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STATEMENT OF
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RESOURCES, COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION
BEFORE THE
COMMISSION ON FAIR MARKET VALUE POLICY
FOR FEDERAL COAL LEASING

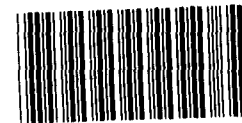
Mr. Chairman and Members of the Commission:

We appreciate the opportunity to be here today to discuss the fair market value implications of our recent report¹.

Our report raised--on the one hand--some serious questions regarding Interior's actions related to the sale and the reasoning behind them. On the other hand, it recognized that Interior faces 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. Thus, our message was that several features of the Department's leasing program need revision, but, to make Interior's task practicable, congressional action is also needed.

¹"Analysis of the Powder River Basin Federal Coal Lease Sale: Economic Valuation Improvements and Legislative Changes Needed" GAO/RCED-83-119, May 11, 1983.

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Breaking our evaluation of the Powder River Coal sale down to its broadest components reveals two basic needs. The first-- a need for economic valuation improvements--could be satisfied by Interior through procedural changes. The second--a need for legislative changes--can only be satisfied by the Congress through amendments to current leasing laws. Since our report was issued Interior has made progress in bringing about some of the procedural improvements we recommended. We understand that our legislative recommendations may be the subject of future hearings before the House Subcommittee on Mining, Forestry and BPA, Committee on Interior and Insular Affairs.

Our objective today is to update the coal fair market value positions taken in the Powder River report. First, I will highlight some of our report's more important findings pertaining to the fair market value of Powder River coal leases. Then, I will discuss the procedural improvements we recommended to the Secretary of the Interior and the extent to which the Department's new coal sale procedures published July 26, 1983, address our recommendations. Last, I will briefly summarize our position on the need for legislative changes.

DID POWDER RIVER COAL LEASES
SELL AT FAIR MARKET VALUE?

Most of our report is directed at answering this fundamental 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 own 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.

We found that the method used by the regional evaluation team to estimate the value of Powder River leases--which resulted in the Department's original presale estimates of value--was not unreasonable considering the less than perfect competitive coal market that existed in the region. However, revisions to eliminate the effects--which turned out to be quite significant--of some unnecessary features of their analysis were needed.

Specifically, we questioned the need to consider certain tax effects and possible differences in rates at which coal might be produced from different leases. In addition, we felt a former policy of cutting the estimated value of certain small tracts in-half was inappropriate. Our analysis of these unnecessary features of Interior's analysis is discussed in detail beginning on page 33 of our report. Though Interior has since dropped the policy of halving the value of small tracts, it continues to believe the other adjustments are appropriate.

We also 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. Interior's contention that the regional team's estimates of lease value were too high was not accurate. Our analysis, using the regional team's estimating approach and correcting for adjustments we deemed inappropriate, showed these estimates were too low.

Interior's postsale procedures for determining whether bids offered for Powder River leases 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. For the five new production tracts--those that can be economically mined by themselves--only one tract received a clearly acceptable bid. Two sold for less than 30 percent of our estimate of their value and thus in our opinion were clearly unacceptable, while the two remaining tracts sold at 48 and 60 percent of our estimate 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.

RECOMMENDATIONS, ACTIONS TAKEN,
AND IMPROVEMENTS NEEDED

Our report recommends the Secretary of the Interior take several actions to ensure the Department can act as a knowledgeable seller at future coal sales and that fair market value is received in exchange for Federal leases. We specifically recommended that Interior postpone scheduled regional coal sales until the Department has revised several features of its program. Although Interior did implement different procedures

since the issuance of our report, we do not believe they adequately address all of our concerns. Let me briefly state the main thrust of each recommendation and outline the extent to which Interior's new procedures address our concerns and--where appropriate--what actions Interior might take to satisfy remaining concerns. We recommended that Interior develop

--A detailed analysis of the economic and geologic variables affecting the value of a Federal coal lease, including how changes in one variable affect others.

At the time of our report, Interior's regional economic evaluation team in Casper, Wyoming, had identified many of the economic and geologic variables affecting coal lease value and in this sense had completed much of the work needed to satisfy this recommendation. We understand a recent Interior Department work group has also undertaken a study to identify factors affecting coal lease value and their relationships--though we have not had an opportunity to evaluate it. After examining Interior's analysis and testing their application of new procedures, we will be in a better position to conclude whether additional study is still needed. Another recommendation called for

--New internal procedures for conducting coal lease valuations, including criteria for comparable sales analyses--refining the technique used to develop original minimum acceptable bids for the April 1982 Powder River sale.

Until recently, Interior did not have uniform procedures for conducting coal lease valuations. In fact, the simulation technique the Casper Economic Evaluation Team employed to value Powder River leases was not widely known or used at other

Department locations, nor even understood by resource evaluation experts at Interior headquarters.

Interior's new sale procedures, however, go a long way toward correcting this deficiency. For example, the presale procedures include specific instructions for selecting, adjusting, and analyzing potential comparable sales. These procedures represent a constructive response to our recommendation and should help assure that the task of resource evaluation is approached in a reasonable, consistent manner at future lease sales. The next recommendation urged

--New guidelines for using untried or experimental bidding systems--such as entry level and intertract bidding--at regional coal lease sales, including limits on the percentage of the leasing target permitted under such experimentation.

The benefit of new guidelines is that they would provide structure to what is currently arbitrary. In essence, guidelines would provide a framework for the timing, design, conduct, and evaluation of future experiments. Guidelines may also save future experiments from controversy such as that which surrounded the one at Powder River. Interior disagrees with this recommendation. It contends that such experiments are infrequent and procedures for conducting each experiment--and the amount of coal to be so offered--should be determined on a case-by-case basis. We disagree and hope Interior will reconsider its position. We also recommended

--Minimum regulatory selling prices for coal leases in each Federal coal region on a cents per ton basis.

Establishing minimum regional cents per ton prices would recognize the fact that coal is a heterogenous resource occurring in various amounts, geologic formations, and qualities in different Federal coal regions. The benefit of replacing the current \$100 per acre minimum with a regional cents per ton minimum lies in the greater prospects for receiving fair market value for smaller tracts--particularly in bypass situations or in all-too-frequent cases when lease valuation techniques yield negative estimates of lease value.

In responding to our report, as required by Section 236 of the Legislative Reorganization Act of 1970, Interior said it had no philosophical objections to our suggestion, but believes that the regulatory minimum should be used to discourage frivolous bidding and not used as a pricing mechanism related to coal value. We disagree because at the Powder River sale the regulatory minimum--then \$25 per acre--became the Department's presale estimate of value which was later used as a basis for accepting bids of \$25.50 per acre for three Colstrip, Montana, lease tracts. Since regulatory minimums can potentially be translated into a bid acceptance criteria, in our view, they should somehow be related to coal value. In fairness to the Department, Interior is considering further study of our suggestion, but to our knowledge has not begun any work in the area. Last, we recommended

--Revised fair market value determination procedures that include specific quantitative tests (1) applicable whether or not adequate bidding competition is present and (2) placing greater reliance on prior comparable sales and recent arm's length sales in the absence of bidding competition at the actual sale.

The interim procedures Interior used after the October follow-up sale were overly dependent on the presence of genuine

bidding competition at the sale itself and--as discussed on page 54 and 55 of our report--were so flexible that they permitted inconsistent postsale analyses of the Fortin Draw and Rocky Butte tracts. Because Interior officials were unable to explain inconsistencies in the analyses of these two tracts, it was not clear to us whether the Department's efforts were directed more to supporting preconceived notions of value than at fairly determining it. The postsale stage of Interior's new procedures, however, now includes specific quantitative tests along the lines envisioned in our recommendation and calls for a complete and fully documented appraisal report as well.

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Thus, the new lease sale procedures narrow somewhat the gap between GAO and Interior on the fair market value issue. However, it should be pointed out that GAO and Interior still have some major differences. Most significantly, we do not share the same views on whether Powder River coal sold for fair market value--which could carry over into how new procedures are applied and coal is valued in future sales. This is because we differ on the appropriateness of including certain variables in calculating the value of a Federal coal lease. Specifically, we continue to believe that a tax effect adjustment should be reserved for those tracts set aside for small businesses and situations where small business participation may be anticipated. Further, we believe that Interior should not adjust lease values for potential production rate differences associated with different size mining operations. Such adjustments are speculative in nature and may duplicate the stripping ratio adjustment. The Commission will find details on our position well documented both in our report and in congressional testimony. Interior's official response to our report--which we plan

to rejoin for the record--continues to take issue with our positions. This completes my discussion of the need for economic valuation improvements.

BECAUSE FEDERAL LEASE LAWS
ARE NOT REALISTIC, LEGISLATIVE
CHANGES ARE NEEDED

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--were 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. For example, 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.

Congress 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.

Mr. Chairman and members of the Commission that concludes my statement; I welcome any questions the Commission may have.