



U.S. Department of Agriculture



Office of Inspector General
Northeast Region

Audit Report

Rural Business-Cooperative Service FY 2004 Rural Economic Development Grant to Shenandoah Valley Electric Cooperative

Report No. 85001-01-Hy
April 2006



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



April 5, 2006

REPLY TO

ATTN OF: 85001-01-Hy

TO: Thomas C. Dorr
Under Secretary
Rural Development

THROUGH: John Dunsmuir
Acting Director
Financial Management Division

FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: Rural Business-Cooperative Service Fiscal Year 2004 Rural Economic
Development Grant to Shenandoah Valley Electric Cooperative

This report presents the results of our audit of the Rural Business-Cooperative Service fiscal year 2004 Rural Economic Development Grant to Shenandoah Valley Electric Cooperative. Your March 9 and April 3, 2006 responses to the official draft report are included as Exhibit D. Excerpts from your responses and the Office of Inspector General's position are incorporated into the Findings and Recommendations section of the report. Based on your responses, we have reached management decision on both of the report's recommendations. Please follow your agency's internal procedures in forwarding documentation for final action for the recommendations to the Office of the Chief Financial Officer.

If you have any questions, please call me at (202) 720-6945, or have a member of your staff call Philip T. Cole, Director, Rural Development and Natural Resources Division, at (202) 690-4483.

Executive Summary

Rural Business-Cooperative Service Review of FY 2004 Grant to Shenandoah Valley Electric Cooperative (Audit Report No. 85001-01-Hy)

Results in Brief

The Administrator of the Rural Business-Cooperative Service (RBS) waived multiple program regulations in order to award a Rural Economic Development Grant (REDG) to the Shenandoah Valley Electric Cooperative (SVEC). The grant had the effect of providing an \$8 million, 30-year interest-free loan to a “for profit” organization known as the Virginia Poultry Growers’ Cooperative (VPGC).

We conducted our review in response to a hotline complaint received by the Office of Inspector General (OIG) in October 2004. The complaint alleged that a grant being made to SVEC for VPGC might be inappropriate. We determined that the Administrator waived REDG program regulations without legal authority, including:

- Exceeding the maximum grant award amount of \$300,000 for an individual recipient for fiscal year 2004;
- Approving a REDG award to fund a project with an ineligible purpose; and
- Failing to require the Rural Utilities Service grantee to provide 20 percent of the funding for the project.

Our review disclosed additional concerns with the \$8 million in REDG funds granted to SVEC and subsequently loaned to VPGC. For example, the loan terms were overly generous regarding repayment. The Administrator extended the term of repayment for \$6 million of the REDG-funded loan to 30 years. Ordinarily, according to program regulations,¹ the total term will not exceed 10 years. In addition, the terms did not provide a mechanism for accelerated repayment.

We also found that the \$8 million zero-interest loan will be subsidizing VPGC’s dividend to its preferred stockholder, [] annually. VPGC will also be dividing a [] in profits from its first year of operation among its 136 members. The cooperative’s members will each earn about [] in the first year, a 500 percent return on their investment.

The RBS Administrator applied exception authority criteria from a different program, the Business and Industry (B&I) loan program, to the REDG program to justify funding a project for an ineligible purpose. The Acting Deputy Under Secretary for Rural Development (RD) supported the Administrator’s waivers by asserting that waiver authority granted under one

¹ Title 7 Code of Federal Regulations (C.F.R.) § 1703.29(a).

program, in the absence of specific prohibitions, could be applied to other programs. A longstanding rule of statutory construction holds that the expression of certain powers implies the exclusion of others.² That is, the waiver authority granted the Administrator under the B&I program does not imply that the Administrator has similar authorities for other programs. Instead, the silence of REDG regulations on the issue of the Administrator's waiver authority implies that no such waiver authority exists.

We examined legal case precedents on similar issues to assess the merits of the Administrator's actions in waiving the REDG regulations. We identified precedent setting case decisions in support of our finding that waiver authority was lacking, and therefore inappropriately exercised. Details of these decisions, and the legal reasoning supporting our position, are included as Exhibit A.

RD initially responded to the official draft audit report on March 9, 2006. The response contained inconsistent statements with regard to the propriety of the RBS Administrator's waiver of REDG program regulations. The agency response states "...the Administrator's decision to approve this grant request was well meaning and does not appear to create any statutory infraction." However, the attached Decision Memorandum approved by the Secretary on February 27, 2006, states "Specifically, while neither the statutory authority for the REDG program nor regulations issued there under contain any provisions for the granting of waivers of program requirements, such waivers have in fact been granted without seeking formal legal review and apparently in contravention of legal authorities. As a result, actions have been taken, and substantial resources have been expended, in cases where the actions should not have been approved."

The comment in the response, that the grant "...does not appear to create any statutory infraction," ignores the fact that the program is implemented by regulations that have the force and effect of law and that RD has no authority to waive those regulations. The response also incorrectly characterizes the regulations as "guidelines" or "internal administrative authority." Finally, whether or not the agency may have been considering amending the regulations is irrelevant to the force and effect of the regulations at the time of the decision to approve the grant. The decision to change a regulation does not confer upon RD the authority to begin applying new substantive regulations. Such authority does not exist until all rulemaking procedures are completed.

² Marshall v. Gibson Products, Inc. of Plano, 584 F.2d 668, 675 (5th Cir. 1978); Alcoa Steamship Co. v. Federal Maritime Commission, 121 U.S. App. D.C. 144, 146, 348 F.2d 756, 758 (1965).

**Recommendations
in Brief**

Before attempting to waive any REDG provision, the RBS Administrator should (1) document the specific regulatory authority for issuing the waiver, and (2) obtain a written opinion affirming this authority from the Office of the General Counsel (OGC). The Office of the Under Secretary for RD should also provide written concurrence with the decision to waive the REDG provisions. Through consultations with OGC, RBS should also determine the options available to recoup the \$8 million in REDG funding provided to VPGC through SVEC and implement the most defensible option. If no options are considered viable by the agency, RBS should document the bases for not pursuing them.

Agency Response

In the March 9, 2006 response, RD provided a document showing that they had obtained the approval of the Secretary of Agriculture to issue a directive requiring that no steps be taken by the Administrator of RBS or by any other officials of that agency which would waive program requirements, or which would have the effect of doing so, without prior review and written approval by the OGC. A subsequent response on April 3, 2006, included assurance by RD that a second-party approval mechanism would be established within 60 days to ensure that OGC-approved waiver requests receive Under Secretary directed concurrence.

RD also agreed to consult with OGC to determine if there are any viable and legally defensible options to recoup the \$8 million in REDG funding provided to VPGC through SVEC. RD agreed to complete an analysis and agreement with OGC regarding actions to be taken on the funds within nine months of the issuance of the audit report with final action to be completed within one year.

OIG Position

We concur with the agency's response and have reached management decision for all recommendations within this report.

Abbreviations Used in This Report

B&I	Business and Industry
BP	Business Programs
C.F.R.	Code of Federal Regulations
COC	Cushion of Credit
FY	Fiscal Year
OGC	Office of the General Counsel
OIG	Office of Inspector General
RBS	Rural Business-Cooperative Service
RD	Rural Development
REDG	Rural Economic Development Grant
REDLG	Rural Economic Development Loan and Grant
RLF	Revolving Loan Fund
RUS	Rural Utilities Service
SVEC	Shenandoah Valley Electric Cooperative
USDA	U.S. Department of Agriculture
VPGC	Virginia Poultry Growers' Cooperative

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Background and Objectives

Background

The Rural Development (RD) mission area of the U.S. Department of Agriculture (USDA) was established as a result of the Department of Agriculture Reorganization Act of 1994, Title II of Public Law 103-354. RD's basic organization consists of its Headquarters in Washington, D.C., and 47 State offices. RD maintains overall planning, coordination, and control of RD agency programs. Administrators head the Rural Business-Cooperative Service (RBS), Rural Utilities Service (RUS), and Rural Housing Service under the direction of the Deputy Under Secretary for Operations and Management. The three agencies' programs are designed to meet the needs of people who live in rural areas and include programs to support infrastructure, housing, health and medical services, education, and employment. State directors head the State offices and are directly responsible to the Deputy Under Secretary for the execution of all RD agency programs within the boundaries of their States.

The Rural Economic Development Loan and Grant (REDLG) program was originally implemented in 1989 as part of the Rural Economic Development Program of the Rural Electrification Administration, predecessor to the RUS. USDA was later reorganized, and responsibility for this program was transferred to the Business Programs (BP) office under RBS, which provides financing for projects in rural areas. This program is administered at the State level through the RD's State offices. Rural Economic Development Grants (REDG) provide funds to electric and telephone utilities financed by RUS to promote sustainable rural economic development and job creation projects through the operation of revolving loan funds (RLF). The REDG program operates through grants to RUS telephone or electric cooperatives.

Grants can be made to any RUS electric or telephone utility that is not delinquent on a Federal debt or in bankruptcy proceedings.³ The utility uses the grant to establish a RLF which loans the funding to an eligible project recipient in the form of a zero percent interest loan. When a project recipient repays the zero-interest loan, the funds remain under the control of the cooperative as long as the RLF continues in operation. The cooperative then lends the funds to other entities at a rate not more than prime. The REDG program is funded by a Cushion of Credit (COC) account, maintained by the Office of Management and Budget, and is allotted annually in an amount requested by RBS. The maximum dollar award amount authorized for individual grants in each fiscal year is limited to 3 percent of the amount allotted from the COC account for that year. In fiscal year (FY) 2004 (the year of the award to Shenandoah Valley Electric Cooperative (SVEC)), the maximum award amount was \$300,000 as published in the Federal Register.

³ 7 C.F.R. § 1703.16 Eligibility.

The grants are authorized under Section 313 of the Rural Electrification Act of 1936, and 7 C.F.R. § 1703, Subpart B.

RBS reported that as of September 30, 2002, the REDLG program had provided \$163.6 million in loans and \$69.7 million in grants, leveraged \$1.38 billion in private capital, and directly created an estimated 27,150 new jobs for rural areas. Exhibit C presents a chart showing the level of program funding for FY 2003 and 2004. In FY 2003, the program provided \$4,066,300 for 22 individual grants, and in FY 2004, it provided \$10,075,000 to 13 recipients (\$2,075,000 was divided among 12 recipients and \$8 million was awarded to SVEC). RBS measures the success of the grant program by the number of jobs created and saved. In FY 2003, the agency reported that 1,032 jobs were created or saved, and in FY 2004, 1,734 jobs were reported as created or saved.

This audit was performed in response to a hotline complaint which alleged that the grant made to SVEC for Virginia Poultry Growers' Cooperative (VPGC) might be inappropriate. We determined that the RD Virginia State office in Richmond, Virginia, was authorized by RBS' National Headquarters in Washington, D.C., to obligate and issue a grant in the amount of \$8 million. The grant funded the establishment of the Shenandoah Valley Rural Business RLF, which in turn provided an \$8 million interest-free loan to the VPGC. This allowed VPGC to purchase an established turkey processing facility in Hinton, Virginia, and a feed mill in Broadway, Virginia.

In addition to the \$8 million REDG-funded loan, VPGC applied for a Business and Industry (B&I) loan guarantee through RBS. At a May 5, 2005, meeting, the Office of Inspector General (OIG) informed the RBS Administrator that our preliminary review showed that VPGC had not demonstrated a financial need for a proposed \$5 million guaranteed loan. Also, VPGC had proposed to use more than 50 percent of the loan proceeds to pay outstanding debt; a violation of the B&I loan guarantee program's regulations.⁴ Nevertheless, the 80 percent B&I loan guarantee for an additional \$5 million was approved on May 12, 2005. VPGC ultimately informed the lender that it had no need for the loan and instructed the lender to decline the guaranteed loan offer from USDA.

Objective

Our objective was to assess the appropriateness of the actions taken by RD in awarding the \$8 million grant to SVEC. We accomplished this by verifying that existing REDG program requirements were waived to award the grant and by assessing the propriety of the waivers.

⁴ See 7 C.F.R. § 4279.113 Eligible Purposes.

To accomplish our objective, we performed fieldwork at the RBS National office in Washington, D.C.; the RD Virginia State office located in Richmond, Virginia; SVEC's office outside Harrisonburg, Virginia; VPGC's processing plant located in Hinton, Virginia; and VPGC's feed mill in Broadway, Virginia. We reviewed pertinent regulations and documentation and interviewed the RBS Administrator, RD employees, Office of the General Counsel (OGC) staff, and others as necessary. (See Scope and Methodology for details.)

Findings and Recommendations

Section 1. REDG Program Regulations Waived Without Authority

Finding 1

RBS Administrator Waived Key REDG Program Regulations Without Legal Authority

In September 2004, the RBS Administrator waived key REDG requirements without legal authority by relying on his own interpretation of his waiver authority, which was incorrect. Specifically, he did not limit the maximum amount of funding awarded to the grantee, did not require the grantee to contribute a share of the funding, and allowed REDG funds to be used for ineligible purposes. As a result, a business that was not eligible to receive REDG funds (i.e., VPGC, a poultry cooperative) received a 30-year, zero-interest \$8 million loan.

The REDG program provides funding through a RLF to programs that promote sustainable rural economic development and job creation projects in areas experiencing the greatest economic hardship. Program regulations limit the size of each grant award, require grant recipients to contribute monetarily to funded projects, and provide criteria for determining the eligibility of recipients of loan funds. Finally, the regulations are silent regarding the Administrator's authority to waive REDG requirements.

The Administrator's actions to waive REDG requirements were affirmed in an October 7, 2004, letter signed by the Acting Deputy Under Secretary for RD. The letter stated that the presence of an abundance of negative impacts on the USDA, the economy of the area surrounding the business, and the businesses and individuals whose livelihood depends on the ongoing operations of the poultry processing facility warranted the waivers. It provided several examples of potential negative impacts if the business closed, such as 21 poultry growers with nearly \$9 million of loans where USDA would be at risk; the local economy would suffer the loss of millions of dollars of business revenue producing opportunities; there would be a potential negative impact on real estate values; and a general negative impact on the turkey industry. Consequently, the office of the Acting Deputy Under Secretary for RD stated that it fully supported the actions taken by the Administrator, which made the REDG assistance available to meet the needs of the VPGC and its members.

Our review demonstrated that the Acting Deputy Under Secretary's rationale was flawed. The outstanding balance of USDA loans and loan guarantees to the poultry growers at the time of the award actually totaled \$7.9 million and was secured by \$21 million in real estate and chattel. RBS asserts that much

of the value of this collateral is based on the value of poultry growing contracts and that recoveries would be substantially less than normal if the poultry processing plant were to close. No evidence was provided to support this claim, and the value of the collateral would need to diminish by more than 62 percent before USDA's recovery would be at risk, an outcome which we believe is highly unlikely.

- **Administrator Lacked Authority to Grant Waivers**

The Administrator interpreted the program regulations' silence on the subject of waivers as an affirmation of his authority to waive requirements. Because the REDG regulations did not specifically prohibit him from granting waivers, the Administrator applied the waiver authority from a different program (RD's B&I program) to justify awarding the grant.⁵ The Acting Deputy Under Secretary for RD supported the Administrator's decision to grant the waivers in a memorandum dated October 7, 2004, which states, "As you are no doubt aware, the REDG program regulations are silent on the issue of waiver authority, while other programs specifically acknowledge it. In the absence of any prohibition on granting waivers, it was decided to apply criteria similar to those programs."

Several legal precedents support our finding that the Administrator exercised waiver authority without legal authority (See Exhibit A). The Administrator cannot waive requirements unless the program regulations explicitly authorize him to do so. Given that the B&I regulations explicitly granted waiver authority, the omission of explicit waiver authority in the REDG regulations means that no waiver authority was intended.⁶ Further, we found that the Administrator did not obtain any guidance from the OGC on whether he had the authority to waive REDG requirements. The Administrator should have obtained legal guidance instead of developing his own, incorrect interpretation of his regulatory authority.

RD responded to the official draft audit report on March 9, 2006. The document contained inconsistent statements with regard to the propriety of the RBS Administrator's waiver of REDG program regulations, which are discussed in the Executive Summary section of this report.

⁵ 7 C.F.R § 4279.15, "Exception Authority" for the B&I loan program states: "The Administrator may, in individual cases, grant an exception to any requirement or provision of this subpart which is not inconsistent with any applicable law, provided the Administrator determines that the application of the requirement or provision would adversely affect USDA's interest." The REDG program regulations do not contain similar language.

⁶ This inference is related to a longstanding rule of statutory construction that the expression of certain powers implies the exclusion of others. (Marshall v. Gibson Products, Inc. of Plano, 584 F.2d 668, 675 (5th Cir. 1978); Alcoa Steamship Co. v. Federal Maritime Commission, 121 U.S. App. D.C. 144, 146, 348, F.2d 756, 758 (1965)).

- **Excessive REDG Funding Awarded**

According to program regulations, the size of each grant awarded in FY 2004 was limited to \$300,000. The Administrator did not document his rationale for awarding an \$8 million grant to a single entity, SVEC. SVEC's loan to VPGC consumed more than 80 percent of total program funding awarded in FY 2004. The REDG program funds do not expire, and the \$8 million could have funded at least 26 additional projects at the \$300,000 level in future years.

- **SVEC not Required to Contribute Funding**

To ensure that grant recipients are fully committed to monitoring the ultimate recipients of REDG funds, they are required to provide at least 20 percent of the funding for REDG projects.⁷ The Administrator waived this requirement because SVEC's board of directors would not agree to administer the RLF if SVEC funds were put at risk.

- **REDG Loan made to Ineligible Recipient**

The Administrator waived the requirement that loans made from REDG funds be limited to community development and to assist in developing emerging enterprises.⁸ The purpose of the \$8 million loan to VPGC was the purchase of an established turkey processing business and feed mill to be operated as a profit-making enterprise, an ineligible use of REDG funding.

Our review disclosed additional concerns with the \$8 million in REDG funds granted to SVEC and subsequently loaned to VPGC. The loan terms were overly generous regarding repayment. Further, VPGC has not produced jobs at costs similar to other REDG-funded projects. Finally, VPGC was not located in an area experiencing economic hardship.

- **Zero Interest Rate Loan Results in Market Place Advantage**

REDG program regulations state: "The Administrator will determine the terms and repayment schedule of the zero-interest loan to the borrower based on the nature of the project and approved purposes. Ordinarily, the total term of the zero-interest loan, including any principal deferment period will not exceed 10 years."⁹

The Administrator extended the term of repayment for \$6 million of the REDG-funded loan to 30 years, with the remaining \$2 million to be

⁷ 7 C.F.R. § 1703.22(a)(5).

⁸ 7 C.F.R. § 1703.22(a)(2) and 7 C.F.R. § 1703.18(d), (f), (g), and (h).

⁹ 7 C.F.R. § 1703.29.

repaid within 10 years. In addition, the terms of the loan did not provide a mechanism for accelerated repayment. The poultry cooperative will not begin making payments on the REDG-funded loan until November 2006. The loan will not be fully repaid until 2034.

RBS stated in its response of March 9, 2006 that: “While initial profitability may have been construed to establish a high profitability, the reality is that projections outlined in March did not come to fruition. Instead, as of December 22, 2005, actual financial results for that period were [].” This statement, based on financial reports issued as of March 31, 2005, incorrectly infers that as of December 22, 2005, financial results were only []. In fact, VPGC has been far more profitable, having earned over [] as of September 22, 2005, (the last date for which we were provided financial information). VPGC earned [] after less than 8 full months of operation.

We found that the \$8 million zero percent loan will be subsidizing VPGC’s payment of an [] annual dividend [] to its preferred stockholder. If its current average monthly rate of earnings accumulation continues, VPGC will also be dividing a projected [] in profits from its first year of operation among its 136 members. Although the cooperative’s members, on average, invested [] of their own funds into the venture, they will earn an estimated [] in the first year, a 500 percent return.

We concluded that the loan terms gave VPGC a marketplace advantage unavailable to its competitors. This is contrary to an intent of the REDG program, which is to not pose undue competition or other adverse effects on existing businesses.

- **Inefficient Job Creation**

The poultry cooperative has not produced jobs in an efficient manner as compared to the job creation generated by other REDG projects. As of April 2005, the \$8 million loan to VPGC has preserved only 520 identifiable jobs in the poultry processing facility, an average cost of \$15,384 per job. In FY 2004, all of the other REDG-funded projects created or preserved 1,214 jobs at an average cost per job of \$2,295. In its March 9, 2006 response, RBS states that the actual job creation is higher as it includes an additional 25 plant jobs and those of 148 grower-members. No supporting documentation was provided for these jobs, and RBS’ claim presumes that the poultry growers would be unable to find alternative ways in which to generate income from their properties. RBS also asserts that a cost per job of up to \$20,000 is the

most efficient use of funding. We disagree as, at an average cost of \$2,295, 6 jobs could have been created for each job created by VPGC.

- **No Economic Hardship**

According to regulation,¹⁰ REDG grants are to be made in areas “experiencing the greatest economic hardship.” However, Rockingham County, where VPGC is located, was not experiencing economic hardship at the time the loan was made. According to data reported to the U.S. Department of Labor, Rockingham County had a 2.7 percent unemployment rate at the time of the award, while the average for the State of Virginia was 3.7 percent and the national average unemployment rate was 5.5 percent. In 2004 only three States (i.e., Hawaii, North Dakota, and South Dakota), with significantly smaller populations than Virginia, had a lower rate of unemployment. Within Virginia, for 134 counties and cities that reported data, only 7 had a lower rate of unemployment than Rockingham County. Five of these areas were within commuting distance of Washington, D.C., and the remaining two were near a large Navy base. In its March 9, 2006 response, RBS stated that if the poultry processing plant had closed the resulting unemployment rate would have risen to 3.8 percent resulting in a devastating impact on Rockingham County. We disagree with RBS’ conclusion as a 3.8 percent unemployment rate would only raise Rockingham County to the approximate Virginia State average, and would be well under the national rate.

Because the RBS Administrator waived REDG requirements without a basis for doing so, VPGC received a 30-year, zero-interest \$8 million loan for which it was not eligible. These actions were taken without obtaining any guidance from OGC on whether the Administrator had the authority to waive REDG requirements. Specifically, the Administrator waived the requirements that limit the maximum amount of funding to \$300,000, require the grantee to contribute a 20 percent share of the funding, and prevent REDG funds from being distributed to a profit-making enterprise. Our review disclosed additional concerns with the REDG funds granted to SVEC and subsequently loaned to VPGC. We found that the loan terms were overly generous regarding repayment, VPGC has not produced jobs at costs similar to other REDG-funded projects, and VPGC was not located in an area experiencing economic hardship. As such, none of the rationale provided by the Administrator and supported by the Acting Deputy Under Secretary for RD for the waivers proved to be true or supported. Moreover, the improper waivers led to the inefficient use of limited REDG funds.

¹⁰ 7 C.F.R. § 51703.11(c).

Recommendation 1

Before attempting to waive any REDG provision, the RBS Administrator should (1) document the specific regulatory authority for issuance of the waiver to include details of any information relied on, and (2) obtain a written opinion from OGC concerning the waiver and setting forth the supporting legal reasoning. This documentation should be provided to the Office of the Under Secretary for RD for written concurrence prior to issuing the waiver.

Agency Response.

In a March 9, 2006 response, RD provided assurance that the Under Secretary for Rural Development, with the concurrence on February 27, 2006 of the Secretary of Agriculture, agreed to direct, effective immediately, that no steps be taken by the Administrator of RBS or by other officials of that agency which would waive REDLG or other RBS program requirements or would have the effect of doing so, without prior review by and written approval from the Office of General Counsel. This directive was delivered to the Administrator and senior leadership of the BP to be incorporated into their administrative notice process and will remain in effect until further notice. A subsequent response on April 3, 2006, included assurance by RD that a second-party approval mechanism would be established within 60 days to ensure that OGC-approved waiver requests receive Under Secretary directed concurrence.

OIG Position.

We concur with the agency response for this recommendation and have reached management decision.

Recommendation 2

Through consultations with OGC determine the options available to recoup the \$8 million in REDG funding provided to VPGC through SVEC. Implement the actions determined to be most defensible. If no options are considered viable by the agency, document the options considered and the bases for not pursuing them.

Agency Response.

RD agreed to consult with OGC to determine any viable and logically defensible options to recoup the \$8 million in funding provided to VPGC through SVEC. An analysis and fundamental agreement regarding actions to be taken will be completed within nine months of the published date of this report, with final action to be completed within one year. If no options are

considered viable, the agency will document the options considered and the bases for not pursuing them.

OIG Position.

We concur with the agency response for this recommendation and have reached management decision.

Scope and Methodology

We performed our audit at RBS Headquarters in Washington D.C., and at the RD State office in Richmond, Virginia. We also conducted fieldwork at SVEC in Harrisonburg, Virginia, the VPGC processing plant in Hinton, Virginia, and the VPGC feed mill in Broadway, Virginia.

We interviewed responsible officials from the RBS National office and RD State office, to include the Deputy Administrator for BP; Special Lender Division Processing Branch Chief; and Loan Specialists from the Special Lenders Division. We worked with the RD BP Director and interviewed the former State Director for the State office located in Richmond, Virginia. We also conducted interviews with the parties involved with the grant to SVEC and subsequent loan to VPGC, to include the Vice-President of the SVEC and supporting staff members, the President of VPGC, the VPGC Controller, the Director of Processing, and the General Manager for the processing plant.

We reviewed pertinent Federal regulations to familiarize ourselves with the requirements, scope, and current operation of REDG program that RBS maintains and oversees. To assist in our familiarization with the REDG program, we spoke to the responsible staff and officials working within the RBS National office.

We reviewed information furnished by the RD National office regarding REDG projects funded for FY 2002 through 2004. The information provided FY funding levels broken down by State, total number of loans and grants issued and awarded, estimates of jobs created or saved, loan or grant amounts, and priority points assigned.

We obtained a Project Information/Fund Request Sheet for a REDG in process to gain an understanding of what is required at the National office regarding the application process. We also requested documentation applicable to the grant under review and received draft grant and loan documents used for review and approval purposes by the RBS Administrator at the National office.

We visited the RBS State office in Richmond, Virginia, to obtain information submitted by the SVEC and the VPGC. These documents included the grant application by SVEC and the subsequent loan to VPGC, along with related documentation submitted by legal representatives for each entity. We also interviewed the RD BP Director to obtain a timeline of events to establish whether REDG procedures were followed for this grant. We also obtained statements on the propriety of the consideration and selection of the SVEC grant.

We visited SVEC's office in Harrisonburg, Virginia, and spoke with the Vice-President of the SVEC and with several staff members. We spoke with SVEC's Vice-President to ascertain its level of involvement as a lender and conduit to the VPGC. The Vice-President provided a timeline of events regarding SVEC's involvement and the related decisions made by directors. We also discussed information on the turkey processing industry such as employment, turkey growing contracts, prices, and market conditions.

We visited VPGC's processing plant in Hinton, Virginia, and spoke with the President of the Cooperative, the Controller, and General Plant Manager. We also spoke with VPGC's Director of Processing and toured the processing facility. In our interviews with VPGC's staff, we inquired about the involvement of the President of the Cooperative and his part in receiving a Federal grant, through the REDG program. The President of the Cooperative provided a timeline of events leading from the creation of a steering committee to assist in the establishment of VPGC to the present. We obtained other relevant information that VPGC retained that was not available via the National or State offices.

We spoke with the OGC to determine whether RBS officials had consulted with OGC prior to deciding to waive program requirements for the REDG to SVEC, and if so, what advice was provided.

Our work was performed from January 2005 through September 2005, in accordance with Generally Accepted Government Auditing Standards.



UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20250



DATE: June 17, 2005

TO: David Gray
Counsel to the Inspector General

FROM: Jill P. Sayre /s/
Assistant Counsel to the Inspector General

SUBJECT: Waiver of Regulations for a Rural Economic Development Grant

This is in response to your request for a legal opinion regarding the propriety of waiving a number of sections of 7 C.F.R. 1703-Subpart B, in approving a rural economic development grant. In my opinion, it was improper to waive these regulations.

BACKGROUND

The regulations at issue here implement 7 U.S.C. 940c, which provides authority for rural economic development grants under the U.S. Department of Agriculture's (USDA) cushion of credit payments program. The cushion of credit payments program provides grant funds to electric and telephone utilities financed by USDA's Rural Utilities Service (RUS). The grant funds are to be used by RUS borrowers to provide loans to third parties for projects that promote rural economic development and job creation.

The RUS borrowers are required to operate and administer revolving loan fund programs using the grant proceeds. The funds are to be operated by the RUS borrowers in accordance with an approved revolving loan fund plan. To establish the revolving loan fund, the RUS borrowers are required to contribute to the fund an amount equal to 20 percent of the grant. Initial loans, at zero-interest, from the revolving loan fund are restricted to certain types of recipients for certain purposes. Subsequent loans, at an interest rate not to exceed prime, may be made to for-profit entities, non-profit entities, or public bodies for any rural economic development purpose eligible under the program in accordance with the RUS borrower's revolving loan fund plan. Subsequent loans are made using repayment funds from the initial loan. The third-party recipient must provide supplemental financing for its project. The minimum requirement is 20 percent of the amount of the loan being provided from the revolving fund. Initial loans made from the revolving fund ordinarily must not exceed a maximum term of 10 years. Lesser term notes are acceptable. The RUS borrower will determine repayment terms on loans made using the RUS borrower's contribution and on subsequent loans made from repayment of the initial loan.

All grant funds available under this program derive from cushion of credit payments, a type of advance loan payment, paid to USDA by RUS borrowers. The Administrator of USDA's Rural Business-Cooperative Service (RBS) has authority to approve the grants under the program. RBS is a service within USDA's Rural Development (RD) mission area.

FACTS

By letter dated September 9, 2004, the Administrator of the RBS approved a rural economic development grant to the Shenandoah Valley Electric Cooperative in the amount of \$8 million. The grant funds were to be loaned to the Virginia Poultry Growers Cooperative, Inc. to continue to operate a turkey processing plant in Virginia that had previously been operated by Pilgrim's Pride Corporation. In approving this grant, the Administrator of RBS authorized a "one-time waiver of the requirements of the regulations governing this program" "for this project only." For example, the Administrator specifically waived the requirement in the regulations regarding the maximum dollar amount for the grants approved under the program. Under 7 C.F.R. 1703.28, the maximum size of a grant to be considered for funding under the program is to be determined every fiscal year based on a specific calculation. That amount is to be published in a notice in the Federal Register and is to remain in effect until the notice has been published for the next fiscal year. The maximum size of the grant to be considered at the time of this grant was \$300,000. 69 Fed. Reg. 16518 (March 30, 2004). As stated previously, the size of the grant involved here was \$8 million, far exceeding the maximum size provided for in the regulations. The Administrator also specifically waived 7 C.F.R. 1703.22(a)(2) restricting the types of recipients and purposes for initial loans under the program and 7 C.F.R. 1703.22(a)(5) requiring the RUS borrower to contribute to the revolving loan fund an amount equal to 20 percent of the grant. The Administrator justified this "one-time waiver" on the negative economic impact of the proposed closing of the turkey processing plant on the surrounding rural community in Virginia.

In a letter dated October 7, 2004, the Acting Deputy Under Secretary of RD provided a clarification of the Administrator's rationale for granting these waivers. The Acting Deputy Under Secretary stated that, while the program regulations were silent on the issue of waiver authority, and while other programs specifically provided waiver authority, "in the absence of any prohibition on granting waivers it was decided to apply criteria similar to those other programs." Again, the negative economic impact of the closing of the turkey processing plant was cited as the justification for the waivers.

In a meeting with USDA OIG officials on March 29, 2005, the Assistant General Counsel for RD in USDA's Office of General Counsel (OGC), stated that his only contact with RBS concerning these waivers was with the Administrator informally and by phone. No opinion was issued by OGC, but the circumstances under which such waivers are typically used was discussed.

ANALYSIS

In Chrysler Corp. v. Brown, 441 U.S. 281 (1979), the Supreme Court of the United States listed three tests that must be met for a regulation to have the force and effect of law. First, the regulation must be a substantive or legislative regulation affecting individual rights or

obligations. Regulations that are interpretative only generally will not qualify. Second, the regulations must be issued pursuant to, and subject to any limitations of, a statutory grant of authority. Third, the regulation must be issued in compliance with any procedural requirements, such as the Administrative Procedures Act (APA), imposed by Congress.

The regulations at 7 C.F.R. 1703-Subpart B provide substantive rights and obligations to RUS borrowers with regard to rural economic development grants provided by USDA under the cushion of credit payments program. For example, 7 C.F.R. 1703.28 provides a maximum and minimum amount for the grants to be provided to RUS borrowers under the program. In addition, the regulations were specifically issued to implement USDA's authority to provide grants under 7 U.S.C. 940c. Finally, the regulations were issued pursuant to the notice and comment procedures prescribed by the APA and are published in the Code of Federal Regulations. I have no reason to otherwise question the validity of these regulations. Therefore, I believe that the regulations at 7 C.F.R. 1703-Subpart B have the force and effect of law.

It is a well-established principle of law that agencies must adhere to their regulations that have the force and effect of law. Thus, an agency may not waive such a regulation on an ad hoc basis, without explicit authority to do so. See Woerner v. Small Business Admin., 1990 U.S. Dist. LEXIS 9081 (D.D.C. July 17, 1990). While the courts have carved out a limited exception to this general rule, that exception only applies to regulations that are procedural in nature and are adopted for the orderly transaction of agency business. Even then, an agency will be required to adhere to its own regulations where a complaining party will suffer "substantial prejudice" in the absence of such adherence. See American Farm Lines v. Black Ball Freight Service, 397 U.S. 532 (1970). I do not believe that the regulations waived by the Administrator in this case fall within this limited exception. By setting forth maximum grant amounts, restricting initial loans to specific purposes and types of third-party recipients, and requiring borrowers to contribute to the loan fund, USDA has provided substantial rights to and obligations on borrowers and third-party loan recipients under the program.

In this case, the Acting Deputy Under Secretary acknowledged that there was a lack of explicit authority to waive the provisions of 7 C.F.R. 1703-Subpart B. The Acting Deputy Under Secretary rationalized the waiver by inferring waiver authority from explicit waiver authorities applying to other regulations. I do not find this rationale persuasive. First, inferred authority is not explicit authority. Second, I believe the natural inference to be drawn from the omission of explicit authority to waive the provisions of 7 C.F.R. 1703-Subpart B, in light of explicit authority to waive other regulations, is that no such waiver authority was intended. This inference is related to a longstanding rule of statutory construction that the expression of certain powers implies the exclusion of others. See Marshall v. Gibson Products, Inc. of Plano, 584 F.2d 668, 675 (5th Cir. 1978); Sutherland Statutory Construction §47.23 (6th ed. 2000); see also, Alcoa Steamship Co. v. Federal Maritime Commission, 121 U.S. App. D.C. 144,146, 348 F. 2d 756,758 (1965).

Furthermore, I question the Acting Deputy Under Secretary's finding that the regulations do not specifically prohibit waiver. It appears that 7 C.F.R. 1703.46(a), which provides requirements for documenting the evaluation and selection of applications for grants under the program, incorporates what is, in effect, a prohibition against waiver of the regulations. Specifically, 7

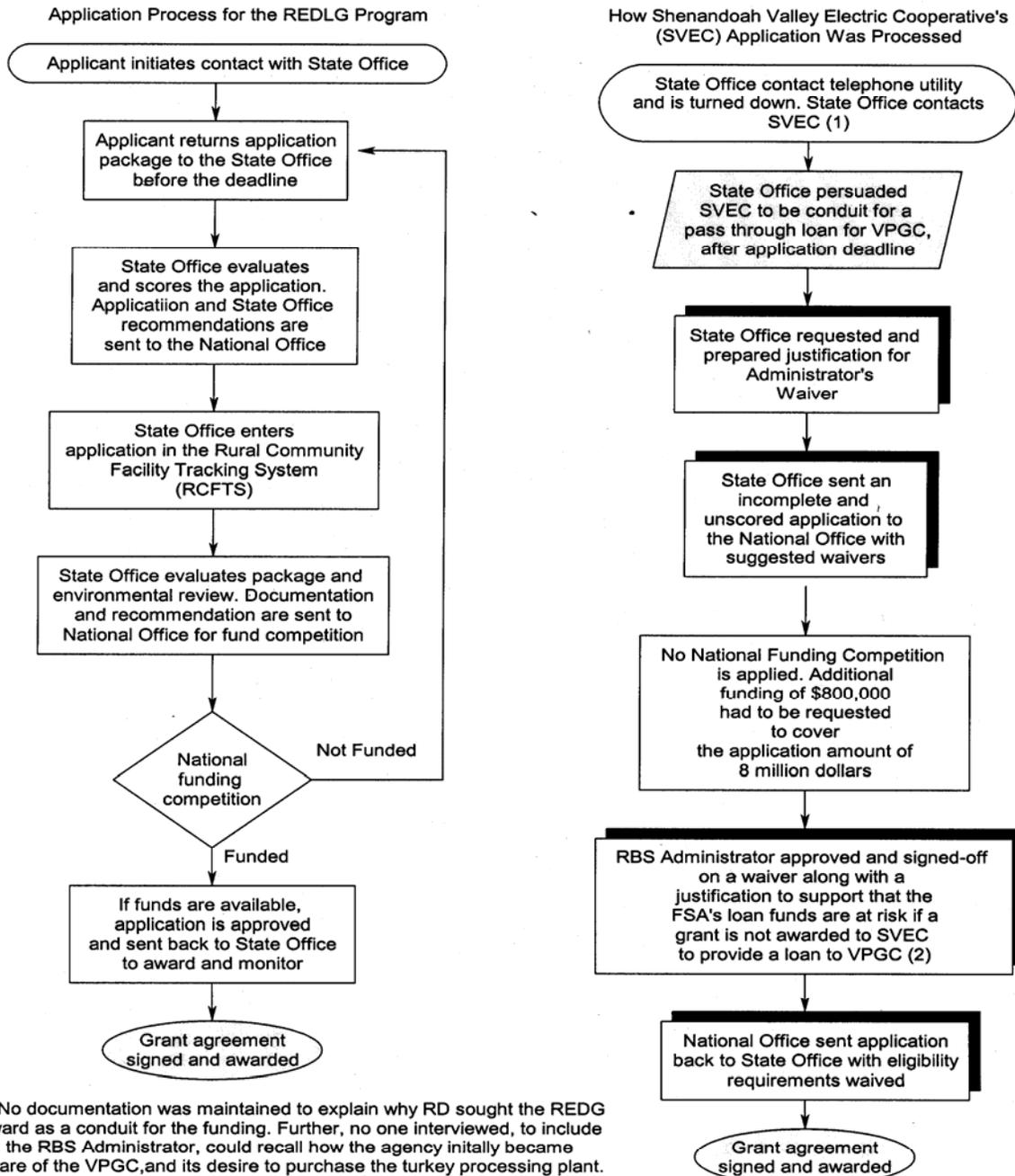
C.F.R. 1703.46(a) states that the “Administrator will not consider applications that do not conform with all of the provisions of this subpart, [referring to subpart B of the regulations] as determined by the Administrator.” (Information in brackets added). In this case, the Administrator specifically determined that the application did not conform to a number of the provisions of Subpart B. For example, in his letter approving the grant, the Administrator specifically stated that “[a] review of the subject proposal indicates that the initial grant will not be made to a nonprofit or public body for eligible purposes as specified in 1703.22(a)(2) and 1703.18(d),(f),(g), and (h).” The Administrator then specifically cites to the sentence in 7 C.F.R. 1703.46(a) that prohibits him from considering applications that do not conform to all of the regulations applicable to the program. Therefore, it appears that pursuant to 7 C.F.R. 1703.46(a), the application should not have even been considered, let alone approved.

Finally, I believe that justifying the waiver on economic factors was improper. While economic factors are criteria for granting waiver under other USDA explicit waiver authorities, those authorities do not apply to this case. See, e.g., 7 C.F.R. 1717.850(m). While promoting rural economic development is cited at 7 C.F.R. 1703.11 as the general policy underlying this program, it is not cited as a criterion for waiving the other requirements of the program that should have been adhered to in this case. Granting this ad hoc waiver had the potential for adversely affecting the substantive rights of other borrowers to a limited amount of funds available under the program. Further, we believe that it is inherently unfair to provide one borrower with special treatment that does not apply to all other borrowers similarly situated. Particularly as it may ultimately have a deleterious economic affect on those not afforded such treatment.

Since the Administrator lacked authority to waive sections of 7 C.F.R. 1703-Subpart B the regulations, I believe it was improper for him to do so in this case.

Exhibit B – REDG Program

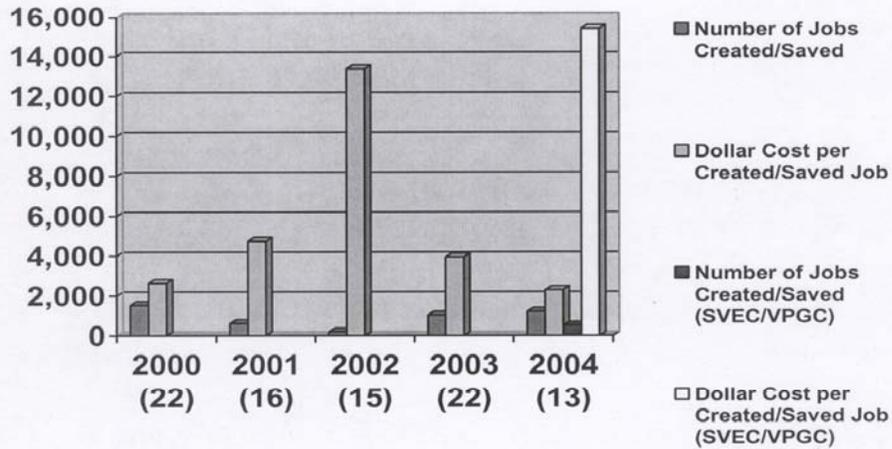
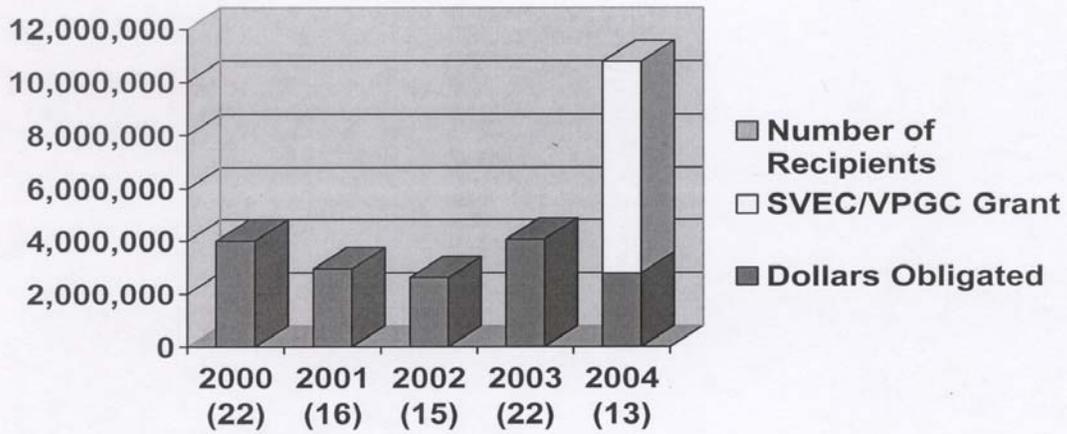
Rural Economic Development Loan and Grant Program



(1) No documentation was maintained to explain why RD sought the REDG award as a conduit for the funding. Further, no one interviewed, to include the RBS Administrator, could recall how the agency initially became aware of the VPGC, and its desire to purchase the turkey processing plant.

(2) Administrator asserts that he did not review supporting materials or independently assess their adequacy. Instead, he "relied on his staff to provide an assessment." The staff's assessment was not supported by adequate documentation.

Exhibit C – SVEC/VPGC Grant Chart



Note:

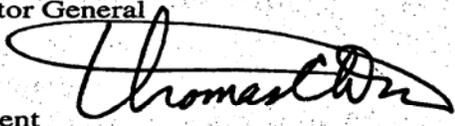
1. Parentheses indicate the number of grants awarded.
2. These statistics were provided by RBS. Their accuracy was not part of the scope of the audit, therefore the statistics were not tested and we make no statement as to their accuracy.



**United States Department of Agriculture
Rural Development
Office of the Under Secretary**

MAR - 9 2006

TO: Robert W. Young
Assistant Inspector General for Audit
USDA Office of Inspector General

FROM: Thomas C. Dorr
Under Secretary
USDA Rural Development 

SUBJECT: Rural Business-Cooperative Service FY 2004 Rural Economic
Development Grant to Shenandoah Valley Electric Cooperative (85001-
01-HY)

I would like to thank the Office of Inspector General (OIG) for the opportunity to review and comment on the above captioned Office Draft report. Foremost, it is important to identify that this audit represents an administrative decision made prior to my confirmation as Under Secretary for Rural Development; consequently I am not inclined to second-guess such decisions made prior to my tenure. Further, I am confident that the Rural Business Administrator's decision to approve this grant request was well meaning, does not appear to create any statutory infraction.

I do recognize however that there appears to be a difference in opinion between the OIG and the Administrator on the justification for authorizing a grant to assist a rural community facing potential economic adversity. The underlying issue that has surfaced as a result of this audit is whether current regulatory guidelines are restricting the ability of business programs to have the necessary flexibility to allow cooperatives to assist economically distressed communities. These existing limitations are being reviewed and adjustments to the program are anticipated. Such adjustments will be implemented in accordance with the requirements of applicable law.

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It is important to note, as is explained in further detail below, that under the Rural Economic Development Loan and Grant (REDLG) program, Rural Development electric and telecommunications borrowers may voluntarily make unscheduled payments into the Cushion of Credit account. Payments into the Cushion of Credit account bear a stated rate of interest and are eventually used to satisfy the contributing electric or telecommunications borrower's outstanding loans. The funding made available to the REDLG program is the interest differential between what Cushion of Credit account earns from the Department of the Treasury and what the account is required to pay under section 313 of the Rural Electrification Act of 1936 to the electric or telecommunications borrowers that have contributed to the account. It is anticipated that as the account continues to create additional and more permanent resources through section 313A of the Rural Electrification Act, more cooperatives will have the opportunity to play a similar role in assisting other economically distressed communities. I believe that these cooperatives are in the position to play a larger role in the promotion of the economic development in their local areas and REDLG provides a vehicle for cooperatives to play this larger role.

Finding 1, RBS Administrator Inappropriately Waived Key REDLG Program Regulations

In determining the risk to the Federal government of not making these waivers, the Administrator took into consideration the risk of losing \$9 million in Farm Service Agency (FSA) loans that had been made to the poultry growers. OIG concluded that since the loans were collateralized by \$21 million in assets, the loans were not at risk. In discussions with FSA staff, it was determined that FSA gives significant consideration to the value of poultry grower contracts with processors as part of their underwriting process. While in this case, loans were collateralized with fixed assets, had Pilgram's Pride processing plant were to have close, as it was scheduled to do, the contracts would have had little or no value. FSA went on to state that, historically, it receives less than 50 cents on the dollar from poultry growers that have defaulted on their loans and file for bankruptcy. Therefore, if the waivers that are the subject of this review had not been made, FSA would have been at risk of losing a substantial portion of its \$9 million investment.

Administrator Lacked Authority to Grant Waivers

In making its determination on the Administrator's waiver authority, OIG states that the RBS administrator relied "on his own interpretation of his waiver authority". OIG further contends that "we found that the administrator did not obtain any guidance from the OGC on whether he had the authority to waive REDLG requirements". While guidance from OGC was informal and limited, the administrator believes that it was within his authorities to apply the waiver authorities, particularly in light of the movement internally to amend program guidelines to support similar request for funding. Given the emerging change in policy direction toward a more flexible funding structure, the Administrator exercised what he believed to be the necessary authorities to support the funding request. Again, this appears to be more internal administrative authorities and not based on any statutory restrictions.

Excessive REDLG Funding Awarded

OIG's conclusion that the \$8,000,000 awarded to Shenandoah Valley Electric Cooperative (SVEC) could have been more effectively applied by granting \$300,000 grants to 26 other projects does not recognize that all funding requests that could be funded, were funded in 2004 and 2005. The funding of the \$8,000,000 project did not result in depriving any other request from receiving funding.

Zero Interest Loan Resulted in Market Place Advantage

OIG states that the \$8 million loan made by SVEC to Virginia Poultry Growers Cooperative (VPGC) provided a marketplace advantage unavailable to its competitors. OIG further states that VPGC's un-audited financial results as of March 31, 2005, show that for the first six months of operation VPGC earned over [] in net profits. OIG further indicated that "at its current rate of profitability, VPGC will have earned [] after only 8 months of operation." While initial profitability may have been construed to establish a high profitability, the reality is that projections outlined in March did not come to fruition. Instead, as of December 22, 2005, actual financial results for that period were [] in net profits.

Further, to imply that profitable operations can, in any way, be a substitute for the capital infusion necessary to incorporate a business is contrary to the basics of economic and business formation. It would have been impossible for VPGC to incorporate, purchase the facility, and begin operating without the requisite seed money.

OIG states that the loan terms were overly generous regarding repayment. The implementing regulations, in 7 CFR Section 1703.29, specifically state that "the administrator will determine the terms and repayment schedule of the zero-interest loan to the borrower based on the nature of the project and approved purposes". In setting the loan terms, the administrator took into consideration the nature of the project and its purpose. While VPGC is currently profitable, it was far from a forgone conclusion at the time of the loan.

Inefficient Job Creation

Reference by OIG that utilizing \$8 million on saving 520 jobs for 520 families is an "inefficient" use of government funding as well as spending \$15,384 per family is an inappropriate use of Federal government's money. Further, the OIG draft report compares the cost per employee at \$15,384 to an average cost per job of \$2,295 for all other REDLG-funded projects in Fiscal Year 2004.

Nearly 700 jobs (545 plant jobs, 148 grower-members) were created or saved as a result of the REDLG funding. Regulations specifically state that the maximum number of points awarded for job creation will go to projects that provide "five or more direct long-term jobs per \$100,000 of total project costs." Therefore, the regulations specify that any job costing less than \$20,000 is, in fact, the most efficient use of this funding. In addition to providing an efficient use of grant funds to create or save jobs directly associated with the poultry facility, hundreds of residual jobs in the region were significantly affected as well, from suppliers, retail establishments, etc.

No Economic Hardship

While OIG is correct in stating that the unemployment rate for Rockingham County was 2.7% in September 2004, that rate appeared to be an anomaly of past and future rates where the rate averaged at 3.0% for 2004. Given the potential loss of an additional 500-700 jobs in the region, it was anticipated that the actual unemployment rate for the county would have increased by 31%, resulting in a monthly rate of 3.8% for that year. While the state of Virginia, as a whole, enjoys a lower than usual unemployment rate, the loss of these jobs would have had a devastating impact on this county.

Not only were the Hinton, Virginia factor workers and the poultry growers at risk, the economy of the region was at risk, as well. In an article published in the Virginia Farm Bureau Federal on September 23, 2004, Mark Deavers, a Rockingham County custom poultry litter applicator stated that "I have three suppliers that I needed litter from, and if they went out of business, I would have been really hurting in that area. They account for about 25 percent of my business." The article went on to state that "Deavers is a prime example of what was at stake had the turkey operation closed. Hundreds of local businesses stood to lose income, even though many were not directly related to the operation."

Recommendation 1:

Before attempting to waive any REDLG provisions, the business administrator should (1) document the specific regulatory authority for issuance of the waiver to include details of any information relied upon, and (2) obtain a written opinion of OGC concerning the waiver and setting forth the supporting legal reasoning. This documentation should be provided to the Office of the Under Secretary for written concurrence prior to issuing a waiver.

Agency Response:

Under Secretary for Rural Development with the concurrence on February 27, 2006 by the Secretary of Agriculture has directed, effective immediately, that no steps be taken by the Administrator of RBS or by other officials of that agency which would waive REDLG or other RBS program requirements, or would have the effect of doing so, without prior review by and written approval from the Office of General Counsel. This directive was delivered to the administrator and senior leadership of the business programs to be incorporated into their administrative notice process and will remain in effect until further notice. (Attachment #1)

Recommendation 2:

Through consultation with OGC, determine the options available to recoup the \$8 million in REDLG funding provided to VPGC through SVEC. Implement the actions determined to be most defensible. If no options are considered viable by the agency, document the options considered and the bases for not pursuing them.

Agency Response:

The agency agrees to consult with OGC in determining any viable and legally defensible options to recoup \$8 million in REDLG funding provided to VPGC through SVEC. An analysis and fundamental agreement regarding actions to be taken will be completed

within nine months of the published date of this report, with final action to be completed within one year. If no options are considered viable, the agency will document the options considered and the bases for not pursuing them.

**Cc: Peter Thomas, Acting Assistant Secretary for Administration
Jackie Gleason, Acting Administrator for USDA Rural Development Business Programs**



United States Department of Agriculture
Rural Development
Office of the Under Secretary

DECISION MEMORANDUM FOR THE SECRETARY

FROM: Thomas C. Dorr
Under Secretary for Rural Development

FEB 21 2006

SUBJECT: Legal Review of Waivers in RBS Programs

As you know, we have had difficulties recently in connection with one or more cases in which requirements of law and regulations, which apply to the Rural Economic Development Loan and Grant (REDLG) program administered by the Rural Business-Cooperative Service (RBS), have not been followed. Specifically, while neither the statutory authority for the REDLG program nor regulations issued there under contain any provisions for the granting of waivers of program requirements, such waivers have in fact been granted without seeking formal legal review and apparently in contravention of legal authorities. As a result, actions have been taken, and substantial resources have been expended, in cases where the actions should not have been approved. As one result, the Office of Inspector General has audited the REDLG program and, based on its audit findings, has recently issued a highly critical report. It is my understanding that similar problems arising in loan and grant program activities of RBS have also occurred in past years, including during the previous Administration, and that prior agreed upon efforts to correct such problems have been unavailing.

As we have discussed, I wish to take steps to assure that similar occurrences do not arise in the future in either the REDLG program or any other RBS program. I propose, therefore, to direct that no steps be taken by the Administrator of RBS or by other officials of that agency which would waive program requirements, or would have the effect of doing so, without prior review by and written approval from the Office of the General Counsel (OGC). These steps would remain in effect until further notice and would, I believe, make a measurable difference in assuring the integrity of all RBS program activities.

I will not take this step until I am assured I have your approval.

APPROVE:

DATE:
2/27/06

DISAPPROVE:

DATE:

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United States Department of Agriculture
Rural Development
Office of the Under Secretary

APR - 3 2006

TO: Robert W. Young
Assistant Inspector General for Audit
USDA Office of Inspector General

FROM: Thomas C. Dorr
Under Secretary
USDA Rural Development 

SUBJECT: Rural Business-Cooperative Service FY 2004 Rural Economic
Development Grant to Shenandoah Valley Electric Cooperative (85001-
01-HY)

The following additional language is provided in support of USDA Rural Development's agency response to recommendation #1. I trust this additional language will assist in finalizing your report relative to this audit.

Amended Agency response:

Under Secretary for Rural Development with the concurrence on February 27, 2006 by the Secretary of Agriculture has directed, effective immediately, that no steps be taken by the Administrator of RBS or by other officials of that agency which would waive REDLG or other RBS program requirements, or would have the effect of doing so, without prior review by and written approval from the Office of General Counsel. This directive was delivered to the administrator and senior leadership of the business programs to be incorporated into their administrative notice process and will remain in effect until further notice. (Attachment #1)

USDA Rural Development also agrees to establish a second-party approval mechanism that ensures OGC-approved waiver requests receive Under Secretary directed concurrence. A second party review process will be developed within the next sixty days.

Cc: Jack Gleason, Acting Administrator, Business Programs

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