BEFORE THE SUBCOMMITTEE ON
ENERGY AND MINERAL RESOURCES
COMMITTEE ON NATURAL RESOURCES
UNITED STATES HOUSE OF REPRESENTATIVES

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 Jonathan Downing, Executive Director of the Wyoming Mining Association. Thank you for the invitation to testify today on the subject of Ensuring Certainty for Royalty Payments on Federal Resource Production.

The Wyoming Mining Association (WMA) is a statewide trade organization that represents and advocates for 39 mining company members producing bentonite, coal, trona and uranium, as well as one company in the permitting and development process for a rare earth element mine. WMA also represents 129 associate member companies, two railroads and 180 individual members.

On January 6, 2015, the Office of Natural Resources Revenue (ONRR) issued a Proposed Rule entitled "Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform." This rule would significantly modify the royalty valuation regulations in 30 C.F.R. Part 1206, Subparts F and J, applicable to coal production from leases on federal and Indian lands, respectively. The focus of the majority of my testimony is with respect to the proposed rule as my organization does not believe it will ensure certainty for royalty payments on federal resource production. The rule if implemented will stifle production on federal lands.

The WMA strongly opposes the proposed changes to the royalty valuation standards for coal sold or transferred to a power plant owned by the lessee or its affiliate, which ONRR dubs "no-sale" situations. The stated goals of the proposed rulemaking, were to "(1) Offer greater simplicity, certainty, clarity, and consistency in reduction valuation for mineral lessees and mineral revenue recipients; (2) be easy to understand; (3) decrease industry's compliance costs; and (4) provide early certainty to industry and ONRR that companies have paid every dollar due."

Instead, for "no-sale" situations, ONRR has proposed implementing the net-back royalty valuation methodology. The net-back method is well known to be the least logical, most complicated, and option of last resort for establishing mineral valuations. ONRR went on to propose bypassing its own rules and essentially setting coal royalty value whenever it chooses and at whatever it chooses for no-sale operations.

The Proposed Rule ignores that the applicable mineral leasing laws and lease terms entitle the lessor to a prescribed percentage of the value of coal at the lease. For non-arms-length (NAL) and no-sale

dispositions, ONRR overlooked that the prescribed royalty rate in the lease contract was agreed to only to value coal, not to value another commodity – electricity – generated by consuming the coal and the price for which is affected by a variety of regulatory and market factors inapplicable to coal. This valuation concept (of valuing the netback from sale of electricity rather than the intended valuation of coal at the lease) is rife with insurmountable issues. The issues are so overwhelming, in fact, that the proposed net-back valuation method would be impossible for producers, ONRR and the State of Wyoming Department of Audit to determine valuations.

As such, WMA respectfully requested that ONRR either withdraw the proposed rule, or at a minimum, adopt simpler methodologies for assessing royalties for no-sale and NAL coal leases consistent with the stated goals in the Proposed Rule.

Arm's Length Situations

The WMA did agree with ONRR's intent to maintain the current benchmark valuation method for arm's-length sale valuations.

Non-Arm's-Length Situations

The WMA disagreed with the proposal by ONRR to modify the methodology to assess non-arm's length (NAL) sales. Currently NAL sales are valued using the benchmark method, and primarily are based on sales of nearby similarly valued coal, or arms-length sales from the same operation. The current method makes sense and has been utilized successfully for many years. However, ONRR is proposing to force any coal lessee to track its coal to an arm's-length contract that might occur anywhere else domestically or globally. ONRR would do so by deeming a sale by the lessee's affiliate as a sale by the lessee, by deleting the benchmarks (including the option to examine comparable arm's-length sales), and instead trying to calculate a net-back valuation method from a final sale many transactions and many miles from the originating coal lease. For sales to utilities, the coal lessee must net-back from the sale of electricity less applicable generation and transmission costs.

The WMA urged ONRR to reject this proposed valuation methodology. The current benchmarks have been generally workable, and the proposed valuation based on "first arms-length less applicable transportation and washing allowances" and "net-back from electricity sales" valuation methodologies will be more complicated and contentious. Indeed, the Proposed Rule only serves to provoke more questions, instead of solving the few problems with the current benchmark methodology. For example, ONRR has failed to articulate how exactly lessees are to net-back that value from the final sale point back to the lease. Also, gross proceeds must be "less an applicable transportation allowance…and washing allowance" to arrive at royalty value at the lease. Without these deductions, lessees would be forced to pay royalty on more than the "value of coal," which ONRR has no authority to compel. Computing these deductible costs, however, is inherently difficult. Transportation costs are not limited to rail costs and terminal fees, but can also include a myriad of additional items, which change as the railroads and trucking shippers find new items to tack on. While ONRR's proposed valuation method appears to provide that the lessee may deduct its transportation costs for coal sold, the proposed rules entirely fail to prescribe which transportation costs will be allowable and which costs ONRR will deny. The WMA is concerned that this will lead to royalties being paid on services that are not the true value of the coal.

No Sale Situations

ONRR proposed a different valuation standard altogether when federal or Indian coal is not sold at all, but is transferred and directly used by a power plant affiliated with the lessee. Currently, such coal would be valued under the same existing benchmarks applicable to all federal and Indian coal not initially sold under an arm's-length contract. The proposed rule would require royalty be assessed against the gross proceeds of electricity generated and sold at arm's-length by the coal lessee or its affiliate. To net-back this value to the coal lease, ONRR would offer deductions for not only transportation and washing, but also "transmission and generation deductions" located in ONRR's separate regulations governing geothermal resources. Separately, if electricity is not sold arm's-length, ONRR would just perform the valuation itself. No explanation or justification accompanies this proposal.

There are insurmountable questions about how to calculate the net-back from sale of electricity. For example, some utilities accept coal from multiple lessees, and the coal is a mix of fee, arm's-length and non-arm's-length coal lessees. How will the NAL lessee alone differentiate the electricity value generated from the three (or more) different types of coals, all with different qualities and different transportation costs, and all with different costs to handle to allow them to be economically burned at the utility?

Similarly, determining the sale price of electricity from utilities is not straightforward. Some is sold to affiliates, who resale the electricity. Some is sold on the market. Some is sold to affiliates who use it to serve rural, retail, and industrial customers. Determining arms-length gross electricity generation pricing will be extremely difficult. Especially for the coal lessee who is not entitled to gross sale and cost of electricity production information. In fact, ONRR may be asking coal lessees to breech confidentiality agreements by asking them to calculate costs and prescribe handling allowances based on utilities purchases of coal from their competitors. To do so, the lessee may need to see the coal contracts and pricing, which is confidential and not to be shared.

Further compounding the issue, at times coal is shipped to a NAL utility where it is stockpiled. The NAL coal may or may not have been used to generate electricity for years or months after being produced at the mine. It is often difficult to obtain information regarding when the coal is removed from the pile. Will ONRR require up-front payment, even though the coal is not utilized and hence there is no sale of electricity?

As a result, the lessees may not even know with certainty which regulatory paragraph applies, let alone be able to actually perform the respective valuation.

The WMA is concerned that the result of this proposed rule will be to create massive confusion, and constant battles and recalculation of the coal valuations from affiliated and no-sale situations. ONRR's stated goals were to "simplify processes and provide early clarity regarding royalties owed" and "to further streamline the valuation process, while also bringing added transparency to the system" and to "improve the current regulations to ensure greater clarity, efficiency, certainty, and consistency in production valuation". However, the proposed regulations will have exactly the opposite effect. It appears that most operators will have to just hand over the valuation process to ONRR, which is not how the process is supposed to work.

Furthermore, if the coal lessee is unable to determine valuation, the proposal allows ONRR to make determination of the coal valuation with no input from the coal lessee. At the same time, the ONRR is

adopting more aggressive new policies on proper initial reporting and payment of royalties and threats of substantial civil penalties for erroneous reporting. Hence, the lessee will be penalized for essentially giving up on trying to make a royalty valuation estimate, which the lessee really cannot do based on the confusing net-back methods in this proposal.

While ONRR stated that the new method of valuation is intended to be revenue neutral, in fact, there is no supporting documentation demonstrating that the result of this net-back methodology will be revenue neutral. Nor any provision ensuring that coal is not over-valued in the ONRR's proposed valuation process.

Royalty on Electricity instead of on Coal Value

The Mineral Leasing Act sets a minimum royalty rate of 12 ½ % of the value of coal by surface mining methods and generally 8 % for coal recovered by underground mining methods. For non-arm's-length sales, current regulations in effect for the last 26 years look first to apply that royalty rate to a coal value based on comparable sales of coal produced in the area. ONRR's proposal is to instead apply that same royalty rate to the value of the electricity generated by the coal (with deductions for generation and transmission costs). No statute authorizes ONRR's substitution of electricity for coal, and ONRR offers no analysis or explanation that could support interchanging the two commodities. ONRR does not justify applying the same royalty rate established in the lease contract for coal to an entirely different energy commodity. ONRR's provisions for transportation, washing, and generation allowances against the price of electricity also provide little comfort given the practical nightmare of determining these costs, the unavailability of information from other parties (including coal cooperative members), and the lack of binding ONRR guidance to clarify calculation of allowable deductions.

That royalty rate is a central term upon which would-be lessees rely to calculate their bonus bids to obtain the lease. Once the lease is executed, that royalty term cannot be unilaterally changed by ONRR or any other federal agency during the term of the lease. It was never contemplated that ONRR would suddenly base royalty on a different energy commodity. WMA does not believe it is proper for ONRR to suddenly burden existing federal and Indian coal lessees with new effective royalty obligations. Nor has ONRR provided any foundation for implementing its proposal for future coal leases. In summary, WMA opposes implementation of this proposed valuation method on existing or new leases.

Same Royalty Rate on Electricity as is on Coal

ONRR appears to suggest that the same royalty rate specified in the coal lease should be applied to the gross proceeds from sale of electricity. If so, ONRR apparently has concluded without any economic justification not only that the value of coal and the value of sold electricity generated from that coal are interchangeable, but also that the same royalty rate is appropriate. Even if ONRR could quantify the relationship between electricity sale gross proceeds and coal value (which again it has not done), ONRR would have to further consider whether substituting one commodity for the other at the contractually prescribed royalty rate would increase the royalty burden on lessees. The Proposed Rule indicates no such economic analysis. ONRR admitted it has little data on the matter and tries to delegate to the regulated community the agency's burden to justify its own proposed rules. Applying the royalty rate for coal to electricity may result in an increase in federal and Indian coal lessees' effective royalty obligation, which presents significant breach of contract issues.

Net-Back Deductions

The proposal links the net-back electricity producer costs to regulations written for geothermal electrical production. However, those costs and procedures may or may not apply to coal fired electric generation. Also, the clear reading of the deduction language, which includes the phrase "if applicable" coupled with ONRR referencing deductions that are listed in a section of the rules regarding geothermal production, make us question whether ONRR could deem any and all generation and transmission deductions as "not applicable" since this coal is not used for geothermal generation.

As with the concerns for non-arms-length sales to affiliates, the net-back determinations may or may not include all costs to produce and transmit both the coal and the electricity. We are concerned that the ONRR will disallow many normal generation and transmission costs inherent in in the utility businesses. While the utility may deem them as necessary for the generation and transmission of electricity, ONRR may not concur. Absent specificity, ONRR will be collecting royalty on the value of these goods and services, not just the value of the coal at the lease. Again, if any error (or perceived error) is made in the net-back calculations, ONRR can unilaterally set value under its default provision.

Creation of Standardized "Schedules" for Transportation and Processing

The WMA is concerned with the ONRR's potential intent to create standardized "schedules" for transportation and processing allowances to reduce the need to rely on case-by case operator reporting and agency review of actual costs. There are simply too many variables to come up with standardized "schedules" for transportation and processing allowance. Transportation costs vary by area, region, product type, and competition (locations where only one carrier is available). In fact, in emergencies, when the primary carrier (rail) is unavailable, coal has to be trucked at great unanticipated expense. Would ONRR keep up with the constantly varying additional tariffs, dust mitigation requirements, fuel costs and other add-ons that crop up?

Such schedules would be undesirable due to the above questions raised. Therefore, this option would not likely be appropriate to impose as an alternative due to the complex nature of the different types of situations that the industries incur. In addition, actual costs incurred would be the preferable treatment of any/all of these allowances by product. These actual costs are definitive and proof that market value was established and paid.

Non-Arm's Length Valuation

ONRR requested comment on "…Opportunities to more fundamentally reassess how nonarm's length transactions are treated for the purposes of determining royalties owed."

If ONRR is truly interested in the goals stated in the proposal, "to ensure greater clarity, efficiency, certainty, and consistency in production valuation," we suggest this cannot be done with the proposed net-back method. WMA believes there are too many concerns with the proposed net-back method, and ONRR should instead keep the current benchmark method of valuing non-arm's length and no-sale coal valuations. WMA also recommends ONRR allow the use of arm's-length sales from the producer's own mine in the first benchmark. Prior to 1989, the MMS condoned use of such sales. Such other arm's-length sales are inherently reliable given that the vast majority of federal and Indian coal is sold domestically at arm's length. Arms-length sales represent the true market valuation of similar coal at the mine, and should be allowed to be used for valuation purposes. Valuation based on existing arm's length

contracts is the most accurate, reliable, and simplistic valuation method. Adoption of the benchmarks enhanced with arms-length sales is much less cumbersome and troublesome than the ONRR's proposed net-back method. An alternative to the current benchmark system, for those rare instances where arms-length sales are not available, would be to review actual cost of production and evaluate a return on investment that is fair to the situation and/or the company under assessment. We would propose this become a sixth benchmark, applicable only in those instances when arms-length sales are not available.

Furthermore, in the proposal ONRR failed to provide the coal lessee (arms-length and NAL) the same option ONRR provides to oil and gas production – i.e. ONRR provides the oil and gas lessee the option of instead basing its value for royalty purposes on a locally-applicable published index price. ONRR would provide no alternative methodology for coal lessees. We believe this should be added as an option for the coal lessee.

Transportation Allowances and Washing Allowances

The Proposed Rule does not limit transportation allowances to 50 percent of the value of coal. Yet, the preamble asks whether ONRR should impose this limitation. Coal currently is not subject to the existing or proposed caps on transportation or washing allowances, nor should it be. The costs of washing and transporting coal are significant, and the corresponding deductions are critical to maintain economic operations. Legally, they also must be deductible from any gross proceeds-based valuation to maintain royalty on value of coal at the lease rather than on an impermissibly inflated basis. ONRR cannot and should not impose an arbitrary 50 percent or any other cap on coal allowances.

Default Rule

Also related to transportation, ONRR's "default" rule would allow ONRR to arbitrarily select an "at the mine" comparable sales valuation method that would disregard a logistics business' risk and loss. The Proposed Rule would also allow ONRR to apply the "default" rule to recalculate the transportation allowance for a business if ONRR arbitrarily believes it is "unreasonably high." In short, ONRR seeks to share in the profits created when a transportation business associated with a mine pays off, but if transporting the coal over 1,500 miles away for export becomes unprofitable, ONRR seeks to insulate itself from that risk and will not mitigate losses. ONRR wants to have it both ways by taking what they think is owed but not taking the risk that goes with those distant contracts. The default provision would introduce massive uncertainties to royalty calculations, and should be abandoned.

Tax on Exports

The rule imposes an unconstitutional tax on exports. The U.S. Constitution specifically prohibits the imposition of duties on goods by reason of exportation to the international country. However, in this proposed rule exported coal is valued in a manner that is different than how coal is valued for traditional domestic customers, with the incremental royalty on exports amounting to an unconstitutional tax or levy. This must be set aside in the final rule.

Summary

The WMA and its members support the ONRR's stated goals of simplifying federal and Indian coal valuation and providing a fair return to the public on that production. ONRR's Proposed Rule, however, would have the opposite effect. It would instead result in burdens and regulatory uncertainty far

outweighing the purported benefits to ONRR, and the public. The WMA recommends that ONRR set aside the proposed rule, and instead re-propose a rule targeted at truly simplifying reporting and administrative burdens for all parties involved.

The fundamental considerations in the current rules and the distinct aspects of the coal market have not changed since the rules were adopted in 1989. WMA believes this rulemaking is being done in haste in response to allegations contradicted by several decades of strict and constant industry audits. ONRR should not simply substitute a different regimen at whim; the agency's justification must be as or more compelling than its justification for the existing coal valuation rules. ONRR's Proposed Rule does not even attempt to explain many of its changes, or why they are warranted at this time.

The final rule should afford lessees the opportunity to perform valuation in no sale and NAL situations based on existing arms-length sales, and recent sales of comparable coal from nearby mines. In those rare situations where there are no arm's length sales, ONRR should use the average price of nearby recent mine sales coupled with a review of actual cost of production and evaluate a return on investment that is fair to the situation and/or the company under assessment.

Thank you for the opportunity to share the Wyoming Mining Association's concerns on these critical issues.