COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-196523

SEPTEMBER 25, 1980

The Honorable Cecil D. Andrus
Secretary of the Interior

Dear Mr. Secretary:

Subject: GAO's Basis for Its Analysis of S.1637 (EMD-80-116)

This is in response to your letter of June 16, 1980, taking issue with our March 14, 1980, report "Impact of Making the Onshore Oil and Gas Leasing System More Competitive" (EMD-80-60). Following is a point-by-point analysis of the issues raised in your letter, along with some restatement or amplification of the basis for the positions taken in our report.

CHANGE FROM PRIOR GAO POSITIONS

It is true that we did advocate competitive onshore oil and gas leasing in 1970 on the grounds that many tracts apparently could have generated greater revenues if leased competitively. We would reiterate, however, the point made in our report as well as in recent testimony before the House Interior Committee's Subcommittee on Mines and Mining--that changing world and national circumstances during the past decade call for some change in emphasis. Domestic energy production is much more vital now than then, and we were unable to satisfy ourselves--nor did Interior offer any evidence--that S.1637 would not have a detrimental effect on production. Moreover, we did not find that it would even necessarily increase revenues to the Government or ensure receipt of "fair market value."

The point should also be made that we are not irrevocably committed to non-competitive leasing; our position is only that major changes should not be made to the present system if the uncertainty of their effect is too great, and particularly if the problems cited can be solved through less drastic administrative or regulatory changes.

We cannot respond specifically to your statement that we endorsed competitive onshore oil and gas leasing in 1978, without knowing the particular report to which you refer. The only report we have issued on this subject since 1970, other than our March 1980 report, is an April 13, 1979, report "Onshore Oil and Gas Leasing--Who Wins the Lottery?" (EMD-79-41), which dealt with potential abuses of the lottery system. It did not advocate a particular leasing system.

OPPOSITION TO S.1637 WHILE ENDORSING MANY OF ITS FEATURES

You feel that our opposition to S.1637 is inconsistent with our endorsing many of its features. We agree with the Department of the Interior that there are many aspects of the present leasing system in need of modification; we had so stated in our 1979 report on the lottery system. GAO has always strived for impartiality and, accordingly, where we saw desirable features in S.1637, we pointed them out. We felt overall, however, that possible adverse effects of the bill outweighed the strong points. We endorsed the bill's objective of limiting assignments and excessive overriding royalties, encouraging diligence, and reducing potential lottery abuses. However, we were reluctant to endorse a bill that could be accomplishing these objectives at the expense of production.

DIFFICULTY IN FORECASTING RESULTS WITHOUT COMPETITIVE EXPERIENCE

You stated that Interior is being unfairly criticized for not adequately analyzing the bill's effects, and that it is impossible to gather the type of data necessary to accurately forecast the effects of S.1637. At least, then, we are in agreement that the impact of S.1637 is difficult to predict. We assume from this statement that if S.1637 were passed and found to have an adverse impact on independent oil companies or on production, that other alternatives would then be tried.

Interior had not attempted to predict the bill's impact on production, and since logical reasons have been offered from many sources as to why production might be adversely affected, we felt precluded from endorsing the bill. We would have felt far less apprehensive had there been some analysis of these issues, e.g., some indication that the areas outside the producing geologic provinces (PGPs) would be sufficient to sustain the independent oil producer, or an analysis of

the significance of large up-front expenditures and increased rentals on the profitability of a typical oil well. We feel that some effort could have been made in these and other regards.

BILL'S LACK OF AN OBJECTIVE

We did not state, as you indicated, that the bill has no objective--only that the objectives are not clear. Certainly the bill has features directed specifically at such things as increased diligence and tighter control over assignments. We acknowledged this. But the central thrust of the bill seems directed toward reducing noncompetitive leasing and increasing competitive leasing. This could have been from a desire to price the speculator out of the market, and open up the land directly to the developer for production; it could be a means to eliminate abuse of the lottery system; it could be a means to increase Federal receipts; or a combination of the three. Our study suggested adverse effects on production, and since there are other less drastic measures to alleviate the other problems, we felt the dominant objective was not clear. Since these objectives tend to be incompatible to a degree, we suggested that a clear objective would be desirable both in formulating and evaluating any such legislation. We still feel that way.

EMPHASIS ON REVENUES

It is also true that our report dwelt heavily on revenues and much more lightly on production, but this is a reflection of Interior's analysis. Our objective was not to formulate our own onshore oil and gas leasing program. Our objective was to evaluate Interior's basis for the leasing system it was recommending, i.e., S.1637.

Interior had made forecasts of revenue and expense which, as you pointed out, we analyzed, but Interior had no projections of production impact. This left us nothing to analyze on the production side and further contributed to our conclusion that production was a subordinate issue to revenues from Interior's point of view. In fact, on July 24, during testimony before the House Mines and Mining Subcommittee, Assistant Secretary Martin acknowledged that Interior still has not forecasted the impact of the bill on production.

USE OF AN UP-FRONT BONUS
AS AN INCENTIVE TO PRODUCE

We do not agree with your observation that an up-front bonus is a major incentive to produce and make the lease "pay off." An up-front cost is a "sunk" cost and while it may be a factor in a decision to develop a lease, we would think such a decision will be based primarily on seismic data and other physical evidence, and on the likelihood of the tract generating revenues above current operating costs to the lessee.

A higher up-front cost will, on the other hand, make an operator more cautious about making the initial investment, and may limit the ability of the smaller firm to even make the investment. We therefore continue to believe that the most likely impacts of a high up-front cost are a reduction in acreage leased and a reduction in capital available for exploration and, as a result, a possible reduction in production.

RELATIONSHIP OF ACREAGE TO PRODUCTION

You state that our report fallaciously equates acres leased to amounts of production. We do not see where our report does this, beyond a general statement (as on pages 32 and 38 of our report) that delays in making lands available for lease could reduce production. In fact we point out on page 25 (and on page 2 of your letter you apparently agree) that much of the currently leased land may well be of interest only to a pure speculator, and would simply lie unleased in a competitive situation, or draw only token bids at best.

We see an inconsistency in anyone's suggestion that production could be enhanced if "valueless" lands being held by speculators were made directly available to developers through competitive leasing. Conversely, of course, a reduction in acreage leased that might otherwise have been developed could reduce production, as discussed in the previous section.

RELATIONSHIP OF PGPs
TO SEDIMENTARY BASINS

Our report stated that much high-interest land may lie outside PGPs and thus not be subject to competitive leasing under S.1637. You disagree, saying that the competitive lease areas, i.e., the PGPs, will go beyond the sedimentary basins.

In an attempt to determine the definition of a PGP we were referred to a U.S. Geological Survey (USGS) official who said that although subject to considerable judgment, the PGPs should equate roughly to a sedimentary basin. The only possible exception to this, we were told, was that it would not likely encompass an area as large as say, the Williston Basin, which covers most of North Dakota and large areas in South Dakota and Montana. We were provided maps of these basins by the USGS, and found that they do not cover the Overthrust Belt in Wyoming and other producing areas.

If we now have PGPs going beyond the basins, i.e., "expanded PGPs" to cover competitive interest areas (rather than areas with known production), that would certainly tend to refute our observation that some valuable areas may be overlooked. However, it would also alter our statement that PGPs are based on generally accepted geologic terminology. This only further emphasizes our observation as to the difficulty in knowing what will happen if this legislation is enacted. Apparently a PGP will be as large as Interior wants it to be. This to us would defeat one of the main stated purposes of the PGP--to keep some promising wildcat areas on a noncompetitive basis as a protection of the small developer.

FRAUDULENT ACTIVITIES

While we have little first-hand knowledge of the extent of the abuses that have been or may be uncovered in the current investigation of the noncompetitive system, we share your concern about the potential for widespread abuse. Both our 1979 report as well as the report which is the subject of this letter have advocated tighter controls--which we have believed can be instituted administratively--through regulations without a major overhaul of the leasing system itself. A competitive system, of course, can also be abused if not properly administered.

In addition, we do note that in suspending the lottery system, you announced that such suspension would remain in effect until changes could be made to correct the abuses or, if found necessary, to convert to an all-competitive system. Changes similar to those we recommended in our 1979 report or endorsed in our recent report have been made and the suspension has been lifted--which would indicate that the potential for such abuses has been greatly reduced.

QUESTIONABLE DOMINANCE OF A COMPETITIVE SYSTEM BY MAJORS

Your letter indicates that the independent producers should fare well if S.1637 is enacted because they are doing well under present competitive situations. We disagree. The way the present competitive system is working is in no way indicative of what would happen in the kind of all-competitive system proposed. First of all, there are very few competitive leases now and most are very small tracts, presumably aimed at enhanced recovery of previously developed deposits. This is hardly a strong motivation for the majors. But, if the tracts are enlarged and most leases become available to the highest bidder rather than to the developer who is willing to assemble small tracts piecemeal, then both the ability of the majors to dominate and their inclination to do so would likely increase--particularly with the lifting of price controls.

RELATIONSHIP OF S.1637 AND REGULATORY AND ADMINISTRATIVE CHANGES

You also state that the regulatory proposals published on September 28, 1979, were not a companion action to S.1637, and that of S.1637 would require further regulatory changes. But in all our discussions with Interior personnel we were led to believe that S.1637 and the proposed rules published in the Federal Register on September 28, 1979, went hand-in-hand, e.g., that S.1637 would increase the competitive tract size while the regulatory changes would be used to increase the noncompetitive tract size.

Further, both S.1637 and the proposed administrative and regulatory changes came from the same task force study and resulting Secretarial Issue Document. Your testimony on the leasing suspension, in fact, linked S.1637 and the regulatory and administrative changes, certainly giving the impression that it was all one "package." In any event, we feel we would have been remiss in ignoring the regulatory changes since they are an integral part of the entire leasing system.

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We agree with your observation that a close working relationship between Interior and GAO is desirable for all concerned, and we recognize your time for comment was limited.

It is our policy to allow up to 30 days if possible for agencies to comment on our draft reports. There are, however, times when the needs of the Congress dictate that our report processing steps be expedited, and in some instances that little or no time be given for agency comments. This report was one such case. We did, however, obtain the requestor's concurrence in this case to allow us to provide a draft of this report to your Department for informal comment. Our draft was hand-carried to responsible program officials on February 29, six calendar days--not two as your letter indicated--before we sat down with them on March 6, to discuss its contents. In view of a deadline imposed by the requestor, we feel we did our best to work cooperatively with your Department--and we intend to continue to do so.

A copy of this letter is being sent at his request to the Chairman, Subcommittee on Mines and Mining, House Committee on Interior and Insular Affairs. We are also sending copies of this letter to other interested Members of Congress.

Sincerely yours,

Comptroller General
of the United States