BEFORE THE SUBCOMMITTEE ON
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COMMITTEE ON NATURAL RESOURCES
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Oversight Hearing
"Ensuring Certainty for Royalty Payments on Federal Resource Production"

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Chairman Lamborn, Ranking Member Lowenthal, and members of the subcommittee, I am Dan Bucks, former Director of the Montana Department of Revenue. Thank you for the invitation to testify today on federal royalty administration.

By way of background, I served as Montana Revenue Director from 2005-2013, longer than any other person in the history of the state. I also served as Deputy Director of the department from 1981-1988. During these periods, among other responsibilities, I oversaw the administration of natural resource production taxes and mineral royalty auditing and provided leadership to strengthen those activities and the rules for administering them. In the early 1980s, I led the effort for Montana to become one of the first states to join the cooperative federal-state mineral royalty auditing program initiated by then Interior Secretary James Watt. Between 1988 and 2005, I served as the Executive Director of the Multistate Tax Commission where I assisted states in addressing corporate income tax avoidance through income shifting among related affiliates—a topic that is directly relevant to improper producer avoidance of federal royalties using the same mechanisms. I continue to provide professional assistance to improving state level efforts to curtail tax avoidance through affiliate transactions.

Policy Goals for Royalty Administration

Whatever else occurs in federal royalty administration, the goals of equity and integrity should guide federal decision-making. Producers of federal minerals should comply fully with the law. The citizens of the United States who own these minerals should be guaranteed that the right amount of royalties are paid, that the law applies equally to all producers, and that no special influences, arrangements or loopholes allow producers to pay less than what the law requires.

The title of this hearing suggests that certainty is another valuable goal of royalty administration. The question is certainty for whom and to what end? If the certainty being sought is one where producers can be content in the knowledge that if they underpay royalties, they will not be called later to pay the full amount they owe, that is an unacceptable form of certainty that should be firmly rejected. However, there are several positive ways to define and pursue this goal:

- Certainty is good if it means that a producer paying the correct amount of royalties from the outset is certain that they will not be asked to pay more.
- Certainty is also good if it means that a producer initially paying less than the right amount is certain that they will indeed be asked to pay the right amount at a future time.
- Certainty is even better if a competing producer is certain that all other producers are paying the proper amount of royalties and that none are receiving hidden subsidies or favorable treatment or are allowed to skirt the law.
- Finally, certainty is best of all if the citizens of the United States and Indian tribes know for certain that each producer of federal minerals is paying the full and fair amount of royalties they owe and that if producers are not, the federal government will certainly ask them to do so.

It is in the latter two areas—certainty for citizens and for competitors—that the current royalty system falls short the most. The shroud of secrecy that hides the facts about royalty payments prevents competitors and citizens from knowing whether each producer is paying a full and fair amount of royalties. Interior should reform royalty administration to provide for sufficient transparency and disclosure of royalty and mineral valuation information such that all interested parties, especially the public, can know that the right amount of royalties are being paid.

The stage has been set well at the Department of Interior for advancing the goals of equity, integrity and certainty in mineral leasing and royalty administration. Nearly a century of recurring scandals and crises have plagued federal minerals management—all well documented through press investigations, independent commissions, Inspector General reports, congressional inquiries and General Accountability Office reviews. However, thanks to the reorganization of that management by former Secretary Salazar and continuing improvements led by Secretary Jewell, the department is now poised for achieving historic, landmark changes in the stewardship of the American people's resources.

The proposed royalty rules by the Office of Natural Resource Revenues (ONRR) would make continuing progress in royalty administration. To help assure the American people that there will be greater certainty that producers will pay the right amount of royalties in the future, the proposed ONRR rules tighten loopholes and strengthen enforcement provisions. The proposed rules also contribute to producer certainty through simple and clear language that provides improved guidance on standards and procedures for royalty compliance. Overall, the rules do not make major, systemic changes in royalty administration. Nor do they solve all the problems that exist in this area. However, they do represent positive steps in the right direction, but more can and should be done as outlined later in this testimony.

Some in the coal industry argue, however, that the improved enforcement measures in the rules, particularly the default mechanism, create uncertainty for producers. This provision is structured to enable Interior to correct some of the most egregious forms of non-compliance with royalty rules. The industry criticism of these essential provisions is based on a false premise that under the rules Interior could set values at any level, even at arbitrarily punitive and confiscatory amounts. This argument is wrong because it ignores the plain language of the law that requires Interior to base royalties on the value of coal. The word "value" is a term of art that ties any valuation action by Interior to the market value of coal as determined by sales in arm's length transactions. The proposed rules themselves clearly indicate that the default provisions will be administered through use of relevant market price data.

The only way a company can argue that the default mechanism creates uncertainty is if they do not know the value of arm's length sales of coal at the time they produce coal, which would call into question their competency as a coal company. In truth, companies know when and to what degree they are reporting values at below market levels and claiming excessive deductions or exclusions. They also know or can determine the actual, contemporaneous arm's length prices of coal and the proper amount of subtractions from value. All the companies need to do to anticipate a default mechanism assessment is to record the difference between the values they report and the true arm's length values and deductions at the same time. Better yet, producers can remove any lingering uncertainty from the default provisions by refraining from the actions that trigger the use of this mechanism and paying royalties in the first place based on the true market value of coal and deductions determined on an arm's length basis. The proposed rules provide sufficient guidance for them do so; producers merely need to decide to follow the rules faithfully.

Let there be no doubt that proposed ONRR rules make important, incremental improvements to enhance the equity and integrity of the federal royalty system. However, they do not go far enough in eliminating the root causes of chronic underreporting of mineral royalties: corporate self-reporting and excessive secrecy in the royalty system. Interior can address these root causes if it returns to the plain language of the federal Mineral Leasing Act that calls upon Interior to directly value coal—just as a property tax assessor directly values homes and businesses. Instead of following the property tax model called for in the law, Interior has instead delegated initial valuation to companies through an income tax approach that opens the door to abuse and underreporting. If people don't value their own homes, why should coal companies be allowed to value their own coal? Why should coal companies be allowed to value their own coal when the Mineral Leasing Act asks Interior to do that job itself?

Interior can effectively eliminate the root causes of royalty underreporting if it directly values coal. By this means, Interior can also achieve full certainty simultaneously for individual producers, competitors, Indian tribes and American citizens. Direct valuation will be simpler and less costly to administer than the current approach even as modified under the proposed rules. It would greatly increase equity and integrity in the payment of royalties because all payments would be made in the first instance on the basis of statistically sound, arm's length values for coal. Because values would be established by Interior, those values, the royalty payments made and how these amounts were calculated could and should be disclosed publicly. The result will be unprecedented transparency that ensures certainty for all stakeholders—especially taxpayers of this nation and the Indian tribes—who have a right to know they are being paid properly for the resources they own.

It should be noted that H.R. 3303 sponsored by Rep. Cartwright would require Interior to implement direct valuation and would provide additional tools to help Interior do that job. While Interior has, in my view, sufficient authority to undertake direct valuation, Congress can also act to ensure and support its implementation.

We will return to describing a system of direct valuation after exploring more fully the problems created by the current system of self-reporting and secrecy.

Root Causes of Royalty Problems: Corporate Self-Reporting and Secrecy

The current system of producer self-reporting of mineral royalties has shortchanged the American people and Indian tribes by an enormous number of billions of dollars over several decades, the exact amounts of which are lost to history. The current system allows some producers to undervalue coal and underpay royalties by ignoring the full value of export sales, manipulating prices through non-arm's length transactions, and inflating deductions and exclusions from value.

Worse yet, these practices are hidden from the American people who own the coal in secret returns and records. The public owns this coal and has a right to know the details of what they are being paid or not paid. Instead, taxpayers, the press and independent experts are all excluded from knowing whether coal producers are paying the right amount of royalties on the correct value for coal. The history of recurring crises over federal mineral royalties teaches that secrecy only perpetuates royalty abuses and that greater transparency is a fundamental remedy necessary to achieve equity and integrity in public royalties.

As noted, relying on producer self-reporting of coal proceeds to determine royalties does not fit well with the Mineral Leasing Act. The law specifies that "a lease shall require payment of a royalty in such amount as the Secretary shall determine of not less than 12 ½ per centum of the value of coal as defined by regulation . . ." The law places the Secretary in charge of determining the value of coal. Instead, Interior allows producers, who have an interest in minimizing payments, to determine in the first instance the base for royalty purposes. In doing so, Interior has reduced its authority over the royalty process and delegated too much power to producers to determine what they pay.

Producer self-reporting also switches the royalty base from the value of coal to the proceeds or receipts received by the lessee from producing coal. The value of coal and producers' reported proceeds are different from each other in concept and frequently in practice. Indeed, some lessees work hard and often successfully to ensure that reported proceeds are often significantly less than the value of coal.

Producers can reduce reported proceeds below market value by several means. They can structure contracts to artificially divide receipts from coal into two parts: (1) unit prices for coal at below market value on which royalties are paid and (2) payments received ostensibly for things other than the production and disposition of coal that are left out of royalties. The latter include take or pay contract penalties, various management fees, contract settlement payments and a host of other payments that are excluded from the base for calculating royalties even though they are actually a part of the value of the coal.

Producers can also sell at higher prices in export markets without paying royalties reflecting those prices—and in the process can also manipulate mine mouth prices below market levels. They can avoid royalties on export values by selling coal to their own captive affiliates at the mine with the affiliate subsequently reselling the coal at a higher price at the export terminal free of royalty on the incremental market value. Producers can add an extra boost to their royalty savings by selling coal at the mine to their affiliates at depressed, non-arm's length prices. Through the use of affiliates, producers can also inflate payments for transportation deductions and implicitly subtract costs—packaged inside other transactions—for marketing activities and other services that, in fact, are not allowable deductions at all. The problem exists beyond export sales. Producers can also use the strategies of marketing through affiliates and manipulating prices to avoid royalties on sales into specialized, domestic markets. Relying on producer reporting of proceeds opens the door to a host of complex accounting strategies that are difficult and costly for Interior to police and that deny the public a fair return calculated on the true value of federal coal.

Coal companies sometimes deny that they make below market sales to their affiliates. One instance of that occurred at the federal coal public listening session conducted in Billings, Montana, on August 11 of this year. At this session, a representative of Cloud Peak Energy Resources stated that the company did not sell coal at below market value to its affiliates.

However, information presented by Cloud Peak Energy itself to the Montana Supreme Court directly refutes the statement made at the Billing listening session. In the case of *Cloud Peak Energy Resources, LLC v. State of Montana Department of Revenue,* Cloud Peak disclosed that in early 2005 it had sold coal to independent third parties at prices approximately 30% above the price it charged to its own affiliates. On page 17 of its brief to the Montana Supreme Court filed on June 13, 2014, Cloud Peak Energy reports that it sold coal from its Spring Creek mine in Montana to its affiliate, Venture Fuels, for $6.50 to $6.85 a ton on January 25, 2005. On page 20 of that same brief, Cloud Peak reports that in January 2005 it sold coal from the same mine to outside, independent parties for $8.87 per ton.

These facts led Judge Jeffrey Sherlock, the district court judge in this case, to conclude that "it seems abundantly clear that the NAL (non-arm's length) contracts were not set at market value under whatever valuation scheme one might adopt." Cloud Peak did not dispute this characterization of the facts in its appeal to the Montana Supreme Court, but instead reported information to the Supreme Court that supported Judge Sherlock's conclusion. The company's own briefs to Montana courts establish that Cloud Peak Energy has sold coal to its affiliates at below market value.

In that same brief to the Montana Supreme Court, Cloud Peak Energy also reported that the predecessor owner of the Spring Creek mine had entered into a settlement agreement with the Department of Interior for federal royalty purposes that required non-arm's length prices to affiliates to be adjusted to market value. The existence of this royalty settlement agreement is further evidence that coal companies have sold coal to captive affiliates at prices below market value.

Captive affiliate sales represent a significant part of the coal market. Energy Information Administration data indicates that in 2013 captive sales were 34% of total coal sales in Wyoming and 30% in Montana.

During my tenure as Deputy Director of the Montana Department of Revenue in the 1980s and again as Director of Revenue from 2005 to 2013, I encountered numerous and extensive problems in the valuation of coal, oil and gas, and other minerals—even though only a portion of producers engaged in questionable practices. Non-arm's length sales are a chronic issue, but so too are claims for excessive deductions for both allowable and non-allowable costs—often bundled together in ways that are hard to untangle. From grappling with actual cases, I can assure the subcommittee that the problems caused by self-reporting of mineral values by producers seriously shortchange the public and are costly and difficult for public agencies to discover and correct. In the real world of limited resources, even diligent efforts by authorities cannot fully correct the problems arising from producer self-reporting of values.

Further Description of a Direct Valuation System

Interior should reclaim its rightful authority under the mineral leasing law to determine the true market value of coal. It should replace producer self-reporting with a professional appraisal system to establish the market value of coal on a full, equitable and uniform basis. Interior should also directly establish the amount of allowable transportation deductions based on the most efficient, lowest cost means of transporting coal to its markets.

A direct coal valuation system should use a uniform starting point: arm's length market prices at the point of final sale in the United States. To set these values Interior can rely on existing coal sales information and on enhanced reporting by producers of sales made both directly and through affiliates—reporting that Interior can require under their contracts with mineral lessees. Through well-established statistical procedures and methodologies, Interior can use a “market basket” of valid, arm’s length sales prices to determine values that are more representative of the true market value of coal than the transactions reported by producers.

Values would be set and published periodically, perhaps quarterly, for categories of coal by quality and type. Because Interior establishes these standardized market values, they can be made public. Indeed, they must be publicly released so that producers know the values they need to use in calculating their royalty payments.

Working with the Surface Transportation Board, Interior would similarly establish allowable deductions for coal transportation deductions on a least cost basis.

As an integral part of this valuation system, Interior would regularly provide a public report to the citizens and taxpayers of this nation on the amount of royalties paid on each lease and the values used in the calculation of those royalties. A direct valuation system allows these public reports to be issued because typically that data will not be proprietary information taken from producer financial statements. In the rare cases of limited sales where proprietary information may be involved, Interior can protect that data. However, those cases should be the exception instead of the rule.

A direct valuation system for coal royalties will best ensure that the public and Indian tribes receive a fair return on the coal they own. It will also improve equity among producers. Those producers paying the right amount of royalties under current practices will no longer be placed at a disadvantage as compared to those producers that game the system. All producers will be encouraged to use the most efficient transportation methods. Most importantly, the system will become open and transparent. By allowing the public to know what they are receiving in royalties on each lease and the values on which those royalties are calculated, abuses of the royalty system will be discouraged and public trust will be enhanced.

Flaws in Federal Leasing Process Contribute to a Lack of Fair Return to Taxpayers

The manner in which Interior leases federal coal exacerbates the problems of royalty administration and generally reduces the return to taxpayers from coal production. While problems of below value coal leases existed earlier (a massive below value lease sale of Powder River Basin coal in 1982 is a notorious example), Interior complicated matters in 1990 when it scrapped an open process it had developed for regional planning for coal production and leasing. (Technically speaking, the action taken by Interior was decertification of coal production regions.) In its place, Interior substituted a closed process that virtually guarantees monopoly control of vast coal tracts by producers.

Monopoly control has created a non-competitive leasing process resulting in lease bonus bids that are often below fair market value—a fact documented in Inspector General and the General Accountability Office reports. In addition to below market value bonus bids, monopoly producers, with the economic and political benefits that flow from that status, are able to exercise greater influence over the royalty valuation process and devote greater resources to accounting and legal strategies to minimize royalty payments. As much as possible, Interior should reverse its 1990 decision and reinstate an open and competitive leasing process for federal coal tracts. Doing so will also contribute to transparency and public participation in the leasing process, restore competitive conditions to the leasing process, and ensure a fair return from leasing and royalty revenues.

Changes in Royalty Payments Have Little Impact on Coal Production or Jobs

The coal industry argues that if the royalty system is reformed to ensure that the right royalties are paid, coal production and jobs will suffer. However, both research and lessons of history effectively refute this argument.

Various experts and researchers have found over several decades that taxes or royalties have little impact on resource production or jobs—even if royalties or taxes change by significant amounts. These experts generally cite two key facts:

(1) Taxes and royalties are a small percentage of the final delivered price of coal. Transportation and extraction costs are the primary components of the final price. Thus, even major changes in taxes and royalties have little impact on the final delivered price.

(2) The demand for coal is inelastic. Changes in the final delivered price of coal produce less than proportionate changes in the volume of coal purchases. Small changes in the final price have an even smaller impact on the amount of coal sold.

Similarly, researchers in the Montana Department of Revenue regularly refuted the notion of any significant connection between taxes and production for oil and gas. Instead, the Department documented the fact that Montana produced less oil and gas than Wyoming or North Dakota even though Wyoming and North Dakota both levied substantially higher taxes on oil and gas production. Geology, not taxes, determined levels of production.

Beyond the comparative and predictive studies by experts, strong evidence that major changes in taxes or royalties will not impact production or jobs comes from a major historical event involving coal in Montana.

In 1987, the Montana Legislature enacted a law reducing Montana's coal severance tax from 30% to 15% in steps from FY 1989 through 1991, contingent on the coal industry selling in FY 1988 coal equal to its average production from 1983 through 1986. This change was made on the basis of industry arguments that a reduction in the coal tax rate would increase the competitiveness of Montana coal in the marketplace and stimulate future coal production in the state.

During the prior 13-year time period when the 30% coal tax rate was in effect, the Montana coal industry increased production rapidly from 22.1 million tons in 1975 to 38.9 million tons in 1988, a 76% increase in total over this period.

As the reductions in the coal severance tax began in FY 1989, the immediate response was a decline in production from the 1988 peak of 38.9 million tons to 37.7 and 37.6 million tons in 1989 and 1990. Production rose to 38.2 and 38.9 million tons in 1991 and 1992, but fell back again to 35.9 million tons in 1993. Over this initial 5-year period when the coal severance tax rate was cut, average annual production was 37.7 million tons, a net decline from the 1988 peak.

After 1993, production first increased and then fell back again, starting an up and down pattern that would continue into the early 21st century. Over the 15 years from 1989 through 2003, annual coal production averaged 38.9 million tons—the same level of coal production in 1988, the last year of the 30% tax rate.

So, while coal production increased dramatically in Montana when the 30% tax rate was in effect, coal production fell on average over the first 5 years after the rate was reduced. Measured over 15 years after FY 1988, there was essentially no growth on average in Montana coal production, even though the tax rate had been cut in half. The absence of growth over these 15 years contrasts sharply with the 76% increase in production while the 30% rate was in effect from 1975 through 1988.

More importantly, this history effectively refutes the idea that a reduction in coal tax or royalty rates can stimulate production to the point of generating more revenue than when rates were higher. From FY 1980 through FY 1988, Montana coal severance tax collections varied between approximately $70 million to $91 million annually. From FY 1994 through FY 2007, under the 15% tax rate, Montana coal severance tax collections varied between from approximately $29 million to about $41 million annually—plummeting to less than half of prior collections. In fact, coal severance tax collections have never regained the level that they achieved in the FY 82-88 period under the 30% rate.

Montana tested the claim that coal rate reductions will pay for themselves with higher revenues—and the test proved the claim to be false. The policy of cutting tax rates in half to stimulate coal production was a failure. Even though the coal tax rate reductions were major, the impact on production levels was minor because the taxes as a percentage of final delivered prices were too small to impact the final demand for coal. The Montana coal tax history fully corroborates and supports expert predictions that changing taxes or royalties have only a minimal, if any, impact on production and jobs.

Conclusion

Interior has taken important steps in recent years to improve the equity and integrity of federal royalty administration, and the proposed ONRR rules contribute to those improvements. However, more needs to be done to make certain that the American people and Indian tribes who are the owners of federal mineral resources are being paid a full and fair amount for those resources. It is entirely possible to achieve that goal—and at the same create certainty for producers that they and their competitors are paying the proper amounts.

Thank you again for this opportunity to address key issues in federal royalty administration.