

April 1988

Federal Coal Royalty Reduction and Product Valuation

David B. Pariser
The Catholic University of America

Follow this and additional works at: <https://researchrepository.wvu.edu/wvlr>

 Part of the [Oil, Gas, and Mineral Law Commons](#), and the [Property Law and Real Estate Commons](#)

Recommended Citation

David B. Pariser, *Federal Coal Royalty Reduction and Product Valuation*, 90 W. Va. L. Rev. (1988).
Available at: <https://researchrepository.wvu.edu/wvlr/vol90/iss3/6>

This Article is brought to you for free and open access by the WVU College of Law at The Research Repository @ WVU. It has been accepted for inclusion in West Virginia Law Review by an authorized editor of The Research Repository @ WVU. For more information, please contact ian.harmon@mail.wvu.edu.

FEDERAL COAL ROYALTY REDUCTION AND PRODUCT VALUATION

DAVID B. PARISER*

I. INTRODUCTION

The Bureau of Land Management (BLM) announced new guidelines in June 1987, setting forth the Department of the Interior's policy of reducing royalties for federal coal and other solid mineral leases below minimum rates established by statute.¹ The guidelines implement Section 39 of the Mineral Lands Leasing Act of 1920 ("MLLA"), as amended,² which grants the Secretary of the Interior broad discretionary authority to reduce royalty rates for purposes of encouraging recovery or conservation of solid leasable mineral deposits, promoting their development, and ensuring the successful operation of mines operating on federal lands. In announcing the guidelines, BLM also lifted its suspension of taking final action on 20 pending applications for royalty rate reductions.

The guidelines establish four categories under which lessees may apply for royalty reductions and provide for uniform criteria BLM is to use to evaluate such applications. The duration of a royalty reduction can vary, depending on the category under which an application is filed. For example, applications approved under two categories would receive an automatic reduction in the royalty rate to 8 percent for surfaced-mined coal and 5 percent for deep-mined coal. Two other categories would require applicants to submit lease-specific financial data and pass a "financial test" for determining whether a royalty reduction would be appropriate.

* David B. Pariser is a faculty member of the Department of Economics and Business, The Catholic University of America; he is also on the Professional staff of the United States General Accounting Office, Washington, D.C.; B.S. West Virginia University; M.S., Southern Illinois University; Ph.D., Southern Illinois University. The views expressed in this article are those of the author and not necessarily those of the General Accounting Office.

1. 52 Fed. Reg. 24,347 (1987).

2. Mineral Lands Leasing Act of 1920, Pub. L. No. 97-98, 95 Stat. 1070-1071 (codified as amended at 30 U.S.C. § 209 (1982)).

Like other areas of federal regulation of energy, complex and technical issues are related to the royalty reduction guidelines and their implementation.³ The development of the guidelines, however, has been surrounded by controversy stemming from the Federal Coal Leasing Amendments Act of 1976 ("FCLAA")⁴ and proposed revisions of coal product valuation regulations administered by the Interior Department's Minerals Management Service (MMS).⁵ Central to the controversy are issues relating to potential coal market distortions caused by a higher royalty rate and an expansive definition of gross proceeds for royalty computation purposes. This Article traces the development of the coal royalty reduction guidelines. It also addresses certain provisions of MMS's proposed coal product valuation regulations which potentially could affect the administration of royalty reduction guidelines.

II. READJUSTMENT OF PRE-FCLAA LEASES

FCLAA changed the basis for royalties from a cents-per-ton (unit royalty) to a percentage of value (ad valorem) royalty, and established a minimum royalty rate of 12.5 percent of the value of the coal as defined by regulation for surfaced-mined coal.⁶ The Act authorized the Secretary to set a lesser royalty rate for underground-mined coal.⁷ Before 1976, federal coal leases were issued for an indeterminate period and were subject to a royalty rate of no less than \$0.05 per ton, and royalties ranged between \$0.15 and \$0.20 per ton. FCLAA also authorized the Secretary of the Interior to readjust lease terms and conditions, including royalties, at the end of the 20-year primary term and every 10 years thereafter, if extended. The Interior Department has promulgated regulations cov-

3. For a thorough discussion of federal regulation of energy, see W. FOX, *FEDERAL REGULATION OF ENERGY* (1983).

4. Federal Coal Leasing Amendments Act of 1976, Pub. L. No. 94-377, 90 Stat. 1083, 1087 (codified as amended at 30 U.S.C. § 201 (1982 & Supp. III 1985)).

5. 52 Fed. Reg. 1,840-1,856 (1987).

6. 43 C.F.R. § 3451.1 (1986) (to be codified at 30 U.S.C. 207). For a discussion of the evolution of coal royalty provisions, see Errebo, *Coal Royalties*, 26 ROCKY MOUNTAIN MIN. L. INST. 75-115 (1980).

7. Although the Secretary of the Interior set a uniform royalty rate for underground coal at a minimum of 8 percent of value, the court in *Coastal States Energy Co. v. Hodel*, 816 F.2d 502 (10th Cir. 1987), held that underground coal lease rates should be determined on a lease-by-lease basis, but not less than 8 percent of value.

ering readjustments of lease terms and conditions of pre-FCLAA leases.⁸

As of September 30, 1986, there were 596 federal coal leases of which 538 were issued prior to the enactment of FCLAA. Of these 538 pre-FCLAA leases, 329 were scheduled to have their royalty provision readjusted from a cents-per-ton to a value-of-production basis. About half, or 167, of these leases had been readjusted while the remaining were in various stages of processing, as shown in Table 1. The readjustments have caused about a 5 to 10-fold increase in the royalty paid on federal coal.⁹ BLM's failure to readjust leases in a timely fashion and impose the 12.5% royalty rate required under FCLAA for surfaced-mined coal was the subject of a recent General Accounting Office (GAO) study.¹⁰ According to the GAO study, between 1976 and 1984, the Bureau of Land Management did not readjust 149 of 241 federal coal leases by their lease anniversary dates. As a result, untimely adjustments resulted in a loss to the federal government estimated at \$187 million in royalty and rental revenue.¹¹

The timeliness of readjustment and the imposition of the 12.5% royalty rate have been principal issues of recent litigation. In *Rosebud Coal Sales Co., Inc. v. Andrus*,¹² the court ruled that the Interior Department has the right to readjust lease terms at the end of each 20-year period, and that this right is in the nature of an option to make adjustments the Department considers necessary or to let the opportunity pass.¹³ The court also ruled that readjustment must be made when each 20-year period expires and not later.¹⁴ In *Rosebud*, there was no notice of any sort sent the coal company by any representative of the Department of the Interior until two and one-half years after the expiration of the second 20-year pe-

8. 43 C.F.R. § 3451.1(c) (1986).

9. U.S. GEN. ACCOUNTING OFFICE, COAL LEASE READJUSTMENT PROBLEMS REMEDIED BUT NOT ALL REVENUE IS COLLECTED 2 (Aug. 1987).

10. *Id.*

11. *Id.* at 16.

12. *Rosebud Coal Sales Co. v. Andrus*, 667 F.2d 949 (10th Cir. 1982).

13. *Id.* at 951.

14. *Id.*

riod.¹⁵ According to the court, such notice was not provided within a reasonable time and did not give the Department authority to readjust.¹⁶

Table 1
STATUS OF PRE-1976 FEDERAL COAL LEASES
AS OF SEPTEMBER 30, 1986

Lease Status	Number of Leases
Readjusted	167
In appeal:	98
IBLA	78
Court	20
Waived ^a	30
Relinquished ^b	33
Total	328

^a Waived—Interior surrenders its right to take any readjustment action on the lease anniversary date for failure to comply with its own regulations.

^b Relinquished—the lessee surrenders the entire lease, or any subdivision of the lease, to the federal government.

Source: U.S. General Accounting Office, *Coal Lease Readjustment Problems Remedied But Not All Revenue Is Collected* (August 1987).

In *FMC Wyoming Corp. v. Hodel*,¹⁷ the court ruled that the decision of the Secretary to readjust terms and conditions when notice was given over six months before an anniversary date was in compliance with both the statute and the language of the leases and, hence, was timely, notwithstanding that final action on the decision did not occur until 37 days after the anniversary date.¹⁸ The court also ruled that the Secretary could increase the royalty

15. *Id.* at 950.

16. *Id.* at 953.

17. *FMC Wyoming Corp. v. Hodel*, 816 F.2d 496 (10th Cir. 1987).

18. *Id.* at 501.

rate on the anniversary date of the lease, subject to any statutory law in effect.¹⁹ As for pre-FCLAA leases containing a minimum royalty rate of \$0.05 per ton, the court ruled that the Department could raise the minimum rate to 12.5% of the value of the coal on the anniversary date subsequent to FCLAA.²⁰

In *Coastal States Energy Co. v. Hodel*,²¹ the court held that notice of intent to readjust terms and conditions of a federal coal lease, if sent before the anniversary date, preserves the right of the Secretary to readjust terms of the lease within a reasonable time thereafter.²² The court also held that Interior Department regulation requiring a royalty rate of not less than 8% of the value of underground-mined coal could not be read as requiring BLM to automatically set the readjusted rate at 8% for all underground-mined coal.²³ The court noted that an exception set forth in the regulation provided that a lesser royalty rate, but not less than 5%, could be set if conditions warranted.²⁴ Thus, the court held that a royalty rate of less than 8% may be placed on readjusted underground-mined coal on the anniversary date if conditions warrant.²⁵

III. POTENTIAL COAL MARKET IMPACTS OF FEDERAL ROYALTIES: UNIT V. AD VALOREM ROYALTY

Under competitive market conditions, microeconomic theory indicates that the imposition of royalty affects the demand for coal, the level of coal production, and coal prices to consumers.²⁶ Basically, royalty may be assessed as a percentage of the selling price

19. *Id.*

20. *Id.*

21. *Coastal States Energy Co. v. Hodel*, 816 F.2d 502 (10th Cir. 1987).

22. *Id.* at 505.

23. *Id.* at 507.

24. *Id.*

25. *Id.*

26. Recent studies indicate that the coal industry is competitive in nature, market forces of supply and demand being the primary determinants of prices and production levels. See U.S. GEN. ACCOUNTING OFFICE, *THE STATE OF COMPETITION IN THE COAL INDUSTRY* (Dec. 1977), Gordon, *Federal Coal Leasing Policy: Competition in the Energy Industries* (1981), ZIMMERMAN, *THE U.S. COAL INDUSTRY: THE ECONOMICS OF POLICY CHOICE* (1981); U.S. DEP'T OF ENERGY, *COAL COMPETITION: PROSPECTS FOR THE 1980s* (1981); U.S. DEP'T OF JUSTICE, *COMPETITION IN THE COAL INDUSTRY* (Nov. 1980).

(i.e., value of coal sales), referred to as an ad valorem royalty, or, it may be imposed as a given amount per unit of output (ton of coal) sold—i.e., a unit royalty.²⁷ From a royalty revenue administration perspective, an ad valorem royalty has the advantage of permitting the same rate to be applied to various types of coal, thus providing a built-in revenue flexibility in inflationary periods. A unit royalty, on the other hand, remains constant per unit of output as prices rise, and lacks built-in revenue flexibility.

A. Unit Royalty

When a unit royalty is imposed upon a competitive coal industry, unit cost of production rises by a constant amount for all levels of output, resulting in a parallel upward shift in the industry marginal cost (i.e., supply) curve. Alternatively, a unit royalty may be interpreted as causing a similar downward shift in the average-revenue (i.e., demand) curve. Figure 1 depicts the latter interpretation. The industry demand curve before imposition of a royalty is represented by line DD, and line SS is the industry supply (cost) curve. The pre-royalty equilibrium is A, where the supply and demand curves intersect at price P_1 and output Q_1 .

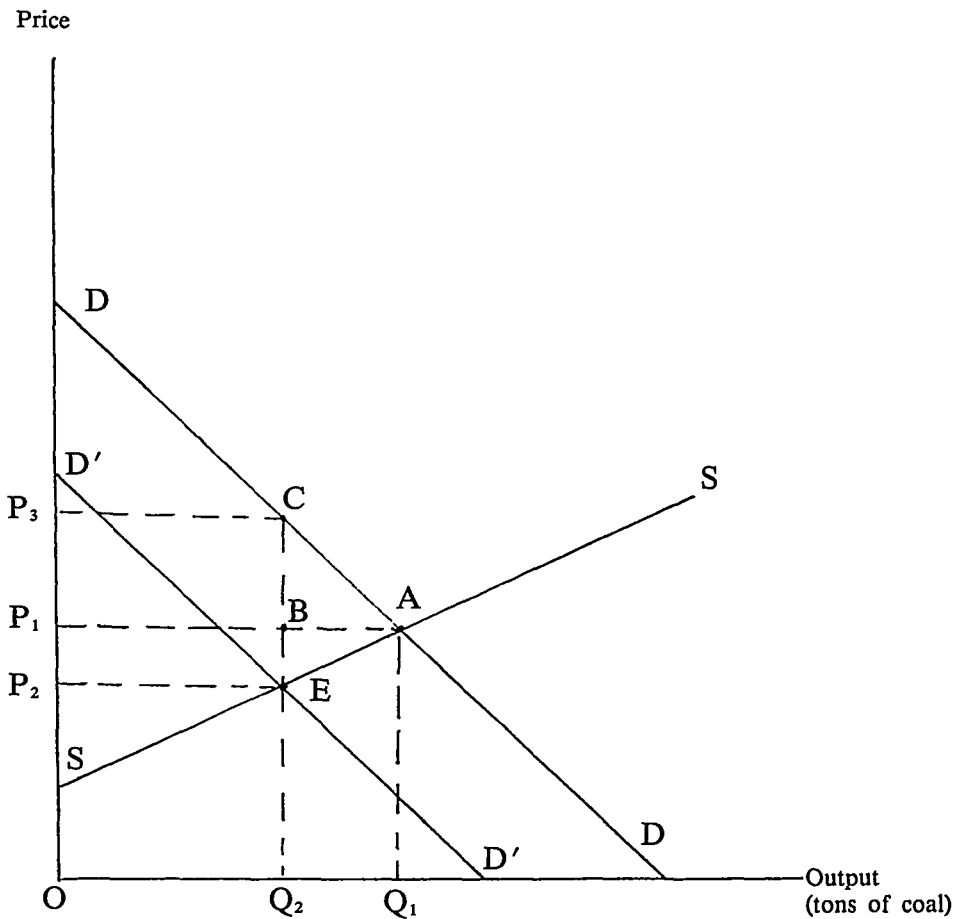
The imposition of a unit royalty is shown by a downward shift in the demand curve from DD to D'D'. The vertical distance between the two demand curves is the amount of the unit royalty (CE). Market adjustment to the unit royalty results in a new equilibrium at C, where the new demand curve and supply curve intersect; output falls to Q_2 , the gross price rises to P_3 , and the net price falls to P_2 .²⁸ The area (P_2P_3CE) represents royalty revenue accruing to the government. The extent of the price increase depends on the slopes of the supply and demand curves. In the case of an increasing cost industry, as shown in Figure 1, the price

27. The impact of an ad valorem and unit royalty on production and price levels is similar to that of an ad valorem and unit sales or excise tax. The discussion is based on microeconomic theory of taxation and public finance. See R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 450-54 (1980), and R. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 302-311 (1959).

28. Gross price is the equilibrium market price after the royalty is imposed, and represents the unit selling price. Net price is the unit price received by the industry after royalty is imposed, and is

increase (P_3 minus P_1 , or CB) falls short of the unit royalty (CE), reflecting the cushioning effect of the reduction in unit cost with declining output. For a constant cost industry (i.e., where the industry supply curve is horizontal), the increase in price equals the unit royalty.

Figure 1
Unit Royalty



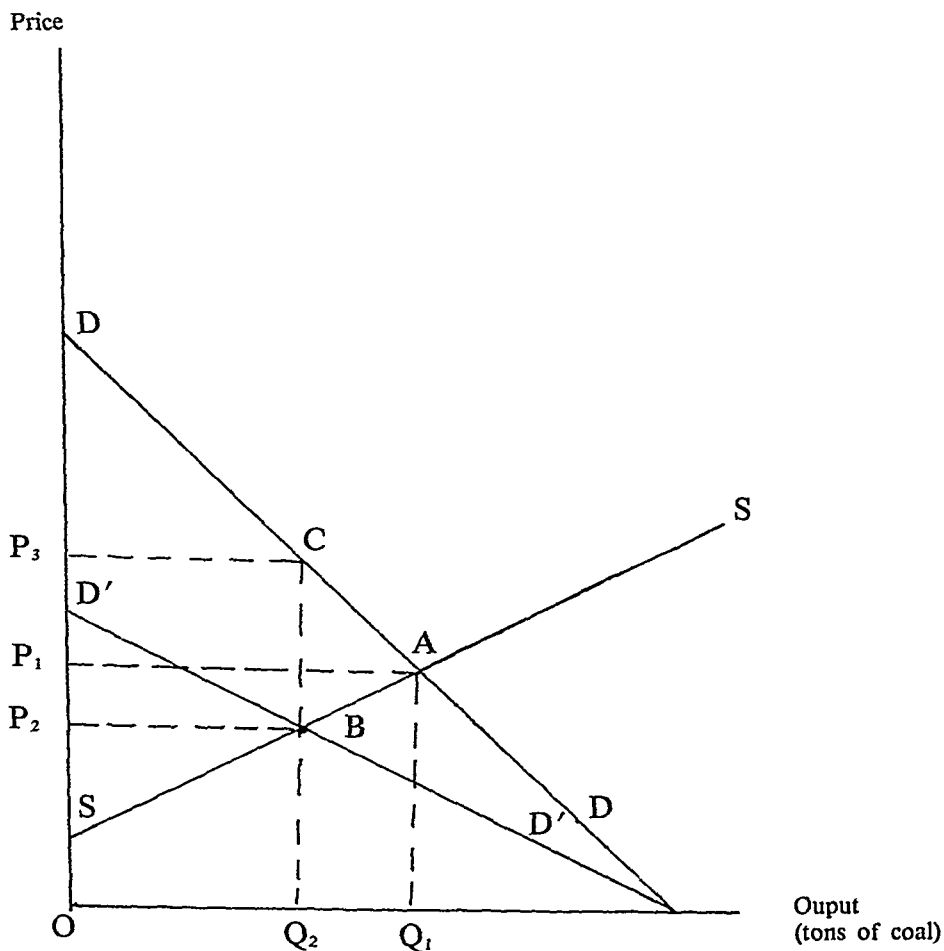
B. *Ad Valorem Royalty*

An ad valorem royalty is a constant percent of price, and amount of royalty per unit of output varies with price. The adjustment to an ad valorem royalty by a competitive industry is shown in Figure 2. The industry demand and supply curves without a royalty are DD and SS, respectively, and equilibrium market price is P_1 and equilibrium output is Q_1 . Imposition of an ad valorem royalty causes the demand curve to pivot downward to the left to D' , the new net demand curve. The new equilibrium is at point C; gross price rises to P_3 , net price falls to P_2 , and output falls to Q_2 . Royalty revenue to the government is shown by the area P_2P_3CB . The effects of an ad valorem royalty are similar in direction to those for the unit royalty.

C. *Comparison of Unit and Ad Valorem Royalty Yielding Equal Revenue*

Theoretically, the government could obtain a desired amount of royalty revenue from either a unit royalty or an ad valorem royalty. From an economic perspective, there is the question of whether the government generally should prefer one type over the other to generate a given level of revenue. Figure 3 compares a unit and ad valorem royalty generating the same amount of revenue. Without a royalty, equilibrium is at A where the industry demand curve DD intersects the industry supply curve SS, at price P_1 and output Q_1 . Assuming that a unit royalty of EG is imposed, the industry demand curve shifts downward to the left from DD to $D'D'$. The new equilibrium is at E; gross price increases to P_2 , net price falls to P_3 , and output falls to Q_2 . Revenue to the government equals the area P_3P_2EG .

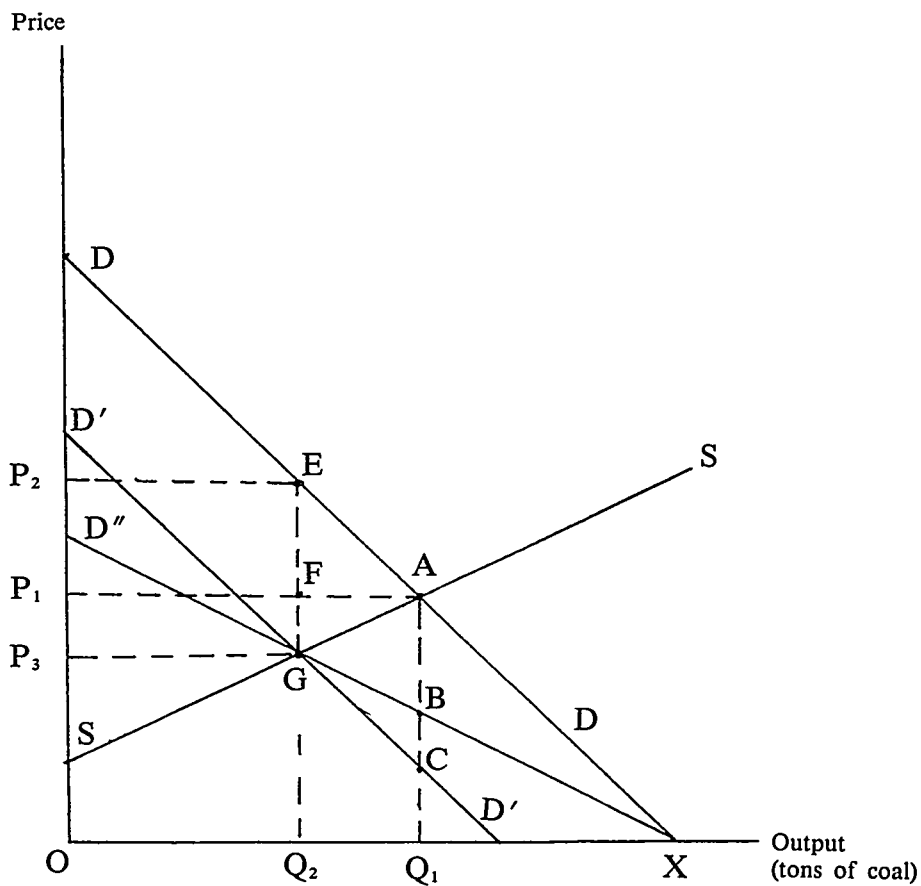
Figure 2
Ad Valorem Royalty



To obtain the same revenue and increase in gross price from an ad valorem royalty, the new net demand curve (D'') must intersect the supply curve at G. Figure 3 also shows that at the equilibrium output the ratio of unit tax to net price (EG/GQ_2) equals the ad valorem royalty rate (EG/GQ_1). It can also be shown that a unit royalty involves a higher burden at the initial price (P_1) compared to the ad valorem royalty.²⁹ Furthermore, when comparing a unit and ad valorem royalty that impose the same burden at the initial price, the ad valorem royalty will result in a larger price increase compared to the unit royalty, since the net demand curve must pivot further downward to the left to intersect at C.

29. Figure 3 illustrates that the unit royalty involves a higher burden at the original price (P_1) compared to the ad valorem royalty. As shown in Figure 3, at the initial price, P_1 , the unit royalty equals AC, whereas the ad valorem royalty of AB is lower. This condition comes about because the unit royalty involves a parallel shift in the demand curve, while the ad valorem royalty involves a pivoting of the demand curve.

Figure 3:
Unit and Ad Valorem Royalty Yielding Equal Revenue



IV. FACTORS SHAPING THE DEVELOPMENT OF ROYALTY RATE REDUCTION POLICY

Federal coal royalty rate reductions authorized under section 39 apply only to previously issued leases; royalty rates cannot be reduced below the statutory minimum prior to a lease sale. Section 39 provides that:

The Secretary of the Interior, for the purpose of encouraging the greatest ultimate recovery of coal . . . and in the interest of conservation of natural resources, is authorized to waive, suspend, or reduce the rental, or minimum royalty, or reduce the royalty on an entire leasehold, . . . whenever in his judgment it is necessary to do so in order to promote development, or whenever in his judgment the leases cannot be successfully operated under the terms provided therein . . .³⁰

An issue currently receiving considerable attention is whether the statutory minimum coal royalty rate is excessive and, if so, the extent to which it adversely affects the timing and operating efficiency of federal coal leases.³¹ A recent study of federal coal leasing policy stated that:

The royalty rate of 12.5 percent on surface-mined coal is probably excessive. Because federal coal is such a large share of western reserves, this royalty tends to be adopted for private as well as federal coal. One effect of the royalty is to make it unprofitable to mine some coal that could be mined profitably in the absence of the royalty The precise coal royalty figure of 12.5 percent was actually selected by the Congress because this amount had long been the minimum permissible royalty rate for federal oil and gas—hardly a sound basis for setting a federal coal royalty.³²

The issue was also addressed recently by the Commission on Fair Market Value Policy for Federal Coal Leasing.³³ The Commission noted that in those cases where federal coal leases are rendered unprofitable to mine because of the minimum royalty, operators are caused to deviate from an otherwise optimal production schedule by

30. 30 U.S.C. § 209.

31. See Gordon, *supra* note 26.

32. R. NELSON, THE MAKING OF FEDERAL COAL POLICY 225 (1983).

33. See REPORT OF THE COMMISSION ON FAIR MARKET VALUE POLICY FOR FEDERAL COAL LEASING 313-19 (Feb. 1984) [hereinafter cited as REPORT OF THE COMMISSION]. Congress established the Commission on Fair Market Value Policy For Federal Coal Leasing by enacting Pub. L. No. 98-63, 97 Stat. 301 (1985), signed into law by President Reagan on July 30, 1983. The purpose of the Commission was to study the federal coal management program and resolve controversies surrounding the Interior Department's coal leasing procedures and the determination of fair market value.

mining adjacent private coal lands available at a lower royalty.³⁴ The implication is that bidders at federal coal lease sales reduce their bids or refuse to bid, opting to bypass unprofitable federal coal or shift production to nonfederal lands having lower royalty rates. In addition, a recent study by the Department of Energy (DOE) expressed concern over obstacles to increased coal use deserving further study and analysis.³⁵ With regard to whether current federal coal royalty rates are excessive, and constraining the efficient development of federal coal lands, the DOE study stated that:

Federal royalties on leases granted since 1976 generally have been 8 percent for underground mines and 12.5 percent for surface mines. When first imposed in 1976, these rates were far above prevailing levels; and if royalties on Federal coal are excessive, the Government may lose revenues in the long run—while at the same time consumers pay higher-than-efficient prices for coal. In addition, pre-1976 lease royalties are typically paid on a cents-per-ton basis rather than being computed as a percentage. This situation may distort production away from the lowest cost coal supplies.³⁶

A. BLM's Royalty Bidding Experiment

Federal coal leases are normally awarded at a fixed royalty rate to the bidder who submits the highest cash bonus exceeding the minimum bid established by BLM. Soon after the enactment of FCLAA, BLM encountered difficulties estimating the value of emergency leases which were not expected to attract competition at lease sale auctions. As a result, BLM experimented with different methods of announcing minimum bids before holding emergency lease sales.³⁷

In June 1977, BLM adopted an experimental royalty bidding policy which allowed coal companies to acquire leases having royalty rates higher than the minimum (12.5%) in lieu of paying higher front-end cash bonuses. The purpose of this policy was to receive fair market value in the form of production royalty over the life of the

34. *Id.* at 315.

35. U.S. DEP'T OF ENERGY, ENERGY SECURITY: A REPORT TO THE PRESIDENT OF THE UNITED STATES (Mar. 1987).

36. *Id.* at 170.

37. U.S. GEN. ACCOUNTING OFFICE, LEGISLATIVE CHANGES ARE NEEDED TO AUTHORIZE EMERGENCY

lease.³⁸ The Department believed that this approach would be less onerous to potential bidders, since the minimal cash bonus (usually \$25 per acre) would be acceptable to bidders.³⁹ Between June 1978 and January 1980, the Interior Department awarded 6 leases through royalty bidding whose royalty rates ranged from 15.5 to 21 percent.⁴⁰

With regard to royalty bidding, the Commission on Fair Market Value Policy for Federal Coal Leasing found significant disadvantages to royalty bidding and to higher royalty rates in general.⁴¹ One disadvantage is the ambiguity concerning which bidder will pay the most for a particular lease, and whether the bidder would actually bring the lease into production. With regard to this point, the Commission stated that:

High royalty rates may make development of the coal reserves uneconomical. This is the greatest economic disadvantage of high royalties; like sales taxes, they raise the price required for profitable operation. If no potential buyer is willing to pay the price needed to cover the royalty and the costs of development and operation, the project may be unprofitable and the lessor will, of course, receive no royalty. Such losses of coal production and royalty payments can occur on marginal decisions to continue or expand development just as they can on an entire project. In general, high royalties may serve to impede development of all but the lowest cost coal.⁴²

BLM's royalty bidding experiment was controversial because the higher royalty rates resulted in making several mining operations unprofitable. Four of the six leases awarded with royalty rates above the 12.5 percent statutory minimum requested and were granted royalty reductions under section 39.⁴³ In December, 1983, BLM denied Peabody Coal Company's application for a 3-year royalty reduction, from 17.08 to 5 percent, for a coal lease awarded in April 1979, under the royalty bidding experiment.⁴⁴

38. U.S. GEN. ACCOUNTING OFFICE, NEED FOR GUIDANCE AND CONTROLS ON ROYALTY RATE REDUCTIONS FOR FEDERAL COAL LEASES 9-10 (Aug. 10, 1982) [hereinafter NEED FOR GUIDANCE AND CONTROLS].

39. For a discussion of alternative bidding systems, see S. McDONALD, THE LEASING OF FEDERAL LANDS FOR FOSSIL FUELS PRODUCTION 95-120 (1979).

40. NEED FOR GUIDANCE AND CONTROL, *supra* note 38, at 11, Table 2.

41. REPORT OF THE COMMISSION, *supra* note 33, at 213-14.

42. *Id.*

43. NEED FOR GUIDANCE AND CONTROL, *supra* note 38, at 10-11.

44. *Peabody Coal Co.*, 93 I.B.L.A. 317 (Sept. 11, 1986).

When Peabody acquired the lease, it was offered the following choice: (1) a lease with a 12.5 percent royalty rate accompanied by a minimum bid of \$4,884.90 per acre, or (2) a lease with a 17.08 percent royalty on production coupled with a minimum bonus bid of \$25 per acre.⁴⁵ Peabody was the only participant at the April 10, 1979, lease sale, bidding \$35.35 per acre bonus payment and a 17.08 percent bonus royalty.⁴⁶ Peabody requested the reduction, based on a perception that the higher royalty rate would render future sales on the open market unprofitable.⁴⁷ BLM denied the reduction on grounds of lack of sufficient justification for the request.⁴⁸ That is, the factors BLM used in calculating the royalty rate at the time of the lease sale were still correct and that Peabody had not shown that the lease could not be successfully exploited.⁴⁹ Peabody appealed BLM's denial to the Interior Board of Land Appeals (IBLA), and IBLA affirmed BLM's decision.⁵⁰

In its decision, the IBLA stated that BLM is authorized under section 39 of the Mineral Lands Leasing Act to reduce the royalty for a coal lease below the minimum specified by statute whenever it is *necessary* to do so in order to promote development, or whenever the lease cannot be successfully operated under the terms provided therein.⁵¹ With regard to the word *necessary* the Board stated:

Although appellant emphasizes the phrase 'to promote development' in the statutory authorization for reducing royalty, appellant fails to notice the statute includes the limiting word '*necessary*.' Because a royalty operates as a direct cost on development, reduction of royalty would almost always promote development, all other things being equal. Thus, the statute cannot be read to authorize reduction of a royalty whenever doing so would promote development; indeed, the statute only authorizes such action where it is *necessary*.⁵²

The Board also stated that the provisions of section 39 specify no circumstances in which BLM is required to reduce the royalty of

45. *Id.* at 320.

46. *Id.* at 320-21.

47. *Id.* at 321.

48. *Id.*

49. *Id.* at 322.

50. *Id.* at 342.

51. *Id.* at 318.

52. *Id.* at 327.

a coal lease.⁵³ The Board ruled that “under the statute no entitlement to . . . a reduction can ever arise.”⁵⁴ According to the IBLA:

BLM remains free to accept the economic consequences of denying a reduction. The discretionary authority conferred by sec. 209 enables BLM to exercise prudent business judgment to select the alternative which best protects the economic interest of the United States as owner of the mineral resource.

The ‘bonus royalty’ bid received in a competitive coal lease sale is properly considered a component of fair market value which the Secretary is required to obtain by terms of the statute, 30 U.S.C. § 201(a)(1)(1982), and, hence, there is no authority for refund of a ‘cash bonus’ from a lease sale. However, where protection of the interests of the United States requires a reduction in royalty to ensure successful operation of a lease, 30 U.S.C. § 209 (1982) authorizes reduction of the statutory minimum component of the royalty.⁵⁵

B. Minimum Royalty and Appalachian Coal Development

The impact of minimum royalty on federal coal is a major concern in Appalachia where the federal royalty rate exceeds royalty on private coal lands.⁵⁶ The federal government’s coal holdings in Appalachia are small and scattered, and coal production patterns in the region are not dependent on federal coal lands. In contrast, in many parts of the west where the federal government has a monopoly position in coal reserves, the prevailing royalty rate is what the federal government sets, causing owners of adjacent private coal lands to increase their royalties to match the federal royalty. In Appalachia, federal coal leasing occurs generally in areas where private coal is being developed adjacent to small tracts of unleased federal coal having royalty rates below the federal minimum. For example, Table 2 shows a comparison of private and federal coal royalty rates in southern Appalachia in 1984.

Because the federal royalty rate in southern Appalachia exceeds private royalty rates in the region, the Department of the Interior, in 1981, adopted a policy of encouraging lessees in the area, im-

53. *Id.* at 326.

54. *Id.*

55. *Id.*

56. *Id.*

mediately after lease issuance, to apply for royalty reductions to the level of the prevailing private rates in the region.⁵⁷

Table 2
Private And Federal Coal Royalty Rates,
Southern Appalachia, 1984

Type of Lease	Minerals Only (%)	Surface Only (%)	Minerals and Surface (%)
Private	6-8	6-8	12-16
Federal	12.5	—	18.5-20.5*

* Includes the royalty paid to surface owners over Federal minerals.

Source: Bureau of Land Management, Eastern States Office, Alexandria, Virginia.

C. *Post-sale v. Pre-sale Royalty Reductions*

The impact of the statutory federal minimum royalty was reviewed by the Commission On Fair Market Value For Federal Coal Leasing. In discussing the merits of the minimum royalty rate and reductions under section 39, the Commission noted that "there may be substantial administrative problems and costs in administering . . . post-sale royalty reductions.⁵⁸ The Commission pointed out that this problem would be reduced considerably if royalty rate reductions were made on a regional basis, such as for all Appalachia, rather than on a lease-by-lease basis.⁵⁹

The Commission also concluded that there are significant advantages to making any royalty reductions before, rather than after, a lease sale.⁶⁰ It reasoned that reductions made after a sale might generate windfall benefits to lessees, and the Interior Department might

57. 46 Fed. Reg. 28,596 (1981):

58. REPORT OF THE COMMISSION, *supra* note 33, at 318.

59. *Id.* at 319.

60. *Id.*

find itself pressured by individual lessees hoping to achieve such windfalls through royalty reductions.⁶¹ On the other hand, the Commission stated that if the reduction could be made prior to lease sale, the government would have the opportunity to capture in bonus bids any higher values that might result.⁶² The Commission felt that the primary reason for royalty reductions should not be lessee "hardship", but rather should be for keeping federal royalty rates competitive with surrounding private and state royalties.⁶³ The Interior Department agreed with the Commission's recommendation, and believes that administrative discretion to reduce federal royalty rates enhances competition and bidding for many tracts which would not otherwise be bid upon.⁶⁴ On the other hand, the Commission also concluded that if the purpose of royalty reduction is to create an economic incentive for development and production of leases that would be uneconomic at higher royalty rates, then defining the allowable level of profit or rate of return is central.⁶⁵

The Commission recommended that Congress give the Secretary of the Interior administrative discretion to reduce federal royalty rates for coal tracts *prior* to a lease sale, where current royalties would have adverse effects on production.⁶⁶

V. ROYALTY REDUCTION GUIDELINES

In 1979 the Department of the Interior received the first request for a reduced royalty rate on a federal coal lease. Prior to that time the Department did not have a well-defined policy translating the broad royalty reduction authority granted the Secretary under section 39 of the MLLA. The Department, however, considered whether the minimum production royalty of 12.5% precluded BLM from granting reductions below that amount, and concluded that section 39 con-

61. *Id.*

62. *Id.*

63. See Pariser, *Current Issues Relating to Emergency Federal Coal Leasing*, 89 W. VA. L. REV. 613-15 (1987).

64. *Federal Coal Leasing; Commission On Fair Market Value Policy: Hearings Before the Committee on Energy and Natural Resources*, 98th Cong., 2d Sess., Hearing Report No. 98-932 (1984).

65. REPORT OF THE COMMISSION, *supra* note 33, at 319.

66. *Id.*

ferred authority to reduce rates below the statutory minimum.⁶⁷

Between April and December 1980, the Minerals Management Service (MMS) developed several sets of procedures, in the form of guidelines, for its field offices to use for granting or denying reduction applications. The General Accounting Office evaluated the guidelines, and identified problems affecting their implementation.⁶⁸ The GAO found that the guidelines were procedures without clear policy direction, merely restating the Department's statutory authority without defining what constituted a successful operation or the circumstances that lead to reductions for promoting development or conserving coal.⁶⁹ For example, with regard to defining a successful operation, the GAO report stated that:

Since the first request for a royalty reduction in 1979, the [Minerals Management] Service has been confronted with the task of defining a successful operation. Albeit MLA provides for reductions when a successful operation is not assured, the Department and the Service have never defined what constitutes a successful operation. The task of defining a successful operation is relegated to the operator. Ancillary definitions of rate of return and profit have changed with each successive guideline revision, and an inequitable application of criteria among requests for royalty re-

67. See REPORT OF THE COMMISSION, *supra* note 33, at 325. "Any liberality in granting reduction requests, however, would seriously undermine Congress' intent in establishing a minimum production royalty. BLM was mindful of this concern when it issued regulations for its coal management program, and BLM stated the Department's policy in exercising the authority conferred. . . . This authority to reduce production royalty below that specified in the lease will be used sparingly, if at all, only upon a convincing showing of hardship, and only for a temporary period or periods on any lease.' 44 Fed. Reg. 42,584 (July 19, 1979)." *Id.*

68. NEED FOR GUIDANCE AND CONTROLS, *supra* note 38, at 6. The GAO report identified the following four problems associated with the guidelines developed between April and December, 1980: (1) guidelines were not used consistently and often were revised to accommodate a specific applicant's needs for a rate reduction; (2) auditing practices were not used consistently to verify the accuracy of financial and production data submitted by applicants; (3) special consideration was given to requests for royalty reductions on coal leases with higher than minimum (12.5 percent) royalty rates; and (4) staff charged with reviewing royalty reduction requests often lacked accounting and auditing expertise. *Id.* at 5.

The GAO report recommended several steps that the Interior Department should take to correct the above problems, including: (1) develop a departmental policy and accompanying procedures on royalty rate reductions that define the limits and conditions under which a reduction would be entertained and granted; (2) submit the Department's reduction policy and procedures to public review and comment and promulgate appropriate royalty rate reduction regulations; (3) provide guidance to field offices on when to audit the financial statements of companies requesting a royalty rate reduction; and (4) direct the agency to better use its existing financial and auditing expertise in evaluating royalty reduction requests. *Id.* at 20.

ductions has resulted.

The earlier guidelines of April and August 1980 provided little guidance on determining a successful operation. During this period, the Service used a successful operation definition that was approved for oil and gas royalty reduction: 'that from which, on an annual basis, gross income exceeds operating cost.' Accordingly, in order for a lease operation to be eligible for a reduction under the oil and gas definition, the operating costs had to equal or exceed gross income. As noted in the Service's December 1980 guidelines, this definition would effectively disallow a reduction if any profit were realized.⁷⁰

A. 1985 Draft Guidelines

As a result of problems administering royalty reduction guidelines, BLM proposed new royalty guidelines in February 1985 for federal coal and other solid minerals.⁷¹ According to BLM, the 1980 guidelines were revised for reasons of consistency among solid leasable minerals, simplification, and policy conformance. Further, BLM suspended all actions on royalty reduction applications until final guidelines were published.⁷²

The proposed guidelines provided stringent criteria for the purpose of ensuring that royalty reductions were granted only in those cases where a reduction was required to allow continuing production.⁷³ For an application to be approved, at least one of the following three criteria had to be met: (1) The lease had to be part of an ongoing mining operation experiencing an overall loss at the time of application—the loss must be projected to continue for the duration of the royalty reduction period requested—and 12 months of verifiable cost, sales, revenue, and other financial data had to be available; (2) The lease was not part of a mining operation, but was expected to be producing within one year of application date. Twelve months of verifiable cost, sales, revenue, and other financial data were required; (3) The greatest ultimate recovery of the mineral resource had to occur

70. *Id.* at 7.

71. 50 Fed. Reg. 6,062-6,065 (1985). "Secretarial Order No. 3087, dated December 3, 1982, transferred the authority of the Minerals Management Service for onshore leasable minerals operations to the Bureau of Land Management (BLM). That authority includes responsibility for approval or rejection of an application filed for a royalty reduction." *Id.* at 6,062.

72. *Id.* at 6,062.

73. BUREAU OF LAND MANAGEMENT, News Release, *BLM Seeks Comments On Royalty Reduction Guidelines For Solid Minerals* (Feb. 14, 1985).

with a royalty reduction, and a bypass would most likely occur without a reduction.⁷⁴

With regard to royalty reductions to prevent the bypass of federal coal—i.e., applications falling under the third criteria, discussed above—the 1985 proposed guidelines provided that such reductions would be granted only where it was shown that alternative reserves were available at an economic advantage.⁷⁵ Applicants would be required to demonstrate conclusively . . . “that mining the alternative reserves would provide a competitive profit advantage due to a royalty rate differential compared to the lease upon which a royalty reduction” was sought.⁷⁶

Further, the proposed guidelines required annual operating costs to exceed annual revenues, and provided for a royalty reduction of up to three years. BLM received considerable comment from the public and coal industry participants. Most of the comments were critical of the rigid criteria included in the draft guidelines.

In a June 1986 report, the House Interior Committee reviewed the Bureau's 1985 proposed royalty reduction guidelines, and concluded that the Interior Department should reexamine the guidelines.⁷⁷ According to the Committee report, the guidelines limit the usefulness of section 39 as a remedy when circumstances exist which justify some relief from the statutory minimum royalty rate.⁷⁸ In addition, the Committee report noted that when the House was considering the 1976 coal leasing amendments, members expressed concern that the proposed minimum royalty of 12.5 percent could be too high in some cases.⁷⁹ Assurances were given, however, that the Secretary of the Interior could afford lessees relief in such circumstances under section 39. The 12.5 percent minimum royalty was approved in reliance on those assurances.⁸⁰

74. 50 Fed. Reg. 6,062-6,065.

75. *Id.* at 6,064.

76. *Id.* at 6,065.

77. HOUSE COMM. ON INTERIOR AND INSULAR AFFAIRS, MINERAL LANDS LEASING ACT AMENDMENTS OF 1986: REPORT TOGETHER WITH SUPPLEMENTAL AND DISSENTING VIEWS, H. R. REPORT NO. 99-628, 99th Cong., 2d Sess. 14-15 (1986).

78. *Id.*

79. *Id.*

80. *Id.* at 14.

B. 1987 Final Guidelines

On June 30, 1987, more than two years after issuing proposed guidelines, BLM published final royalty reduction guidelines.⁸¹ In response to public comment, BLM modified the 1985 guidelines to substantially reduce and simplify the financial analysis required in an application, and to allow for a royalty reduction based only on submission of geologic and engineering data in cases where expanded recovery and mine life extension are desirable. According to the final guidelines, the Secretary of the Interior has discretion to reduce royalty rates, but only under prescribed standards to ensure equal treatment of applicants having the same circumstances.⁸² In addition, BLM stated that the final guidelines are consistent with the intent of Congress in providing a mechanism that allows for the exercise of the Secretary's discretion—based on uniform criteria that will promote development—in approving or rejecting an application for a royalty rate reduction.⁸³

The final guidelines reflect the Secretary of Interior's policy for solid mineral leases, namely that a royalty rate reduction may be granted when necessary in those instances where greatest ultimate recovery would be encouraged and where it is in the interest of conservation of natural resources to:

1. promote development by providing an incentive to extract resources not recoverable under current standard industry operating practices and that would be bypassed;
2. promote development by providing an incentive to extract resources that would be forgone when a mine ceases operations permanently; and
3. grant temporary relief for leases that cannot be successfully operated under the lease-specific production royalty rate when it can be shown that the resource is not

81. 52 Fed. Reg. 24,347 (1987). See also BUREAU OF LAND MANAGEMENT, News Release: *Interior Department Publishes Guidelines On Royalty Reduction* (June 30, 1987); BUREAU OF LAND MANAGEMENT, MEMORANDUM FROM ASSISTANT DIRECTOR FOR ENERGY AND MINERAL RESOURCES TO DIRECTOR OF BUREAU OF LAND MANAGEMENT REGARDING ROYALTY RATE REDUCTION GUIDELINES FOR SOLID MINERALS (June 26, 1987); and BUREAU OF LAND MANAGEMENT, DIVISION OF SOLID MINERALS OPERATIONS, ROYALTY RATE REDUCTION GUIDELINES FOR SOLID LEASABLE MINERALS (June 26, 1987) [hereinafter ROYALTY RATE REDUCTION GUIDELINES].

82. ROYALTY RATE REDUCTION GUIDELINES, *supra* note 81, at 6-7.

83. *Id.* at 7.

economic, i.e., that lease operating costs have exceeded lease production revenue and this condition is projected to continue.⁸⁴

To enable BLM to implement this policy, the guidelines established four distinct categories of royalty reduction applications: (1) expanded recovery, (2) extension of mine life, (3) financial test—unsuccessful operations, and (4) financial test—expanded recovery/extension of mine life.⁸⁵ The following discussion briefly describes each category.

1. Expanded Recovery

This application category applies where a lessee certifies that, without a royalty rate reduction, either: (a) adverse geologic and engineering conditions make the identified solid leasable mineral resources economically unrecoverable at the lease royalty rate using current standard industry operating practices, or (b) the lease royalty rate, with geologic and engineering conditions being the same or similar, will likely cause the identified mineral resources to be bypassed because they are less economically recoverable than resources on non-federal leases that are part of the near-term mining sequence within the same operation.⁸⁶

2. Extension of Mine Life

This category applies to a lessee whose operation is near the end of mine life, where a reduced royalty rate would extend the period during which mining would occur and thereby enhance the greatest ultimate recovery of solid leasable mineral resources. The lessee must show that adverse geologic and engineering conditions make these incremental resources economically unrecoverable, using current standard industry operating practices, without a royalty rate reduction.⁸⁷

3. Financial Test—Unsuccessful Operations

This category applies where operations on a lease are not financially profitable under the terms of the lease, with lease operating

84. *Id.* at 8.

85. *Id.* at 9-10.

86. *Id.* at 9.

costs exceeding lease production revenue. The BLM, with Minerals Management Service (MMS) assistance, would evaluate the financial justification based on the submission of detailed operating data as well as the geologic and engineering data required in categories 1 and 2.

4. Financial Test—Expanded Recovery/Extension of Mine Life

This category applies to situations where the lessee qualifies under categories 1 or 2, but requests a royalty rate reduction to a level below the minimum rates established in BLM regulations, namely 8% for surface-minable coal and 5% for deep-minable coal. A degree of profitability would be allowed as an incentive to encourage the lessee to produce the identified resources. The BLM, with MMS assistance, would evaluate the financial justification based on the submission of detailed operating data as well as the geologic and engineering data required in categories 1 and 2.

Table 3 summarizes the four royalty reduction categories and information relating to royalty rates and duration of the reduction period.

C. *Technical Evaluation Criteria*

The June 1987 guidelines also establish technical criteria that BLM will use to evaluate applications submitted under each of four categories. BLM would evaluate all applications, regardless of category, to determine whether the lessees are conducting their operations in a reasonable and prudent manner. BLM may disapprove an application where the operator is clearly utilizing mining practices not consistent with current industry operating practices or has made little or no effort to reduce operating costs and/or increase operating revenue.⁸⁸ The guidelines require BLM to use cost analysis in its evaluation and review of applications.⁸⁹

In discussing general evaluation criteria, the guidelines require BLM to review cost determinations of mining operations at certain stages

88. *Id.* at 26.

89. *Id.* at 47.

of the application review process. For example, in determining whether a royalty rate reduction is warranted, the guidelines require BLM to consider whether a lessee's operations are being conducted in a reasonable and prudent manner, and whether the lessee has taken appropriate cost reduction measures. The guidelines state: "The BLM State Director May disapprove applications where, in the BLM State Director's judgment, the operator is clearly utilizing mining practices not consistent with current industry operating practices or has made little or no effort to reduce operating costs and/or to increase operating revenue."⁹⁰ The guidelines do not explain the cost determination criteria and procedures BLM is to use evaluate an operator's performance and cost reduction measures.

Table 3

Royalty Reduction Categories and Related Information

Royalty Reduction Category	Rates Automatically Granted Upon Application Approval		Duration of Royalty Rate Deduction
	Surface Coal	Deep Coal	
(1) Expanded recovery	8%	5%	Reduced rate remains in effect until the identified reserves are extracted.
(2) Extension of mine life	8%	5%	Reduced rate remains in effect until the identified reserves are extracted.
(3) Financial test—unsuccessful operation	Rate is reduced to a level, not less than 2%, that would allow lessee to avoid financial loss during reduction period.		2 years

(4) Financial test— expanded recovery or extension of mine life	Rate is reduced to a level, not less than 2%, that would enable lessee to earn an operating margin above cash operating expenses equal to the weighted average of margins for mines in the region.	Reduced rate remains in effect as long as affected reserves are being extracted or for 2 years, whichever period is shorter
--	--	---

Source: Bureau of Land Management, *Royalty Reduction Guidelines For the Solid Leasable Minerals* (June 26, 1987)

1. Categories 1 and 2—Expanded Recovery and Extension of Mine Life

Royalty reduction applications submitted by coal companies for the purpose of expanding recovery or extending mine life (i.e., categories 1 and 2) are to be evaluated on the basis of either (1) lease-specific geologic and mining engineering factors presented in an approved mining plan, or (2) comparison of lease royalty terms with those on a non-federal lease within the same mining operation.⁹¹

Coal resources identified for royalty reduction under categories 1 and 2 must be judged, by BLM, to be (1) economically unrecoverable without a royalty reduction, or (2) less economically recoverable, and therefore likely to be bypassed, than resources on non-federal lands with lower royalty rates which are part of the same operation.⁹² The guidelines, however, do not indicate how BLM is to make these determinations. In situations where a company is seeking a reduction below the minimum royalty rates established in BLM's regulations (8% for surface-minable coal and 5% for deep-minable coal), then its application would be evaluated using a financial test similar to

91. *Id.* at 17.

92. *Id.* at 27.

the one BLM would use to evaluate applications submitted under the fourth category.

2. Category 3—Financial Test: Unsuccessful Operations

Applications submitted under this category will be subject to a comprehensive evaluation based on historical and projected financial data, submitted by the applicant, relating to lease operating costs and revenues. The guidelines define an unsuccessful operation to mean a mining operation in which aggregate lease operating costs exceeded lease production revenues for the most recent 12-month historical test period and are projected to continue to do so for a prospective 24-month period.⁹³ BLM would set the reduced royalty rate—based on historical and projected financial data submitted by the lessee—at a level that would allow lessees to avoid a loss during the 2-year reduction period. That is, the test is designed to allow zero net lease income⁹⁴ for the royalty reduction period. During the term of the royalty reduction, in the event revenue or cost conditions change so as to permit net lease income above zero, the lessee would be permitted to earn and retain net lease income sufficient to offset the loss reported in the 12-month historical test period.

Under the guidelines, lease production revenue means gross revenue derived from coal sales, and lease operating costs means all direct (variable) mining costs, including production royalty royalties, excise taxes, and depreciation and amortization for capitalized assets.⁹⁵ The guidelines specify the types of operating costs excluded from lease operating costs, which generally encompass off-site costs or costs not directly related to the extraction of minerals from the lease. In addition, the guidelines do not permit the cost of capital to be taken into account in the determination of net lease operating income.

93. *Id.* at 53.

94. The guidelines define net lease income to mean lease production revenue minus lease operating costs.

95. ROYALTY RATE REDUCTION GUIDELINES, *supra* note 81, at 51-52.

3. Category 4—Financial Test: Expanded/Extension of Mine Life

According to the guidelines, the financial test applied to category 4-applications is less stringent than the one for unsuccessful operations. BLM is to determine a royalty rate that would enable the lessee to earn an operating margin above cash operating costs⁹⁶ equal to the weighted average of operating margins for mines in that region having recent representative spot sales and new long-term contract sales. The reduced royalty rate is to apply solely to those resources identified in the application. In cases of potential bypass, the guidelines do not allow BLM to reduce the royalty rate below that of the non-federal lease that would be mined if the federal coal were to be bypassed.⁹⁷

In addition to the above technical evaluation factors, the guidelines describe in detail the various types of information applicants are required to submit, the procedures BLM will use to process applications, responsibilities of BLM evaluation teams, and protection of proprietary information submitted by lessees.

IV. COAL PRODUCT VALUATION ISSUES

Implementation of the royalty reduction guidelines are likely to be affected by the Interior Department's coal product valuation regulations, since these regulations set forth procedures for calculating the amount of royalty lessees owe to the government. The FCLAA requires federal coal leases to pay a royalty of not less than 12.5 percent of the value of the coal, as defined by regulation, except the Secretary may determine a lesser amount in the case of underground-mined coal.⁹⁸ The current debate focuses on the meaning and measurement of "value of the coal" for the purpose of calculating royalty payments. Basically, royalty calculation is based on the following for-

96. The guidelines define operating margin above cash operating costs as a rate of return corresponding to the following formula: $(P - C)/C$, where P = selling price and C = cash operating costs. The expression $(P - C)$ is equivalent to "net lease income" before depreciation and amortization are subtracted from lease operating costs.

97. ROYALTY RATE REDUCTION GUIDELINES, *supra* note 81, at 19.

98. *See supra* note 4.

mula: Royalty Obligation = Royalty base \times Royalty percentage (12.5%).

A. Current Coal Product Valuation Regulations

Under current coal product valuation regulations, where Federal coal royalty is calculated on a percentage basis, the value of coal for Federal royalty purposes is the gross value at the point of sale, normally the mine.⁹⁹ The regulations define gross value as unit sale price times the number of units sold, unless MMS determines that: (1) a contract of sale or other business arrangement between the operator/lessee and a purchaser of some or all of the coal produced from the federal lease is not a bona fide (i.e., other than arms-length) transaction, or (2) no consideration is received from some or all of the production on which federal royalty is due and payable because the operator/lessee is consuming the coal or adding it to inventories.¹⁰⁰ In either of these cases, MMS determines the gross value of the coal taking the following into account: (1) any consideration received or paid by the operator/lessee in other related transactions; (2) the average price paid for coal of like quality produced from the same general area; (3) contracts between other coal producers and purchasers which are comparable in terms, volume, time of execution, area of supply, and other circumstances; (4) mining cost plus reasonable profit margin; (5) prices reported to a public utility commission and/or the Federal Energy Regulatory Commission; and (6) other relevant factors as MMS deems appropriate.¹⁰¹

In its report to Congress, the Commission on Fair Market Value Policy for Federal Coal Leasing recommended that the base for calculating federal royalty payments should be the F.O.B. (free-on-board) price minus all state and local severance and similar taxes.¹⁰² The Commission found that the base for calculation of federal royalties is the F.O.B. price to the utility or other coal purchaser. It noted that this price will have to cover not only the cost of coal production

99. 30 C.F.R. § 203.200(f) (1986).

100. *Id.* at § 203.200(g)(1)-(2).

101. *Id.* at § 203.200(g)(2)(i)-(vi).

102. REPORT OF THE COMMISSION, *SUPRA* note 33, at 821.

and normal profits, but also the various State and local taxes and other levies against coal production.¹⁰³ This component can make up a significant part of the total royalty base. The Commission also reported that the Interior Department has authority to define an appropriate base for the purpose of calculating royalty payments, and concluded that royalty should be based on the value of the coal being produced, not on State and local taxes as well.¹⁰⁴ The Commission further concluded that Federal royalty policies should not create an incentive for higher State and local taxes, and that State and local governments should bear the direct responsibility for the full financial impact of their severance taxes.¹⁰⁵

B. Proposed Coal Product Valuation Regulations

On January 15, 1987, the Minerals Management Service issued proposed rulemaking to amend (i.e., to increase) the royalty base component of its coal product valuation regulations.¹⁰⁶ The proposed rules are controversial because MMS believes that all leasable federal energy resources should be treated in a consistent manner, and that the concept of gross proceeds should be used for product valuation purposes. If adopted as final regulations, the proposed changes would pose significant implications to the administration of Section 39, since a higher royalty base would increase lessees' royalty obligations which in turn could potentially cause adversely affected lessees to seek royalty reductions. With regard to ad valorem leases, the proposed re-

103. *Id.*

104. *Id.*

105. *Id.* at 320-21.

106. 52 Fed. Reg. 1,840-1,856 (1987). MMS reopened the original 90-day comment period three times: July 9, 1987, for 14 days (52 Fed. Reg. 29,887); August 12, 1987, for 60 days (52 Fed. Reg. 29,868); and November 17, 1987, for a comment period to be announced subsequently (52 Fed. Reg. 43,920). During the second comment period, MMS received significant comments from principal interested parties raising issues which merited further consideration and response from the public. Of particular interest was a comment submitted jointly on behalf of the coal and electric utility industries, which included a comprehensive, section-by-section set of revisions to the MMS's January 15, 1987 proposed rulemaking, including justification for the suggested modifications. MMS also received a brief response to the industry proposal from the Governor of Wyoming, which questioned some of the basic concepts in the proposal. In addition, MMS received a comprehensive set of section-by-section Comments from Indian representatives. According to the November 17, 1987, FEDERAL REGISTER notice, because of the difficult issues and diversity of comments received, MMS planned to publish a further notice after having an opportunity to evaluate the comments received to date.

gulations change the royalty base for coal sold under arms-length contracts, and would give MMS discretionary authority in defining the components of "gross proceeds" as the benchmark for valuing coal for royalty purposes. Although the Interior Department has a long-standing history of using gross proceeds in oil and gas royalty valuation, it has not used gross proceeds for coal product valuation.

1. Definition of Gross Proceeds

According to MMS, the proposed regulations were designed to achieve certain objectives, including placing the coal product valuation regulations in a format compatible with the valuation of all leasable minerals.¹⁰⁷ The proposed regulations state that the term gross proceeds is important because it would be a common royalty valuation determinant. MMS's definition of gross proceeds was intended to be expansive to ensure that it includes all monies paid to a coal lessee for the disposition of coal.¹⁰⁸ Gross proceeds would be defined to include payments to the lessee for certain services such as crushing, storing, mixing, loading, treatment with chemicals or oil, and other coal preparation that the lessee is obligated to perform at no cost to the lessor. Gross proceeds would also be defined to include: payments of credits for advanced prepaid reserve payments, or advanced exploration or development costs, subject to recoupment through reduced prices in later sales take-or-pay payments; and reimbursements where the purchaser reimburses the seller, or pays any costs on behalf of the seller, for such items as severance taxes and income taxes.¹⁰⁹ MMS proposes, however, to exclude two types of reimbursements which otherwise would be included in the definition of gross proceeds—i.e., reimbursements for Federal Black Lung fees and Abandoned Mine Lands fees authorized by the Surface Mining Control and Reclamation Act of 1977.¹¹⁰

107. 52 Fed. Reg. at 1,842.

108. *Id.*

109. *Id.*

110. Surface Mining Control and Reclamation Act, Pub. L. No. 95-87, 91 Stat. 445 (codified at

2. Industry Alternative Proposal

Industry representatives hold that using the concept of gross proceeds as the ultimate benchmark for product valuation purposes cannot be justified for the coal industry. For example, they state that take-or-pay and similar payments where no coal is actually produced or sold should not be subject to royalty assessment, since such payments to the miner assure a measure of protection from the burden of fixed costs in the event of a loss of production. Industry representatives have also stated the following with regard to the gross proceeds concept:

The new concept constitutes a major departure from the existing method of valuing coal for federal royalty purposes—i.e., valuation based on the *severed* or *produced* product at the point of severance or production. Whatever historical validity the concept has had in the oil and gas industry, coal is not oil and gas, and oil and gas are not coal. The industries are distinct and different. For example—

— the development of a coal mine is capital intensive—that is not the case in oil and gas.

— coal is sold, for the most part, under long-term contracts, most often obtained before mine development begins. Oil and gas are generally sold at posted or field prices.

— If an oil or gas producer does not like the posted price, it can cap the well. Western coal producers do not have that option—they cannot stockpile coal in large quantities over a lengthy period.¹¹¹

In July 1987, industry comments were submitted as a joint proposal by six groups representing the coal producers and electric utilities.¹¹² The proposal included a comprehensive, section-by-section set of revisions to the MMS's January 1987 proposed rulemaking, including a justification for the suggested modifications. The most significant revision suggested in the joint-industry proposal was to remove the valuation standards contained in the proposed rules and substitute instead the concepts of gross royalty value and net royalty value. Basically, the industry proposal would base royalty values on the Internal Revenue Code's concept of gross income from property used

111. Comments of the National Coal Association and the American Mining Congress regarding proposed *Revision of Coal Product Valuation Regulations*, 52 Fed. Reg. at 1,840.

112. Joint Coal/Electric Utility Royalty Valuation Proposal (July 21, 1987) as published in *Revision of Coal Product Valuation Regulation and Related Topics*, 52 Fed. Reg. at 1,840-1,856.

for depletion allowance calculations. Gross royalty value would be increased by amounts for non-Federal royalties and reduced by processing allowances and amounts based on Federal Black Lung excise taxes, Abandoned Mine Land fees, and state and local severance and income taxes. The resulting figure would be net royalty value upon which royalties would be paid.

In the course of evaluating the joint-industry proposal, the Interior Department solicited interested persons to review the industry proposal and provide comments. After receiving considerable comment on the joint-industry proposal, Interior Department officials met with representatives of the governors of western coal producing states, and subsequently received written comments from some of the governors expressing their concerns about the proposed coal product valuation regulations.

The joint industry proposal embraces the following coal valuation concepts:

—Value for royalty purposes should be determined at a fixed, defined point in the production process immediately upon completion of crushing and sizing of coal actually mined from federal leases.

—Value should be calculated starting with an established and consistent benchmark which is “gross income from the property” as determined in accordance with the provisions of Internal Revenue Code Section 613 and related regulations. “Gross Income from the property” includes all income generated by mining, basic processing and loading functions. Each mine operated by a coal producer is required by Internal Revenue Service to calculate “gross income from the property” on a mine specific basis to claim statutory depletion.

—Value should exclude all processes and handling beyond the defined point of valuation.

—Value should exclude all direct government levies such as Federal Black Lung Excise Tax, Federal Abandoned Mine Land Fees, state severance and production taxes.

—To arrive at net royalty value, it would be necessary to make certain mechanical adjustments to the Internal Revenue Code 613 depletion base. Specifically, it would be necessary to add all non-federal royalties attributable to coal produced from federal leases, since these amounts are the only portion of the selling price excluded from the depletion base. It would also be necessary to deduct the processing allowance as well as Federal Black Lung Excise Tax, Federal Abandoned Mine Land Fees and state taxes.¹¹³

3. Interior Department Views on Basic Issues Relating to Coal Product Valuation

In hearings before the Subcommittee on Mineral Resources Development and Production in November 1987, the Interior Department's Assistant Secretary for Land and Minerals Management discussed essential issues surrounding the debate over the proper basis for the valuation of coal for royalty purposes.¹¹⁴ The Secretary stated that the essential issue is how much coal producers will be expected to pay and the magnitude of payment relative to historical obligations. He noted that changing to an ad valorem royalty has resulted in producer royalty obligations as much as 5 to 10 times greater than the producer originally anticipated when signing the Federal lease.¹¹⁵

Since the royalty percentage for surface mining is defined by law at 12.5%, the Secretary stated that coal producers have focused their efforts on the royalty base portion of the royalty calculation formula. A reduction in the royalty base will result in a lower royalty obligation and a smaller negative impact associated with complying with the statutory royalty requirement. According to the Secretary, comments on MMS's proposed rulemaking and the joint-industry proposal, have indicated two principal questions involving the royalty base:¹¹⁶

—What deductions from gross proceeds will be allowed prior to calculating royalty obligations?

—What approach will be used to view the relationship between net proceeds (gross proceeds after allowable deductions) and the royalty obligation?

With regard to the first question, the Interior Department historically has allowed few deductions from gross proceeds, but the Department's proposed regulations sought public comment on the appropriateness of allowing deductions for reimbursements for Abandoned Mine Lands and Black Lung fees. The Secretary indicated that the coal industry would prefer to have additional items deducted—including reimbursements for State severance taxes, amounts for be-

114. Opening statement of J. Steven Griles (Asst. Sec'y for Land and Minerals Management, U.S. Dep't of Interior) before the subcommittee on Mineral Resources Development and Production (Nov. 16, 1987).

115. *Id.* at 8.

116. *Id.* at 10-11.

neficiation (or processing costs) and royalty payments—and noted that each deduction would have a direct impact on State and Federal royalty receipts.¹¹⁷

As for the second question, the amount of the producer's royalty obligation can vary depending upon the approach to the relationship between royalty obligation and the producer's portion of the net base adopted by the Interior Department. Because of the brief history of the use of an ad valorem royalty approach to coal, the Secretary indicated that MMS adopted the long-standing approach used for oil and gas and to adopt an approach other than that would likely result in lower royalty receipts. The Secretary stated that:

In the past, DOI has instructed industry to pay royalty based on 12.5 percent of gross proceeds. This practice has raised the issues of royalty on royalty and royalty on taxes, in which the government share is greater than one-eighth of the lessee share. Industry has offered some alternatives which would establish different relationships between the royalty and operator portions of gross proceeds. For example, one could argue that the royalty portion of gross proceeds should be 12.5 percent and the operator is entitled to the other 87.5 percent. One could also agree that the lessor is only entitled to one-eighth of the 87.5 percent. Other positions are also possible.¹¹⁸

In view of the importance of the above issues, the Secretary indicated that the Department would be seeking additional public comment and conducting a significant amount of analysis of alternative approaches before reaching a final decision on any royalty approach.¹¹⁹

VII. CONCLUSION

The Interior Department's royalty reduction guidelines and proposed coal product valuation regulations introduce concepts and technical factors which are likely to affect the administration of federal coal leases for many years into the future. The above discussion indicates that a linkage exists between the royalty reduction guidelines and product valuation regulations, as both affect the economics of mining and marketing of federal coal and the financial returns to lessees and government. In light of the complex issues surrounding

117. *Id.* at 10.

118. *Id.*

royalty reduction and coal product valuation, there is a need for analysts to focus their efforts on unresolved issues discussed above.

Although BLM's June 1987 royalty reduction guidelines eliminated many of the rigid standards proposed in the 1985 draft guidelines, any potential benefits (e.g., enhancing production efficiencies and avoiding the bypassing of federal coal deposits) resulting from royalty reductions could be dampened or eliminated if MMS adopts the proposed changes to its coal product valuation regulations. On the other hand, adverse effects of complying with the coal product regulations potentially could lead to more operators filing applications for royalty reductions than initially anticipated. Whether additional changes to the guidelines will be necessary depends upon the extent to which BLM and coal industry participants are able to apply the guidelines effectively and achieve the purposes of section 39 of the Mineral Lands Leasing Act. The first two application categories allow reductions without requiring lessees to submit detailed financial data for testing, while the two other categories do. On the surface, it would appear that few applicants would be inclined to apply for reductions under categories requiring submission of detailed financial data and testing. Thus, there is a need for public and private-sector analysts to monitor and evaluate the implementation of royalty reduction guidelines.

In addition, analysts and the appropriate Congressional committees should give further consideration to the recommendations of the Commission on Fair Market Value Policy for Federal Coal Leasing. As a result of the changing regulatory and economic environment, the Commission's recommendation of authorizing the Secretary of the Interior to reduce federal coal royalties prior to a lease sale could provide a degree of flexibility to the administration of a complex program.

