Western Fuels Association/Western Fuels-Wyoming

Proposed Responses to ONRR Notice of Proposed Rulemaking

July 25, 2011

What alternatives to gross proceeds would you recommend?

We have never been opposed to paying Federal royalties on gross proceeds, other than it has consistently resulted in a royalty valuation that exceeds the actual market value of the coal. Our concern has been the interpretation and application of the bench marks by ONRR. Clearly the individual benchmarks could be modified, as discussed below.

An alternative approach would be to consider the published coal price in publications like Coal Daily which publishes coal prices for physical delivery on a weekly basis. This publication covers coal markets in Central Appalachia, Northern Appalachia, Illinois Basin, PRB 8800, PRB 8400 and Western Bituminous. However, in using an index system it must be recognized that the prices from one quality to another is not linear as explained in the next section.

Would a dollars-per-energy content unit (e.g., dollars-per-million British thermal unit ($/MMBtu)) or dollars per-weight unit (e.g., $/ton) valuation method be reasonable?

A valuation method using $/ton would not be reasonable because the market value for any coal sold at arm's-length is determined more by its energy content than by weight.

A valuation method calculated strictly on a $/MMBtu basis would also not be reasonable because the change in market value from, for instance, 8400 Btu coal to 8800 Btu coal is not linear. Using this method would suggest it is linear. For example, consider a price of $14.50/ton for 8800 Btu coal. On a linear basis, this price translates to $13.84/ton for 8400 Btu, a price differential of $0.66/ton or 4.6% of the 8800 Btu coal price. The usual price difference in the market between 8800 Btu and 8400 Btu coal is currently about $2.50/ton or 17.2% of the 8800 Btu coal price. The non-linear price differential is due to factors such as derating and higher transportation cost on a $/mmBtu basis associated with lower Btu. That differential is further magnified when translating to even lower quality coal like the 8100 Btu coal from WFW. The true market value for 8100 Btu coal is about 20% below the market value of 8400 Btu coal even though the difference in quality is only 3.6%.

Should the current non-arm's-length benchmarks and their current sequential priority be retained? If not, what other methodologies might ONRR use to determine the royalty value of coal not sold at arm's-length?

We believe that the first benchmark should remain but should be modified as follows:

The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition of produced coal by other than an arm's-length contract), provided those gross *proceeds are within the range of the gross proceeds derived from, or paid under, comparable arm's-length contracts for sales, purchases, or other dispositions of like-quality coal produced in the area, or from the same mine.*

Deleted: *between buyers and sellers neither of whom is affiliated with the lessee*

In WFW's situation, there is no other coal sold from the Powder River Basin in Wyoming of comparable quality to that of WFW. The quality of coal sold by WFW under non-arm's-length agreements is 8100 Btu or less. The next highest rank coal sold from the PRB is at least 8300 Btu and most PRB coal is between 8400 and 8800 Btu. Other than arm's-length sales from WFW, there are no arm's-length sales of comparable quality to provide a meaningful comparison.

The requirement that comparable arm's-length contracts be between buyers and seller neither of whom is affiliated with the lessee implies that a mine may make arm's-length sales at a lower price simply to minimize royalties on its non-arm's-length sales. Unless those arm's-length sales are for minimal quantities in total, an operator would lose more in the lower selling price on its arm's-length sales than it would gain in royalty savings on its non-arm's-length sales.

Benchmarks 3 and 4 are of little value because the prices reported, at least those reported to the Energy Information Administration of the Department of Energy, include, at least for WFW coal shipments, rail transportation expenses and handling expenses incurred by the end user as well.

Should the factors for determining the comparability of arm's-length contracts to arm's-length contracts, at 30DFR 1206.257 ©(2)(i), be amended, clarified, or removed?

The first thing that comes to mind when comparability is mentioned is Btu's. However, other elements in the coal can have an impact on comparability depending on the final user i.e. sulfur, sodium, calcium, etc. WFA does not believe the reference to comparability should be changed. Amending or clarifying may result in something that is so restrictive it may not useful.

Should the royalty value of coal initially sold under non-arm's-length conditions be based on the gross proceeds received from the first arm's-length sale of that coal in situations where there is a subsequent arm's-length sale?

We would not have an issue if the royalty value were based on the gross proceeds of the first arm's-length sale as long as that value excluded costs that are not associated with mining or marketing the coal, such as the management fee paid to WFA by its members. In 1994 the Interior Board of Land Appeals determined that the management fee was not subject to Federal royalty.

Should the royalty value be determined by calculating the cost to produce the coal plus a return on capital investment, if the particular coal is never sold at arm's length or if sold by a coal cooperative of which the lessee is a member? If so, how should the return on capital be calculated?

WFW and WFA have always opposed a valuation that includes a return on capital investment. A calculation of that type assumes coal sold through cooperatives, or through a non-arm's-length contract could always be sold on the open market at a value much higher than the non-arm's-length contract price, which is usually based on cost plus a margin. WFW's production costs have consistently exceeded the market value for the same coal. Therefore, ONRR is receiving royalties on that coal in excess of the actual market value for that same coal.

Adding a return on capital investment would penalize WFW for mining coal that may not otherwise be mined if it were not sold on a cooperative basis or via a non-arm's-length contract.

Should the royalty value of coal sold by these cooperatives be determined based on a different method than is used for coal not sold by or through cooperatives due to the unique aspects of these cooperatives? If so, what method(s) would you propose?

No. WFW is at a loss as to what "unique aspects" the ONRR feels exist under a cooperative structure versus another form of business. We believe that non-arm's-length sales should be valued at gross proceeds subject to bench mark one as modified above. We would be pleased to discuss this with ONRR to clarify the cooperative structure.