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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

ON
AMENDING TITLE III OF 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 September 30, 1983, expiration date. Title III authorities can be used to provide financial and other assistance to private industry. Title III, together with title I priorities and allocations, facilitates the production of goods and services necessary for national defense. You also requested our views on an August 1982 Federal Emergency Management Agency (FEMA) proposal for using title III to help meet the national defense stockpile cobalt goal and the relationship between this proposal and the administration's fiscal year 1984 title III budget request.

Currently, the Congress is considering two title III funding initiatives. First, 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. The second initiative is H.R. 2057, the "Defense Industrial Base

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Revitalization Act," authorizing $6.75 billion over the next 5 fiscal years, of which $5 billion is earmarked for credit assistance, price guarantees, and purchase agreements for industrial modernization and critical and strategic materials. Implementation of either inititative would require extending DPA's title III authorities beyond their current expiration date.

While we agree with extending both title I and III, 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 addressed. Further, 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 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 DPA's title I and III authorities should be extended and our involvement with title III over the past 2 years.

EXTENDING THE DPA

The DPA, originally intended to terminate in 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. In January 1983, the Department of Defense stated that DPA "is a statutory cornerstone of our country's national security."

At the October 8, 1982, request of the former chairman of this subcommittee, we have just completed an evaluation of the effects of a lapse in the DPA, focusing on the priorities and allocations provisions of title I. We 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 the expiration date for titles I and III. The 5-year extension proposed in H.R. 2057 appears reasonable.

## OUR RECENT INVOLVEMENT WITH TITLE III

Our views on the need to couple amendments to title III with extending DPA's titles I and III authorities are based on work we have done over the past 2 years.

--First, following an October 1981 request by Senator Proxmire, we have regularly monitored executive branch activity relating to title III.

--Second, in April 1982 we provided comments on the Defense Industrial Base Revitalization Act bill questioning the viability of certain contemplated title III proposals to either reduce long-term national vulnerability in strategic and critical mineral markets or improve domestic producers' ability to compete at home or abroad.

--Third, in June 1982 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.

--Finally, in response to a March 1983 request to testify before the Senate Committee on Banking, Housing, and Urban Affairs, we evaluated, to the extent that time permitted, FEMA's proposal for using title III to help meet the national defense stockpile cobalt goal. At the committee's request, we limited our review primarily to the most cost-effective means of meeting this goal.

## ECONOMIC AND NATIONAL SECURITY BENEFITS AND COSTS SHOULD BE CONSIDERED

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.

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

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. Over the past 2 years, the executive branch has discussed the possibility of using title III to expand domestic production of cobalt, titanium, aluminum ore (refractory bauxite), and natural rubber (guayule). We believe that a proper analysis of the 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. Our assessment of this analysis raises important issues concerning which economic and national security benefits and costs should be considered. On April 1, 1983, we forwarded a copy of our assessment to FEMA and offered to meet with appropriate FEMA officials. We have been in contact with FEMA officials concerning the differences in our respective analyses.

## Assessment 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 DPA 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.

FEMA's recommendation was based on a cost comparison which concluded, in part, that cumulative Federal expenditures would be substantially less under its proposed option. However, we question the results of FEMA's analysis and resulting recommendation based on what we regard as deficiencies in the data, assumptions, and methodology used.

Data

For example, FEMA's data base reflects an 11-percent discrepancy in the amount of cobalt in the stockpile. It does not account for 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 reasonable basis for FEMA's projected cobalt price. Studies by both the Departments of Commerce and the Interior in 1981 projected a price of $18 a pound or less through 1990, the time frame of FEMA's analysis. Yet, FEMA's nondisruption stockpile-only option assumes a price increasing to over $36 a pound, or more than double Commerce's and Interior's 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 dropped 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 FEMA's 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 decreases.

For example, FEMA's analysis includes a minimum floor price of $15 a pound. At today's market price of approximately $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 consider in reaching a sound conclusion on the national security issues associated with any title III proposal. FEMA's 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."

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

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 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 --

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

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

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. H.R. 2057 recognizes that technology is a key in reducing U.S. vulnerability in strategic and critical minerals and materials markets and provides financial assistance for conservation, substitution, and recycling in addition to expanding domestic mining and processing capacity. The bill does not, however, require that the economic and national security benefits and costs of a domestic mining proposal be weighed against these other mitigating alternatives to determine the most effective approach to reducing U.S. vulnerability in a given mineral or material market. Therefore, we believe that the Congress should consider amending title III to require that these benefits and costs are properly addressed.

Moreover, the results of any benefit/cost analysis are only as valid as the data, assumptions, and methodology used. Given our preceding assessment, we believe that FEMA's cobalt analysis does not provide the information necessary to (1) identify the most economical investment alternative to meet the 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. Therefore, we believe that the Congress should also consider amending title III to provide the Congress with ample opportunity to review each title III proposal and associated benefits and costs before entering into any commitment to provide financial or other assistance.

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

--First, we agree with extending DPA's title I and III authorities relating to nonfuel minerals and materials, but believe that amendments to title III are needed.

--Second, while instances may exist where the use of title III authorities are needed to stimulate domestic production of strategic and critical minerals and materials, our work indicates that title III 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 title III 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.