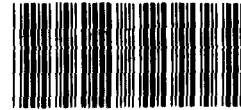


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**Forest Service Needs to Improve Efforts to
Protect the Government's Financial Interests
and Reduce Below-Cost Timber Sales**

Statement of
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Before the
**Subcommittee on Interior and Related Agencies
Committee on Appropriations
House of Representatives**



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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our work for this Subcommittee and Representative Vic Fazio. With the permission of Representative Fazio, I will first discuss our work on the status of Forest Service collection efforts on defaulted contracts and its actions to reduce future timber sale contract defaults. For this work we compared contracting measures used by the Forest Service to two other federal timber sellers, three states, and two private companies. I will then turn to the work we performed on below-cost timber sales at your request. As agreed with your offices, this statement closes out our work and completes our reporting on these issues.

TIMBER CONTRACT DEFAULTS

As a result of work on defaulted timber sale contracts, we found the following:

- The Forest Service has thus far collected about 11 percent, or \$35 million, of the \$302 million in damages due from defaulted contracts. Forest Service officials told us they are taking steps to improve their collection efforts.

- The Forest Service's key contracting measures such as down payments, periodic payments, performance bonds, and

calculation of damages are similar to those of other timber sellers, with the exception that the Forest Service, and one other federal timber seller, return or credit the down payment or deposit before a contract is substantially complete. By crediting or returning the down payment the Forest Service has less security, in terms of access to funds in the event of a default, to protect the federal government's financial interests.

Background

During the late 1970s, a variety of factors, including an increased demand for timber products, resulted in aggressive bidding for federal timber. To protect their supply and build a hedge against further inflation, purchasers bid increasingly higher amounts for federal timber--especially in the West.

Between 1979 and 1981, the price of timber dropped by more than 80 percent bringing lumber prices down to a point which prevented many timber purchasers from selling the processed timber at prices that would recover their costs. Thus, many timber purchasers were faced with financial problems, including bankruptcy, if they executed the high-priced timber contracts. To provide relief, the Congress enacted the Federal Timber Contract Payment Modification Act in 1984. This act allowed holders of certain high-priced federal timber contracts to be released from

their contracts by paying a charge to the government. Purchasers paid about \$172 million to buy out more than 1,600 contracts, which, if executed under the original terms, would have provided payments of \$2.5 billion to the Forest Service.

Forest Service Contracting Measures

Reviewed and Compared

During the last quarter of 1989 and early 1990, the prices bid for federal timber increased substantially, raising questions as to whether purchasers could harvest the timber at a profit. As a result, Representative Fazio was concerned that the conditions that had previously led the Congress to provide financial relief to timber purchasers might recur. Although relatively few contract defaults have occurred recently, Representative Fazio asked that we examine four of the measures the Forest Service uses to help protect the government's interests and discourage defaults: (1) down payments, (2) periodic payments, (3) performance bonds, and (4) calculation of damages.

We reviewed these four measures and compared them with those used by two other federal agencies selling large amounts of timber--the U.S. Department of the Interior's Bureau of Land Management (BLM) and the Bureau of Indian Affairs (BIA). We also compared the Forest Service's measures with those used by California, Oregon, and Washington because the Forest Service

reported that 60 percent of the 9.3 billion board feet of timber sold in fiscal year 1990 came from forests in those states. Finally, we compared the Forest Service's measures with those used by two large private timber sellers in the West. When performing our review, we spoke with agency officials and private industry representatives and reviewed relevant documents.

Forest Service Collection of Defaulted
Damages Has Been Low

The financial relief that the Congress provided to timber purchasers holding high-priced contracts did not prevent contract defaults. Since January 1, 1982, timber contracts valued at about \$646 million have been defaulted. The Forest Service assessed the original purchasers about \$302 million in total damages on these contracts. Thus far, however, it has collected about \$35 million, or 11 percent of the total damages. Most of these defaulted contracts were executed before the Forest Service strengthened its measures to protect the government's financial interests. As such, the Forest Service had fewer security measures available to enhance collections.

The U.S. Department of Agriculture's Office of Inspector General (OIG) has, on several occasions, recommended that the Forest Service do more to collect such delinquent debt. For example, in a September 1987 report, the OIG stated that the

Forest Service had not used a number of collection measures available, such as installment payments. The Forest Service concurred with this finding and noted that it would review and clarify how such measures could be used. In a June 1990 OIG report, the OIG determined that the Forest Service had not established or enforced policies requiring the use of additional collection techniques, such as referring delinquent accounts to collection agencies. The report stated that the agency had made minimal use of several potentially effective collection techniques. Forest Service officials told us that they would act upon the OIG's 1990 recommendations regarding debt collection.

Forest Service Contracting Measures Are Similar,
But May Provide Less Financial Protection

We reviewed four contracting measures that the Forest Service uses to help discourage defaults: down payments, periodic payments, performance bonding, and calculation of damages.

Down Payments

All of the eight timber sellers we reviewed, including the Forest Service, require a cash down payment or deposit ranging from 3 to 25 percent of the sale price or advertised price at the time of the bid or contract execution. The Forest Service, BIA and BLM

return or credit the down payment before the contract's completion.

The Forest Service returns or credits the down payment after 25 percent of the timber has been removed. After returning or crediting the down payment, the Forest Service has only a performance bond remaining to protect the government's interests. The BIA converts the deposit it obtains from the purchaser into an advance payment account that is then used for payments on harvested timber. BLM credits half of the down payment to the sale when payments equal to 60 percent of the sale price have been made and returns the remainder at contract completion. In contrast, the other timber sellers credit or return the down payment when the contract is almost or fully completed. The Forest Service is the only timber seller in our review that allows credits to be applied to the down payment requirement. Purchasers may earn credits for, among other things, road construction or the purchase of rights-of-way.

The Forest Service has recognized that retaining the down payment would increase its ability to protect the government's financial interests. In 1987, a Forest Service task force recommended that the agency retain a higher down payment until contract completion. The task force noted that the retention of payments encourages harvesting and provides the government with additional security.

In December 1990 the Forest Service proposed in the Federal Register to change the down payment requirements. It recommended (1) increasing the down payment, (2) changing the basis on which the down payment is returned from 25 percent of the timber volume removed to 25 percent of the timber value removed, and (3) granting the Chief of the Forest Service authority to extend retention of the down payment when speculative bidding might occur. The Forest Service has completed its assessment of public comments on these changes, prepared a final rule, and is currently sending this final rule through U.S. Department of Agriculture (USDA) officials for review. If implemented, these actions still do not provide as much access to funds for the collection of default damages as would retaining the down payment through most or all of the life of the contract, as is practiced by some other timber sellers we reviewed.

Periodic Payments

Periodic payments are required by seven of the eight timber sellers included in our review. These payments are based on contract length and are due whether timber is harvested or not. For contracts longer than 12 months, the Forest Service requires a payment at the midpoint, which may be in addition to payments required on the basis of timber removed. Failure by a purchaser to make the midpoint payment within 30 days of the due date results in a breach of contract, which begins the default process.

In contrast to the Forest Service's requirement, the state of Oregon requires a number of periodic payments, 12 to 14 equal payments over a 3-year contract.

The Forest Service has previously recommended that periodic payments be required throughout the life of the contract. In the 1987 report I referred to earlier, an agency task force recommended that the Forest Service require periodic payments throughout the life of the contract. According to the task force, this requirement would have several benefits, including providing additional security and reducing speculative bidding. However, to date, the Forest Service has not increased the number of periodic payments.

As part of the December 1990 proposed changes in the Federal Register, the Forest Service suggested increasing the amount of the midpoint payment and adding another periodic payment. The Forest Service has prepared a final rule on these changes and the rule is being reviewed within USDA. These actions may provide greater protection against contract defaults after the midpoint payment.

Performance Bonds and Damage Assessment

All timber sellers in our review used performance bonds but the calculation of default damages varied. Without exception,

these timber sellers protect themselves through some form of performance bonding, but the amounts and the sellers' requirements varied. Used to help recover damages in the event of contract default, the performance bond may be provided by a surety company, through a corporate guaranty, in cash, or by letter of credit.

Generally, the Forest Service and other timber sellers included in our review require performance bonds that vary from 5 to 25 percent of the sale price. Bonding limits range from \$100,000 for the state of Washington to \$500,000 for the Forest Service. The Forest Service has recently proposed to remove the limit on the amount of its performance bonds.

While the Forest Service relies on a performance bond to protect its interests after the down payment is returned or credited, its past experience with these bonds shows that about one-third of the amount billed is actually collected when defaults occur. According to the latest Forest Service information, the Forest Service has billed surety companies \$25 million on contracts that defaulted since 1982; of this amount, the Forest Service has collected \$8 million.

The Forest Service's calculation of damages for defaulted contracts is similar to three of the other timber sellers methods we reviewed. The exceptions were BIA, the state of Washington, and the two private timber sellers. The method used by the Forest

Service for calculating damages is to reappraise or resell the remaining timber on the sale. The amount of the damages due is the difference between the current market value of the remaining timber and the value the Forest Service would have received on the timber had a default not occurred, plus any administrative charges. In contrast to this method, the state of Washington includes a liquidated damages provision in each of its contracts, which specifies a predetermined formula for calculating damages. BIA and the two private timber sellers we examined generally calculate damages on a case-by-case basis.

Conclusion and Recommendation

In conclusion, the Forest Service's practice of returning the down payment before contracts are substantially complete does not protect the government's interests as effectively as the down payment requirement used by some other timber sellers. By returning the down payment after 25 percent of the timber has been removed, the Forest Service is left with a performance bond alone to secure the government's interests throughout the remaining life of the contract. Although the Forest Service has proposed to grant the Chief authority to extend the retention of the down payment, this authority appears to be limited.

We believe that by retaining the down payment for a longer period, the Forest Service could lessen its reliance on

performance bonds and, thereby, increase the government's access to funds in cases of default. Therefore, we recommend that the Secretary of Agriculture direct the Chief of the Forest Service to

- retain the down payment until the contract is substantially complete.

BELOW-COST TIMBER SALES

Mr. Chairman and Members of the Subcommittee, I would now like to turn to the work we carried out for you on below-cost timber sales. Our work was aimed at identifying the current extent of below-cost timber sales, assessing actions undertaken by the Forest Service to reduce the number of below-cost sales, and recommending any additional steps the Forest Service should take.

In summary, we found the following:

- In fiscal year 1990, under our most conservative definition of costs, the Forest Service had timber sale preparation and administration expenses of \$35.6 million that went unrecovered as a result of below-cost timber sales. These expenses range as high as \$112.2 million when all costs are considered. Timber sale preparation and administration costs varied greatly from forest to forest, with costs per thousand board feet of timber harvested on

the highest-cost forest being 23 times greater than those on the lowest-cost forest.

-- The Forest Service has issued a draft policy to reduce losses from below-cost timber sales. While the draft policy is a step in the right direction, we believe that it leaves gaps in a comprehensive approach to below-cost sales because (1) many below-cost sales will not be subject to review, (2) Forest Service costs are not considered when advertised prices are set for timber sales, and (3) the Forest Service does not evaluate, before incurring most preparation costs, whether the benefits of a below-cost sale justify the unrecovered costs.

Background

When the Forest Service sells timber from national forests, it incurs costs for a variety of activities, such as conducting environmental reviews, preparing the timber contract, appraising the value of the timber, and building access roads. In fiscal year 1990, the Forest Service reported that it had sold 9.3 billion board feet of timber and received about \$1.4 billion in revenues.

Concerns regarding below-cost timber sales are long-standing. In 1976, the National Forest Management Act directed the Forest Service to provide information on sales below estimated expenditures for a representative sample of timber sales. In its fiscal year 1985 appropriation, the Congress directed the Forest Service to develop an accounting system with the capacity to compare the cost of selling timber with the estimated value to be received from the sales. The system that was subsequently created with our assistance--called the Timber Sale Program Information Reporting System, or TSPIRS--became operational in fiscal year 1989.

Forest Service Reports on Timber Sales

Costs and Revenues

Using TSPIRS, the Forest Service reports on timber sale costs and revenues for the nation, individual states, and each forest. For fiscal year 1990, the Forest Service reported that revenues from timber sales exceeded costs (before payments to states, which, under federal law, receive 25 percent of all timber revenues) by about \$629 million. However, for individual forests, revenues often did not exceed costs. In all, according to TSPIRS data, timber sale costs exceeded revenues for 65, or more than half, of the 122 national forests.

The Forest Service does not report costs and revenues for each sale. At your direction, we used average forest costs to compare costs and revenues on a sale-by-sale basis. In doing so, we used three different cost categories: first, the costs to prepare and administer the sale; second, a more inclusive set of all operating costs (such as investment costs for fertilizing, thinning, and taking other actions as the timber is growing); and third, all operating costs plus payments to states. Attachment I describes our methodology in greater detail.

Analysis of Fiscal Year 1990 Sales

Using these three categories, we compared timber sale costs to actual sale prices for 3,731 "large" timber sales, which we defined as sales greater than \$2,000 in value and/or 2 million board feet in size, and about 258,000 "small" timber sales, which we defined as sales \$2,000 or less in value. (See table 1.) More detailed results on large sales are included in attachments II through IV.

Table 1: Unrecovered Costs on Sales Using the Three Different Cost Categories

Dollars in millions	<u>Large sales</u>	<u>Small sales</u>	<u>Total</u>
Preparation and administration	\$ 14.9	\$ 20.7	\$ 35.6
All operating costs	46.9	41.0	87.9
Operating costs plus payments to states	68.4	43.8	112.2

Unrecovered costs for large sales ranged from \$14.9 million when only costs to prepare and administer the sale are considered, to \$68.4 million, when all operating costs plus payments to states are included. For small timber sales, unrecovered costs ranged from \$20.7 million, when only costs to prepare and administer the sales are considered, to \$43.8 million, when all operating costs plus payments to states are included.

We also compared sale, preparation and administration costs for the 122 national forests. We found that these costs ranged from a low of about \$15 per thousand board feet of harvested timber to a high of about \$348 per thousand board feet. Although the scope of our review did not permit us to fully analyze these differences, we believe that they could occur for a variety of reasons. For example, some forests operations could operate more efficiently than others, differences in timber sales practices could affect costs, and costs might not be uniformly captured from forest to forest. A review of these wide disparities could result in discovering ways to reduce costs. In this regard the Congress has directed the Forest Service to reduce timber sale costs by 5 percent each year for the next 3 years.

Forest Service Actions

On April 11, 1991, the Forest Service issued a draft policy and guidelines to address below-cost timber sales programs on

individual national forests. The draft policy calls for evaluating below-cost sales for forests as a whole rather than for individual sales. Work on this policy started with the August 1989 issuance of an action plan by the Below-Cost Timber Program Guidelines Task Force, a working group within the Forest Service. The Forest Service also used this continuing effort to respond to the congressional directive to reduce timber sale costs. To implement this policy, the Forest Service plans to concentrate its efforts on below-cost forests but is also asking all forests to look for ways to reduce costs.

Delays in completing this policy is affecting action on two recommendations we made in our May 1990 report to this Subcommittee.¹ In our report we recommended that

-- all timber sale costs be considered in establishing advertised prices for timber sales. The Forest Service assembled a study team, but the team's proposal for redefining minimum rates has been set aside until the below-cost policy is developed. In the meantime, advertised prices continue to be set without consideration of Forest Service costs.

¹Federal Timber Sales: Process for Appraising Timber Offered for Sale Needs to Be Improved (GAO/RCED-90-135, May 2, 1990).

-- a formal decision-making process be adopted as part of any procedures for offering below-cost sales. Our recommendation called for a decision to (1) raise the price to cover costs, (2) terminate the sale, or (3) proceed with the sale on a below-cost basis but explain the reasons for doing so, such as needing to remove diseased timber that could affect other resources.

In addition, TSPIRS continues to undergo change. Because TSPIRS has been in operation for only 2 years, it continues to change to fit its users' needs. Major changes that have been made to TSPIRS in 1991 will affect the way in which timber program costs are collected and reported. Some of these changes could affect average operating costs on some forests. In April 1991, the Forest Service also began using TSPIRS to track separately the costs of large and small sales, which had been tracked together. This change will provide a clearer picture of revenues and expenses associated with large and small sales.

Conclusions

In our opinion, the Forest Service's proposals for addressing below-cost timber sales do not go far enough. We think additional actions are warranted in three areas.

First, we believe that the Forest Service should extend consideration of below-cost sales beyond forests as a whole, as presently proposed, to the individual sales. In fiscal year 1990, nearly every forest had below-cost sales, and more than half of the total unrecovered preparation and administration costs on large sales occurred on above-cost forests. However, the proposed policy calls for potentially adjusting the timber sale level only in below-cost forests.

Second, the Forest Service should consider its costs when setting minimum rates for timber sales. When the Forest Service first established minimum rates in the early 1900s, it defined its minimum rate as the cost to make the sale. Over time, however, this definition fell from use. As a result, the minimum rates often do not reflect the preparation and administration costs currently captured in TSPIRS. With TSPIRS, it is now possible to return to this original basis for setting minimum rates.

Third, the Forest Service is not evaluating, before incurring most preparation costs, whether the benefits of a below-cost sale justify the unrecovered costs. The current timber sale planning process provides the information needed to make a below-cost determination at the first decision point in the preparation process. If the sale were to be classified as marginal or below-cost at this time, we believe that the Forest Service should stop further work, avoiding the cost for such work as environmental

reviews and contract and appraisal preparation. If the Forest Service had made these determinations for large sales conducted in fiscal year 1990 and concluded that the sales should not have been made, almost all of the \$35.9 million in preparation and administration costs could have been avoided. And if the Forest Service had determined that some or all of these below-cost sales should still have been prepared, it would have had an opportunity to raise prices or document its reasons for selling below cost.

Recommendations

On the basis of our data analysis and our understanding of planned Forest Service actions, we recommend that the Secretary of Agriculture direct the Chief of the Forest Service to take the following actions:

- Expand the below-cost sales policy beyond forests as a whole, as presently proposed, to individual sales.
- Define the minimum rate for timber sale bids as the cost of timber sale preparation and administration, and ensure that the sale price recovers these costs.
- Amend the timber sale process to include a below-cost determination at the first decision point in the sale preparation process, so that, if the sale is not

conducted, unnecessary preparation costs can be avoided.
If a below-cost sale proceeds, the reasons should be
documented.

Mr. Chairman, this concludes my prepared statement. I would
be pleased to answer any questions you or Members of the
Subcommittee might have.

OBJECTIVES, SCOPE, AND METHODOLOGY

In a letter dated August 27, 1990, the Chairman and Ranking Minority Member, Subcommittee on Interior and Related Agencies, House Committee on Appropriations, expressed concern about the Forest Service's procedures for selling and administering federal timber assets. We were asked to (1) identify Forest Service timber sales that did not recover their associated costs and (2) determine what actions the Forest Service has taken or plans to take to reduce the occurrence of such below-cost timber sales.

To identify below-cost timber sales and calculate unrecovered costs, we used the Forest Service's 2400-17 Report of Timber Sale data base and data from its Timber Sale Program Information Reporting System (TSPIRS) for fiscal year 1990. We concentrated our review on sales greater than \$2,000 in value or 2 million board feet in size. The Forest Service Report of Timber Sale data base contained 3,731 sales that met these criteria for fiscal year 1990.

Since we had assessed the reliability of selected data elements from the 1988 data base in connection with our 1990 report of Federal Timber Sales Appraisals (GAO/RCED-90-135), we did not test again for reliability.

We used the Forest Service's Timber Sale Program Information Reporting System annual reports for fiscal year 1990 to obtain the costs associated with the timber sales. We calculated three different categories of costs for each national forest:² (1) the costs to prepare and administer the sale, (2) all operating costs, and (3) all operating costs plus payments to states. For the latter two categories of costs, we allocated operating expenses for the Forest Service's Washington office and regional offices to the 122 national forests on the basis of the volume of timber harvested. The payment to states was calculated individually for each sale as 25 percent of gross revenues. We then calculated average costs per thousand board feet³ (MBF) for each of the three categories in keeping with the method generally used by the Forest Service and accepted by GAO. We did not verify the cost figures drawn from the published TSPIRS reports.

For all large sales, individual sale volumes were converted to MBF, multiplied by the average cost per MBF under each cost category for the associated forest, and then compared with the total selling price. The sales highlighted in this testimony are

²Although there are 156 national forests, the TSPIRS cost information we used in our cost analyses was based upon 122 administrative units.

³A board foot is a unit of quantity for wood equal to the volume of a board 12 inches by 12 inches by 1 inch.

those that failed to recover costs under any one of the alternatives. If cost data were available on a sales basis, then the number and dollar amount of below-cost sales could be greater or lesser than our analysis calculates on an average-forest basis.

Unrecovered costs on the small timber sale program were calculated using figures supplied by the Forest Service for fiscal year 1990 and the timber sales program annual report for the same year.⁴ Total national volumes for sales \$2,000 or less were multiplied by national TSPIRS unit cost figures using the same three cost definitions used for the large sales. The 25-percent payment to states was based on the value of the small sales. These cost figures were then compared with the total sales amount of the small sales. We did not perform this analysis on an individual sale basis because there were so many sales in this size class-- 258,336 in fiscal year 1990 and the limited time available to respond to this request.

To determine what actions the Forest Service has taken or plans to take to reduce below-cost timber sales, we interviewed Forest Service headquarters officials and reviewed pertinent documents.

⁴The small timber sale program is generally referred to as "personal use" sales and includes such things as firewood, fence poles, and Christmas trees.

Our review was performed between September 1990 and April 1991 in accordance with generally accepted government auditing standards.

**ACTUAL UNRECOVERED SALES PREPARATION AND ADMINISTRATION COSTS
ON LARGE FISCAL YEAR 1990 TIMBER SALES**

<u>Region</u>	<u>Total number of sales</u>	<u>Sold below sales preparation and administration costs</u>	
		<u>Number of sales</u>	<u>Unrecovered costs^a</u>
1	263	38	\$ 773,019
2	122	48	1,235,989
3	54	24	1,421,335
4	186	24	563,226
5	430	83	3,491,334
6	1,128	52	3,364,469
8	1,026	168	2,306,317
9	518	109	1,784,351
10	4	0	0
Total	3,731	546	\$14,940,040

^aCalculated as the difference between the total high bid price on each sale and the corresponding forest's average sales preparation and administration cost per MBF multiplied by the total volume for each sale.

**ACTUAL UNRECOVERED TOTAL OPERATING COSTS
ON LARGE FISCAL YEAR 1990 TIMBER SALES**

<u>Region</u>	<u>Total number of sales</u>	<u>Sold below total operating costs</u>	
		<u>Number of sales</u>	<u>Unrecovered costs^a</u>
1	263	64	\$2,298,007
2	122	71	3,232,279
3	54	37	4,028,574
4	186	65	2,547,748
5	430	146	7,781,615
6	1,128	99	9,369,541
8	1,026	391	9,190,357
9	518	292	8,493,140
10	4	0	0
Total	3,731	1,165	\$46,941,261

^aCalculated as the difference between the total high bid price on each sale and the corresponding forest's average total operating cost per MBF multiplied by the total volume for each sale.

ACTUAL UNRECOVERED TOTAL OPERATING COSTS PLUS PAYMENTS
TO STATES ON LARGE FISCAL YEAR 1990 TIMBER SALES

<u>Region</u>	<u>Total number of sales</u>	<u>Sold below total operating costs plus payments to states</u>	
		<u>Number of sales</u>	<u>Unrecovered costs^a</u>
1	263	106	\$ 3,739,452
2	122	90	4,539,442
3	54	43	5,811,407
4	186	99	3,984,554
5	430	200	10,184,130
6	1,128	154	14,250,783
8	1,026	588	14,113,060
9	518	372	11,823,419
10	4	0	0
Total	3,731	1652	\$68,446,247

^aCalculated as the difference between the total high bid price on each sale and the corresponding forest's average total operating cost (including allocation of Washington office and regional office operating costs) per MBF multiplied by the total volume for each sale, plus the 25-percent payment to states.