THE GREAT GIVEAWAY:
AN ANALYSIS OF THE COSTLY FAILURE OF FEDERAL
COAL LEASING IN THE POWDER RIVER BASIN.
EXECUTIVE SUMMARY

By Tom Sanzillo, president of TR Rose Associates

Acknowledgement: I want to thank Heidi Binko for all of her help in the research, writing and editing of this paper.

Rapidly changing market forces are driving a profound transformation of the Powder River Basin (PRB), which contains the United States’ largest remaining coal reserve. Historically less significant than the country’s other coal producing regions, the PRB has increased in national—and even global—significance in the last 40 years. Located in southeastern Montana and northeastern Wyoming, the PRB currently produces 44 percent of the nation’s coal. The Department of Interior (DOI), through its agency the Bureau of Land Management (BLM), is responsible for the sale of PRB coal. Given that the United States owns almost all the coal in the region, the U.S. government holds an effective monopoly of western coal. As a result, government policies—or more precisely those of the DOI—are extremely influential and shape annual coal production levels and the market price of coal. The BLM has a legal obligation to the American public to secure a fair market value for coal on public land. Historically the agency has sold PRB coal for below fair market value, and it continues to fail the public to this day. As a result of policy choices and an inherently subjective and flawed fair market value appraisal process—the problems of which are exacerbated by the agency’s failure to consider changing market dynamics—the U.S. Treasury has lost approximately $28.9 billion in revenue throughout the past 30 years. Despite past political scandals and promises of programmatic reform, neither the DOI nor the BLM coal-leasing activities have been audited or the subject of any major publicly available, external review regarding the sale of PRB coal for almost 30 years. As applied by the federal government in the case of federal coal leasing, the term “fair market value” rings hollow.

THE 1982 POWDER RIVER BASIN LEASE SALES

In a tightly controlled and mostly secret process, the BLM leases coal tracts to private coal producers. After the BLM and the coal industry select parcels to mine, the agency establishes a fair market price for the coal tract that is held strictly confidential. The parcels are offered at a competitive auction, and the highest bidder that exceeds the confidential price is then awarded the mining lease. Most coal tracts sell for hundreds of millions of dollars and typically generate at least 20 years of revenue for federal and state governments, which split the revenue 50/50. If the BLM fails to set the price at fair market value—or, in other words, if it sets the price too low—both federal and state governments lose revenue.

The government has historically lost revenue as a result of the flawed fair market value process. The issue of lost revenue in the federal coal-leasing program was most clearly brought into the public consciousness in the mid-1980s. Following a period of intense program review and redesign, the agency lifted a 10-year federal moratorium on coal sales and placed 1.6 billion tons of PRB coal for sale in 1982. Surrounded by criticisms of leaked information, botched policies, and abrupt program changes, the sale quickly devolved into scandal. A congressional committee, the General Accounting Office (GAO), and the congressionally chartered Linowes Commission reviewed the sales and determined that the agency had effectively ignored its own appraisals and sold the coal at below fair market value.

“As a result of policy choices and an inherently subjective and flawed fair market value appraisal process... the U.S. Treasury has lost approximately $28.9 billion in revenue throughout the past 30 years.”
According to GAO, DOI’s internal checks, which were designed to ensure the receipt of fair market value, all failed. The one external check on the system, the failsafe on which the program relied—competition among coal producers—also failed. As the studies showed, there were a severely limited number of bidders on each of the 11 tracts offered for sale in 1982. In the end, the federal government lost $100 million in revenue. The agency originally denied that it sold coal tracts below fair market value. Over time, however, DOI has taken credit for this action, claiming it wanted to provide domestic utilities with low-priced coal.

LACK OF OVERSIGHT

Although the DOI implemented reforms in the wake of the scandal—particularly those designed to increase external review and enhance the transparency of the bidding process—not Congress nor any independent entity has conducted an evaluation of the program in nearly 30 years. This lack of reporting is in sharp contrast to the years prior to the scandal when the GAO and other public interest research created a healthy body of literature for decision makers and the public. Moreover, there has been no follow-up to any of the audits or studies conducted after the controversial 1982 sales. The last on-point review that covered the major issues related to fair market value was a 1983 GAO audit.

Making matters worse, the DOI disbanded a resource available to help the BLM manage this process. In 1990, the agency decertified the PRB as a coal-production region. The designation would have required BLM to plan and monitor coal production in the region according to a systematic, rational management process. The DOI justified its decision to decertify the region by claiming there was no interest in coal mining in the PRB at the time. Immediately after announcing the decertification, however, the BLM was flooded with applications for new coal leases. Although the BLM continues to deny that the PRB is a coal-production region, the country’s largest remaining coal reserve produces 47 percent of the coal used to generate electricity.

Recently, Congressman Edward Markey, the ranking Democrat of the House Committee on Natural Resources, requested a GAO review of the federal coal-leasing program. Concerned about the rising levels of exports, the flawed fair market valuation process, and the fact that the program hasn’t been evaluated in 30 years, Markey made the request in order to provide Congress with the most up-to-date and relevant information and analysis on the topic. The BLM, which has built a wall of resistance to oversight, was hostile to the request.

LOSS OF REVENUE

Because BLM sold U.S. coal for below fair market value, the U.S. Treasury lost $100 million as a result of the 1982 lease sales.

As this report demonstrates, an analysis of all of the lease sales and royalty payments since that time shows that the U.S. Treasury lost out on an additional $28.9 billion, adjusted to 2011 dollars. (To determine this figure, the author applied the adjustment used by the GAO in 1983 audit to calculate the actual fair market value for each lease sale since 1982. After determining the difference between the BLM’s fair market value and the accurate value, the author then calculated the sum of all bonus payments and royalties.) As this analysis demonstrates, reduced competition and an appraisal process skewed toward low coal prices result in this revenue loss.

The current lease program allows coal producers to set the terms for the mining, distribution, and pricing of coal. Theoretically, the bid process should stimulate competition among coal producers and this competition should then drive up prices to a market level. Competition is meant to both augment the valuation and serve as an independent check on
BLM’s coal appraisals. But without competition, the appraisal process is inherently flawed. Since 1991, the BLM has issued 26 coal leases; of these, only four have had more than one bidder. (And these leases had only two bidders each.) It is well known among industry officials that the BLM’s common practice is to allow lease applicants to designate coal tracts to inhibit competition. Thus, competition between coal producers in the PRB is virtually nonexistent.

The U.S. Treasury also loses revenue because the fair market value appraisal process itself is largely skewed in favor of lower coal prices. More than simply selling coal inappropriately, the 1982 sales essentially flooded the market with low-cost coal, and that has had ramifications to this day for U.S. coal markets. The response by the stock market and coal analysts to recent lease awards reveals that the BLM is still selling coal below market value. The sale price of a lease awarded in 2011 to Cloud Peak Energy, a PRB coal producer, was so much lower than expected that the stock market—instantly recognizing the bargain—revalued the company and raised Cloud Peak’s stock price that same day. When two additional auctions were held six weeks later, despite flaws in those processes, coal of lower quality than that in the Cloud Peak sale was sold for the highest price in the history of the program. BLM’s recent acceptance of Peabody Energy’s bid on the South Porcupine lease led one industry review of the proceeding to declare, “looks like a bargain” when compared with other recent sales.

**IGNORING LARGER MARKET FORCES**

The skewed appraisal process is revealed most clearly by the limited explanation given by the BLM in its Records of Decision (RODs), the agency’s formal justification for a lease transaction. These justifications fail to address the fundamental market challenges facing the BLM and the nation regarding the current and future use, as well as the price, of coal. Today, market dynamics—such as the depletion of Central Appalachian coal reserves and low natural gas prices, which are edging out coal—are placing upward pressure on long-term PRB coal prices. In addition, the BLM fails to consider recent studies that call into question current coal reserves estimates. A recent report by the U.S. Geological Survey raises questions about the long-term accessibility of affordable coal in the PRB. However, the BLM does not recognize any of these significant market forces in its RODs.

Perhaps the most alarming aspect of the BLM’s flawed appraisal process in the current market is its silence on the topic of coal exports. Although producers will continue to mine coal for U.S. domestic electricity generation, the most significant revenue generators (and the source of future share value) for these companies are export sales. Today every coal producer in the PRB region has announced expanded export scenarios. To improve their bottom line—particularly given the uncertainty of U.S. coal markets—coal producers are investing in port activity across the United States to increase export potential and improve revenues and profits. One recent study places the export potential of U.S. coal producers at 500 million tons per year, half of the nation’s typical annual production. As more U.S. coal is exported, it is likely that upward pressure on coal prices will also raise the price of electricity generated by coal. When it conducts its leasing activity, the BLM is neither accounting for these trends nor facilitating discussion regarding the implications of selling one of the nation’s last remaining coal reserves to foreign markets.

**RECOMMENDATIONS**

The Powder River Basin is undergoing a rapid and profound transformation, one likely to come at a significant cost to both U.S. taxpayers and ratepayers. The concerns associated with the BLM’s federal coal-leasing program—lack of oversight and accountability, loss of revenue, failure to consider changing market dynamics—warrant robust oversight. To address these issues, the author calls for the following immediate actions:

1. **The Department of the Interior should implement an immediate moratorium on the sale of federal coal leases in the Powder River Basin.**

   The current lease program is purportedly designed to provide coal supplies for U.S. electricity
The DOI’s real rationale for the sale of below market value PRB coal was to provide cheap coal for cheap electricity. Although the demand driver for expanded coal production was once domestic electricity generation, this is no longer the case. While the region will continue to provide coal to meet domestic energy needs (over the longterm) as PRB coal becomes more expensive, the primary revenue driver for coal producers will be export sales. Today, the demand for new PRB lease applications and coal reserves is driven by coal producers responding to international supply and demand price signals in global markets, not to meet the need of the nation for electricity. This is modern-day coal-producer speculation—a practice that has been a concern of both Congress and presidents going back to Theodore Roosevelt. An immediate moratorium is necessary because the actions of these coal producers have clear implications for the U.S. economy and its environment, as well as for the electricity grid and political system. In the history of the coal lease program, policy makers have implemented moratoriums when far fewer challenges faced the program.

2. The Department of Interior should reinstate the PRB as a Coal Production Region.

The BLM’s Records of Decision (ROD) reflect that the BLM is paying attention only to low-level microeconomic issues when selling coal. This fundamental failure reflects the inadequacy of an agency with neither a publicly accountable, regularized system of monitoring and analyzing coal markets nor the information necessary to grapple with the globalization of PRB coal. There are no publicly available documents or studies that reflect the multiplicity of issues that face the agency in this time of dramatic change. The claim, for example, in the RODs that use of coal for domestic electricity protects national security, when coal producers will actually export increasing amounts of coal to Asia, borders on the Kafkaesque. Redesignating the PRB and other areas as coal production regions will help the BLM address these broader economic issues.

3. Congress must conduct a fundamental review of the federal coal-leasing program, beginning with an evaluation of the use of U.S. coal assets.

Eighty percent of the coal in the PRB belongs to the U.S. government, granting the federal government an effective monopoly on western coal. The effective monopoly has ramifications for coal production throughout the country. Given that this resource is a public asset, coupled with the fact that there are significant economic, environmental, and foreign policy dimensions to this issue, a thorough review of the program is warranted. The failure of Congress to address the coal-leasing issue publicly, despite rising production and revenue growth, is a significant lapse that only now is being recognized. Critical to the debate are the following questions: What, for the foreseeable future, will be the primary use of PRB coal? Who will be its primary beneficiaries? What are the future prospects for coal use in America?

In addition to these primary recommendations, the author also suggests the following:

The General Accounting Office should conduct an audit, or series of audits, of the Bureau of Land Management’s federal coal-leasing program. From the early 1970s through 1983 the GAO produced over 20 policy driven audits of the coal-lease program. The BLM’s federal coal-leasing program has not been the subject of an independent review in nearly 30 years. Although the GAO reviewed the program in 1983, it has never conducted an audit of the program since issuing its original report (a 1994 audit of a specific lease problem provided some additional insights but was not an on-point audit of the full program). Recently, as a result of changing market conditions, Representative Edward Markey requested an audit of the program in order to provide Congress with up-to-date analysis and information. The BLM responded in a hostile manner. The fair market value lease program—which is shrouded in secrecy on the grounds of protecting the federal government and third party interests—warrants investigation.

“In 1991, the BLM has issued 26 coal leases; of these, only four have had more than one bidder.”
The Department of Interior’s Office of the Inspector General should conduct oversight activities regarding the Bureau of Land Management’s interactions with coal producers. During the 1982 scandal, a federal investigation discovered that DOI staff leaked confidential pricing information to coal industry representatives. In the wake of the scandal, both the Linowes Commission and the GAO Office acknowledged the need for more oversight of the BLM’s dealings with the industry to avoid potential conflicts of interest.

An independent entity should evaluate the Bureau of Land Management’s coal-leasing program, with specific attention paid to fair market valuation. Throughout the past 30 years, there has been a lack of public oversight of the federal coal-leasing program. The lack of oversight, accountability, and transparency continues today. The BLM policy requires public inspection and external review to ensure program integrity, particularly those aspects of the process that are protected by the BLM’s confidentiality claims. However, the external review process has not occurred. Given the scandal that ensued after the 1982 lease sales—and the promise of reform that never materialized—it is readily apparent that a new entity, independent of the current oversight bodies, must be created in order to provide adequate oversight. This organization, which could be patterned on the Independent Private Sector Inspector General, could provide an external review of the program and ensure public inspection. The entity, which should remain in existence for at least 10 years, should regularly report to the president, Congress, and the public.

CONCLUSION
The BLM’s process for valuing and selling federal coal in the Powder River Basin in essence created a de facto energy policy for the nation. The significant volume of coal that flooded the market after the 1982 sales, coupled with 30 years of anti-competitive program practices, drove the price of coal down for more than two decades, making coal artificially cheap. As this report shows, a continued failure to correct the BLM’s flawed process and lax oversight exposes both federal and state governments to a significant loss of revenue.

In today’s rapidly changing environment, the business consensus that produced the BLM’s practice of selling coal below its fair market value is unraveling. Coal producers, now faced with a changing market, a host of potential regulatory conditions, and far more lucrative opportunities in the export arena, will be raising the price of PRB coal, and the nation’s coal in general, to support their own needs. The long-term price outlook for PRB coal is upward and volatile. The long-term supply outlook for PRB coal is aggressive and global, not domestic.

The BLM is poorly prepared to handle these issues. The coal industry, which has a track record of limited transparency, has enjoyed a long history as a protected political class. Unfortunately, the BLM has adopted this same culture of insularity. Given future mining projections—12 billion tons by 2035—it is time for Congress to reevaluate the program. The last public discussion regarding the agency’s mission and program was nearly 30 years ago. The stakes are much higher now.