REAUTHORIZATION OF THE DEFENSE PRODUCTION ACT OF 1950

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY, TECHNOLOGY,
AND ECONOMIC GROWTH

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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WEDNESDAY, JUNE 13, 2001

APPENDIX

REAUTHORIZATION OF THE DEFENSE PRODUCTION ACT OF 1950

WEDNESDAY, JUNE 13, 2001,

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
TECHNOLOGY, AND ECONOMIC GROWTH,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 3:00 p.m., in room 2220, Rayburn House Office Building, Hon. Peter T. King, [chairman of the subcommittee], presiding.

Present: Chairman King; Representatives Grucci, Capito, C. Maloney of New York, J. Maloney of Connecticut, and Capuano.

Chairman KING. The hearing will come to order.

I've been advised that Mrs. Maloney will be arriving in a few minutes. She has no objection to starting this meeting.

The subcommittee is meeting to consider reauthorization of the Defense Production Act of 1950. I will make a brief statement and then I will ask each of the witnesses to testify. Hopefully there will be no major incidents at the subcommittee hearing and we can move forward.

The Defense Production Act is a little-known bill of great national significance. It has provided vital support to the United States military in every conflict since it was enacted in 1950 during the Korean War. It also holds the promise of helping to mitigate civil emergencies during peacetime.

DPA gives the President a vital set of tools to insure the constant readiness of those portions of our industrial base that support national security. The tools include production priorities and financial incentives, but also extend to monitoring the increasing effects of globalization on the defense base. It falls under the jurisdiction of this subcommittee, and I should say that to date the subcommittee is unaware of any significant adverse impact on the economy caused by DPA. All Administrations since President Truman have used it carefully and prudently.

It's important to note that in the reauthorizing of DPA and monitoring, this subcommittee makes no judgments about particular defense programs. Those decisions are left to the President, who has delegated the job to the appropriate departments: chiefly the Defense Department, of course, but where appropriate the Departments of Commerce, Energy, Transportation, Agriculture and so forth, under the administration of the National Security Council and FEMA.

At this stage I believe the DPA should be reauthorized virtually unchanged from its current form. Through a mishap of timing, the legislation did lapse briefly in 1990 during the buildup to Desert Storm. That was quickly corrected, however, as the Defense Department used the production priorities extensively to acquire items as diverse as computers and communications equipment, satellite-based mapping systems and materials to help protect our troops against chemical weapons.

Fortunately, we do not appear to be in that situation now, but geopolitical situations can change quickly. Also, civil emergencies are particularly hard to predict. For those reasons, I expect a speedy and non-controversial reauthorization process for this year, and that can be almost guaranteed if we finish this hearing before anybody else arrives.

[Laughter.]

Chairman KING. It is my hope the subcommittee will see a legislative proposal from the Administration soon. Given the short number of legislative days left in the fiscal year, I would start moving the bill before midsummer.

I thank all the witnesses for appearing. I will now recognize Mrs. Maloney, who is not here, as soon as she comes to make a statement or insert a statement in the record.

I will now ask the witnesses to testify. We have copies of all your statements, so I would strongly suggest that you keep your statements under 5 minutes. There is a vote on the House floor probably in about 45 minutes. It will be in everyone's interest, primarily the interest of making sure that ultimately this legislation is reauthorized, to keep your statements under 5 minutes. Your statements will be inserted in the record and considered as read.

With that, I would call the first witness, the Honorable David R. Oliver, Jr., the Principal Deputy Undersecretary of Defense for Acquisition, Technology and Logistics. Mr. Oliver.

STATEMENT OF HON. DAVID R. OLIVER, JR., PRINCIPAL DEPUTY UNDER SECRETARY FOR ACQUISITION, TECHNOLOGY AND LOGISTICS, DEPARTMENT OF DEFENSE

Mr. OLIVER. Mr. Chairman, I appreciate the opportunity.

We'd like to see it reauthorized for 3 years, if possible. The key issue has to do with, under no other legislation are we able to maintain an assured supply for our allies when they buy our equipment and we want them to operate with us. And there are other problems that exist.

But what I would like to share with you is the Kosovo incident. When we needed to reprioritize some suppliers for various precision weapons, and it was really important to do so, the Act enabled me to get the contractors' attention. Without that authority, we might have been able to work it out, but it was much more effective to have their attention right from the beginning.

There are other issues that I've looked at in the last 3 years that are directly affected by the Act, but this is a significant facilitator, and we ask that it be reauthorized.

Chairman KING. How about Bosnia?

Mr. OLIVER. The same thing, sir. In both cases, within a few days after we started hostilities, we were finding areas that we needed

the Act's legislation in order to take immediate action. We even went with flat panel displays—I'm not sure the Chairman is aware of that problem over the last few years.

But essentially, small key businesses and key technologies I don't think about 2 years in advance. And then something comes up in terms of a problem, and it is a very small area, but it's terribly important to the military, and the Act permits us to take action.

Thank you, sir.

[The prepared statement of Hon. David R. Oliver can be found on page 12 in the appendix.]

Chairman KING. The Under Secretary for Export Administration in the Department of Commerce and a fellow New Yorker, Ken Juster.

STATEMENT OF HON. KENNETH I. JUSTER, UNDER SECRETARY FOR EXPORT ADMINISTRATION, DEPARTMENT OF COMMERCE

Mr. JUSTER. Mr. Chairman, I appreciate the opportunity to be here today to testify on reauthorization of the Defense Production Act. As with Mr. Oliver, we too would like to see the DPA reauthorized for at least a 3-year period.

Let me briefly discuss the aspects of the DPA that are relevant to the Department of Commerce. We really have four areas that are relevant to us.

First, under Title I of the DPA, we administer the defense priorities and allocation system. Second, under Title III, the Department reports on defense trade offsets. Third, under Title VII, the Department analyzes the health of U.S. industrial base sectors. Also under Title VII, the Department plays a significant role in analyzing the impact of foreign investments on the national security of the United States. I cover these areas in my written statement.

Briefly touching on each of these points for a minute or two, the Defense Priorities and Allocation System, which is known as DPAS, has two primary purposes. First, it ensures the timely availability of products, materials and services that are needed to meet current national defense and emergency preparedness requirements with minimal interference to the conduct of normal business activity. Second, it provides an operating structure to support a timely and comprehensive response by U.S. industry in a national emergency situation.

The Commerce Department administers the system in accordance with the priorities and allocations provisions of the DPA. Those provisions provide authority for requiring U.S. companies to accept and perform contracts or orders necessary to meet national defense and civil emergency needs. They also provide authority for managing the distribution of scarce and critical materials in time of emergency.

The second area is the defense trade offsets. The Department provides Congress with an annual report on the impact of offsets in defense trade. The defense trade offsets are industrial compensation practices required as a condition of purchase in either government-to-government or commercial sales of defense articles or services.

We believe that offsets generally are not efficient economically, because the foreign customer bases the purchase decision on something other than the quality of the product or service being provided.

The third area applies to the Department of Commerce's defense industrial base studies under Section 705 of the DPA. The Department of Commerce conducts analyses and prepares reports on individual sectors of the defense industry. These studies provide a comprehensive review of specific sectors within the U.S. defense industrial base, and they analyze the current capabilities of these sectors to provide defense items for the U.S. military services.

The final area that's relevant to the Commerce Department is the Committee on Foreign Investment in the United States, known as CFIUS, which was originally established by executive order in 1975. The Department of Commerce is a member of the CFIUS process chaired by the Department of the Treasury.

The provision that provides for CFIUS relates to a national security review of foreign mergers or acquisitions of U.S. companies. The intent of the provision is to provide a mechanism to review and, if the President finds it necessary, to suspend or prohibit a foreign direct investment that threatens the national security, but not to otherwise discourage foreign direct investment. The Department of Commerce's contribution to the CFIUS process includes providing a defense industrial base perspective as well as export control perspective.

In sum, we believe all of these are very important authorities to the Department in terms of the programs we carry out. And as I mentioned at the outset, we fully support reauthorization of the Defense Production Act for at least a period of 3 years.

Thank you.

[The prepared statement of Hon. Kennith I. Juster can be found on page 21 in the appendix.]

Chairman KING. Thank you, Mr. Secretary.

We've been joined by Ranking Member, Mrs. Maloney. Do you want to make an opening statement at this time?

Mrs. MALONEY. In the interest of time—and I want to hear from the panelists—I request permission to put my opening statement in the record.

Chairman KING. Without objection.

Chairman KING. I call on the Honorable Eric Fygi, Deputy General Counsel for the Department of Energy.

STATEMENT OF HON. ERIC J. FYGI, DEPUTY GENERAL COUNSEL, DEPARTMENT OF ENERGY

Mr. FYGI. Thank you, Mr. Chairman, and Congresswoman Maloney.

As you suggested, I will summarize very briefly the prepared statement which responded to particular elements of the subcommittee's invitation to address the Energy-related experiences of the Defense Production Act. Most prominent of these recent events, of course, was our use—that is to say, the President's use—of the Defense Production Act in January of this year to avoid a very serious breakdown in the northern California natural gas distribution system that was prompted by the insolvency of the combined gas

and electricity utility that services that part of the state. Those particulars are described thoroughly in the prepared statement, and I will not now repeat them here.

But, I think it's fair to note that there were two particularly controversial aspects of our use of the Defense Production Act authority in that setting. The common thread of them was that the authority is being used to compensate for financial breakdown rather than a shortage, and because the authority was used in a novel way that placed at risk the economic circumstances of the natural gas providers who were ordered to continue making their deliveries to Pacific Gas & Electric.

In the event, however, I am pleased to report that the apprehensions about the gas producers—and even more significantly on a volumetric basis, the natural gas resellers, which included some major financial institutions— proved ill-founded. The overall approach that was hammered out to deal with that emergency resulted in each natural gas supplier being paid in full within the normal business cycle that hitherto had obtained for all of PG&E's natural gas purchases.

In terms of other prior instances in which the Energy Department has employed this scheme set forth in Sections 101(a) and (c) of the Defense Production Act, this has been sporadic with respect to our organization, in contrast to for example the Defense Department. These authorities were used from time to time during the nuclear weapons buildup and production acceleration period in the early 1980's, and likewise were used in the early 1980's to accelerate development of Alaska North Slope energy reserves, particularly natural gas reserves.

In conclusion, as the chair observed a moment ago, we regard the Defense Production Act as an extremely important element of the toolbox that's available for utilization by the President, in addition to being the foundation for the priorities and allocation systems that were described a moment ago. And therefore we wholeheartedly join in the recommendation that the statute be extended for a period of 3 years.

Thank you very much.

[The prepared statement of Hon. Eric J. Fygi can be found on page 26 in the appendix.]

Chairman KING. Thank you very much, Mr. Fygi.

Mr. Michael Brown, General Counsel to FEMA.

STATEMENT OF MICHAEL D. BROWN, GENERAL COUNSEL, FEDERAL EMERGENCY MANAGEMENT AGENCY

Mr. BROWN. Thank you, Mr. Chairman, Congresswoman Maloney.

I'm honored to be here today and appreciate the opportunity to testify today on behalf of Director Allbaugh, the new director of the Federal Emergency Management Agency, and to tell you I'm a little intimidated and overwhelmed by the expertise in this room regarding DPA.

I've learned all that I can in the past 120 days in coming on with Director Allbaugh, and find out that I have much, much more to learn. They've tasked me well and they've advised me well.

Rather than go through my prepared statement, I'd like to just make a few comments that I think reflect the views of the Administration and Director Allbaugh.

We also request a 3-year extension of the Act, reauthorization of the Act. We believe it is important to carry out the duties and obligations of FEMA as the lead coordinating agency for consequence management in the United States. We are prepared to carry out our responsibilities under Executive Order 12919, which indeed involve such things as coordinations.

We are a coordinating agency. We think we do that job very well. The expiration of the Act would hinder us in our full capacity to do that type of activity.

The DPA itself gives us the additional tools we need in the event of a catastrophic event that goes beyond the Stafford Act and goes beyond the capability of FEMA to react properly. Therefore, we believe that its expiration will have dire consequences for us.

In addition, you may recall that the President has tasked the Office of National Preparedness, and we believe the reauthorization of the DPA is important to the continued function of that particular office. We may be looking to authorities under the DPA to respond to the consequences of weapons of mass destruction or other terrorist attacks on the United States, and believe that these authorities are vital to our coordinating function in that consequence management role.

On behalf of the Administration, we would ask for reauthorization for 3 years. Thank you, Mr. Chairman.

[The prepared statement of Michael L. Brown can be found on page 38 in the appendix.]

Chairman KING. We're joined by Mr. Maloney from Connecticut. Do you have any opening statement?

Mr. MALONEY. No, sir.

Chairman KING. I have a series of questions, but in the interest of speed, I will submit these questions to you in writing.

I have one question I would ask each of the four of you. Just turn this around and ask you, what would be the situation if this Act were not reauthorized?

Mr. Oliver.

Mr. OLIVER. We have certain authorities that we don't have in any other way, Mr. Chairman. We do not have something that applies to service contracts. We don't have something that applies to maintaining continuity or surety of supply. Or, let's say I've sold England U.S. helicopters, which gives us a significant interoperability. It gives us significant military capability in addition to maintaining the defense industrial base. I have to be able to then make sure they have the parts, particularly if I'm going to ask them to do something.

Take, for example, the Australians in East Timor, where it's in the United States' best interest for them to go do something essentially all by themselves, although they used equipment they had bought from the United States, which was essential. If they have a problem with supply, it's in our best interest to be able to divert support for that, and I don't have that capability without this Act.

In addition, there's a legal problem if they're not provided complete liability coverage to the contractors if I ask them to divert from one source to another.

The other thing that's terribly important to me is that, when we have issues come up, for example—flat panel displays or radiation-hardened chips for these satellites coming in—when a problem comes up, I don't have authority without this Act to take the necessary quick action to get industry's attention and keep them alive until such time as I can consult.

Mr. JUSTER. Let me just reiterate what Mr. Oliver has said.

The loss of the Defense Production Act would significantly weaken our ability to support national defense programs and civil emergency preparedness, and our overall industrial base capability. I think as you had mentioned earlier, without the DPA, we'd still have some authority under the Selective Service Act of 1948, but it is very limited. And in addition to what Mr. Oliver mentioned, we would have no allocation authority for possible use in a national security emergency without the Defense Production Act.

Also, there would be no civil emergency preparedness programs that we could draw upon, or defense-related programs for agencies such as the FBI or the National Security Agency.

In addition, from the perspective of the Department of Commerce, we would not have the authority that we need to collect the necessary data for our analyses of industrial base sectors or defense offsets. So again, we regard the DPA as a very critical authority that's essential to our programs.

Chairman KING. Mr. Fygi.

Mr. FYGI. Well, I don't expect us to confront in the near future an event, a set of circumstances as peculiar as the earlier emergency in California. But there are other instances that our experience indicates are very plausible, in which these authorities would be of crucial importance.

Let us suppose, for example, that world circumstances were such that we had to draw down the Strategic Petroleum Reserve, and coincident with that realization, directions from the President to take that action. Then there's a significant equipment breakdown in the facility on that installation.

That would be the type of circumstance, if it were urgent to replace scarce and backlogged specialized pumps and other apparatus, where we rely upon the Defense Production Act to bring the facility back on line in an operational sense as promptly as we could. And absent the Defense Production Act, it would be exceedingly difficult, as has been pointed out by the prior witnesses, to persuade vendors to let our order come to the head of the line for fear of the third-party contract liability that they might otherwise expose themselves to, even if they were willing to cooperate with us in the interests of the country.

So that's one example that occurs to me.

Chairman KING. Mr. Brown.

Mr. BROWN. Mr. Chairman, Members of the subcommittee, from FEMA's point of view, if we were to experience a truly catastrophic event, something beyond the magnitude of the Northridge Earthquake or Hurricane Hugo—a Northridge expanded all the way from San Diego to Seattle and truly devastated the West Coast—a ter-

rorist attack, a truly frightening situation like the WMD situation, it would limit our ability to really coordinate and provide the kinds of coordinating responses that we could in terms of consequence management. It is a piece of legislation that allows us to do what we need to do to respond appropriately.

I can't imagine an event—I don't want to imagine an event—of that size. But if an event of that size were to occur, the DPA is necessary for us to make that type of coordinating effort beyond the Stafford Act to do what we need to do to respond appropriately.

Chairman KING. Thank you, Mr. Brown.

I have no further questions today. As I say, I will be submitting questions to you, and I'd appreciate your response to them.

Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman. Here's my opening statement.

I would just like to state that I am supporting this bill, and I support the 3-year reauthorization. But there are some Members of Congress who don't support it, most notably Senator Gramm. He objected publicly.

I understand he's held public hearings on it, and he expressed concern apart from the crisis about, and I quote, "expansive reach of the statute." And he announced that he is going to continue to look at it.

I would like to know your responses to his concern. He's a serious leader in our legislature.

Mr. FYGI. Perhaps I can begin, because I spent several hours with Senator Gramm having an interesting conversation on this point on the 9th of February.

His concerns were directed to the use of the Defense Production Act to deal with the California emergency that I have described extensively in our prepared statement. His concerns seemed directed primarily to the prospect that some of the gas vendors assumed a risk of uncompensated losses of property by reason of the orders.

As I indicated earlier in a summary of my statement, those risks proved unfounded in that all vendors were, in fact, paid by Pacific Gas & Electric.

I think it fair to say that his descriptions during that hearing indicated a philosophical view that was broader than just those sorts of adverse consequences, in which he felt it an inappropriate power for the Government to retain—to direct individual participants in the private marketplace to contract with others in the private marketplace.

Mrs. MALONEY. I guess another part of it is, it's very clear that he thought it was an inappropriate time to use the DPA. But why did the situation in California warrant the use of the DPA by the Clinton and Bush Administrations?

Mr. FYGI. Those circumstances were described, as I said, extensively in our prepared statement.

Briefly summarized, they included the unique coincidence of a major investor-owned utility on the brink of insolvency, which investor-owned utility was a combined gas and electric utility; and that even though, unlike its electricity sales, it was guaranteed reimbursement for its natural gas acquisition costs. Noneless, its otherwise parlous financial situation resulted in its natural gas ven-

dors threatening and beginning to curtail service to PG&E, which culminated on the 19th of January.

The prospect of curtailments of all deliveries to PG&E presented the real likelihood that the electricity crisis in California would further be exacerbated, because under California law, if PG&E experienced a significant shortfall in its natural gas supplies, it—PG&E—would have to seize natural gas supplies not owned by PG&E, but owned by others, but being delivered to industrial facilities through PG&E's system. That in turn would have provoked a cutoff of those continued industrial supplies, which in turn would have provoked the cessation of substantial amounts of electricity generation in the entire northern California area.

Never before had we in this country confronted such a circumstance, which also had dire immediate prospects for public health and safety throughout the entirety of northern California.

Mrs. MALONEY. I'd like to ask Mr. Brown, and then Mr. Oliver—unfortunately, the State that I live in and the city that I live in, New York City, has been a target repeatedly of major terrorist attacks in recent years. Could you provide an example of how the DPA could be used in the event of such an attack, or a major natural disaster?

Mr. BROWN. The primary example I can think of is, if it was devastating to Manhattan—just destroys all of Manhattan—and we need to make sure, in terms of consequence management, we're going to get food, water, electricity, everything we need to get in to a population of that size and magnitude, where we cannot draw upon ordinary suppliers, ordinary contractual agreements, ordinary arrangements of the staff, DPA would allow us to do that.

That's the kind of event that we think, in terms of a catastrophic event, the DPA may come into play. To take it down to a slightly lower level, I've heard examples of where Hurricane Hugo has been utilized to that purpose. We just could not get enough tarps to prevent further damage, which would further exacerbate the problem. DPA could be utilized in that type of situation.

We would want to be prudent and very conservative in our approach and use. That's why I keep throughout this hearing using the term, a truly catastrophic event, which is the type of situation we would utilize it.

Mr. OLIVER. I have nothing to add to Mr. Brown.

Mrs. MALONEY. Just finally, very briefly, Mr. Brown: In 1997, FEMA produced a report recommending modernization of DPA. One of the report's recommendations was to change the Act to reflect economic globalization and not to leave the term "domestic" as the sole focus of defense industrial capabilities.

Would you like to comment on that? Do you think we should expand the definition?

Mr. BROWN. I would like to comment to this extent. I will go back and ask the staff to give me this report, and I will look at it and see what it says.

Mrs. MALONEY. Get back to us in writing.

I have other questions, but I'll place them in writing. Thank you, Mr. Chairman.

Chairman KING. Thank you, Mrs. Maloney.

Mr. Grucci.

Mr. GRUCCI. I have no questions at this time, Mr. Chairman.

Chairman KING. Mrs. Capito.

Mrs. CAPITO. I have no questions at this time.

Chairman KING. The distinguished gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. I never have any questions, Mr. Chairman.

[Laughter.]

Chairman KING. Again, I want to thank the panel for your testimony today. I believe there is consensus for reauthorization. As Mrs. Maloney mentioned, there have been questions raised by some Members and some Senators, but mostly there is strong bipartisan consensus for reauthorization.

With that, I would thank you for your testimony today. Members may have additional questions for the panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for those Members to submit written questions to the witnesses and place their responses in the record.

The hearing is adjourned.

[Whereupon, at 3:30 p.m., the hearing adjourned.]

A P P E N D I X

June 13, 2001

Statement of
Honorable David Oliver
on the
Reauthorization of the Defense Production Act
before the
Subcommittee on Domestic Monetary Policy, Technology, and Economic Growth
House Committee on Financial Services
June ~~12~~ 13, 2001

Good morning, Mr. Chairman and members of the committee. I appreciate the opportunity to share with you the Department of Defense (DoD) views regarding the Defense Production Act (DPA) and the role it plays in helping to obtain the goods and services needed to promote the national defense. Although enacted originally in 1950, the Act provides statutory authorities still relevant and necessary for the national defense in the 21st century. I also want to express the Administration's support for reauthorizing the Act through September 30, 2004.

Let me start by saying a few words on why the Defense Production Act is important to the Department of Defense. A strong domestic industrial and technology base is one of the cornerstones of our national security. The Act provides the DoD tools required to maintain a strong base that will be responsive to the needs of our armed forces. It provides the President the authority to (1) establish, expand, or maintain essential domestic industrial capacity; (2) direct priority performance of defense contracts and allocate scarce materials, services, and industrial facilities; and, suspend or prohibit a foreign acquisition of a U.S. firm when that acquisition would present a threat to our national security. The authorities in this Act continue to be of vital importance to our national security.

My testimony today focuses on the three remaining provisions of the original Defense Production Act, namely Title I, Title III, and Title VII.

Title I

Title I (Priorities and Allocations) of the DPA provides the President the authority to:

1. require preferential performance on contracts and orders, as necessary, to meet approved national defense and emergency preparedness program requirements; and

2. allocate materials, services, and facilities as necessary to promote the national defense in a major national emergency.

Executive Order 12919 delegates these authorities to the Federal Departments and Agencies. The Department of Commerce (DoC), is delegated responsibility for managing industrial resources. To implement this authority, DoC administers the Defense Priorities and Allocations System (DPAS). The DPAS:

1. establishes priority ratings for contracts;

2. defines industry's responsibilities and sets forth rules to ensure timely delivery of industrial products, materials and services to meet approved national defense program requirements; and

3. sets forth compliance procedures.

The DoC has delegated to DoD authority under the DPAS to:

1. apply priority ratings to contracts and orders supporting approved national defense programs. (However, DoD is precluded from rating orders for end items that are commonly available in commercial markets and for items to be used primarily for administrative purposes, i.e., office computers); and

2. request DoC provide Special Priorities Assistance (SPA) to resolve conflicts for industrial resources among both rated and unrated (i.e., non-defense) contracts and orders; and to authorize priority ratings for allied nation defense orders in the United States when such authorization furthers U.S. national defense interests.

Except as noted above, all DoD contracts are authorized an industrial priority rating. DoD uses two levels of rating priority, identified by the rating symbols "DO" or "DX." All DO rated orders have equal priority with each other and take preference over unrated orders. All DX rated orders have equal priority with each other and take preference over DO rated orders and unrated orders. If a contractor cannot meet the required delivery date because of scheduling conflicts, DO rated orders must be given production preference over unrated orders and DX rated orders must be given preference over DO rated orders and unrated orders. Such preferential performance is necessary even if this requires the diversion of items being processed for delivery against lower rated or unrated orders. Although the DPAS is largely self-executing, if problems occur, the contractor or the DoD can request the DoC provide SPA to resolve the problem.

During peacetime, the DPAS is important in setting priorities among defense programs that are competing for scarce resources and backlogged parts and subassemblies. Delayed deliveries to producers of weapon systems have consequences in terms of system cost and ultimately on the readiness of operational forces. DPAS gives DoD an opportunity to prioritize deliveries and minimize cost and schedule delays among DoD orders and for allied nation defense procurements in the United States. For example:

1. U.S. DoD: Production resource conflicts for canopy transparencies from Sierracin Aerospace impacted program schedules for the F-22, F-18A/B/C/D, and F-18E/F aircraft. Navy and Air Force DPAS and program office personnel met with the contractor, evaluated production resource shortfalls and delivery conflicts, and made delivery modifications that minimized program delays.

2. NATO: The German and Belgian Air Force, on behalf of NATO's Tactical Leadership Program, were unable to obtain global positioning system navigational processors from Rockwell Collins in a timely manner, adversely impacting pilot training. DoD/DoC

authorized ratings authority that enabled the contracts to be filled in advance of lesser priority US DoD orders.

3. United Kingdom (U.K.): GKN Westland Helicopters experienced delays in receiving identification friend or foe transponders from Raytheon Systems Company that were needed for U.K. WAH-64 Apache helicopters. DoD/DoC authorized GKN Westland to use a DO rating priority that permitted Raytheon to ship the transponders sooner than would have been possible without the rating authority, which allowed and permit GKN Westland to meet its production delivery requirements to the U.K. Ministry of Defence.

In the event of conflict or contingency, however, the DPAS becomes indispensable. While DoD has used Title I since the 1950s, recent history, including that associated with Operation Desert Shield/Storm, Bosnia, and Kosovo, illustrates its continued importance. Title I authorities proved invaluable during Operation Desert Shield/Storm and ensured that industry provided priority production and shipment of essential items urgently needed by the coalition forces. At the request of DoD, DoC formally took action to provide SPA in 135 cases during Operation Desert Shield/Desert Storm. For example:

1. Global Positioning System Receivers: When demand for these receivers outstripped the capacity of suppliers, DoD/DoC used DPAS to expedite shipments and to provide available systems to units in the coalition force that had the most urgent requirement.

2. Activated Charcoal for Gas Masks: When the demand for activated charcoal filters for gas masks outstripped the production capacity of Calgon Corporation (the sole producer of activated charcoal filters for military use gas masks), DoD/DoC used DPAS to direct Calgon to ship all charcoal filters produced to meet military requirements.

3. Search and Rescue Radios: Motorola, the producer of these radios, had closed its production line and anticipated it would take several months to restart production; vendor supply of component parts was the pacing item. Using its DPAS authority, DoC worked with Motorola's supplier base and reduced the time to restart production of the radios by more than half.

Even more recently, since 1995, DoD/DoC has used SPA on more than 100 occasions to resolve industrial conflicts among competing U.S. defense orders and to permit NATO and specific allied nations to obtain priority contract performance from U.S. suppliers. These SPA cases can be categorized in two ways:

1. Wartime vs. Peacetime Support: Sixty-eight percent of the cases supported "wartime" needs (fifty percent Bosnia and eighteen percent Kosovo) for items such as Satellite Communication (SATCOM) and walkie-talkie radios, secure facsimile machines, Joint Direct Attack Munitions (JDAMs), and computer equipment for NATO command and control infrastructure. Thirty-two percent of the cases supported "peacetime" requirements.

2. U.S. vs. non-U.S. Support: thirty-seven percent of the cases supported U.S. defense requirements (thirty-two percent for DoD and five percent for defense-related activities of

NASA, NSA, and the FBI), forty-seven percent for NATO (NATO monies used), nine percent for the United Kingdom, three percent for Canada. In addition, there were two cases for Israel, and one case each for Japan and Germany.

The authorities contained in Title I that permit DoD to provide preferential treatment for foreign defense orders in the United States when such treatment furthers U.S. national defense interests are increasingly important. Among the consequences of globalization and industrial restructuring are the creation of multinational defense companies and an increasing degree of mutual defense interdependence. Reciprocal industrial priorities systems agreements with our allies encourage them to acquire defense goods from U.S. suppliers, promote interoperability, and simultaneously provide increased assurance that the DoD's non-U.S. defense suppliers will be in a position to provide timely supplies to DoD during both conflict/contingency situations and peacetime.

Such reciprocity considerations have been a topic of discussion within NATO for some time. The DoC has the U.S. lead to develop and negotiate a NATO-wide agreement to provide reciprocal priorities support within the alliance.

In addition to a NATO-wide agreement we are exploring formal *bilateral* agreements with key allies of the United States. These provide an opportunity to establish stronger government-to-government agreements for reciprocal priority support, more quickly. The United States has a longstanding bilateral priorities support agreement with Canada. Within the past year, DoD representatives have had discussions about such bilateral agreements with United Kingdom, German, French, Italian, Dutch, Norwegian, and Swedish government representatives. As a matter of fact, DoD and United Kingdom Ministry of Defence representatives now are negotiating a formal bilateral agreement that would commit each nation to establish and maintain a reciprocal priorities system; and provide the other nation reciprocal access to that system.

DPA Title I provisions are an important tool in DoD's arsenal. It would be very difficult for DoD to meet its national security responsibilities without that tool.

Now, I will turn my attention to Title III of the Defense Production Act.

Title III Program

The primary objective of the Title III Program is to work with U.S. industry to strengthen our national defense posture by creating or maintaining affordable, and economically viable production capabilities for items essential to our national security. The Title III Program meets this objective through the use of financial incentives to stimulate private investment in key production resources. These incentives include sharing in the costs of capital investments, process improvements and material qualification, and providing when necessary, a purchase commitment that will ensure a market for their product. Through these incentives, domestic industry is encouraged to take on the business and technical risks associated with establishing a commercially viable production capacity.

The focus of the Title III Program is on the transition of emerging technologies that will

provide technological superiority on the battlefield and support defense wide programs. The Title III partnership with industry ensures DoD access to critical technologies, usually much sooner than would otherwise occur.

In addition to establishing production capacity, Title III helps to improve the quality, and reduce the acquisition and life cycle cost of defense systems and improves defense system readiness and performance by promoting the use of higher quality, lower cost, technologically superior parts and components.

By law, Title III projects cannot be initiated until a presidential determination has been made and Congress has been notified. The presidential determination verifies that

1. the material shortfall being addressed by the Title III project is essential for national defense;
2. domestic industry can not or will not on their own establish the needed capacity in a timely manner
3. Title III is the most cost effective or expedient method for meeting the need; and
4. defense and commercial demand exceed current domestic supply.

Our recent report to Congress entitled "Annual Industrial Capabilities Report to Congress" (January 2001) affirmed Title III's unique importance as one of the programs we execute to maintain our industrial readiness. Title III is a key element in our Industrial Capabilities Improvement Activities.

Title III Projects

Title III projects transition new materials and technologies from research and development to production. In other words, these projects reduce the costs and facilitate the insertion of advanced technologies by improving the capabilities of our defense industrial base.

Without a program like Title III, the insertion of these technologies would be delayed for many years. Title III reduces this time by first, eliminating market uncertainties and reducing risks that discourage potential producers from creating new capacity and potential users from incorporating new materials in their products. Second, Title III financial incentives create more efficient, lower cost production capabilities which reduces prices and increases demand. Third, Title III projects generate information about the performance characteristics of new materials and promote dissemination of this information to the design community, which would otherwise lack sufficient knowledge to incorporate these materials into defense systems. Fourth, Title III projects support testing and qualification of new materials in defense applications, reducing the delay and cost that might otherwise discourage consideration of new materials by defense programs.

Current Program

There are currently eight active Title III projects and DoD is initiating a new thrust into radiation hardened electronics. This initiative will establish a domestic production capacity for

radiation hardened, high-performance electronics materials and components to support the National Missile Defense Program and other strategic space systems.

These projects, plus recently completed projects, address a variety of advanced materials and technologies. These include:

1. electronic materials and devices, such as gallium arsenide, indium phosphide, high-purity silicon, silicon carbide, silicon on insulator, and power semiconductor switching devices;
2. structural materials, including discontinuous reinforced aluminum, aluminum metal matrix, and titanium metal matrix composites.

The advanced electronic materials supported by Title III are enabling technologies, without which potential advances in microelectronics would be far more limited. These materials offer advantages in terms of faster device performance, greater resistance to radiation and temperature, reduced power requirements, reduced circuit size, increased circuit density, and the capability to operate at higher frequency levels. Advances in electronic materials enable new capabilities for defense systems and improvements in old capabilities.

The new structural materials supported by Title III generally offer significant improvements in terms of strength, weight, durability, and resistance to extreme temperatures. These benefits are particularly important in aerospace applications. Lighter-weight components in aircraft and missiles reduce fuel consumption and increase range, payload, and maneuverability. Increased durability and reliability of aircraft structures reduce inspection, maintenance, repair, and replacement requirements, improve force readiness, and extend system life. Increased strength and enhanced resistance to extreme temperatures enable more powerful engines that increase speed and payload. Continued advances in aerospace technologies would be severely constrained without improved materials to enable these advances.

Title III Success Stories

Two recent Title III projects highlight the benefits of the program.

Gallium Arsenide Wafers

The first was for gallium arsenide semi-insulating wafers. Gallium arsenide is a semiconducting material used in the fabrication of advanced electronic devices. It provides advantages in terms of speed, power consumption, cost, and reliability over more commonly used semiconductor materials, such as silicon. It is also resistant to radiation and is routinely used in "hardened" electronic devices. Electronic devices built on gallium arsenide semiconductors are enabling technologies for a wide variety of defense weapon systems, including radars, smart weapons, electronic warfare systems, and communications. These semiconductors can be found in such systems as the Airborne Early Warning/Ground Integration System (AEGIS), the B-2 Bomber, the Longbow Apache helicopter, fighter aircraft (including F-15, F-16, F-18, and F-22), missiles (including Patriot, Sparrow, and Standard), and various radar systems.

At the outset of this Title III project, the long-term viability of U.S. gallium arsenide wafer supplier base was in doubt. Foreign firms dominated the industry with a seventy-five percent world market share. U.S. firms were discouraged from competing more vigorously by the relatively small market for these wafers, by the dominant market position of the foreign suppliers, and by the high capital investment required to remain competitive in this market. Foreign firms controlled pricing, availability, and the pace of technological advancement.

With the help of Title III, the U.S. producers made a dramatic turnabout. By 2000 these contractors accounted for sixty-five percent of wafer sales worldwide. Their combined sales of gallium arsenide wafers grew by nearly four hundred percent. In addition, wafer prices dropped by approximately thirty five percent. This reduction in wafer prices and improvement in wafer quality resulted in significant reductions in defense costs for critical electronics. More importantly, the performance of dozens of major defense systems was enhanced through the use of gallium arsenide semiconductors.

Gallium arsenide components can also be found in a variety of commercial wireless applications such as cellular phones, direct broadcast television and collision avoidance radar.

Discontinuous Reinforced Aluminum Project

The second Title III project involved Discontinuous Reinforced Aluminum (DRA). This project was also successful, in terms of reduced defense costs, accelerated use of a superior material in defense applications, and improved domestic production capabilities for a high-tech material. DRA is a metal matrix composite that is significantly stiffer, stronger, lighter weight, more wear-resistant and more dimensionally stable than aluminum alloys and many other composite materials. This material has potential applications in virtually every type of aircraft, missile, and armored vehicle.

Prior to the Title III initiative, DRA was produced only in small quantities at high cost. When this Title III project was completed, domestic production capacity was increased by more than one hundred fifty percent and the price was reduced by sixty percent from $40 per pound to less than $16 per pound. The reduced price and improved qualities stimulated a substantial increase in demand for this material. DRA is currently being used for F-16 Fighter airframe and engine parts. Use of DRA for the F-16 ventral fin has increased the mean time between failure rate for this structure from 1,450 hours to over 6,000, and will save $60 million in maintenance and repair costs for the F-16 fleet. The savings for this one defense system alone are triple the Title III investment. Pratt & Whitney has forecasted savings of $100 million over the next ten years from the use of DRA in aircraft engine parts. DRA also flies on the Boeing 777, forming the Fan Exit Guide Vanes in its Pratt & Whitney 4000 engines.

New Projects

During the last year, we began three new projects involving silicon on insulator wafers, laser eye protection, and microwave power tubes.

Silicon-on-Insulator (SOI) Wafer technology, like other semiconductor materials targeted by Title III, offers enhanced performance capabilities, including greater resistance to radiation, reduced power consumption, and faster device performance. The goals of this project are to create a domestic, source for SOI wafers, to improve wafer quality and reduce wafer cost. This will promote insertion of SOI devices into defense systems and expand potential applications to include telecommunications, laptop computers, and automotive and medical diagnostic and control equipment.

The **Laser Eye Protection (LEP)** project is establishing a large volume, domestic production capacity for near-infrared filters on laser eye protection spectacles and goggles. The modern battlefield is seeing increased use of lasers for target designators, range finders, and target illuminators by both friendly and unfriendly forces. Exposure of the eye to these lasers can cause harm ranging from temporary disorientation to permanent blindness. Over ninety-nine percent of the lasers currently fielded operate in the near-infrared spectrum. Spectacles and goggles with thin-film dielectric near-infrared filters are the best way to protect personnel from the accidental or purposeful exposure to these lasers. Without this project this protection will not be available in a timely manner to our forces in the field.

The **Microwave Power Tubes** Supplier Base Initiative addresses critical components and materials used in the manufacture of microwave power tubes (MPT). MPTs are vital to the operations of military radar, electronic counter measures, communication systems and satellites. The project goal is to maintain a supplier base for critical components used in the manufacture of MPTs. This project will drive down the production and life cycle costs of MPTs to the DOD, while ensuring continued long-term supply of these critical components. The future effectiveness of U.S. military forces is dependent on access to affordable high power microwave power tubes.

Title VII

Title VII contains general provisions including authorization of appropriations, termination of authorities, definitions, and enforcement, as well as a number of other authorities relating to the defense industrial base and emergency preparedness. Section 721 is of particular importance to DoD.

Section 721 allows the President to suspend or prohibit a foreign acquisition of a U.S. firm when that transaction would present a credible threat to the national security of the U.S. and remedies to eliminate that threat are not available under other statutes. Administration of this section has been delegated to the Committee on Foreign Investment in the U.S. (CFIUS) which is chaired by the Department of the Treasury and includes the departments of Defense, Commerce, State, and Justice as well as several organizations in the Executive Office of the President.

The DoD considers the CFIUS review to be an essential and effective process for analyzing the national security implications of foreign acquisitions of U.S. companies and resolving issues related to these transactions. While the DoD has its own Industrial Security regulations which are used to review foreign acquisitions and provide a regulatory basis for

imposing measures to reduce the risk of unauthorized disclosure of classified information and controlled technology, CFIUS is important in several ways:

First, the DoD Industrial Security regulations which control the granting of facility clearances generally apply only to firms with classified contracts. Therefore, they do not normally cover transactions in which dual use firms with export controlled but unclassified technology are acquired by a foreign firm.

Second, the initial CFIUS review has a 30-day deadline which facilitates an efficient DoD review under its Industrial Security regulations because the Department does not want to approve a transaction under CFIUS unless adequate risk mitigation measures have been agreed to under the Industrial Security regulations.

Third, the CFIUS process is structured to require explicit determinations which are not part of the Industrial Security review. These include whether the acquired firm possesses critical defense technology under development or is "otherwise important to the defense industrial and technology base" as well as development and distribution of a Risk of Technology Diversion Assessment by the intelligence community.

Fourth, the CFIUS review is an interagency process which allows all Federal departments to coordinate their analyses of the national security implications of a review and balance risks of disclosure against the benefits of foreign investment.

The DoD believes the CFIUS review process is working well. The effectiveness of the CFIUS process should be judged on the quality of the risk mitigation measures which the various CFIUS members, including DoD, negotiated during the review process. The threat of a Presidential Investigation prohibiting the transaction is a major incentive for the firms to agree to the risk mitigation measures in a timely fashion. These mitigation measures can include a Special Security Agreement which imposes DoD-approved outside directors, visitation requirements, export licensing compliance procedures and Technology Control Plans as well as National Interest Determinations where the acquired firm holds contracts with Proscribed Information. Other mitigation measures are available under the DoD's Industrial Security regulations as well as the export licensing regulations of the Departments of Commerce and State. CFIUS has provided a timely review of the national security implications of 1,358 foreign acquisitions of U.S. firms since the enactment of section 721 in 1988.

Extension of the DPA

As you know, most provisions of the Defense Production Act are not permanent law and must be renewed periodically by Congress. The Act has been renewed many times since it was first enacted. The current law will expire September 30, 2001. We fully support reauthorizing the Defense Production Act through September 30, 2004.

Conclusion

In summary, the DoD needs the Defense Production Act. It contains authorities that exist no where else and I hope that I have conveyed to you the significant role those authorities play in ensuring our nation's defense.

Thank you for the opportunity to discuss the DPA with you today. We look forward to working with you to ensure a timely reauthorization of the DPA.

Statement of Kenneth I. Juster
Under Secretary for Export Administration
Department of Commerce
before the
Subcommittee on Domestic Monetary Policy,
Technology, and Economic Growth
of the
Committee on Financial Services
U.S. House of Representatives

June 13, 2001

Mr. Chairman, Congresswoman Maloney, and Members of the Subcommittee:

I appreciate the opportunity to testify on the reauthorization of the Defense Production Act, which expires on September 30 of this year.

For more than fifty years, the Defense Production Act (DPA) of 1950, as amended (50 U.S.C. App. 2061, et seq.), has enabled the President to ensure our nation's defense, civil emergency preparedness, and military readiness. The DPA provides the statutory framework that will enable the Administration to meet future threats to our national security in light of a streamlined armed forces, a consolidated defense industrial base, and a globalized economy.

I will focus my comments on the DPA authorities that are relevant to the Department of Commerce. The Department of Commerce plays several roles in implementing those DPA authorities that relate to the defense industrial base. First, under Title I of the DPA, the Department administers the Defense Priorities and Allocations System. Second, under Title III, the Department reports on defense trade offsets. Third, under Title VII, the Department analyzes the health of U.S. defense industrial base sectors. And fourth, also under Title VII, the Department plays a significant role in analyzing the impact of foreign investments on the national security of the United States. I will briefly discuss each of these roles.

I. Defense Priorities and Allocations System

The Defense Priorities and Allocation System (known as "DPAS") has two purposes. First, it ensures the timely availability of products, materials, and services that are needed to meet current national defense and emergency preparedness requirements with minimal interference to the conduct of normal business activity. Second, it provides an operating structure to support a timely and comprehensive response by U.S. industry in the event of a national security emergency.

Under Executive Order 12919, the Department of Commerce administers this system in accordance with the priorities and allocations provisions of the DPA. Those provisions provide authority for requiring U.S. companies to accept and perform contracts or orders necessary to

meet national defense and civil emergency needs. They also provide authority for managing the distribution of scarce and critical materials in an emergency.

The DPAS is not used solely for defense items and military crises. It also may be implemented to meet urgent requirements for energy and law enforcement programs. Under the DPAS, the Department of Commerce delegates the authority to use the system to obtain critical products, materials, and services as quickly as needed by several federal agencies, including the Departments of Defense and Energy. To implement this authority, the Department of Defense and the other agencies -- called Delegate Agencies -- place what are known as "rated orders" on essentially all procurement contracts with industry. The prime contractors, in turn, place "rated orders" with their subcontractors for parts and components down through the vendor base. The "rated orders" notify the contractors that they are accepting contracts with the U.S. government that must be given priority over unrated orders to meet the delivery dates of the rated orders.

In the vast majority of these cases, the procuring federal agency and the contractor quickly come to mutually acceptable terms for priority production and delivery. If the company and the delegated federal agency cannot reach such agreement, the Department of Commerce, as the primary liaison with U.S. industry, plays a crucial role in resolving the issue. The Department provides "Special Priorities Assistance" to resolve critical production bottlenecks for many military and national emergency requirements.

I would like to share some examples of the Department's work in this important area.

A. Operation Desert Shield and Desert Storm

One of the best examples of the Commerce Department's work was its support of U.S. and allied requirements for Operation Desert Shield and Desert Storm in 1990-1991. The Commerce Department worked closely with U.S. industry and the Department of Defense on 135 Special Priorities Assistance cases to assure timely delivery of critical items, such as avionics components for aircraft, precision guided munitions, communications equipment, and protective gear for chemical weapons. Due to the Commerce Department's involvement, in the majority of cases delivery schedules were reduced from months to weeks or from weeks to days.

B. Coalition Action in the Balkans

The North Atlantic Treaty Organization (NATO) coalition action in the Balkans resulted in a number of instances of industrial bottlenecks for critical equipment. Starting in 1993 and continuing through 2000, the Department of Commerce worked 73 Special Priorities Assistance cases in support of U.S. forces, allied forces, and NATO command and control requirements. Although most of these cases pertained to NATO acquisition in the United States of communication and computer equipment, Special Priorities Assistance under DPAS also was used to expedite the production and delivery of such military items as antennas, positional beacons, and precision guided munitions for both U.S. and allied forces.

C. Federal Bureau of Investigation

In 1995, the Federal Bureau of Investigation (FBI) urgently required delivery of special communications equipment to meet the needs of a critical and classified national defense related anti-terrorist law enforcement program. Accordingly, Commerce staff worked with four contractors and their lower tier vendors to achieve timely delivery of parts and components to meet the FBI deployment requirement in the face of conflicting customer demands.

D. United Kingdom's Royal Air Force (RAF) Apache Longbow Helicopters

The Commerce Department's involvement in the DPAS supports not only the requirements of U.S. armed forces, but also the requirements of our allies. The Department is currently working with U.S. industry, the Department of Defense, and the United Kingdom's Ministry of Defence to meet a Royal Air Force requirement for Apache Longbow helicopters. Without the DPAS, U.S. firms supplying transponders and Hellfire missile launchers would not be able to meet RAF requirements while also meeting urgent U.S. Army requirements. It is important to note that the Department of Commerce will not take action on behalf of an allied government unless the Department of Defense determines it is in the U.S. national interest to do so.

As demonstrated by these examples, the DPAS provides the means for clearing any commercial bottlenecks that might otherwise interfere with meeting the critical production and service requirements of the U.S. armed forces, other Federal agencies, NATO, and our close allies.

II. Defense Trade Offsets

Pursuant to Section 309 of the DPA, the Department of Commerce provides Congress with an annual report on the impact of offsets in defense trade. Defense trade offsets are industrial compensation practices required as a condition of purchase in either government-to-government or commercial sales of defense articles and/or services, as defined by the International Traffic in Arms Regulations. For example, a foreign government may agree to purchase fighters from an American company but could insist that the engines for the jets be produced in the foreign country using local suppliers. We believe that offsets are economically inefficient when the foreign customer is basing the purchase decision on something other than the quality of the product or service being provided. Furthermore, offsets do a disservice to the defense supplier base in the United States by transferring work and technology overseas.

The Department of Commerce's annual report on defense trade offsets has become an integral part of the U.S. government's effort to monitor this critical issue for the U.S. defense industry. On the basis of the trends that we have identified through these reports, a Presidential Commission has been established to investigate more formally the economic and competitiveness effects of offsets on U.S. prime contractors and their suppliers.

III. Defense Industrial Base Studies

Under Section 705 of the DPA and Executive Order 12656, the Department of Commerce conducts analyses and prepares reports on individual sectors of the defense industry. These studies are either self-initiated or requested by the Armed Services, Congress, or industry. Using these industrial base studies, the Departments of Commerce and Defense can, for example, measure industry capabilities in an area such as shipbuilding or measure industry dependence on foreign components in U.S. weapons systems. The studies provide a comprehensive view of specific sectors within the U.S. defense industrial base, and they gauge the current capabilities of these sectors to provide defense items to the U.S. military services. The studies provide detailed data that are unavailable from other sources.

To give you a recent example of one of these studies, the Department of Commerce is about to release a detailed assessment of the shipbuilding and repair industry in the United States. This is one in a series of analyses related to the maritime industry that were requested by the U.S. Navy. We understand that the Navy is very pleased with the quality and thoroughness of the report and looks forward to future cooperative efforts. In another instance, the U.S. Air Force requested the Commerce Department to conduct an assessment of the ejection seat sector in the United States. Several of the recommendations in that report have been implemented by the Air Force and industry.

IV. Committee on Foreign Investment in the United States (CFIUS)

The Committee on Foreign Investment in the United States (known as "CFIUS") was originally established by Executive Order 11858 in 1975. The Department of Commerce is an integral member of CFIUS. In 1988, the President, pursuant to Executive Order 12661, delegated to CFIUS certain of his responsibilities under Section 721 of the DPA (known as the "Exon-Florio" provision). Exon-Florio provides for a national security review of foreign mergers and acquisitions of U.S. companies. The Committee, which is chaired by the Department of the Treasury, implements Exon-Florio in the context of an open investment policy. The intent of Exon-Florio is to provide a mechanism to review and, if the President finds necessary, to suspend or prohibit a foreign direct investment that threatens the national security, but not to discourage foreign direct investment generally. The Department of Commerce's contribution to the CFIUS process includes providing a defense industrial base and export control perspective to the CFIUS reviews. In the last year, there have been several contentious CFIUS cases. Although I cannot discuss the details of these cases because of the confidentiality extended to CFIUS reviews by Exon-Florio, the Department of Commerce was actively involved in each of the reviews, focusing particular attention on the national security impact of the acquisition. In this period of rapid globalization, continuation of this interagency review process is vital.

* * *

In sum, the DPA provides authority for a variety of programs at the Department of Commerce. My remarks illustrate the importance of the DPAS not only to our military services, but also to NATO and our close allies that operate our weapons systems. The Department of Commerce, in its role of primary liaison to U.S. industry, has been able, through DPAS, to ensure timely delivery of products and services essential to U.S. and allied forces.

The DPA also affords the Department of Commerce the opportunity to assess fully the economic efficiency of defense trade offsets and the national security implications of international consolidation of the defense trade industry. In addition, the DPA enables the U.S. government to monitor the U.S. defense industrial base in this era of globalized markets, coalition military campaigns, and electronic battlefields.

For all these reasons, the Department of Commerce fully supports extending the Defense Production Act for at least a three-year period.

Thank you.

STATEMENT OF ERIC J. FYGI

DEPUTY GENERAL COUNSEL

DEPARTMENT OF ENERGY

BEFORE THE

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY, TECHNOLOGY, AND ECONOMIC GROWTH

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

JUNE 13, 2001

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee in response to its request for testimony by the Department on the reauthorization of the Defense Production Act of 1950. The Subcommittee's invitation letter requests the Department to address, in particular, the Defense Production Act's energy-related authorities and their past use and ways in which those could be useful in meeting future energy needs of the country.

It would be helpful in addressing these topics to describe the most recent use of the Defense Production Act in responding to an energy crisis situation. I am referring to the Department's use, as directed by former President Clinton, of the Defense Production Act in responding to actual and threatened interruptions of natural gas supplies in northern and central California in January of this year.

The circumstances that gave rise to the interruption of natural gas supplies in northern and central California actually began with the cumulative effects of electricity sales within the State under California's 1996 electricity restructuring legislation. Under that structure State-regulated electric utilities were required to sell electricity to their customers at frozen rates that could not be adjusted upward to reflect increased acquisition costs of wholesale electric power. At the same time, the State required Pacific Gas and Electric Company ("PG&E") and other State-regulated electric utilities to purchase their electricity supplies in the day-ahead or real time spot

market (in contrast to long-term contracting, which permits hedging), provided for partial divestiture of the utilities' fossil generation assets, and required utilities to sell their electricity into the Power Exchange rather than use it to serve their customers. In addition, growth in electricity demand far outpaced growth in electricity supply. Between 1996 and 1999, demand in California rose 5,500 MW, while supply rose only 670 MW. This combination of factors put the utilities in the position of buying wholesale power for as much as 30 cents per kilowatt-hour, while only being allowed to sell it for 3 cents.

Beginning in May 2000, State-regulated electric utilities began to accumulate huge debts in the form of unrecovered wholesale power costs as a result of the rate freeze. These unrecovered wholesale power costs significantly weakened the financial health of the utilities and, in many cases, the utilities approached insolvency. PG&E's debts alone totaled $6.6 billion.
The reluctance of electricity generators and marketers to sell to PG&E and Southern California Edison, the other major State-regulated electric utility that accumulated large unrecovered wholesale power costs, deepened as the financial condition of the utilities worsened. In order to prevent loss of electricity supplies to the customers of the utilities, then-Secretary of Energy Richardson issued an emergency order under the Federal Power Act on December 14, 2000, directing certain electricity generators and marketers to continue to sell electricity upon request by the California Independent System Operator, a nonprofit corporation established by the 1996 California electricity restructuring law charged with operation of the transmission system and assuring system reliability in California. This type of emergency order ultimately was extended

to 3:00am EST on February 7, 2001.

The poor financial condition of PG&E also led some natural gas suppliers to terminate sales to the utility, out of concern that the losses the utility was incurring in its electricity operations would lead to insolvency, notwithstanding the fact that PG&E's gas operations themselves could recover costs under its tariff. Unlike Southern California Edison, PG&E is both a gas and electric utility. On January 9, 2001, one supplier, which supplied approximately 14 percent of PG&E's core gas supplies, terminated sales to PG&E. Other gas suppliers soon followed suit and still others threatened to stop deliveries absent prepayments or credit guarantees. About 25 percent of PG&E's January baseload supply of natural gas was terminated and substantial additional volumes were threatened.

PG&E serves 3.9 million "core" gas customers in California, both residential consumers and small businesses. PG&E also transports natural gas to about 5,000 "noncore" customers, including industrial consumers and electricity generators. If PG&E experienced a shortage in gas deliveries, it would have to increase withdrawals from gas already in storage and divert gas from noncore customers. Diversion from noncore customers would exacerbate the California electricity shortage, since two-thirds of PG&E's noncore gas is used for electricity generation.

PG&E and Southern California Edison first sought redress at the State level by applying to the California Public Utilities Commission for retail electricity rate increases. On January 4, 2001,

the California Public Utilities Commission increased retail electricity rates by a surcharge of one cent a kilowatt-hour among its classes of customers. It did so for a period of 90 days, and did not otherwise alter the rate freeze under which PG&E and Southern California Edison were operating. PG&E also sought action from the State to prevent a loss of gas supplies. PG&E asked the California Public Utilities Commission for emergency authorization to draw on the gas supplies of the other major gas utility in the State. The California Public Utilities Commission never acted on this request.

On January 10, 2001, PG&E and its parent filed a Form 8-K with the Securities and Exchange Commission in which they announced suspension of dividend payments and postponement of release of financial results for the fourth quarter of 2000. The stated reason for postponing release of financial results was that the outcome of then on-going State and Federal efforts involving the California electricity market could result in measures that "significantly and adversely affect" PG&E Corporation's financial results.

Beginning the first week in January, the Department was advised by PG&E's General Counsel that debt rating agencies had reacted negatively to the California Public Utilities Commission's January 4 Order, and that if PG&E's outstanding debt were reduced to junk status that event would constitute a default under PG&E's various natural gas supply contracts. Were that event to occur it would accelerate the payment obligation of all of PG&E's natural gas supply contracts. While we understood that at the time PG&E had acquiesced in pre-paying some of its

natural gas suppliers, the normal payment schedule of PG&E was that its contracts required payment in full on the 25th day of each month for the entire prior month's deliveries of natural gas to PG&E for sale to its gas customers. While PG&E's tariff with the California Public Utilities Commission enabled it to recover the full amount of increased acquisition costs for natural gas resold by PG&E (unlike the case for electricity), because of PG&E's precarious operating revenue posture stemming from the electricity market, PG&E indicated that it could not continue to purchase the needed volumes of natural gas if it were required to pre-pay for them.

At about the same time, beginning January 9, 2001, then-Treasury Secretary Summers and then-Energy Secretary Richardson participated in extensive meetings that included the Governor of California, California legislative leaders and the President of the California Public Utilities Commission, the CEOs or Presidents of the major California electricity suppliers, and the CEOs of the California investor-owned utilities or their parents. While the objective of these meetings was to assist the State of California in formulating a solution to the evolving situation, no such solution was announced.

On January 12, 2001 the CEO of PG&E formally requested President Clinton to invoke emergency authorities in order to assure continuity of natural gas supplies through PG&E to its service territory in northern and central California. That letter was accompanied by an affidavit executed the same day by the Chief Financial Officer, Treasurer and Senior Vice President of PG&E that described in detail the circumstances giving rise to the threatened interruption of

natural gas supply through PG&E to northern and central California. On January 13, 2001 Governor Davis sent a letter to President Clinton in which the Governor described his inquiry into the circumstances, his finding that there was an "imminent likelihood that natural gas supplies in northern and central California will be interrupted," and requested the assistance of the President and the Secretary of Energy on an urgent basis.

On January 15, 2001 then-Deputy Energy Secretary Glauthier conducted a telephone conference that included operational executives of PG&E in order to ascertain further the logistical and operational circumstances that necessitated immediate action at the Federal level. On January 16, 2001 Reuters reported that Standard & Poor's had downgraded PG&E's debt to "low junk" status. President Clinton's instructions to the Secretary of Energy, and the Secretary of Energy's accompanying Order to PG&E and its natural gas suppliers, were issued on January 19, 2001. As the text of each document indicates, their issuance was based not only on the emergency provisions of the Natural Gas Policy Act of 1978, but also on the Defense Production Act of 1950. I now turn to the reasons that prompted the Department to formulate this approach.

When it appeared in early January that it might prove necessary to formulate emergency orders for continued delivery of natural gas through PG&E, we first examined the emergency provisions of the Natural Gas Policy Act of 1978, 15 U.S.C. 3361 - 3364. Those provisions appeared useful in that they authorized designation of continued use of natural gas for electricity generation as a "high-priority use" in an emergency, and authorized specification by the Federal Government of the "terms and conditions" including "fair and equitable prices" for natural gas delivered under

an order. The ability to determine that continued use of natural gas was a "high-priority use" under the Natural Gas Policy Act was quite important because, without such Federal action, under California law, any reduction in gas volumes available to PG&E as merchant impairing its ability to serve its "core customers" (residences and small businesses) would result in mandated redirection of gas volumes delivered through PG&E (but not owned by it) destined for non-core customers, including most significantly electricity generators. Were such redirection to occur it would have further reduced the volumes of natural gas available for electricity generation in California.

Despite the technical utility of section 302 of the Natural Gas Policy Act, 15 U.S.C. 3362, in these respects, we remained concerned that it only would "authorize" purchase, rather than also to require deliveries, of natural gas to enable PG&E to continue to distribute sufficient volumes of natural gas. During January PG&E advanced arguments asserting that the allusion to an "order" in section 302 suggested that it embraced an ability to impose a supply mandate. Based on textual analysis of the Natural Gas Policy Act we remained unpersuaded on this point. In forming our view of this question we also consulted with an attorney of the Federal Energy Regulatory Commission who had been designated by the Commission's General Counsel to aid us in our examination of this question. Our textual analysis coupled with that of the Federal Energy Regulatory Commission attorney, together with our understanding of the provenance of section 302 as having had the original objective simply of permitting emergency sales into interstate commerce by non-jurisdictional gas producers without becoming thereby subject to then-existing wellhead price controls, prompted us to conclude that the Natural Gas Policy Act's

emergency provisions, standing alone, would not suffice if the Federal Government were to mandate continuity of natural gas deliveries through PG&E to all of its service territory in northern and central California.

We then considered whether the Defense Production Act provided the authority to complement the emergency provisions of the Natural Gas Policy Act such that the entities (largely resellers and not producers) that had recently provided PG&E with natural gas could be directed to continue to make similar volumes available to PG&E. We concluded that the Defense Production Act would provide this authority.

Title I of the Defense Production Act authorizes the President to require the priority performance of contracts or orders in certain circumstances. Under section 101(a), 50 U.S.C. App. 2071(a), the President may require performance on a priority basis of contracts or orders that he deems "necessary or appropriate to promote the national defense." In determining what the national defense requires, it is clear the President may consider the potential impact of shortages of energy supplies. In the Energy Security Act Congress specifically designated energy as a "strategic and critical material" within the meaning of the Defense Production Act and also added language to its Declaration of Policy that establishes a link between assuring the availability of energy supplies and maintaining defense preparedness. The Defense Production Act's Declaration of Policy, 50 U.S.C. App. 2062(a)(7), states:

> [I]n order to ensure national defense preparedness, which is essential to national security, it is necessary and appropriate to assure the availability of domestic energy supplies for national defense needs.

PG&E's customer base in northern and central California includes a number of defense (including "space," as the term "defense" is defined in the Defense Production Act) installations and defense contractors that use natural gas and electricity and that clearly would be adversely impacted by interruption of natural gas service. Continuity of supply to these facilities was threatened in the same fashion as other industrial natural gas consumers in PG&E's service territory.

Section 101(c) of the Defense Production Act, 50 U.S.C. App. 2071(c), authorizes the President to require priority performance of contracts or orders for goods to maximize domestic energy supplies if he makes certain findings, including that the good is scarce and critical and essential to maximizing domestic energy supplies. In the situation existing in California in mid January, natural gas supplies would have become acutely scarce had the withholding by PG&E's suppliers continued and expanded to more suppliers than those that already had terminated deliveries. Moreover, continuity of natural gas supply is critical and essential in PG&E's service area to electric energy generation, petroleum refining, and maintaining energy facilities. These factors seemed directly to bear on the terms of section 101(c) of the Defense Production Act relating to continuity of energy production.

Accordingly, we structured the emergency natural gas order to include the supply obligation authorized by the Defense Production Act. Our understanding of the Defense Production Act regime was that it is broad enough to embrace mandates for priority performance of new orders to vendors, as well as priority performance of existing contracts. Thus this authority fit well in a transactional sense in which some vendors' contracts to supply gas might have expired by their terms just before the order.

This aspect of the Defense Production Act regime permitted the Department to impose a temporary supply assurance for natural gas to northern and central California comparable to that done with the electricity orders for the area of the State served by the California Independent System Operator by the Department's prior orders under section 202(c) of the Federal Power Act. The emergency natural gas order issued by former Secretary of Energy Richardson on January 19, 2001 and extended by Secretary Abraham on January 23, 2001, was directed just to the group of suppliers that had provided PG&E natural gas on commercial terms during the 30-day period prior to issuance of the order. This approach was chosen as the least intrusive means that would achieve the public health and safety and defense preparedness objectives of continuing for the near term natural gas supplies into PG&E's service area. The order is best understood as an emergency, temporary action designed to afford California the opportunity to abate the emergency by its necessary further actions.

As a result of the Department's emergency orders natural gas supplies continued to flow through

PG&E into northern and central California, averting a natural gas supply crisis. Despite the apprehensions about payment by PG&E that had prompted the threatened interruptions of natural gas deliveries, every natural gas supplier named in the emergency orders was paid in full by PG&E on the schedule required by those orders.

Prior to its use in the emergency natural gas supply orders described above, section 101(c) of the Defense Production Act was used in the late 1970's and again the in the 1980's and early 1990s to facilitate petroleum production development of the Alaskan North Slope.

Finally, you have asked me to address ways in which the Act's authorities could be useful in addressing future energy needs of the country. Whether the Defense Production Act authorities placed in the President might be useful in addressing energy needs of the country in the future would be highly fact-dependent. Because the Act's use would require a fact-dependent judgment, it would be difficult to predict whether circumstances might arise that would prompt the President to conclude that direct Federal action under this authority was warranted.

The Department fully supports extending these Defense Production Act authorities which have proven so useful in a variety of circumstances in making a contribution to the national security, including energy security, for three years.

This concludes my prepared statement. I will be pleased to respond to any questions the Subcommittee may have.

Statement of Michael D. Brown

General Counsel

Federal Emergency Management Agency

Before the Subcommittee on Monetary Policy,

Technology and Economic Growth

Committee on Financial Services

United States House of Representatives

June 13, 2001

Good afternoon, Mr. Chairman. I am Michael Brown, General Counsel of the Federal Emergency Management Agency. FEMA Director Joe M. Allbaugh asked me to represent him today, and regrets that he is unable to be here.

FEMA is pleased to appear before you today to discuss the reauthorization of the Defense Production Act—the Nation's major statute for mobilization readiness. As you know, the non-permanent provisions in Titles I, III, and VII will expire on September 30. The expiration of these provisions could have a severe impact on the Nation's emergency resource preparedness to meet threats to our national security—including a terrorist weapon of mass destruction. We may also need to use DPA authorities to respond to *catastrophic* civil emergencies.

The Administration views the possibility of such expiration as disruptive to ongoing programs under the Act. FEMA requests that a reauthorization of at least three years be considered by the Congress to ensure the continuation of these programs.

FEMA intends to carry out our responsibilities under Executive Order 12919. Specifically, the FEMA Director's delegated responsibilities for coordination and support under E.O. 12919 are to:

- Serve as an advisor to the NSC on DPA authorities and national security resource preparedness issues and report on activities conducted under the order;

- Provide central coordination of the plans and programs incident to the authorities under the order;

- Develop guidance and procedures under the DPA that are approved by the NSC;

- Attempt to resolve issues on resource priorities and allocations;

- Make determinations on the use of priorities and allocations for essential civilian needs supporting the national defense; and

- Coordinate the National Defense Executive Reserve (NDER) program activities of departments and agencies in establishing NDER units and provide guidance for recruitment, training and activation.

In implementing its responsibilities, FEMA supported the NSC in coordinating the updating of Executive Orders relating to the DPA and chairing an interagency effort resulting in the President's Report to the Congress on the Modernization of the Defense Production Act submitted in 1997. In 1997, FEMA aided the Federal Bureau of Investigation in obtaining equipment in their counter-intelligence role. We are currently developing new delegations for the FEMA Director to use DPA authorities in support of catastrophic emergencies when needed materials and services are not available in a timely fashion.

At the Federal level, FEMA is the lead agency for domestic consequence management. We work with other departments and agencies to ensure that the Federal Government is prepared to respond to the consequences or potential consequences of an incident as they relate to public health, safety, and property. DPA authorities are available to support consequence management—specifically those all-hazards emergency preparedness activities defined under Title VI of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

The term "emergency preparedness" means all those activities and measures designed or undertaken to:

- Prepare for or minimize the effects of a hazard upon the civilian population, such as procurement and stockpiling of materials and supplies;

- Respond to the hazard; and

- Recover from the hazard.

As you can see, the scope of these activities includes the preparedness, response and recovery phases of a disaster.

FEMA's new Office of National Preparedness will be coordinating and integrating Federal preparedness activities in support of developing and building the national capability to manage the consequences of a terrorist incident involving a weapon of mass destruction. As part of this integration effort, the Office will be looking at the range of available authorities that can support terrorism preparedness and response, to include DPA authorities, as appropriate.

In summary, FEMA is committed to fulfilling its coordination responsibilities under E.O. 12919. In addition, the DPA's linkage to the Stafford Act ensures the availability of needed resources when the Nation is facing a catastrophic disaster—whether natural or manmade.

I thank you for the opportunity to appear today. I would be pleased to answer any questions you may have.