May 8, 2015

Armand Southall
Regulatory Specialist
Office of Natural Resources Revenue
P.O. Box 25165
MS61030A
Denver, Colorado 80225

Re: Proposed Rules Regarding Coal Royalty Administration

Dear Mr. Southall:

The signatories to this letter include seven members of the Montana State Legislature and a former Montana Director of Revenue, who together have broad and diverse experience in natural resource policy, economics and revenue policy and administration. We welcome the opportunity to comment on proposed rules by the Office of Natural Resources Revenue (ONRR) designed to improve federal royalty administration, especially with regard to coal production on federal lands.

The proposed rules represent a significant step toward basing federal royalties on the true market value of coal. We support the overall direction of the proposal, but recommend improving the rules to ensure they apply uniformly to all coal production and to strengthen their market valuation methods. By linking the base for coal royalties to market values, ONRR can rely on and apply time-tested property valuation principles and methods to the task of valuing coal.

Using property valuation practices to value coal creates an opportunity to achieve another overdue reform: making coal valuation open and transparent to the public. The public has a right to know the value of publicly owned resources, how those values are established and the amounts being paid on their behalf. Within property tax systems, assessed values, methodologies and payments are a matter of public record. Accordingly, these same key facts about coal royalties can be open to the public without interfering with legitimate proprietary interests. Transparency will restore public trust in federal royalty administration and will help prevent royalty problems from recurring in the future as they have in the past.

ONRR is proposing two significant, positive steps away from the existing system of basing royalties on company reported proceeds from coal production and distribution. One step is the proposed use of the first “arm’s length sale” of coal as the starting point for royalty valuation. The second step is providing circumstances under which ONRR will directly value coal based on market valuation principles. These steps are important because the proceeds approach does not properly represent the "value of coal" and allows coal producers too much latitude, through exclusions, deductions and other loopholes, in determining what, how and when they will pay royalties.[1] The discretion allowed coal producers in reporting their proceeds undermines the intent of the Mineral Leasing Act for the Secretary of the Interior to establish the value of coal for royalty purposes. It is a wasteful system that subsidizes inefficient producers and those that engage in strategies to minimize royalty payments to the public. The shortcomings of the proceeds approach results in coal royalties being chronically underpaid, with effective coal royalty rates running at approximately 40% of the 12.5% rate established by Congress.[2]

<u>Recommendations</u>

1. Restore the Secretary's Authority to Value Coal.

The Mineral Leasing Act provides 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 Mineral Leasing Act does not link royalties to the proceeds or earnings of the coal producers, but to the value of coal. Thus, ONRR's rules should convert the proposed "default mechanism" under §1206.254 for direct valuation in certain cases into the standard means of valuing coal generally. Under the direct valuation approach, Interior would establish the value of coal through valid market data on sales involving willing buyers and willing sellers. If valid market data is not available, Interior may rely on other established valuation methods to determine the value of coal.

Coal producers should pay royalties not on what they report as payments received, but instead on the market value for the coal they deliver to customers. The market value approach is inherently more consistent with the Mineral Leasing Act than the current method of calculating royalties. Market valuation by Interior would end the ability of producers to improperly minimize royalty payments through contract terms, pricing practices, and various accounting methods. Through this improved valuation method, Interior would reclaim its rightful authority over the determination of royalties as intended by the Mineral Leasing Act.

Using direct market valuation as the primary means for assessing royalties will also achieve greater equity, uniformity, efficiency and simplicity in the royalty system. The rules as proposed include two broad, but distinctly different systems of valuation: (1) self-reporting

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[1] See Isaiah T. Peterson, "Devaluing Coal: Reasons for Restructuring How Federal Coal Is Valued," *Georgetown Review of Law and Public Policy,* Winter 2015, for a review of some of the problems of the current coal royalty valuation process. ONRR acknowledges the existence of these problems in the proposed rule §1206.253, which provides criteria for ONRR to establish the value of coal for the lessee.

[2] Headwaters Economics, "An Assessment of U.S. Federal Coal Royalties," January 2015.

on a proceeds basis by producers and (2) the "default mechanism," which is direct valuation based on market principles. Maintaining two systems of valuation appears inherently more complex and costly than using a single system. It will trigger new sources of controversy and litigation over whether ONRR has properly switched a producer from one system to another. Worse yet, having two distinct systems of valuation risks inequitable and non-uniform results among competing producers. Under direct valuation, all like coal marketed at like times will be valued equally.

Most importantly, however, direct valuation establishes the foundation for a royalty system that is transparent and understandable to the public.

If ONRR is not prepared to employ direct valuation immediately on a general basis, an acceptable alternative would be for ONRR to use the proposed rules with two systems of valuation temporarily. ONRR could establish a transition plan and publish within the final rules a date certain on which it would cease using the company proceeds approach to valuation in favor of direct market valuation.

Sophisticated property valuation standards, methodologies and statistical techniques are well developed and available from state and local governments and professional associations. Those sources can aid ONRR in establishing the direct market valuation process.

2. Apply the Market Value Principle Uniformly.

Interior should establish market values through use of comparable arm's length sales for similar coal sold during similar periods at similar points in the distribution process. We recommend that the valuation process begin with valid market sales data for coal at its destination, with the domestic power plant or export terminal deemed to be the destination. However, if ONRR determines that transactions at another stage are a better source of independent market data for coal valuation, the rules should allow for a general, uniform change to that stage.

Using market data at a common destination point effectively responds to criticism of the proposed rules that the "first arm's length sale" approach would value coal at different points in the distribution process depending on where that first sale occurred. Critics charge that the proposed rules disadvantage coal sold through captive purchasers as compared to coal sold to independent parties at a point short of the destination. Relying on market data at export terminals and power plants effectively eliminates that criticism and establishes a uniform and equitable method of valuing coal at comparable stages.

As discussed below, direct market valuation can retain a transportation deduction. In conceptual terms, allowing a transportation deduction also moves the "point of valuation" back to the origin of the coal from the destination market.

3. Provide a Limited Deduction Only for Transportation Costs Set by ONRR.

Please note: This recommendation responds to both the proposed rules and the question from ONRR as to whether the coal transportation deduction should be limited to 50% of the value of coal, as is the case with oil and gas.

Conceptually, a case can be made for eliminating all intermediate deductions prior the final market value at the destination. The Mineral Leasing Act does not require any such deductions. The market value of coal supports and incorporates all the costs that precede its delivery to customers. These costs are simply part of the value of coal.

However, one can also argue for a transportation deduction as a means of "equalizing" the value of coal for royalty purposes between coal shipments that travel varying distances to their market destination. Further, federal rules also provide competing fossil fuels, oil and gas, with a transportation deduction, up to 50% of the value of the oil and gas. For these two reasons, the rules should provide for a transportation deduction.

ONRR should establish the amounts of the allowable deduction based on the lowest reasonable cost of transportation for coal to its destination. The current deduction wastes royalty revenue on subsidizing costs that exceed the most efficient means available and encourages contractual and accounting strategies that inflate the deduction. These problems are eliminated by ONRR establishing the allowable deduction. ONRR should use publicly available data from the Surface Transportation Board and other sources to establish the allowable deductions for transportation from each lease location to its destination.

If ONRR directly establishes the allowable deduction for coal transportation, it is unnecessary to adopt a percent of value limit—50% or otherwise. However, if ONRR does not accept our recommendation and continues to allow transportation deductions on the basis of costs reported by producers, then limiting the transportation deduction as a percent of value is necessary to discourage inefficiencies and inflated deductions. In that event, Interior should consider setting the percent of value limit for each fossil fuel proportionately based on the relative average costs per mile of transporting quantities of coal, oil and gas of comparable energy value. It remains our strong recommendation, however, that ONRR directly set the allowable deduction at the lowest reasonable cost to each destination and thereby eliminate the need for a percent of value limit.

Finally, deductions for washing should be eliminated. Washing is an extension of the extraction process for which deductions are not otherwise allowed. Eliminating this deduction further simplifies the valuation process.

4. Establish Administrative Systems to Enable Market Valuation.

Property valuation procedures typically begin with samples of market data verified as arm's length sales. ONRR will necessarily use all currently available information concerning market transactions to undertake the valuation process. However, if judged necessary, ONRR could supplement existing information through a sales reporting process. If, in certain cases, valid market prices are unavailable, ONRR can rely other professionally accepted valuation methods to establish equitable values for coal.

If needed, ONRR could implement a sales reporting process to secure supplemental market data. Through that process, ONRR would require coal lessees to provide sales prices at destinations and other relevant information. For lessee sales to independent brokers, ONRR would require lessees to incorporate in their sales contracts with purchasers the reporting of information on subsequent sales through the destination market point. Those contract provisions should allow intermediate brokers with the choice of reporting the data through the coal lessee or directly to ONRR. Further, ONRR could provide that this sales information be treated as confidential, proprietary data.

Because ONRR's posting of market values for coal will lag at least one period behind dates when royalty payments are due, the rules should allow coal lessees to pay royalties without penalty at 90% of the last posted market values for the actual volume of coal sold during the period for which the payment is made. The rules would provide for adjusting payments in future periods to 100% of what is required for the current period.

5. Report to the Public Key Royalty Information.

The new market valuation process will enable the Department of Interior to achieve transparency for the public with regard to federal mineral royalty valuation. ONRR will set the values of coal, the allowable transportation deduction and the amount of required payments. All of this information will be established pursuant to official actions by the agency.[3] None of this information can reasonably be considered proprietary, especially since this proposal does not involve any new disclosures of sales prices or corporate financial information. Once the valuation process is operational, the Department should publish at the close of each payment period a "Public Royalty Report" that details for each coal lease the market value of the coal, the method by which the value was determined, the amount of transportation deduction allowed, and the amount of royalty payments.

Citizens certainly have the right to know the key information that determines the royalty receipts collected on their behalf. As noted, providing this information will restore public trust in federal royalty administration.

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[3] In fact, the key items of royalty information—ONRR's values for coal by type at each destination for each period and the allowable transportation deductions—would best be publicly posted for ready access by coal producers to calculate their royalty payments.

It is an unfortunate fact of history that federal royalty administration has been periodically beset by controversy over the past century. Problems develop under the cover of secrecy and worsen to a point that an untoward event or report triggers the emergence of a new crisis or a scandal. Problems that emerged over the last decade led former Secretary Salazar to restart royalty administration anew with the creation of the Office of Natural Resources Revenue and to the proposal of the new valuation rules under Secretary Jewell's leadership. Those are extraordinarily important initiatives to restore public trust.

One further step is needed to remedy the past difficulties and prevent them from recurring again. That step is simply to end the secrecy and let the sun shine on the royalty process. Our recommendations for valuation and transparency are all of one piece. They offer the Department of Interior an opportunity to start and welcome a new day in federal royalty administration based on the highest values of equity, integrity and public transparency.

Thank you for the opportunity to comment.

Sincerely,

Dan R. Bucks
Former Montana Director of Revenue (2005-2013)

Senator Christine Kaufmann
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