CHAPTER 1

EXECUTIVE SUMMARY

In 1976, concerned over the large number of nonproducing Federal coal leases, Congress amended the Mineral Leasing Act of 1920 (M LA) to prevent the issuance of new onshore mineral leases to any person or company that owns a nonproducing coal lease and has held it for more than 10 years after August 4, 1976.[1] This restriction on the issuance of new leases, found in section 3 of the Federal Coal Leasing Amendments Act of 1976 (FCLAA), applies not only to coal leases, but also to leases for oil and gas and other minerals on Federal lands leased under the MLA. (Federal offshore lands are not leased under the MLA and thus are not affected.) The disqualification attaches to the noncomplying lessee and to any other firms "controlled by or under common control with" the lessee. Under section 3 a major oil company could be barred from competing for Federal oil and gas leases if the oil company's coal mining subsidiary had even one noncomplying Federal coal lease. While there has been a significant increase both in the number of producing Federal coal leases and in the amount of coal produced from Federal reserves in the past decade, over 40 percent of existing Federal leases remain undeveloped. As a result of section 3, some major U.S. energy firms will be ineligible to compete for new onshore Federal mineral leases when section 3 disqualifications take effect unless they sell or relinquish their old nonproducing Federal coal leases.

Legislation to repeal or modify section 3 has been introduced in Congress, but may conflict with a basic policy of FCLAA: that Federal coal leases are to be held only for timely production. As the result of administrative actions by the Department of the Interior, section 3 now is the only penalty that might be imposed on most nonproducing Federal coal leases before the mid- 1990s. Following hearings on section 3 legislation in June 1984, the House Committee on Interior and Insular Affairs asked OTA to assess the potential impacts of both enforcement and repeal of section 3 and to examine alternative legislative options for promoting timely development from Federal coal leases.

WHAT DOES SECTION 3 REQUIRE?

As a lessee qualification, section 3 is similar to citizenship requirements and acreage limitations; it does not directly affect the terms or conditions of any existing lease. Section 3 creates a nonproduction penalty only if and when the noncomplying lessee or a related company seeks a new Federal mineral lease. Moreover, section 3 does not restrict the Secretary's approval of lease assignments between private parties nor limit the noncompetitive modification of an existing coal lease to include up to 160 more acres. Enforcement of a section 3 disqualification is nondiscretionary. The Secretary however was given considerable discretion in defining the amount of coal that must be produced to avoid disqualification, i.e. "commercial quantities", and in interpreting the availability of statutory exceptions. The Secretary of the Interior can thus influence significantly the extent of the potential impacts of section 3 enforcement.

OTA has found that Department of Interior guidelines and regulations have made section 3 compliance more difficult for some producing lessees than previously anticipated. OTA believes, however, that Department has ample, though not unlimited, discretion to resolve

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[1] Congress delayed the effective date of section 3 disqualifications to Dec. 31, 1986, in the Continuing Appropriations Resolution for FY 1986, H.J. Res. 465, 99th Cong., 1st sess., Dec. 19, 1985, (Public Law, 99-190).

many of the compliance problems of producing lessees. The Department has very limited discretion to assist lessees with no production. Moreover, the Department's delay in issuing final section 3 policy guidance has left many lessees with less than a year to complete all the administrative steps necessary to avoid disqualification, such as formation of a logical mining unit (LMU), assignment, lease amendment, or relinquishment.

HOW CAN A LESSEE AVOID A SECTION 3 PENALTY?

Section 3 gives a lessee 10 years after acquiring a lease before imposing its nonproduction penalty. A lessee has at least eight options for avoiding a section 3 disqualification: 1) The lessee can produce commercial quantities of coal from the lease which may require mining of up to 1 percent of lease reserves annually from the 10th year on. 2) If there is already some commercial production, the lessee may be eligible to comply by paying advance royalties in lieu of production. 3) If mining has been disrupted because of strikes, the elements, or other casualties not attributable to the lessee, the section 3 production obligation can be suspended under a nondiscretionary statutory *force majeure* suspension provision. 4) The lessee can assign (i.e., sell) the lease to an unrelated party. 5) The lessee can relinquish all or part of the noncomplying lease. 6) Under section 39 of the MLA, the Secretary can suspend lease production requirements in the interests of resource conservation. These discretionary suspensions can not be granted for purely economic reasons, such as lack of markets, but can be used, for example, to defer development while additional environmental studies are done. 7) The noncomplying lease can be combined with producing leases in an LMU and total LMU production can be used to comply with section 3. 8) The lessee can ask the Department to consolidate the nonproducing lease with one or more of the lessee's producing leases to form a single producing lease.

Lessees may encounter several constraints in using these options for compliance with section 3. The Department has decided to limit *force majeure* suspensions and payment of advance royalties only to leases that have been specifically amended by readjustment or voluntary agreement to include higher post- FCLAA advance royalties and production requirements. For policy reasons, current regulations provide that coal leases cannot be assigned to a noncomplying lessee, thus eliminating some potential buyers for nonproducing leases. LMU formation is perhaps the most flexible and powerful compliance mechanism for leases tied to producing mines, however nonstatutory preconditions for LMU approval may make this option unattractive for some lessees. OTA has found at least two producing mines that may not be able to form LMUs to comply with section 3 because of the statutory-requirement that all lands included must be contiguous.

WHAT IS THE CURRENT DEVELOPMENT STATUS OF FEDERAL COAL LEASES?

OTA reviewed a total of 648 Federal coal leases for this report. We found that 33 coal leases have been relinquished, exchanged, or consolidated since 1981 leaving 615 Federal coal leases in effect ("existing leases") as of September 1985. Our focus was primarily on the 583 existing leases in seven western states of Colorado, New Mexico, North Dakota, Oklahoma, Utah, and Wyoming, representing 95 percent of the existing leases and over 99 percent of the Federal reserves under lease. There are 32 leases in other states.

Since 1976, there has been a significant increase in the number of Federal coal leases that are producing or are under development. Over 48 percent of western leases and 61 percent of the leased reserves are in or associated with permitted mines. Another 6 percent of leases and 5 percent of reserves are covered by proposed mines now under permit review. About 40 percent of existing leases with 30 percent of the reserves under lease still remain undeveloped, however.

WHAT IS THE LIKELY SECTION 3 COMPLIANCE STATUS OF FEDERAL COAL LEASES?

OTA found that nearly all of the undeveloped leases and some leases within or associated with mines that are permitted or under permit review will face section 3 compliance problems if leases are retained beyond the 10-year holding period. Section 3 disqualifications will initially involve nonproducing leases that were issued before passage of FCLAA.

There are 489 western pre-FCLAA leases with over 16.2 billion tons of reserves. About 330 of these leases have section 3 deadlines in 1986; because of transfers after 1976, section 3 dates for the remaining leases fall over the next 10 years.

OTA estimates that 189 pre-FCLAA leases with 8.3 billion tons of reserves are likely to comply with section 3. Another 56 leases with 1.6 billion tons of reserves have an uncertain status because of insufficient production, lack of contracts for planned production, or the need to obtain LMU approval for non-Federal coal. Many of these 56 leases will eventually comply, however some lessees may be disqualified briefly and others may have to relinquish or sell some lease reserves in order to qualify.

About half of the western pre-FCLAA leases (244 leases with 6.2 billion tons of reserves) are unlikely to be producing in commercial quantities by their section 3 deadlines. Because of probable continued low growth in energy demand and the large inventory of undeveloped lease reserves, most of these 244 leases will not be mined in time to comply with section 3 and other production requirements despite even the most diligent efforts at developing and marketing the coal. The current market outlook suggests that slow growth in western coal demand will continue until the late 1990s. The noncomplying leases include some tracts in areas such as southern Utah and the Star Lake-Bisti area of the San Juan Basin of New Mexico, where coal development is controversial because of potential environmental impacts on National Parks, wilderness areas, and roadless areas.

WHAT ARE THE POTENTIAL IMPACTS OF SECTION 3 ENFORCEMENT?

The effects, or threat, of a disqualification could lead to the relinquishment or sale of noncomplying leases. In fact some recent sales and relinquishments were prompted in part by section 3. Noncomplying leases with unfavorable short-term development potential or poor quality reserves are most likely to be relinquished. Nonproducing leases with better quality reserves and favorable or uncertain development potential will probably be sold to new owners.

The legislative history indicates that section 3 was directed at the nonproducing Federal lease holdings of major oil companies and large energy conglomerates. OTA's analysis indicates that many, but not all, of these lessees will have section 3 compliance problems. Section 3 will have little or no effect on some nonproducing lessees, particularly individuals and companies that are not actively involved in mineral leasing because they are unlikely to seek additional mineral leases.

OTA estimates that as many as 120 of the more than 220 current Federal coal lessees face a potential section 3 penalty. When the holdings of corporate subsidiaries and joint ventures are attributed to the controlling companies, about 70 distinct corporate families and about 20 individuals and other lessees could be disqualified.

The 20 largest Federal coal reserves holders control over 65 percent of the Federal coal reserves under lease. Fifteen of these 20 lessees face potential disqualification because their leases are either uncertain or unlikely to be producing in commercial quantities. It is likely, however, that several of these firms will be able to resolve their compliance problems through LMU approvals, lease assignments, or relinquishments before their section 3 dates. But several major energy company lessees are likely to be disqualified from Federal leasing unless they get rid of their noncomplying Federal coal leases.

Section 3 applies to the issuance of all minerals on Federal onshore lands including coal, oil and gas, oil shale, gilsonite, and fertilizer minerals. If section 3 disqualifications take effect, the number of potential bidders for Federal coal leases and other mineral leases will be reduced creating an incentive for the remaining participants to bid less. This could theoretically reduce the government's ability to capture any increased value in Federal leases due to competitive interest. The impacts on competition for and bonuses for coal leases are likely to smaller than the section 3 noncompliance figures suggest however, because there are normally few bidders for any given coal tract and the statutory fair market value requirement, if strongly administered, can assure that acceptable bids reflect a fair return to the government. It is possible also that fewer new tracts may be leased if the most likely bidders are disqualified. OTA found that coal production is unlikely to be affected for several years, as few producing mines are nearing exhaustion of their Federal reserves and many other producers who will be in compliance with section 3 have excess production capacity available to meet any shortfall.

The overall impacts of section 3 on competition for oil and gas leases also should be minimal. Most Federal oil and gas leases are not awarded by competitive bidding. As a practical matter, many potential oil industry bidders for competitive and "lottery" leases will be unaffected by section 3. It is doubtful that any major oil and gas producer would abandon participation in Federal onshore oil and gas leasing to preserve nonproducing coal leases, particularly since coal typically contributes only a minor share of corporate revenues for such companies. Because noncomplying firms could still acquire oil and gas leases by assignment, the primary adverse impact of any disqualification will be their exclusion from noncompetitive or "over the counter" leasing for lands in previously unleased and unexplored frontier areas.

Section 3 guidelines have been adopted for coal leases, but several major uncertainties remain unresolved. Other leasing programs could be disrupted and lease issuances contested if the Department fails to move quickly and effectively to prepare for the implementation of section 3 for all leasable minerals. The Department has not established procedures for reviewing section 3 qualifications for the thousands of new oil and gas leases issued yearly or to acquire the information needed to make the determinations.

Section 3 could potentially enhance competition in the western coal supply market by transferring nonproducing leases to new entrants. However, these leases could also be sold to existing producers possibly reducing potential competitors for coal supply contracts. Some major energy firms with noncomplying or problem leases may at least temporarily withdraw from western Federal coal leasing by selling or spinning off their coal subsidiaries, or as a last resort, relinquishing their leases, further reducing the number of existing competitors. Once purged of section 3 disqualification, these firms could later reenter western leasing and thus remain as potential new competitors.

As better quality reserves are sold to new owners and poorer quality reserves are relinquished, the amount of undeveloped Federal coal reserves under lease could be reduced, but the overall quality of the remaining inventory in private hands would be improved. Old leases could be turned back and could be sold again if they survive the land use planning, suitability screening, and surface owner consent reviews required of new leases. New leases require payment of a fair market value bonus and higher statutory royalties which might offset any loss in rentals or royalties from relinquished leases. The leases that have been relinquished so far will probably not be reoffered for lease because they generally had poor quality reserves or were located outside of active mining areas.

WHAT IF ANY IS THE IMPACT OF SECTION 3 ENFORCEMENT OR REPEAL ON FEDERAL MINERAL REVENUES?

Repeal or modification of section 3 without imposing substantial payment obligations on nonproducing leases as the price of relief would be a lost opportunity to generate additional revenues from nonproducing leases and, perhaps, to recapture a portion of value of old leases originally sold at very low prices. OTA examined several payment options that might be used as alternatives to section 3 as it currently exists and found that such an approach has some advantages. A payment alternative gives the lessee additional flexibility in deciding how long to hold a nonproducing lease and allows lessees to qualify for additional leases. The payment creates an economic penalty for nonproduction, thus reinforcing basic policies of FCLAA, and has the additional benefit of generating some preproduction revenues for Federal and State governments. The payments could be based on a flat or escalating rate on the acreage, reserves, or minimum production levels or could be a percentage of the value of the coal. A relatively simple payment structure of cents per ton of reserves or dollars per acre offers the advantage of predictability and ease of administration. The payment should be high enough to force some leases to be relinquished and to lessen the assignment values of other leases, thus discouraging potential speculation. OTA found that a minimum annual payment of at least one cent per ton of recoverable reserves, for example, would measurably affect the economics of holding leases in virtually all coal regions and would provide at least some economic pressure on the lessee to develop or get rid of a nonproducing lease.

WHAT ALTERNATIVES ARE AVAILABLE TO ENCOURAGE THE TIMELY DEVELOPMENT OF FEDERAL COAL LEASES?

A dynamic Federal leasing system that offers Federal resources to create opportunities for private sector firms to compete for coal supply contracts and thus keep fuel costs low for consumers is highly dependent on a diligence mechanism. Without some means of returning undeveloped tracts to the system, the Government might soon exhaust its supply of marketable tracts and lose its ability to affect the price or supply of coal to consumers. However, section 3 and the current diligence requirements can have harsh consequences on some lessees that have made substantial investments in mine development, but fall short of required production levels. OTA believes that the existing system could be improved by the adoption of provisions that allow more flexibility in the achievement of diligence, while reaffirming the principle that Federal resources are to be held for timely production. For example, as noted previously, properly structured holding fees create an economic incentive to develop a lease and offer greater flexibility than the existing system in avoiding forfeiture of leases that are otherwise economically viable because of unforeseen or unavoidable delays in lease development.

OTA examined various approaches for promoting timely production used in Federal and private coal leases. Examples include minimum annual production clauses, minimum investment or equipment clauses, recoupable advance royalties, minimum annual royalties, and short primary lease terms that can be extended only by production or payment of an additional delay rental. OTA found that the effectiveness of the minimum production and investment requirements in Federal coal leases has been hampered historically by the lack of a prompt and efficient enforcement mechanism. Before 1976, advance and minimum royalties in Federal leases were generally too low to have any effect on the economics of holding the lease. FCLAA sharply increased advance royalties for new and readjusted leases, but this condition is only triggered once the lessee has produced enough coal to satisfy the diligent development obligation. Current advance royalty provisions in Federal leases therefore do not encourage initial development and production, and in some cases may be a deterrent.

OTA looked at the advantages and disadvantages of keeping section 3 unchanged and of a range of alternative legislative options. The possible legislative options for section 3 relief are: repealing section 3, limiting the new lease disqualifications to coal leases only, extending the 10-year holding period, using the attainment of lease development milestones as an alternative to actual commercial production, allowing the payment of holding fees on nonproducing leases instead of production, requiring a turnback of an equivalent amount of old leases to acquire any new leases, and allowing noncomplying leases to be relinquished in exchange for a preferential option to purchase a new lease on the same lands. OTA also analyzed the potential effects of applying the section 3 producing in commercial quantities requirements to all leases that are more than 10 years old, regardless of how long they have been held. Some of OTA's conclusions from its analysis of these options are summarized here.

Leaving section 3 unchanged retains perhaps the only statutory production requirement for most old Federal coal leases, particularly because the Department of the Interior has substantially relaxed, or even nullified, most other production requirements for pre-FCLAA leases. This "no action" option would maintain fairness for lessees who have already relinquished or sold leases in order to comply.

Lessees with leases that are producing or under active development but which cannot satisfy the Department's producing in commercial quantities test would be aided most by three options: an extension of the section 3 deadline; acceptance of qualifying payments in lieu of production; and acceptance of achievement of alternative mine development milestones to comply with section 3.

The lease turnback option is administratively workable only if section 3 is limited to coal leases. Turnback primarily benefits lessees with large amounts of nonproducing acreage or reserves. Turnback offers no relief to lessees who merely need additional time to produce coal and do not have nonproducing leases to relinquish.

Repeal of section 3 or limiting the disqualification to coal leases only would provide the greatest relief from the effects of section 3 enforcement. For some large lessees, limiting section 3 disqualifications to coal leases only would be tantamount to repeal. It is probable that some lessees with very large holdings of noncomplying reserves will have little need for additional Federal coal leases for many years. However, more than two thirds of noncomplying coal reserves are held by lessees who are also actively involved in onshore oil and gas leasing. The threat of disqualification from oil and gas leasing makes section 3 a powerful development incentive for these large energy firms. If section 3 were repealed or limited to coal only, lessees could maintain their existing inventory of leased reserves for later development or sale and compete freely for other Federal mineral resources. These two options remove or lessen the only statutory incentive for the major nonproducing lessees to either begin mining coal from their leases or get rid of them before the mid-1990s when current diligence regulations might be enforced. Given the uncertainty created by Department policies about what diligence requirements are applicable to pre-FCLAA leases and when, if ever, they must be enforced, these options may effectively remove the only restraint on continued holding of these old leases without production. These two options would not promote timely development or limit the potential for speculation in Federal coal were either to be adopted without substantial counterbalancing changes in section 7 diligence requirements for pre-FCLAA leases.

There is now more Federal coal under lease than can be sold or burned within the market areas served by Federal coal within the next two decades and beyond. It is likely that the amount of Federal coal under lease will exceed by a significant margin, the amount of coal expected to be needed by consumers. Many lessees will be unable to comply with lease development and production requirements despite even their most diligent efforts at securing purchasers for their coal. Allowing lessees to retain coal leases indefinitely without development in the same manner that companies might, for example, hold the coal reserves that they own outright, would be equivalent for policy purposes to transferring ownership of these reserves to private parties and runs contrary to the longstanding Federal policy against disposal of public coal resources. For this reason, the Federal leasing program will need some mechanism to determine which leases can continue to be held, and for how long, and which must be returned to the government for possible resale to others. Whether this mechanism will be section 3, the current diligence system, or some other provision is a matter for congressional consideration.