

June 2002

DEFENSE LOGISTICS

Better Fuel Pricing Practices Will Improve Budget Accuracy



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G A O

Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

June 21, 2002

Congressional Committees

The Defense Working Capital Fund is the financial vehicle the Department of Defense (DOD) used to buy about \$70 billion in commodities in fiscal year 2001 for peacetime, contingency, and wartime missions. This amount is estimated to grow to about \$75 billion for fiscal year 2003. By statute (10 U.S.C. 2208), working capital funds are devices to effectively control and account for costs of goods and services provided. The department's financial management regulation states that fund activities will operate in a business-like fashion and incorporate full costs in determining the pricing of their products. The regulation also states that the activities' cost of operations should break-even over time and that losses can be occasionally funded through appropriations or by transfers from another DOD account. Annual DOD appropriations acts have also contained provisions transferring money from the fund under some circumstances.

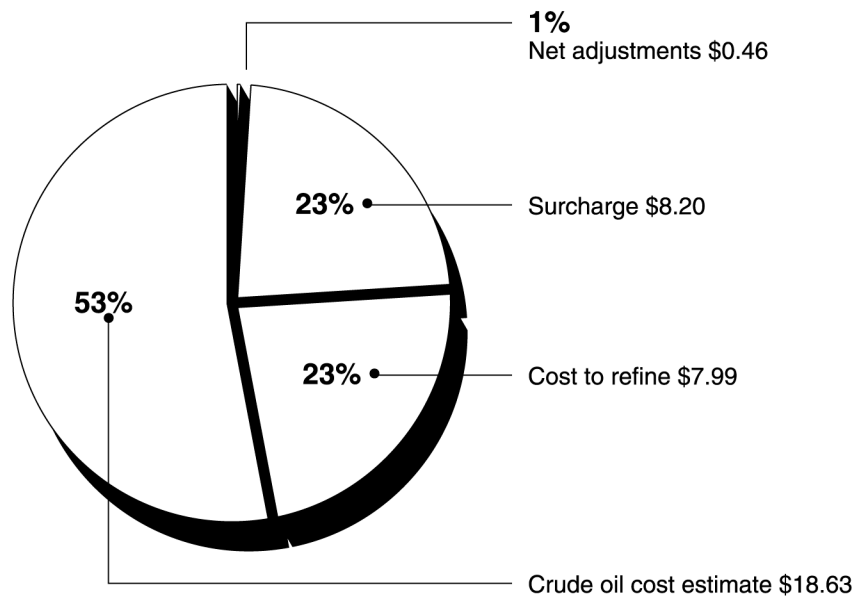
The National Defense Authorization Act for Fiscal Year 2001 (P.L. 106-398) requires that we review the working capital fund activities to identify any potential changes in current management processes or policies that, if made, would result in a more efficient and economical operation. The act also requires that we review the Defense Logistics Agency's (DLA) efficiency, effectiveness, and flexibility of operational practices and identify ways to improve services. One such DLA activity, the Defense Energy Support Center, sold about \$4.7 billion of various petroleum-related products to the military services in fiscal year 2001. The services primarily use their operation and maintenance appropriations to pay for these products. The basis for the military services' annual budget request to Congress related to fuel needs is what DOD refers to as the stabilized annual fuel price. The stabilized annual fuel price, along with the services' estimated fuel requirements, is used to compute budget estimates. Therefore, it is important that the fuel price accurately reflect the full cost as envisioned in the concept. If the price is too high, the fund will receive more funds than required, funds that otherwise could be used to meet other priorities. If the price is too low, the fund will not have sufficient funds to cover the cost of fuel, prompting DOD to either increase prices in future years, request a supplemental appropriation, or transfer funds from another DOD account.

In response to the mandate, we have undertaken a body of work that will result in a series of reports on working capital fund activities. This report

addresses (1) whether DOD's stabilized annual fuel prices have reflected the full cost of fuel and (2) our views on the process to establish the stabilized annual fuel price.

To make the pricing assessment, we reviewed the pricing components—crude oil cost estimates, cost to refine, adjustments, and surcharges—¹ used in determining budget year fuel prices for fiscal years 1993-2003. Figure 1 identifies these components as a percentage of the total price for the fiscal year 2003 stabilized price, which is the amount per barrel that DLA charges its military customers.

Figure 1: Components of Fiscal Year 2003 Stabilized Annual Fuel Price of \$35.28 Per Barrel



Source: GAO analysis of DOD data.

¹ *Crude oil cost estimates* are forecasted crude oil prices provided by the Office of Management and Budget. *Cost to refine* is the Defense Energy Support Center's calculated estimate of the cost to refine crude oil. *Adjustments* are increases and decreases to the price to account for a variety of factors such as prior year fund losses, legal judgments, and rounding. *Surcharges* are comprised of DLA overhead costs and Defense Energy Support Center operational costs such as transportation, labor, and maintenance.

Although the net adjustment shown above was only \$0.46 per barrel, it represents positive and negative cash adjustments totaling \$16.08 per barrel (or \$1.8 billion). Positive adjustments totaling \$8.27 per barrel (or \$910 million) included a \$4.67 per barrel increase to compensate for not receiving an anticipated \$514 million appropriation for fiscal year 2002. Negative adjustments totaling \$7.81 per barrel (or \$860.9 million) included decreasing the price by \$6.13 per barrel as a result of an estimated decrease in refined oil prices for fiscal years 2002 and 2003.

Results in Brief

DOD's fuel prices have not reflected the full cost of fuel as envisioned in the working capital fund concept. This is because cash movements (adjustments) to the fund balance and surcharge inaccuracies have affected the stabilized annual fuel prices. First, fund balances have been used by Congress, and to a lesser extent DOD, to meet other priorities. The cash became available when crude oil costs were less than expected. Conversely, on one occasion, Congress appropriated money to the fund when higher-than-expected crude oil costs created a large loss. Both types of actions, while recognized by DOD's Financial Management Regulation and disclosed in budget documents, affected the development of future years' stabilized annual fuel prices. Second, we identified inaccuracies in DOD's surcharge estimates that also affected the development of prices based on full cost. More specifically our work shows

- Over \$4 billion was moved into and out of the working capital fund from fiscal year 1993 to 2002. These adjustments, which were made through the appropriations process and disclosed in DOD's budget process, affected the extent to which subsequent years' prices reflected the full cost of fuel. The services' budget requests since fiscal year 1996 were about \$2.5 billion higher over 5 years than full fuel costs and about \$1.5 billion lower than the full fuel cost in another year. Congress, as part of the appropriation process, identified reasons for moving about \$2 billion to meet other defense budget needs. Alternatively, in another instance the fund balance was increased when Congress provided about \$1.6 billion in an emergency supplemental appropriation to offset fund losses in fiscal year 2000. This appropriation was necessary because of a worldwide increase in the price of crude oil. With congressional notification, \$0.5 billion from the fund was used to pay for specific nonfuel-related expenses such as the Counter Drug Effort. However, DOD's budget documents did not include a rationale for moving the funds. We noted in one instance that the Senate Appropriations Committee essentially reversed a DOD decision to use fund revenues for a nonfuel-related purpose during the appropriations process. Moving money into and out of the fund, which could be used to

affect future fuel prices, causes future service appropriations to be higher or lower than they otherwise would be.

- In addition, the surcharges did not accurately account for fuel-related costs as required by DOD's Financial Management Regulation, which further affected the development of full-cost-based fuel prices. This occurred for two reasons. First, the surcharges were not adjusted to reflect prior year results and did not include all costs. Even though the surcharge was overstated on average \$99 million annually, no adjustments were made prior to fiscal year 2002. The surcharge also did not include inventory losses, which ranged from about \$12.0 million to \$27.5 million a year. Second, some costs were not adequately supported. For example, DLA could not provide the basis for its over \$40-million annual overhead charge.

To improve DOD's fuel pricing process, we are making two recommendations to the Secretary of Defense. These recommendations are to provide rationale to support future cash movements from the fund and to require methodologies that fully account for and document the surcharge costs. DOD generally concurred with the recommendations, but provided explanatory comments. In general, DOD was concerned as to whether it was necessary to have additional documentation to explain the actions being taken. We continue to believe a formal record of the rationale would be useful to improve full disclosure and accountability for funds.

Background

DOD has been trying to successfully implement the working capital fund concept for over 50 years. However, Congress has repeatedly noted weaknesses in DOD's ability to use this mechanism to effectively control costs and operate in a business-like fashion.

The Secretary of Defense is authorized by 10 U.S.C. 2208 to establish working capital funds. The funds are to recover the full costs of goods and services provided, including applicable administrative expenses. The funds generally rely on sales revenue rather than direct appropriations or other funding sources to finance their operations. This revenue is then used to procure new inventory or provide services to customers. Therefore, in order to continue operations, the fund should (1) generate sufficient revenue to cover the full costs of its operations and (2) operate on a break-even basis over time—that is, not have a gain or incur a loss. In fiscal year 2001, the Defense Working Capital Fund—which consisted of the Army, Navy, Air Force, Defense-wide, and Defense Commissary Agency working

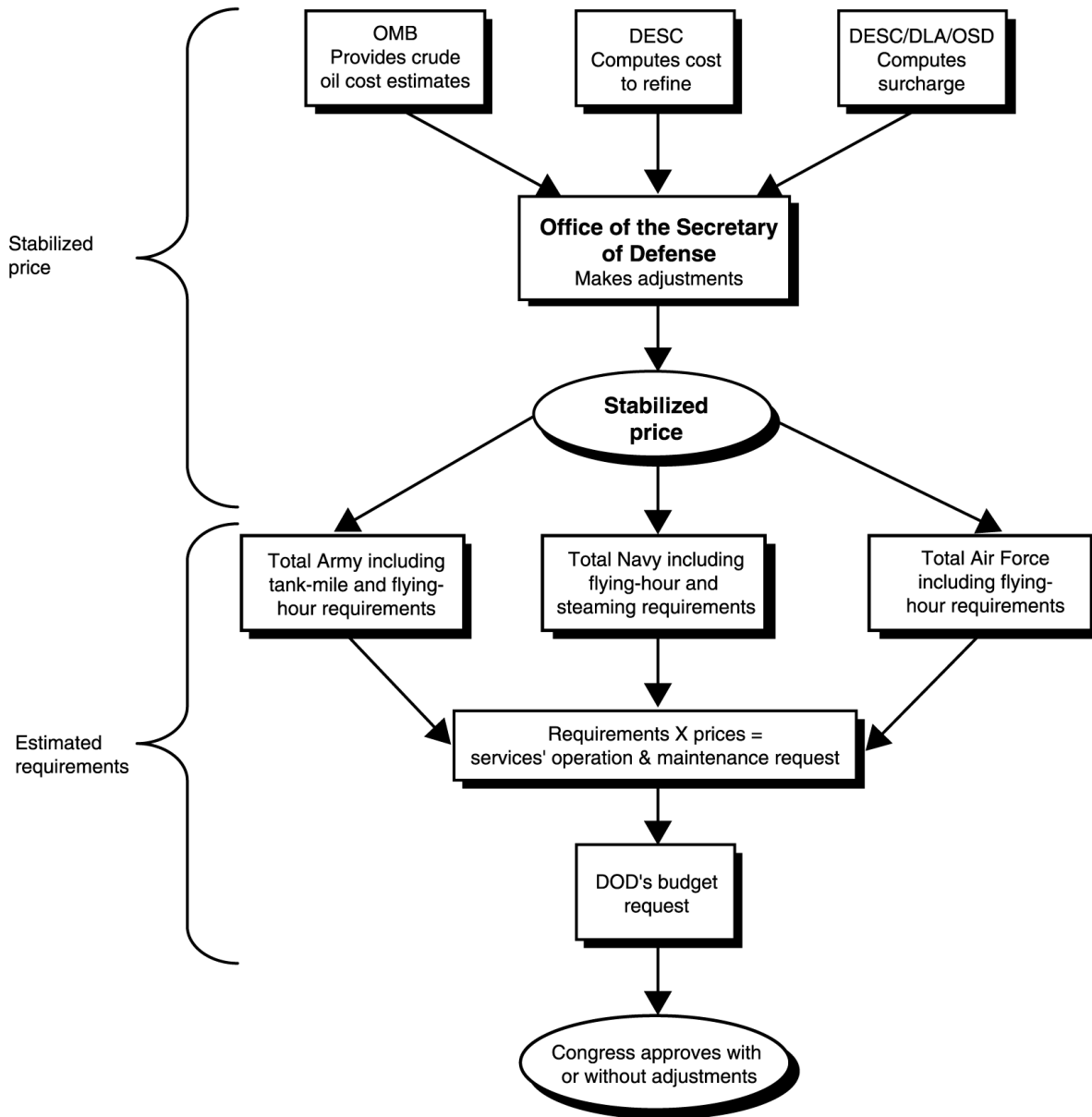
capital funds—was the financial vehicle used to buy about \$70 billion in defense commodities including fuel.

The Defense Energy Support Center, as a subordinate command of DLA, buys fuel from oil companies for its customers. Military customers primarily use operation and maintenance appropriations to finance these purchases. In fiscal year 2001, reported fuel sales totaled about \$4.7 billion, with the Air Force being the largest customer, purchasing about \$2.7 billion.

Each year the Office of the Under Secretary of Defense (Comptroller) faces the challenge of estimating and establishing a per barrel price for its fuel and other fuel-related commodities that will closely approximate the actual per barrel price during budget execution, almost a year later. The Office of the Under Secretary of Defense (Comptroller) establishes the stabilized annual price based largely upon the market price of crude oil as estimated by the Office of Management and Budget, plus a calculated estimate of the cost to refine. To this price is added other adjustments directed by Congress or DOD and a surcharge for DLA overhead and the operational costs of the Defense Energy Support Center. The services annually use these stabilized prices and their estimated fuel requirements based on activity levels (such as flying hours, steaming days, tank miles, and base operations) in developing their fuel budget requests.² Figure 2 generally illustrates the process and the main organizations involved in budgeting for fuels.

² Because of wide variations, volatility of fuel prices, and their corresponding impact on the budget, GAO provides periodic updated information to appropriation and authorization committees that shows the impact of more recent fuel price estimates on the services' budget requests.

Figure 2: Budget Process for DOD Fuel

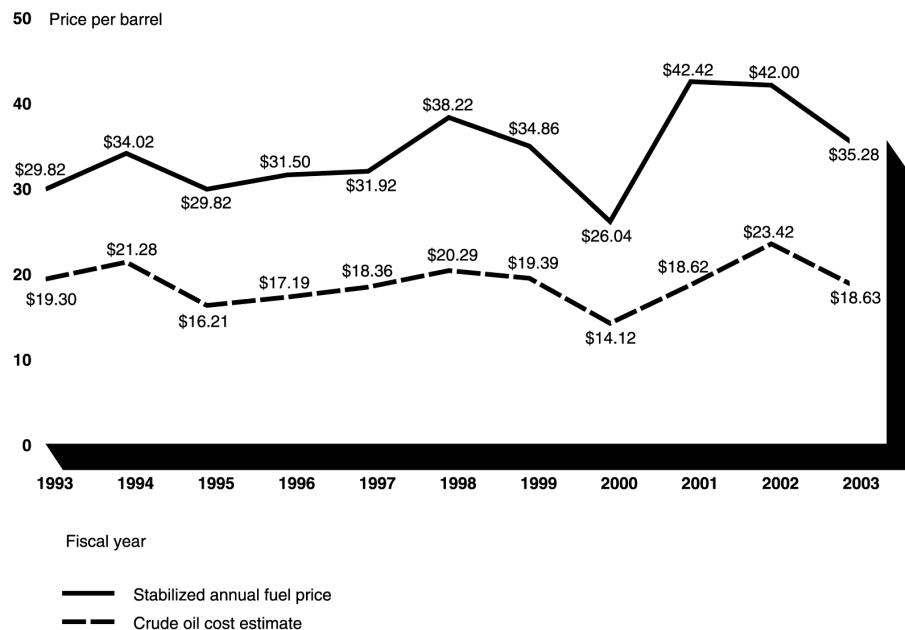


Legend:
 DESC Defense Energy Support Center
 OMB Office of Management and Budget
 OSD Office of the Secretary of Defense

Source: Developed by GAO.

The stabilized annual fuel prices computed by DOD have varied over the years, largely due to volatility in the price of crude oil. For example, the stabilized annual fuel price and the Office of Management and Budget's estimated crude oil price, on which the stabilized price was based for fiscal years 1993 through fiscal year 2003, are shown in figure 3.

Figure 3: Stabilized Annual Fuel Prices and Crude Oil Cost Estimates for Fiscal Year 1993 through Fiscal Year 2003



Source: GAO analysis of Office of Management and Budget and DOD data.

The stabilized fuel price for each budget year remains unchanged until the next budget year, to provide price stability during budget execution. According to DOD's Financial Management Regulation, differences between the budget year price and actual prices occurring during the execution year should increase or decrease the next budget year's price. However, according to DOD's Financial Management Regulation, fund losses can occasionally be covered by obtaining an appropriation from Congress or by transferring funds from another DOD account. DOD is also authorized to move money out of the fund by annual appropriation

acts.³ These acts limit the amount of funds that can be moved and the purposes for which the funds can be used. Specifically, money can only be removed from the fund for higher priority items, based on unforeseen military requirements, than those for which originally appropriated and cannot be used for items previously denied by Congress. These acts also require the Secretary of Defense to notify Congress of transfers made under this authority.

Fuel Prices Used in Budget Requests Do Not Reflect Full Cost

The stabilized annual fuel prices used in the services' budget requests to Congress do not reflect the full cost of fuel because of cash movements (adjustments) and inaccurate surcharges. Therefore, the services' budgets for fuel may be greater or less than needed and funds for other readiness needs may be adversely affected. Based on our review of Office of Management and Budget and Defense Energy Support Center methodologies, the crude and refined oil price components appeared reasonable (see app. I for details). However, in fiscal years 1993-2002, cash movements into and out of the fund (adjustments) amounting to over \$4 billion, while disclosed to Congress in DOD budget documents, were used for other purposes rather than to lower or raise prices. Some of the cash was moved at the direction of Congress and some at the direction of DOD. Congress makes such decisions as part of its budget deliberations. While authorized to move funds, DOD did not provide Congress with any rationale for the movements based on the limitations in the applicable appropriations acts. Identifying the rationale for moving these funds would be helpful to DOD and congressional decisionmakers as part of the budget review process. Removing money from the fund, which could be used to reduce future fuel prices, causes future service appropriations to be higher than they otherwise would be. In addition, the estimated surcharge component of the price used in budgeting was consistently higher than actual; it did not contain all costs; and in some cases, the costs were not adequately supported.

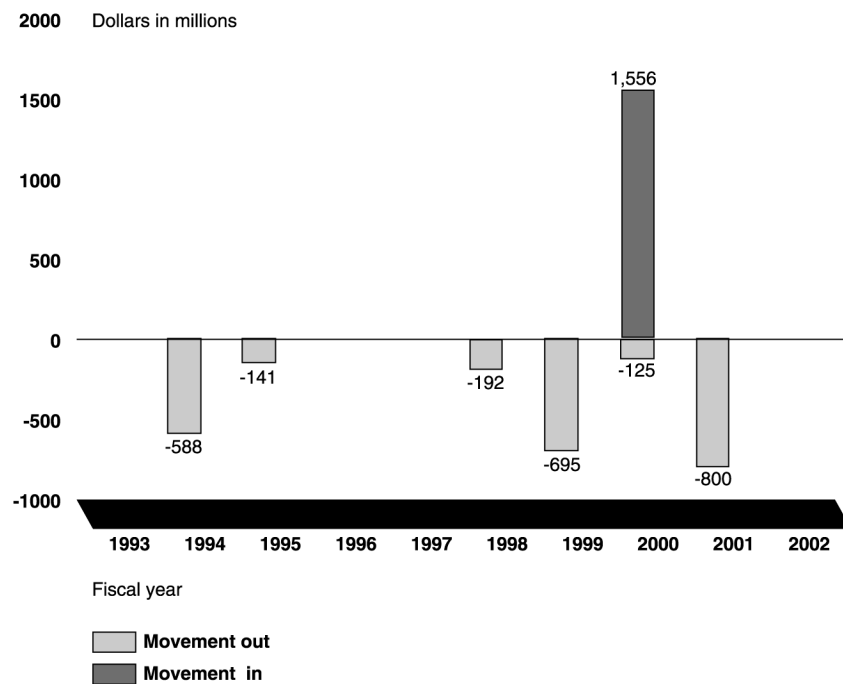
Cash Movements Masked the Full Cost of Fuel and Affected the Budget

Substantial cash movements (adjustments) into and out of the fund, while disclosed to Congress in budget documents, have kept prices from reflecting the full cost of fuel and affected the development of future years' stabilized annual fuel prices. As a result, the fuel-related portion of the

³ Section 8005, P.L. 107-117, is the most current iteration of this authority. Appropriations acts for recent fiscal years include similar provisions.

services' operation and maintenance budgets totaled about \$2.5 billion too high in 5 fiscal years and about \$1.5 billion too low in another. The cash taken out of the fund went for the services' operation and maintenance and other nonfuel-related expenses. Further, Congress provided a \$1.56 billion emergency supplemental appropriation in fiscal year 2000 to help offset a loss due to a worldwide increase in crude oil prices. This was necessary because DOD had established a stabilized price of \$26.04 per barrel but the actual cost that year was \$48.58 per barrel. This appropriation allowed DOD to avoid recovering the loss through a price increase. Figure 4 shows the various fuel-related cash movements during fiscal years 1993 through 2002.

Figure 4: Fuel-Related Cash Movements for Fiscal Years 1993 through 2002



Source: GAO analysis of DOD data.

Table 1 shows the various cash movements out of the working capital fund from fiscal years 1993 through 2002. In total, about \$2.5 billion of fuel-generated funds was removed from the fund. Of this amount, \$0.5 billion was used to pay for specific nonfuel-related expenses such as the Counter Drug Effort. The remaining \$2.0 billion was used to meet the services' other operation and maintenance needs.

Table 1: Cash Movements Out of the Working Capital Fund

Dollars in millions		
Action	Amount	Total
Service Operation and Maintenance Account	\$2,037.5	
Subtotal	\$2,037.5	\$2,037.5
Air Force Working Capital Fund	\$125.0	
U.S. Transportation Command	107.0	
Defense Commissary Agency	85.0	
Army Transportation in Bosnia	81.0	
Army National Guard	60.0	
Counter Drug Effort	45.0	
Subtotal	\$503.0	\$503.0
Total		\$2,540.5

Source: GAO analysis of DOD data.

In reviewing these cash movements, we noted that DOD had notified Congress. However, when doing so, DOD did not provide rationale for the cash movements based on the law, which stipulates that the authority for such movements may not be used, unless for higher priority items, based on unforeseen military requirements, and where the item for which the funds are requested has not been previously denied by Congress. As a good management practice, such rationale, along with other information, such as the impact on future prices, would serve to provide more visibility to cash movements. In fact, in one instance, the Senate Appropriations Committee disallowed the \$125-million request created when DOD moved these funds from the Defense-wide Working Capital Fund to cover Air Force Working Capital Fund losses. The Senate Appropriations Committee Report on the Department of Defense Appropriation Bill, 2002 and Supplemental Appropriations, 2002, stated that it could not support such a cash movement because it was inconsistent with DOD's existing policies for recovering working capital fund losses. As a result, the committee reduced the appropriation to DOD's working capital fund by that amount.

Table 2 shows the effect of these cash movements on the stabilized annual fuel price if they had been used to lower or raise future year prices.

Table 2: Effect That Cash Movements Could Have Had on the Stabilized Annual Fuel Price

Dollars per barrel

Fiscal year affected	Stabilized price	Cash out of fund	Cash into fund	Adjusted price including movements	Percent change
1996	\$31.50	(\$4.91)	0	\$26.59	(15.6)
1997	31.92	(1.18)	0	30.74	(3.7)
1998	38.22	0	0	38.22	0
1999	34.86	0	0	34.86	0
2000	26.04	(1.76)	0	24.28	(6.8)
2001	42.42	(6.45)	0	35.97	(15.2)
2002	42.00	(1.13)	\$14.12	54.99	30.9
2003	35.28	(7.27)	0	28.01	(20.6)

Note: Numbers in parentheses are negative.

Source: GAO analysis of DOD data.

Cash removed in 5 years caused the services' fuel budgets to be about \$2.5 billion higher than necessary because the prices could have been lowered. For example, \$800 million removed in fiscal year 2001 caused the stabilized price in fiscal year 2003⁴ to be \$7.27 per barrel higher than necessary. As a result, the services' fiscal year 2003 fuel budgets were overstated by \$800 million. However, in fiscal year 2000, a \$1.43 billion net cash movement into the fund caused the fiscal year 2002 stabilized price to be \$12.99 per barrel lower than necessary to recover the full cost. As a result, the services' fiscal year 2002 budgets were understated by \$1.43 billion.

While military service comptroller officials responsible for managing fuel costs for each service stated that they were aware that DOD sets the stabilized annual fuel price that they must use in the budget process, they believed any gains in 1 year were being used to lower future fuel prices. These officials were not aware that funds generated from fuel sales in 1 year were being used to pay for nonfuel-related DOD needs. In their view, lower prices would have allowed them to use more of their operation and maintenance funds for other priorities.

⁴ Budgets are developed using stabilized prices established about a year in advance for any given fiscal year.

Surcharge Inaccuracies also Affect Budget Information

The estimated surcharge portion of the price supporting budget requests has not accurately accounted for fuel-related costs consistent with DOD's Financial Management Regulation. The surcharges were consistently higher than actual but did not include all costs. Furthermore, some costs were not adequately supported. These problems were due to deficient methodologies and record-keeping. As a result the stabilized annual prices and resulting services' budgets were inaccurate.

Surcharge Overstatements

Consistent surcharge overstatements caused the stabilized annual price of fuel to be higher than necessary and cost customers on average about \$99 million annually from fiscal years 1993 through 2001. Our analysis of the surcharge costs shows that the estimated obligations exceeded actual obligations for every year from fiscal years 1993 through 2001 except for fiscal year 1999 as shown in table 3 below.

Table 3: Difference Per Barrel between Estimated and Actual Surcharge Obligations for Fiscal Year 1993 through Fiscal Year 2001

Dollars in millions											
	Fiscal year										
	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total	Avg.
Estimated	\$5.35	\$5.70	\$6.08	\$6.75	\$6.69	\$6.65	\$7.32	\$7.16	\$7.34	\$59.04	\$6.56
Actual	5.27	5.54	5.53	4.24	4.22	5.41	7.32	6.69	7.02	51.24	5.69
Difference	0.08	0.16	0.55	2.51	2.47	1.24	0	0.47	0.32	7.80	0.87
Number of barrels sold (in millions)	140.8	127.9	110.0	120.1	111.7	111.3	112.5	107.7	110.3	1052.3	116.9
Difference	\$11.3	\$20.5	\$60.5	\$301.5	\$275.9	\$138.0	0	\$50.6	\$35.3	\$893.6	\$99.3

Source: GAO analysis of DOD data.

We recognize that variances will occur between estimated and actual surcharge obligations. Differences, however, should be assessed annually and appropriate adjustments made to the next year's surcharge. We found that no adjustments for these overcharges, as required by DOD's Financial Management Regulation, were made in fiscal years 1994 through 2001. After we brought this to DOD's attention, adjustments were made when computing the fuel price for fiscal years 2002 and 2003.

All Surcharge Costs Not Included

The surcharges, however, did not include all required costs. Inventory losses were not included in the surcharge as required by DOD's Financial Management Regulation.⁵ For fiscal years 1993 through 2000, these losses

⁵ Volume 2B, chapter 9, paragraph 090203 C.

ranged from \$12.0 million to \$27.5 million a year. Adding these losses would have increased surcharges by about 9 to 23 cents per barrel. While officials stated that inventory losses were a factor in determining the number of barrels to be purchased, this practice does not comply with DOD's regulation, which stipulates that inventory losses should be included in the surcharge.

Inadequate Support

Our analysis of the estimated surcharge components disclosed that support for some costs was inadequate. We found that DLA had inadequate support for its \$40-million annual headquarters overhead charge that is passed on to the Defense Energy Support Center. This amount equated to over 5 percent of the fiscal year 2002 and 7 percent of the fiscal year 2003 surcharges. While DLA has a methodology for allocating its overhead costs to the affected business activities, we could not verify/validate the portion that was assessed to the center. As a result, we could not determine whether the Defense Energy Support Center was charged the appropriate amount. This is of particular concern because in the most recent budget submission for fiscal year 2003, DLA requested a \$16.9 million increase in its overhead charges to the center. The Office of the Under Secretary of Defense (Comptroller) refused to grant the increase because it did not believe the increase was merited.

Furthermore, the Defense Energy Support Center could not provide support for the \$342 million terminal operations component cost for fiscal years 1997 and 1998. There was also about a \$2 million difference between supporting documentation and the budgeted amount for depreciation in fiscal year 2001. The Defense Energy Support Center could not support any of the component costs prior to fiscal year 1997. According to officials, this documentation was not maintained during the move to their current location.

Conclusions

Fuel prices have not reflected full costs. Fund cash balances have been used by Congress, and to a lesser extent DOD, to meet other budget priorities. Given the volatility in crude oil prices, these cash balances are DOD's primary means of annually dealing with drastic increases and decreases in fuel costs. Furthermore, DOD has removed cash from the fund without providing Congress with a rationale based on appropriation act language. In one recent instance, Congress reversed one of DOD's cash movement decisions. DOD also has not calculated surcharges consistent with the governing financial management regulation.

Recommendations for Executive Action

To improve the overall accuracy of DOD's fuel pricing practices, we recommend that the Secretary of Defense direct DOD's comptroller to:

- Provide a rationale to Congress, consistent with language in the applicable appropriations act, to support the movement of funds from the working capital fund and to identify the effect on future prices.
- Require DLA and the Defense Energy Support Center to develop and maintain sound methodologies that fully account for the surcharge costs consistent with DOD's Financial Management Regulation and maintain adequate records to support the basis for all surcharge costs included in the stabilized annual fuel price.

Agency Comments and Our Evaluation

DOD generally concurred with the recommendations, but provided explanatory comments on each one. With regard to our recommendation that it provide Congress the rationale for cash movements, DOD stated that information is already being provided through formal and informal means that it believes are sufficient to report why cash was moved. We recognize this may be occurring; however, we believe that to improve visibility of fund operations, it is reasonable to provide a formal record of the rationale to fully disclose and account for each cash movement. Such a formal record does not exist; therefore, we continue to believe our recommendation is appropriate.

In concurring with the recommendation to maintain adequate records, DOD expressed concern about how long to retain them and proposed 5 years. We believe DOD's proposal represents a reasonable timeframe consistent with our recommendation.

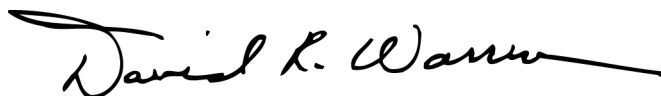
In its cover letter conveying the recommendations, DOD stated our report overlooks the fact that while covering gains or losses to the fund by either decreasing or increasing fuel prices the next year is a basic principle, it is not often practical to rely exclusively on this principle when establishing such prices because of transfers into and out of the fund. We disagree. While our report points out that under the working capital fund concept fuel prices should cover gains and losses, it also acknowledges that there have been numerous transfers. Our point is that to ensure fund accountability when such transfers occur, DOD's fuel pricing practices should include providing Congress a full disclosure of the rationale for the transfer and its impact on the price. Otherwise, the ability of the working fund to effectively control and account for costs of goods and services is compromised.

DOD's comments are printed in appendix II. DOD also provided technical comments, which we have incorporated as appropriate.

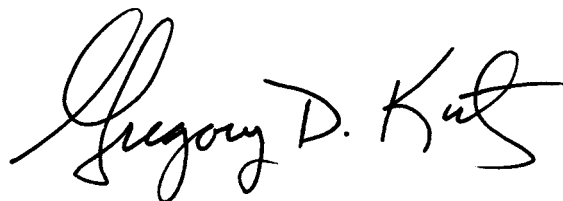
We performed our review in accordance with generally accepted government auditing standards. Further details on our scope and methodology can be found in appendix I.

We are sending copies of this report to the Senate Committee on Governmental Affairs; House Committee on Government Reform; Senate and House Committees on the Budget; and other interested congressional committees; the Secretary of Defense; and the Director, Defense Logistics Agency. Copies will also be made available to others upon request. In addition, the report will be available at no cost on the GAO Web site at <http://www.gao.gov>.

If you or your staff have questions concerning this report, please contact us on (202) 512-8412. Staff acknowledgements are listed in appendix III.



David R. Warren
Director, Defense Capabilities and Management



Gregory D. Kutz
Director, Financial Management and Assurance

List of Committees

The Honorable Carl Levin
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Committee on Armed Services
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Committee on Armed Services
House of Representatives

The Honorable Jerry Lewis
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Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
House of Representatives

Appendix I: Scope and Methodology

In assessing the accuracy of DOD's stabilized annual fuel prices from fiscal years 1993-2003, we reviewed each of the four components—crude oil cost estimates, cost to refine, adjustments, and surcharges—and identified the major offices, DOD organizations, and other components involved in pricing. For the crude oil cost estimate component, we reviewed the Office of Management and Budget's methodology for estimating crude oil prices. We discussed the Office of Management and Budget's methodology with the analyst that prepares the forecasted crude oil prices. We also reviewed the Office of Management and Budget's use of West Texas Intermediate crude oil futures prices and the historical relationships between those prices and domestic, imported, and composite crude oil prices in making crude oil price forecasts. We concluded that this approach was reasonable. For the cost to refine component, we reviewed the Defense Energy Support Center's methodology for calculating refined costs. In assessing the Defense Energy Support Center's methodology, we relied on our previous analysis of its regression equation and a suggested change that was adopted. This same methodology was being used as of May 2002 and remains reasonable.

For the third component of fuel pricing—adjustments—we discussed and examined Office of the Under Secretary of Defense (Comptroller) documents related to stabilized annual fuel prices and applicable Program Budget Decisions to determine what costs were included in the component. To determine criteria, we reviewed the applicable portions of DOD's Financial Management Regulation and the legislative history pertaining to the creation of revolving funds since 1949. To identify any fuel-related cash movements into or out of the working capital fund that occurred and might have affected adjustments, we interviewed various DOD officials and obtained and reviewed the applicable appropriations acts and the committee and conference reports on those acts. We analyzed the results, developed a methodology for determining the effect, and discussed our conclusions with various DOD program and budget officials.

Finally, for the fourth component of fuel pricing—surcharges—we obtained, reviewed and discussed DLA and Defense Energy Support Center methodologies and documentation used in computing the estimated and actual surcharge costs. To identify criteria for what surcharge costs should include, we obtained and reviewed DOD's Financial Management Regulation and any other policies and procedures governing or affecting fuel pricing. To determine whether the support for the surcharge costs was adequate, we requested, reviewed, and analyzed pertinent documentation and records supporting budgeted and actual obligations for each surcharge element for fiscal years 1993-2003.

However, officials were unable to provide support for estimated surcharge costs from fiscal years 1993-1996 and were unable to provide support for several actual costs for fiscal years 1993 and 1994.

We met with and/or contacted various program and budget officials within the Office of the Secretary of Defense; Office of Management and Budget; DLA Headquarters; Defense Energy Support Center; and the various military services.

We performed our work from June 2001 to April 2002 in accordance with generally accepted government auditing standards. As part of our review, we examined DOD's Financial Management Regulation to ensure that it incorporated the Statement of Federal Financial Accounting Standards (SFFAS) No. 4 "Managerial Cost Accounting Standards" (Feb. 28, 1997). We did not independently verify DOD's financial information used in this report. Prior GAO and Department of Defense Inspector General audit reports and Federal Manager's Financial Integrity Act reports have identified inadequacies in the fund's accounting and reporting. As discussed in our report on the results of our review of the fiscal year 2001 Financial Report of the U.S. Government,¹ DOD's financial management deficiencies, taken together, continue to represent the single largest obstacle to achieving an unqualified opinion on the U.S. government's consolidated financial statements.

¹U.S. General Accounting Office, *U.S. Government Financial Statements - FY 2001 Results Highlight the Continuing Need to Accelerate Federal Financial Management Reform* (GAO-02-599T, Apr. 9, 2002).

Appendix II: Comments from the Department of Defense



COMPTROLLER

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100



JUN 14 2002

Mr. David R. Warren
Director, Defense Capabilities and Management
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Warren:

This is the Department of Defense (DoD) response to the GAO draft report, GAO-02-582, "DEFENSE LOGISTICS: Better Fuel Pricing Practices Will Improve Budget Accuracy," dated May 10, 2002 (GAO Code 350045). The DoD partially concurs with one recommendation and concurs with comment on the other recommendation included in the draft report.

The report focuses on the general principle that gains or losses to the Working Capital Fund because of actual fluctuations of fuel prices are to be covered by either decreases or increases in the stabilized fuel prices in the following budget year. The report overlooks the fact that, while this method may be a basic principle in establishing such prices, it is not often practical or reasonable to rely exclusively on this principle in considering fuel prices. Both the law and regulations permit transfers in and out of the Working Capital Fund to address exigencies arising during the course of the fiscal year. While transfers into and from the Working Capital Fund with respect to any fiscal year can have an impact on the establishment of the stabilized fuel price for the following budget year, the Department does not believe that this is any indication of any basic flaw in the process, but rather a recognition of the realities of budgetary formulation, the appropriations process, and budgetary execution.

Comments on the draft report recommendations, along with additional comments concerning specific parts of the report that need clarification or correction are included in the enclosures.

The Department appreciates the opportunity to comment on the draft report.

Sincerely,

Dov S. Zakheim

Enclosures:
As stated

**GAO DRAFT REPORT DATED MAY 10, 2002
(GAO CODE 350045) /OSD CASE**

**"DEFENSE LOGISTICS: BETTER FUEL PRICING PRACTICES WILL
IMPROVE BUDGET ACCURACY"**

**DEPARTMENT OF DEFENSE COMMENTS
TO THE GAO RECOMMENDATIONS**

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense direct the Comptroller to provide a rationale to Congress, consistent with language in the applicable appropriations act, to support the movement of funds from the working capital fund and to identify the affect [sic] on future prices.

DOD RESPONSE: Partially concur. This recommendation overlooks two important factors concerning transfers that have been made with respect to fuel prices.

The first is that the vast majority of transfers that have been made in the past are specific statutory transfers reflecting congressional action in connection with annual appropriations acts. Congress either acted on its own initiative or in response to information provided to the appropriations committees by the Department concerning fuel pricing issues. By both formal and informal means, the Department provides information to congressional committees concerning fuel price issues, including transfers. Therefore, we believe that Congress is clearly aware of the impacts of all issues, including issues presented by transfers, that might have an impact on both current and future fuel prices.

The second is that, in the case of a general statutory transfer under either the Department's general transfer authority provision (e.g., section 8005 of the FY 2002 Appropriations Act) or the general provision specifically providing transfer authority for working capital funds (e.g., section 8006 of the FY 2002 Appropriations Act) transfers are only made to meet the needs and exigencies of the fiscal year in which they are made. If such transfers involve fuel pricing issues, the congressional committees would be aware of any impact of such transfers on fuel costs and charges.

Finally, the comments in the draft report concerning such general transfers indicate that they deal with matters that would be applicable to the Department's general transfer authority (FY 2002 section 8005), rather than the specific working capital fund transfer authority provision (FY 2002 section 8006). In fact, in the last 9 years only one of the Working Capital Fund transfers has involved the use of the general transfer authority general provision. In either case, however, the Department believes that the notification procedures that have

case, however, the Department believes that the notification procedures that have been developed over the years are sufficient to provide the congressional committees with the information that they need with respect to transfers under either of the provisions. We also believe that the committees share this view.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense direct the Comptroller to require the Defense Logistics Agency and the Defense Energy Support Center to develop and maintain sound methodologies that fully account for the surcharge costs consistent with DoD's Financial Management Regulation (FMR) and maintain adequate records to support the basis for all surcharge costs included in the stabilized annual fuel price.

DOD RESPONSE: Concur, with comment. To the extent that the recommendation concerns maintenance of records beyond the period generally established under the Federal Records Retention Schedules, it is overly broad.

With respect to the foregoing, General Records Schedule 5 "Budget Preparation, Preservation, and Apportionment Records" appears to be the applicable schedule with respect to the type of records involved. Under this schedule, information concerning the surcharge costs for any particular fiscal year (developed in connection with the Department's budget request) would appear to fall within either the category of "Budget Correspondence Files," (destruction authorized when 2 years old) or "Budget Background Records" (destruction authorized when 1 year old). While records relating to the basis on which the surcharge is calculated are only relevant to one fiscal year, the Department recognizes that there might be some need for some historical information beyond the period authorized for the destruction of such records. Accordingly, we plan to maintain such historical records in detail for 5 years after they were created.

Appendix III: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Acknowledgments

In addition to those named above, Bob Coleman, Jane Hunt, Patricia Lentini, Charles Perdue, Greg Pugnetti, Chris Rice, Gina Ruidera, Malvern Saavedra, and John Van Schaik made key contributions to this report.

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