



Comments on the Department of Interior (DOI) Notice of Intent to Conduct a Programmatic Environmental Impact Statement of Federal Coal Leasing Programs

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The U.S. Department of the Interior (DOI) has issued a Notice of Intent to prepare a programmatic environmental impact statement (PEIS) of the federal coal lease program.¹ The Notice asks for public comment on various ways to reform the program and invites alternative program concepts.²

The Institute for Energy Economics and Financial Analysis (IEEFA) has concluded that the time has come for adopting wholesale alternatives to the federal coal lease program. Smaller reforms are unlikely to produce sound results. IEEFA recommends that DOI eliminate the current fair market value criteria and replace it with a new partnership model between government agencies and private industry, operating under new rules to protect the interest of U.S. taxpayers. The product to be produced from the partnership would be coal, mined for the purpose of domestic consumption principally in the electricity sector.

Our proposal for how this program would work is outlined in detail below and contains the following major elements:

- Planning for new coal offerings set by DOI based on accurate analysis of coal reserves and demand.
- Financing for the coal industry provided by a combination of private sector borrowing, and public sector asset transfers of coal, revenue and market guarantees, and regulatory streamlining.

¹http://www.blm.gov/style/medialib/blm/wo/Communications_Directorate/public_affairs/news_release_attachments.Par.37562.File.dat/Coal%20PEIS%20NOI%203_24_16.pdf

² See page 29 for discussion of alternatives to the current program.

- Coal prices set by a committee made by a federal-state coal price Commission, with a pricing structure that takes into account the need to maintain affordable and reliable electricity and to adjust to changing market conditions.
- Eliminating the self-bonding system for coal mine reclamation, replacing it with a program in which coal producers and the federal government share responsibility for clean-up and in which royalty payments are set aside to cover liabilities (and to provide for pensions for coal miners).
- Regular bi-annual external audits of the program by the inspector generals of the Department of Energy and the Department of the Interior.

IEEFA has commented extensively on the federal coal leasing program in the past,³ beginning with our [Great Giveaway](#) report in 2012, which demonstrated that the coal lease program had not been audited in 30 years, recommended a moratorium, and prompted several federal investigations of the program. IEEFA [provided extensive comments](#) on the DOI Inspector General's audit of the program in 2013, [commented on proposed royalty reforms](#) in 2015, and [testified at Bureau of Land Management \(BLM\) "listening sessions"](#) in 2015. Our research on the coal industry is informed by continuous monitoring of companies, coal production and pricing trends.

The PEIS and the moratorium that accompanies it come at a time of energy transition in the U.S. The coal industry's widespread financial distress has now moved from being a principally Central Appalachian phenomenon to the Powder River Basin. Three of the largest holders of coal leases on western land—Peabody Energy, Alpha Natural Resources, and Arch Coal — have declared bankruptcy. Most of the coal producers in the U.S. presume that bankruptcy will allow them to get rid of burdensome debt and liabilities, close some mines, and emerge as new companies, leaner and able to operate as going concerns.

This presumption is false because it assumes there will be an ongoing, stable demand environment for coal (and that demand may even increase) and that coal prices will rise. It ignores the reality that the coal industry is undergoing a structural realignment, caused by shrinking demand for coal in the United States and globally. As the largest owner of coal in the U.S., DOI must address the reality that the current coal lease moratorium will not be followed by robust expansion of coal markets, but instead by a period in which the coal industry and the Powder River Basin will face a declining market.

The coal industry's failure to provide manageable financial and economic models in the current environment makes DOI's response all the more urgent.

McKinsey & Co., a prominent global business consultancy, has recently observed that coal companies require "a major mindset industry change" if they are to fashion a winning strategy. McKinsey warns that coal companies emerging from bankruptcy run a risk of adopting business strategies that will result in another round of bankruptcies:

"It is also possible that other ailing mining companies could follow their competitors into Chapter 11. Such a development may make it possible to close unprofitable mines, restructure their debt (especially nonsecured debt), sell or shut noncompetitive assets, and start to restore their businesses to a firmer financial footing. In addition, some companies may wind up liquidated and their creditors wiped out, creating the

³ A complete list of IEEFA's work on PRB issues can be found at: <http://ieefa.org/category/subject/powder-river-basin-coal/>

opportunity for players that provide new capital to earn profits by buying up the mine properties that are cash positive and would then be unencumbered by previous obligations. But these initiatives might have only limited impact on the overall financial health of the industry, given that there could continue to be many miners sticking to the business as usual path.”⁴

An example of the industry's failure to grasp new market realities is the outlook that Peabody Energy projects in its bankruptcy filings. Rather than recognizing the shrinking markets and persistent low prices, Peabody's plans for success require increases in natural gas prices and a more robust global market to support the new entity as a going concern.⁵ Neither of these trends in the cards for the foreseeable future, yet this is the position of the largest holder of federal coal leases.

As the largest owner of coal reserves in the U.S., the federal government must now revamp federal coal lease policy against a backdrop of decline in demand for coal in the U.S. that is both market and policy driven. It must also do so with a coal industry that seems determined to sell more coal into an oversupplied market using traditional business models. The coal industry proposals identified in the Notice of Intent (Page 26) would either: 1) speed up the lease process to allow more coal to be mined with less oversight, or 2) reduce revenues from coal sales to state and federal governments.⁶

Key Findings of the PEIS

The PEIS⁷ provides an accurate summary of recent results oversight studies involving the federal coal lease program. Its key findings include:

- The program design in place to insure that taxpayers received a fair market value of federal coal on federal land has been weak decades. The program assumed that private sector competition would create a fair price. However, there has been no competition. The program had no oversight for 30 years. Recent reviews found that U.S. taxpayers have lost millions, if not billions, of dollars as a result of low valuations for the leases.
- The current fair market value system places control of the mine selection, timing, extraction process, distribution, sales and price in the hands of coal producers rather than in the hands of the federal owners of the land.
- Despite the substantial findings of the weaknesses in this fair market value process, the coal industry has adopted a position that there are no problems. The PEIS also accurately describes the current state of the nation's coal market and the PRB's role in it. Looking ahead, there will be a declining demand for coal for America's domestic electricity needs. The PRB will nevertheless play an important role in coal production as part of an uncertain, new norm for coal use in the U.S.

⁴ <http://www.mckinsey.com/industries/metals-and-mining/our-insights/downsizing-the-us-coal-industry>, p. 12 and 13.

⁵ See Taylor Kuyendall, *Headwinds that pushed coal to bankruptcy potentially changing course*, SNL, April 29, 2016.

⁶ We have not examined one of the proposals identified as making a distinction between recoverable coal and coal reserves in the valuation process.

⁷ http://www.blm.gov/style/medialib/blm/wo/Communications_Directorate/public_affairs/news_release_attachments.Par.37562.File.dat/Coal%20PEIS%20NOI%203_24_16.pdf

Major Changes Are Needed to Respond to the “New Normal” of Coal Mining in the U.S.

Coal producer business models were predicated historically on a slow, steady increase in coal demand and use, producing modest profits. Recently the industry has distorted the model by perpetuating the idea that global coal markets will offer an opportunity to super-size domestic coal production and profits.

The federal coal lease program is also built on a cornerstone belief in constant growth, whether it be slow and steady or more aggressive. The federal government expects coal producers to apply for new sites when there is a market for the coal and it always presumes a market for coal, more or less. Prior coal lease moratoria always took place when the industry and the federal government were facing growth and coal market expansion. This is not the case in the current environment.

Step One: Phase Out the Fair Market Leasing Program

Although the fair market value program was supposed to encourage competition, in fact quite the opposite has occurred.⁸ In fact, leases under the BLM's program typically have only one bidder. This lack of competitive bidding is evidence that the federal government may not be receiving a fair market value for its coal. In addition, the fair market equivalent pricing used by BLM is suspect because the price-setting mechanism was not independently reviewed for 30 years. The lack of internal controls is pervasive. When external reviews have finally taken place over the last few years, BLM has adopted a position of “evasive cooperation,” that is, avoiding transparency while appearing to cooperate. The DOI Inspector General concluded in 2013 that the Secretary of the Interior had such limited control over the operations that it was unlikely that needed reforms could be implemented.

When the current fair market leasing program was first envisioned, policy-makers may have had an honest aspiration that the system would foster a competitive coal market in the West. Public officials essentially turned over the program to the coal industry as a way to address many of the perceived and real complications of more regulated decision-making.

It is time to abandon the pretense that the rules of the fair market lease program are designed to create a fair market return for the taxpayer. Program implementation over the last 30-plus years has resulted in a steady supply of low cost coal provided by relatively healthy coal companies. But the situation has now changed dramatically and the objectives of the program are no longer being achieved.

The actual relationship between the coal industry and the federal government under the current system is not a functioning lessee/lessor relationship. It is instead an unbalanced public

⁸ For a very good discussion of the nature of the arguments on competition versus planning and regulation see Robert H. Nelson, *The Making of Federal Coal Policy*, Duke University Press, 1983. Nelson's work is also particularly good at pinpointing why specific policy options were chosen during the debates of the 1970's and 1980's, the last time any serious review of the program took place.

private partnership—one in which the private sector has the upper hand, determining where, when and how coal is mined, who it is sold to and at what price. Consequently, as the PEIS indicates, the government now support a lease payment system based on a fundamentally flawed valuation process, a royalty payment system in search of a rationale, and an antiquated annual rent payment.

Step Two: Establish a True, Balanced Public Private Partnership⁹

A public private partnership is generally understood as a business venture between government and business designed to provide a service or good. The private vendor and the government enter into a contract in which the private sector accepts technical, financial and operational risks. Financing can be either wholly the responsibility of the private sector or supported by some combination of public and private resources. Government contribution to financing typically flows from in-kind contributions such as the transfer of assets, capital subsidies, revenue guarantees, tax breaks, regulatory streamlining or quasi-monopolistic markets. The private sector usually contributes its value with production efficiencies the government could not achieve. The combined package draws investment capital based upon a holistic evaluation of the quality of the partnership. The borrowing and the financial life of the investment is considered an off-balance-sheet activity for government, allowing it to use its balance-sheet resources for other public needs.

The adoption of an alternative model for the federal coal leasing system would rebalance the current partnership and allow it to address the conditions of a declining market. The product to be produced from the partnership would be coal, mined for the purpose of domestic consumption principally in the electricity sector.

IEEFA proposes an alternative to the current system that incorporates the following major elements:

- Financing would come from a combination of private-sector borrowing and public-sector asset transfers (of coal), revenue and market guarantees (through price setting) and regulatory streamlining. This public-private partnership arrangement would will be faster, more certain and more accountable than the current system (see discussion on planning) below.

⁹ Most of the concepts and program suggestions offered here are not new at all. Robert Nelson's book, cited above explains many of them in prior historical contexts. A 1979 GAO Review identifies many of the issues faced by the program today, albeit without the benefit of the last 37 years. <http://gao.gov/products/EMD-79-47>. The Linowes Commission released its findings in 1982 and is a resource for anyone interested in assessing program options and the pros and cons of suggested changes. See: <https://catalog.hathitrust.org/Record/000845851>.

- All planning for new coal offerings would be the domain of the Department of Interior¹⁰ in consultation with the Department of Energy (DOE). The first assignment of the DOI/DOE team would be to assess the true level of economically available coal under lease, various coal demand scenarios,¹¹ and an accurate read of the life cycle of existing mines. This analysis would provide the basis for determining if and when new coal reserves are needed. Based on this information, a system would be established for the federal government to take back leases from coal companies (many such mines will have no value and carry only liabilities).¹² The review should establish the broad parameters for the demand for coal in the U.S. and the role of federal coal in meeting that demand. The Departments, collectively and with the advice and guidance of Congress, would work with the coal industry to implement public policy goals. Coal producers would submit both long-term and short-term mining plans very similar to the planning analysis that currently takes place within each corporation under the current program design.
- Price-setting for the sale of coal would be done by a federal-state coal price commission. The Commission would establish prices that would cover a coal producer's reasonable operational costs (including full funding of pension and environmental liabilities), debt, and profit (reinvestment and dividends). The lower limit of the pricing structure would be driven in large measure by state public service commissions. They would set the lower price levels consistent with their mission to maintain affordable and reliable electricity to residents. The price would be set at the upper limit by establishing a national energy adjusted average for the price of coal sold in the rest of the country (outside the PRB) through traditional market mechanisms. The Commission would be bound by these upper and lower limits and set annual prices according to their own methodology.
- Prices would be established annually to allow for changing market conditions and state variations. Adjustments on a year-to-year basis could be established very much like that used in rate-setting for regulated utilities. A price-setting committee could consist of representatives of the Department of Energy, Department of the Interior, Office of Management and Budget, Securities and Exchange Commission¹³ and two members selected by the National Governors Association and two members selected by the National Association of Regulatory Utility Commissions. Staff from the Department of Energy would be responsible for technical monitoring and data inputs necessary to maintain real-time changes. DOI would be required to maintain basic financial and economic data required to ensure market balance and adherence to national policy directives. The Department of Interior would be the lead staff and prepare all documents and studies necessary to set annual prices and keep committee members informed. All of this information should be

¹⁰ Coal reserve studies carried out by the United States Geological Survey offer important methodological and technical insights regarding coal reserves in the Powder River Basin. DOI should avail itself of the talent base in this agency. <http://energy.usgs.gov/Coal/AssessmentsandData/CoalAssessments.aspx>

¹¹ Coal demand scenarios for the PRB are necessarily tied to dynamics occurring in other coal regions in the country and to the market potential for natural gas, renewable energy, hydroelectric and nuclear power.

¹² The recent inability of Peabody Energy to secure a viable buyer and investor for three of its Western coal mines (not in the PRB) suggest the mines are worth zero. When reclamation liabilities are added they will have a negative value. Just prior to its bankruptcy declaration Peabody tried to pledge southwestern and Illinois Basin coal reserves as collateral for a debt swap. This transaction did not move forward either. Peabody's bankruptcy filings also contain statements that its 2012 federal lease acquisition for the North and South Porcupine reserves added to the company's substantial financial liabilities as prices began to fall from the peak pricing of recent years.

¹³ The SEC might serve as a non-voting member of the price setting commission. The SEC oversees coal producer investment disclosures and arguably should not be involved in any actions that might influence the revenues of a company under its jurisdiction. The SEC, however needs to consider inherent weaknesses in the reporting of coal reserves to investors going forward.

presumed to be public information for the purpose of stimulating and maintaining a robust environment for external review.

- Coal producer borrowing for any venture outside of mining operations for mines under contract with the federal government would have to receive the approval of the Department of Interior in consultation with the price-setting Committee. As a matter of national security and to protect against reckless speculation, coal exports would be prohibited. Such prohibition would cover mine acquisitions outside the U.S., mine acquisitions inside the U.S. to be used for exports, and port and rail projects related to exporting coal.
- Consistent with the public-private partnership, the lease program would establish standards for coal producers based upon coal producer competencies in coal mining and production efficiencies, not the gaming of a government program.
- Royalty policy would be amended. The current policy of dividing coal royalty revenue between the federal and state government lacks a rationale. The federal portion of the money goes for general funding purposes at the federal level, and states tend to do much of the same with some targeting money to coal infrastructure and other coal-related programs. The federal portion of the royalty money should instead be set aside to satisfy coal liabilities: 1) to establish a new arrangement where coal producers and the federal government share responsibility for coal reclamation cleanups (bonds should be required of coal producers for their portion, self-bonding should be eliminated, and the federal government should set aside an actuarially-sound portion of federal coal revenues to meet their portion of cleanup costs) and 2) to provide additional set-asides for coal miner employee pensions.
- For the first six years of the Committee's existence, the Inspector Generals from both the Department of Energy and Department of Interior would be required to conduct bi-annual oversight evaluations¹⁴ of price setting and other related program elements to insure: 1) adherence to internal control procedures; 2) proper accounting for coal price setting and underlying valuation mechanisms; 3) proper accounting for the levels of government support of coal production and coal producers; 4) protections against fraud and abuse; 5) assessments of methods used by state public service commissions to establish the price floor, the methods used by the Commission to establish the ceiling and to establish an annual coal price; and 5) assessments of the impact of lobbying and political interference on the program design and model.
- Consistent with the management of an ongoing public-private partnership, the BLM would retrain staff and add new competencies to secure the benefits sought on the government side of the equation. BLM would need to hire at a minimum: 1) expert investment specialists with core competencies in infrastructure development (supported by individuals that possess an understanding of institutional investment asset allocations); 2) mining engineers and mine operators; 3) labor experts; 4) energy planners and 5) negotiators with competency in business, contract and budget negotiations.

¹⁴ We also would recommend that Congress work with the Government Accountability Office to establish the coal lease program as "High Risk" and to conduct oversight studies for at least the next five years accordingly.

Conclusion

The proposals advanced in this paper are not new—they can be found in a number of the policy documents we have identified. But they have never been more timely.

The heavy emphasis on regulation that we recommend in our proposal is informed by the past (specifically the past 30 years), by energy market developments, and by a rational outlook. The coal industry itself has shown it cannot manage a declining market for its product. It is not clear that the federal government is up to the task either. The required transition around federal coal-reserve management will take work, IEEFA is not naïve as to the difficulty of changing this system wholesale. The political problems alone are daunting. But major public policy reform has never been easy.

In 1979, one political commenter, Guy Paul Land, made a salient observation on why the courts are sometimes asked to resolve problems that are more appropriately the domain of legislative and executive action. The political dynamic he describes can clearly be applied to coal policy in the U.S. today:

“Perhaps the most crucial factor shaping the increased resort to the courts—and the one with the most important long-term consequences—is the growing dissatisfaction and disillusionment with the ability of representative assemblies, at whatever level, to reflect accurately, efficiently and effectively the desires of the people whom they presume to represent. Over the past decade, public opinion polls have shown a consistent decline in the American public’s belief in the efficacy of Congress to solve major problems or protect private rights ... In the view of many Americans, their representatives are more the voices of large, organized special interests and less the spokesperson for individual constituents. In short, there is a growing feeling among the public that many of its elected officials and their agents cannot or will not adequately serve the individual interests and needs of the members of society.”¹⁵

The “fair market value” design used by the federal government has run its course. And although the type of public-private partnership we recommend here may be controversial, the federal coal lease program is clearly in need of a new paradigm. Proponents and opponents of the public-private model, as well as neutral third parties¹⁶ all agree that sound planning, a skilled public sector negotiating team, good financial advice and openness will be critical elements of success.

¹⁵ The quote is from an article by Guy Paul Land, *Judicial Process and the Decline of Twentieth Century American Liberalism*, Harvard Journal of Legislation 26 (Spring 1979, p.286. David Nelson (op cit), p.211 carries the quote in his treatise on federal coal leasing.

¹⁶ http://www.cscd.gov.bc.ca/lgd/policy_research/library/public_private_partnerships.pdf