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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Chairman, Subcommittee On Oversight
And Investigations, Committee On Energy And Commerce
House Of Representatives

Circumstances Surrounding The First Colony
Peat-To-Methanol Project

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RELEASED

On December 13, 1982, the Chairman of the U.S. Synthetic Fuels Corporation signed a letter of intent to favorably recommend to the Board of Directors the initial award of up to \$465 million in loan and price guarantees for a project to produce 60 million gallons per year of methanol fuel from North Carolina peat lands. The project is scheduled to start production by December 1986 and will be situated on a 15,000 acre tract of peat land near Creswell, North Carolina. GAO addresses questions regarding this project, including the legal authority for the letter of intent, Corporation staff recommendations against federal backing of the project, specific criticisms of the project by North Carolina environmentalists, and the justification for the project's receiving Corporation price guarantees.



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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES, COMMUNITY,
AND ECONOMIC DEVELOPMENT
DIVISION

B-201035

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

Your January 11, 1983, letter asked, among other things, that we review the circumstances surrounding the issuance of a letter of intent by the chairman, U.S. Synthetic Fuels Corporation, to favorably recommend to the Corporation's Board of Directors the initial award of up to \$465 million in loan and price guarantees to Peat Methanol Associates for a project to produce methanol fuel from peat stripped from North Carolina coastal lands. (See app. II.)

You asked that we specifically examine

- the legal authority for such a letter of intent and the authority of the Corporation chairman to issue this letter,
- whether the Davis-Bacon Act applies to the project,
- the reasons why the Corporation staff recommended against federal backing of the project,
- the specific criticisms of the project by North Carolina environmentalists and the extent to which the Corporation has considered such criticisms,
- the justification for the Corporation's providing price guarantees for the project,
- the ownership of the peat land on which the project will be situated and the arrangement for developing it, and
- the identity of the project sponsor.

You also asked that we examine Corporation administrative matters such as salaries, expenses, travel costs, contracts, and consultant fees. In addition, you asked that we review Corporation achievements, including those resulting from project solicitations. As agreed with your office, because these matters are being covered in other GAO work or issued reports, this report would cover only the Peat Methanol Associates project.

In reviewing the circumstances surrounding this project, we researched the legislative history of the Energy Security Act--which created the Corporation--and obtained comments from the Corporation regarding the issuance of the letter of intent. In addition, we visited the various departments at the Corporation that had responsibility for evaluating this project.

We found that the letter of intent clearly specifies that it is not a binding agreement between the Corporation and Peat Methanol Associates and that any binding agreement for financial assistance must be approved by the Corporation's Board of Directors. This approval has not yet occurred and is not expected to occur before the end of 1983.

We also found that:

- Nothing legally prohibits the Corporation from being a party to a letter of intent. Given that, the question then becomes whether the chairman had the authority to sign the letter of intent without formal approval from the Board of Directors or a formal delegation, by resolution, of the Board. It is the chairman's position that such a delegation was not necessary and that signing a letter of intent falls within his statutory responsibility for the management and direction of the Corporation. In our view, it is unclear whether the section of the legislation which the chairman cites includes the authority to sign letters of intent.
- The Davis-Bacon Act is applicable to this project if financial assistance is to be provided in accordance with the letter of intent. The Energy Security Act provides that the Davis-Bacon Act shall apply to those projects for which financial assistance is to be provided by the Corporation in the form of loans, loan guarantees, or joint ventures, either in whole or in part. The letter of intent includes financial assistance in the form of loan guarantees.
- At the time of the signing of the letter of intent, the Corporation staff was not recommending against federal backing of the project. However, the staff had raised certain questions in its evaluation of the project that,

in our view, had not been completely answered at the time the chairman signed the letter of intent. The Corporation staff has acknowledged that some questions are, as yet, unanswered, and has continued its evaluation of them with a view to resolving them before the execution of the final agreement. The Corporation staff believes that two key questions--replication potential of the project and successful testing of the peat in a pilot-scale facility--have been adequately addressed and is not contemplating any additional analysis. However, we believe there is conflicting Corporation information on both questions.

--Environmentalists and local fishing groups are opposed to the project primarily because of its potentially damaging effects on the fishing industry and the air and water quality. They believe that peat harvesting and later large-scale agricultural use of the land will have profound impacts on the environment. The Corporation stayed abreast of the environmental issues surrounding this project by maintaining extensive contact with environmental groups and state regulatory agencies. Apart from this, the Corporation did not attempt to resolve the issues prior to signing the letter of intent. Instead, it is relying on the North Carolina State regulatory permitting process to address and resolve the issues.

--Corporation officials believe that price guarantees are needed to induce Peat Methanol Associates' participation in this project by providing it with an appropriate return on its equity investment. Price guarantees represent an intent between the Corporation and the sponsor to share in the risks associated with development of synthetic fuels projects on a commercial scale. For this project, Corporation officials indicated price guarantees serve to insulate the project sponsor from those risks over which the sponsor has no control. These risks include such things as market prices, inflation, and interest rates. On the other hand, this leaves the project sponsor subject to those risks it can control such as capital and operating cost, start date, and amount of production. If the project sponsor does a good job of controlling these latter risks, then price guarantees will assure that Peat Methanol Associates receives a return on its equity investment of between 15 and 20 percent for this project.

--Peat Methanol Associates plans to lease peat land under an agreement being negotiated with First Colony Farms, Inc., of Creswell, North Carolina. First Colony Farms, Inc., is wholly owned by McLean Securities, Inc., and the sole stockholder of McLean Securities, Inc., is

Mr. Malcolm P. McLean. Under the agreement being negotiated, Peat Methanol Associates will acquire real property for the plant site and loading terminal, easements for access to the plant site, and mineral rights to about 15,000 acres of peat land. It also has an option on about 100,000 acres more, but according to the agreement being negotiated, Peat Methanol Associates must exercise its option to portions of this acreage on a time-phased basis by 1988 or forfeit its rights to the additional land.

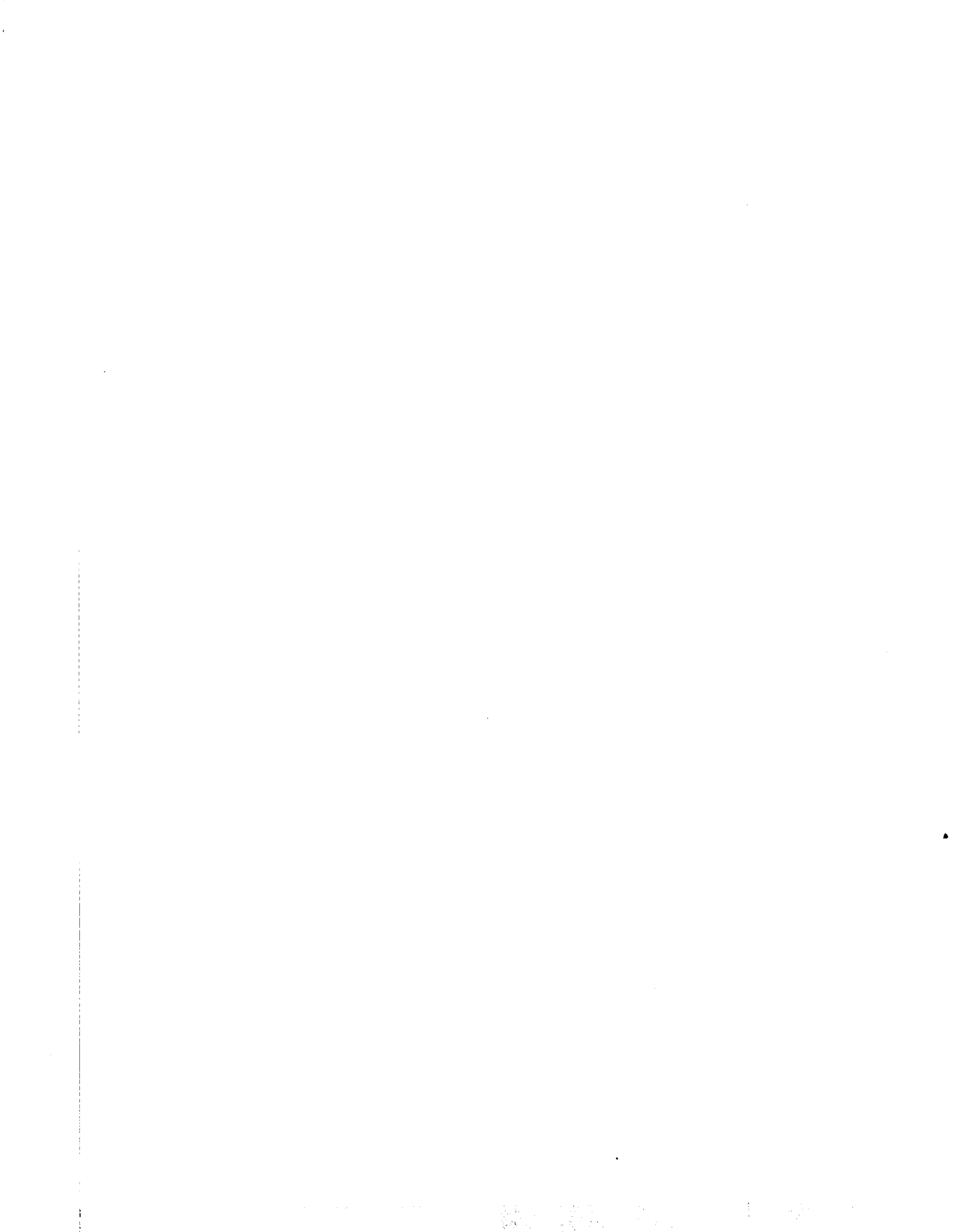
--The project sponsor--Peat Methanol Associates--is a partnership comprised of North Carolina Synfuels Corporation, Transco Peat Methanol Company, Energy Transition Corporation, and J.B. Sunderland (an individual). North Carolina Synfuels Corporation and Transco Peat Methanol Company are subsidiaries of Koppers Company, Inc., and Transco Energy Company, respectively. According to the partnership agreement, equity in Peat Methanol Associates currently consists of North Carolina Synfuels Corporation owning 70.3 percent, Transco Peat Methanol Company owning 23.45 percent, Energy Transition Corporation owning 5 percent, and J.B. Sunderland owning 1.25 percent. Despite its small equity share, Energy Transition Corporation has generated considerable publicity because it is owned by four former officials of the Ford administration and one current official of the Reagan administration. According to one of the former officials, however, only two of the former officials have made a commitment of time to the project, and these two individuals own 91 percent of Energy Transition Corporation's 5-percent equity in Peat Methanol Associates. The other three individuals only own a 3-percent interest each of the 5 percent.

CONCLUSIONS

According to the Energy Security Act, the Board of Directors acts for the Corporation except for those functions statutorily given to the chairman and those which the Board, by resolution, has delegated to the chairman or other directors. In the peat-to-methanol project, we found that the chairman signed the letter of intent without the prior formal approval or formal delegation of the Board of Directors. It is the chairman's position that such a delegation was not necessary and that signing a letter of intent falls within his statutory responsibility for the management and direction of the Corporation. In our view, it is unclear whether the section of the legislation which the chairman cites includes the authority to sign letters of intent. We believe that, because the Corporation is making widespread use of letters of intent in its financial negotiation process, the Board of Directors should either formally authorize or prohibit the chairman's signing of any future letters of intent.

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In specific regard to the peat-to-methanol project, there is conflicting Corporation information on two key questions-- replication potential, which is a statutory factor to be considered in awarding financial assistance to a project, and successful testing of the North Carolina peat in a pilot-scale facility, which was a condition placed upon the project by the Board of Directors during the Corporation staff's review of the project. For each question, we believe that the information developed by the Corporation staff is inconclusive. Given the importance of both questions to the overall success of the project, we believe the Board of Directors should assess the adequacy of the Corporation information on these two questions to assure itself that both have been fully resolved.

RECOMMENDATIONS

We recommend that the Board of Directors of the Corporation:

- either formally authorize or prohibit the chairman's signing of any future letters of intent, and
- assess the adequacy of Corporation information on two key questions regarding the peat-to-methanol project-- replication potential, which is a statutory factor to be considered in awarding financial assistance to a project, and successful testing of the North Carolina peat in a pilot-scale facility, which is important to the economic viability of the project and a condition placed upon the project by the Board of Directors during the Corporation staff's review of the project--to assure itself that both have been fully resolved.

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Appendix I contains additional information in response to your specific questions. As requested by your office, we did not obtain written agency comments. However, we discussed the contents of the report with Corporation officials in order to ensure the report's accuracy. Except as noted above, we made our review in accordance with generally accepted auditing standards. Further, as arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of its issuance. At that time we will send copies to the Corporation; the Director, Office of Management and Budget; the Senate Committee on Energy and Natural Resources; the Senate Committee on Governmental Affairs; the House Committee

B-201035

on Government Operations; and others upon request. We will ask the Corporation to advise the committees and us within 60 days of any action it has taken or plans to take on our recommendations.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "J. Dexter Peach".

J. Dexter Peach
Director

DETAILED DISCUSSION OF THE
PEAT-TO-METHANOL PROJECT

BACKGROUND AND STATUS

The First Colony peat-to-methanol project is a proposal to synthetically produce 60 million gallons a year of methanol fuel from peat stripped from North Carolina coastal lands. The project is scheduled to start production by December 1986 and will be situated on 15,000 acres of peat land near Creswell, North Carolina. The project's sponsor--Peat Methanol Associates--is a partnership composed of North Carolina Synfuels Corporation, Transco Peat Methanol Company, Energy Transition Corporation, and Mr. J.B. Sunderland.

In December 1982, the chairman, U.S. Synthetic Fuels Corporation, signed a letter of intent to favorably recommend to the Board of Directors the initial award of a maximum of \$465 million in assistance to the project. The letter of intent specified that such assistance will initially be in the form of a loan guarantee of up to \$341 million of principal and \$25 million of interest and up to \$99 million for a guarantee of future methanol prices.¹ Peat Methanol Associates will provide up to \$172 million in equity.

As of October 1983, ratification of the final agreement had not yet occurred. According to the Corporation staff, the preparation of certain supporting financial and legal documentation had delayed this ratification and the final agreement would not occur before the end of 1983.

Peat as an energy resource

Peat is a natural organic deposit which develops in wetlands throughout the world under special circumstances. It consists of partially decomposed plant matter that has accumulated and been saturated in a water environment over thousands of years.

¹As portions of the \$341 million loan principal are repaid, equal portions of the loan guarantee may be converted to additional price guarantees. Also, if Peat Methanol Associates can sell methanol for more than the Corporation-guaranteed price, revenue-sharing payments from Peat Methanol Associates to the Corporation will be deposited in an escrow account up to \$150 million. This account may be used for additional price guarantees should the market reverse itself, in which case the market price for methanol would be less than the Corporation-guaranteed price.

In many European countries, peat has been an important domestic fuel for centuries, and it is in these countries that efforts to develop the industrial use of peat have found most favor. In most cases where this is true, there is a lack of alternative fuels, although tradition has also played some part in encouraging the use of peat. The countries best known for using peat are the Soviet Union, Ireland, Finland, and Sweden.

Peat has not been considered an important source of energy in the United States because of the ready availability of other energy resources, especially coal. Also, while the acreage covered by peat in the United States is large, the availability of fuel grade peat which may be economically and environmentally harvested has been considered limited. For example, much of the U.S. peat is located in the permafrost regions of Alaska. Also, certain peat areas are contiguous with wetlands and other environmentally sensitive areas. Only about one-fourth of the 200 million peat acres in the United States is regarded as capable of being harvested to serve as an economical source of energy.

However, during 1980, interest in peat and other domestic resources began to grow. In that year, the Congress enacted the Energy Security Act, which directed the Nation's attention toward reducing its dependence on foreign energy resources. For this purpose, the act created the U.S. Synthetic Fuels Corporation, a Federal entity of limited duration that provides financial assistance to private industry for the commercial production of synthetic fuels. Many companies immediately seized upon this opportunity and began evaluating possible synthetic fuels projects. One of these companies was Energy Transition Corporation which started considering a peat-to-methanol project in North Carolina.

Description of the peat-to-methanol project

Peat-to-methanol conversion begins by harvesting the peat from the field by using farm-type equipment. The peat is ground in a milling machine and left to dry in the sun. Solar drying reduces the moisture in the peat from about 90 percent in its natural state to about 40 percent. The peat is transferred to a storage pile where it is screened to remove any wood particles, and then is fed into a mechanical dryer for further moisture reduction. The dried peat is pulverized into a fine powdered material and then conveyed to a gasifier. The gases from the peat are circulated over a catalyst repeatedly until they react to form methanol. The crude methanol is refined into a finished methanol product for blending with unleaded gasoline to make a premium blend or for use as a fuel by itself.

Corporation review of the project

By the end of 1980, Energy Transition Corporation concluded that North Carolina would be ideal for a peat-to-methanol project because of its close proximity to the East Coast automotive fuels market and the obvious economic advantages offered by the North Carolina climate for the solar drying of peat. Therefore, Energy Transition Corporation decided to bring this project to fruition by forming a partnership--called Peat Methanol Associates--with North Carolina Synfuels Corporation, Transco Peat Methanol Company, and Mr. J.B. Sunderland.

Responding to the Corporation's November 1980 initial solicitation of synthetic fuels projects, Peat Methanol Associates submitted a proposal for the project to the Corporation by the March 31, 1981, deadline. At the Corporation's request, it provided more detailed information on the project in January 1982. From January until March of that year, the project underwent a succession of Corporation reviews aimed at determining whether the project was financially stable and technically and economically viable, with demonstrable markets for its products, reasonable evidence of ultimate regulatory acceptability, and sound management.

In March 1982, the staff recommended, and the Board of Directors approved, the advancement of this project toward further Corporation review, subject to compliance with a number of conditions. Most notably, the Corporation wanted the sponsor to have its management capability substantially in place by June 1982 when a discussion of financial assistance terms was planned to begin. In that month, the staff reported that management capability for this project was not substantially in place but recommended that a discussion of financial assistance for the project begin. The Board of Directors, however, unanimously voted that the project not be considered further under the Corporation's initial solicitation.

In June 1982, Peat Methanol Associates was considered as a participant in the Corporation's second solicitation for proposals which had closed on June 1, 1982. The project once again underwent a succession of Corporation reviews and, in September 1982, the staff again recommended that the project be passed forward into a discussion for financial assistance. This time, the only condition placed upon the sponsor was the successful testing of the North Carolina peat in a pilot-scale facility.²

²The Corporation staff had determined that the sponsor had satisfied the earlier condition regarding its management capability.

The Board of Directors adopted the staff's recommendation by a narrow margin, and from September until November 1982 the staff and Peat Methanol Associates actively negotiated a draft financial assistance agreement. In November 1982, the staff reported that the condition placed on the sponsor had been satisfied. Therefore, it recommended that the Board authorize a cost sharing arrangement with Peat Methanol Associates to further refine the project's cost and design and that the Board chairman sign a letter of intent and term sheet which would set forth the anticipated conditions and terms for providing financial assistance.

OBJECTIVE, SCOPE, AND METHODOLOGY

We performed our work between March 1983 and September 1983. The objective of our work was to answer the questions the chairman asked regarding the Corporation's intentions to award financial assistance to the peat-to-methanol project. The chairman also asked that we examine Corporation administrative matters, such as salaries, expenses, travel costs, contracts, and consultant fees. In addition, he asked that we review Corporation achievements, including those resulting from project solicitations. As agreed with his office, because these matters are being covered in other GAO work or are included in issued reports, this report would cover only the First Colony project. We performed our work in accordance with generally accepted Government auditing standards.

We researched the legislative history of the Energy Security Act--which created the Corporation--and obtained comments from the Corporation regarding the issuance of the letter of intent. In addition, we visited the various departments at the Corporation that had responsibility for evaluating this project. Within each department, we interviewed appropriate Corporation officials and reviewed agency documentation used in the project evaluation.

We discussed the project with three of its sponsors. We talked with officials of Energy Transition Corporation, which has a minor equity share in the project, and with the North Carolina Synfuels Corporation and Transco Peat Methanol Company, which have a 70.3 percent and 23.45 percent equity share of the project, respectively. We also discussed the project with a representative of the peat land owner, officials of the contracting company that will construct the facility, and with officials of the contracting company that will harvest the peat.

Within the state of North Carolina, we met with and obtained the views of interested parties associated with the project. Specifically, we spoke with certain environmentalists and attended several public meetings where environmentalists and local inhabitants expressed these concerns. We also met with

state regulatory officials who have the responsibility for granting the project its necessary environmental permits. Finally, we visited the proposed project site and witnessed a scale-model demonstration of the peat drying and grinding aspect of the project.

LEGAL AUTHORITY FOR AND SIGNIFICANCE OF
THE LETTER OF INTENT AND AUTHORITY OF
THE CORPORATION CHAIRMAN TO SIGN THE LETTER

In December 1982, negotiations between the Corporation and Peat Methanol Associates had reached a sufficiently serious stage that both parties thought it important to commit to writing the tentative terms of the financial agreement for this project. Therefore, both parties signed a letter of intent. From the Corporation's perspective, the letter of intent provided a framework for the continued evaluation of the project and the basis for completion of proposed documentation. From the sponsor's perspective, the letter of intent represented an indication that the project was close enough to Corporation acceptance that it could advance its engineering design of the project and seek that portion of debt financing not guaranteed by the Corporation.

A letter of intent is used to reduce to writing a preliminary understanding of parties who intend to enter into a contract. It is used within the financial community, which does not generally regard it as a binding agreement but rather an expression of tentative intentions. Nevertheless, it can be a binding agreement if the parties so intend.

In this case, the letter of intent clearly specifies its nonbinding intentions. The letter of intent says that it constitutes a statement of mutual understanding and intentions and neither the letter nor the accompanying term sheet constitutes or creates an obligation binding on any person or creates any right in favor of any person. In addition, the letter of intent provides that before the project is recommended to the respective Boards of Directors, it is subject to (1) negotiation of acceptable definitive agreements, (2) compliance with necessary legal requirements, and (3) the absence of changed circumstances which would adversely affect the financial prospects of the project. Moreover, we found nothing that would legally prohibit the Corporation from entering into this type of letter of intent.

Another legal issue relates to who, on behalf of the Corporation, is empowered to approve and sign the letter of intent. According to the Energy Security Act, the Board of Directors acts for the Corporation, except for those functions statutorily given to the chairman and those which the Board, by

resolution, has delegated to the chairman or other directors. One of the statutorily nondelegable powers of the Board of Directors is that of awarding financial assistance. However, in our view, the signing of the letter of intent was a part of the solicitation/agreement preparation process and preliminary to actual award of financial assistance. Therefore, we believe the Board of Directors need not have approved this letter of intent and could have delegated the authority to perform this function.

Nevertheless, we found that the chairman signed the letter of intent without the prior formal approval or formal delegation of the Board of Directors. It is the chairman's position that such a delegation was not necessary and that signing a letter of intent falls within his statutory responsibility for the management and direction of the Corporation. In our view, it is unclear whether the section of the legislation which the chairman cites includes the authority to sign letters of intent.

Conclusion and recommendation

We believe that, because the Corporation is making widespread use of letters of intent in its financial negotiation process, the Board of Directors should either formally authorize or prohibit the chairman's signing of any future letters of intent. This delegation should, however, be limited to those letters of intent in which it is expressly provided that the Corporation is not legally bound by the document. This is essential because, as stated above, the awarding of financial assistance is statutorily designated as a nondelegable responsibility and function of the Board of Directors. As such, a letter of intent could still reflect a preliminary understanding between a sponsor and the Corporation staff regarding the tentative terms of financial assistance for a project.

Therefore, we recommend that the Board of Directors of the Corporation either formally authorize or prohibit the chairman's signing of any future letters of intent.

APPLICABILITY OF THE DAVIS-BACON ACT TO THE PROJECT

It is our view that the Davis-Bacon Act is applicable to this project if financial assistance is to be provided in accordance with the letter of intent. The Energy Security Act specifies, in part, that all laborers and mechanics employed for the construction, repair, or alteration of synthetic fuel projects funded in whole or in part by loans, loan guarantees, or joint ventures shall be paid wages at rates not less than those prevailing on projects of a similar character in the locality as determined by the Secretary of Labor in accordance with the Davis-Bacon Act. The term sheet accompanying the letter of intent clearly

indicates that loan guarantees are a part of the financial assistance to be provided.

STAFF RECOMMENDATIONS AGAINST
THE PEAT-TO-METHANOL PROJECT

In its initial evaluation of this project, the Corporation staff expressed some concern about the project's economic viability. However, the Corporation staff never recommended against the project and did not recommend against it at the time of the signing of the letter of intent. Rather, the Corporation staff's evaluation of the project continually led to raising of certain questions about the project. In most cases, it appears that the staff's questions were properly answered. In a few instances, however, Corporation documents suggest that some questions were still unanswered at the time of the signing of the letter of intent. The Corporation staff believes that two key questions--replication potential for the project and successful testing of the peat in a pilot-scale facility--have been adequately addressed and is not contemplating any additional analysis. However, we found conflicting Corporation information on both questions.

Whether the staff made available this conflicting Corporation information to the Board of Directors is unclear. Normally, a project undergoes a number of concurrent reviews by the Corporation staff in such offices as finance, technology and engineering, and projects. The Vice-President for Projects is responsible for coordinating these reviews and developing a staff summary report and an oral staff briefing on those projects undergoing Board consideration. The summary report represents a prevailing staff position on the project. As such, it is not used as an instrument to highlight staff disagreement over a project and, according to the Corporation staff, there is no Corporation requirement that staff dissenting views, if any, be presented to the Board.

Replication potential for the
peat-to-methanol project

One of the primary concerns which the staff addressed and which is a statutory factor to be considered in awarding financial assistance is the replication potential for the project. That is, what is the possibility that this project will either (1) be expanded onsite, (2) result in the construction of other peat-to-methanol plants elsewhere in the country, or (3) have its technology used with some other resource to produce synthetic fuel. The official Corporation position is that the project has good replication potential; however, other Corporation information also suggests that the project's replication potential may be low

to moderate instead of good. Because of this conflicting information, we believe the Corporation should fully explore and resolve this question.

As support that the project has good replication potential, the Corporation used several studies prepared by Corporation staff. These studies conclude that (1) on the North Carolina site, there is the potential for an eight-fold expansion of the project, with enough economically recoverable resource to last 20 years, (2) peat is a very large resource of fossil energy, and under proper site conditions, could support a portion of a synthetic fuel industry, and (3) the technology for converting the North Carolina peat to methanol is widely replicable to the complete spectrum of peat-lignite-coal resources throughout the United States.

On the other hand, we found other Corporation information which questions the replication potential of the North Carolina project. For instance, the project, as currently planned, will require the harvesting of peat on approximately 15,000 acres. A harvesting permit from the state of North Carolina has already been obtained for this. However, if the project expands eight-fold, an additional 100,000 acres of peat would be required.

In our view, it is uncertain at this time whether a permit for this additional acreage could be obtained. For one reason, a portion of this acreage lies at or beneath sea level and a North Carolina peat mining task force has recently recommended that permits for mining in such peat areas should not be issued unless, and until, adequate environmental safeguards are developed. Also, a part of this acreage overlaps an Air Force bombing range and is a more environmentally sensitive area than the 15,000 acres. Lastly, some 65,000 of this additional acreage lies in Dare County, whose board of commissioners recently passed a resolution asking the State to forbid peat mining there. Thus, we believe the potential for replication of this project on site is uncertain.

Offsite, the most likely locations for a similar peat-to-methanol project would be in Alaska or the northern tier states. However, according to an August 1982 report on the First Colony project by the Corporation's technology and engineering department, the lack of information about the peat, environmental considerations, and economics for specific projects creates an uncertainty in the replication potential for peat to other areas. The report also said that, in most instances, the extensive harvesting requirements for peat seriously limit utilization. The report acknowledged that the North Carolina project was more favorable because of a longer harvesting season and capability to remove most of the moisture from the peat in the field by drainage and solar drying. The

report concluded the potential replication of this project to another peat area was low.

The last remaining consideration for replication is whether or not the project's technology can be used with other energy resources, such as coal or lignite. According to a December 1982 status report from the Corporation's technology and engineering department, the project's technology can be used for coal gasification. If the coal is low in sulfur and ash, the report says, modifications to the technology would be limited to the resource storage areas and preparation plant and should not be extensive. If, however, the technology was to be used to handle relatively inexpensive, high sulfur coal, major modifications would be required primarily in the acid gas removal, sulfur recovery, steam generation, and ash removal and disposal areas. To put these modifications in perspective, the report indicated that the sulfur volume in the plant would increase 15 to 20 times and the ash 2 to 3 times. Thus, the report suggested that the project's technology could be made to work with all types of coal, and was engineeringly possible, but would necessitate certain changes which could be costly. Because of that cost, we believe that, contrary to the Corporation's position that the project is widely replicable to the complete spectrum of peat-lignite-coal resources in the United States, economically, this may not be true.

Conclusion and recommendation

We believe Corporation information to support the replication potential for this project is inconclusive. Therefore, we believe the Board of Directors of the Corporation should assess the adequacy of the Corporation information on the question of replication potential to assure itself that this question has been fully resolved.

Corporation officials told us that the demonstration of certain technologies has made the harvesting of additional peat areas increasingly feasible. This may have an impact on one of the three ways the project's replication potential has been considered. However, because this information has only recently come to light, its impact on the overall replication potential for this project is uncertain.

Accordingly, we recommend that the Board of Directors of the Corporation assess the adequacy of the Corporation information on the question of replication potential, which is a statutory factor to be considered in awarding financial assistance to a project, to assure itself that this question has been fully resolved.

Successful testing of the North
Carolina peat in a pilot-scale facility

Another concern of the Corporation staff is yield data for the North Carolina peat; that is, how much peat must be fed into the project to generate a specified amount of methanol. Therefore, in September 1982, the staff recommended, and the Board of Directors approved, moving the project forward under the condition that there be successful testing of the peat in a pilot-scale facility.³ While the condition itself is vague, Corporation documents indicate that the staff thought yield data important and wanted it obtained from this testing. However, we found no evidence of this data being obtained.

Since its February 1982 review of the project, the Corporation staff has believed that the yield data on the North Carolina peat was weak. The staff believed that such data in support of peat gasification had largely come from basic laboratory experiments. To the staff's knowledge, practically no yield data was available on the North Carolina peat under pilot-scale or full-scale process conditions. Therefore, the staff wanted to obtain yield data by testing the peat on a pilot-scale basis.

While testing was eventually conducted at a facility in Tullahoma, Tennessee, in October 1982, it did not produce the yield data expected by the Corporation staff. According to a Corporation official, the Corporation had hoped that Peat Methanol Associates would be able to use a specific facility for the testing. However, because this facility was unavailable, it had to use a smaller-sized facility that apparently was incapable of generating the desired yield data.

Despite this, the Corporation staff reported, in November 1982, that the condition placed on the project by the Board of Directors had been met. Because of this apparent inconsistency, we asked the Corporation to clarify the matter. A Corporation official told us that once the Corporation staff became aware of the size and type of facility to be used, its expectations about the testing began to change. He said the Corporation staff no longer expected yield data from the testing. Nonetheless, this official indicated that the testing did produce a great deal of important information, particularly in the area of environmental sampling. Also, this official indicated that although yield data had not been generated from the testing, there might be some pilot-scale testing of the North Carolina peat in the future.

³A facility of small or intermediate size used to show that processes and systems function properly.

Therefore, we asked Peat Methanol Associates officials if they would be testing the North Carolina peat in a pilot-scale facility. They responded that they have plans to duplicate and operate one of the eight burners that will be used to gasify peat in the full-scale facility. They indicated that this operation will provide yield data but that they have no plans to conduct this operation until after the final agreement is signed.

Conclusion and recommendation

In our view, yield data is important to the economic viability of the project. It is the basis for determining the production output and the resulting rate of return on the plant. As early as February 1982, the Corporation staff determined that yield data for this project was weak. Since then, we have found nothing to suggest that additional data has been generated. Thus, we believe the Corporation staff's question regarding yield data for this project is still relevant.

For that reason, we recommend that the Board of Directors of the Corporation assess the adequacy of the Corporation information on the question of successful testing of the North Carolina peat in a pilot-scale facility, which is important to the economic viability of the project and a condition placed upon the project by the Board of Directors during the Corporation staff's review of the project, to assure itself that this question has been fully resolved.

SPECIFIC CRITICISMS BY NORTH CAROLINA ENVIRONMENTALISTS OF THE PEAT-TO-METHANOL PROJECT

Environmentalists and local fishing groups are opposed to the peat-to-methanol project because of its potentially damaging effects on the fishing industry and the air and water quality. They consider peat harvesting as a form of land clearing for agriculture, and they believe peat harvesting and large-scale agricultural use of these North Carolina coastal lands will have profound impacts on the environment.

The peninsula where the peat-to-methanol plant and harvesting operations will be located is bordered on the north by the Albemarle Sound and on the south by the Pamlico Sound. Environmentalists believe that this region is wetlands because it is integrally related to the surrounding estuaries which collectively support a highly productive marine nursery habitat. Brown shrimp, the state's most valuable shrimp species, rely on this estuarine system, and information indicates this species is highly sensitive to changes in temperature and salinity of the water.

A major result of peat harvesting is increased surface water runoff. For example, water drainage from the plant site could discharge as much as 3 million gallons of water a day for a 18-month period into the surrounding canals. The increased runoff often contains sediment, fertilizers, and pesticides that could contribute to algae growth and killing and contaminating fish. Also, the water in the canals near the peat fields has been determined to contain mercury in excess of the state's water quality standard. Because peat apparently contains high concentrations of mercury and other metals, environmentalists believe that any disturbance of peat might release the mercury into the estuaries where it could accumulate in the food chain and become toxic.

Peat Methanol Associates asserts, however, that fresh surface water runoff rates can be controlled by diverting runoff from the site to a man-made lake it plans to build near the center of the property. The discharge will be managed to ensure that the rate of runoff will approximate the natural rate. Peat Methanol Associates also states that the lake will provide water for fire protection and for settling peat particles.

Regarding mercury, Peat Methanol Associates contends that mercury is already present in the water, land, and peat, and mining will not add more mercury to the area. Nevertheless, Peat Methanol Associates has given its assurance that mercury concentrations in the runoff water will remain at or below natural levels. It says the settling process in the man-made lake should ensure that.

A further concern of environmentalists is that the peat harvesting may adversely affect air quality, mainly by increasing the amount of suspended particulates. Dust is generated both by the harvesting process and the traffic associated with transporting the product. The effect of this dust may be particularly important in the peat fields near a large local lake since particulates which accumulate in that lake are not flushed out. Environmentalists believe the recreational values of this lake could be impaired by the accumulation.

Peat Methanol Associates contends, however, that several methods are available to control dust at the site. In addition to using the best available technology, the company will build windbreaks to help reduce blowing dust during operation. Because dust begins to increase when the peat is allowed to dry in the fields to around 30-percent moisture, Peat Methanol Associates plans to remove the peat from the fields at 40-percent moisture and complete the drying in the plant.

Corporation position concerning environmentalists' criticisms

The Corporation has not been directly involved in evaluating the environmentalists' concerns. Instead, it is relying on those federal and state agencies that have the responsibility for evaluating environmental impacts to identify any possible negative effects of this project and take any necessary corrective action.

For example, the Corporation is relying on the Corps of Engineers' determination that the project site is not a wetlands area. If the Corps of Engineers had determined otherwise, a special permit and an environmental impact statement would have been required for the project. Also, the Corporation is relying on the state's decision that the project site is not a "key energy facility area of environmental concern." If the state had decided it was, an environmental assessment and state management of peat land development would have been required.

The Corporation staff told us its primary concern is whether Peat Methanol Associates can demonstrate that it can promptly comply with whatever regulatory requirements North Carolina imposes. To assure that, the Corporation staff said it has maintained fairly extensive contact with environmental groups and state agencies. For instance, as early as May 1982, members of the Corporation Board of Directors met with the head of a North Carolina environmental group to discuss the environmental effects of the project. Also, the Corporation staff has closely followed the state's recent task force study of peat mining in North Carolina. That study--completed in January 1983--concluded that peat mining can be permitted in North Carolina if carefully managed to protect the valuable coastal resources. The study further concluded that the state's mining act and its permits for water discharge, water use, and air quality provide an adequate framework for managing peat mining.

Because the Corporation did not anticipate any major environmental impacts from this project, the Corporation staff told us it did not give major consideration to resolving these impacts prior to signing the letter of intent. As a result of the state's January 1983 task force study, the Corporation staff also said it believed that any environmental impacts can be addressed under the state's regulatory permitting process.

Nevertheless, the Corporation staff believes the acquisition of certain environmental permits by Peat Methanol Associates is an important issue that the Corporation must address before executing any final financial agreement. Therefore, the staff has identified four major state permits or actions that it is closely following. They include (1) a change in the state's

water quality standard for mercury, (2) a pollutant discharge elimination permit for the project's methanol plant, (3) a pollutant discharge elimination permit for the project's peat harvesting operations, and (4) transfer of a permit to harvest the peat from First Colony Farms to Peat Methanol Associates. The Corporation staff estimates that each of these permits or actions will be decided on or around March 1984.

Because the Corporation plans to sign the final financial agreement around the end of 1983, it must decide whether or not it believes Peat Methanol Associates will face any difficulty in getting these major environmental permits or actions. According to the Corporation staff, the Board of Directors will make this decision after it has asked the staff for its "best judgment" on the matter.

The Energy Security Act states that the Corporation shall consider the potential to comply with applicable regulatory requirements as a factor in awarding financial assistance to a project. With respect to environmental compliance, the Corporation has interpreted this to mean it is not necessary for the project sponsor to have each and every permit or action in hand before signing a financial agreement. Instead, the Corporation is satisfied if there is reasonable assurance that all necessary permits or actions can be obtained by the project sponsor according to an established schedule.

In our view, this is not an unreasonable position. However, this raises the additional issue of whether or not Federal funds are at risk for a Corporation-approved project that is ultimately unable to obtain all necessary environmental permits or actions. According to the Corporation staff, it is their intent to include in any final agreement with Peat Methanol Associates a provision that will cover such a possibility. It will stipulate that if all necessary environmental permits or actions are not obtained according to an established schedule, this will be a basis for the Corporation's voiding the agreement.

JUSTIFICATION FOR THE CORPORATION'S PROVIDING PRICE GUARANTEES FOR THE PROJECT

In order to establish a synthetic fuels industry, the Congress authorized the Corporation--through the Energy Security Act--to provide project sponsors with various forms of financial assistance. These may include, in order of priority: (1) price guarantees, purchase agreements, or loan guarantees, (2) loans, or (3) joint ventures. The Congress considered it necessary to provide synthetic fuels projects with such financial assistance because of the inherent uncertainties associated with creating a new industry and the resulting probable lack of private investment capital.

Thus, the Corporation has the authority to enter into a financial agreement in which it guarantees a project sponsor a specified sales price for all or part of the output of the project. If the project sponsor is able to obtain, on the open market, a price for its output equal to or higher than the specified sales price, then the Corporation is subject to no financial obligation. If, however, the project sponsor can only obtain on the open market a price lower than the specified sales price, then the Corporation is obligated to pay the project sponsor the difference.

According to the Corporation, price guarantees are needed as an incentive to induce private capital investments in synthetic fuels projects. They represent an intent, between the Corporation and the sponsor, to share in the risks associated with developing commercial-size synthetic fuels projects. For this project, Corporation officials indicated that price guarantees serve to insulate the project sponsor from those risks over which the sponsor has no control. These risks include such things as market prices, inflation, and interest rates. On the other hand, this leaves the project sponsor subject to those risks it can control such as capital and operating costs, start date, and amount of production. If the project sponsor does a good job of controlling these latter risks, then price guarantees assure the sponsor a certain equity return on its investment.

In this particular project, the Corporation has agreed in the letter of intent to initially provide the project sponsor with a price guarantee of up to \$99 million. During the first 15 years after initial production or until the total amount of price guarantee runs out, for each gallon of methanol produced at the plant the Corporation will pay the sponsors an amount by which the specified sales price exceeds the price of the methanol on the open market. The price guarantee will be subject to review and possible renegotiation within 10 years after initial production. If, on the other hand, the price of the methanol on the open market exceeds the specified sales price, then Peat Methanol Associates and the Corporation will share the revenue on a 50/50 basis. This stipulation was added to prevent the sponsor from experiencing any windfall profits from the project without the federal government also participating.

Any revenue payments from Peat Methanol Associates to the Corporation will be deposited in an escrow account up to \$150 million. This account may be used for additional price guarantees should the market reverse itself, in which case the market price for methanol would be less than the Corporation's specified sales price. The specified sales price will start at \$1.05 per gallon as of January 1, 1983, and will be adjusted in accordance with appropriate standard indices plus 2 percent a

year. The market price will be calculated monthly on the basis of the weighted average sales price per gallon of methanol sold by Peat Methanol Associates during such month.

The Corporation estimates that this amount of price guarantee will provide the project sponsors with an annual return of its equity investment of between 15 percent to 20 percent over the life of the project. According to the Corporation staff, this range represents the low end of what it takes to get project sponsors to invest in a synthetic fuels project as opposed to some other venture. The Corporation staff said that during the last year it visited several investment bankers, insurance companies, and banks and determined from these sources what constituted a reasonable return on equity investment. The staff believes these visits support the return for this project.

OWNERSHIP AND DEVELOPMENT OF FIRST COLONY PEAT LANDS

According to a company representative, Peat Methanol Associates plans to lease peat land under an agreement being negotiated with First Colony Farms, Inc., of Creswell, North Carolina. First Colony Farms is wholly owned by McLean Securities, Inc., and the sole stockholder of McLean Securities, Inc., is Mr. Malcolm P. McLean. Under the agreement, Peat Methanol Associates will acquire real property, easements, and mineral rights to about 15,000 acres for which it will pay First Colony Farms

- \$2 million for the plant site, loading terminal, and easements;
- \$800 per acre for the peat reserves (subject to increase for actual inflation); and
- \$2 per dry ton of peat subject to adjustment if the wood content exceeds 25 percent and/or the British thermal unit value is less than 10,000 per pound.

First Colony Farms retains ownership of the harvested land and plans to convert the land to agricultural use.

Peat Methanol Associates also has an option to lease an additional 100,000 acres of First Colony Farms peat land. According to the agreement being negotiated, however, Peat Methanol Associates must exercise the option on a time-phased basis by 1988 or forfeit its rights to this additional land. The phases are 10,000 acres by the end of 1984, 20,000 acres in 1985, 20,000 acres in 1986, and the remaining 50,000 acres by the end of 1988. A representative of Peat Methanol Associates,

however, told us it will not consider expansion until sometime after its first plant is running.

IDENTITY OF THE PROJECT SPONSOR

The project sponsor--Peat Methanol Associates--is a partnership comprised of North Carolina Synfuels Corporation, Transco Peat Methanol Company, Energy Transition Corporation, and J.B. Sunderland (an individual). North Carolina Synfuels Corporation and Transco Peat Methanol Company are subsidiaries of Koppers Company, Inc., and Transco Energy Company, respectively. According to the partnership agreement, equity in Peat Methanol Associates currently consists of North Carolina Synfuels Corporation owning 70.3 percent, Transco Peat Methanol Company owning 23.45 percent, Energy Transition Corporation owning 5 percent, and J.B. Sunderland owning 1.25 percent.

This project has had considerable publicity because Energy Transition Corporation is owned by four former officials of the Ford administration and one current official of the Reagan administration. Specifically, these officials are Mr. Frank Zarb, former head of the Federal Energy Administration; Mr. Charles Robinson, former Deputy Secretary of State; Mr. William Turner, former United States representative to the Organization for Economic Cooperation and Development; Mr. Robert Fri, former head of the Energy Research and Development Administration; and Mr. William Casey, present head of the Central Intelligence Agency.

According to Mr. Fri, only he and Mr. Robinson have made a commitment of time to the project. Because of that, they own 91 percent of Energy Transition Corporation's 5-percent equity in Peat Methanol Associates. The other three individuals own a 3-percent interest each of the 5 percent. Mr. Fri also said that when Mr. Casey was appointed head of the Central Intelligence Agency he was removed as an officer and director of Energy Transition Corporation to avoid any possible conflict of interest. Mr. Casey sees none of the company's financial reports, and the only time he is involved with the company is when his signature, as a shareholder, is needed.

According to Mr. Fri, Energy Transition Corporation is not a cash contributor to Peat Methanol Associates.⁴ Its equity in the project is a result of it having initially conceptualized and defined the project. Energy Transition Corporation will participate in the profits of Peat Methanol Associates only after the facility has successfully operated and a period of

⁴Only North Carolina Synfuels Corporation and Transco Peat Methanol Company are cash contributors to the project.

time has elapsed during which cash has flowed to the cash contributors of Peat Methanol Associates. Thus, Mr. Fri said that Energy Transition Corporation may not start sharing in the profits of the project until the late 1980's.

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 CHIEF COUNSEL/STAFF DIRECTOR

Honorable Charles A. Bowsher
 Comptroller General
 General Accounting Office
 441 G Street, N. W.
 Washington, D. C. 20548

Dear Mr. Bowsher:

On October 29, 1982 I joined in a letter with the then Chairman of the Subcommittee on Environment, Energy and Natural Resources of the Committee on Government Operations, Congressman Toby Moffett, requesting that the General Accounting Office (GAO) examine certain financial assistance arrangements of the Synthetic Fuels Corporation (SFC) and that the GAO brief our Subcommittees concerning the legality of these arrangements. I continue to want the GAO to examine these matters and brief us, but I also want the GAO to provide a legal opinion as well. I would appreciate your advising me of the GAO's progress and when an opinion can be expected.

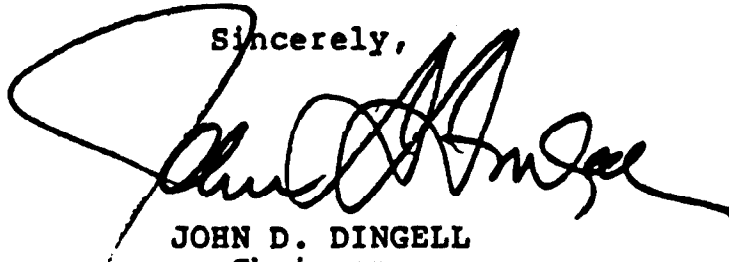
In addition, I request that the GAO examine the activities of the SFC, including the SFC salaries, expenses, travel costs, contracts, and consultant fees, and the achievements, if any, of the SFC, including a review of the results of the SFC general solicitations. I am particularly interested in the GAO examining all the circumstances surrounding issuance of a letter of intent by the Chairman of the SFC Board of up to \$486 million in loan guarantees and price supports for a project to produce methanol fuel from peat stripped from swampy North Carolina coastal lands. Enclosed is an article from the December 22, 1982 edition of the Washington Post concerning the project and a copy of a letter I have sent to the SFC concerning this project. I am interested in the legal authority for such letter of intent, the authority of the Board Chairman to issue such documents, why the staff recommended against such Federal backing of the project, why the project is being criticized by North Carolina environmentalists,

Honorable Charles A. Bowsher
January 11, 1983
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the extent to which the SFC has considered such criticism and taken into account the impact of the project on pollution and valuable natural resources, whether or not the Davis-Bacon Act applies, as a result of this financing, to this and other SFC projects, why price guarantees are required for the project, who owns the coastal peat lands, the arrangements for developing the lands, and who are all of the project sponsors.

The examination should also include a review of the new SFC approach of offering to guarantee payments of up to double current oil prices as an incentive under a new solicitation approach to begin this month, including the legality and reasonableness of this approach, at a time of falling oil prices.

Sincerely,



JOHN D. DINGELL
Chairman
Subcommittee on
Oversight and Investigations

Enclosures

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