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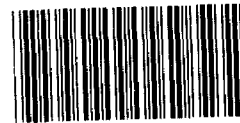
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GRAIN INSPECTION

Industry Views on the Decline  
in Official Inspections and  
Inspection Costs

Statement of John W. Harman,  
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Resources, Community, and Economic  
Development Division



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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our report on selected aspects of the official grain inspection system, administered by the U.S. Department of Agriculture's (USDA) Federal Grain Inspection Service (FGIS).<sup>1</sup> The Congress enacted the U.S. Grain Standards Act of 1976 in response to widespread abuses in the quality and quantity of grain delivered in the mid-1970s. The act requires official inspection and weighing of all grain of a specified grade for export and provides for official inspection as an option in the domestic market. Export inspections are carried out by FGIS or by state-operated agencies under delegation from FGIS; voluntary official inspections in the domestic market are carried out by 72 state-operated and privately owned inspection agencies designated by FGIS. FGIS supervises state-operated and private agencies and collects fees for some of the services it provides.

Our testimony is based on work we did at the request of Senators Daschle, Kerrey, Leahy, and Lugar. Specifically, we answered several questions about (1) the decline of official inspections in the domestic grain market and the impact of that decline, (2) fees that official inspection agencies charge for official domestic inspections, (3) fees that FGIS charges for export inspections, and (4) potential options for reducing inspection fees.

In summary, we reported the following:

- Official domestic inspections performed by the 72 agencies declined by about 19 percent from 1985 to 1992, even though 30 of the agencies performed more official inspections of grain in 1992 than in 1985. Industry representatives cited several factors influencing the decline, including the cost of official inspections and a trend to improved internal quality assurance programs. They also said that the decline has not resulted in increases in buyer complaints that sellers are not delivering the quality of grain purchased.
- Fees for official domestic inspections vary widely among the state and private agencies, each operating exclusively in a specified geographical area. For example, the fee for inspecting any size truckload of grain varies from \$5.30 to \$16.55 among the official agencies that perform most official truckload inspections with FGIS' supervision fees averaging about 5 percent of the 72 agencies' estimated fee charges of \$28 million in 1992.

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<sup>1</sup>Grain Inspection: Industry Views on the Decline in Official Inspections and Inspection Costs (GAO/RCED-93-147, Apr. 30, 1993).

- FGIS' fees for verifying the grade and weight (i.e., official inspection and weighing) of export grain averaged an estimated .47 cent per bushel. The eight states performing identical services charged an average of .41 cent per bushel. In total, exporters paid FGIS and state inspection agencies about \$17.7 million in 1992 for required export inspections of grain valued at about \$14.5 billion, or about one-tenth of 1 percent of the value of the grain.
  
- Industry representatives said that the fee-setting process, which essentially provides a monopoly for official domestic inspection agencies in a specified geographic area, needs to be more competitive. Potential options mentioned include (1) developing a more competitive process for designating inspection agencies to perform official domestic inspections and approving the inspection fees and (2) turning export inspections performed by FGIS over to state and private inspection agencies. Some of the options can be considered and acted on by FGIS; others cannot because the law does not give FGIS any discretion.

#### BACKGROUND

Following widespread disclosures of misgrading and "shortweighing" of grain in the mid-1970s, particularly of export grain, the Congress amended the U.S. Grain Standards Act (USGSA) (7 U.S.C. 71-87) by enacting the U.S. Grain Standards Act of 1976 to reform the system. In sum, the 1976 act gave the FGIS Administrator the responsibility for promoting, facilitating, and regulating the merchandising of U.S. grain in an orderly, objective, and timely manner by establishing official standards for grain and uniformly applying those standards through a system of official inspection and weighing.

Wanting to ensure that the quality of grain exported is correctly represented, the Congress in the 1976 act required that shipments of grain of a specified grade for export be inspected and weighed at the export terminal. FGIS performed about 82 percent of the export inspection and weighing in 1992.<sup>2</sup> FGIS may also delegate its authority to state government agencies to perform the services under FGIS' supervision, if the agencies meet specified requirements of the act. Under delegations from FGIS, eight state agencies perform export inspection and weighing services.

The 1976 act made official inspections of grain optional in the domestic market. It authorizes FGIS to designate private and state agencies to offer and perform official inspections in the domestic

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<sup>2</sup>All years presented are fiscal years.

market. FGIS has designated 72 official agencies (20 state and 52 private), each of which operates in an exclusive geographical area under FGIS oversight.<sup>3</sup>

FGIS and the official agencies also provide other types of services, including measuring wheat and soybean protein content and soybean oil content, as well as measuring for the presence and amount of aflatoxin. In addition, under the Agricultural Marketing Act (AMA) of 1946 (7 U.S.C. 1621 et seq.), the Secretary of Agriculture has delegated to the FGIS Administrator responsibility for developing inspection and weighing standards and inspecting specified commodities (rice, pulses, beans, and processed grain products, such as flour and corn meal). FGIS collects fees to cover its costs of performing inspections under the AMA.

As shown in appendix I, FGIS' expenditures for 1992 totaled \$40.5 million. Fee income for its supervision and services totaled about \$29 million.

#### DECLINE OF OFFICIAL INSPECTIONS IN THE DOMESTIC MARKET

As shown in appendix II, from 1985 to 1992, the most recent period for which FGIS has separate data for domestic inspections, the number of official domestic inspections performed by official inspection agencies declined from about 2.7 million to 2.2 million, or about 19 percent. During the same period, the number of total metric tons inspected declined from about 152 million to 137 million, or about 10 percent. Appendix III indicates that the decline in volume of grain was less severe than the decline in the number of inspections because of changes in the mix of inspections performed. For example, the number of inspections of rail cars hauling grain was greater in 1992 than in 1985, while the number of inspections of trucks hauling grain was less.

Our interviews with government and industry representatives indicated that several factors, in addition to cost, have contributed to the changes in demand for official domestic inspections, beginning in the 1970s. First, consolidations in the grain industry have reduced the number of times the ownership of grain changes hands from the farmer to the end-user; fewer changes in ownership require fewer third-party inspections. Second, there is a trend among grain merchandisers to "in-house" grading, prompted by cost considerations and the need for internal quality assurance programs. Third, buyers have greater confidence than in past years that sellers will deliver the quality of grain agreed upon and work out acceptable solutions in those instances in which problems occur. Fourth, the Agricultural Stabilization and

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<sup>3</sup>One of the 72 designated agencies performs weighing services only.

Conservation Service (ASCS), which manages the government's grain inventories obtained under farm commodity programs, has changed the way it manages its inventories and has substantially lower grain acquisitions, which has resulted in fewer movements of grain.

According to industry representatives, the decline in demand for domestic inspections has not harmed the integrity of grain merchandising. That is, they do not believe that the decline has resulted in increased buyer complaints that sellers are not delivering the quality of grain that buyers purchased. One grain association's representatives said that the number of arbitration cases has not increased in recent years, which is one indication that the integrity of grain transactions has not been harmed.

FGIS representatives believe that integrity has not been compromised because the official system serves as a safety net for the unofficial system. According to FGIS, unofficial agencies obtain samples regraded by official agencies to measure the accuracy of their grading and to settle disputes between buyer and seller when an official inspection was not initially obtained.

The major benefits of official inspections, according to industry representatives, are that the inspection is performed by an independent third party and that the grading results are highly reliable. Nonetheless, those we interviewed unanimously opposed amending the USGSA to require official domestic inspection.

At some point, continuing declines in the number of official inspections will make it financially infeasible to continue an official domestic inspection system. However, the level of inspections necessary to maintain the economic viability of an agency varies from agency to agency. Moreover, the number of inspections performed by the official agencies in 1992 ranged from under 1,000 to just over 235,000. As shown in appendix IV, 30 of the 72 agencies increased their number of inspections compared with 1985. As shown in appendix V, 16 of the 72 agencies performed over 50,000 inspections and accounted for 63 percent of the inspections, while more than one-half of the agencies performed 25,000 or fewer inspections.

FGIS representatives said that they are not sure what impact a continuing decline in the use of the official system in the domestic market might have on the integrity of grain transactions. If an agency relinquished its charter, FGIS would try to get a new agency or have an existing agency add the area to its operation.

FEES FOR OFFICIAL  
DOMESTIC INSPECTIONS

The 72 official domestic inspection agencies charged their users an estimated \$28 million (excluding variable charges)<sup>4</sup> for 2.2 million official inspections in 1992. Each official agency sets its own fees, although FGIS must initially approve agencies' fee schedules as well as any changes. The official agencies paid FGIS about \$1.5 million in fees for its supervision in 1992, or an average of about 5 percent of the total fees they charged. Thus, on average, 95 percent of the costs of official domestic inspections are controlled by the agencies.

As shown in appendix VI, the official agency fees, as of November 1992, varied widely for the same inspection service even when comparisons are limited to those agencies performing most of a particular type of inspection. The variance in fees was greatest for trucks, ranging from \$5.30 to \$16.55.

Although FGIS' regulations require that each agency's fees be reasonable and supported by cost data, official agency inspection fees vary widely even among agencies operating in adjacent areas. For example, one agency charged \$23.70 for inspecting a rail car of grain, while agencies operating in adjacent geographic areas charged from \$9.45 to \$18.20.

The FGIS fee for supervision does not include its total cost of overseeing the official agencies performing domestic inspections. Following its regulations, FGIS does not include in the fee the cost of (1) regrading samples of grain graded by the official agencies to verify the accuracy of the grading and (2) FGIS' annual management review. FGIS' costs for these oversight activities, which it pays from appropriated funds, totaled \$2.57 million for 1992.

Recognizing that its procedures governing an official inspection might be too stringent and costly to meet some of the needs of potential domestic customers, FGIS developed the new official commercial inspection. This new inspection, approved in April 1992, allows agencies to deviate from the requirements for the standard official inspection and tailor inspections to the customers' needs. FGIS also believed that the new inspection would

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<sup>4</sup>The estimate is based on each official agency's 1992 inspection activity reported to FGIS, multiplied by the price shown on each agency's fee schedule for each type of inspection for grade. The estimate excludes any additional variable charges for travel time or mileage for drawing samples, which FGIS estimates at about \$10 million. Also, the estimate excludes any charges for performing additional services, such as protein measurements or aflatoxin tests.

enable the official agencies to better compete with the price of unofficial inspections; it estimated that fees for the new inspection should be from 10 percent to 40 percent below the standard fees. Some official inspection agencies' representatives explained that the official commercial inspection enabled them to obtain inspection business that they would not have otherwise attracted. Use of the new inspection had increased to about 5 percent of the total domestic inspections by early 1993. However, many industry representatives we interviewed were unfamiliar with the inspection.

#### FGIS FEES FOR EXPORT INSPECTIONS

Of the \$14.5 billion in grain exports that FGIS and state official agencies inspected and verified weight for,<sup>5</sup> the exporters paid FGIS \$14.9 million and paid the state agencies \$2.8 million for a total of about \$17.7 million in 1992, or about one-tenth of 1 percent of sales. This amount includes charges for inspection and weighing required by the USGSA for all grain exported, but it does not include any additional services requested by exporters, such as testing for wheat and soybean protein content and soybean oil content, or measuring for the presence and amount of aflatoxin.

To compare FGIS and state inspection fees, we calculated an average price per bushel for both FGIS and the eight state agencies. FGIS' charges for inspecting and weighing export grain for 1992 averaged an estimated .47 cent per bushel while the eight state agencies charged an average of .41 cent per bushel. FGIS performed about 82 percent of the export inspection and weighing services in 1992. FGIS' export inspection fees are expressed in hourly rates per person needed to perform the inspections at each location. The eight states charge by the bushel or short ton, which ranges from three-tenths to nine-tenths of a cent per bushel.

Our review of FGIS' accounting records indicates that direct costs charged to the FGIS services-performed account for 1992, which is predominantly FGIS export inspection activity, were appropriate. However, FGIS used a questionable methodology to allocate indirect costs, which may have resulted in an undercharge of \$695,000. The FGIS Acting Administrator said that the agency would review its methodology for allocating indirect costs.

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<sup>5</sup>The total bushels for each of the 8 types of grain that FGIS and state official agencies inspected and weighed for export multiplied by the average sales price provided by USDA's Economic Research Service for 1992.



POTENTIAL OPTIONS FOR  
REDUCING INSPECTION FEES

The American Association of Grain Inspection and Weighing Agencies (AAGIWA), an association of official inspection agencies, suggested that FGIS could reduce its operating costs and possibly official agencies could reduce their costs by combining USGSA's and AMA's inspection functions. In addition, industry representatives suggested that more competition should be introduced into the fee-setting process. However, the extent to which implementation of these options would result in savings is unclear because no studies are available showing the costs of the alternatives compared with current practices.

Combine USGSA's and AMA's Inspection Functions

AAGIWA recommends that official agencies be allowed to conduct AMA commodity inspections as well as grain inspections, which they are not now permitted to do. AAGIWA believes that combining the two functions would allow FGIS to consolidate more field offices, more effectively utilize personnel, and allow official agencies to operate more efficiently by performing AMA inspections when demands for grain inspection are low.

Although FGIS' field offices do much of the inspection work under the AMA, the agency does have cooperative agreements with 20 states to perform some of these services, including such things as grading rice and drawing samples of processed commodities for inspection by FGIS. According to a FGIS representative, if all AMA rice work could be performed by outside inspection agencies, some field offices could be consolidated or closed.

Under existing AMA and USGSA legislation, the Secretary of Agriculture and the Administrator of FGIS do not have the authority to create a national, unified inspection system. At present, the inspection of grains is conducted under authority of the USGSA, and the inspection of certain other commodities (such as beans and lentils) is conducted under the AMA. Under the AMA, the Secretary would have to decide whether to enter into arrangements with private firms to perform AMA inspection services. FGIS' position is to be supportive of efforts to allow official agencies to handle AMA commodity inspections. According to FGIS, the skills and knowledge used for grading grain and edible beans, peas, and lentils are very similar. However, FGIS representatives pointed out that, if AMA inspections are opened to private firms, official agencies would have to compete with any other qualified applicants to perform the inspections.

## Domestic Inspection Fees

Some industry representatives suggested that FGIS could make the periodic chartering of official domestic agencies and approving fee increases more competitive.

In accordance with the USGSA (7 U.S.C. 79 (g)(1)), FGIS issues a charter for a period of up to 3 years to state and private agencies performing official domestic inspections. The charter authorizes the agencies to perform official inspections exclusively in a specified geographical area. As the end of the charter period approaches, FGIS invites and considers applications from interested parties before issuing a new charter or renewing an existing charter.

In determining who should be awarded the charter, FGIS evaluates the degree to which the applicant meets the requirements for designation set out in the USGSA (7 U.S.C. 79 (f)(1)). One of the requirements is that the agency will not charge unreasonable inspection fees. FGIS' implementing regulations provide that the Administrator may decline to renew an incumbent's designation if the agency does not comply with any of the criteria set out in the USGSA. However, we noted that the incumbent is usually chartered for another 3 years, unless an agency has had major performance problems. Although FGIS solicits proposals for each designated area as charter expirations approach, competition has been limited. When each of the 72 charters last came up for renewal, only 13 had proposals from other than the incumbent.

Some industry representatives have stated that they would be supportive if FGIS introduced more price competition into the process for setting official domestic inspection fees by (1) more actively encouraging applications when a charter is up for award and placing greater emphasis on the reasonableness of fees both in evaluating the incumbent's performance and selecting the designated agency and/or (2) eliminating exclusive territories. However, one large merchandiser said that, while more competitive inspection fees are desirable, he is not sure that he would like to see ownership of official agencies changing every 3 years. He said that there are some merits in having stable ownership and building good working relationships with the industry.

FGIS can consider and, if it deems appropriate, place greater emphasis on fees when chartering agencies. However, the USGSA (7 U.S.C. 79 (f)(2)) requires that the official agencies operate in an exclusive geographical area. This provision was included in the act, according to a FGIS representative, with the thought that FGIS could more easily attract an agency to develop customers in an entire area if the area was protected from the threat of competition from other official agencies.

FGIS is concerned that any increased regulatory effort on its part to oversee official agencies' fees could be viewed as setting rates, which would result in additional regulatory requirements. FGIS does not view additional regulation as desirable.

FGIS' Export Inspection Fees

Because industry representatives believe, and FGIS generally agrees, that FGIS is limited in further reducing its fees for export inspections, they suggest that FGIS turn export inspection and weighing activities over to state-operated and privately owned official agencies.

Although the USGSA precludes FGIS from turning export inspection and weighing over to a number of state-operated agencies and to any privately owned inspection agencies, FGIS representatives said that doing so is conceptually feasible. Because FGIS would still have the supervisory authority over official agencies provided to it by the 1976 act, FGIS representatives believe that they could prevent a recurrence of the inspection and weighing abuses that occurred in the 1970s. However, whether such a change would produce any savings to exporters is unclear because no comparative cost study has been made. FGIS representatives said that FGIS' supervision fees would have to be added to state and private inspection fees, which could increase the combined costs above those FGIS now charges.

FGIS opposes the further delegation of export inspection and weighing to state-operated and privately owned inspection agencies at the major export locations now serviced by FGIS. FGIS pointed out that the current user-fee arrangement has been in place for 17 years and that during that period FGIS has developed a streamlined inspection and weighing process resulting in a high level of productivity. Furthermore, FGIS does not believe state and private agencies could perform the services at less cost.

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Mr. Chairman, this concludes my formal statement. We would be happy to respond to any questions you or other Members of the Subcommittee may have.

FGIS' EXPENSES AND FEE INCOME FOR FISCAL YEAR 1992

Thousands of dollars

Fund/program title	Expenses	Fee income
USGSA trust funds		
FGIS services performed	\$18,814	\$19,074
FGIS supervision of official agencies	1,443	1,577
Montreal, Canada, office	299	264
Registration of exporters	9	16
Subtotal	\$20,565	\$20,931
USGSA appropriated funds		
Standardization	\$7,216	\$0
Compliance activities	3,555	0
Subtotal	\$10,771	0
Total--USGSA	\$31,336	\$20,931
AMA trust funds		
Rice inspections	\$3,347	\$2,870
Other commodity inspections	5,338	5,159
Subtotal	\$8,685	\$8,029
AMA appropriated funds		
Standardization	461	0
Total--AMA	\$9,146	\$8,029
Total USGSA and AMA	\$40,482	\$28,960

TOTAL NUMBER OF OFFICIAL DOMESTIC INSPECTIONS AND METRIC TONS  
INSPECTED, 1985 to 1992

Fiscal year	Inspections		Metric tons	
	Number	Percent increase (decrease) since 1985	Number	Percent increase (decrease) since 1985
1985	2,692,661		152,246,527	
1986	2,710,696	1	147,506,564	(3)
1987	3,071,179	14	172,591,628	13
1988	2,934,696	9	174,810,526	15
1989	2,572,576	(4)	163,630,359	7
1990	2,559,225	(5)	159,280,149	5
1991	2,228,685	(17)	145,785,818	(4)
1992	2,168,063	(19)	137,436,699	(10)

TOTAL NUMBER OF OFFICIAL DOMESTIC INSPECTIONS BY TYPE OF SAMPLE AND  
TOTAL TONS INSPECTED, 1985 to 1992

Year	Inspections					Total no. of metric tons inspected
	Truck	Rail car	Barge	Samples submitted	Total no. of inspections	
1985	594,712	893,926	37,265	1,166,758	2,692,661	152,246,527
1986	536,428	933,195	31,483	1,209,590	2,710,696	147,506,564
1987	553,568	1,164,663	35,089	1,317,859	3,071,179	172,591,628
1988	514,048	1,227,698	35,891	1,157,059	2,934,696	174,810,526
1989	416,099	1,125,772	37,408	993,297	2,572,576	163,630,359
1990	451,208	1,122,475	34,347	951,195	2,559,225	159,280,149
1991	403,115	983,110	35,184	807,276	2,228,685	145,785,818
1992	426,330	961,979	30,512	749,242	2,168,063	137,436,699

Note: For truck, rail car, or barge, the official agency draws the sample and grades it; the results are applicable to the universe from which the sample was drawn. For samples drawn and submitted by the customer, the official agency grades the sample, but the results are applicable only to the sample.

NUMBER OF AGENCIES WITH INCREASES IN DOMESTIC INSPECTIONS  
SINCE 1985 AND NUMBER WITH DECREASES

Number of inspections in 1992	Agencies with increases		Agencies with decreases	
	Number	Combined increases	Number	Combined decreases
Over 100,000	2	44,572	2	34,329
75,001-100,000	0	0	2	43,901
50,001-75,000	6	80,548	4	96,509
25,001-50,000	3	32,139	8	147,815
25,000 or less	19	67,919	24	352,275
<b>Total</b>	<b>30</b>	<b>225,178</b>	<b>40</b>	<b>674,829</b>

Note: Two agencies had no change between 1985 and 1992.

NUMBER OF DOMESTIC INSPECTIONS THAT OFFICIAL  
AGENCIES PERFORMED IN 1992

Number of inspections	Number of agencies	Percent of inspections	
		Total	Cumulative
Over 100,000	4	26	26
75,001-100,000	2	9	35
50,001-75,000	10	28	63
25,001-50,000	11	18	81
25,000 or less	45	19	100
Total	72	100	



RANGE OF FEES CHARGED BY OFFICIAL AGENCIES  
PERFORMING MOST OF EACH TYPE OF INSPECTION

Type of inspection	Number of agencies <sup>a</sup>	Range of agencies' fees <sup>b</sup>		Weighted average	FGIS' fees
		Low	High		
Truck	11	\$5.30	\$16.55	\$9.59	\$.30
Rail car	30	9.45	23.70	15.15	.95
Barge	17	122.27	184.15	153.98	6.15
Submit <sup>c</sup>	25	4.30	10.80	6.70	.30

<sup>a</sup>Because some inspection agencies perform fewer inspections of a particular type than others, we compared fees for agencies performing the vast majority of each type of inspection to minimize any differences in fees that might be related to the volume of inspections. Collectively, the agencies included in the analysis account for about 90 percent of each type of inspection performed by all agencies combined.

<sup>b</sup>The fees shown do not include any additional variable charges for travel time or mileage to draw the sample.

<sup>c</sup>Submits are samples drawn and submitted by a customer.

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