United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on National Parks and Public Lands, Committee on Interior and Insular Affairs, House of Representatives

April 1989

FEDERAL TIMBER SALES

Legislative and Administrative Assistance Provided to Timber Purchasers

GAO/RCED-89-117

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-232914

April 21, 1989

The Honorable Bruce F. Vento
Chairman, Subcommittee on National Parks
and Public Lands
Committee on Interior and Insular Affairs
House of Representatives

Dear Mr. Chairman:

In your March 21, 1988, letter you expressed concern that a number of timber purchasers, especially in the Northwest, who purchased federal timber before 1982 still appear to be in financial trouble despite the relief provided by the Federal Timber Contract Payment Modification Act of 1984—commonly referred to as the Buy-Out Act. To help these purchasers, the Forest Service and the Bureau of Land Management (BLM) recently implemented deferred payment policies which provide additional assistance to purchasers of federal timber. Based on your request and subsequent agreements with your office, this report (1) evaluates Forest Service's and BLM's administration of the 1984 act and (2) provides information on the implementation of their deferred payment policies. Appendix I contains more details of our objectives, scope, and methodology.

Results in Brief

The Forest Service and BLM effectively administered the Buy-Out Act of 1984. Both agencies effectively determined eligibility requirements and generally calculated accurate buy-out charges. Under the buy-out provisions, 436 purchasers bought out 11 billion board feet[1] of timber priced at about $2.9 billion. They paid buy-out charges of about $184 million.

The Forest Service and BLM implemented interim policies that allow purchasers to defer portions of their payments for certain timber sale contracts in November and September 1988, respectively. As of October 30, 1988, we identified 68 purchasers eligible to participate in Forest Service's Regions 1, 5, and 6 and BLM's Oregon State Office. These purchasers held 346 contracts containing 1.8 billion board feet of timber priced at $585 million. The amount of payments that could be deferred on these contracts totaled about $234 million.

[1] A board foot is the equivalent of a piece of wood 1-inch thick, 1-foot wide, and 1-foot long.

As of December 31, 1988, the Forest Service and BLM have received applications from 6 purchasers to defer payments on 25 contracts with 118 million board feet of timber priced at about $38 million and estimated deferred payments of about $18 million. At that time, the Forest Service had extended the payment provision on one contract involving 3 million board feet of timber priced at $1.3 million and a payment deferral of about $645,000.

Background

Each year, the federal government sells billions of board feet of timber from the nation's forests. The Forest Service and BLM sell the timber by designating the timber to be sold, appraising the timber, and offering it for sale to the highest bidder under competitive bidding procedures. Most timber sales take place several years before the timber is harvested. Contract terms often call for the timber to be cut within 3 to 5 years, but cutting time can range to as much as 10 years for large sales. In fiscal year 1987, the Forest Service reported that it sold 11.3 billion board feet of timber for about $1 billion. A lesser amount—1.3 billion board feet—was sold for about $142 million that same year by BLM.

Timber Price Changes in the Late 1970s and Early 1980s

During the late 1970s, projections for a continuing rise in housing starts, increasing inflation, increasing demands for forest products, and industry's concern that the federal timber supply was shrinking, resulted in aggressive bidding among members of the timber industry. To protect their supply of timber and build a hedge against further inflation, purchasers bid increasingly higher amounts for federal timber—especially in the West.

The market value of timber can change substantially between the time it is purchased and when it is cut. Between 1979 and 1981, the price of timber dropped by more than 80 percent. Despite some subsequent recovery in housing construction, lumber prices in 1984 remained below the 1979 average. This meant that high-priced timber purchased in 1979 and 1980 was due to be processed into building materials that were selling for prices that would not recover costs. Thus, many companies would be faced with financial problems or even bankruptcy, if they performed the high-priced timber sale contracts.

Legislative Assistance

To deal with this situation in the timber industry, the Federal Timber Contract Payment Modification Act (16 U.S.C. 618)—Buy-Out Act—was enacted on October 16, 1984. The act pertained to "high-priced" Forest

Service and BLM timber contracts. These contracts were defined as those bid prior to January 1, 1982, that had an original contract length of 10 years or less, and were held as of June 1, 1984. The act allowed purchasers to buy out of high-priced contracts by paying a fee to the government.

The act specifies conditions under which timber purchasers were allowed to "buy-out" timber sales contracts. It specified criteria for determining which contracts and what volume of timber were eligible for buy-out and procedures for calculating the buy-out charges. The act allowed purchasers, holding more than 27.3 million board feet of eligible timber, to buy-out 55 percent of the qualifying volume under contract up to a maximum of 200 million board feet. Purchasers holding 27.3 million board feet or less could buy-out up to 15 million board feet or the volume of one contract, whichever is greater. The purchaser's estimated losses on all eligible timber contracts were to be compared with the purchaser's net book worth to determine the buy-out rate to be charged. The highest buy-out rate would be charged to those purchasers whose net book worth would be least affected and the lowest would be charged to those purchasers that would be most affected.

Buy-Out Effectively Administered

Under the Buy-Out Act, the Forest Service and BLM were responsible for, among other things, (1) reviewing purchasers' eligibility for the program, (2) calculating the losses that purchasers would bear if the timber sales were completed, and (3) determining the amount that purchasers should pay to buy-out their contracts. We found that the Forest Service and BLM effectively administered the program in accordance with the act.

Forest Service Administration of the Buy-Out Act

On June 27, 1985, the Forest Service published its implementing regulations and began accepting applications for buy-out. The Forest Service regions coordinated their review of buy-out applications so that companies dealing with several regions did not receive more relief than they were entitled. The Forest Service also coordinated its review with BLM's Oregon State Office.[2] In most instances, the region that had the largest number of outstanding sales with a purchaser processed that purchaser's buy-out application.

[2]The only BLM contracts bought out were those that purchasers held with BLM's Oregon State Office.

According to the Department of Agriculture's Office of Inspector General (OIG), 364 purchasers, holding Forest Service timber sale contracts, elected to participate in the buy-out program. These purchasers bought out 1,625 contracts containing about 9.7 billion board feet of timber originally priced at about $2.5 billion. Most buy-outs of Forest Service timber occurred in Region 6, the Pacific Northwest Region (Oregon and Washington). The OIG calculated that purchasers of Forest Service timber paid buy-out charges of about $172 million.

The OIG audited the Forest Service's processing of buy-out applications and compliance with the provisions of the act and agency regulations. In February 1986, the OIG issued a summary report concluding that the Forest Service effectively implemented the provisions of the act.

We evaluated the OIG's audit by examining their workpapers and interviewing staff who conducted the audit. We concluded that the audit's scope and methodology were sound and that their findings were supported.

We supplemented our review of the OIG's audit by reviewing six purchasers' files in Region 6. We found the Forest Service properly processed the purchasers' applications, computed the correct buy-out charges, and authorized the proper volumes to be bought out.

BLM Administration of the Buy-Out Act

BLM also published its implementing regulations on June 27, 1985. BLM examined all pre-1982 sales to determine whether they qualified for buy-out. BLM then sent application packages to each purchaser advising them of which of their contracts qualified for buy-out, the estimated losses on the pre-1982 BLM contracts they held, and other pertinent data needed to apply for buy-out.

According to BLM records, in Oregon and Washington, the only states where BLM contracts were bought out, 72 purchasers elected to participate in the buy-out program, buying out 279 contracts containing about 1.3 billion board feet of timber priced at about $436 million. These purchasers paid $11.9 million in buy-out charges.

Since no independent review had been done of BLM's implementation of the buy-out program, we conducted a more extensive test of its administration of the program. We found that all 72 purchasers who elected to participate in the program complied with the application requirements.

In addition, we randomly selected a statistical sample of 80 of the 279 bought-out contracts to evaluate the accuracy of the calculated buy-out charges. On the basis of our sample, we believe that BLM generally calculated accurate buy-out charges.[3]

Implementation of Forest Service and BLM Deferred Payment Policies

Despite the relief provided by the Buy-Out Act, as of June 30, 1988, purchasers still held over $942 million of federal timber contracts bid prior to 1982. Because most of these contracts are approaching their expiration dates in 1989-90, several proposals were made by the private sector, including industry and a local government association, to provide additional assistance to these purchasers. More details on the alternative proposals considered by the Forest Service and BLM are discussed in appendix II. The Forest Service and BLM rejected the proposals. However, in November and September 1988, respectively, they implemented interim policies to provide administrative assistance to purchasers holding high-priced contracts. Their policies allow purchasers to defer certain portions of their payments for harvested timber.

The interim policies are controversial as evidenced by the public comments received by the Forest Service and BLM and the comments we received from companies that held high-priced timber contracts. For example, some commentors viewed the interim policies as being inequitable to those who operated their high-priced contracts while others said they did not provide enough relief. More details on the comments are discussed in appendix III.

Purchasers Still Hold Pre-1982 Timber

As of June 30, 1988, a number of purchasers still held timber sale contracts bid prior to 1982. The purchasers were not able to buy-out of all of their contracts because of volume limitations included in the Buy-Out Act. These uncompleted contracts contained more than 4.1 billion board feet of timber with contract prices of about $942 million. Table 1 shows the volumes and amounts of these remaining Forest Service and BLM contracts by the year in which harvesting is to be completed. Over half of the contracts are due in 1989 and 1990. During those 2 years, purchasers are obligated to complete harvesting on 547 sales containing about 2.6 billion board feet with contract prices over $622 million.

[3]See appendix I for additional details.

Table 1: Remaining Timber Contracts Bid Prior to 1982

Expiration year	Number of contracts	Contract volume (MBF)[a]	Contract amount
1988	109	382,769	$91,067,995
1989	361	1,499,138	381,415,729
1990	186	1,090,669	240,753,767
1991	121	790,707	156,783,913
1992	35	299,813	68,069,186
1993	3	61,047	3,917,445
Total	**815**	**4,124,143**	**$942,008,035**

[a]Thousand board feet.

Interim Policies to Defer Contract Payments

Citing the need to avoid the adverse economic impacts and forest management disruptions that would occur if these sales were defaulted, the Forest Service and BLM announced interim policies on August 22, 1988, to allow purchasers to defer payment on qualified timber contracts. Under the interim policies, the government will receive full contract price, but part of the purchase price can be deferred. The deferred amount is to be determined by subtracting the current 6-month average bid value per thousand board feet (MBF) for the forests or districts plus $50 per MBF from the original contract bid value per MBF. For example, if a deferred payment were negotiated on timber initially bid at $300 per MBF in 1981 and selling at an average price of $80 per MBF over the most recent 6 months, the deferred amount would be $170 per MBF ($300 - ($80 + $50)). The deferred amount will be paid with interest (see app. III) over a 5-year period under terms of a fully secured promissory note. If the purchaser demonstrates a compelling need, this period can be extended to 10 years by the Forest Service's Regional Forester or BLM's State Director.

Not all timber contracts will be eligible for deferred payment. To qualify, contracts must meet the following criteria:

- The bid date must be prior to January 1, 1982.
- The remaining timber must have a contract price per MBF greater than the average bid value for the previous 6 months on the forest or district where the sale is located, plus $50 per MBF.
- The contract must have a sufficient contract period remaining to allow for removal of the timber prior to expiration of the contract.

The agencies initially decided to make the policy effective September 1, 1988, to allow payment deferral procedures during the current operating season since several of the affected sales were scheduled to terminate between the date of publication and March 30, 1989. However, the Forest Service delayed the effective date of their interim policy until November 1988 to consider the public comments received on the policy.

Purchasers Eligible to Participate in the Interim Program

As of October 30, 1988, we analyzed Forest Service contracts[4] in Regions 1, 5, and 6 and BLM contracts bid prior to January 1, 1982. As shown in table 2, we identified 68 purchasers eligible to participate in the interim program. These purchasers had 346 contracts containing about 1.8 billion board feet of unharvested timber priced at $585 million. The amount of payments that could be deferred totaled about $234 million.

Table 2: Demographic Data on Eligible Contracts

Dollars in millions

Region Number or BLM	Number of purchasers	Number of contracts	Remaining volume (MBF)	Remaining amount	Amount deferable
1	9	37	180,516	$33.9	$12.4
5	20	65	424,375	139.6	59.8
6	44	176	908,431	327.2	132.8
BLM	17	68	264,282	84.0	29.3
Total	**68[a]**	**346**	**1,777,604**	**$584.7**	**$234.3**

[a]The total number of purchasers is 68. Some Forest Service purchasers operate in more than one region and/or have contracts with both Forest Service and BLM.

Status of Interim Policy

As of December 31, 1988, the Forest Service has received applications from four purchasers to defer their payments on 10 contracts with about 56 million board feet of timber priced at $22 million. BLM has received applications from three purchasers to defer their payments on 15 contracts with about 62 million board feet of timber priced at about $16 million. The Forest Service and BLM purchasers could defer a total of about $18 million on these contracts. The Forest Service has modified the payment provision on one contract involving 3 million board feet of timber priced at about $1.3 million to allow a payment deferral of $645,000.

[4]These contracts represent 86 percent of the eligible contracts.

We discussed with Forest Service and BLM officials the status of, and the limited participation in, the interim policies. These officials said that while they expected additional activity in the future, certain factors have limited participation thus far. The principal reasons cited were (1) the market for lumber and plywood is very good, (2) the sales that recently have come due have already been planned to be harvested by the companies and would not be considered for deferral, (3) some companies have been able to extend some contract due dates because they volunteered to cut adjacent fire salvage sales, and (4) companies will usually wait to the last moment to take advantage of the deferral because it will have to be recognized as a liability on their financial statements.

Observations

On the basis of our discussions with the Forest Service and BLM and a review of industry participation to date, we believe that under current economic conditions relatively few companies will avail themselves of the policies[5]. Many companies are harvesting, or are prepared to harvest, their high-priced timber. While the policies will provide assistance to some companies that might otherwise default, they may also encourage bidders to rely on the government to provide further assistance if similar conditions arise in the future.

We discussed the report's contents with responsible Forest Service and BLM officials and have incorporated their comments where appropriate. However, as requested by your office, we did not obtain official agency comments on this report. As agreed with your office, unless you release its contents earlier, we will not distribute this report until 10 days from its issuance date. At that time, we will send copies to the appropriate Senate and House Committees; interested Members of Congress; the Secretaries of Agriculture and Interior, the Chief of the Forest Service, the Director of BLM; the Director, Office of Management and Budget; and other interested parties.

In addition, as agreed with your office, we have sent a separate report to the Chief of the Forest Service pointing out that the Forest Service

[5]Some of the public comments suggested that participation by small companies may be limited regardless of economic conditions. (See app. III.)

has been awarding timber sale contracts to firms without performing required financial ability reviews.[6]

Major contributors to this report are listed in appendix IV.

Sincerely yours,

John W. Harman
Director, Food and
Agriculture Issues

[6] National Forests: Financial Ability Reviews of Prospective Timber Purchasers Need Improvement (GAO/RCED-89-110, March 31, 1989).

Contents

Abbreviations

BLM	Bureau of Land Management
GAO	General Accounting Office
MBF	Thousand board feet
OIG	Department of Agriculture's Office of Inspector General

Objectives, Scope, and Methodology

The objectives of this report are to provide the Subcommittee with

- our evaluation of Forest Service's and BLM's administration of the Buy-Out Act and
- information on the implementation and status of the recently approved interim policies of the Forest Service and BLM which provide additional assistance to purchasers of high-priced timber sales contracts.

To address the Forest Service's administration of the Buy-Out Act, we relied to a great extent on the work previously performed by the Department of Agriculture's OIG. The OIG had performed comprehensive reviews of (1) Forest Service's compliance with the Buy-Out Act, (2) purchasers holding high-priced Forest Service timber contracts that might be in financial jeopardy, and (3) Forest Service's collection of damages on defaulted timber contracts. We reviewed the OIG's reports and workpapers and interviewed staff who conducted the audits. In addition, we selected a judgmental sample of six Forest Service timber purchasers.

At BLM, because no independent review had been made of the administration of the program, we conducted more extensive test work of our own. We reviewed the application files of all 72 purchasers who elected to participate in the program and analyzed this information based on the application requirements. We also randomly selected 80 contracts out of the 279 contracts at various districts and area offices that were bought out to evaluate the accuracy of the calculated buy-out charges.

Because we reviewed a statistical sample of BLM contracts, each estimate developed from the sample has a measurable precision, or sampling error. The sampling error is the maximum amount by which the estimate obtained from a statistical sample can be expected to differ from the true universe characteristic (value) we are estimating. Sampling errors are stated at a certain confidence level—in this case, 95 percent. This means that the chances are 19 out of 20 that, if we reviewed all of the BLM contracts, the results of such a review would differ from the estimate obtained from our sample by less than the sampling error of such estimates. We estimate that 12.5 percent of the BLM contracts contain errors with a sampling error of plus or minus 6.1 percent. We calculated the upper bound estimate for the dollars in error to be $172,340. Since the maximum dollar error is only 1.4 percent of the $11.9 million in buy-out charges, we believe that BLM generally calculated accurate buy-out charges.[1]

To identify various proposals to remedy the current situation, we interviewed Forest Service and BLM officials and obtained data on all relief proposals that had been made. Also, through these interviews, we determined why the Forest Service had rejected them and what they had done to develop their interim policies.

To obtain information on the Forest Service's and BLM's implementation of their deferred payment policies, we requested the views of 27 companies identified by Agriculture's OIG as being in financial difficulty regarding (1) the need for further relief and (2) the Forest Service's and BLM's interim policy on deferred payments. We also obtained copies of the public comments received by the Forest Service and BLM on their interim policies and analyzed them. Further, using the agencies' timber sale information systems and the criteria established in the interim policies for determining deferred payments, we identified the potential amounts that companies could defer under the policies.

To determine the status of the interim policies, we obtained a listing of companies as of December 31, 1988, that submitted applications to the agencies to defer payments under the interim policies which included number of contracts, remaining volumes, and the deferable payments.

We performed our review from April to December 1988 in accordance with generally accepted government auditing standards. It was conducted at Forest Service and BLM headquarters offices in Washington, D.C., and the field locations cited in the report.

[1]Dollar errors can be made in favor of BLM or the purchaser. In our analysis, we considered errors in either direction as an error. Thus, our estimate is the total error made rather than errors that favored either party.

Alternative Proposals Considered by the Forest Service and BLM

The Forest Service and BLM considered the following alternative proposals in formulating the agencies' deferred payment interim policies.

County Association Proposal

An Oregon county association feared that strict enforcement of the high-priced contracts would result in widespread defaults that would reduce harvest levels. These lower harvest levels would cause unemployment in their counties and reduce the counties' share of federal timber receipts. The Association, therefore, suggested an alternative that would permit companies to harvest timber at rates reduced from contract rates but higher than current market rates. The Forest Service and BLM rejected this proposal because it would allow for less than contract value being received for harvested timber and would negate the fundamental principle that a contract is binding on the parties who enter it. Moreover, legislative authority would be required to allow the agencies to reduce contract rates on existing sales.

Timber Company Proposal

An Oregon timber company, which held the largest volume of high-priced Forest Service and BLM contracts, proposed an alternative that would have allowed purchasers to operate sales at reduced rates, with the difference between those rates and the original contract rates due at the date that the contracts are terminated. This concept would be used on a few test case contracts, mutually selected by the agencies and the purchasers, and the final amount due would be litigated or settled by negotiation through the Department of Justice. The rates, thus established, would have been used for negotiating how much would have to be paid on all contracts put under the proposal. The Forest Service and BLM rejected this alternative because it would have resulted in allowing the harvest of timber without payment in advance of cutting and without the payment guarantee required by law. According to the Forest Service, this alternative would also require legislation to authorize harvesting without payment in advance of harvest.

"Do Nothing" Proposal

The agencies would follow their current policies and procedures and enforce the contractual provisions. The Forest Service and BLM officials told us that this was the safest alternative from the standpoint of criticism but that a significant number of high-priced contracts may be defaulted, thereby requiring the agencies to collect damages, and forcing the companies to seek protection through bankruptcy proceedings. The agencies rejected this alternative because of the (1) adverse impacts on dependent communities, (2) reduced revenues to the federal Treasury and to counties sharing timber receipts, and (3) the lengthy and costly default litigation efforts that would be required of the government.

Comments on Forest Service and BLM Interim Policies

Both agencies received public comments on their interim policies. A total of 20 companies, organizations, or individuals responded. Twelve respondents opposed the policies, eight supported them. However, five of the supporters indicated that they did not provide enough relief.

Those who opposed the policies objected to them for various reasons. Some thought the policies to be inequitable to those companies that had already operated their high-priced contracts because they, in effect, provide low interest loans to a few companies to finance their cash flow needs—thus giving them a competitive advantage in bidding on new timber sales.[1] Others indicated that they would encourage and perpetuate poor business practices of the least efficient and least responsible purchasers because they will expect the government to "bail out purchasers whenever it is disadvantageous for them to live up to their contractual commitments." Several respondents objected to specific provisions in the policies. They noted that the policies

- have no requirement to commit all eligible sales to the program, thus allowing purchasers to default some sales while taking advantage of the program with others;
- give Forest Service and BLM the discretion to extend deferral from 5 up to 10 years; and
- understate the 6-month average price for timber because low-value salvage sales are included in the calculation.

Those that indicated that the policies did not provide enough relief urged that the BLM and the Forest Service develop policies similar to the alternative proposed by the Oregon timber company that had been rejected earlier by the agencies. (See app. II.) They replied that the government's interim policies contained two provisions that would create problems for companies (especially small companies) that may be so insurmountable that the companies may not be able to participate in the program to any meaningful extent. First, by requiring a promissory note, the companies would be required to record contract losses and long-term debt in their financial statements. This could cause companies to violate their financial covenants (debt to equity ratio, current ratio, etc.) with their lending institutions resulting in those institutions calling the loans due. Second, purchasers may not be able to obtain bonding to

[1]At the time Forest Service and BLM received these comments, the proposed interest rate was the average yield of outstanding Treasury obligations with a remaining maturity of 5 years. In February 1989, the agencies informed us that the interest rate will be revised to a higher rate equal to the prime rate as published in the Federal Reserve Bulletin.

provide 100-percent security for their promissory notes. These respondents concluded that the policy provides little assistance to those companies least able to perform their high-priced contracts.

We solicited comments from an additional 27 companies holding high-priced timber contracts. These companies were identified by the Department of Agriculture's OIG as being in financial difficulty. Twenty-two companies informed us that they did not believe further relief was necessary or desirable and five said the opposite. The rationale given by the companies was similar to the public comments received by the agencies.

Major Contributors to This Report

Resources, Community, and Economic Development Division, Washington D.C.

John W. Harman, Director, Food & Agriculture Issues (202) 275-5138
Gustave A. Johanson, Assistant Director
John P. Murphy, Jr., Assignment Manager
Gloria Sutton, Writer-Editor

Seattle Regional Office

Leo H. Kenyon, Evaluator-in-Charge
Linda Bade-Percival, Evaluator
David L. Hilliard, Evaluator
Brent L. Hutchison, Evaluator