

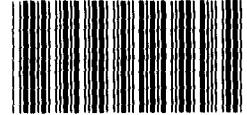
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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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STATEMENT OF
J. DEXTER PEACH, DIRECTOR
RESOURCES, COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION
BEFORE THE
SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES



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Mr. Chairman and Members of the Committee:

We appreciate the opportunity to be here today to discuss our recent report entitled "Analysis of the Powder River Basin Federal Coal Lease Sale: Economic Valuation Improvements and Legislative Changes Needed" (GAO/RCED-83-119). In response to Congressman Edward Markey's request--later joined by Senator Max Baucus--we have spent almost a year studying this very sensitive and controversial sale. The many issues surrounding the sale are technically complex, interrelated, and simply cannot be examined in isolation. The issues we have evaluated include:

- an alleged unauthorized disclosure by Interior of proprietary coal data prior to the sale;
- the change of bidding systems made about 6 weeks before the Powder River sale;
- whether Interior received fair market value for leased coal; and
- a question over whether the objectives of current coal leasing law are realistic in light of actual coal development patterns.

In evaluating these issues we raise--on the one hand--some serious questions regarding Interior actions and the reasoning behind them. On the other hand we recognize that Interior faces

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the very difficult task of trying to sell--competitively--leases many of which are attractive only to adjacent mining operations and of little interest to the rest of the industry. For this reason our questions extend beyond the April and October Powder River coal sales to the Federal coal management program as well. In summary, our message is that several features of the Department's program need revision, but, to make Interior's task practicable, congressional action is also needed.

Our objective today is twofold. First, to outline our principal findings in each issue area. Second, to provide a perspective for viewing these findings and interpreting what they mean in the context of Federal coal leasing. Before walking you through each of the issues we evaluated, let me spend a few minutes discussing our methodology in coming up with GAO's revised estimates of values for the Powder River coal tracts--an important part of our analysis. Basically we reviewed in detail, validated, and--where we could--relied on the analysis used by Interior's regional economic evaluation team to establish its original estimates of minimum value (the so-called MABs) for the coal tracts. But where we found wrong assumptions or inappropriate adjustments, we made revisions to Interior's calculations. This resulted in GAO's revised estimates of coal value. It is important to understand, however, that rather than devising our own independent approach we worked closely with the approach followed by Interior--which we found generally reasonable under the circumstances--but making revisions to their analysis for assumptions or adjustments we found inappropriate.

EFFECT OF THE ALLEGED DISCLOSURE
OF PROPRIETARY COAL PRICE DATA
ON THE APRIL SALE

Concerning the first issue--allegations have been made that an unauthorized disclosure of proprietary coal data may have led to pressure on Interior from coal companies to change its bidding system and lower its selling price for coal tracts to be offered at the April sale. While we found evidence that such a disclosure may have occurred, we could not substantiate that it had any direct impact on preparations for--or thus compromised--the sale.

A memo dated March 26, 1982, from the North Central Regional Office of Interior's Minerals Management Service to Service headquarters asserted that the minimum acceptable bid (MAB) values for the April sale were distributed by unknown parties (not within the Service) and were in the hands of some industry, State, and private individuals. The memo also expressed a concern that the sale procedures may have been compromised. Interior has taken the position that since the memo is dated one week after the Department's March 19 decision to scrap the use of MABs in favor of a new bidding concept featuring entry level bids--the controversy surrounding the allegation is overemphasized. This position, however, does not account for the roughly 2-week period--beginning March 2--when the MABs were transmitted from the Casper regional office to the BLM Wyoming and Montana State offices until March 19 when the decision to change bidding systems was made. Thus, the possibility exists that during this time the MABs found their way into industry hands and that industry subsequently pressured Interior into changing bidding systems as a means of lowering coal selling prices.

Though internal Service and Bureau controls over the MABs were not in compliance with Departmental regulations (43 C.F.R. 2.20)--and numerous Service and Bureau field officials told us

that an unauthorized disclosure had occurred--we were not able to verify details relating to it or to establish a link between it and any "lobbying" by industry which might have resulted in the change in bidding systems. However, we found the allegations were not investigated within Interior. Under Departmental procedures--Department Manual, 355.2.1--the matter should have been referred to Interior's Inspector General after the March 26 memo was received. We furnished the results of our review to the Inspector General and understand that sometime last week he completed his investigation and issued a report which based on interviews with Interior officials and coal industry persons concluded that no leak occurred.

In any event, because the alleged disclosure was not investigated before the sale, controversy arose in May when the news media widely reported it. Rightly or wrongly, the possible disclosure was linked in the public eye with the new bidding system instituted for the April sale.

CHANGE TO ENTRY LEVEL BIDDING

At a March 19, 1982, meeting, senior Interior Department officials decided to change the bidding system to be used at the April sale. The new system--called the entry level system--was patterned after the auction principle of starting the bidding at a "floor" or entry level price well below its real estimated value. Thus, instead of publishing and using the Department's presale estimates of fair market value as minimum acceptable bids (MABs)--its normal approach--lower "entry" level prices, to start the bidding, were published and later used at the sale. Interior felt that the MABs calculated by the Casper regional team were too high, based on faulty tract appraisal methods, and might scare away prospective bidders--whereas the entry level bids, generally set at 40 to 50 percent of a tract's value, were likely to spur bidding competition.

The decision to adopt entry level bidding had a dramatic impact on the lease prices which would have been published in Interior's Notice of Sale. At the time Interior was planning to offer 19 leases at the April sale. Entry level prices, developed over the weekend of March 20-21 for the 19 leases, totaled about \$70.6 million, compared with their original MAB values of about \$144 million. Thus, the impact at the time of the decision to adopt entry level bidding was to reduce the coal selling prices by over \$73 million. However, resource data errors for the Spring Draw and Fortin Draw tracts--which came to light after the March 19 decision--reduced the difference between MABs and entry level bids to about \$47 million. The subsequent elimination of six tracts from the sale--five due to an inability to gain surface owner consent, the other because of a resource data error--further reduced the difference to \$24.6 million for the 13 tracts offered at the April sale.

Because it is easy to get confused with differences in values assigned and bids received among the number of (1) tracts originally selected for sale, (2) tracts actually offered for sale, (3) tracts receiving bids, and (4) tracts for which bids were accepted, we have developed a chart (Attachment I) showing for each category, as appropriate, the original MABs, the corrected MABs taking into account resource data errors on two tracts, the entry level prices established by Interior, GAO's revised values, and the actual bids received.

When we conducted our review, Interior headquarters officials had no records documenting and could provide no written quantitative basis supporting the need to change the bidding system, just six weeks prior to the sale. We believe this lack of analysis is particularly significant since the system implemented was an experimental one, and the lease sale planned was

the largest in history. The system did not spur bidding competition as Interior had envisioned. In this regard, we cannot visualize any rationale for believing that values for production maintenance-type tracts would be "bid up" since such tracts are only of interest to the adjacent mining operations they border. Instead of doubling entry level prices as anticipated, actual bids, for the 11 tracts bid on, exceeded entry levels by only \$2.2 million, falling \$15 million short of Interior's original estimates of their value--as corrected--of \$70 million.

DID POWDER RIVER COAL LEASES
SELL AT FAIR MARKET VALUE?

Most of our report is directed at answering this basic question. Based on our evaluation, we believe that most Powder River leases sold for less than fair market value. Before reaching that conclusion, however, we made numerous analyses of the

- economic valuation methods employed by the Department's experts on the North Central Regional Economic Evaluation Team,
- criticisms of the regional team's methods voiced at Interior headquarters, and
- procedures for determining--after the sale--whether or not bids received represented fair market value.

In what economists call a "perfect market," these analyses would not be necessary. Several companies--each with relatively equal ability to develop a mine--would be bidding for each coal lease and the resulting competition would unquestionably yield fair market value. No further analysis would be needed. But, today's coal market is far from perfect. Under current conditions, active bidding competition for Federal coal leases cannot reasonably be expected. Thus, to determine whether or not a

coal lease sold for fair market value, the Government must resort to more sophisticated economic analyses. Both an estimate of the lease's value and a means for evaluating bids received against that estimate are needed.

We found that the method used by the regional evaluation team to estimate the value of Powder River leases--which resulted in the original MABs--was not unreasonable under the circumstances. However, revisions to eliminate the effects--which turned out to be quite significant--of some unnecessary features of their analysis were needed. On the other hand, we found Interior headquarters officials' criticisms of the team's methods neither supportable nor warranted since the officials could not provide us detailed information documenting weaknesses in the methods used and based on our interviews did not appear to know details of the method itself.

Based on our analysis, we believe Interior's contention that the regional team's estimates of lease value were too high was not accurate. In fact, our analysis, using the regional team's estimating approach and correcting for several inappropriate adjustments, showed these estimates were too low. With closer attention to the regional team's lease valuation methods, Interior would have had a better understanding of the worth of Powder River coal and a better basis for determining fair market value after the sale. In addition, had the Department more closely analyzed its own criticisms of the regional team's methods, Interior may not have changed to the experimental entry level bid system but instead made appropriate adjustments to the regional team's original estimate of fair market value.

Interior's postsale procedures for determining whether bids represented market value were conceptually flawed and improperly administered. Though the procedures used after the April and

October sales differ slightly, both suffer from the same conceptual illness--an overdependence on data from the actual sale itself. Put simply, the procedures unrealistically anticipated genuine bidding competition. In addition, they were unclear and confusing in parts and also included bid acceptance criteria which were unrelated to determining market value.

From our analysis we found that most Powder River coal leases sold for less than fair market value. In fact, actual selling prices for leases sold in April and October were roughly \$100 million below our estimates of their value. Powder River tracts fall into two categories--new production and production maintenance tracts. Of the five new production tracts--those that can be economically mined by themselves--only one was clearly acceptable based on our revised values. Two sold for less than 30 percent of our revised value and thus in our opinion were clearly unacceptable, while the two remaining tracts sold at 48 and 60 percent of our revised value and thus while not clearly unacceptable--considering changes in demand for new coal production--were at least questionable. In our opinion, none of the seven maintenance tracts--those tracts designated to be a logical extension of an adjacent mining operation--sold at fair market value. All should have been rejected. We have attached some charts, which I will walk you through, which illustrate the extent to which Powder River tracts sold for less than our estimates of their fair market value.

FEDERAL LEASE LAWS
ARE NOT REALISTIC

Under the Mineral Lands Leasing Act of 1920, as amended by the Federal Coal Leasing Amendments Act of 1976 [30 U.S.C. 201 (a)(1)], the Secretary of the Interior must award coal leases by competitive bidding, but shall accept no bid which he determines

is less than fair market value. The many laws influencing the Federal Coal Management Program, however, tend to restrict leasing to areas where coal is already being mined. The Western coal industry has learned to live with this approach and is expanding existing mines rather than opening new ones. Since coal production lags about 10 years behind the date a company obtains a coal supply contract, expanding existing mines can provide a company with coal needed to either satisfy contract commitments, negotiate longer-term contracts, or compete for new contracts. Many experts think this development pattern results in more efficient and economic mining operations. Environmentalists seem to prefer this approach to other approaches for developing western coal because the impact of mining is restricted to a particular area. States generally agree with it because socioeconomic impacts are similarly limited.

Western coal development patterns are today well established--growing from years of noncompetitive leasing and speculation. The current elaborate land use and lease planning processes tend to reinforce these patterns. As a result, many leases offered at regional coal sales--8 of 13 Powder River leases offered in April--are for the purpose of expanding existing mines. These are known as production maintenance leases, which for all intents and purposes, are noncompetitive.

Under the present statutory framework, Interior's task is difficult at best. The present law assumes all coal lease tracts are competitive. It does not recognize that essentially noncompetitive production maintenance tracts not only exist but are in many cases desirable. Thus, present law does not allow Interior to value and sell coal leases in a manner consistent with actual coal development patterns. As a result, the manner in which the Government leases coal does not correspond to the way industry is developing the resource.

Since tracts are offered for sale based on expressions of interest, companies need only ask Interior to offer a specific property and the Department usually obliges. Conducting a "competitive lease sale" under these circumstances offers little assurance that the Government will receive a reasonable return for leased coal. The captive nature of the six production maintenance leases receiving bids at the April 1982 Powder River sale can be seen by comparing their expressions of interest against the actual number of bidders. All of the six tracts were offered based on a single expression of interest and received only one bid--except for West Decker which received two bids (the second bidder did not appear to be a "sincere" one--since only the first bidder could mine the coal). Continuing to sell production maintenance tracts at regional coal sales only creates the pretense of competition and offers little assurance that the Government will receive a reasonable return for its coal. In our view this problem of "maintenance leasing" deserves Congressional attention.

CONCLUSIONS AND RECOMMENDATIONS

Mr. Chairman, I have covered several sensitive and controversial issues surrounding the Powder River Basin Coal Sale and before moving into our recommendations I would like to recap our key findings which raise serious questions about the manner in which Interior conducted the sale.

--While we found limited evidence that a disclosure of proprietary coal data may have occurred, we were unable to verify related details or to confirm that it had an impact on preparations for the April sale.

--The disclosure allegations were not investigated within Interior or promptly referred to Interior's Inspector General as required under Departmental procedures.

--Interior had no records documenting and could provide no written quantitative basis supporting the need to change the bidding system for the April sale. The "entry level" system used did not work as Interior envisioned. The October followup sale, while featuring yet a different approach, offered little indication of the worth of Interior's "minimum" bidding concept, since only two tracts were offered.

--Based on our evaluation, most Powder River coal leases sold for less than fair market value. Actual selling prices for leases sold in April and October were roughly \$100 million below our estimates of their value.

Our report recommends that Congress and the Secretary of the Interior take several actions to ensure a reasonable return to the Government for leased coal.

We specifically recommend that Interior postpone scheduled regional coal sales until the Department has revised several features of its program. Briefly stated we recommend that Interior develop

- a detailed analysis of factors affecting the value of a Federal coal lease;
- new internal procedures for conducting coal lease valuations;
- new guidelines for using untried or experimental bidding systems;
- minimum regulatory selling prices for coal leases in each Federal coal region on a cents per ton, rather than dollars per acre, basis;
- revised fair market value determination procedures.

We also recommend that the Secretary direct the Bureau of Land Management to establish Bureau-wide, written internal procedures for safeguarding coal lease pricing, economic valuation, and other proprietary data.

While Interior prepares for future lease sales, Congress, too, should take steps to make the Department's task more practicable. Legislative amendments are needed to authorize Interior to negotiate the essentially noncompetitive production maintenance leases. In addition, to ensure public and industry awareness of the lease negotiation process, and to provide ample opportunity for affected parties to influence the process, the amending legislation should require that Interior publish its (1) intent to negotiate a proposed maintenance lease, (2) decision to negotiate the lease as proposed and its evaluation of public comments, (3) intent to sell the lease and the proposed sale terms, and (4) decision to sell the lease as proposed, or under modified terms, and its evaluation of public comments. Further, to facilitate future evaluations of the negotiation process, we recommend that the amending legislation require that detailed records be kept of the negotiations, including evidence presented by Government and industry representatives, and of its disposition.

The issue of whether Interior obtained fair market value for Powder River coal leases ultimately may be resolved in the courts. The U.S. District Court for the District of Montana currently has the Powder River coal fair market value question before it. In the interim, we urge Interior to reconsider the bids for these leases--in light of our findings--and if the evidence does not support a determination of fair market value, the Department should cancel the leases. This action would be consistent with the view of the United States Supreme Court that in a proper case the Secretary of the Interior has the power to correct his own errors, by lease cancellation (Boesche v. Udall, 373 U.S. 472 (1963)).

Mr. Chairman that concludes my statement; I welcome any questions the committee may have.

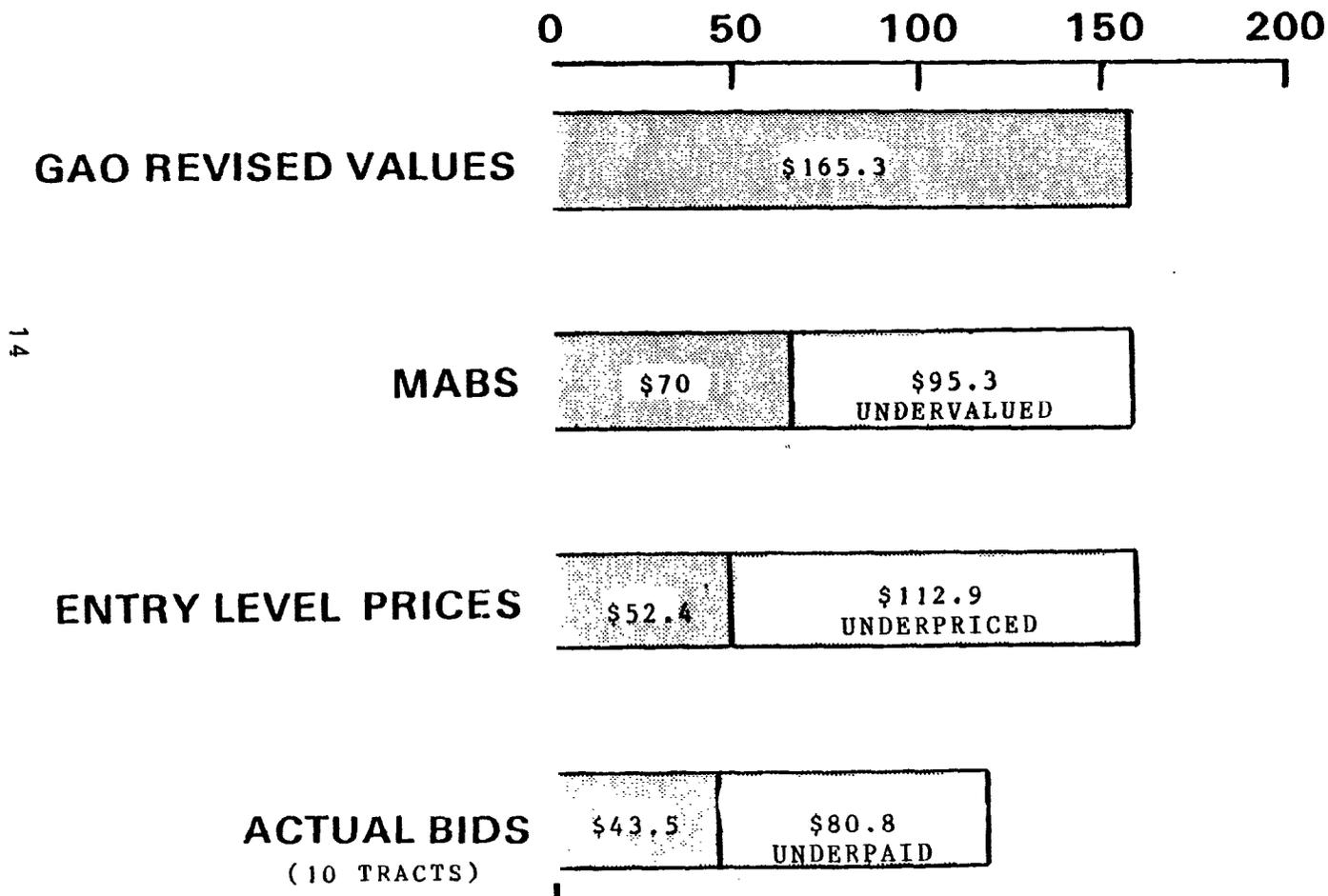
Comparison of Actual Bids
with Estimates of Tract Value

	<u>Original MABs</u>	<u>"Corrected" MABs*</u>	<u>Entry level prices</u>	<u>GAO revised value</u>	<u>Actual bids</u>
	-----\$ Millions-----				
19 tracts originally selected (Feb.'82)	\$144	\$117.4	\$70.6	-	-
13 tracts offered, (Apr.'82)	107.9	83.2	58.5	-	-
11 tracts bid on, (Apr.'82)	94.7	69.95	52.4	165.3	54.7
10 tracts for which bids accepted, (May'82)	68.1	43.4	41.27	124.3	43.5
12 tracts for which bids accepted, (Apr. and Oct.'82)	97.2	70.7	54.6	167.8	67.2

*MABs corrected to account for data errors related to Spring Draw and Fortin Draw tracts. Error on Fortin Draw discovered Apr.'82, tract dropped from sale, reoffered Oct.'82. Partial error on Spring Draw discovered May'82, in time for postsale analysis--full error discovered Aug.'82.

COMPARISON OF GAO'S REVISED VALUES TO MABS, ENTRY BIDS, ACTUAL BIDS, APRIL 1982, 11 TRACTS

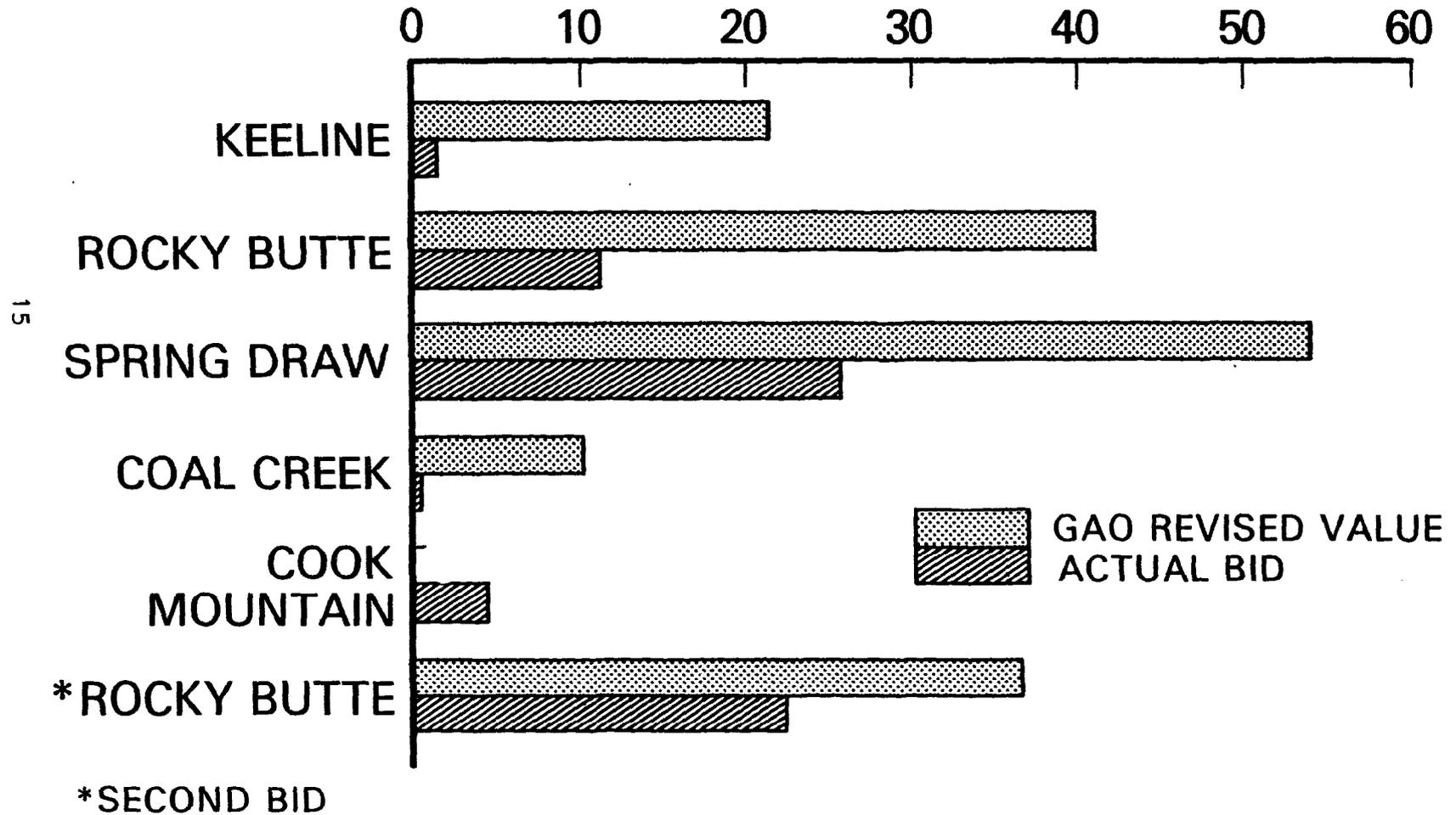
(Millions)



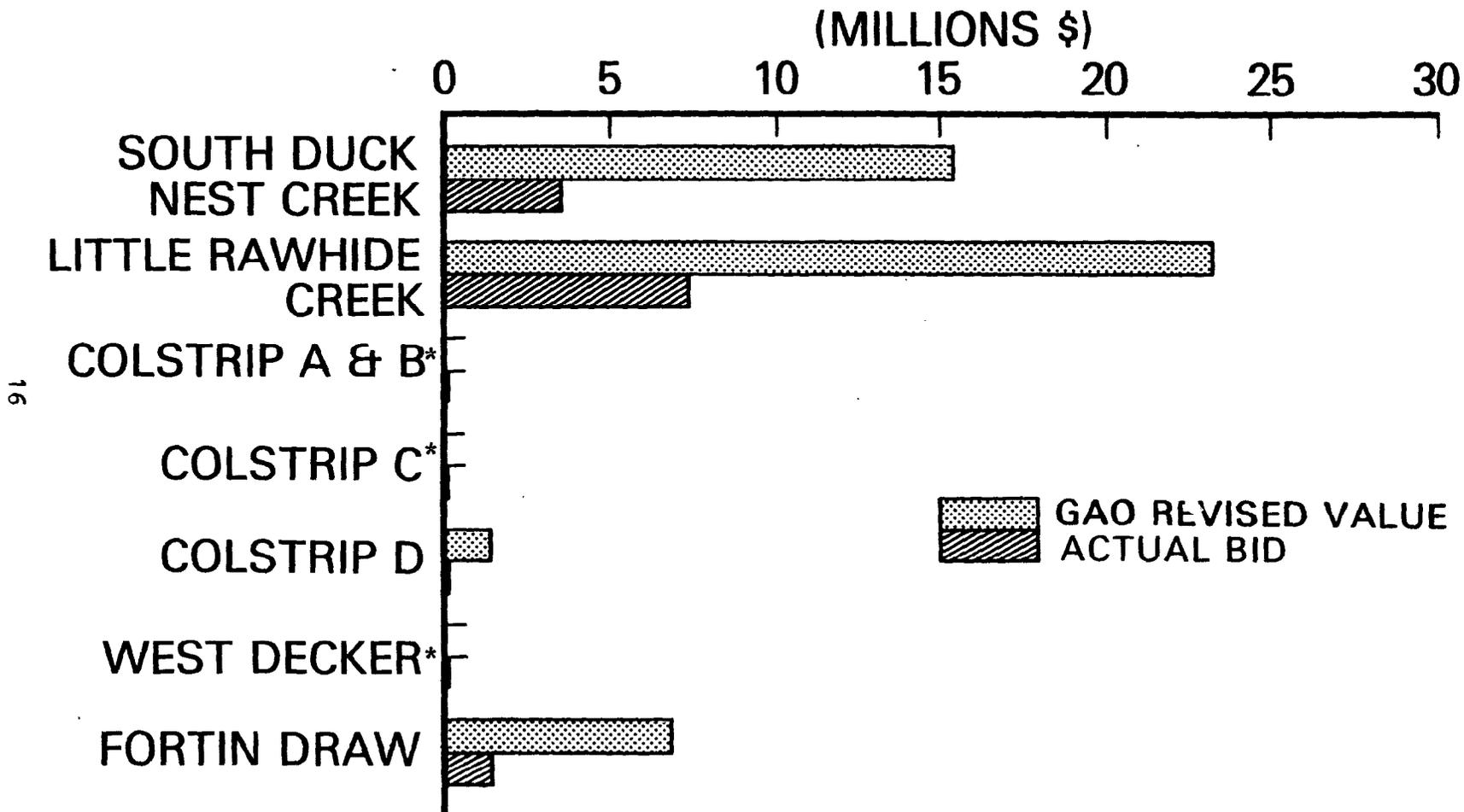
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REASONABLENESS OF BIDS ANALYSIS FOR POWDER RIVER NEW PRODUCTION TRACTS

(MILLIONS \$)



REASONABLENESS OF BIDS ANALYSIS FOR POWDER RIVER MAINTENANCE TRACTS



*GAO's revisions to Interior's analysis still resulted in negative values. Actual bids amounted to less than .2¢ per ton.

FOR EXAMPLE . . . LITTLE RAWHIDE AND SOUTH DUCK NEST TRACTS

LITTLE RAWHIDE

SOUTH DUCK

(MILLIONS)

ORIGINAL MAB VALUE	\$12.1		\$ 3.6
ENTRY LEVEL PRICES	7.2		3.6
ACTUAL HIGH BIDS	7.4		3.6
GAO'S REVISED MABS	23.4		14.1
AMOUNT UNDERSOLD	\$16.0		\$10.5

BASIS FOR GAO'S REVISIONS:

ORIGINAL MABS	\$12.1		\$ 3.6
LESS: PRODUCTION			
RATE ADJUSTMENT	-2.4		+3.0
TAX EFFECT			
ADJUSTMENT	+1.6		+3.9
50/50 SPLIT	<u>+12.1</u>		<u>+3.6</u>
REVISED MABS	\$23.4		\$14.1

17