CHAPTER 4

LEGAL AND LEGISLATIVE ANALYSIS: SECTION 3 AND OTHER PRODUCTION REQUIREMENTS FOR FEDERAL COAL LEASES

Federal coal leases impose various conditions on the lessee in return for granting of exclusive rights to mine and sell coal resources owned by the United States. This chapter analyzes the lease development and production obligations imposed under Federal law and how they have been interpreted and applied to Federal coal leases. The chapter concludes with an examination of several alternative mechanisms for encouraging timely production of Federal coal.

What Is Section 3?

Section 3 of the Federal Coal Leasing Amendments Act of 1976 (FCLAA) added a new section 2(a)(2)(A) to the Mineral Leasing Act of 1920 (MLA):

> The Secretary shall not issue a lease or leases under the terms of this Act to any person, association, corporation, or any subsidiary, affiliate, or persons controlled by or under common control with such person, association, or corporation, where any such entity holds a lease or leases issued by the United States to coal deposits and has held such lease or leases for a period of ten years when such entity is not, except as provided for in section 7(b) of this Act, producing coal from the lease deposits in commercial quantities. In computing the ten-year period referred to in the preceding sentence, periods of time prior to the date of enactment of the Federal Coal Leasing Amendments Act of 1975 shall not be counted.[1]

The phrase "this Act" is defined in FCLAA as the MLA.[2] Section 3 was intended t. prevent a coal lessee, and any affiliated entities, from obtaining new leases if the coal lease has been held for 10 years and is not producing in commercial quantities. The first section 3 disqualifications were to be effective on August 4, 1986, however language added to the Fiscal Year 1986 Continuing Appropriations Act passed at the close of the 1st Session of the 99th Congress delayed the effect of section 3 to December 31, 1986.[3]

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[1] **Public Law 94-377, 90 Stat. 1083, Aug. 4, 1976; 30 U.S. C. 201(a)(2)(A). The Act was passed in August, 1976, as the "Federal Coal Leasing Amendments Act of 1975." This overnight was corrected in Public Law 95-554, sec. 8, 92 Stat. 2075, Oct. 30, 1978, so that FCLAA is now properly cited as the "Federal Coal Leasing Amendments Act of 1976."**

[2] **See 90 Stat. 1083: "(b) except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision of the Mineral Lands Leasing Act, the reference shall be considered to be made to a section or other provision of the Act of February 25, 1920, entitled 'An Act to Promote the Mining of Coal, Phosphate, Oil, Oil Shale, Gas, and Sodium on the Public Domain' (41 Stat. 437)." As a result, section 3 of FCLAA is codified as follows: "The Secretary shall not issue a lease or leases under the terms of <u>this chapter.</u>.. except as provided for in section 207(b)... prior to August 4, 1976." See 30 U.S.C. 201(a)(2)(A) (1982). Section 201 (a)(2)(A) is found in Chapter 3A, Title 30 of the United States Code which is codification of the Mineral Leasing Act of 1920, 30 U.S. C. 181 et seq.**

[3] **H.J. Res. 465, 99th Cong., 1st sess., Dec. 19, 1985, Public Law 99-190. The text of the amendment extending the section 3 deadline is found at 131 Cong. Rec. H12,865, Dec. 19, 1985.**

LEGISLATIVE HISTORY OF SECTION 3

The legislative history indicates that the purposes of section 3 were:

1. to deter speculation in Federal coal leases;
2. to promote the transfer of nonproducing leases back to the Government or to companies with the resources and capability to mine them;
3. to limit the control of nonproducing Federal coal reserves by Iarge energy companies and conglomerates; and
4. to back up the diligence policies of section 7 and the 1976 regulations that required existing leases to begin producing within ten years.

In the Senate debate on passage of FCLAA, Senator Metcalf, then Chairman of the Senate Committee on Interior and Insular Affairs, described how section 3 and section 6 of FCLAA (which amended section 7 of the MLA) would work together:

> S. 391 states in section 6 that "any lease that is not producing in commercial quantities at the end of 10 years shall be terminated." Under the provisions of Section 3, the Secretary could not issue anew lease to any party holding such a nonproductive lease, the 10 year period to be computed from the effective date of the act.
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> These two provisions are meant to guarantee diligent development and an end to speculative holding of leases. Contrary to what the Department claims, the two provisions are entirely consistent. The Secretary would simply be precluded from issuing any new lease to a party which had failed to produce coal in commercial quantities--as defined by regulations--within 10 years after the enactment of the bill. Such party would be required to divest itself of the unproductive lease before it would become eligible for a new lease.
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> The bill would thus make it possible for other operators to bid for the nonproductive lease and undertake to develop the lease and produce coal in keeping with the intent of the legislation. In this way, over time, the large proportion of idle leases which have been held, by the Department's own admission, for purely speculative reasons, will eventually be brought into production and royalty payments commensurate with the value of the coal will begin flowing into the public treasuries.[4]

The section 3 disqualification strikes hardest at large oil and gas companies, coal companies, and other resource extracting conglomerates. The report, floor debate, and hearings on FCLAA are replete with expressions of concern by members over the concentration of holdings and speculation in Federal coal leases by these entities. The House report cites the conclusions of the Ford Foundation's Energy Policy Project.

> The coal leasing program presents a clear pictures of private speculation at the public expense. In the past decades, but particularly during the 1960s, vast amounts of Federal coal passed freely to private ownership under situations of little or no competition and extremely low payments.[5]

[4] 122 Cong. Rec. 19,377, June 21, 1976.

[5] H. Rpt. 94-681, 94th Cong., 1st sess. at 11, (1975), citing Energy Policy Project of the Ford Foundation, (1974). A Time to Chose: America's Energy Future.

Representative Young of Georgia opened the House discussion of FCLAA by describing what he saw as the basic thrust of the legislation:

> This bill is designed to encourage coal production on Federal lands... Hopefully it will end the speculative holding of leases by requiring that coal is actually produced where leases have been obtained. In the past, coal operators -- including some of the giant mining and oil companies -- have gotten leases on these Federal lands and held them without actually mining the coal, just waiting for coal prices to rise to a level where huge profits would be assured. In effect, these companies have sat on large supplies of coal in a period when the consuming public is told we have an energy shortage.[6]

These comments were echoed in other congressional criticism of the speculative activities of lease brokers, and other individuals and companies that held coal leases for resale and did not mine coal. Representative Seiberling summarized some of the concerns over the effects of coal lease ownership trends on energy competition:

> Among other industrial giants, the big oil companies have been moving into coal in a very heavy way. As a matter of fact, over 30 percent of all the coal reserves in this country today are controlled by the oil companies. Incidentally they already control over 60 percent of the Nation's uranium reserves. Many other huge conglomerate corporations have moved into coal, and they hold a great many leases that have already been let on Federal coal.
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> As a matter of fact, . . . 5 of the 15 largest lessees of Federal coal are oil companies, and some of the others are huge corporations such as Kennecott Copper, which also owns Peabody Coal, the biggest producer in the United States . . .
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> Therefore Mr. Chairman, we not only have the problem that many of these huge companies have gotten leases and then sat on the coal waiting for the price to rise, I suppose; but we have the problem of preventing monopolistic control of the Nation's coal reserves.[7] (The information referenced in the quote is reproduced as table 29.)

Many provisions of FCLAA were expressly intended to counteract the patterns of nonproductive lease ownership and concentration that had developed. FCLAA imposed a 10 year diligent production period on all new leases and provided that no lease could be extended beyond its initial 20 year term unless it was producing in commercial quantities. Other reforms include the elimination of preference right leasing, the establishment of a higher minimum royalty, the use of deferred bonus bidding, and the authorization of special leases for public bodies. (The higher royalty would have the effect of lowering the bonus payment required to constitute fair market value to reduce the entry cost for smaller companies and other new competitors in the Federal coal leasing.)

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[6]See 122 Cong. Rec. 484, Jan. 21, 1976.

[7]122 Cong. Rec. 493, Jan. 21, 1976.

Table 29

The Top 15 Federal Leaseholders 1975
(Federal and Indian Lands)

	Federal	Indian	Total
Kennecott Copper Co.:			
Peabody Coal Co	81,981,29	100,345	
Kenn. Coal Co	2,736.14		
Total	84,717.43		185,062.43
2. Continental Oil Co.:			
Consolidation Coal	45,452.12		
1/2 of Consol and Kemmerer	9,372.97		
1/2 of Consol and El Paso		20,143.5	
Total	54,825.09		74,968.59
3. Utah International	24,229.61	31,416	55,645.61
4. Pacific Power & Light:			
Pacific Power & Light	35,078.15		
Decker	13,610.31		
Total	48,688.46		48,688.46
5. El Paso Natural Gas:			
El Paso	27,018.72		
½ Consol-El Paso		20,143.5	47,162.22
6. Garland Coal Co	40,559.40		40,559.40
7. Arizona Public Service and San Diego Gas & Electric Resources Co. et al	39,355.19		39,355.19
8. Lincoln Corp.			
Kemmerer Coal Co	22,854.73		
Consol-Kemmerer	9,372.97		
Gunn Quealy	1,751.54		
Total	33,979.24		33,979.24
9. Westmoreland Resources		30,876	30,876
10. Shell Oil Co		30,248	30,248
11. Gulf Oil Corp.:			
Gulf	2,560.00		
Pittsburg & Midway	6,871.72	13,237	
Total	9,431.72		22,668.72
12. Sun Oil Co.:			
Sun			
Colorado Mining Co			
Total	21,239.97		21,239.97
13. Bass	20,700.71		20,700.71
14. Amax:			
Amax		14,237	
Meadowlark Farms	5,960.31		20,197.31
15. ARCO	19,185.98		19,185.98
Total	429,871.83	[illegible]60,646	690,517.83

Source: H.Rpt. 94-681, 94th Cong., lst sess. (1975), at 16

Does Section 3 Apply to Issuance of All Onshore Mineral Leases?

By its plain language, section 3 forbids the issuance of any lease under the MLA for coal, oil, gas, oil shale, gilsonite and the fertilizer minerals (sodium, phosphate, potassium, and sulfur). The legislative history is vague on section 3's applicability to other minerals, but it does not contradict this interpretation of the plain meaning of the statutory language. The report and floor debate say only that the nonproducing leaseholder and any affiliates shall not be issued "leases" -- The term leases is not modified by the word "coal" as in this discussion in the section by section analysis of the house report:

> This amendment would bar the issuance of new leases to any individual or corporations that have held a lease for a period of 15 years, beginning on the date of enactment of the Federal Coal Leasing Amendments (Act of 1975, without producing coal therefrom.[8]

Elsewhere in discussing how FCLAA would address the problem of speculation in Federal coal lands the report says:

> The problems of speculation are addressed directly by H.R. 6721, which requires termination of any lease which is not producing in commercial quantities at the end of 15 years. Old leases (those existing on the date of enactment of the 1975 Act) would be exempt from this provision, except to the extent it might be made applicable upon readjustment of lease terms, *but the lessees would be prohibited from acquiring any new Federal leases should they continue to hold old leases 15 years after enactment without therefrom.*[9]

The concept of stimulating development of existing Federal coal leases by restricting the availability of new leases to lessees who did not produce coal from the leases they already had was advanced in the March 1975 testimony by the National Rural Electric Cooperative Association.10 Their original proposal would have immediately prohibited the holding, owning, taking, or controlling or issuance of new leases to any lessee and related entities that already had "an economically developable lease or leases" and was "not producing coal from such deposits in substantial quantities or where the entity does not establish, to the satisfaction of the Secretary, that reasonable, but not speculative, assurances exist that coal will be produced in substantial quantities from such deposits within the following 5 years, or such longer time as established by the Secretary for good cause shown."[11]

A similar, but not as stringent approach, was adopted in H.R. 6721, introduced May 6, 1975:

> No person... shall take, hold, own, or control any lease issued by the Secretary under the terms of this Act, nor shall the Secretary issue a lease or

[8] H. Rpt. 94-681, at 22. Note: FCLAA was amended on the house floor to cut the production period for compliance with the section 7 diligence provision and section 3 from 15 to 10 years, as had been recommended by the Subcommittee on Mines and Mining.

'H. Rpt. 94-681, at 15, emphasis added.

[10] Statement of D avid B. Graham, National Rural Electric Association in <u>Hearings on H.R. 3265 (Federal Coal Leasing) Before the Subcommittee on Mines and Mining of the House Committee on Interior and Insular Affairs</u>, 99th Cong.,1st sess. (1975), at 128, 133. Western Fuels Association, Inc., and the American Public Power Association also endorsed the proposal.

[11] Id.

> leases to any such person.. where such entity holds a lease or leases issued by the United States to coal deposits and has held such lease or leases for a period of ten or more years when such entity is not, except as provided for in section 7(b) of this Act, producing coal from the lease deposits in commercial quantities.[12]

The provision was modified by the full Interior Committee to apply to the issuance of "new leases under the terms of this act" after a coal lease had been held from 15 years and further gave lessees an additional 15 year period to comply before the sanction would be imposed, by excluding all periods of time before passage of the act. Section 3 was later amended on the floor to cut the holding period to ten years to make it compatible with time given under the 1976 diligence regulations.

The FCLAA clearly states that references to "this Act" are to be interpreted as amending the MLA. Section 3 refers to leases issued under the terms of "this Act'' and not to either coal leases or leases issued under section 2 of the MLA which would limit the provision to coal only, Other provisions of the MLA were modified by FCLAA by virtue of the "this Act" provision and another interpretation would make these provisions puzzling. Section 3 may be arguably misplaced as a generally applicable restriction. It might have been enacted as an amendment to the general MLA provisions on other lease qualifications, such as U.S. citizenship.[13] The full impact of section 3 on other mineral leases did not escape the notice of the Interior Department in its comments on the earlier, more extensive version of section 3 in H.R. 6721, the proposed legislation. In a letter to the House Interior Committee which is reprinted in the House Report on FCLAA, Jack Horton the Assistant Secretary of the Interior observes:

> Section 3 of H.R. 6721 would amend the last sentence of section 2(a) of the Mineral Leasing Act to prevent any person who holds or has held for 10 years a Federal coal lease which is not producing in commercial quantities, from taking, holding, owning or controlling any lease under this Act, and would prohibit the Secretary from issuing a lease to such person.
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> This section should be deleted. Although we favor early production, there can be valid reasons for holding reserves under a Federal lease for more than 10 years without development. This is particularly true if the lease is part of a logical mining unit which is being developed. Lead time for power plants is now generally approaching IO years; in many cases it now exceeds 10 years. The start-up period for a new mine may be as long as 5 to 7 years. This provision might force an uneconomic and perhaps more environmentally costly technique of mining in order to avoid the limitation it would impose.
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> It should also be noted that the penalty for not producing within 10 years would not only be cancellation of the lease, but cancellation of any other lease issued under the Mineral Leasing Act that the person, association, or corporation holds. We recommend that this unusually onerous subsection be deleted from the bill.[14]

Partially in response to the Department's objection, the Committee dropped that portion of proposed section 3 that would have barred any lessee from the continuing to take or hold

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[12] H.R. 6721, sec. S, 94th Cong., 1st sess. (1975).

[13] See, for example, 30 U. S. C. 181, 184, and 187.

[14] H. Rpt. 94-681, at 38.

leases issued under the MLA, but kept the language barring issuance of new leases. The inclusion of this letter in the Committee's report adds further explanation to how the provisions were interpreted at the time of enactment.

Despite the very strong indications that section 3 applies to and was intended to apply to all onshore mineral leases, this view is not universally held. (Conoco, one of the major Federal coal leaseholders, is currently seeking a declaratory judgment from the Federal district court in Delaware that section 3 does not in fact apply to leases for other minerals) .15 The argument that section 3 should be interpreted as applying to coal only generally makes the following points.

1. The prohibition appears in a section of the MLA dealing with coal leasing detailing preconditions to issuance of a Federal coal lease. This might be interpreted as suggesting that the disqualification applied only to coal leases. If it were intended to apply to all MLA leases, the argument goes, Congress might have amended the MLA provisions that are generally applicable to all leases rather than placing the provision in sections applicable primarily to coal leases.

2. The use of the term "new leases" in the legislative history might be construed as referring only to coal leases in that context since the term is frequently preceded by discussions of coal leases.

3. The "contemporaneous interpretation" by the Department of the Interior in modifying its regulations for coal leases to incorporate provisions of FCLAA in January 1977 included the section 3 restriction only in the new coal leasing regulations.[16] Current coal leasing regulations contain the section 3 disqualification provision, but other mineral leasing regulations do not include section 3 restrictions in their lease qualifications provisions.

In addition to the points of statutory construction argued above. Several policy objections are also generally advanced. (1) It is unfair to penalize oil and gas operations for the failures of a lessee, (or its subsidiaries of affiliates) in the operation of its coal lease(s) over which the oil and gas operations may have no control. (2) Enforcement of the provision will be too complex, burdensome, and or disruptive to the coal program and other mineral leasing activities. (3) Enforcement of the provision will have "disastrous", far reaching, and unintended impacts on noncoal leasing areas, particularly oil and gas. (4) The revenue impacts from the disqualification of section 3 leaseholders and affiliated entities would be significant and undesirable. (5) Section 3 creates an unfair enforcement scheme since not all lessees are placed under the same risks for nonproduction.

OTA concludes, however, on the basis of the explicit language of FCLAA and the concerns expressed in congressional history that section 3 does indeed restrict the issuance of all Federal onshore mineral leases to leaseholders not in compliance with the section 3. We note that the Department of the Interior has reached a similar conclusion in the February 1985 Solicitor's Memorandum. M-36951.[17]

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[15] Conoco, Inc. v. Hodel, Civil No. 85-27 (D.Del, filed May 10, 1985).

[16] See 42 Fed. Reg. 4,454, Jan. 25, 1977 and 43 C.F.R.3525.1(f) (1977).

[17] Solicitor's Memorandum M-36951 to the Assistant Secretary for Land and Minerals Management on Section 2 (a)(2)(A) of the Mineral Leasing Act of 1920, Feb. 12, 1985.

WHAT DOES SECTION 3 DO?

Section 3 is independent of any other coal lease diligence provision and its applicability is not contingent on lease readjustment or the issuance of regulations or guidelines. The only precondition for a section 3 penalty is that a lessee has held a lease for ten or more years after August 4, 1976 and the lease is not producing in commercial quantities and is not subject to one or more limited exceptions to the production requirement. Section 3 was primarily aimed at nonproducing pre-FCLAA leases. But it can, in come circumstances, apply to nonproducing post-FCLAA leases and thus provide an additional, and nondiscretionary production forcing mechanism that backs up the diligence provisions of the MLA and regulations. Compliance with other lease diligence provisions is not, however, sufficient to satisfy the section 3 producing in commercial quantities requirement.

As a qualification provision section 3 is similar to other eligibility requirements under the MLA such as U.S. citizenship, limitations on the total acreage holdings, and the Section 2(c) restriction on railroad leaseholding.[18]

Section 3 penalties affect lessees, not leases. A single noncomplying lease will invoke the disqualification. The section 3 disqualification attaches to a lessee (and related entities) as long as the lease is in noncompliance. The disqualification is lifted if the lease is brought into production, assigned to an unaffiliated party, relinquished, suspended, or advance royalties are paid in lieu of continued operation under section 7(b) of FCLAA. The 10-year holding period for section 3 compliance is restarted when a noncomplying lease is assigned to an unaffiliated party.

Section 3 does not raise any constitutional issues involving the alteration or taking of rights under existing leases because it does not affect the terms or conditions of existing leases. Section 3 restricts the actions of the Secretary of the Interior in managing Federal lands. Ownership of a Federal coal lease conveys no “right” to acquire additional Federal coal leases. The Constitution vests in the Congress extremely broad authority over the management disposition of the Federal lands and Congress may set virtually whatever conditions it wishes on their use. Congress might legally, if it so chooses, amend section 3 to eliminate the ten-year holding period and to provide that the Secretary may not issue a lease to anyone who holds a Federal coal lease that is not producing in commercial quantities.

The reach of the section 3 disqualification is extensive and bars the issuance of new leases for coal and for all other minerals leased under the terms of the MLA on public lands and on acquired lands. The minerals covered include onshore deposits of “coal, phosphate, sodium, potassium, oil, oil shale, gilsonite (including all vein-type solid hydrocarbons), or gas”. OTA interprets lease issuance as the creation of a new lease by the Secretary that grants mineral development rights in lands that are not already subject to a lease for that mineral.

Lease Transactions Not Subject to Section 3

The ban on issuance of new leases to noncomplying parties does not foreclose all means of acquiring Federal coal, however. Section 3 does **not prevent:**

- o lease assignments (the transfer of a Federal lease between private parties after issuance);
- o modifications (the expansion of a lease to include unleased Federal land - limited by statute to 160 additional acres for most coal leases);

[18] See 30 U.S.C. 181, 184, and 202.

0 lease segregations (the transfer of land under an existing lease by subdivision into two or more separate leases bearing the same terms, conditions, and effective date as the original lease); or

o lease consolidations (the merger of leased lands from one or more existing leases into a single existing lease).

These lease transactions thus remain available to the Department and to a noncomplying lessee as means of acquiring additional Federal minerals and/or as a means of reconfiguring a lease to comply with section 3.

Preference Right Lease Applications (PRLAs)

Because of the plain meaning of the language "the Secretary shall not issue any lease," OTA concludes that section 3 bars the issuance of coal leases to preference right lease applicants who are not in compliance with the section 3 producing in commercial quantities requirement. (This is consistent with the effect of other eligibility provisions that would stop issuance of a PRLA in excess of acreage limitations or to a U.S. company controlled by foreign nationals from a non-reciprocal country.) Section 3 was not enacted "subject to valid existing rights as were some other sections of FCLAA. Addition of a savings clause would have exempted PRLAs as did other sections of FCLAA. Although it might be argued that Congress did not anticipate that processing of some 172 pending PRLAs arising from prospecting permits issued in the late 1960s and early 1970s would still be continuing in 1986, the statute does not allow exception. By similar reasoning, OTA concludes that section 3 also prohibits the issuance of preference right leases for fertilizer minerals to applicants who are not in compliance.

Leases on Acquired Lands

Section 3 clearly applies to leasing of public domain lands, but does it restrict the leasing of Minerals on acquired lands (those lands or mineral interests acquired by the United States from private owners through purchase, condemnation, or gift, for example)? Leasing of acquired lands is authorized by the Mineral Leasing Act for Acquired Lands, Chapter 7 of Title 30.[19] It can be argued that section 3 does not apply to acquired lands since such lands are not leased under the authority of Chapter 3A, however, section 3 applies to "any lease under the terms of" this chapter. The Mineral Leasing Act for Acquired Lands provides that minerals on acquired lands may be leased by the Secretary "under the same conditions as contained in the leasing provisions of the mineral leasing laws" (subject only to requirements that the surface management agency must consent to the lease and may specify conditions that will insure that the lands can continue to be used for the primary purpose for which they have been acquired or administered).[20]

Moreover, section 3 authorizes the Secretary to prescribe rules and regulations necessary to carry out the purposes of acquired lands leasing and further provides that such "rules and regulations shall be the same as those prescribed under the mineral leasing laws to the extent that they are applicable." It appears therefore that acquired lands leases are leases under the terms of the Mineral Leasing Act and subject to section 3. In the administration of the coal leasing program and its regulations, there is virtually no distinction drawn between public domain and acquired lands, and thus section 3 might be extended administratively to acquired land leasing as well even if it were not required by FCLAA,

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[19] 30 U.S.C. 351 et seq.

[20] See 30 U.S.C. 352.

WHAT IS PRODUCING IN COMMERCIAL QUANTITIES?

FCLAA does not define "commercial quantities." Moreover, the legislative history is not explicit in defining what is commercial quantities or how it should be determined for purposes of section 3. By regulation, commercial quantities is currently defined as 1 percent of the recoverable of lease or LMU reserves.[21]

The term "commercial quantities" is used several places in FCLAA and has been a term of art in Federal mineral law. Section 6 of FCLAA (section 7(a) of the MLA) provides: "Each lease shall be for a term of 20 years and for so long thereafter as coal is produced annually in commercial quantities from that lease. Any lease that is not producing in commercial quantities at the end of 10 years shall be terminated."[22] The new Federal coal exploration program established by of FCLAA, is to be designed for "determining whether commercial quantities of coal are present, in Federal lands."[23] It appears that FCLAA left the definition of commercial quantities to the Secretary's discretion. That discretion is, however, not unbounded and is tempered somewhat by the historical use of the term in Federal mineral law.

Section 2 of the MLA originally provided that a prospector who demonstrated the discovery of coal in commercial quantities was entitled to a preference right lease.[24] This authority was repealed by FCLAA subject to valid existing rights.[25] Under the preference right leasing system, commercial quantities is defined using a "prudent man" or "marketability" test that includes an reasonable expectation that mining of the property will be profitable.[26]

In correspondence with the House Interior Committee, the DOI recommended modifying language in the proposed bill that required production in "paying quantities" under section 7(a) to "quantities which, in the judgment of the Secretary, would justify the continued operation of the mine or mines."[27] Thereafter the term "paying quantities" was changed by the Committee to "commercial quantities" without explanation. Both commercial quantities and paying quantities as used in mineral leasing law suggest operations that are profitable or give rise to a reasonable expectation that they will be profitable in the future such that a "prudent" man would be justified in continuing operation of the project.

There is no requirement or suggestion in the FCLAA that commercial quantities be defined the same in section 3 and section 6. The language in section 3 easily lends itself to several interpretations. The Interior Solicitor's Opinion M-3695 1 offered four possible ways of defining "producing in commercial quantities":

> There are several lawful ways to implement the term: (1) as the term is used in oil and gas law to describe a rate of production from a solid mineral mine

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[21] **See 43 C.F.R. 3472.1-2(e) and 3480. O-5(a)(6) (1985).**

[22] **Public Law 94-377, sec. 6, 90 Stat. 1087 (1976); 30 U.S.C. 207(a).**

[23] **Public Law 94-377, sec. 7, 90 Stat. 1087 (1976); 30 U.S.C. 208-1.**

[24] **Act of Feb. 25, 1920, ch. 85, sec. 2, 43 Stat. 438.**

[25] **Public Law 94-377, sec. 4, 90 Stat.1085 (1976).**

[26] **See 43 C.F.R. 3430.1-2 (1985). The regulation defines commercial quantities aa "The coal deposit discovered under the prospecting permit shall be of such character that a prudent person would be justified in further expenditure of his labor and means with a reasonable prospect of success in developing a valuable mine, Further, the applicant must demonstrate that "there is a reasonable expectation that revenues from the sale of the coal shall exceed the cost of developing the mine and extracting, removing, transporting, and marketing the coal."**

[27] **See H. Rpt. 94-681 at 33.**

> meeting reasonable commercial standards; (2) as the term is used in regulations defining "continued operation" on a Federal coal lease, as a rate (an amount over a short period like 1 year) of sustained production; (3) as the term is used in the regulations defining "diligent development" on a Federal coal lease, as a cumulative amount (over a longer, fixed period, taking into account start up time and initial mine production) of initial production, with a succeeding rate thereafter; or (4) by some combination of the foregoing.[28]

OTA concludes that at a minimum section 3 requires actual production of coal in commercial quantities of coal before or at the time a new lease is issued. Section 3 does not define the period over which the production is to be measured. The Secretary was left to interpret both "producing" and "commercial quantities."

By regulation, the Department has established production of 1 percent of the recoverable reserves of a lease or of the approved logical mining unit (L MU) containing the lease as "commercial quantities" for both section 3 and the diligent development and continuous operations requirements of section 6 of FCLAA.[29] The production periods are different for each however. For diligent development purposes a lessee must produce 1 percent of lease recoverable reserves within 10 years of lease issuance or readjustment. Continued operations requires an average annual production rate of 1 percent of lease reserves after satisfying the diligent development requirement.

OTA concludes that the term "commercial quantities" is a term of art in Federal mineral law and need not be defined as production of a fixed amount of recoverable reserves for purposes of sections 3 or diligence requirements of FCLAA. OTA believes that as long as a lessee is actually producing or has produced coal after August 4, 1976, FCLAA allows the Secretary to consider other factors in determining whether the amount of coal produced is commercial quantities for the purposes of these provisions or whether the amount produced is merely "frivolous. " Examples of such other factors include: the eventual capacity of the mine; the amount of reserves, and geological and engineering restraints on the rate of initial production; the demonstrated investment in mine construction and facilities; and the schedule for production and delivery of coal under a long term contract. The term "producing" implies some continuity of activity, however OTA believes that section 3 does not impose an additional annual or continued operation obligation on the lessee. Intermittent or sporadic production from an ongoing commercial mining operation could be sufficient for compliance with section 3, even if the mine is temporarily idled. We do not however, conclude that production restarts the 10 year section 3 "clock." The Secretary has virtually no discretion under FCLAA to find compliance with section 3 in cases where there is not any production from the lease after 1976.

Are there any difficulties or uncertainties in the determination of commercial quantities under DOI regulations and guidelines? If a lease has an approved mine plan and is permitted, there is ample information on which to base a commercial quantities determination of reserves for the area that is being mined. This information is adequate for DOI and the lessee to estimate reserves with an acceptable degree of certainty. If the lease has very large reserves that are not currently proposed to be mined and for which there is less information available, it is possible that the lessee and the Department might disagree over the reserve base for commercial quantities. The lessee may, however, be able to demonstrate to the satisfaction of the Department that portions of the deposit are not, in fact, economically recoverable according

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[28] Solicitor's Memorandum M-36951 to the Assistant Secretary for Land and Minerals Management on Section 2(a)(2)(A) of the Mineral Leasing Act of 1920, Feb.12, 1985, at 1.

[29] 43 C.F.R. 3480.9 5(a)(6) and discussion in preamble of 1982 regulations, 47 Fed. Reg. 33,157, July 30, 1982.

to the approved plan of operations. The Department could then reduce the commercial quantities amount. If the Department disagreed, the lessee might relinquish sufficient reserves to reduce the base, or, alternatively, appeal the Departments action.

HOW HAS THE DEPARTMENT OF THE INTERIOR PREPARED TO IMPLEMENT SECTION 3?

Since passage of FCLAA, the Department has thrice issued several regulations defining section 3 production obligations.

In January 1977, final regulations were adopted that made compliance with section 3 a qualifications requirement for Federal coal leases. Under the 1977 regulation, production of coal in commercial quantities was "production adequate to meet the requirement for continuous operation", which at the time required production at an average annual rate of one percent per year.[30] The provision was consistent with the 1976 diligence regulations that required all existing leases to produce 2.5 percent of reserves by June 1, 1986 and 1 percent of reserves annually thereafter. Exceptions were allowed for operations disrupted by strikes, the elements, and casualties not attributable to the lessee, and when production was suspended by the Secretary on payment of advance royalties.

In July 1979 regulations *were* promulgated that created a substantially revised Federal Coal Management Program. Compliance with section 3 was continued as a qualifications requirement for obtaining Federal coal leases .31 The regulations provided that:

> After August 4, 1986, no lease shall be issued to any applicant or bidder that holds and has held for 10 years any lease from which coal is not being produced, except as authorized under section 3475.4 of this title, in commercial quantities as defined in 3400.0-5(i)(l) of this title.[32]

At the time there was no mention of the provision in preamble to the final regulations. (The provision did not appear in the March 1979 proposed regulations, which were said in the preamble to restate current regulations adopted in 1976.) Commercial quantities, however, was defined as production of an amount equal to one fortieth of lease or LMU reserves, an apparent, but perhaps inadvertent increase over the 1977 requirement. The exceptions refer to the provisions for diligent development and continued operations under the 1976 diligence regulations and do not directly track the language of sections 3 and 6 of FCLAA. The 1979 regulations would seem to allow payment of an advance royalty in lieu of continued operations with approval of the mining supervisor as an exception to section 3. This options was not limited to leases readjusted after FCLAA. Advance royalties for pre-FCLAA leases were to be based on a percentage of the value for a minimum number of tons of coal. "The percentage is not to be less than that prescribed in the lease." For pre-FCLAA leases, "the minimum number of tons shall be determined on a schedule sufficient to exhaust the leased reserves in 40 years from June 1, 1976" or an average of 2.5 percent annually. (This production rate was similar to that required under the 1976 diligence regulations that were continued under the 1979 coal management program.) These regulations suggest that these payment obligations would be undertaken voluntarily by the lessee. The regulations also suggested that discretionary extensions of the 10 year diligent production period for pre-FCLAA lessees might also be an exception from the producing in commercial quantities requirement of section 3.

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[30] See 42 Fed. Reg. 4,454, Jan. 25, 1977; 43 C.F.R. 3525.1(f) (1977).

[31] 44 Fed. Reg. 42,645, July 19, 1979; 43 C.F.R. 3472.1-l(e) (1985).

[32] 1 d .

In July 1982 the Department changed the qualifications provisions as part of yet another overhaul of coal leasing regulations. The regulations establishing the qualifications of coal lessees and bidders currently provide:

> After August 4, 1986, no lease shall be issued to any applicant or bidder and no existing lease shall be transferred to any party that holds and has held for 10 years any lease from which coal is not being produced, except as authorized under the advance royalty payment provisions of 43 CFR Part 3480, in commercial quantities as that term is defined in 43 CFR Part 3480.[33]

The provisions amended the 1979 qualifications regulations by adding a restriction on lease assignment, limiting the availability of exceptions, and reducing the commercial quantities production from 2.5 percent to 1 percent of lease reserves.

The 1982 regulations limited the exceptions for payment of advance royalties under section 3480. Minimum production payments paid under any lease issued before August 4, 1976 and not readjusted are not considered to be advance royalties under section 7(b) of the MLA for purposes of section 3. When compared with the 1976 and 1979 provisions, the 1982 regulations in many ways tightened up the qualifications provision and limited the options available to a lessee and to the Department in determining compliance with section 3. The rulemaking again had 1ittle discussion of the section 3 provisions, except to note that no determination had been made about the applicability of section 3 qualifications requirement to other minerals.

In response to inquiries by coal lessees and the absence of congressional action on repeal of section 3, the Department issued proposed guidelines on section 3 on the related matter of LMU formation in Spring 1985. The proposed guidelines were published for public comment; final guidelines were published in August 1985.

OTA has found that the Department's section 3 guidelines and related regulations are, in some respects, more stringent than required by FCLAA, and in other respects, border on accepting very small amounts of production as commercial quantities for compliance with section 3.

By regulation, the Department has extended the section 3 production requirement to the qualifications for approval of lease assignments. This is not required by FCLAA. In fact, the original version of section 3 included language that would also have prevented a noncomplying lessee and related entities from acquiring a lease by assignment or other means, and might have required divestiture of other leases. This language was dropped by the Committee on the advice of the Department in favor of the current provision restricting only lease issuance.

The 1976, 1979 and 1982 coal leasing regulations each restricted the Secretary's discretion in applying section 3 and created compliance difficulties for some newly opened mines by defining "commercial quantities" for section 3 purposes as an inflexible, fixed amount in the absence of, any guidelines explicitly interpreting section 3. The section 3 guidelines may partially overcome the impact of the regulations through the flexible interpretations of "producing" and the period over which commercial production must be measured.

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[33] 43 C.F.R. 3472.1 -2(e) (1985).

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SECTION 3 GUIDELINES

The Department has issued guidelines describing current plans to administer section 3 for Federal coal leases. The guidelines are intended to assist Bureau of Land Management (BLM) field staff in determining compliance and to answer these questions: When is a lease subject to the section 3 producing in commercial quantities requirement? What is commercial quantities? When must that production have occurred? What are the recoverable coal reserves for the purposes of section 3? What can a lessee do to satisfy the requirement? What is an affiliate of the lessee under section 3?

The draft guidelines on section 3 were published for public review and comment in February 1985,[34] followed by draft guidelines on LMU formation in April 1985.[35] After review of the comments, final section 3 and LMU guidelines were published on August 29, 1985.[36] Because the guidelines were not promulgated as regulations, there was no requirement that the Department publish either the proposed or the final guidelines or respond to public comments. In publishing the final guidelines, the Department noted that the guidelines are meant to serve solely as an aid to BLM field offices in determining section 3 compliance within the discretion allowed to them under existing rules and consistent with the policy statements contained in the guidelines.[37] These "internal" guidelines and policies can be changed without advance public notice or publication. As guidelines, they may not be as judicially reviewable or enforceable as regulations. The guidelines offer little assurance to lessees that the current interpretations will be binding on the Department in the future or given deference by the courts should section 3 decisions be challenged in litigation. Representatives of the coal industry and environmentalists testified at June 1985 hearings of the House Subcommittee on Mining and Natural Resources on the unreliability of guidelines as regulatory tools and their preference for regulations.

The Department has considerably limited its discretion in implementing section 3 by regulations defining commercial quantities for section 3 purposes as production of 1 percent of lease or LMU reserves. The guidelines note the difficulties that may have been created by this and other provisions in the 1982 rules changes and note that they will be examined during a planned regulatory review of the coal management program.[38] The guidelines nevertheless attempt to create some flexibility within the constraints imposed by the current regulations through the interpretation of "producing" and in setting the time frame over which production of commercial quantities is measured.

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[34] 50 Fed. Reg. 6,398, Feb. 15, 1985.

[35] 50 Fed. Reg. 14,303, Apr. 11, 1985.

[36] 50 Fed. Reg. 35,125, Aug. 29, 1985.

[37] 50 Fed. Reg. 35,137, Aug. 29, 1985.

[38] The BLM solicited comments on alternative definitions of producing in commercial quantities when it published the draft guidelines in February. The alternative measures of producing in commercial quantities include:

(i) requiring that the lease be producing and that 1 percent of reserves must have been mined before lease qualifications are determined, without regard to when they production occurred (an approach similar to the diligent development requirement);

(ii) requiring production of 1 percent of reserves in the year before lease qualifications are determined (making it similar to the continuous operations obligation); and

(iii) defining commercial production as production under a coal sales contract, or production at a rate that operating revenues exceed operating costs exclusive of capital investment (terms that are similar to the producing in paying quantities obligations of oil and gas leases).

See 50 Fed. Reg. 6,399, Feb. 15, 1985. Adoption of any of these alternative definitions would require a change in regulations.

In determining compliance the field office must first ascertain whether the lease has been held for 10 years after August 4, 1986. If it has not been held for a total of ten or more years, section 3 does not apply. If the lease has been held for 10 or more years, the BLM must determine whether the lease is producing, or is part of an LMU that is producing. If the lease or LMU is not producing and not subject to an exception, the lessee and all affiliated firms are disqualified. If the lease or LMU is producing, the guidelines will assist the BLM field offices in deciding whether the amount of production is sufficient to satisfy the producing in commercial quantities requirement.

The MLA and regulations set production time frames of 10 years for diligent development and one year for continuous operations.[39] However, neither section 3 nor existing rules specify a time period for measuring production of commercial quantities. The guidelines adopt the view that "producing" in section 3 implies a continuing obligation on the part of the lessee. The guidelines therefore require at least some production at the time that Federal lease qualifications are being determined, but how much production is necessary depends on the particular characteristics of the mining operation and whether or not the lease has been made subject to the 1982 regulatory diligence system.

Lease qualifications are established by the lessee's compliance status at the time the new lease is sought. If the old coal lease later goes out of production, the new lease is not revoked.

BLM will determine an appropriate production bracket for each lease to measure producing in commercial quantities. The maximum production period allowed under the guidelines is 10 years; most production brackets will be less than 10 years. For the majority of pre-FCLAA Federal coal leases the production bracket could begin as early as the date that production begins after August 4, 1976, but not more than 10 years before the date that lease qualifications are determined. Production before 1976 cannot be credited. The production bracket is independent of the section 3 10-year holding period. The production bracket can extend beyond the time when lease qualifications are reviewed and projected production can be used in determining compliance.

The guidelines interpret "producing in commercial quantities" differently for 3 categories of producing leases depending on whether a lease has been made subject to the 1982 diligence rules and other requirements of FCLAA. Production brackets, commercial quantities amounts, and determination of recoverable reserves are different for each category. No distinctions are made for nonproducing leases that are not under one of the section 3 exceptions.

Category 1: Producing leases that are subject to the 1982 diligence "system".

Category 1 includes all leases issued since enactment of FCLAA and all pre-FCLAA leases that have been amended to include the requirements of the 1982 regulatory diligence system. According to the guidelines, there are five ways that pre-FCLAA leases come under the 1982 diligence system.

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[39] 43 C.F.R. 3472.1-2(3) (1985).

1. Readjustment of a pre-FCLAA lease after August 4, 1976 to make it subject to the 1982 diligence provisions.[40]

2. Modification of a pre-FCLAA lease to add new acreage after August 4, 1976.[41]

3. Voluntary amendment of lease terms to include specific diligent development terms in response to BLM request during 1980.[42]

4. BLM approval of the voluntary amendment of lease terms to be include the 1982 diligence provisions in lieu of lease specific diligence provisions in response to a lessee's request filed between August 1982 and August 1983.[43]

5. Amendment of a pre-FCLAA lease to include the 1982 diligence requirements on approval of LMU formation.[44]

Any production after a lease is subject to the diligence system is credited toward achieving the diligent development requirement and once that is satisfied, production is credited to meeting the annual continuous operation requirement. (In some circumstances, any production after August 4, 1976 may be credited toward diligence obligations at the lessee's request).

The relevant production bracket for measuring commercial quantities is the 10 year diligent development period for leases that have not yet produced 1 percent of reserves under the 1982 diligence system. For these leases, the Authorized Officer will determine whether coal is being mined at a rate that will result in satisfaction of the 1 percent diligent development obligation at the end of 10 years.[45] The lease must actually be in production at the time the lease qualifications are being determined in order to comply with section 3. If the lease is not producing, it is not in compliance with section 3, even though it may be fully in compliance with any diligence obligations. The lessee may actually have produced considerably less than 1 percent of lease reserves on a lease held for 10 or more years when a new lease is sought. Future production expectations are credited toward the 1 percent commercial quantities amount if the lease has not yet achieved diligence. If the lessee subsequently fails to produce commercial quantities on the old lease, the new lease will not be revoked.

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[40] Pre-FCLAA leases were originally "subject to" readjustment every 20 years. FCLAA shortened the readjustment periods for leases to every 10 years after expiration of the initial 20-year term. Pre-FCLAA leases can be readjusted at the end of their current 20-year pre-FCLAA term and every ten years thereafter. The MLA and regulations do not require that leases actually be readjusted, however it is and has been Department policy to do so. See discussion elsewhere in this report of recent problems with ineffective lease readjustments by BLM. Some leases that missed readjustment after Aug. 4, 1976 will not become subject to the 1982 diligence system until their next lease readjustment. The issue of how a lease actually readjusted between Aug. 4, 1976 and Aug. 30, 1982 when the current rules took effect is an interesting one. One ostensible reason that the diligence rules were changed in 1982 is that the Solicitor's opinion suggested that production obligations could not be altered except on readjustment. But the 1982 rules attempt to rewrite diligence terms for leases that had already been readjusted to contain the more stringent terms of the 1976 regulations.

[41] The Department has required lessees to consent to amendment of lease terms to include revised diligent development terms as a condition of lease modifications.

[42] BLM sent notices to many lessees in 1980 advising them of the requirements of the 1976 and 1979 diligence requirements and asking them to sign and return a lease amendment form that required compliance with the rules. Some lessees complied. Other lessees objected and the Department dropped its efforts to have leases specifically amended to include the new terms.

[43] BLM required lessees to file an election with the BLM to take advantage of the provision and to gain credit for post-1976 production for diligence purposes. See 43 C.F.R. 3483.1(b)(1) (1985). Conditional elections were filed on about 30 leases by the August 1983 deadline, but approvals have been delayed pending clarification of section 3 requirements. Personal communication from BLM to OTA, May 1985.

[44] BLM rules require that LMUs comply with the 1982 diligence requirements. See discussion of diligence obligations and LMUs later in this chapter.

[45] The "Authorized Officer" is defined as "any employee of the Bureau of Land Management delegated the authority to perform the duty described in the section in which the term is used," See 43 C.F.R. 3400. O-5(b) (1985).

Once the diligent development requirement has been met, the relevant commercial quantities production bracket is the continuous operations year. Compliance with section 3 requires that in the judgment of the authorized officer the lease is producing at an average annual rate of 1 percent of reserves based on a three year average. A lessee may pay advance royalties in 1ieu of actual production to comply with the section 7(b) continuous operations requirement. Payment of advance royalties also suspends the section 3 production requirement for that year.

The amount of recoverable reserves on which commercial quantities is calculated is the amount of reserves as of date the lease became subject to the 1982 diligence system. Under the 1982 regulations, the original recoverable reserves base does not decline with production for purposes of determining compliance with section 3 and diligence obligations. (The reserves estimates can be modified to reflect new information or changed conditions however.) The guidelines suggest that the regulations create a situation where a lessee might be required to pay advance royalties to satisfy the continuous operations and section 3 requirements for a category 1 lease that has been mined out and is under reclamation with no prospect of recouping the payments out of future production royalties on the lease.

The 10-year production bracket over which section 3 compliance is measured begins for category 1 leases on the date the lease became subject to the 1982 diligence system and may extend after the date on which new lease qualifications are determined. Once diligent development has been met, the 10-year bracket is not relevant, the lease must either be producing an average of 1 percent annually or paying advance royalties.

Category 2: Producing pre-FCLAA leases not yet subject to the 1982 diligence system

Most pre-FCLAA leases will initially be Category 2 leases not subject to the 1982 diligence system because most scheduled readjustment dates for pre-FCLAA leases are in the late 1980s early 1990s. The guidelines largely leave the determination of how much production is actually necessary and when it must occur to the discretion of the Authorized Officer taking into consideration the characteristics of the mine. For these leases, producing in commercial quantities means the lease is producing at a rate that will result in production of a total of 1 percent of recoverable lease reserves over an appropriate production bracket assigned by the Authorized Officer. The production bracket can be no more than 10 years. The guidelines state that " The time period should be set at less than 10 years in cases where that more closely approximates what is "commercial" given the reality of the operation."[46] The time frame may be readjusted to reflect changes in conditions. The bracket begins on the date that production started after August 4, 1976, but no more than 10 years before the date on which lease qualifications are determined if production began before 1976 or the lease has been producing for more than ten years after 1976. The production bracket can extend after the date on which a new lease is sought and projected production can be used. Commercial quantities is 1 percent of recoverable reserves existing on the date the bracket begins. The amount of recoverable reserves on which commercial quantities is calculated will decrease with production until the lease becomes subject to the 1982 diligence system and thus a category 1 lease.

The guidelines suggest that production of much less than 1 percent of reserves before the time a new lease is sought can be sufficient for compliance if the lease is producing and the BLM concludes that it will produce 1 percent of lease reserve by the end of the assigned bracket under its plan of operations. The guidelines are silent as to when and how much

[46] 50 **Fed. Reg. 35,134, Aug. 29, 1985**

commercial production must occur before qualifications are determined to be considered as "producing" at that time.

This commercial quantities production rate of one percent over whatever production bracket might be assigned to the lease by the BLM is now, in practical effect, the only production requirement imposed on old leases before readjustment assuming 1) that the lessee wishes to acquire a new lease and 2) that the Department will not attempt to enforce any specific minimum production clauses in existing leases or the more general diligence obligation of the original section 7 of the MLA.

Category 3: Leases in Approved LMUs that are producing.

For Category 3 leases in an producing approved LMU producing in commercial quantities requires that the LMU production is being credited toward commercial quantities for either diligent development or continuous operations requirements of the 1982 diligence system. Section 5 of FCLAA allows production anywhere in an LMU to be used to satisfy production requirements for all Federal leases in the LMU. The Solicitor's Memorandum M-36951 concluded that the language of section 5 allows LMU production to satisfy the section 3 producing requirement. Under the 1982 diligence system, the 10-year LMU diligent production period begins on the date of LMU formation or, if there are no unadjusted pre-FCLAA leases in the LMU, on the most recent date of post–FCLAA lease issuance readjustment, modification or election. The determination of whether an LMU is producing in commercial quantities is similar to that for category 1 leases. The LMU must be currently "producing" and the production rate must be sufficient to result in satisfaction of the initial 1 percent diligent development obligation by the end of the applicable LMU diligence period or the 1 percent annual LMU continuous operations obligation. The LMU recoverable reserves are the total reserves in the LMU on the effective date of LMU approval. Leases in an LMU can also satisfy the continued operations and section 3 production requirement by paying section 7(b) advance royalties.

Impacts of the Guidelines on Section 3 Implementation

The guidelines effectively set different minimum production amounts and production "brackets" for pre-FCLAA leases depending on whether or not the 1982 diligence regulations have been made applicable to the lease and when the lease began producing. This means that some lessees have to be producing at a rate of as much as 1 percent of reserves annually to comply with section 3, while other lessees have to be producing towards a projected total of 1 percent of lease reserves over a period of up to 10 years which may extend after the time the new lease is issued. Such a scheme is neither contemplated or required by section 3, but may be within the Secretary's discretion. Alternatively, a simple rule change making the determination of producing in commercial quantities a factual judgement based on consideration of the lessees overall investment and production efforts, pattern of operations, contractual commitments, and actual production would provide the necessary flexibility while also maintaining the intent of section 3.

> The production requirement assures that no Federal lease that "meets" section 2(a)(2)(A) is being held for speculative purposes; any lease on which production (of other than frivolous amounts of coal) is occurring has seen the investment of millions of dollars of fixed, sunk, costs. Thus the Congressional intent to force production or relinquishment, in order to qualify for new Federal leases is fully satisfied.[47]

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[47] 50 Fed. Reg. 6,398, Feb. 15, 1985.

The Department's guideline approaches have a number of weaknesses and some strengths. One weakness is that defining producing in commercial quantities for one class of lessees as "producing toward" achievement of production of 1 percent of lease or LMU reserves over a period of up to 10 years after new lease issuance might be viewed as accepting frivolous amounts of production to qualify under section 3 for some lessees while requiring more significant efforts from others. Another major weakness, in the view of many lessees and others, is that the internal guidelines are an unreliable basis for corporate investment decisions because they could be changed without public notice.

Leaving the determination of the lease production bracket and whether the lessee's level of production is sufficient for commercial quantities to the discretion of field office on a lease by lease basis creates great uncertainty for lessees as to whether at some time in the future their current or past production levels will be deemed inadequate to qualify them for leases. Moreover, once a pre-FCLAA lease is readjusted or otherwise made subject to the current regulatory diligence system, the definition of producing in commercial quantities changes. The current regulations leave lessees who have depleted their currently recoverable reserves but retain their leases for reclamation, access, or LMU purposes at considerable risk of noncompliance.

Section 3 is independent of section 7, there is no requirement that commercial quantities amounts be the same for both. Many of the contortions and complexities in the guidelines are attributable to the 1982 diligence rule changes and the adoption of production of 1 percent of lease reserves as commercial quantities for both the section 7 diligence and continuous operation requirements and section 3 purposes. The linking of section 3 and section 7 production obligations and exceptions, however, reinforces the 1982 regulatory diligence system and could potentially bring many pre-FCLAA leases under its requirements voluntarily in order to comply with section 3. As a result of the voluntary lease amendments and LMU approvals, many pre-FCLAA lessees could face earlier diligence deadlines than if they waited until the leases were readjusted as scheduled. On the other hand, the guidelines may tend to undercut the potential impacts of section 3 by, in some cases, authorizing the acceptance of very small amounts of production to satisfy the section 3 commercial quantities requirement to counteract the impact of the regulations.

WHO IS SUBJECT TO SECTION 3 DISQUALIFICATION?

The section 3 nonproduction penalty is a far-reaching disqualification from acquiring new Federal onshore mineral leases that affects not only the record title holder of the lease but "any person, association, corporation, or any subsidiary, affiliate, or persons controlled by or under common control with such person, association, or corporation." The legislative history did not discuss this language specifically with regard to section 3. The language is identical to Section 11 of FCLAA amending section 27(a) of the MLA which imposes acreage limitations on total Federal leaseholdings. Because the same language was used in the same Act, the legislative history of section 11 is particularly pertinent. The section 11 amendment was made to broaden the definition of an entity to which the acreage limitation applied "to assure that the restrictions on leaseholdings are not circumvented by the formation of holding companies, or other devices of corporate organization. Henceforth no one entity, under whatever corporate or other form, will be permitted to take, hold, own or control coal leases on more than 100,000 acres in the United States or more than 46,080 acres in any one State..."[48]

[48] H. Rpt. 94-681, at 25-26 (1975).

The Department's guidelines offer some assistance in determining how many lessees and their corporate families might be affected by section 3. However, the Department has not yet sufficiently and clearly interpreted the meaning of "affiliate" or "controlled by or under common control with" for section 3 purposes to predict how section 3 will be enforced against certain lessees and leases, particularly those that have been transferred in complex corporate acquisitions and mergers.

The February 1985 Solicitor's memorandum finds that "control is the key concept through which ownership of a nonproducing Federal coal lease will be attributed to related corporate entities."[49] The Solicitor's opinion concludes that the question of whether a particular entity is "controlled by or under common control" with another entity (for section 3 purposes) -- is an issue of fact which generally must be resolved on a case-by-case basis under established, but inexact, legal principles."

Coal leases are held in various forms: in the name of corporations, wholly-owned corporate subsidiaries, joint ventures, by two or more corporations with various percentage shares, by individuals (singly, as joint tenants, and as tenants in common), and by partnerships, associations, estates, and trustees (both for individuals and business trusts).

OTA believes that the statutory language and the Secretary's discretion are sufficient to apply the section 3 penalty to all types of leaseholding arrangements avoid evasion of Section 3. However, we note that the Department might use its discretion under this provision to narrow the applicability of section 3 to certain classes of leaseholders by defining control as ownership of 51 percent or more of the stock of a corporation or the lease. Similarly, a decision by the Department to restart the section 3 clock when a lessee is acquired by another corporation could effectively extend, by five or more years, the compliance period for several corporate lessees who control a significant share of the currently nonproducing leases.

The preamble to the final section 3 guidelines suggests how how some types of assignments and acquisitions might be handled. Any record title holders will be deemed to "hold" a lease for section 3 purposes even if it has a less than 50 percent interest in the lease. Assignments of leases between parent corporations to subsidiaries or between subsidiaries of the same corporation will not restart the section 3 holding period. If a new parent corporation gains control a lessee corporation, the new parent would be governed by the lessee's original 10-year holding period. If a lessee (or a related company) reacquires a lease that it previously held after August 4, 1976, the lease will not have a new 10-year holding period. The subsequent ownership period will be added to the prior term in determining whether a lease has been held for a total of 10 or more years.

The preamble and the Appendix C to the final guidelines reiterate that the Secretary will use "relevant, well accepted principles" in making the determination of parent - subsidiary and affiliate relationships under section 3. The issue will be decided on a case by case basis when lease qualifications are determined guided by several principles:

1. A corporation is a *subsidiary* of another corporation if more than 50 percent of the its voting securities are held directly or indirectly by the other corporation.

2. A corporation is an *affiliate* under legal control of another corporation when more than 50 percent of the voting securities of each such corporation is held directly or indirectly by another person, corporation, or entity; or

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[49] **Solicitor's Opinion M-36951, at 28.**

3. The Secretary may determine that in the absence of legal control through stock ownership a person, association, or corporation is under the actual control of another person, association or corporation.[50]

These above "guides" set a very high threshold for presuming control. The appendix discussion notes the possibility that smaller ownership percentages might confer control over a company. "Actual control of a corporation will often exist without ownership of a majority of the corporation's voting stock. Ownership of less than 50 percent may provide actual control where stock ownership is widely dispersed." The appendix does not suggest what circumstances or criteria might be used to indicate the existence of control by ownership of less than 50 percent of the voting stock of a corporation. For partnerships, joint-ventures, the appendix notes that BLM intends to "implement ownership/control/affiliation concepts with respect to such entities in a manner consistent with the Office of Surface Mining's rules for control-responsibility of noncorporate business entities."[51]

The preamble to the guidelines that corporate affiliations will have to be determined at the time of lease qualification and notes that this will require changes to lease certification rules for all onshore leases and the development of procedures and standards that BLM can apply generically in making these determinations. These changes to regulations and procedures have yet to be proposed.

IS SECTION 3 RELEVANT FOR POST-FCLAA LEASES?

It is clear that section 3 was aimed primarily at old leases. It can also apply to leases issued after passage of FCLAA and provides a backup and nondiscretionary production incentive for such leases. Any post-FCLAA lease not producing within 10 years after issuance is automatically terminated by operation of law under section 7 of the MLA, making Section 3 redundant as a mechanism to force a post-FCLAA lessee to start producing. However, Section 3 still could apply to a post-FCLAA coal ease once it assignments and other assignments filed in the future would swell the number of leases and lessees that face Section 3 deadlines far into the 1990s. OTA has not included pending assignments in its analysis since assignments *can* and have been withdrawn and assignments are not effective until approved by DOI.

WHAT MUST A LESSEE DO TO COMPLY WITH SECTION 3?

Section 3 of FCLAA gives a lessee 10 years from August 4, 1976 or 10 years after acquiring a lease, whichever is later, to bring a coal lease into commercial production or face disqualification. A lessee has eight options for complying with section 3 and avoiding disqualification.

1. The lessee can produce coal in commercial quantities from the lease.

Under current regulations and guidelines the amount of production necessary for commercial quantities depends on whether the lease is subject to the 1982 diligence system and whether it has satisfied the initial diligent production requirement, Compliance with section 3

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[50] 50 **Fed. Reg. 35,144, Aug. 29, 1985.**

[51] **Such rules were proposed Apr. 5, 1985, 50 Fed. Reg. 13,724, but have not been issued in final form.**

may require production at a rate of as much as 1 percent of lease or LMU reserves per year if the lease is subject to the continued operations requirement of the 1982 regulations. If however, the lease is not under the 1982 diligence system or has not yet satisfied the initial 1 percent diligent production obligation, commercial quantities compliance requires that the lease be producing at a significantly lower rate that will result in production of atotal of 1 percent of lease or LMU reserves over period of up to 10 years

2. *The lessee can pay advance royalties in lieu of continued operation.*

Section 3 recognizes payment of section 7(b) advance royalties as an exception to the producing in commercial quantities requirement. Section 7(b) authorizes suspension of production and payment of advance royalties in lieu of continued operation if the Secretary determines that the public interest will be served.[52] The advance royalties must be 'no less than the production royalty which would otherwise paid and shall be computed on a fixed reserves to production ratio." Advance royalties may only be accepted for a total of ten years during the period of any lease.

The availability of this option to pre-FCLAA leaseholders whose leases have not yet been readjusted has been cast in doubt by the February 1985 Solicitor's Opinions and the section 3 guidelines. The opinion concluded that only advance royalties paid under a lease subject to the requirements of the amended section 7(b) can be used to avoid section 3 disqualification. The provisions of the amended section 7(b) can not be applied to pre-FCLAA leases that have not yet been readjusted. The opinion cited three reasons: (i) Section 3 refers specifically to section 7(b) and not generally to payment of advance royalties; (ii) Section 7(b) did not exist before passage of FCLAA; and (iii) FCLAA significantly altered the advance royalty provisions in comparison to the advance royalty terms of existing pre-FCLAA leases. Among the significant differences in the post-FCLAA advance royalty provision was that the amount to be paid was increased significantly, is not creditable against rentals, and can be paid in lieu of production for only 10 years.

The statutory language could however support an interpretation that is not as exclusionary on or inconsistent with basic thrust of section 3. One could interpret the designation of subsection 7(b) as a nonrestrictive reference to the MLA provision authorizing advance royalties and force majeure suspensions. Pre-FCLAA leases issued under section 7 of the MLA before 1976 are also subject to the conditions of diligent development and continued operation of the mine or mines, "except when such operations" shall be interrupted by strikes the elements, or casualties not attributable to the lessee." Payment of advance royalties in lieu of production was authorized for the continued operation requirement in language similar to that used in section 7(b). The 1976 and 1979 section 3 qualifications provisions seemed to adopt this less restrictive interpretation.

An important limitation on the availability of advance royalties as a compliance mechanism under either interpretation is that both the original MLA and FCLAA only authorize payment of advance royalties in lieu of continued operation and not diligent development. The lease must be in production before advance royalties can be used to extend the lease. A producing pre-FCLAA lessee might consent to voluntary amendment of the lease to include the post-FCLAA advance royalty provision --in effect an early readjustment). This would allow advance royalties to be used to satisfy section 3. The lessee would have to pay higher royalties, but it might, in some circumstances, be preferable to forming a logical mining unit or litigating over the Department's interpretation.

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[52] **30 U.S.C. 207(b).**

OTA estimates that at most only about 130 pre-FCLAA leases might qualify for this exemption initially through scheduled readjustment. As more leases are readjusted, more will qualify for the advance royalty exception. It is probable, however that not all of the first 130 leases were effectively readjusted between 1976 and 1984 because of the Department's failures to notify the lessees properly and to adjust leases in a timely manner. Many lessees have contested post- 1976 lease readjustments and some have been successful in appeals to the Federal Courts and to the Interior Board of Land Appeals. Some post- 1976 lease adjustments were thus reversed or nullified so that the leases continue with pre-FCLAA terms and royalty provisions. Under the Department's section 3 guidelines, these lessees will not be eligible to pay section 7(b) advance royalties to comply with section 3 unless the leases are amended.

3. *The lessee might obtain a force majeure suspension under section 7(b) if the lease operations are interrupted because of strikes, the elements or casualties not attributable to the lessee.*

Section 7(b) provides in pertinent part that:

> Each lease shall be subject to the conditions of diligent development and continued operation of the mine or mines, except where operations under the lease are interrupted by strikes, the elements, or casualties not attributable to the lessee (emphasis added).

Casualties not attributable to the lessee do not include ordinarily foreseeable risks of doing business, such as ordinary delays in acquiring permits or the lack of markets. The Department's guidelines limit section 7(b) force majeure suspensions to leases that have been readjusted or otherwise amended to include all FCLAA terms and conditions. Force majeure suspensions for unadjusted leases are still available under the prior language of section 7 which is incorporated by reference into the lease terms.

4. *The lessee can assign the lease to an unrelated entity.*

An assignment of a nonproducing lease to an unaffiliated party restarts the clock for the assignee and purges the assignor of its noncompliance status for that lease. A lessee may assign or all part of the lease to another. An application must be filed with the Department for approval of the transfer and must show that the new owner is qualified to hold a lease. (Transfers of other interests in the lease such a working agreements and subleases must also be approved.) Transfers take effect on the first day of the month following approval by BLM or by previous agreement, on the first day of the month of the approval.[53] An assignment does not alter any other terms or extend the time periods for diligent development and continued operations or for lease readjustment. State governors must be given reasonable notice of any lease transfer. Until the transfer is approved, the lessee remains the record title holder and can not obtain new leases if it is in noncompliance with the section 3 production requirement. Delays in approval of assignments of 6 months or more have been reported. The guidelines note that regulations and procedures will be developed to protect the priority of applications for noncompetitive leases due to delays in processing lease assignments and other transfers.

Secretary of the Interior James Watt created a further restraint on a lessee's ability to rid itself of nonproducing leases or to obtain new leases by assignments in the 1982 regulations.[54] Coal lease assignees must meet all the qualifications of a bidders or applicants, including the

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[53] **43 C.F.R. 3453.3-3 (1985).**

[54] **See 43 C.F.R. 3472.1-2(e) (1985).**

section 3 production requirement for a transfer to be approved. This restriction is not required by FCLAA and was a policy decision. This decision was explained as follows:

> The Department of the Interior does not interpret section 3 of the Federal Coal Leasing Amendments Act to prohibit lease transfers to such lessees, but the Act appears to weigh against allowing these transfers. Section 3 of the Mineral Leasing Act as amended (30 U.S.C. 184), gives the Secretary of the Interior discretion to approve or disapprove any transfer and requires his consent for assignment or sublease of leases. This authority was discussed in the July 1979 preamble to the existing regulations (44 Fed. Reg. 42602). The Secretary has decided to exercise this authority to refuse approval of a lease transfer by requiring transferees to comply with section 3 of the Federal Coal Leasing Amendments Act, that is transferees must be eligible to bid for new leases under that section in order to qualify to receive leases by transfer.
>
> If such lessees are not eligible to receive new leases as a result of the provisions of section 3 of the Federal Coal Leasing Amendments Act, then it follows that these lessees should not be allowed to receive Federal coal leases by transfer. Such transfers would circumvent section 3 because a lessee not eligible for a new coal lease could purchase that lease from the person to whom it was issued by transfer. This rulemaking makes consistent the legislative policy not to put leases into the hands of persons who, after 1986, have held any nonproducing leases for more than ten years.
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> The Department of the Interior recognizes the burden placed on industry by section 3 of the Federal Coal Leasing Amendments Act, but suggests that a legislative solution is more appropriate than a rulemaking which allows circumvention of the intent of the Act.[55]

This restriction has two effects. It significantly limits the pool of potential purchasers for nonproducing leases to those lessees who are in compliance or to whom section 3 does not apply because leases have been held for less than 10 years and to individuals or companies that hold no Federal coal leases. Secondly, it prevents a noncomplying lessee from obtaining additional coal leases through the assignment mechanism either as a means of obtaining new leases that they are barred from bidding on or other old leases.

The Department's policy goes beyond what FCLAA requires. As discussed previously, an early version of section 3 would have limited assignments to noncomplying's lessees, however this expansive restriction on lease holding and acquisition was deleted and section 3 was limited to the issuance of new leases.

Regulations governing relinquishment require that an application be filed with the State BLM office.[56] The applicant must show that all accrued rentals and royalties have been paid and that all other lease obligations have been met.[57] A lessee may relinquish all or part of the lease or any bed of the coal deposit under lease. The Secretary must find that relinquishment would not impair the public interest. The preamble to the regulations noted that

> ...there may be cases where relinquishment would not be in the public interest. It would not be in the public interest to allow manipulation of logical mining

[55] 47 Fed. Reg. 33,130, July 30, 1982.

[56] 43 C.F.R. 3452 (1985).

[57] 43 C.F.R. 3452.1-3(1985).

unit diligence, high grading and failure to achieve maximum economic recovery. such practices could theoretically occur if lease relinquishments were automatically granted.[58]

There are other circumstances where relinquishment might not be found to be in the public interest, such as relinquishment of old leases with abandoned and unreclaimed mine workings. (OTA found that there are at least 47 of these leases that are currently nonproducing.) The Federal lease form commonly requires that the lessee seal openings and remove equipment and structures and restore the surface after mining has ceased. Reclamation must be complete before approval of any relinquishment. Many old, unreclaimed leases were mined before permit conditions and reclamation standards for active coal mines were imposed under the Surface Mining Control and Reclamation Act of 1977 (SMCRA). The lease terms are probably the only affirmative obligations to clean up any surface disturbance. Although a relinquishment will be effective as of the date it is filed, it may take some time to determine whether all the lessee's obligations under the lease have been satisfied. One or more one complete growing seasons (i.e., years) may be required to demonstrate compliance with the lease terms, if for example, the surface restoration involves, for example, revegetation of disturbed areas. In the interim, since the relinquishment is not yet effective, the lessee still "holds" the lease and could be barred from obtaining new leases or assignments until the relinquishment becomes final. If the Department accelerates the relinquishment approval process without a reasonable assurance that restoration efforts will be successful, the Government might later have to pay for correction of dangerous or environmentally harmful conditions in inactive mine workings. One possible solution might be for the Department and the lessee to enter into a legally enforceable agreement obligating the lessee to restore the surface and to guarantee any expenses in return for approval of the relinquishment.

6. *The lessee can obtain a suspension of the lease under section 39 of the MLA.*

The Secretary can suspend operations and production on any coal lease "in the interests of conservation of the resource" under section 39.[59] During the suspension the rights and obligations of the lease are held in abeyance. No development or production activities can take place, no rent is due. (FCLAA amended section 39 to provide that it could not be used to suspend or reduce advance royalties due under section 7(b), so that advance royalties are due on new and readjusted leases under the continued operations require merit.) A section 39 suspension might be justified for a lease that was not currently in production and which would not be reached for a number of years and which could not be mined except from the lessee's operation. The Secretary might suspend the lease until it could be mined to conserve coal resources that might otherwise never be extracted. Other options available to prevent the bypass of Federal coal in such a situation are LMU formation or issuance of an order barring wastage of the leased coal. A suspension allows the lessee to preserve the advantages of a pre-FCLAA lease without satisfying all of the requirements imposed on it. It would also delay readjustment and would extend the section 3 clock by the duration of the suspension. Section 39 suspensions are not available for purely economic reasons, such as failure to find a buyer for the coal or generally poor market conditions.[60]

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[58] **47 Fed. Reg. 33,129, July 30, 1982.**

[59] **30 U.S.C. 209.**

[60] **FCLAA's amendment of section 7 of the MLA repealed the Secretary's authority to suspend operations for up to 6 months during periods when market conditions were such that a lease could not be operated profitably. Public Law 94-377, 90 Stat. 1087. The Secretary retains authority to reduce production royalties for leases that can not be operated at a profit under their terms.**

7. *The lease can recombined with other Federa! or non-Federal coal into a producing LMU.*

Under section 5 of FCLAA, production anywhere in an approved LMU can be used to satisfy the production requirements for any Federal leases in the LMU. The Department has determined that LMU production can be used to satisfy the section 3 "producing in commercial quantities" requirement.

Section 3 is silent as to whether production from an LMU is sufficient for section 3 compliance. The language of section 7(b) and section 5 and legislative history of section 5, however, strongly suggest that LMU formation was intended as an aid to development and maximum economic recovery of Federal coal and to satisfaction of diligence production and continued operations requirements. Section 7(b) provides that each lease is subject to the conditions of diligent development and continued operation. If production in an approved LMU can satisfy the section 7 diligence requirement, by extension such production should also satisfy the section 3 production requirement for a nonproducing lease in the LMU.

Section 5 of FCLAA allows the formation of an LMU and provides that:

> In approving a logical mining unit, the Secretary may provide among other things that (i) diligent development, continuous operation, and production on any Federal lease or non-Federal land in the logical mining unit shall be construed as occurring on all Federal leases in the logical mining unit. The Secretary may even amend the terms of lease included in a logical mining unit so that mining under that lease will be consistent with he requirements imposed on the logical mining unit.[61]

Section 5 specifies certain conditions for a logical mining unit. LMU formation is not without problems and issues of its own. Under the Department's regulations and recently proposed guidelines there are many incentives and disincentives for lessees to form an LMU. Before issuance of the 1982 diligence regulations and the February 1985 Solicitor's Opinion and proposed section 3 and LMU guidelines, it was generally assumed that LMU formation would be sufficient to deal with any section 3 and diligence problems for producing mines. The major concerns with LMU formation had been the problem of noncontiguous mine areas, how "excess" reserves would be handled, and how the Department would interpret the provision that the LMU mine plan must provide for extraction of reserves in 40 years or less.

8. *The lessee can consolidate the nonproducing lease and a producing lease into a single lease.*

There is an eighth option for bringing a nonproducing lease into compliance that may be appropriate in some circumstances. Under his general administrative authority over Federal coal leasing, the Secretary may approve the combining into a single lease of two or more coal leases held by the same owner. Two provisions of the MLA expressly authorize lease consolidation or combination. Section 5 of the MLA allows consolidation of two or more contiguous lease parcels into a single lease of no more than 2560 acres if the Secretary finds it in the public interest.[62] Section 6 of the MLA allows up to 2560 acres of noncontiguous lands to be included in the same lease.[63] The consolidation mechanism could be used to combine a producing lease with a nonproducing lease and might thus allow the lessee to comply with section 3, Consolidation does not impose any of the conditions of LMU approval such as the "40 year

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[61] Public Law 94-377, 90 Stat.1086; 30 U.S.C. 202a.

[62] 30 U.S.C. 205.

[63] 30 U.S.C. 206.

mine out" or application of the 1982 diligence system to the leases. Lease consolidation might allow noncontiguous lease areas to be combined. There are currently no regulations governing consolidations. Although the two express consolidation provisions have acreage limits, there is no longer a statutory acreage limit for coal leases other than the overall limits on total acreage holding within a State.

Consolidations have been used in the past to combine producing and nonproducing leases held by the same owner, so that minimum production obligations in the lease terms could be satisfied. Such requests, however, were not always granted, but there was also little effective enforcement of the minimum production obligation. More recently Mobil's Rojo Caballo leases were recombined into a single lease. An 80 acre tract of acquired land in the original lease had been segregated administratively because BLM at the time was unsure whether a lease could contain both public domain and acquired lands. Later, BLM concluded that it could and consolidated the tracts back into one lease. The consolidation removed the possibility that Mobil would have to form an LMU or mine each lease separately in order to comply with diligence and section 3 requirements for what was originally a single lease. Mobil is seeking approval of an LMU combining Federal and non-Federal lands in its Rojo Caballo Mine.

Diligent Development Requirements and Other Production Incentives for Federal Coal Leases

Section 3 creates a strong incentive for at least some Federal coal lessees to bring their leases into production. Section 3 however has disparate effects, it has virtually no impact on a lessee with no immediate need for more coal leases or one that is not involved in other mineral leasing activities. Advocates of repeal and modification of section 3 argue that it is a redundant provision because Federal coal leases are subject to other more direct production requirements that would remain if section 3 were removed. This section examines the production requirements currently imposed on Federal coal leases and explores various alternative mechanisms that can be used to promote timely development of Federal coal deposits.

The expectation of a profit to be made from mining and selling coal is, clearly, the most powerful incentive for a lessee to develop any mine, however, there are times when nondevelopment may be economically preferable. For example, if the lessee anticipates that the price of coal will go up in the future, a delay in development of a particular property may offer prospects for a greater profit later. In other instances, market conditions and excess capacity in existing mines may significantly reduce the probability that a lessee can successfully find a buyer for the coal if development proceeds without any assured contracts. If the lessee is particularly risk averse, it may decline to develop the lease until it has what it perceives as a greater probability of success. Thus a lessee's economic interests can at times be better served by delay than development. But does delay advance the lessor's interest or the public interest? If the lessor's major interest in leasing the coal is receiving royalty payments from mining, delay is not to his benefit. Early production or return of the lease so that it could be sold to another potentially more successful developer would be more advantageous to the lessor. The public interest is also served by encouraging more development so that competition among coal suppliers will tend to keep fuel prices low. To protect the interests of the lessor and to balance them against the interests of the lessee, mineral leases typically contain provisions that assure that the lessee will make a diligent effort to develop the lease or pay the lessor in lieu of production revenues or turn back the lease. These diligence provisions are an important and longstanding part of Federal mineral law as well.

A 1975 study of the Federal energy mineral leasing systems by the staff of the Federal Trade Commission noted the benefits of diligence provisions in Federal coal leases:

> Underlying the imposition of diligence requirements is the notion that the public has an interest in early development and continuous operation of leased Federal resources. Diligence requirements may be viewed as one means of ensuring that the public and not private speculators, recoups any benefit from the increased value of coal over time. In addition they could facilitate alternative uses of coal lands, such as for agricultural purposes, if those uses become more attractive than coal mining and no coal has been mined from the leases.[64]

The Congress reaffirmed the basic policy of the MLA that leases by strengthening the statutory diligence requirements for new leases so that leases not actually producing commercial quantities of coal after 10 years are terminated by operation of law. More recently the Report of the Commission on Fair Market Value Policy for Federal Coal Leases, frequently referred to as the Linowes Commission, made the following findings concerning Federal coal leases:

> The Commission found that diligent development requirements play a central role in the Federal coal leasing program. In the absence of a diligence requirement, the leasing of Federal coal would amount for many purposes to the disposal of coal. The congressional insistence on diligent development of Federal coal is consistent with the broader congressional philosophy of retention of the public lands. Diligent development requirements allow each generation to make its own decisions as to the appropriate development of Federal coal resources. If Federal coal were to pass into private hands it would be much more difficult to maintain control over its development...
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> Diligent development requirements also serve more specific purposes. Significant Federal royalties and state severance taxes create an artificial incentive to delay production on Federal coal. The diligence requirement ensures that production begins fairly promptly.[65]

Section 7 of the MLA in its original and amended forms provides that all Federal coal leases are to be held on conditions of diligent development and continued operations of the mine or mines except when interrupted by strikes, the elements, or casualties not attributable to the lessee. With the Secretary's approval a lessee may comply with the continued operation requirement by paying advance royalties in lieu of production. Payments in lieu of diligent development are not authorized. The penalty for violation of these statutory conditions is revocation of the lease.

IMPLEMENTATION OF DILIGENCE REQUIREMENTS

The Department has implemented the MLA diligent development and continued operations requirements of Federal leases in different ways. All leases are subject to the statutory obligations, although they were not explicitly defined by regulation until 1976. Before 1976, these requirements were applied through various lease provisions and by supervision of

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[64] U.S. Federal Trade Commission, Bureaus of Competition and Economics, <u>Report to the Federal Trade Commission on Federal Energy Land Policy: Efficiency, Revenue, and Competition,</u> Senate Committee on Interior and Insular Affaira, 94th Cong., 2d sess., (Comm. Print 1976), at 622-23.

[65] <u>Report of the Commission on Fair Market Value Policy for Federal Coal Leasing,</u> February 1984, at 295.

lease operations. In 1976, the Department adopted regulations that defined diligent development for all leases as requiring actual production of coal within 10 years. In 1982, the regulations were relaxed to require production within 10 years of the first post- FCLAA lease readjustment for old leases. Separate diligence requirements were adopted for logical mining units.

Lease forms adopted by the Department used several approaches to require production. These lease-specific production obligations are relevant because under the 1982 diligence system, pre-FCLAA leases are subject only to these conditions until the lease is readjusted or otherwise amended to apply the 1982 regulations.

From 1920 to the mid-1950s leases generally had both a minimum investment clause requiring investment of a specified dollar amount in development of the lease within the first three years after lease issuance and a minimum production clause requiring the mining of a minimum tonnage beginning in the fourth or sixth year of the lease. These terms could impose quite substantial obligations.

For example, according to the lease records, Utah lease U06039, issued on May 1, 1953, carried a minimum investment requirement of $75,000 of which not less than one third was to be spent during each of the first three years of the lease, unless sooner expended, and a minimum production requirement of 60,000 tons per year beginning with the sixth lease year. The lease rental was set at $1 per acre per year and the royalty at 15 cents Per ton. The annual rental payments were $1360.00 and minimum investments were $25,000 per year for three years. Royalty payments on the specified minimum production in year six would be $9000. Not insignificant amounts at the time.[66] Although the lease contained these minimum production terms, the lease was not mined on schedule, and, in fact, it appears never to have been mined. The Department did not, however, routinely ignore the minimum annual production requirement. The lease records show that an application was made in 1958 in the fifth year of the lease to waive the annual production requirement for that year. Another request for suspension was received in August 1959 and was denied in September 1959. An application to consolidate the lease into another lease was also denied.

In 1960 the minimum production requirement was suspended for year ending April 30, 1960, but rental payments were not suspended. This decision was appealed. The lease was subsequently assigned several times and subdivided. It was acquired in 1979-80 by Utah Power and Light Co. The lease was not adjusted when scheduled in 1973, but was readjusted in 1979 for another 20-year term ending in 1993. According to the Department's automated lease record system, the statutory royalty increases were applied to the lease.

Many pre-FCLAA leases also carried a minimum royalty or advance royalty payment tied to the production of a specified tonnage. The effectiveness of these provisions was undercut by another lease provision that allowed suspension of the lease production and payment requirements on payment of an advance royalty with the approval of the Secretary. The advance royalty in many early leases was set equal to the minimum tonnage, even though rentals can be subtracted from royalties, these leases still required royalty payments in excess of rental. In the mid-1950s, the minimum investment clause was dropped and the minimum

[66] The minimum annual production requirement strangely enough appears to be comparable to the 1 percent commercial quantities figure. There is no information available on how the production level waa determined. However if one makes some very conservative assumptions about the characteristics of minable reserves in that area circa 1953: 6 foot seam, and underground recovery rate of 40 percent and 1800 tons of coal per acre foot for bituminous coal. total estimated recoverable reserves for the tract would be approximately 5.9 million tons. Annual production of 1 percent would be 60,000 tons.

production obligation was shifted to the sixth year. The advance royalty in lieu of production was set equal to the rental and since royalties could be deducted from rentals was effectively $0.

Two observations may be made about these requirements. There were fewer than 200 leases issued before the mid-1960s and many of them eventually produced coal. Suspensions were often given because of difficulties in developing the lease, market conditions, or the lessee's financial status. But an inspection of some lease records by OTA indicates that the suspensions allowing payment of advance royalties in lieu of the minimum production obligation were denied at times and appeals of these suspensions were also denied. The nonproducing leases apparently continued to be held in violation of lease terms because cancellation proceedings, the penalty for violation were not initiated. It is not known if the' cases were ever referred to the Attorney General for prosecution. After about 1960, however, the Department seems to have routinely accepted nonproduction payments on all leases without making specific approvals. The MLA does not authorize payments in lieu of the requirement of diligent development, and the Department in the past has never adopted the interpretation of the MLA or the lease terms that payments suspended the statutory diligence requirement. The lessee's obligation to diligently develop the lease continued even though he might be relieved of annual minimum production and payment obligations. The diligent development obligation can only be suspended for strikes, the elements, or casualties not attributable to the lessee under section 7 and under section 39 in the interests of conservation of the resource, an application for suspension must be made to and approved by the Secretary.

According to an analysis by the Department in 1980, some leases issued between 1920 and 1946 are likely to still contain advance royalty provisions in excess of rental because they were not subsequently readjusted. In 1956 the lease form was changed to delete the minimum investment requirement and to require production in the sixth and succeeding years, but the amount of production was set so that it would yield an advance yield equal to the annual rental of $1 per acre per year. These leases were issued until the early 1970s and many of the earlier leases were readjusted to include these more lenient terms.

In the mid- 1960s the minimum production clause no longer specified a minimum tonnage and the advance royalty was still set equal to the rental, calculation of the minimum tonnage was that amount that created an advance royalty of $1 per acre. Also in 1965, the lease form was changed to provide that the lease was subject to reasonable regulations of the Secretary hereinafter in force.

In the early 1970s, the Department began charging slightly higher rentals of $5 acre in the sixth lease year and higher royalties and experimented with advance royalties that might create an economic incentive to produce. Several leases were offered that contained minimum production clauses and significant advance royalty requirements.

One of the major criticisms of the past administration of the Federal coal leasing program in the 1970s was that the Department had failed to enforce the diligence and continued operations requirements against nonproducing lessees by revoking such leases. This view was shared by the Department which adopted final regulations in May 1976 interpreting the diligent development provision of the 1920 MLA as requiring actual production of 2.5 percent of lease reserves by June 1, 1986 under threat of cancellation.[67] Under limited circumstances, extensions of up to 5 years were allowed. These regulations were intended to supersede the unenforced

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[67] See 41 Fed. Reg. 21,779, May 28, 1976. The 1976 diligence regulations are discussed at length in United States Congress, Office of Technology Assessment, An Assessment of Development and Production Potential of Federal Coal Leases, December 1981, at 238-252.

minimum production lease obligations and gave all lessees 10 years to begin mining their undeveloped leases. Despite assurances that the Department was embarking on a vigorous program of enforcement and that the 1976 regulations and other mechanisms would prevent such nonenforcement in the future, the Congress adopted a strict 10-year diligent production provision for new leases and added section 3 to deal with any nonproducing old leases after 1986.

The 1976 regulations defined diligent development and continued operations for all leases and were intended to assure that any future enforcement efforts would withstand court challenge. All lessees were placed on an equal footing, the 10-year lead time before enforcement would make it likely that a court would reject a lessees argument that the requirement was unreasonable. The minimum production clauses of most existing leases imposed only token production obligations on the lessees, the 1976 regulations imposed more substantial requirements superseding the lease terms. Even if a lessee might successfully argue that the regulations could not alter the terms of the lease, the lessee would be hard pressed to defend an assertion that failure to develop a lease after more than 16 years was diligent development under the MLA or the Departments regulations or even under the lease terms calling for production beginning in year six. Moreover, the extension provisions added additional flexibility that would also help withstand any challenges as to the reasonableness of the regulations.

The 1976 regulations required pre-FCLAA leases to produce 2,5 percent of lease or LMU reserves by June 1, 1986 or face cancellation for lack of diligent development. Limited force majeure exceptions and five year extensions were allowed. Post- FCLAA leases were bound by the statutory requirements to produce commercial quantities within 10 years of issuance with only force majeure exceptions allowed.[68] Commercial quantities for post-FCLAA leases was set at production of 1 percent of lease or LMU reserves. The Department's position at the time was that the regulations were of general applicability and superseded other lease terms. The existing leases did not specifically equate the minimum production and advance royalty provisions as constituting full compliance with statutory diligent production requirements. Notices were sent to lessees advising them that the regulations were fully applicable and that leases would be explicitly readjusted to require production if due for readjustment before 1986. In 1980 lessees were asked to voluntarily agree to amend their leases to acknowledge the 1976 diligence requirements. A few lessees complied with the request, but following objections from lessees and coal industry trade organizations, the Department discontinued its lease amendment efforts. The lease term used in the late 1970s provided:

> Diligence: To engage in the diligent development of the coal subject to the logical mining unit of which the lease is a part. After diligent development is achieved, the lessee agrees to maintain continued operation of the mine or mines on leased lands, unless consistent with the regulations advance royalty is paid in lieu of continued operations, the terms and diligent development and continued operations are defined in the regulations.

New leases and leases that were readjusted after August 4, 1976, were also required to file mine plans for development of the leases within three years under the 1976 policy.

Because the 1976 regulations superseded the lease specific diligence and production requirements, the Department was not required to treat nonproduction on a lease that provided

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68 The May 1976 regulations were revised to include the statutory changes made by FCLAA. See 41 Fed. Reg. 56,643, Dec. 29, 1976.

that production must begin and continue after the sixth year of the lease, as violation of the applicable diligence deadline subjecting the lease to cancellation. The Department's 1976 regulations, in fact, avoided an early test of the lessee's diligent development requirement. In 1976 all but a few nonproducing leases were more than six years old. The Department might have ceased to accept nonproduction payments and immediately sued to have leases cancelled for nondevelopment in compliance with the express provisions of any leases with minimum production clauses.

In 1982, the DOI significantly revised the diligence provisions for pre-FCLAA leases.[69] Various explanations were given. But, in essence, the change reflected a fundamental shift in the DOI's interpretation of its authority to set diligence requirements for existing leases under FCLAA, the MLA, and the lease terms. The Department cited a September 1981 Solicitor's Opinion reinterpreting the effect of FCLAA on existing lease diligence obligations as requiring the changes.[70] The referenced Solicitor's opinion did not address the applicability of diligent production requirements to pre-FCLAA leases, but rather dealt with whether the Department must include the higher minimum royalty provisions of FCLAA in leases readjusted after FCLAA. The Opinion concluded that the higher royalty must be applied if and when a lease is readjusted, however, the opinion noted that by statute leases are only "subject to" readjustment so that the Secretary was not required to readjust the leases and could by inaction allow a lease to continue at the lower pre-FCLAA royalty.[71]

The Department issued regulations that extended the date by which existing leases must produce or be cancelled (or terminated) to 10 years after the first lease readjustment after FCLAA. The new rules reduced the amount of production required for "commercial quantities" to 1 percent of lease or LMU reserves for both diligence and continued operations. This action lifted the 1976 diligence requirements in force at passage of FCLAA and that were cited in floor discussion of FCLAA. The effect of the change was to give existing leaseholders up to 30 years from FCLAA to produce 1 percent of coal reserves, before the Department would terminate the lease rights under the readjusted lease terms.

The 1982 regulations substituted yet another diligence system for Federal leases and tied lease production obligations to whether leases were issued or readjusted after enactment of FCLAA. The rules create three categories of leases: pre-FCLAA leases not subject to the regulatory diligence system; post-FCLAA leases and pre-FCLAA leases subject to the regulatory diligence system; and leases in LMUs subject to the regulatory diligence system.

Pre-FCLAA leases not yet readjusted are subject to their specific Federal lease conditions, including minimum production clauses, until the first lease readjustment after FCLAA. Any production on the lease will not credited toward achievement of diligence or continued operation under the 1982 rules until the effective date of the first lease readjustment after August 4, 1976. Pre-FCLAA lessees were given one year, i.e., until August 1983, to elect

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[69] See 47 Fed. Reg. 33,153, July 30, 1982.

[70] Solicitor's Opinion M-36939, 80 I.D. 1003(1981). The Solicitor's reinterpretation came over five years after passage of FCLAA. The interpretation was either not shared or overlooked by two previous administrations in issuing regulations concerning lease diligence obligations, including contemporaneous interpretations by the Department of the Interior in 1976 when it revised its may 1976 diligence rules to accommodate changes made by FCLAA.

[71] The Department also cited as the basis for its conclusion that Congress did not intend any production requirements to be imposed on pre-FCLAA leases until after readjustments a letter from Secretary James D. Watt to Governor Richard Larnm of Colorado with an accompanying memorandum from the Interior Solicitor of April 21, 1981. The letter was in response to the Western Governors' expressed concerns over and opposition to rumored changes in the diligence requirements for existing leases.

to become subject to the 1982 diligence system by notifying the Department in writing. Lessees could request that production after 1976 but before approval of the election be credited toward the diligent production requirement. (Under this system, producing leases that have not been readjusted have not complied with the MLA diligent development obligations as defined in the regulations, because they only receive credit for production after the lease has been readjusted or amended to conform to the 1982 rules. Some of these lessees may have already produced enough to satisfy the more stringent standards of the 1976 regulations).

The 1982 diligence system replaced the 1976 diligence regulations and left unadjusted or unamended pre-FCLAA leases subject to whatever production provisions were in the individual lease forms, and also to some as yet undefined Federal common law diligence obligation. As a result, the Secretary could at any time decline to accept payments in lieu of continued operations and decline to waive by inaction the lessee's failure to diligently develop the lease and move to have the lease cancelled in Federal court. There is not however any indication that the Department of the Interior intends to enforce the existing minimum production lease obligations.

Post- FCLAA leases and pre-FCLAA leases readjusted or amended after August 4, 1976, must satisfy the diligent development obligation by producing commercial quantities of coal, defined as 1 percent of lease reserves, within 10 years of lease issuance or readjustment. The diligent development obligation can only be suspended by the Secretary for strikes, the elements, or casualties not attributable to the lessee.[72] After meeting the diligent development obligation, the lessee must maintain continuous operations by mining at an average annual rate of 1 percent of lease reserves based on a three year average. With the approval of the authorized officer, advance royalties can be paid in lieu of production to comply with the continued operations requirement. Only production on the lease after it becomes subject to the 1982 diligence system will be credited toward production of commercial quantities.[73] Any production on the lease after 1976 can be credited towards commercial quantities if the lessee filed a request by August 30, 1983. The lessee must also submit a resource recovery and protection plan within three years after lease issuance or readjustment.

Any Federal coal lease in an approved LMU is subject to the separate diligent development and continued operation requirements imposed on the LMU. The LMU requirements replace the conditions that would apply to the Federal lease individually. Commercial quantities is 1 percent of the total Federal and non-Federal LMU reserves. A schedule for achievement of diligence requirements is established when the LMU is approved, All Federal leases in the LMU are in compliance with diligent development and continued operations requirements as long as the LMU as a whole is in compliance with its LMU obligations. An LMU must produce a total of 1 percent of LMU reserves by the end of its diligent development period. The length of the LMU diligent development period is determined by the applicable diligence dates for Federal leases in the LMU. If all leases in the LMU are already subject to the 1982 diligence system the diligence deadline is 10 years from the most recent post-FCLAA lease issuance or readjustment of the leases in the LMU. If the LMU contains an unreadjusted pre-FCLAA lease, the LMU diligence deadline is 10 years from the effective date of LMU approval. A resource recovery and protection plan for the LMU must be submitted within three years from the effective date of the LMU.[74]

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[72] **Note: The Secretary can also grant suspensions in the interests of conservation of the resource under section 39 of the MLA, 30 U.S. C. 209. The 1976 rules allowed discretionary extensions of diligence dates for pre-FCLAA leases. By law, there are no discretionary extensions for post -FCLAA lessees under section 7, 30 U.S.C. 207.**

[73] **This has the effect of delaying the attainment of diligence in some cases and thus avoiding the imposition of the requirement to produce 1 percent annually or pay advance royalties** in lieu of continued operation.

[74] The determination of the diligence periods and recoverable reserves for LMUS are discussed in the LMU guidelines at 50 Fed. Reg. 35,145, Aug. 29, 1985 and in 43 C.F.R. 3480.0-5. (1985).

Under the Department's regulations and guidelines, LMU formation can apparently be used in some cases to extend the diligent development dates of leases in the LMU to the latest date that would be applicable. For example, a lessee might acquire a new small bypass lease or an unreadjusted pre-FCLAA lease in the ninth year of the diligence period of another lease subject to the 1982 diligence system. The lessee could then petition to combine the newly acquired lease into an LMU and thus gain an additional 10 years to achieve diligence and delay any requirement to pay advance royalties if production falls short of the 1 percent annual continued operations level. If the LMU contains only post-FCLAA leases and readjusted leases, LMU formation cannot be used to extend the diligence period.

Payment Requirements for Federal Coal Leases

The payment requirements imposed on Federal coal leases are similar in many respects to payments for non-Federal coal and currently include bonuses, rentals, advance royalties, and production royalties.

A bonus is the amount paid for a new lease. In a competitive lease sale, a lease is awarded to the highest bonus bid that equals or exceeds the fair market value of the coal and can be based on a per acre or a per ton payment. The bonus bid is the primary mechanism for recovering the difference in value of Federal coal tracts because under current policy rentals and royalty payments are standard for all leases even though tracts may vary widely in potential profitability y. No bonus is required at present on the issuance of noncompetitive preference right leases, but the possibility of requiring some additional payment as a means of assuring a fair return to the public from such leases has been under review.

Rental is the annual payment to hold a lease. For Federal leases it is currently set at $3.00 to $5.00 acre, with an increase after the sixth or tenth year in some leases. Many old pre-FCLAA leases allow rental payments to be offset against any royalty payments, but FCLAA disallowed this credit. Because the setting of rentals is left to the Secretary's discretion, the Department could impose a different rental scheme on leases at readjustment or modification of lease terms with a higher rental for nonproducing leases.

The production royalties for Federal coal are set by FCLAA at 12.5 percent of selling price of surface-mined coal and a lesser amount (usually 8 percent) for underground coal. Unreadjusted pre-1976 leases carry significantly lower production royalties than new and readjusted leases; payments of 15 to 20 cents per ton are most common. Only about four leases that were issued or readjusted in the early 1970s contain pre-FCLAA percentage royalties of 4 to 8 percent.[75] The Secretary can temporarily reduce the statutory royalty rates for any lessee that shows that the lease cannot be successfully operated under its terms.

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[75] The FTC staff report used average f.o.b. mine price data to calculate the percentage royalty equivalent of the 22.5 cents per ton royalty in 1971. The percentages were: Colorado, 3.5 percent, New Mexico, 6.9 percent, North Dakota, 11.8 percent, Oklahoma, 3.3 percent, Wyoming, 6.6 percent. On a national basis, a payment of 22.5 cents per ton waa equivalent to a 3.2 percent royalty in 1971. Reported f.o.b. mine prices of coal in 1971 were as low as $1.82 in Montana, thus a 22.5 cent royalty on Montana coal would equal a 12. S percent royalty, the current statutory level. The percent of the coal sales price paid in Federal royalties on a cent per ton basis dropped sharply because of the significant increases in coal prices during the 1970s. See Federal Energy Land Policy: Efficiency, Revenue, and Competition, supra note (64),at 619.

The MLA authorizes payment of advance royalties in lieu of continued operations with the approval of the Secretary. The minimum production clauses of many leases require payment of an advance royalty in the sixth year of the lease. However, this requirement was effectively nullified by setting the advance royalty equal to the rental payment and fully crediting rentals against royalties. Advance royalties are now set by regulation as payment of the production royalty that would be due on 1 percent of the lease reserves at a minimum royalty of 12.5 percent for surface mined coal and 8 percent for underground coal. Some leases readjusted between 1976 and the adoption of the 1982 rules changes require advance royalties on production of 2.5 percent of reserves if the lease is not producing at a continued operations rate of 1 percent of reserves. Advance royalties can only be accepted in lieu of production for a total of 10 years over the life of the lease and are recoupable against production royalties. The Secretary can not reduce or suspend payment of advance royalties.

HOLDING FEES FOR FEDERAL COAL LEASES

Holding fees for nonproducing leases are used in private leases, but only to a limited extent in Federal coal leases. Holding fees can generate as much revenue as actual production for private lessors and provide some additional economic incentive for the lessee to produce or turn back the property. Holding fees can be found in various forms, delay rentals, minimum royalties, and advance royalties, for example, and reflect the flexibility and variety that result from lease negotiations between private parties.

A delay rental is an amount paid for the privilege of deferring development of a property and can be avoided by relinquishing the lease, or by commencing production. A minimum royalty requires that the lessee pay the lessor a minimum royalty annually whether or not coal is actually produced in an amount great enough so that production royalties would equal the minimum royalty. An advance royalty is paid before the coal is actually mined and sold either as a deposit against future production royalties or in lieu of production under a minimum royalty provision. In this report "holding fee" is used to refer to any type of payment imposed on a nonproducing lease that might be avoided by producing or relinquishing the lease.

A lease may provide that the holding fee can be fully or partially recoupable against production royalties. There do not appear to be any firm rules for formulations of these provisions in private transactions. Many of the distinctions reflect the difference in tax treatment of such payments. For Federal coal lessees however, the current tax code is flexible in the treatment of delay rentals and many forms of advance royalties.[76]

STRUCTURING A HOLDING FEE

A holding fee can have one or more purposes that will influence how high the fee is set, the fee base, and whether it is recoupable against production royalties. In structuring a fee, one should consider its purpose. For example, is the the fee paid merely to extend the lease for an additional period without production? Is the fee intended to replace production royalties that would otherwise be paid? Is the fee intended to create an economic incentive to force production or reversion of the lease?

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[76] For Federal income tax purposes a minimum royalty which "requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount" can be expensed in the year paid, 26 C.F.R. 1.612-3, 1985. An advance royalty paid under a minimum royalty clause can be expensed in the year of production or else capitalized and recovered through depletion at the option of the taxpayer. A delay rental is deductible in the year paid.

If a private lessor wants the fee to accomplish all of the above goals, the nonproduction payments would be set high enough to provide a return on the property and to make it economically disadvantageous to keep the lease without going into production shortly, but not so high as to cause abandonment of an otherwise viable property or to unreasonably divert resources from development. As an additional incentive the payment may be recoupable against future production royalties. Private lessors can negotiate each lease individually and tailor the requirements according to the characteristics of each lessee. Moreover, they can modify the original terms if the lessee encounters unanticipated economic problems in development. Private lessors generally do not allow their leases to be assigned without their consent.

Federal lease provisions are generally standardized for all leases. Because of the large amount of Federal coal, it would probably be impractical for the Department to devote the same level of effort and care as a private lessee in the crafting of individual lease production payment arrangements. For the Federal government as a lessor, it may be better as a matter of policy to accept a holding fee than that is lower than private leases to assure that economically viable properties are not needlessly abandoned because of inflexible standard lease provisions. This does not mean that the Federal payments must be set so low that no properties are abandoned. Because the Federal government leases such large amounts of coal in excess of demand, imposition of very high production forcing advance royalty payments may be burdensome to lessees who have only a slim probability of successfully mining and marketing their coal. But that imprecisely the effect such payments are intended to have. If lands are not very close to production, they would not be leased because of the deterring effects of the fair market value bonus payments, diligence requirements, and advance royalty payments. If leased, it would not be economically advantageous to hold them for long periods of time without generating income from them. This assumes that the payment to the government or an assignor for the leases was not so low that it is still economically advantageous to hold the leases even with high advance royalty or nonproduction payments because the cost of acquiring new reserves would be so much higher. If lessees continue to hold old leases with higher rentals and nonproduction payments, that is an indication that the lease is still valuable.

The holding fees need not be recoupable, although it is generally thought that recoupability creates an incentive to produce by holding out the prospect of gaining at least partial credit for payments against future obligations and allows higher payments to be extracted in advance of production. Some private lessees have tempered the impact of advance payments by making them partially recoupable over a short period of time. For example, a lessor might include a provision that 50 percent of the advance royalty paid is recoupable against production royalties in excess of minimum production levels for a period of five years after payment. This provides an incentive to bring the lease into production at greater than the minimum production rate within five years to recapture part of the advance royalty, while assuring the lessor a fairly constant stream of revenue.

If the holding fee is not intended as a major spur to development but rather as an additional payment for the privilege of extending a nonproducing lease, it need not be as high as an advance royalty intended as an effective production forcing mechanism and it need not be recoupable.

But to encourage development production, advance royalties must be high enough so that the lessee is deterred from delaying production, assuming that he can sell any coal that is mined. If the 10-year or other production deadline for Federal leases is maintained a modest holding fee, such as a delay rental payment, might be an effective means of generating revenue from nonproducing leases which provides flexibility to both the government and the lessee, but makes the holding of such leases less economically attractive after a few years. If the fee were too low its effects would be insignificant.

There are many decisions in setting an appropriate holding fee. Payments can be based on acreage, reserves, or minimum production levels. A flat rate can be imposed for all leases or varied by region and mine type or on the sales price of coal. The payment can be fully or partially recoupable or nonrecoupable. Payments might start immediately or after the lease has been held for 10 years, or when the lessee wishes to acquire a new lease. An additional consideration is how long payments should be accepted instead of production. Should the payment in lieu of production be discretionary or nondiscretionary, i.e. must the Secretary approve it initially or every year, or will it be left to the lessee to decide when and if to pay. OTA's review of suggested types of holding fees revealed that different kinds of payments may have different results on project economics depending on high they are, whether they are recoupable and how they are handled for tax and accounting purposes.

Acreage based payments offer the advantage of ease of calculation and little margin for error or uncertainty; but have the disadvantage (assuming a uniform acreage payment for all leases) of not reflecting the differences in the sales price of the coal, mining costs, seam thickness, or coal quality. Reserves-based payments can be made using either a flat cents per ton or percent of value approach. The payment can be made on either total in-place or recoverable reserves. Because of the uncertainties in calculating the reserves under lease, there is more uncertainty and potential for disagreement in setting reserves payments than acreage payments. However, OTA believes that there insufficient reliable information on leased coal reserves for the Department and the lessees to estimate reserves within an acceptable margin of error for the purposes of establishing reserves-based payments.

A flat rate per ton offers ease of calculation but does not distinguish between the characteristics of coals in different regions. Unless it includes an inflation adjustment, it would remain constant as the price of coal rises or falls. An ad valorem tonnage based payment is more closely tied to the price of coal, and to high mining costs. It rises with inflation and declines with a drop in coal prices. In the absence of mine specific production costs, the Secretary would have to establish a mine mouth price of coal for some leases. The additional calculations and information requirements of an ad valorem rate could also make the determinations suspect if they appeared to be too low.

Lessees with thick or multiple seams (more tons per acre) generally prefer an acreage based payment, because they effectively pay less. Lessees with thin seams would prefer a tonnage based payment up to a certain level in comparison with an acreage payment. Lessees who have coal with a high sales price, generally would not like an ad valorem rate. Coal sells for a high price generally because of high mining costs primarily associated with underground mines and the higher per ton price needed to recoup the investment and a reasonable return than required for a larger surface mine with the same investment. Ad valorem rates would tend to have a greater impact on them. A flat rate of, for example, 1 cent per ton would tend to have less impact on the high cost underground mine producers than it would on the relatively low cost surface mines. This does place greater economic pressure on low cost producers to develop, which for many policy reasons may be a desirable result.

The ad valorem approach also has some advantages. It seems to produce more revenue. It increases as the price of coal increases, thus could keep pace with inflation, An ad valorem rate favors low cost producers as it tends to make high cost and underground coal even more costly, assuming they pay the same rate. It's major disadvantages is that it is more complex to administer if it is done lease by lease rather than on regional basis, because the Department must establish a selling price for coal that has not yet been sold. If the same rate is applied to all coal, it has an uneven effect.

The relative advantages and disadvantages of escalating payment requirements are based almost entirely on how such a mechanism is structured. Properly constructed, it could be quite effective in imposing increasingly more pressure. Failing that, it seems to offer no significant benefit over other payment approaches for the lessor.

Advantages include a low initial cost, higher later cost, which allows cost impact to be phased in gradually. The low initial holding cost might allow flexibility and low cost extension of time to comply. Steeper later payments may provide the effective force for lessee to develop or divest and is similar to payments associated with a gradual scale up of mine development and production. The approach is intuitively appealing as an increasingly more stringent requirement. A major disadvantage is that unless the step up in payments were steep, there is no inherent production forcing effect of graduated payments that are set at the low rates that have been suggested. At year 10 or 11, graduated payments starting from low level would not tend to place lessor in same position as either actual development or arguably lease turnback with the chance or resale. Graduated payments will yield less in actual terms than an average of the graduated payments over the same period because of the time value of higher payments in later years. Graduated payments may actually be slower than mine scale up and might be an incentive to delay production. Only with very large mines or unusual circumstances would startup rate be at a tenth of a percent per year. The escalating rate yields less revenue that the constant rate, when the constant rate is the average of the escalating rate; this is due to the time value (discounted value) of the higher rates in later years.

A payment lower than that required to force production that was adopted as an adjunct to the section 7 diligence provision could be useful tool and revenue option. OTA assumes that any section 3 holding fees are intended to impose a penalty or additional financial obligation on the lessee. The purposes of such a payment would be: for the privilege of continuing to hold the lease without production; for maintaining the qualification for more leases; to provide an incentive for either developing or getting rid of the lease; and to generate some income to the government from old leases that were originally acquired at very low or no bonus payments. The levels of payment required to satisfy each of these goals is different. The payments can be as high as needed, in the judgment of Congress or the Secretary, to extract a fair price in return for the benefit conferred. If the intent is to allow a lessee to buy out of the section 3 penalty and to generate some revenue, comparison with other lease obligations or the bonus to be paid for a new lease are useful in deciding “how much is enough” for such payments. If, however, the payment is intended primarily to spur the lessee into making a decision to produce or give up the lease by making holding the lease without producing too costly, then the determination becomes more complex. Production forcing payments would have to be set high to force such action for old leases over 5 to 10 years, and even higher if recoupable.

The relationship of any new payment to existing requirements is an additional consideration in setting a production forcing payment. Section 7(b) allows payment of advance royalties in lieu of continuous operation, Currently these royalties are based on production of 1 percent of reserves at the 12.5 percent or 8 percent of value for new and readjusted leases. There is no authority to reduce these payments. The continued operation payments become due once the diligent development requirement is satisfied and the lease is not being mined. These advance royalty payments can be quite high. A lease with a 400 million ton reserve with 4 million tons of production in the Powder River basin at a f.o.b. mine price of $7.00 per ton would require an advance royalty of $3.5 million per year for the privilege of deferring production. The additional new holding fee should not be so low that it actually creates a disincentive to commercial production. Conceivably it might be less risky financially for a lessee to stay nonproducing than to satisfy diligence and become subject to section 7 advance royalties. Also one might consider whether a producing lessee should be allowed to make section 3 payments in lieu of production rather than paying advance royalties under section 7(b) or forming an LMU.

A holding fee, similar to a delay rental, a payment for extending a lease without production, would seem to be an appropriate approach for section 3 and possibly section 7(a). If two payments were be imposed then each might have to be set lower, or some kind of setoff might be considered. For most leases a section 3 payment will become due well before any lease might be subject to termination under section 7(a) or under the Department's 1982 diligence system. A payment that effectively resulted in paying 10, 25, or even 50 percent of what would be paid for a new lease seems to have some merit for old leases. Value is returned to the government, the lessee can continue to hold the lease for less than acquiring a new lease, but there is the prospect of a significant financial loss if the lease is lost.

OTA estimated the payments to the government and the net present costs to the lessee for a range of holding fees described in Table 30. Table 31 shows the total payments over 10 years, the net present value of the payments, the net present cost to the lessee, and the after tax net present cost to the lessee. OTA estimated the relative costs of selected fee formulations to show how different formulas might have different results for two model mines: a large surface mine in the Powder River basin of Wyoming with 200 million tons of reserves and an underground mine in Utah with over 21 million of reserves. Mine size was based on a review of tracts with section 3 compliance problems. OTA has a computer model available that allows the calculation of different fee structures for Federal coal leases. The appendix includes a summary of the mine characteristics and includes more information on the assumptions used in the analysis and the holding fees analyzed.

The fees analyzed in Table 31 are similar to some recently proposed holding fees summarized in Table 30. Are these various holding fees reasonable? How high can they be without creating a deterrent for developing otherwise viable operations? There are a number of proposals and analyses that support the use of very small payments for section 3 compliance. OTA found that some of the suggested payment levels are probably too low to have any real impact as production incentives. (See Appendix C.) OTA found that there are several available kinds of lease transactions that provide a useful reference for comparing the potential economic impacts of holding fees. These include: a comparison of cumulative holding fees with the bonuses paid to acquire new lease tracts; a comparison of annual holding fees with rentals and royalties on existing leases; a comparison of total holding fees with the overall investment in development of a new mine.

OTA looked at the prices per ton in the 1981-82 regional coal sales to select several representative costs per ton in those sales assuming that the sale data reflect what lessees might have to pay for a new tract.[77] The bonus payments ranged from a low of $ 0.0003 per ton for a production maintenance tract in the Hanna Basin of Wyoming to as much as $0.46 for a large new production tract in central Utah. Very large new production or production maintenance tracts in the Powder River basin were sold at between $0.025 and $0.08 per ton in 1982. The better quality new production tracts in Northwest Colorado sold from $0.11 to $0.33 per ton in 1981. In Utah production maintenance and new production tracts sold from $0.06 per ton to as much as $0.68 per ton in 1981 to 1982. All new leases carry the higher 12.5 percent (or 8 percent underground) statutory royalties and ten year diligence periods. Many noncomplying section 3 leases carry significantly lower royalties and more lenient production requirements and so may be worth considerably more than new leases on the same lands. If one compares the net

[77] **Without expressing any determination of whether the prices received were truly reflective of fair market value or represented the actual market value of the Federal reserves in those regions at the time, or now, OTA notes that there is substantial disagreement between the Department and its critics in Congress and elsewhere over whether the prices were adequate.**

TABLE 30

SELECTED HOLDING FEE PROPOSALS FOR FEDERAL COAL LEASES

FEE STRUCTURE	SOURCE
Acreage-based:	
Flat rate $25 per acre per year for each noncomplying sect on 3 lease; recoupable against future production royalties	Testimony, B.R. Brown, Consolidation Coal Co., 06/04/85
Annual Rental Surcharge on new coal leases to noncomplying section 3 lessees $25 per acre for tracts up to 100 million tons of reserves $35 per acre for tracts from 100 to 300 million tons of reserves $45 per acre for tracts over 300 million tons of reserves Total acreage on which annual rental surcharge is paid not to exceed total acreage of noncomplying section 3 leases; payments are recoupable against future production royalties.	National Coal Assoc. proposa ; also S.372
Reserves-based:	
Annual advance royalty of $0.0005 per ton of recoverable reser om ying section 3 leases and for extending the ten year diligence period readjusted leases; recoupable.	American Petroleum Institu e proposa , staff paper 7/85
Annual holding fee of from $0.001 to $0.01 per ton of recoverable reserves for noncomplying section 3 leases; payment level to be set by Secretary at level sufficient to create a production incentive; nonrecoupable.	Subcomm. on Mining and Natural Resources, H.R. 1934, 7/85
Annual holding fee escalating from $0.00' to $0.01 per ton of recoverable reserves over ten years for noncomplying section 3 leases; nonrecoupable.	Remarks before American Min ng Congress, Rep. Udall, 2/85
Ad valorem or production-based:	
Annual advance royalty at statutory rate (12.5 percent) on assumed production escalating from 0.5 percent of reserves n the first year to 2.5 percent of reserves in years 5 to 10 for readjusted leases and for extending the ten year diligence period on new leases beginning in the eleventh year.	Commission on Fa r Market Value Policy for Federal Coal Leases, example
Annual advance royalties at the statutory rate on assumed production escalating from 0.1 percent of reserves in year 11 and an additional 0.1 percent of reserves for each subsequent year to a maximum of 1 percent in year 20 for the purposes of extending the ten year diligence period for new and readjusted leases; recoupable against future production royalties in excess of annual 1 percent continued operat ons requ rement.	Nationa Coal Assoc. proposal S. 570, (also S. 372 without minimum royalty)
Annual advance royalties at the statutory rate on assumed production of 0.3 percent of reserves; creditable aga nst future production royalties in excess of annual minimum royalty.	Department of the Interior, Bureau of Land Management, Staff proposal, 9/85

TABLE 31

ANALYSIS OF SELECTED HOLDING FEE PROPOSALS

HOLDING FEE		ANNUAL PAYMENT		TOTAL PAYMENT		NET PRESENT COST	
		Wyoming	Utah	Wyoming	Utah	Wyoming	Utah
Flat Rate							
1.	$25 /acre	50,000	50,000	500,000	500,000	250,938	250,938
2.	$0.001/ton of reserves	180,000	21,600	1,800,000	210,000	903,378	108,405
3.	$0.01/ton of reserves	1,800,000	216,000	18,000,000	2,160,000	9,033,784	1,084,054
4.	$0.0005/ton of reserves	90,000	10,800	900,000	108,000	451,689	54,203
Ad Valorem on Production							
5.	0.3 % reserves at standard rate 12.5% surface 8% underground (without adj. for recoupment)	513,000	134,784	5,130,000	1,347,840	2,477,774	648,790
6.	Escalating from 0.5 to 2.5 % reserves at standard rate over years 1-5, then at 2.5 % years 5-10 (without adj. for recoupment)	855,000-4,275,000	351,000 1,755,000	34,200,000	14,040,000	14,923,170	6,126,354

SOURCE: Office of Technology Assessment

present cost of various holding fee options to what a lessee might expect to pay for a similar tract as a new Federal coal lease, one finds that the total holding fee payments range from five percent or less of the bonus value to as much as one half of the bonus value. Using the net present cost allows the two lump sum payments to be compared

Existing leases pay from $1 to $5 per acre in annual rentals. A 2,000 acre lease would thus generate from $2000 to $10,000 annually. Leases that are subject to continued operations requirements can pay advance royalties of as much as 12.5 percent of the selling price on annual production of 1 percent of reserves. For a mine with 200 million tons of reserves in the Powder River basin, section 7(b) advance royalties, which can be used to comply with section 3, would be $1.5 million per year on coal selling at $6.00 per ton. These advance royalties can later be credited against production royalties.

According to testimony presented before Congress in hearings on section 3 legislation, pre-mining capital investment costs for a large surface mine in the Powder River basin of Wyoming can be in excess of $100 million.[78] For a large underground mine in the Uinta Region of Colorado, capital costs were estimated at about $50 million, with total operating costs of over $65 million during mine development and initial commercial production.

OTA's review of various holding fees indicated that aggregate payments under some options when compared with other types of payments on Federal coal leases and the overall investment required for a new lease or mine, were probably not significant enough to prompt a lessee to relinquish a lease if production were not imminent within a few years. Moreover many holding fees have disproportionate regional impacts because of the difference in mining costs between regions. Taking into account the various considerations in setting a holding fee, such as ease of administration, predictability, and effectiveness, OTA found that a nonrecoupable annual payment at a level of about 1 cent per ton of recoverable reserves, for example, would measurably affect the economics of holding nonproducing leases in virtually all regions and would place at least some economic pressure on lessees to develop or relinquish leases. It would place considerably more pressure on lessees with low cost low price reserves than on higher cost high price producers. It would provide lessees with some flexibility in complying with section 3 and would additionally generate revenues to the Federal government and the States from pre-1976 leases. If the payments were made to run with the lease and not end if the lease were assigned, it would also diminish the potential for lessees to benefit from any increase in the price of Federal reserves, because the new lessee would have to factor in the payment of holding fees to the government in deciding how much to pay for the lease. The use of holding fees as alternative production incentives for Federal coal leases is further discussed in the following chapter.

[78] See **for example, Statement of Mobil Corporation in Hearings on H.R. 1530 Before the Subcommittee on Mining, Forest Management, and Bonneville Power Administration of the Committee on Interior and Insular Affaira, 98th Cong. 2d Seas., June 21, 1984.**