE APPEARS PROPER

Industrial diamonds are 1 of the 93 minerals and materials maintained in the strategic and critical materials stockpile. The Strategic and Critical Materials Stockpiling Act of 1946 provides for acquiring and retaining certain strategic and critical materials needed to supply U.S. industrial and military needs during a national emergency. The material is obtained, stored, maintained, and disposed of by General Services. Sales of excess materials from the strategic and critical materials stockpile must be authorized by the Congress.

In 1971, under Public Law 92-108, the Congress authorized the disposal of 4,961,000 carats of industrial diamonds.

From July 1974 through May 1975, the United States worked with Israel on ways to improve the Israeli economy. In July 1974 the U.S.-Israel Joint Committee for Investment and Trade, cochaired by the U.S. Secretary of the Treasury and Israel's Finance Minister, was established to identify ways to strengthen Israel's economic base in nonsecurity areas. Four subcommittees were set up to define ways to increase exports, improve capital investments, promote research and development, and increase supplies of raw materials. In October 1974, the subcommittee on raw materials recommended that a procedure be developed to facilitate Israel's access to the excess stockpile material on the most favorable terms of credit, maturity, and interest and on the basis of negotiated prices.

Section (2)(a) of Public Law 92-108 provides that the sales of excess material be made by advertised bid. An exception was allowed, however, within section 2(b)(3), which permitted disposal without advertising for bids when "sales are made pursuant to requests * * * from other

agencies of the United States in furtherance of authorized program objectives * * *." The law does not specify whether the request must be formal or informal, oral or written. The only written request for the sale we could find was one draft letter from the Treasury Department. This letter specifically requested the sale, and although it was located in both General Services and Treasury Department files, it was never finalized or dispatched. Likewise, we could not find any memorandum for the record or other documentation confirming an oral request. General Services accepted the joint statement by the U.S.-Israel Joint Committee for Investment and Trade, dated May 13, 1975, and signed by the Secretary of the Treasury, as the basis of a request for sale. The legislative history does not indicate what is required to satisfy the request provision of Public Law 92-103, but we believe that there are sufficient references, discussions, and documents to comply with that provision.

On May 23, 1975, an operating agreement was reached between the two countries. It provided that the United States would make available to Israel raw materials in the custody of General Services which are excess to U.S. stockpiling requirements when such material is available for export and when its disposal is authorized by law. The agreement stated that the sale of the material was to be negotiated and that the specific terms would be set forth in separate subsidiary agreements for each increment.

RESULTS OF NEGOTIATION

Also on May 23, 1975, the United States and Israel entered into a contract for the sale of excess industrial diamonds. By that time, all but 300,000 of the 4.9 million carats had been sold. The sales contract covered this 300,000-carat authorization. Israel was permitted to select its 300,000 carats from the entire stockpile available in General Services' New York City vault, one of three locations where the stones are stored.

The 300,000 carats was to be split into four 75,000-carat increments. Under the terms of payment, Israel was to furnish irrevocable letters of credit within 5 days after each incremental sale. The letters would cover the full purchase price plus interest. Government drafts against the letters of credit would mature 2 years after the date of each incremental sale and would be payable in U.S. dollars.

General Services officials prepared the first offering of stones on July 22, 1975, based on the size and grouping normally sold in sealed bid sales. Under normal advertised sales procedures, industry is invited to bid on a variety of stone groupings. For example, in an offering of class 1 drilling stones, the quality and size of the stones vary. Thus, to obtain high quality stones, the buyer must take the whole package, which also includes stones of lower quality. In fact, to retain a high-quality diamond inventory at all times, General Services usually disposes of the lowest quality material first. The agency's diamond disposal policy does, however, allow stone qualities to be mixed to effect orderly disposal of excess materials, in keeping with industry requirements. Agency officials stated this policy helped obtain higher prices.

The quality spread for a March 1975 sealed bid sale, which was accepted by various dealers in industrial diamonds, was also used in the initial offer to Israel. The quality spread is shown below:

<u>Stone quality</u>	<u>Percentage of sale</u>
First	25
Second	35
Less than second	<u>40</u>
Total	<u>100</u>

Agency officials involved in the negotiations said the Israelis rejected the initial selection because they were looking for higher quality stones. In fact, according to one official involved in the negotiations, Israel was only interested in gem quality stones.

ISRAEL RECEIVED HIGHER QUALITY STONES THAN IN SEALED BID SALE

Agency officials explained that the negotiations were a type of "horse trading," with General Services having to increase the quality and size of the stones offered several times. They pointed out, however, that the Israelis did not have open access to the stockpile.

General Services officials assured us that they did their utmost to maintain the quality of the stockpile. The Federal Preparedness Agency's Assistant Director for Stockpile Disposal said that he took full responsibility for the quality and size of the stones selected for offer. He

pointed out that there are no criteria governing the maximum and minimum quality and sizes which should be offered for disposal. He felt such guidance would be helpful in maintaining a high-quality diamond stockpile and in handling future excess diamond sales. However, he also felt it would be very difficult to administer such guidelines because diamond dealers do not like to publish information on prices, quality, and size of diamonds or on market trends.

General Services internal auditors provided the following data showing the differences in quality between the four sale increments of the Israel sale and those of a comparable industry sealed bid sale:

<u>Quality</u>	<u>Sale to Israel</u>				<u>Sale by sealed bid</u>
	<u>First purchase order</u>	<u>Second purchase order</u>	<u>Third purchase order</u>	<u>Fourth purchase order</u>	
	----- (Percent) -----				
First	73	47	65	100	25
Second	22	53	35	0	35
Less than second	<u>5</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>40</u>
Total	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>

The agency internal auditors are completing a report on the sale to Israel. On this aspect of the sale, they point out:

"While one sale of 300,000 carats has a limited effect on the composition of an inventory of 20 million carats, the continued practice of selling off first quality stones would reduce the quality of stones available for future strategic and critical requirements."

The internal auditors also pointed out that, although disposal of first- and second-class drilling stones has been limited, they believe the Federal Preparedness Agency should identify specific lots to be either retained or disposed of in accordance with established criteria. The auditors recommended that the Federal Preparedness Agency follow its

present policy of disposing of the lowest quality material first, except when necessary to meet industry requirements. It should also establish retention priorities for diamonds that identify the lots to be made available for release under proposed disposal legislation.

U.S. RECEIVED FAIR MARKET VALUE
FOR STONES SOLD TO ISRAEL

General Services officials said that information on prices is closely held by the industrial diamond industry. However, they determine whether the prices bid are reasonable by (1) analyzing the range of price bids received from past competitive sales and (2) examining price estimates from independent appraisers on a sample lot before the public offering. These appraisals are made by independent diamond appraisers selected by General Services.

A General Services comparison of the per carat price for each stone quality received from the sale of stones to Israel with recent sealed bid sales to diamond industry dealers showed that generally Israel paid prices equal to or higher than those resulting from sealed bid sales.

CONTRACT PROVISIONS FOR RESALE

In answer to your question concerning contractual restrictions, the sales contract did not prohibit resale of the diamonds. It did, however, contain provisions aimed at lessening market disruption by the sale. The contract states that Israel certifies and agrees that (1) the diamonds will be processed (sorted) in Israel, (2) they will not be distributed in the world market in the same lot composition as purchased from the United States, and (3) they will be marketed in a manner that will prevent market disruption.

To implement these provisions, the contract requires that Israel:

- Make these conditions binding on any subcontractor or purchaser of the diamonds.
- Require any subcontractor or purchaser to guarantee compliance by posting a substantial performance bond.
- Limit any distribution of processed diamonds by Israel, any subcontractor, or any purchaser to a rate per quarter which is consistent with the rate of U.S.

deliveries (that is, no more than 75,000 carats per quarter).

--Make any resale of processed diamonds conform to prices reasonably close to, but not below, comparable world market price levels.

According to General Services officials, these restrictive provisions do not generally appear in the sealed bid contracts. However, in a previous noncompetitive sale involving negotiations, the contract did include some specific restrictive provisions.

The contract with Israel further provided that, if at any time the United States believes these provisions are not effective, (1) it "may suggest other measures for adoption;" or (2) if no measures are feasible, it may terminate the agreement without penalty, except to demand payment for previously delivered diamonds. A General Services legal counsel representative felt that the provisions would be difficult to enforce. The report by the agency internal auditors on the diamond contract provisions states:

"Our review found no indication that Israel enforced these measures or required them of their subcontractors. We did find an allegation by the Industrial Diamond Association that the diamonds were resold in the exact same form and were not processed, sorted or even repacked in any substantial manner. This was denied by the purchasing firm but the evidence provided by them appeared to be incomplete and inconclusive."

General Services officials felt that splitting the 300,000 carats into four 75,000-carat increments would help prevent market disruption. The quarterly increments were sold on August 31, 1975, and January 19, May 7, and July 22, 1976.

Because of the general lack of information for monitoring or enforcing contract provisions, the internal auditors concluded that the contract controls could not be relied upon. They also felt that, in keeping with its responsibilities, General Services should better insure orderly disposals.

The internal auditors recommended that the Director of the Federal Preparedness Agency plan a diamond disposal

program to effectively control the future release of stockpiled diamonds on the market.

CONCLUSIONS

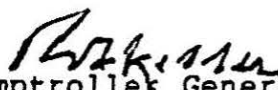
The sale of diamonds to Israel was unprecedented. General Services did not follow its own disposal policy of selling the lower quality stones first. Mixing different quality stones may increase profits and help dispose of lower quality materials. However, the high percentage of first-quality stones sold to Israel differed greatly from the mix usually found in sealed bid sales. Although the amount of stones sold to Israel was small, the precedent established must be carefully considered in future negotiated diamond disposals. Further negotiated sales of this type, particularly for larger quantities, could greatly lower the quality of the diamond stockpile.

In addition, U.S. Government representatives must realize that restrictions in contracts with foreign governments are difficult to enforce. GSA attempted to lessen market disruptions by spreading out the sale in four increments, but its efforts to enforce contract provisions restricting resale actions were perfunctory at best.

We are making no recommendations at this time. We do, however, endorse General Services internal audit recommendations to improve the agency's control over future releases of stockpiled diamonds. We suggest that the committee take into account the agency's actions on these audit recommendations when considering future sales proposals.

Sincerely yours,

ACTING


Comptroller General
of the United States