KATIE SWEENEY
General Counsel

July 26, 2011

Ms. Hyla Hurst
Regulatory Specialist
Office of Natural Resources Revenue
P.O. Box 25165
Denver, CO 80225

Dear Ms. Hurst:

RE: RIN 1012- AA00, Advanced Notice of Proposed Rulemaking on Federal and Indian Coal Valuation

On May 27, 2011, the Office of Natural Resources Revenue (ONRR) published an advanced notice of proposed rulemaking (ANPR) regarding potential changes to federal and Indian coal valuation regulations. 76 Fed. Reg. 30,881. The National Mining Association (NMA) appreciates the opportunity to provide these comments in opposition to changes to the coal valuation regulations. Such changes are not justified and a major overhaul of the 1989 regulations at this juncture would only create additional uncertainty for the agency and the coal lessees. NMA's members are producers of most of America's coal, metals, industrial and agricultural minerals; manufacturers of mining and mineral processing machinery and supplies; transporters; financial and engineering firms; and other businesses related to mining. NMA's members include companies that lease federal coal and therefore have a significant interest in the ANPR.

GENERAL COMMENTS

As a general matter, NMA doubts the contemplated changes will be revenue neutral despite ONRR's stated intention in the ANPR that the final regulations will be revenue neutral. It is unclear how the ONRR defines revenue neutral. Likely ONRR means keeping the federal government whole with the adopted method resulting in winners and losers between the state and tribal recipients of federal royalty or keeping the individual states and tribal recipients whole that in effect keeps ONRR whole. NMA is concerned that regardless of which government entities ONRR keeps whole, there will probably be a shift in royalty liability between producers.

Furthermore, NMA disagrees with the primary contention that changes to the regulations are merited by "significant" changes in the domestic coal market over the last 20 years. Neither the changes discussed nor the report relied on by ONRR, "Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf" justify the wholesale changes to coal valuation regulations contemplated in the ANPR. In NMA's view, these flaws are representative of the failure of ONRR to appropriately distinguish between the production and marketing of coal and production and marketing of oil and gas.

Specifically, the ANPR identifies changes such as increasing vertical integration of mining and power production, and increasing production by coal cooperatives as well as continued difficulties regarding non-arm's length valuation and other continued controversies over valuation. However, ONRR is mischaracterizing some of the changes and failing to acknowledge that some of the agency's concerns are self-inflicted. For example, ONRR is mistaken in its assumptions regarding vertical integration and coal cooperatives. Since 1989 the production from federal coal leases in the Powder River Basin (PRB) has increased significantly with very little of the coal going to mine-mouth power plants. Therefore, this percentage of coal used at such facilities has likely declined instead of increasing as alleged by ONRR.

While as the ANPR indicates, there are some controversies over royalty payments, the controversies have largely declined over the years as the agency and lessees became more familiar with the 1989 coal valuation regulations. Most of the controversies today relate to line item adjustments for transportation and processing as opposed to disputes regarding valuation methodologies

The ANPR asserts that the cumbersome nature of the existing regulations justifies new regulations, asserting the that the agency's need to analyze literally thousands of sales, transportation and processing transactions results in disputes regarding valuation methodologies. ONRR's concern, however, regarding the need to analyze so many transactions, fails to acknowledge the self-imposed nature of the agency's obligations. It is the agency's reporting requirements that create such duties due to the requirement that timely reported routine price adjustments for quality, changes in indexes within coal contracts, estimated non-arm's-length washing and transportation true-ups to actual must be reported for each month's previously reported royalty value. Since the monthly reporting of a prior period adjustment is primarily to determine if late payment interest should be assessed, ONRR should determine if their current reporting process results in more cost incurred to determine late payment interest than the amount of late payment interest being assessed and if there is a better method to determine when late payment interest should be assessed.

Furthermore, the report referenced in the ANPR, "Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf," fails to justify wholesale changes to the coal valuation regulations. The majority of the report is focused on oil and gas reporting with few specific references to coal or solid minerals. Almost all of the background information forming the recommendations in the report comes from the oil and gas industry issues, not surprising as based on statistics in the report coal comprises approximately 6% of the federal royalty received while oil and gas comprises approximately 88% of the federal royalty received for FY2007. And even for recommendations that do pertain to coal, ONRR misapprehends the nature of those recommendations. For example, in Chapter 4, Audits, Compliance, and Enforcement, the only specific recommendation pertaining to coal is 4-27,"By the end of FY 2008 MMS [Minerals Management Service] should review, and (as appropriate) revise and implement the regulations and guidance for calculating prices used in checking royalty compliance for solid minerals, with particular attention to non-arms-length transactions." If reviewed in context, it is apparent that ONRR is making a stretch that the report is actually recommending that solid minerals go to a simplified reporting basis as implied in the advance rule making notice. Since coal is already required by regulation to submit detailed sales and quality information by individual customer, the recommendation should be read as urging the agency to use the already reported information more efficiently as "implementation of a risk-based process could assist MMS in making the most efficient use of its resources."

Many of NMA's concerns regarding the ANPR stem from ONNR's failure to understand the fundamental differences between oil & gas and coal. As the coal industry has explained during previous rulemakings, coal, its production and marketing, have characteristics distinct from oil and gas. At least some of these differences were acknowledged in the 1989 rules but are never mentioned in the 2011 ANPR. As there is different statutory authority for imposing royalties on coal versus oil and gas, there is additionally a distinction in the royalty valuation history for such commodities. Specific differences relate to market, production and reserve development, marketing and contract practices, large ongoing capital and operating expenses, and long-term contract arrangements. Such differences were recognized in the congressionally mandated study that provided much of the bases for the 1989 regulations. That report, the 1984 Report of the Linowes Commission, Fair Market Value Policy for Federal Coal Leasing, emphasized that "the market for coal leases is quite different from that of oil and gas leases, in which there is a readily identifiable market and an established price, great uncertainty in discovering deposits, and high levels of competition." Report at p. 59. Similarly, the 1989 regulations themselves acknowledged the considerable differences between coal and oil and gas. Specifically, the final rule acknowledged key differences that required disparate treatment for coal, including differences in markets; production and reserve development; and marketing and contract practices. 54 Fed. Reg. at 1518. These considerations have not changed since 1989 and remain sound public policy reasons for the different treatment of coal versus oil and gas.

The comprehensive 1989 rulemaking that established the coal valuation regulations was the result of several years of consideration and efforts to develop an appropriate set of rules for the determination of value of coal for royalty purposes. The rulemaking represented a compromise on all sides; few stakeholders were completely satisfied but there appeared general recognition that the final regulations represented the best compromise that could be developed. Such a deliberative process should not be undone without significant evidence that the existing rules are inadequate. Complexity of rules in and of itself does not justify wholesale changes, especially when the existing rules are well-understood by both regulators and the regulated community. In fact, efforts at simplification subsequent to the 1989 rules have been unsuccessful due to lack of consensus on what would be a fair simplification. For example, over several years, the Department of Interior's Royalty Policy Committee's Coal Subcommittee has explored the suggested alternatives included in the ANPR and many others used by states and foreign countries that have not been included in the ANPR. The Coal Subcommittee, whose members represent the Indian Tribes, states and industry, was unable to come to any agreement on a fair and equitable alternative valuation method compared to the current valuation method. ONRR should recognize that instead of providing certainty, a major overhaul of the coal valuation regulations at this juncture would only create additional uncertainty. Thus, the new rulemaking effort should be abandoned.

SPECIFIC COMMENTS

This section of NMA's comments pertains to questions raised in section III of the ANPR, "Description of Information Requested." 76 Fed. Reg. 30883-30884. The comments attempt to address in the same order the topics raised in this section of the ANPR. If the comments do not directly address a given topic, that omission indicates that NMA has not yet formed a position on that topic.

Alternative Valuation Methodologies

- Alternative to Gross Proceeds

In an ideal world, NMA would recommend a return to the traditional view of "value of coal" as opposed to gross proceeds. Such an approach would allow current deductions for coal washing and transportation as well as exclusions for certain taxes, freezeproofing and dust suppression. Realistically, NMA does not believe ONRR would consider that approach so, to retain the certainty provided by the existing regulations, would not recommend changes to the current structure.

- Dollars-Per-Energy Content Unit; Dollars-Per-Weight Unit

Based on the language in the ANPR, NMA assumes that if ONNR established the royalty due on a "dollars-per-energy content unit (e.g. dollars-per-million British thermal units ($/MMBtu)," this means a set $/MMBtu. Such an approach would not work for federal coal leases for the following reasons. The majority of coal purchasers make their purchasing decision on a total delivered cost per MMBtu, i.e. f.o.b. mine cost plus shipping. The availability of multiple shipping options results in different f.o.b. mine prices due to the freight competition. This is particularly true in the PRB where the middle and southern mines in Wyoming enjoy rail competition from two railroads, while the northern Wyoming PRB mines are limited to a single rail option. Since there are only two published index prices quoted for PRB coal, 8400 Btu and 8800 Btu, and the freight differentials between the Wyoming mines, the actual price received by the lower Btu mines compared to the higher Btu mines is not determined on a straight linear calculation when comparing the published prices for 8400 and 8800 Btu coal. This is demonstrated by comparing the royalty per MMBtu that would be due on the July 8th OTC Broker Index published prices for 8400 and 8800 Btu coal assuming the current 12.5% royalty rate. The $11.83 published price for 8400 Btu coal equates to $.7042 per MMBtu or a royalty of $.0880 per MMBtu while the $14.03 published price for 8800 Btu coal equates to $.7972 per MMBtu or a royalty of $.0996 per MMBtu.

When the revisions to the coal valuation regulation were adopted on January 13, 1989, NMA notes the MMS response at 54 Fed. Reg. 1494 to General Issue 2: Valuation of Coal under Some Form of a Cents-per-Million British Thermal Units (Btu) Valuation Procedure "concluded the proposal may not represent the market value" and "also concluded that the development and selection of a single dollar amount per million Btu would not be easy and could gravitate into a highly complex, labor intensive exercise."

As regards dollars-per-weight unit (e.g. $/ton), NMA further notes that if ONRR maintains revenue neutrality for the states and Indian Tribes, ONRR would in all likelihood have to establish a separate $/ton rate for each state where federal and Indian coal is currently being produced. Converting to this method while maintaining revenue neutrality would result in a significant shift in the royalty liability to the producers of lower Btu coal from the producers of higher Btu coal based on the current royalty.

- Fixed Royalty Values

As to ONRR's request for comments on fixed royalty rates, NMA has several critical questions regarding how ONRR would proceed. First, currently the royalty rate for surface mined coal is 12.5% of value while underground mined coal has a royalty rate of 8%. If ONRR implemented some fixed royalty rate, would there be a differential in the fixed royalty rate between surface and underground mined coal? Would producers still be able to request royalty relief for unique mining circumstances and how would such relief be determined?

In response to the question whether fixed royalty values ($/MMBtu or $/ton) be revised from time to time, NMA notes that since many tons of coal are sold in advance of the actual year of production and shipment, any revision to a fixed royalty value from time to time, particularly after the coal has been sold for future shipment, may result in less certainty in the overall price. Thus, such an approach may place federal and Indian coal that competes for sales in marketplaces served by non-federal coal at a competitive disadvantage. In addition, to better answer this question, NMA would need ONRR to provide additional information regarding (1) the trigger or parameters for determining changes in the fixed rate; (2) assurances to the producer that increases in the fixed royalty rate due to a price spike will be reduced if prices drop in the future; and (3) whether the change in fixed royalty rate would be applied against the previously reported production for the period used to determine the change in the fixed royalty rate or only prospectively until the next review.

- Use of Published Index Prices

NMA does not believe the use of published index prices to determine the value of coal is a workable approach for the following reasons. First, while PRB coal has a recognized published index price, PRB published index prices are quoted in one train increments which does not reflect how the majority of the PRB is sold. The majority of PRB coal is sold based on the annual needs of the coal purchaser. Second, research conducted by the State of Wyoming using published index pricing for ONRR's Coal Subcommittee indicated significant issues regarding value for coal. Third, there is no published index price for federal coal outside of PRB.

Furthermore, use of published index prices would be extremely complicated given the fact that a significant percentage of Federal and Indian coal is sold in advance of when production occurs, i.e. today most producers are selling coal for delivery in 2012, 2013 and 2014. If ONRR would go to a published index market price to value coal, how would ONRR implement the published index price? Would ONRR establish the royalty basis for coal sold today for delivery in 2014 at today's 2014 published index market price or would ONRR require the actual published market price for each month in 2014, when the coal is actually produced and shipped, as the applicable price basis for determining the royalty for coal sold today but shipped three years later?

- Concentration of Federal or Indian Production in Certain Areas

The ANPR specifically asks whether the concentration of federal or Indian production in some areas of the country creates any potential problems with relying on index prices in those areas, now or in the future. NMA believes that this situation further complicates the use of index prices in such areas particularly since the majority of Indian production occurs on areas where there are no publicly published prices.

Non-Arm's Length or No-Contract Situations

- Retention of Current Non-Arms Length Benchmarks

NMA disagrees with ONRR's contention that the benchmarks have been difficult to use. From NMA's members' perspective the non-arm's-length benchmarks are generally workable.

- Revisions to Benchmarks

The only change that NMA would recommend to the benchmarks would be to allow the use of arm's-length sales from the producer's own mine in the first benchmark. When the original benchmarks were published in the proposed valuation rule, 52 Fed. Reg. 1851, January 15, 1987, adopted January 13, 1989, 54 Fed. Reg. 1492, the use of a producer's arm's-length sales from their own mine was not precluded. However, inexplicably, the final rule excluded use of the producer's own arm's-length sales. NMA advocates that ONRR allow the use of comparable arm's length sales by the lessee or its affiliates.

- Use of Published Index Price

NMA opposes the use of published index prices to value non-arm's length transactions for the same reasons articulated above opposing the use of published index prices for alternative valuation methodologies.

Transportation and Washing Allowances

- Potential Simplification of Allowances

NMA does not believe major changes to allowances are necessary. NMA would, however, recommend one change to mirror the IRS estimated tax payment system for interest due on underestimated tax payments. Such a change would reflect that the majority of adjustments reported are for the true-up of non-arm's-length allowances originally reported as estimates that ONRR requires to be reported for each period primarily for computing interest on late payment if the estimate was greater than the actual cost calculated on an annual basis. ONRR should consider that if the estimated allowance amount deducted on an annual basis is within 90% of the actual allowance amount on an annual basis then no interest would be due on the reported adjustment. This would mirror the IRS estimated tax payment system for when interest is due on underestimated tax payments. As an alternative, ONRR could determine a safe harbor estimated calculation for interest payments. Use of the 90% or some safe harbor would allow for a net amount to be reported for the allowance for the last month of the year instead of reporting the change in the estimated amount to actual for each month of the previous year.

- Standard Cents Per Ton Allowance Amounts

NMA does not believe that ONRR should establish standard per ton allowances for washing and transportation in lieu of calculating actual costs. The recovery ratio of clean coal from washing varies from mine to mine and therefore results in different cost per ton as the washing allowance that should be maintained. The transportation allowance is based on the distance the coal is shipped prior to sale and standardizing the transportation allowance regardless of the distance shipped would probably reduce the market penetration of some federal and Indian coal. Some coal is shipped by rail to market while other coal may be shipped by rail to a river dock for further transport by barge. NMA believes trying to differentiate between the transportation methods used to transport coal to market would be overly complicated and therefore not further ONRR's goal of simplification.

- Coal Washing

Coal washing should not be characterized as an operation necessary to put coal into marketable condition for which no allowance should be permitted. Without the current washing practices, federal and Indian coal produced would be a lower quality product that would be sold in the market place at a significantly lower price than the washed tons currently being sold. The washing allowance allowed is compensated for by the higher price received for the washed product compared to the price a producer would receive for an unwashed product.

- Transportation Allowances

NMA opposes basing transportation allowances on yearly averages from one region to another. The transportation allowance is based on the ultimate destination of the purchasing customer which varies from customer to customer. For example, PRB coal is currently being exported through terminals on the West Coast and through the Gulf of Mexico which results in different costs from the same region. It would be overly complicated for ONRR to set a standard transportation allowance from the PRB to the West Coast and a different standard transportation allowance to the Gulf of Mexico from the PRB and other standard transportation allowance for coal shipped to other regions. Such an approach seems to add more complexity and uncertainty that ONRR is trying to avoid.

- Limitations on Allowances

The ANPR asks whether coal transportation and washing allowances should be limited to a maximum percentage in a manner similar to gas transportation and processing allowances. Currently, coal can claim a transportation and washing allowance up to sales price of the coal less one cent—i.e. report a royalty value of one cent per ton. NMA would not oppose a limit as long as the current policy of allowing the allowances up to one cent less than the gross proceeds received is maintained.

Coal Cooperatives

Generally, since based on the description of coal cooperatives in the ANPR, these facilities are similar to some of the mine-mouth operations at existing power plants, NMA believes that the current non-arm's-length benchmarks are workable for such facilities.

Other Issues

- Combination of the Federal and Indian regulations

While there are legitimate reasons for combining the federal and Indian coal valuation regulations, NMA believes that the Indian tribes are likely to oppose such a combination.

NMA RECOMMENDATIONS FOR SIMPLIFICATIONS

NMA contends that the current reporting requirements create many of the valuation issues ONRR is trying to address. Thus NMA recommends the following reporting alternative which would specifically address ONRR's statements that it "must analyze literally thousands of sales, transportation, and processing transactions each month. Performing this analysis is costly and burdensome for both the Federal Government and the regulated industry. . . . . Provide methodologies that are as efficient as possible for lessees to use. Provide early certainty that correct payment has been made." NMA believes that there are efficiencies that can be gained by going to an annual reporting with estimated payments being trued up compared to the current detailed monthly reporting that is causing all of the prior period adjustments. The early certainty that correct payment has been made on the current monthly reporting is less efficient than early certainty the correct payment has been made on an annual reporting basis. ONRR should adopt a monthly estimated royalty payment with an annual (or quarterly or semi-annual) report filing of the detail as the true-up to the estimated payments. Interest would be due on any underpayment of the estimated royalty if the estimated amount paid did not reach some threshold much like the IRS does with income taxes and federal excise taxes.

Such an approach would eliminate the analysis of many of the transactions ONRR currently reviews on a monthly basis. Also the payment of estimated taxes with a later actual filing truing-up the estimates is a fairly standard practice in the tax world. As examples: (1) quarterly estimated taxes are paid for income tax liability with an annual return due the following year; (2) bi-weekly estimated tax deposits are paid for black lung excise tax liability with a quarterly return filed the month after the end of a quarter to true-up the deposits made; (3) DOI's Office of Surface Mining requires quarterly reporting the abandoned mines land fee liability with no estimated payments made for the quarter; (4) the State of Wyoming requires monthly estimated severance tax payments with a true-up to the actual liability determined by the annual severance tax report filed the following year. ONRR could recognize many benefits to adopting this NMA recommendation, including: (1)

elimination of the monthly review with the review of actual reported data over a longer time period which would result in fewer prior period adjustments being reported; (2) many of the lessees contractual commitments are for a calendar year; (3) when audits are conducted they are generally on an annual basis, but due to ONRR reporting requirements, the data is split by month instead of looking at annual amounts.

Conclusion

NMA does not believe wholesale changes to the coal royalty valuation regulations are justified. While the current regulations may not be perfect in all respects, they are workable and provide much needed certainty to both regulators and the regulated community. Broad changes to the regulations would create regulatory uncertainty that would outweigh the benefits of simplification. Some narrowly targeted simplifications, as NMA suggests above, could avoid wide-ranging regulatory uncertainty yet still accomplish many of ONRR's objectives as laid out in the ANPR. If you have any questions regarding these comments, please contact me at 202/463-2627 or ksweeney@nma.org.

Sincerely,

Katie Sweeney

Katie Sweeney