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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

January 27, 1984

B-208410

The Honorable Mark O. Hatfield
Chairman, Committee on Appropriations
United States Senate

Dear Mr. Chairman:

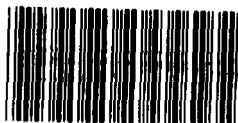
Subject: Evaluation of Department of the Interior Comments on GAO's Report on the Powder River Basin Coal Sale

On May 11, 1983, we issued a report to the Congress entitled Analysis of the Powder River Basin Federal Coal Lease Sale: Economic Valuation Improvements and Legislative Changes Needed (GAO/RCED-83-119). As you know, this report has been one of the focal points for congressional debates on the continuation of federal coal leasing activities. On July 20, 1983, the Department of the Interior submitted comments--as required by the Legislative Reorganization Act of 1970 (31 U.S.C. §720)--to our report, including actions it would take in response to our recommendations. Because of continuing congressional interest in coal leasing, we believe our evaluation of Interior's comments is needed to complete the record.

Overall, Interior indicated agreement with a number of our recommendations and other parts of our report, but also registered some major disagreements. Most significantly--as highlighted in its cover letter--Interior (1) raised strong objections to our contention that Powder River leases sold for roughly $100 million less than their fair market value and (2) disagreed with our recommendation to postpone scheduled lease sales until deficiencies in Interior's fair market value determination procedures are corrected. In addition, Interior noted that it was developing the best possible procedures to assure receipt of fair market value without improperly dictating or influencing that value.

We continue to believe, as stated in our Powder River report and subsequent congressional testimonies, that most Powder River leases sold for less than fair market value and that several features of Interior's leasing program need revision. Since our report was issued, Interior has made progress in bringing about some of the procedural improvements we recommended and is committed to making other changes in response to recommendations of the Commission on Fair Market Value Policy for Federal Coal Leasing.

With regard to our view that Interior accepted $100 million less than fair market value for Powder River leases, Interior's response implies that we arrived at the $100 million figure by making our own technical assumptions and judgments of tract value



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independent of Interior's professional appraisers. Interior also asserted that we had not demonstrated that industry would have paid the extra $100 million and that we did not consider the decline in the coal market from 1980 to 1982. Contrary to the implications of Interior's letter, we would emphasize, as we did in several testimonies before congressional committees, that we did not devise our own approach for valuing coal tracts but simply used Interior appraisers' basic approach and methodology. However, we did eliminate certain adjustments from their analysis which we found either invalid or unvalidated and which in our view had the effect of raising the fair market value of the Powder River coal tracts by about $100 million.

Whether industry would have been willing to pay more for the leases is not the central issue, given the limited competition at the sale and the existing legislative mandate to either obtain fair market value or not to lease the coal. Even so, there was at least an indication that industry might have been willing to pay more. At the April 1982 Powder River sale, a bid of $11 million was rejected for the Rocky Butte tract. When the tract was reoffered in October 1982, the same single bidder offered $22 million for the tract.

Interior's contention that we did not consider the decline in the coal market between 1980 and 1982 ignores the treatment afforded the changing market conditions in our report. The Dry Fork tract that fell in selling price from $68 million in 1980 to $22 million in 1982 was given extensive treatment in our report. Essentially, our analysis showed that the Dry Fork tract was sold on a competitive basis in 1980 and under conditions approaching a distress sale in 1982. In fact, we subsequently used data from the 1982 sale of this tract as criteria in our review for judging whether bids for new production tracts in the Powder River sale represented fair market value.

In addition, the question of whether Interior should postpone further scheduled lease sales until its fair market value determination procedures have been corrected has largely been overcome by events. The Congress has already decreed that sales will be postponed up to 90 days after the Commission on Fair Market Value Policy for Federal Coal Leasing issues its report to the Congress (scheduled for January 1984) addressing the need for changes in Interior procedures.

Finally, while we have not analyzed the current actions being taken by Interior, we agree that there is a need to develop the best possible procedures to assure receipt of fair market value without improperly dictating or influencing that value by making available either too little coal or far more than the market will bear. Ideally, a balanced pace responsive to the needs of industry and considering the effects on others impacted by federal

leasing is needed. Interior has the challenging task of maintaining such a balance when considering the substantial amount of coal already under lease and the changing market conditions and outlook for coal.

In addition to overall comments highlighted in its cover letter, as discussed above, Interior's response included two enclosures--one addressing our individual recommendations, the other providing specific comments on chapters 2 through 6 of our report. Because of the extensive nature of Interior's comments, our responses have been annotated--paragrapn by paragraph or section by section, as appropriate--to the full text of Interior's letter. (See enc. I.) Some redundancy is inherent in this approach, but we believe it is necessary in order to give fair treatment to Interior's comments.

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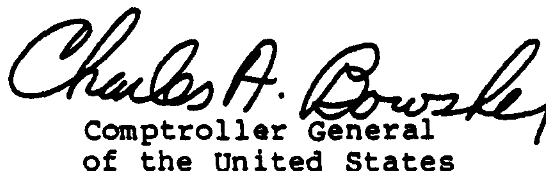
This letter is also being sent today to the Chairmen, Senate Committee on Governmental Affairs, House Committee on Appropriations, and House Committee on Government Operations who also received Interior's response. Copies of this letter are being sent to other Committees having oversight responsibilities for Interior programs as well as to Senator Max S. Baucus; the Secretary of the Interior; the Director, Office of Management and Budget; and the Chairman, Commission on Fair Market Value Policy for Federal Coal Leasing.

Sincerely yours,



Comptroller General
of the United States

Enclosure

United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

JUL 20 1983

Mr. Charles A. Bowsher
Comptroller General of the
United States
Washington, D.C. 20548

Dear Mr. Bowsher:

We are pleased to comply with Section 236 of the Legislative Reorganization Act of 1970. This letter responds to the General Accounting Office (GAO) report, "Analysis of the Powder River Basin Federal Coal Lease Sale: Economic Valuation Improvements and Legislative Changes Needed" (RCED-83-119), dated May 11, 1983.

A number of the GAO recommendations are constructive and are currently being implemented. The Department also agrees with the GAO report that:

1. Estimating the value of a Federal coal lease is a difficult process that requires considerable professional judgment.

2. The approach used by the Department of the Interior's evaluation team, although imperfect and in need of some improvement, was reasonable under the circumstances and provided a technically sound basis for estimating the fair market value of Powder River tracts.

However, the Interior Department objects strongly to the GAO contention that the fair market value of the Powder River leases sold was $100 million higher than the total of the accepted high bids. The GAO report itself states that the total of the accepted high bids approximately equalled the estimates of tract values made by the Department's professional appraisers, adjusted for resource data errors and new information. The GAO obtained the $100 million figure by revising the assumptions employed by the Interior appraisers. Because appraisals require professional judgment, it is inevitable that no two appraisers will agree precisely on assumptions. Indeed, the GAO's revised assumptions are themselves open to questioning and criticism.

The Interior Department welcomes suggestions for improvement in its appraisal procedures. However, it is inappropriate for GAO to portray a disagreement about debatable technical assumptions as a failure to achieve fair market value. Such a misleading characterization invites public misunderstanding and damages support for the coal leasing program, which is essential to the nation.

The Interior Department's evaluation of Federal coal lease tracts involves a series of detailed and complicated calculations. These calculations are an attempt to characterize nine basic factors affecting the value of a coal

tract through equations using in excess of 40 different elements. These calculations have been assembled into a computer model that was first developed in 1976 and has been continuously updated to account for changes in conditions such as tax laws and mining technology.

In the evaluation of the Department's conduct of the Powder River lease sale, the GAO requested the Department to make several runs of the Interior model, inserting the GAO's adjustments for some factors and, most importantly, omitting an adjustment for the production rate. Since the GAO omitted the production rate adjustment, the resulting tract values differed by a significant amount from Interior's appraisals. This is the largest source of the dramatic "losses" claimed by the GAO in the sale.

[GAO COMMENT: Interior states that the accepted bid approximately equaled the lease value estimates and that it is inappropriate for us to disagree about debatable technical assumptions as a failure to achieve fair market value. We must point out that our disagreement is not with the basic approach used by Interior to estimate coal tract value but with the use of certain inappropriate adjustments which resulted in lower estimates of value. Thus, while we found Interior's lease valuation approach generally reasonable under the circumstances, we revised the calculations of its evaluation team to eliminate the effect of these inappropriate adjustments--designed to reflect economies of scale associated with different-size mining operations and small business tax effects--and an improper policy of reducing the value for certain small tracts.

We revised the calculations because the evaluation team (1) could not demonstrate that an adjustment to reflect varying economies of scale was needed, (2) agreed that the small business tax effect adjustment should not have been made except in one case involving a small business set-aside tract, and (3) agreed that its policy of reducing the value of certain small tracts was inappropriate. Interior subsequently discarded this latter policy. Interior officials themselves had earlier identified the first two adjustments as speculative, believing that the adjustments were the reason why the evaluation team's original lease value estimates were so high. We found, however, that instead of making the estimates too high, the inappropriate adjustments and the other reduction made the estimates too low. As a result of eliminating these adjustments, the estimated worth of the coal leases was raised by about $100 million. We continue to believe that these adjustments are inappropriate. (See pp. 25-27 of this enclosure for detailed discussion.)

Eliminating the production rate adjustment from Interior field appraisers' analyses does not account for the bulk of the $100 million difference between Interior's and our estimates of tract value, as Interior's letter states. Of the $100 million figure--which includes both the April and October Powder River Basin sales--about $37 million applies to the production rate, about $36 million is attributable to an inappropriate tax effect adjustment, and $16 million to a policy--which has since been dropped--of halving the value of certain small tracts. The remaining $11 million is attributable to changes in other economic factors affected by the elimination of the three inappropriate adjustments.]

The results obtained from economic models are driven by the assumptions made. The Department necessarily relies on its own professionals who have spent most of their careers evaluating coal resources. Furthermore, the GAO fails to consider that fair market value requires a willing seller and a willing buyer; the seller's estimate of value is not fair market value until a buyer willing to pay that price comes forth. The GAO did not demonstrate that industry would have been willing to bid the extra $100 million the GAO claims was lost; in fact, two tracts received no bids even at the entry levels set by the Department.

[GAO COMMENT: The Mineral Lands Leasing Act of 1920, as amended, states that the Secretary of the Interior must award coal leases by competitive bidding but shall accept no bid which he or she determines is less than fair market value. We believe that Interior accepted bids which were $100 million less than fair market value. We found weaknesses in Interior's presale coal lease valuation procedures used to make accept/reject decisions on the Powder River sales high bids. The presale methods included inappropriate adjustments in estimating lease value while the postsale fair market value determination procedures were unclear and overly dependent on data derived from the sales themselves, which--absent competition--was not appropriate for measuring fair market value. Thus, by eliminating certain adjustments from Interior's lease valuation analysis, we developed revised estimates of market value for the sales' leases. In conclusion, most bids accepted for tracts at the April and October 1982 Powder River sales were well below our revised estimates of market value. At issue is the scope of the Secretary of the Interior's discretion in determining to accept a bid as representing market value. In examining the Secretary's determinations of market value, the basic question is one of reasonableness. Can a decision to accept or reject a bid be logically justified or was there an error in judgment? Our analysis of accepted bids as a percentage of our revised value indicated that Interior erred in accepting many bids at the two sales.

Although Interior has not demonstrated that industry was unwilling to pay more for Powder River coal, it nonetheless emphasizes that we did not prove industry was willing to pay an additional $100 million for it. Interior's argument implies that proof of industry's willingness to pay more is somehow critical to determining whether a coal lease sold at fair market value. We disagree. Just because a bidder is not willing to pay more does not mean that the amount he/she is willing to pay represents fair market value. Estimated worth of the coal should initially be determined analytically and then these estimates should be compared to the bids received. In noncompetitive situations, such as Powder River, if the bids do not equal or exceed the calculated values, then the tracts should be rejected. As documented in our report, at the April and October 1982 Powder River sales, Interior accepted bids for tracts which were roughly $100 million less than our revisions indicated.

Regarding the prospect of finding a buyer willing to pay a higher price, two instances at the April 1982 sale shed some light on industry's willingness to pay more for Powder River coal. In one case, involving the Rocky Butte tract, an April bid of $11 million was rejected by Interior. When the tract was reoffered in October 1982--after the market for Powder River coal had supposedly slumped even further--the same single bidder bid $22 million for the tract. In the second case--Cook Mountain--the tract was originally valued at 0.029 cents per ton (equal to the then-regulatory minimum amount of $25 per acre), or $52,000. However, when Interior included the tract as one of four candidate tracts for the first planned test of the experimental concept of intertract bidding, it was offered at a 2.5 cents-per-ton entry level price or $4.45 million--85 times higher than the previous minimum amount. Since surface owner consents for the other three candidate tracts were not filed, the intertract bidding experiment was abandoned. Through an oversight, however, Interior left the Cook Mountain tract priced at 2.5 cents per ton (rather than lowering it to the previous $25 per acre minimum amount). A bid for $4.45 million (equal to the higher 2.5 cents per ton) was made and accepted and, in our view, it was the only clearly acceptable one of the April sale.]

In calculating the $100 million "loss", the GAO also failed to consider the decline in the coal market from 1980 to 1982. The one tract used as the basis for the Department's comparable sales analysis fell in selling price from $68 million to $22 million over this period. The GAO knew of this decline but failed to consider it without any valid explanation. The fact that few comparable tracts were available for use in economic evaluations emphasizes the uncertainties of tract evaluation after a 10-year moratorium on Federal coal leasing in a region with little nonFederal coal.

[GAO COMMENT: Interior's comment that we did not consider the decline in the coal market between 1980 and 1982 ignores the treatment afforded changing market conditions in the Powder River report. The report not only considers changes in the demand for coal, but also weighs the impact of demand changes on

--calculating estimated tract values (see pp. 24-30),

--determining the reasonableness of bids for new production tracts (see pp. 57-60), and

--evaluating the reasonableness of bids for production maintenance tracts (see p. 63).

The example Interior mentions in its comments refers to the Dry Fork new production tract in the Wyoming sector of the Powder River Basin. This tract was first sold in July 1980 and resold in December 1982. This sale is not only given extensive treatment in our report (see pp. 57-60), but was used as criteria in our subsequent review for judging whether bids for new production tracts represented fair market value. The tract sold at a distress sale in December 1982 for 30 percent of its July 1980 competitive purchase price. In evaluating bids received at the April and October 1982 sales, we used the 30 percent figure as an indicator of the lowest possible level of bid acceptability for new production tracts. In comparing high bids offered against our revised fair market value figures using the 30 percent base, we found that only one of five new production tracts received a bid which was clearly acceptable. Two others--though questionable--may have been acceptable. The remaining two high bids were clearly unacceptable, in our opinion, in that they were below the 30 percent threshhold, which we considered the lowest possible level of acceptability even in a greatly distressed market.]

The Department disagrees with the GAO's recommendation to postpone scheduled regional coal sales while correcting what the GAO perceives as deficiencies in the Department's fair market value determination procedures. The Department believes that the current procedures assure receipt of fair market value in full compliance with statutory requirements and does not intend to cancel any of the leases issued in the Powder River lease sale. We are actively analyzing and improving our economic evaluation and fair market value procedure; however, a postponement of coal sales would only distort the market and make evaluations more, rather than less, difficult. We agree with several of the specific GAO recommendations and, in some cases, already use the recommended procedures.

[GAO COMMENT: Interior's disagreement to postpone scheduled regional coal sales while correcting deficiencies in Interior's fair market value determination procedures may be a moot point. Since the issuance of our report, the Congress has postponed regional coal lease sales up to 90 days after the congressionally established Commission of Fair Market Value Policy for Federal Coal Leasing issues its report to the Congress. One major part of the Commission's task is to evaluate the new postsale fair market value procedures to determine if they are adequate to ensure fair market value.

The issue of whether Interior obtained fair market value for Powder River coal leases, however, ultimately may be resolved in the courts. Currently, the U.S. District Court for the District of Montana has the fair market value question before it.]

The Department is taking actions to develop the best possible procedures to assure receipt of fair market value without improperly dictating or influencing that value. When the Federal government is a near monopolist, as it is in the ownership of coal in the west, special care must be taken to ensure that the government does not act as a monopolist to maximize revenue. We continue to believe that fair market value can only be determined in the marketplace and that the Department's responsibility is to see that bids for Federal coal leases accurately reflect the state of the market.

[GAO COMMENT: We agree with Interior that there is a need to develop the best possible procedures to assure receipt of fair market value without improperly dictating or influencing that value. The federal government conceivably could do this with western coal--either by offering too little coal, thus driving up the price, or by offering far more coal than the market will bear, thus making it of very little value. Neither approach is appropriate. Ideally, a balanced pace responsive to the needs of industry but considering the effects on others is needed. Interior has the challenging task of developing such a balance when considering the substantial amount of coal already under lease and the changing market conditions and outlook for coal.]

The Department's detailed response to the GAO report is enclosed.

Sincerely,

UNDER SECRETARY

Enclosures

GAO'S RECOMMENDATIONS TO THE SECRETARY OF THE INTERIOR

Recommendation

Under the Federal Coal Leasing Amendments Act of 1976, which amended the Minerals Lands Leasing Act of 1920 (30 U.S.C. 201 (a)(1)), no bid which is less than the fair market value of the coal shall be accepted by the Secretary of the Interior. As we have previously indicated, however, bids in amounts substantially below fair market value were accepted and leases issued. 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. During the interim, however, the Secretary may wish to reconsider the reasonableness of the Department's methods and determinations--in light of our findings. If the Secretary determines that the evidence does not support a determination of fair market value, he 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 has the power to correct his own errors, by lease cancellation (Boesche v. Udall, 373 U.S. 472 (1963)).

Response

The Department's methods for determining if the high bids represented fair market value were reasonable. Fair market value was obtained for each tract leased. The Department has no intention of cancelling the leases because there is no basis for such action. The Department does not agree with GAO's conclusion that the Powder River sale procedures resulted in the government's receiving $100 million less than fair market value. There is no firm basis for assuming that cancellation of the leases and resale of the tracts would result in any increase in bonus bids. Any action to cancel the leases would almost certainly be challenged in court, resulting in costly and time-consuming delays for both the Department and the lessees in development of the Federal coal reserves. Since the issue of fair market value for the Powder River leases is now the subject of litigation, we will wait for the outcome of the litigation before considering any further action with respect to those leases.

[GAO COMMENT: As stated in our report, we believe that fair market value was not obtained for most of the leases issued by Interior in the Powder River sale--based on Interior's own estimates of value, as revised by us to eliminate certain inappropriate adjustments. However, as noted by our report and Interior's response, the U.S. District Court for the District of Montana currently has the fair market value question before it and may ultimately have to answer this question.

Interior's statement that no firm basis was established for assuming that cancellation of the leases and resale of the tracts would result in any increase in bonus bids does not adequately consider the results of the Rocky Butte tract. In that case, Interior rejected an April bid of $11 million. When the tract was reoffered in October 1982, the same bidder bid $22 million for the tract. Regardless of what industry's response might or might not have been, however, we believe that the law is clear in requiring that federal coal be leased at fair market value or not be leased.]

Recommendation

The Secretary of the Interior should postpone scheduled regional coal lease sales until Interior has developed:

-- 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;

-- 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;

-- 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;

-- minimum regulatory selling prices for coal leases in each Federal coal region on a cents per ton basis; and

-- 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.

Response

We recognize our obligation to ensure that fair market value is received for Federal coal leases. While we are confident that our procedures were adequate to ensure receipt of fair market value for the Powder River tracts, we recognize that our coal lease sale procedures, like any other procedures, can be improved. We see no need, however, to postpone any coal lease sales while evaluating and improving our procedures. It is only through continued coal lease sales that the Department can gain the experience and information needed to refine our tract evaluation and lease sale procedures.

[GAO COMMENT: We disagree with Interior's assertion that the procedures in place for the April and October 1982 Powder River coal sales were adequate to ensure receipt of fair market value. Interior's postsale fair market value determination procedures were driven by Interior's desire to provide additional emphasis on market indicators for measures of fairness or reasonableness. The postsale procedures used for the April and October sales relied heavily on data anticipated from the actual sales themselves and not on Interior's original estimates of tract value--with some revisions--as the foundation for fair market value determinations. For this approach to work, however, at least some of the offered tracts would have had to stimulate genuine bidding competition. As noted elsewhere, however, this did not happen.

At the April sale, only 3 of 11 tracts brought any measure of competition, although even here it was limited to two bidders. Apart from this limited bidding, there was no evidence of competition at either sale. In our view, therefore, comparable sales analysis of prior sales could and should have been used as the essential benchmark for bid accept/reject decisions--but this was not a fundamental part of Interior's procedures. Our detailed analysis of the fair market value determination procedures in place for the Powder River coal sales begins on page 46 of our report.

Interior's disagreement with our recommendation to postpone scheduled regional coal sales may be a moot point. The Congress has postponed regional coal sales up to 90 days after the congressionally established Commission of Fair Market Value Policy for Federal Coal Leasing issues its report to the Congress.]

The Department is currently engaged in a two-part study of its coal lease sale procedures. The first part consists of an analysis of alternative pre and postsale evaluation procedures, such as the determination and use of presale estimates of tract value and alternative postsale evaluation procedures. Public comments received on the interim Federal coal lease sale procedures published in the Federal Register on September 13, 1982, are being considered as part of this analysis.

The Department expects to complete this analysis and select policies and procedures developed in the analysis by the end of July 1983.

[GAO COMMENT: Our report recommends that the Secretary of the Interior take several actions to ensure that Interior can act as a knowledgeable seller at future coal sales and that fair market value is received in exchange for federal leases. Interior has taken steps in the right direction by implementing different procedures since our report was issued. For example, the

postsale stage of Interior's new procedures includes specific quantitative tests along the lines envisioned in our recommendation and calls for a complete and fully documented appraisal report as well. However, we have not analyzed Interior's use of these new procedures for estimating tract value and ensuring fair market value in an actual coal lease sale.]

The second part of the study consists of testing variables that affect the value of coal leases through the discounted cash flow evaluation models. This test not only examines the effect of specific variables on the model but also, as GAO recommends, the interaction between variables such as stripping ratio and production rate. The discounted cash flow model used for the comparable sales analyses for the Fort Union coal lease sale scheduled later this summer will incorporate the results of these tests.

[GAO COMMENT: 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 already completed much of the general work needed to address this recommendation. In a September 19, 1983, letter to the Comptroller General (copies of which were distributed widely), the Deputy Assistant Secretary for Land and Water Resources forwarded an analysis which he claimed demonstrated the independence of the production rate and stripping ratio variables. After examining the analysis, we found that it served only to demonstrate that Interior's discounted cash flow model treats the two variables as independent--not that they should be treated as such. We subsequently noted this in a response to the Deputy Assistant Secretary. We have met on several occasions with Interior's technical staff and exchanged ideas on how to resolve our differences on the production rate adjustment issue. Along these lines, Interior has developed a research proposal to analyze data from operating western surface mines, and the analysis is being performed by the Oak Ridge National Laboratory.]

The Department disagrees with GAO's recommendation to develop guidelines for using untried or experimental bidding systems. Such experiments are infrequent and the procedures for conducting each experiment, and the amount of coal to be so offered, should be determined on a case-by-case basis.

[GAO COMMENT: Although Interior disagrees, we continue to believe that the development of guidelines for using untried or experimental bidding systems, like the one used for the Powd River coal sale, would be beneficial in laying o some basic ground rules for such experiments and thereby preventing the kind of hasty decision--change from the minimum acceptable bidding system to the entry level bidding system within only 6 weeks--which led to much of the controversy and still

unanswered questions surrounding the sale. In essence, such guidelines could provide needed structure and a systematic framework for considering the timing, design, conduct, and evaluation of future experiments. The guidelines could, and should be, applied on a case-by-case basis.]

While the Department has no philosophical objection to setting the minimum regulatory selling prices for coal leases in each coal region on a cents-per-ton basis as GAO recommends, we believe that GAO misunderstands the Department's purpose in establishing regulatory minimum bids. The Department has established a regulatory minimum bid of $100 per acre to screen out frivolous bids, to help recover the costs of leasing coal, and to establish as policy an intent to lease and develop coal worth at least that much first. The regulatory minimum bid is not intended to represent a pricing mechanism related to the actual value of coal in a particular tract in a particular region.

[GAO COMMENT: Establishing minimum regional cents-per-ton prices would recognize 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 cases where lease valuation techniques yield negative estimates of lease value. Interior has said that it has no philosophical objection 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. In reality, however, it frequently does become a pricing mechanism relative to value. At the Powder River sale, for example, the regulatory minimum--then $25 per acre--became Interior'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 potentially can be--and frequently are--translated into a bid acceptance criterion, in our view, they should be related to the value of the coal. We understand that Interior is considering further study of our suggestion.]

Recommendation

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

Response

This is a useful recommendation and the Department has begun to implement it. The Bureau already has adopted the former Minerals Management Service

procedures for safeguarding confidential and proprietary information. In addition, a study group consisting of both the Bureau and former Minerals Management Service employees has been appointed to consider additional changes in the Bureau's security procedures. The results of the study will be provided to the Secretary for review and approval.

[GAO COMMENT: Interior's efforts in this area are constructive.]

SPECIFIC COMMENTS BY CHAPTER

CHAPTER 2: ALLEGATIONS THAT A DISCLOSURE OF PROPRIETARY DATA COMPROMISED THE APRIL SALE COULD NOT BE SUBSTANTIATED

The Department's Inspector General began an investigation of the allegations of unauthorized disclosure of proprietary data after the GAO reported that it was unable to substantiate these allegations. On May 11, 1983, the Inspector General released a report on his investigation. The Inspector General concluded that no "leak" occurred and that suspicions of a leak arose from a lack of communication between the MMS and BLM.

By memorandum dated March 26, 1982, the Casper Office of the MMS notified its headquarters office that the presale estimates of value, the preliminary minimum acceptable bids, had been obtained by some industry representatives. Casper Office personnel suspected a "leak" of the preliminary minimum acceptable bids, which were considered to be proprietary, as a result of telephone conversations with press and industry representatives.

These conversations however actually occurred after the BLM released the Powder River Sale Notice with the entry level bids to the public on March 25, 1982. The entry level bids were also termed "minimum acceptable bids" in the Sale Notice. During the conversations with the Casper Office personnel, the industry and press representatives referred generally to "minimum acceptable bids". The Casper Office personnel assumed that the industry representative was referring to the preliminary MABs based on presale estimates of value and not the entry level bids and concluded that a "leak" of the preliminary minimum acceptable bids had occurred. The MMS field official had not been informed that the BLM had released the Sale Notice with entry level bids as "minimum acceptable bids" when the conversation in question occurred.

The merger of the MMS and BLM onshore mineral operations on December 3, 1982, should prevent this type of coordination problem. In addition, stricter procedures for handling proprietary data will be adopted by the BLM. These organizational and procedural changes will prevent the type of confusion that surrounded the Powder River sale and the alleged data leak.

[GAO COMMENT: The so-called leak incident has been discussed extensively in hearings and in follow-up investigations by the Interior Inspector General's office. Subsequent to the release of our report on the Powder River coal sale, the Interior Inspector General's office issued two follow-on reports (dated July 6 and 25, 1983) to its initial May 11, 1983, report. These follow-on reports provide additional information about the disclosure allegations. We have not reviewed these reports.

As stated on the previous page, we believe that Interior's efforts in establishing Bureau-wide written procedures for safeguarding proprietary coal lease data are a constructive response to our recommendation.]

CHAPTER 3: CHANGE TO ENTRY LEVEL BIDDING UNTIMELY AND INEFFECTIVE

We are pleased that the GAO recognizes that "coal valuation is inherently difficult because of uncertain market factors, costs, and prices related to the long-term investment potential of a given coal lease." An estimate is one person's opinion of value. Rarely would two appraisers working independently arrive at exactly the same estimate of market value for any item and this is especially true in the valuation of coal leases.

It is precisely because of these uncertainties that the Department decided to experiment with the use of entry level bids rather than presale estimates of tract values as minimum acceptable bids for the Powder River sale. Under the procedure used prior to the Powder River sale, the Department would estimate the value of a lease tract and set the minimum acceptable bid for the tract at that value estimate. This procedure required bids to equal or exceed the Department's estimate of value to be considered, thereby ignoring the possibility that the Department's estimate was too high and actually exceeded fair market value. Interested parties in these cases were forced to pay this inflated price or decline to bid. This very situation occurred in a coal lease sale in Utah in February 1982, only two months before the Powder River sale. Of four tracts offered, three received no bids even though all three had received expressions of leasing interest from industry.

The object of the entry level bid procedure was to evaluate bids to determine whether they accurately represented the state of the market rather than whether they merely met or exceeded the Department's unilateral estimate of market value. The entry level bids were set at representative tract values and were designed to be high enough to screen out nuisance bids without discouraging legitimate bids. The Department then conducted a postsale analysis of the bids. The postsale analysis was designed to determine whether the bids represented fair market value by considering the level of competition for each tract and the bid results for all tracts, factors which would not be available under the previous procedure, as well as the presale estimates of value.

The GAO's characterization of the switch to entry level bidding for the Powder River sale as "untimely and ineffective" is nothing more than second-guessing. The Department had every reason to believe before the sale that the entry level bidding procedure would be an improvement over the previous procedure. Expressions of leasing interest and industry participation in exploratory drilling indicated that competition was likely to occur for the new production tracts. While competition did not materialize to the extent expected, that does not invalidate the entry level bidding procedure as an appropriate procedure in the Powder River or any other lease sale. As for the effectiveness of the entry level bidding procedure, nine of the 10 accepted bids from the April 28, 1982, sale met or exceeded the Department's corrected presale estimates of value. The high bid for the tenth tract, while below the presale estimate of value, was accepted only because the tract involved was a potential bypass tract. It is difficult to understand why GAO considered the change to be ineffective when the total of the accepted high bids exceeded the Department's corrected presale estimates of value.

[GAO COMMENT: We agree that Interior's task of valuing coal leases is difficult because of the many uncertainties affecting the value of coal. This was true for the coal sold at the 1982 Powder River lease sale. To deal with the tract valuations for this sale, Interior adopted an experimental entry level bidding system which provided for bidding to begin at "entry" levels instead of at levels considered to be the coal tract's fair market value, as used under the previous minimum acceptable bid system. Interior's rationale for the new bidding system was that fair market value could best be determined after an actual sale because presale coal valuations--comparable sales analysis and discounted cash flow analysis--had proved to be historically difficult, particularly in regions such as the Powder River Basin where few leases had been sold over several years. In addition, Interior was concerned about the changing coal market in the region and a recent sale experience--a February 1982 coal lease sale in Utah where three of the four tracts offered by Interior received no bids.

Interior combined the concept of postsale valuation with the theory that competitive coal lease sale procedures should follow the standard bidding principles used at auctions. Auction procedures call for bidding to start at a "floor" level--normally 40 to 50 percent of the item's true value. This floor or entry level is meant to assure that bidding is encouraged, thus elevating the price received for the item. However, this elevating effect did not happen at the Powder River coal lease sale.

As stated in chapter 3 of our report, we question Interior's decision to change bidding systems less than 2 months prior to the single largest coal sale in history. We found that the system had not been previously tested in federal coal leasing and its use was unsupported by economic analysis. In addition, none of Interior's reasons for discarding the original minimum acceptable bids developed for the proposed Powder River coal tracts as being too high (or inflated) could be sustained.

Our conclusion that the switch to entry level bidding was untimely and ineffective was based on an analysis of the information available to Interior at the time of that decision. In short, given the depressed coal market at the time Interior made the decision, the results were predictable. Our conclusion is not based on "second guessing." Thus, we continue to believe that the switch was untimely and ineffective. Also, Interior now argues that expressions of leasing interest and industry participation in exploratory drilling indicated that competition was likely to occur for such tracts. This argument contradicts one of the rationales provided us by Interior officials for switching to the entry level bidding system, namely that a downturn in the coal market, as evidenced then by a prior (February 1982) sale in Utah, was likely to reduce competition and therefore reduce the bids on the offered tracts. In essence, Interior made the change to the entry level bidding system using the reduced entry level bids in the effort to spur competition.

Regarding Interior's statement that it is difficult to understand why we considered the change in the bidding system to be ineffective, we believe that our report clearly explains our reasons. We reviewed the effectiveness of the system in terms of how it accomplished its objectives of spurring competition, stimulating bidding significantly above the entry level, and obtaining fair market value. The system accomplished none of these objectives.

First, the entry level bidding system, designed to spur bidding competition at the April sale, did not attract competition for the most part. Of the 13 tracts offered, 2 received no bids, 8 received one bidder each, and the other 3 tracts each received two bidders.

Second, the entry level bidding system--using the auction theory where bidding starts at a floor level normally 40 to 50 percent of the estimated value--did not elevate the actual bids very far above the floor price set by Interior. Total actual bids at the sale were elevated only about $2.2 million, or about 4 percent above the entry level minimums. For example, the new production tracts, where greater bidding participation might have been expected, increased only $2 million, or about 5 percent, not 100 percent or more as envisioned in Interior's bidding theory. In addition, we questioned the application of the entry level bidding concept to maintenance tracts--since these leases are essentially noncompetitive--captive to adjacent mining operations. Conceptually, the entry level bidding or floor prices for these tracts were set at 40 to 50 percent of the best estimate of value. We

believe the April sale's preponderance of maintenance tracts made it less than the best test of an experimental bidding system designed to enhance bidding participation. The presence of eight maintenance tracts increased the likelihood that the bids would not be elevated very far above the floor price set by Interior.

Third, although Interior's statement that the total accepted high bids for the 10 tracts exceeded Interior's estimates of value is true, it should not be taken as an affirmation that fair market value was received. We contend that fair market value was not obtained because Interior's presale estimates, even as corrected, included certain inappropriate adjustments (discussed later in this enclosure) which allowed Interior to accept the high bids offered. Of the 10 accepted bids for the April sale, we found only 2 bids which approximated fair market value, and one of those--the bid for Spring Draw--was questionable. In our view, the measure of the effectiveness of the system is its ability to solicit bids equal to fair market value--which Interior is legally required to obtain before it can issue a federal coal lease (see pp. 56-62 of our report).]

CHAPTER 4: INTERIOR'S CRITICISMS OF COMPARABLE SALES ANALYSIS UNWARRANTED, BUT IMPROVEMENTS ARE NEEDED

The Department has no criticism of comparable sales analysis. We encourage its use whenever sales data of reasonable comparability can be obtained. Courts recognize that the comparable sales or market approach is the preferred method of valuation.

The Department's concern prior to the Powder River sale was not that the comparable sales analyses were based on faulty tract appraisal methods, but that the only comparable sales data available were two years old and that the coal market was down from the unusually high levels of 1980 when the sales took place. That period produced some usually high prices for coal reserves because of expectations of: 1) continuing increases in the real price of oil, 2) huge Federal subsidies for synfuels, 3) continuing expansion of aggregate energy demand, and 4) consequent major increases in coal demand in both the short and long terms. In addition, coal reserve supplies were artificially restricted by a 10-year moratorium on Federal coal leasing that still had not ended in 1980. These factors had waned by 1982. This was recognized by both field and headquarters personnel. The comparable sales analyses did not take the changes in the coal market into account. Contrary to the GAO report, however, the Department did not "discard" the estimated tract values determined through the comparable sales analysis. These values were used as a bid acceptance/rejection criterion in the postsale evaluation. The Department, however, did set minimum acceptable bids at entry levels rather than at the presale estimates of value, as was done in the past. This was done to avoid chilling potential competition by setting minimum bids at high levels and thereby to generate current market data for use in the postsale evaluations.

The Department certainly agrees with GAO that improvements are needed. We know of no system that could not be improved. As we gain more information and more experience, we are modifying both our presale and postsale procedures. Based on the April sale, we modified some of our procedures for the October sale. Public comments were solicited and received on the modified procedures. The Department is now reconsidering its fair market value policies and procedures in light of the public comments, the GAO report, and the comments and concerns of Congress.

[GAO COMMENT: Interior's statement that it had no criticism of comparable sales analysis contradicts evidence clearly cited in Interior's own files. For example, in correspondence dated July 14, 1982, to three Members of Congress, Interior's Under Secretary referred to the appraisal methods, one of which was comparable sales method, of its regional economic evaluation team as "exceedingly weak." After careful examination, we found these criticisms of the regional team's methods unwarranted, particularly--as noted on page 27 of our report--because headquarters critics could not document the weaknesses and, we found, did not know the details of the methodology the regional team used. Specifically, Interior headquarters officials expressed concern over several factors pertaining to the comparability of the tracts used as a basis for the comparable sales analyses. These factors included (1) the demand for coal had changed since the comparable tract--Dry Fork--was sold, (2) the tract was sold in the private assignment market rather than in a competitive federal coal lease sale, and (3) the tract was subject to different statutory requirements. After a detailed analysis of these factors, we found that (1) changes in the demand for coal were not a major factor, (2) contrary to Interior's contention, assignment market transactions make good comparable sales, and (3) differences in the statutory requirements--diligence and royalty rate requirements--were not significant. Thus, Interior's reasons for rejecting the team's analysis were not valid, although certain revisions were needed to the team's calculations. We concluded that absent sufficient competition at the sale, Interior should have used the comparable sales analysis, but with revisions to eliminate certain inappropriate adjustments and another questionable reduction in tract values made by the team. (Pages 22 through 24 of this enc. provide more details on these inappropriate adjustments and questionable reduction.)

Interior disagrees with our contention that estimates of tract value determined through comparable sales analysis were discarded. Interior argues that we did not recognize how these estimates--known as minimum acceptable bids--were used in postsale analyses. We believe that Interior's comments do not reflect properly the context in which we reported that tract value estimates were discarded. In addition, by citing the use of these estimates in postsale analysis, Interior further complicates the issue.

In our report, presale and postsale activities are discussed separately. Chapter 4 discusses what we viewed as unwarranted criticisms of the presale comparable sales analysis made by Interior's economic evaluation team in Casper, Wyoming. In introducing this chapter, we state that

> "Interior used comparable sales analysis for calculating minimum acceptable bids (MABs) for leases being offered at Federal coal lease sales. The MABs are commonly accepted as Interior's presale calculation of fair market value. The Minerals Management Service's regional economic evaluation team followed this approach in preparing for the April 1982 Powder River sale. The MABs developed were discarded, however, when Interior management decided that they were not reliable lease value estimates. As discussed earlier, the MABs were replaced by lower entry level values designed to spur greater bidder participation at the sale."

We believe the use of the term "discarded" in this context is clearly an appropriate characterization in that the presale tract value estimates were not used in the same manner at the April 28, 1982, Powder River coal sale as they had been used in the past. No mention of possible postsale use of the minimum acceptable bids was made at this point in our report because Interior's postsale procedures are discussed later and at length in chapter 5, beginning on page 46. For example, in chapter 5 we discussed Interior's use of its presale estimate of value as a bid acceptance/rejection criterion in its postsale evaluation.]

CHAPTER 5: DID POWDER RIVER COAL TRACTS SELL AT FAIR MARKET VALUE?

The most publicized contention of the GAO report was that the Federal Government received $100 million less than fair market value in the Powder River sale. Bonus revenues were allegedly lost because the Department's procedures included three adjustments used to derive presale estimates of tract value which the GAO felt were inappropriate. The GAO calculated that if these adjustments were excluded, the Department's presale estimates of value would have been $100 million higher.

The adjustments excluded by the GAO were a production rate adjustment, a small bidder tax adjustment, and a "50-50" split adjustment. These were three of nine adjustments made during the presale tract evaluation to the value of a comparable sale tract to account for the differences between the comparable tract and the tract being evaluated. The Department believes that the production rate adjustment was sound and that the other adjustments were not unreasonable. The following paragraphs discuss each adjustment in more detail.

Production Rate Adjustment - This adjustment was made to reflect the fact that tracts included in larger reserve units and therefore in larger prospective mines have more value because production costs are lower and reserve value per ton are higher. The Departmental professional staff had engineering estimates of the cost and value implications of large or small mines and could estimate the likely production rate of a mine which included each offered tract. There was nothing speculative in adjusting the comparable tract value to simulate the offered tract in those cases where different production rates were expected from each of their likely mines. Admittedly this adjustment needs to be applied thoughtfully but to exclude it is merely to assume that its value is zero and to assure an incorrect estimate. We are confident that the production rate adjustment made for the Powder River tracts was made carefully and appropriately. However, we are continuing to study this and other adjustments in an effort to develop the best possible economic analyses.

[GAO COMMENT: Interior's comments on the three adjustments--production rate, small business tax effect adjustment, and "50-50" split--excluded by us in revising estimates of value for the Powder River coal lease tracts pertain to material in chapter 4 of our report, not chapter 5 as Interior indicated.

Regarding Interior's belief that the production rate adjustment was sound and that its use was not speculative as we suggest, we first must state that Interior officials themselves characterized the adjustment as "speculative," because of the large number of uncertainties which accompany it. We maintain the position that the adjustment is questionable because it requires too many evaluative assumptions about factors influencing the size of future mining operations and annual production levels over time. Such factors are difficult, if not impossible, to predict with adequate levels of confidence.

Also, Interior's use of the production rate adjustment may "double account" for differences already considered in the stripping ratio adjustment (cubic yards of overburden per ton of coal recovered) also used by Interior. For example, economies of scale--cost savings--associated with different production levels may already be considered given production cost variances of mining tracts with different stripping ratios. Finally, because it is not clear that separate adjustments are appropriate for the production rate and stripping ratio, we feel that making no adjustment for the production rate is a more prudent course than making a questionable one. By our eliminating the production rate adjustment from Interior's analysis, the estimated values of many Powder River coal tracts were substantially raised--about $37 million.

Subsequently, we have met with Interior's technical staff to exchange ideas on how to resolve our differences on the production rate adjustment issue. Interior has developed a research proposal to analyze data from operating western surface mines, and that analysis is being performed by the Oak Ridge National Laboratory.]

Adjustment for Unfavorable Tax Loss Situation - The GAO also excluded an adjustment to the comparable tract value which was made because the Department believed that some potential bidders would not have been able to use mine development costs to offset profits on other ventures to reduce their tax burden. The GAO suggested that only tracts certain to be sold to small businesses have the benefit of this adjustment. The Department felt that it was reasonable to apply this adjustment to all tracts to avoid discriminating against possible small business buyers. We are reconsidering this adjustment as a result of GAO's concerns to determine what limits, if any, should be placed on the use of the adjustment.

[GAO COMMENT: The tax effect adjustment included in Interior's evaluation team's comparable sales analyses rests on the assumption that some bidders may be small businesses with weaker capital structures. We feel, however, that prevailing market conditions in the Powder River Basin reflect the economies of large-scale mining operations in western states and offer limited mining opportunities for small businesses. Because applying the small business tax effect adjustment results in a reduction to the estimated lease value, we believe it should be made only for analyses of tracts set aside for small businesses and situations where small business participation may be anticipated. By backing out this adjustment from Interior's analyses, our estimate of lease value for the Powder River tracts sold increased about $36 million.]

50/50 Split - After long examination of coal fair market value procedures, the previous administration adopted in 1980 a procedure for valuing high surplus profit maintenance tracts. This procedure calls for the Department to split the surplus value of valuable maintenance tracts with the neighboring mine owners. This policy was based on the observation that surplus value is often split 50/50 in noncompetitive private negotiations. While the Department considers this adjustment to be appropriate in certain situations, we agree with GAO that it is not always appropriate and we dropped this adjustment as a matter of general policy in September 1982.

[GAO COMMENT: We agree with Interior's decision to drop this policy adjustment from its comparable sales analyses in September 1982. Nevertheless, in regard to the fair market value issue at the Powder River sale, the values of two tracts sold at the April sale were cut in half, resulting in their devaluation. Our revised estimates of value by eliminating the adjustment for the tracts raised their values by about $16 million.]

In summary, the supposed $100 million revenue loss has not been shown to exist. Instead, GAO has shown that one can selectively eliminate professionally sound adjustments to achieve higher tract values. The GAO has not demonstrated that industry would have been willing to bid an extra $100 million for the tracts. In fact, two tracts did not receive any bids even at the lower entry levels. The GAO completely ignores the implications of the lack of bids for these two tracts in its analysis. Until a buyer comes forward willing to pay a specific asking price for coal or any other commodity, the asking price, no matter how carefully or artfully contrived, is merely an asking price and not fair market value. The GAO has demonstrated only that it would have asked $100 million more for the Powder River leases.

[GAO COMMENT: The Mineral Lands Leasing Act of 1920, as amended, states that the Secretary of the Interior must award coal leases by competitive bidding, but shall accept no bid which he or she determines is less than fair market value. We believe that Interior accepted bids which were $100 million less than fair market value. We found weaknesses in Interior's presale coal lease valuation procedures used to make accept/reject decisions on the sales' high bids. The presale methods included inappropriate adjustments in estimating lease value, while the postsale fair market value determination procedures were unclear and overly dependent on data derived from the sales themselves, which--absent competition--was not appropriate for measuring fair market value. Thus, by eliminating certain adjustments from Interior's lease valuation analysis, we developed revised estimates of market value for the sales' leases. In conclusion, most bids accepted for tracts at the April and October 1982 Powder River sales were well below our revised estimates of market value. At issue is the scope of the Secretary's discretion in determining to accept a bid as representing market value. In examining the

Secretary's determinations of market value, the basic question is one of reasonableness. Can a decision to accept or reject a bid be logically justified or was there a clear error in judgment? Our analysis of accepted bids as a percentage of our revised value indicated that Interior erred in accepting many bids at the two sales.

Although Interior has not demonstrated that industry was unwilling to pay more for Powder River coal, it nonetheless argues that we did not prove industry was willing to pay an additional $100 million for it. Interior's argument implies that proof of industry's willingness to pay more is somehow critical to determining whether a coal lease sold at fair market value. We disagree because the willingness of a buyer to pay more does not necessarily mean that that additional amount represents fair market value. Estimated worth of the coal should be determined analytically. Once calculated, the estimates are compared to bids received. As documented in our report, at the April and October 1982 Powder River sales, Interior accepted bids for tracts which were roughly $100 million less than our revisions indicated.

Regarding the prospect of finding a buyer willing to pay a higher price, two instances at the April 1982 sale shed some light on industry's willingness to pay more for Powder River coal. In one case, involving the Rocky Butte tract, an April bid of $11 million was rejected. When the tract was reoffered in October 1982--after the market for Powder River coal had supposedly slumped even further--the same single bidder bid $22 million for the tract. In the second case--Cook Mountain--the tract was originally valued at 0.029 cents per ton (equal to the then-regulatory minimum amount of $25 per acre) or $52,000. However, when Interior included the tract as one of four candidate tracts for the first planned test of the experimental concept of intertract bidding, it was offered at a 2.5 cents per ton entry level price or $4.45 million--85 times higher than the previous minimum amount. Since surface owner consents for the other three candidate tracts were not filed, the intertract bidding experiment was abandoned. Through an oversight, however, Interior left the Cook Mountain tract priced at 2.5 cents per ton (rather than lowering it to the previous $25 per acre minimum amount). A bid for $4.5 million (equal to the higher 2.5 cents per ton) was made and accepted and, in our view, it was the only clearly acceptable one of the April sale.

Interior states that we completely ignored the implications of the lack of bids for two tracts not receiving bids in the Powder River sale. It is true that our report does not mention the two tracts--Spring Creek

and North Decker--other than that the tracts did not receive bids. The reason for this is that information was not substantive in nature. The two tracts were designated by Interior as maintenance tracts with no competitive interest likely to occur other than from the two adjacent operators who nominated the tracts. Prior to the sale, both adjacent operators reassessed their needs for the proposed coal tracts at the offered prices in relation to their individual coal contract and reserve requirements. For example, one operator no longer needed the coal for contract requirements partly because the coal's sulfur content was too high. Receiving no bids on these noncompetitive tracts reflected more the operators' market conditions than the offered price of the coal.

Regarding Interior's response that we have shown that one can selectively eliminate professional, sound adjustments to achieve higher tract values, we emphasize again that we did not devise our own approach for valuing coal tracts but simply used Interior appraisers' basic approach and methodology except for eliminating from their analysis certain adjustments, discussed above, which we found either invalid or unvalidated. As a result, the worth of the coal leases was raised by about $100 million. Of the $100 million figure--which includes both the April and October Powder River Basin sales--about $37 million applies to the production rate, about $36 million is attributable to an inappropriate tax effect adjustment, and $16 million to a former policy of halving the value of certain small tracts. The remaining $11 million is attributable to changes in other economic factors affected by the elimination of the three inappropriate adjustments.]

The GAO also fails to consider the decline in the coal market from 1980 to 1982. The selling price of the tract used as the basis for the Department's comparable sales analysis fell from $68 million to $22 million over this period. The GAO provided no valid explanation for discounting this price drop except to say that the 1982 price reflects a distress sale. The GAO does not consider that the 1980 price, upon which the GAO relied so heavily, may have reflected a restricted market in which holders of existing Federal coal leases exerted a disproportionate influence. The selling price of a lease in 1980 may have been inflated as a result of a 10-year moratorium on Federal coal leasing. A new entrant seeking Federal coal leases in the Powder River region in 1980 was forced to deal with holders of existing leases or wait at least two years for the uncertain prospect of renewed Federal leasing. The GAO provided no evidence to indicate that the 1980 price of the comparable tract was a more accurate basis for estimating the fair market value of the Powder River tracts than the 1982 price that GAO discounts.

[GAO COMMENT: Interior's comment that we did not consider the decline in the coal market between 1980 and 1982 ignores the treatment afforded changing market conditions in the Powder River report. The report not only considers changes in the demand for coal, but also weighs the impact of demand changes on

--calculating estimated tract values (see pp. 24-30),

--determining the reasonableness of bids for new production tracts (see pp. 57-60), and

--evaluating the reasonableness of bids for production maintenance tracts (see p. 63).

The example Interior mentions in its comments refers to the Dry Fork new production tract in the Wyoming sector of the Powder River Basin. This tract was first sold in July 1980 and resold in December 1982. This sale is not only given extensive treatment in our report (see pp. 57-60), but was used as criteria in our subsequent review for judging whether bids for new production tracts represented fair market value. The tract sold at a distress sale in December 1982 for 30 percent of its July 1980 competitive purchase price. In evaluating bids received at the April and October 1982 sales, we used the 30 percent figure as an indicator of the lowest possible level of bid acceptability for new production tracts. In comparing high bids offered against our estimates of fair market value using the 30 percent base, we found that only one of five new production tracts received a bid which was clearly acceptable, while two others--though questionable--may have been acceptable. The remaining two high bids were clearly unacceptable, in our opinion, in that they were below the 30 percent threshold, which we considered the lowest possible level of acceptability even in a greatly distressed market.

Finally, Interior does not substantiate its comment that the selling price of a lease in 1980 may have been inflated as a result of a 10-year moratorium on federal coal leasing. Interior provided no information to show that the moratorium was a price-determining factor susceptible to quantification. In our view, because of the large amounts of coal under lease prior to the moratorium and the continued issuance of emergency coal leases during the moratorium, the price for the Dry Fork coal lease tract was not inflated in 1980.]

CHAPTER 6: HOW REASONABLE ARE THE COMPETITION AND FAIR MARKET VALUE REQUIREMENTS OF CURRENT LEASING LAW ?

The GAO points out what it sees as a deficiency in the Federal Coal Leasing Amendments Act of 1976, in that the Act requires the competitive leasing of maintenance tracts that in many cases can be developed only by a single adjacent operator. The GAO then recommends a change in the Act to permit noncompetitive, negotiated lease sales for these tracts to the adjacent operator.

The Department's initial reaction to this proposal is to continue to lease maintenance tracts competitively. However, we recognize the limitations of the market place in this situation. The GAO recommendation for legislative changes to allow negotiated sales of maintenance tracts will be further analyzed as will all constructive proposals to improve the Federal coal management program.

In the report the Powder River sale is used as an example of the extent to which Federal leasing has narrowed its role to primarily leasing maintenance tracts. However, this result was not by intent. Initially 11 new production tracts and eight maintenance tracts were scheduled to be offered for sale. Due to surface owner consent problems, five new production tracts were dropped from the Powder River sale. In the future the Department hopes to offer a larger percentage of new production tracts to provide more opportunities for new entrants to obtain coal leases. Of the 158 tracts being considered for regional lease sales in fiscal years 1983 and 1984, 116 are considered new production tracts.

There are 33 companies holding federal coal leases in the Powder River coal region. In the Powder River sale, four companies obtained Federal coal leases for the first time. One of the main objectives of further Federal coal leasing is to facilitate competition within the region. By offering additional coal tracts for lease, new companies are given the opportunity to enter into the market. Moreover, by offering maintenance tracts the government assures that existing companies can also continue competing for contracts.

[GAO COMMENT: We believe Interior's statement that it hopes to offer a larger percentage of new production tracts in future sales than was offered in the Powder River sale--116 of 158, or 73 percent, of the total tracts being considered in fiscal years 1983 and 1984--is overly optimistic. As stated beginning on page 67 of our report, federal coal leasing will primarily include noncompetitive maintenance tracts, because the current market for new production tracts is depressed. Based on our evaluation of recent sales in the Green-Hams Fork and Powder River regions, most of the federal regional coal leases appear captive (maintenance) to adjacent mining operations. Also, the results of the recent (September 1983) Fort Union coal sale also seem to bear out the lack of a market for new production tracts. In that sale, five of eight tracts offered were maintenance tracts. None of the three new production tracts received a bid, while the five maintenance tracts each received one bid.

Interior states that one of the main objectives of further federal coal leasing is to facilitate competition within the Powder River region. Interior further states that by offering additional coal tracts for lease, new companies are given the opportunity to enter into the market and, by offering maintenance tracts, the government assures that existing companies can also continue competing for contracts. We believe that Interior's objective of further federal coal leasing to facilitate competition within the region is not always realistic. Based on our analysis of the Powder River sales and our observations of an earlier coal lease sale in the Green River-Hams Fork region, competition between companies for leases occurs infrequently. The institutional processes stemming from the land use and coal activity planning systems, coupled with decades of speculation and noncompetitive lease sales, have structured a market characterized by the deep entrenchment of large energy corporations. The major leaseholds in the current coal market have been acquired and there appear to be very few opportunities for new mining operations. In the current "soft" coal market, active competition for future federal coal leases--maintenance or new production--cannot reasonably be expected.

In summary, we recognized in our report that under the Federal Coal Leasing Amendments Act, Interior is charged with a very difficult task: selling coal competitively in a market which is in many cases noncompetitive. Thus, certain fundamental disparities between the manner in which coal is being leased and developed must be rectified before Interior's task becomes one that is practicable. In our view, continuing to offer captive (maintenance) leases under the mantle of "competitive" leasing only creates the pretense of competition and provides little assurance that the government will receive a reasonable return for leased coal. In chapter 7 of our report, we recommend legislative change to allow for negotiated sales of maintenance tracts as a solution.]