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Comments on Proposed Consolidated Federal Oil and Gas and Federal and Indian Coal Valuation Reform, ONRR-2012-0004-0024

COAL SOLD FOR EXPORT SHOULD NOT BE EXEMPT FROM FEDERAL ROYALTY PAYMENTS

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Abstract

The U.S. Department of the Interior (DOI) manages how federally owned coal is leased to private mining companies. One condition of a lease is that a company (lessee) is to pay royalties on each ton of coal extracted. The royalty revenue is divided between the federal government and the states where the mining activity takes place. Royalties are based on the gross payments or revenues from the sale of the coal. However, the current royalty program, administered by the Office of Natural Resource Revenues (ONRR), contains a major exemption: When the coal is sold for export (generally at a higher price than it would be sold for in the domestic market) the royalties are set at the domestic price for coal rather than the export price. This exemption reduces the amount received by the federal government and the states. This practice should be ended.

The royalty exemption not only provides a *de facto* subsidy to the coal industry, it provides benefits to several foreign countries that are in economic and political competition with the U.S. The U.S. coal industry is going through significant changes and requires a new business model. This is also true of the federal lease program and the various divisions within the Department of Interior. Eliminating the royalty exemption should be part of a broader overhaul.

DOI-ONRR proposed regulations in January 2015 that would repeal the export royalty exemption as part of broader regulatory changes. This letter comments on the proposed regulations, outlines the arguments in favor of ending the export exemption, and responds to points made in a November 2014 National Mining Association presentation opposing these changes.

Our comments on the proposed regulations can be summarized as follows:

- ONRR's proposal to set the royalty revenue base on the first arm's-length transaction after the coal is mined should be adopted (the current arrangement allows the base to be set on non-arm's-length transactions, which include sales to the company's own subsidiaries).
- ONRR's proposal to base expense deductions for transportation costs on a reasonableness standard is sound and should be adopted.
- ONRR's proposal to allow the agency to substitute its own method if it is dissatisfied with coal company presentations reflects the need for flexibility in a changing marketplace. It should be adopted.
- As written, the proposed regulations appear to reduce royalty payments to zero in a low-price environment (such as exists now). This part of ONRR's proposal should be corrected. If it is not corrected, federal and state governments will actually lose revenue from this portion of the proposed rules. Under no circumstances should these regulations result in per-ton revenue collections for the federal and state governments that are less than currently received.
- No deductions should be allowed for coal producer expenses that are related to the speculative aspects of export transactions. No deductions should be allowed for liquidated damages, for instance, or for take-or-pay contract penalties.
- A program of external, independent and public overview should be instituted to protect the taxpayer and the coal industry from any imbalances that may be introduced as a result of the proposed changes.

Background: The federal coal-leasing program

The U.S. government owns the largest remaining coal deposits in the country, in the Powder River Basin (PRB), which is located primarily in Montana and Wyoming. The government leases the coal to private companies in order to provide access to the reserves.[1] After entering into a lease, the coal company is required to pay a royalty to the federal government amounting to 12.5% of the gross proceeds[2] received from each ton of coal (minus certain transport and other cost deductions). The royalty payment, or rent, is then divided 50-50 between the federal government and the host state—usually Montana or Wyoming.

The lease allows the coal company (lessee) to control the mining process, timing, price, distribution and use of the coal.[3] The U.S. government, as owner and partner with the coal

[1] For in-depth discussion of leases and lease process see: Institute for Energy Economics and Financial Analysis, The Great Giveaway, May 2012. http://216.30.191.148/IEEFA/062512_IEEFA_PRB_coal_report_FINAL2.pdf (IEEFA-Great Giveaway)

[2] http://www.law.cornell.edu/cfr/text/30/1206.257

[3] BLM's website identifies the basis of royalties as "gross proceeds on the value of the sale" http://www.blm.gov/wo/st/en/prog/energy/coal_and_non-energy.html. The standard lease (Section 2a Production Royalties) bases valuation on the regulations. "Sec. 2. Lessor, in consideration of any bonuses, rents, and royalties to be paid, and the conditions and covenants to be observed as herein set forth, hereby grants and leases to lessee the exclusive right and

company, in effect trades away its control and rights for a share of future revenues through the royalty payment (and an upfront payment based on a fair market valuation). In theory, when the market price is up, the royalty payment ensures that all partners receive greater revenue and, when the market price is down, each stakeholder bears the brunt.

The current program presents a glaring exception to this simple federal risk-sharing arrangement. As a result of regulatory amendments to the lease agreement, coal companies do not have to pay any royalty on "gross proceeds" generated as a result of export sales. Coal companies pay the royalty only on a "mine mouth" coal price, established in relation to the U.S. domestic coal market as defined by current regulations.

For instance, if the mine mouth price of PRB coal is $10 per ton in the U.S., but a ton of coal is fetching $90 per ton on the international market, only the $10 per ton is subject to the 12.5% royalty rate (with the transport and coal preparation deductions). The difference of $80 per ton is exempted from any royalty rules governing the treatment of income and expenses related to exports.

To take advantage of the exemption, the coal industry has created an accounting treatment that relies on the creation of separate, wholly owned subsidiaries.[4] The entity that mines the coal sells the coal to a subsidiary (or affiliate), which then transports the coal and sells it for export. Under the existing rules, the revenue from the first sale to the subsidiary is deemed the "proceeds" for the purpose of applying the royalty rate. The revenue from the second sale is exempt from the royalty payment.

Powder River Basin coal producers and the current regulations hold that gross proceeds from coal sales at the "mine mouth" or to the subsidiary should be the only transaction subject to royalty payments.

The current regulatory treatment and its attendant accounting protocols allow producers to make one set of profit-and-loss presentations to regulators for the purpose of royalty payments and another set of financial presentations for investors. Neither represents a complete and true view.

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privilege to drill for, mine, extract, remove, or otherwise process and dispose of the coal deposits in, upon, or under the following described lands:"

[4] In the regulations these transactions between parent and subsidiaries are referred to as non-arm's length transactions. For coal sold pursuant to an arm's-length contract, the fair market value of the coal is deemed to be the gross proceeds of sale. For coal sold pursuant to a non-arm's-length contract (between a parent and a subsidiary), the value of the coal must be determined by using the first applicable technique of five listed in 30 CFR 1206.257(c)(2)(i-v). The techniques used to calculate coal value for the non-arm's-length contracts are, in order:

1. Gross proceeds, so long as the gross proceeds are similar to those of the arm's-length contracts of unaffiliated buyers and sellers
2. Prices reported to a public utility commission
3. Prices reported to the Energy Information Agency of the Department of Energy
4. Published, publicly-available spot prices or unique lessee-submitted information
5. Net-back calculations (sale prices less transportation costs)

Industry reporting (see articles below Gartrell) suggests that methods 4 and 5 are the most prevalent. However, since there is little transparency regarding actual ONRR practice, we are surmising the fact.

Private coal companies like Peabody Energy and Arch Coal provide reports to their investors that show it is typically much more profitable to sell PRB coal for export than to sell it on the domestic market. In late 2010 and early 2011, both companies told investors that coal sold for export, at an estimated market price of coal of $90 per ton, would yield a $20 per ton margin (after deductions).[5] This margin was between 5 and 10 times the margins for PRB mines selling coal in the domestic market at the time.

What prompted the federal reassessment of this exemption?

The National Mining Association, in its presentation to ONRR,[6] asked what has changed that now warrants action to require them to pay a royalty on previously exempted revenues.

Here is the sequence of events that led to the promulgation of the current proposal. The federal coal-lease program was not been audited or effectively reviewed by an independent outside entity for almost 30 years, although calls for regular external reviews had been made.[7]

In April 2012, then-Rep. Ed Markey asked the Government Accountability Office (GAO) to examine various broad aspects of its fair-market value-lease process, including whether the Bureau of Land Management was adequately counting the value of exports in the price charged for leases.

Subsequently, the Department of Interior's Office of Inspector General initiated a review of the program. As that review unfolded, Thomson Reuters[8] published an investigative article raising deeper questions about the treatment of export income for the purposes of assessing royalty payments.

Senators Ron Wyden and Lisa Murkowski followed up on the policy discussion by requesting the Secretary of the Interior to specifically examine the royalty issue, and by October 2014, Thomson Reuters had reported that the Interior Department had presented a plan to the White House Office of Management and Budget to revoke the royalty exemption.[9] The regulations were promulgated in January 2015.[10]

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[5] Peter Gartrell, *Peabody projections shows lucrative Chinese market for PRB coal,* Platts Coal Trader, December 6, 2010.

[6] The most recent presentation of industry views on royalty issues can be found in: National Mining Association, Industry Concerns: Office of Natural Resources Revenues Federal Coal Valuation Regulations, November 3, 2014. (NMA), available at: http://www.reginfo.gov/public/do/viewEO12866Meeting?viewRule=true&rin=1012-AA13&meetingId=672&acronym=1012-DOI/ONRR

[7] See discussion in the Great Giveaway of reform efforts in the 1980's that occurred in the wake of scandal regarding the program. One critical reform articulated at the time by Linowes Commission, a congressionally impaneled oversight body was to open up the program to various types of external reviews. The real impact of the scandal in the 1980's was not to improve oversight and transparency but to terminate it.

[8] Patrick Rucker, *Asia coal export boon brings no bonus for U.S. taxpayers*, Thomson Reuters, December 4, 2012.

[9] Patrick Rucker, Exclusive: U.S. plans to plug coal royalty loophole padding export profits, Thomson Reuters, October 23, 2014

[10] http://www.doi.gov/news/pressreleases/upload/2014-30033_PI.pdf

DOI Regulations: What they do and what should be done

The specific content of the proposed regulation

The proposed regulations address the practice by coal companies of selling federally leased coal to an affiliated or subsidiary organization and basing the coal value for royalty purposes on the price of coal in that non-arm's-length sale. The subsidiary (which is a marketing or logistics affiliate of the producer) then exports the coal to an end-user at a different price that reflects the subsidiary's risk and business-cost model. The coal industry is comfortable with this model. Opponents of the practice argue that it drives down revenues because the coal sales shortchange the government of its full royalty payment based on the full value received by the coal company and its subsidiaries. Critics have said that this practice amounts to the companies "selling the coal to themselves."

The issue has been elevated in recent years because PRB producers have turned to exports as a way to offset losses from shrinking domestic markets and revenue.

What do the new rules do?

ONRR proposes that the value of the coal be set based on the first arm's-length transaction after the coal is mined. This means that the value of the coal could no longer be set on the basis of sales to subsidiaries, which by definition are not arm's-length transactions. ONRR proposes a deductible allowance for transportation and other costs. Conceptually, therefore, the royalty rate is to be applied to gross proceeds less allowable transportation costs. This is very similar to the netback modeling provided by the industry in the Arch and Peabody examples provided above.

ONRR also would have the right under the new regulations to reject company presentations and to set its own valuation using any information it deems relevant, including:

- The value of like-quality coal from the same or nearby mines or regions.
- Public sources of reliable price and market information.
- Information reported to ONRR including that reported on its Form ONRR-4430 Production & Royalty Report.
- Transportation and any other costs it deems relevant.

This example illustrates the existing rules: a coal producer mines the coal, and then sells it to a subsidiary at a market price of $10.00/ton. The royalty payment is based on that price. The royalty amounts to 12.5% of US$10.00/ton or US$1.25/ton. The coal is sold again by the subsidiary to the ultimate buyer (perhaps for export) at a higher price, which is exempt from the royalty payment.

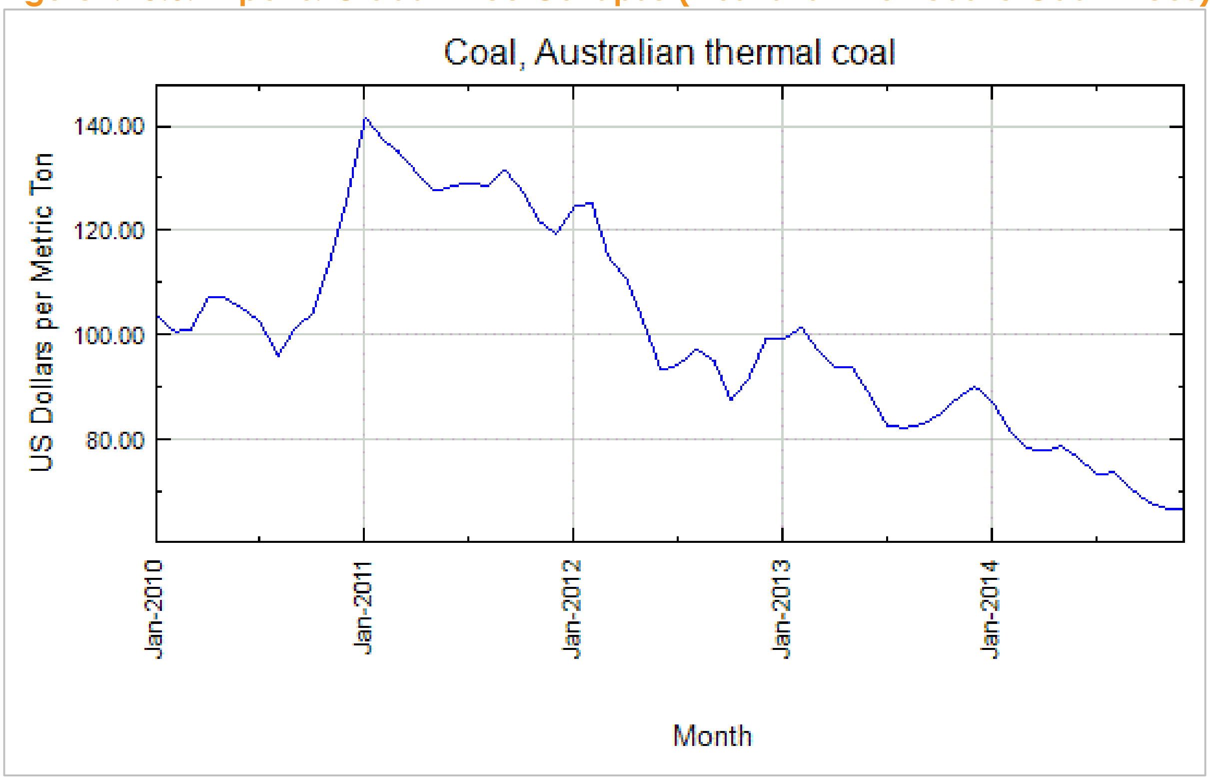
Under the new rules, the royalty would be based instead on the coal price at the first arm's-length sale. The first arm's-length sale would be the point at which the parent or subsidiary sells the coal to a party with "opposing interests," presumably an end user.

The proposed regulations would allow coal producers to deduct some of their costs of doing business from the price upon which the royalty is paid, although they regulations are not entirely clear on which deductions would be allowed. The types of deductions that might be allowed include inland transportation costs, port costs, liquidated damages, and take-or-pay obligations.

Impact of global coal markets on royalty payments

Global coal market prices have fluctuated considerably over the past five years, have recently collapsed (see Figure I), and are likely to stay low for the foreseeable future. The price of Newcastle Coal, an Australian coal product used as a global benchmark for thermal coal, has fallen dramatically since 2011. At its peak in January 2011, the price was $141.94 per ton. On April 15, 2015, the Newcastle price was $58.30 per ton.[11]

Figure I: U.S. Exports: Global Price Collapse (Australian Newcastle Coal Prices).



Index Mundi.com[12]

During the years when coal was trading for $70 and above (up until early 2014), the federal and state governments lost millions of dollars in royalties due to the export exemption. This is because coal producers were paying royalties based on the prices of the coal sold to their own subsidiaries ($10 per ton in the example above) rather than on the price of coal sold for export (for example, $70 minus allowable deductions).

[11] For the current price of coal see: Platts Coal Trader International, *Platts Physical Thermal Coal Assets, Newcastle*, March 19, 2015. Some analysts see the price dropping below $60.00 per ton through 2016. http://www.worldcoal.com/coal/12032015/Coal-prices-to-drop-further-BofA-Merrill-Lynch-coal2059/

[12] http://www.indexmundi.com/commodities/image.aspx?commodity=coal-australian&months=60

However, in current low-global-price environment, the tables have turned. In this low-price environment, the new rules will produce very little royalty revenue, and may even result in zero royalties in some cases—a circumstance which that not be permitted by the federal government, the owner of the coal.

To illustrate this point, we can take the example of 5,000 kcal/kg (9,000 Btu/lb) Indonesian coal sold into South Korea. We use the Indonesian coal product as the example because it is the PRB's closest competitor in coal quality and price.

Table I: New Royalty Regulations Applied to Export Transaction

Price and Deductions	$ Per Ton
PRB Coal Price (using proxy of price of Indonesian Sub-bituminous to South Korea)	60.00
Ocean Freight U.S. Port to South Korea	(17.00)
Free On Board – In vessel	43.00
Inland Transport – U.S. Rail (mine to port)	(35.00)
Port Fees	(8.00)
PRB Mining Costs	(11.00)
Royalty Margin	(11.00)

Assuming the coal would be sold at a market price of $60 per ton, we estimate the FOB (Free on Board) origin port (in the vessel) price of PRB coal to be about US$43 per ton.[13] The proposed rules allow for the deduction of inland transportation costs, which are approximately US$35/ton for rail and US$8/ton for port costs. This leaves royalties to be based on a coal value of negative US$11/ton, which would actually produce a royalty payment of zero. If any costs related to liquidated damages and/or take-or-pay agreements were to be included (this is not clear in the regulations) then the coal value net of all deductions would be even less. Thus, in a down market, there would be no royalty payments.

In this sense, the new regulations in a down market would zero out the royalty revenue and result in less money flowing to the federal and state governments.

However, if the market were to return to higher prices, the new rules would generate more income for the state and federal governments. Newcastle prices (the Australian thermal coal price often used as the international standard) would need to return to the mid $80/ton range in order for royalty payments on coal sold for export to be equal to the existing regulatory system.

In order for royalty payments (and the margins for U.S. coal producers) to reach healthier levels, Newcastle coal prices would need to be in the high $80/ton to low $90/ton range.[14] This

[13] The numbers used in this model are illustrative. They are in the range of plausibility. Different analysts may use different numbers. The point nevertheless is that in a down market the proposed regulatory scheme actually loses money.

[14] In this new, up market there will also be higher costs so it is difficult to predict U.S. Coal producer margins at this level with a high degree of accuracy.

level is approximately what Arch and Peabody estimated in their 2010-2011 calculations to investors. Some forecasters look to 2030 and beyond for these higher price levels.

This means that ONRR's proposed regulations are unlikely to produce new revenue for more than a decade. Revenue goes up only when the markets improve appreciably. As it stands, the proposed regulations will generate less royalty revenue for the government during this period than the current system does. How ONRR sets transportation deductions and treats liquidated damages and take-or-pay obligations are also factors to be considered. They are not settled in the proposed regulations.

What to do?

The federal government, as the owner of the coal, must decide whether it is in its interest to allow coal to be mined and sold to other countries if the federal government and the states receive no money for it. Very few private owners would accept a decade of receiving almost no revenue in order to sell a product that is already oversupplied on the world market.

Further to the point: as noted above, the U.S. government has given away all of its control and rights under existing leases. As a contractual matter, the questions of how the coal is mined, when it is mined, how much it is sold for on the market, and where it is sold are all made by U.S. coal producers. The only real consideration the U.S. government has is whether it is receiving revenue from the sales. And, under ONRR's new proposal it would receive no revenue for the foreseeable future.

Coal markets have changed significantly in the past 25 years

Representatives of the coal industry have responded to calls for reform by arguing, contrary to fact, that coal markets have not changed appreciably since the 1980s and that, therefore, no reform is required.

In an especially jarring assertion, the National Mining Association (NMA), in its Nov. 3 submission to the Office of Natural Resources Revenue, offered a largely wishful portrayal of the industry in hopes of keeping the royalty exemption in place.[15]

"Changes to the existing regulations are not justified as there have been no significant market changes in the last 25 years and markets are even more transparent," the NMA stated in the presentation.

The truth is quite the opposite.

The coal industry is by no stretch the same industry it was 25 years ago when royalty exemptions were granted. The pace of its transformation has gained momentum over the past five years, as a fundamentally new energy landscape has taken root nationally and globally.

In 1990, U.S. coal producers mined 934 million tons of coal. Production then rose, and reached 1.13 billion tons in 2005. Since then, it has declined: in 2013, it totaled 984 million tons and it remained at approximately the same level in 2014, at 987 million tons.[16] Production is expected to decline again in 2015. Coal-industry jobs, in the meantime, have been eliminated, dropping from 131,000 in 1990 to 80,396 in 2013.[17]

Features of the new energy economy that are affecting the coal industry include:

- Greater use of natural gas, and at lower prices. Natural gas prices have dropped substantially since 2009, making coal a much less competitive fuel. Forward-looking projections show some upward price pressure for natural gas but not enough to incentivize a new cycle of investment in the coal industry. In 1990, natural gas commanded 10.6 percent of the U.S. fuel market for electric generation. By 2013, natural gas had a 26 percent share.
- Wind and solar energy becoming more competitive. In 1990, wind and solar energy constituted barely 1 percent of the U.S. power generation market. By 2013, wind- and solar-power generation had quadrupled, to 4.3 percent of the market.
- U.S. coal's share of power generation dropping. In 1990, coal accounted for 55 percent of the U.S. market for power generation. By 2014, that share had dropped to 38 percent.
- Central Appalachia slide into permanent, secular decline. The cost of production of Central Appalachian coal has risen dramatically since 1990, coal produced in the region today has very limited power-generation value, and the region's higher-quality metallurgical coal is struggling for market share. In 1990, Central Appalachian states produced 31 percent of all U.S. coal production; by 2012 that share had dropped to 14 percent.
- Powder River Basin coal producers dominating U.S. coal markets. The royalty exemption (and other state and federal subsidies) have helped the PRB's domestic market share increase from 15 percent in 1990 to 43 percent in 2012.
- A collapse in coal stock prices. The decline of coal stock prices and the decoupling of those stock prices from broader indexes has occurred over the past five years. While the broader U.S. stock market is up 60 percent since 2010, coal industry stocks have dropped 60 percent. (Notably, three of the four largest coal producers in the Powder River Basic (Alpha Natural Resources, Arch Coal, and Peabody Energy) are in various stages of reporting multi-year losses, and the fourth-largest producer, Cloud Peak Energy, is marginally profitable. There is little likelihood, even with the royalty exemption and the current advantageous treatment of subsidies, that any of these companies will appreciably improve financial performance through 2015.)[18]

These six points above represent a short list of changes that have shaped the U.S. coal industry as it has morphed dramatically and fundamentally over the past 25 years.

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[16] www.eia.gov/beta/aeo/#/?id=95-AEO2015&cases=ref2015

[17] See: Energy Information Administration, *1994 Annual Coal Report*, Average Number of Miners by State, 1985, 1990-1994. See: EIA, *2013 Annual Coal Report*, Table 18: Average Number of Employees by State and Mine Type, 2013.

[18] http://www.ieefa.org/report-nyc-and-nys-pension-funds-should-divest-coal-stocks-a-shrinking-industry-weak-upside-and-wrong-on-climate-change/

Ending the royalty exemption is in the national interest and is necessary for defining a new era for the U.S. coal industry

The U.S. coal industry is going through what most observers see as a period of shrinkage.[19] Even stalwart industry leaders acknowledge this reality.[20] The NMA and its member companies, in its presentation filed with OMB, deny that fundamental fact.

The coal industry is losing market share in the U.S. and is expected to experience further erosion in the coming years. In the face of this shrinkage, the coal companies had planned to recover their markets and recover revenues by selling coal overseas—a theory that Platts has called "Export or Die." However, the global thermal export market is now weakening as it becomes clearer that Chinese and Indian coal demand is unlikely to continue at record growth levels.[21]

At this point in history, the broad, balanced question should be: what will a smaller coal industry in the U.S. (and perhaps the world) look like? What will be the new business models and partnership arrangements? How will the industry be financed?

Ending the royalty holiday is a part of the beginning of a new coal industry. The industry itself by and large is reluctant to acknowledge the nature of changes going on or to offer cooperative and creative solutions. Actions to manage the change are instead likely to come from policy changes and from the harsh changes wrought by continued bankruptcies, distressed sales and industry convulsions.

In this context there are several reasons to remove the royalty exemption now. Ending the royalty waiver is fiscally rational, promotes energy security and acknowledges the real world financial condition of the coal industry,

Removal of the royalty exemption re-establishes the fundamental risk and reward sharing relationship between coal producers and the U.S. taxpayer. Although exports are not likely to be as high in the future as the industry had hoped, some coal from the PRB will still be exported out of the U.S. The U.S. government and host states should receive their legal and fair share of the revenues derived from these sales.

Despite coal industry claims that markets have not changed in 25 years, the current business model of the coal industry is failing spectacularly. The current federal coal lease program in the PRB is operating in a new investment climate in which it does not compete successfully with the new forces unleashed by low natural gas prices, rising renewable market penetration

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[19] http://online.wsj.com/articles/hedge-funds-bet-on-coal-mining-failures-1416790137, http://www.bloomberg.com/news/2014-07-24/coal-bankruptcies-loom-on-pain-from-cheap-gas-new-rules.html. See also: Darren Epps, *Bankruptcies continue to rock coal companies in 2014, but hope for the survivors,* SNL, December 5, 2013; Dan Lowrey, *Recent coal asset sales in Appalachia see fire sale mentality gripping market*, SNL, October 30, 2014; Taylor Kuykendall, *Moody's projects coal to remain 'stable but weak' in the near term*, SNL, October 1, 2014;

[20] http://powersource.post-gazette.com/powersource/companies-powersource/2014/09/23/Murray-CEO-predicts-doom-for-coal-says-own-company-will-survive/stories/201409220208

[21] UBS Investment Research, U.S. Coal, *Some Coal Export and Port Capacity Math,* May 21, 2012. See also Morgan Stanley's short term review of both metallurgical and thermal coal: http://www.bloomberg.com/news/2014-04-08/morgan-stanley-says-coal-exporters-making-loss-as-estimates-cut.html and Michael Parker, Bernstein Research, *Asian Coal, Power and Renewables: Less, Less, Less: The Beginning of the End of Coal,* Prepared for the Institute for Energy Economics and Financial Analysis, March 17, 2014. For a summary article see: Jonathan Fahey, *Coal's Future darkens around the world,* AP, September 18, 2013.

and increased public support for alternatives to coal. New business models are necessary for both the Department of Interior and the coal industry. The new business models go far beyond the federal coal lease program, but have significant implications for its future direction.

The royalty exemption acts as an incentive created by the Department of Interior and the coal industry to sell coal to the nation's economic and perhaps political competitors. This is in direct contradiction to the premise of the federal leasing program, which has existed since the 1970's. The PRB coal reserve should be used as a tool to maintain America's energy independence. In fact, the lion's share of PRB coal is still used for domestic electricity generation, Every Record of Decision on lease applications written by the Department of Interior since the early 1990's has stressed the domestic use of PRB coal.

With the permanent geological depletion and permanent decline of Central Appalachian coal, the PRB becomes the nation's largest and last publicly owned coal reserve. The coal industry's desire to accelerate coal sales abroad to China, Taiwan, Japan, South Korea, Vietnam, Thailand and India changes the very definition of market. The aggressive demands by the industry to export coal are occurring at a time of profound economic and political change. Why should the U.S. government subsidize the economic development of these countries?[22] And why is the entire national security apparatus between the executive branch and Congress not involved in these multi-billion dollar decisions?

Who in the U.S. government decided that the U.S will never need this coal reserve? Who decided that there will never be a technological breakthrough and that it was okay to export air pollution and more greenhouse gas to other countries?

There is currently no longer a political consensus that large-scale coal burning is a defensible environmental proposition. Financial markets have rendered much the same verdict. The complex and largely permanent regulatory debates in the country over various types of air, land and water pollution demonstrate that the country has not yet found a publicly acceptable safe use for coal. And, the issue of climate change will not recede. These are powerful headwinds for the coal industry.

There is no policy consensus on what to do about climate change in the U.S. It is plainly inconsistent to espouse policies to fight climate change by lowering coal use while providing financial incentives to export it to other countries. Yet one does not need to embrace a climate-change rationale to support ending the royalty exemption for exported coal.

Examining the National Mining Association's case for preserving the exemption

In its presentation to the Office of Natural Resource Revenues, the National Mining Association argues against the closure of the loophole by saying that the federal government would be taxing the industry unfairly.

[22] Recently China passed a tariff on coal imports. The levy on coal produced outside of China raises the cost of imported coal. The Chinese government exempted coal mined in Indonesia from the tariff and is considering a similar exemption for Australian coal. (see: http://www.reuters.com/article/2014/10/22/china-coal-australia-idUSL3N0SH1CO20141022)

Industry has two sets of presentations: one for the government, one for investors

The industry argues that its arrangement of having different corporate entities conduct different activities in the coal sales chain is legitimate. They argue that the gross proceeds from coal sales at the mine mouth are the only transaction that should be subject to the royalty payment.[23] The industry sees the transactions that occur after the coal is mined and sold to a subsidiary—the transport of the coal by rail to the port and shipping of the coal to the ultimate consumers in another country—as a series of separate logistical transactions.

However, the industry case loses plausibility because it does not ultimately treat these companies as separate entities in their reports to investors. The coal producers make clear to their investors that they achieve a kind of excess profit from typical export sales.[24]

U.S. coal companies would not mine coal for export if they did not control the distribution chain that ultimately created the enhanced margins on their balance sheets. The current royalty system allows a coal company to capture the benefit from the market disequilibrium between domestic and international prices without paying a royalty to the coal owner, the U.S. government.

When coal companies discuss the benefits and risks of exporting coal with investors they make no distinction between mining and transport logistics. Arch and Peabody, in the aforementioned investor presentations on China, presented the financial margin, or netback as an enterprise-wide gain, not as segmented profits from companies in different lines of business.[25]

Arch and Peabody export small amounts of PRB coal, [26] as compared to Cloud Peak Energy. A careful read of Cloud Peak Energy's financial filings with the Securities and Exchange Commission shows they disaggregate the mining and transport logistics operations— revenue, expenses and margins.[27] At bottom, however, Cloud Peak combines all of these calculations on its corporate balance sheet using gross revenue and expenditures to create an enterprise wide bottom line. The entire enterprise is then valued to investors and the company trades on the stock market based on these aggregated financials.

If the transport and logistics subsidiary were not owned and controlled by the coal company parent there would be little or no incentive to mine coal for export out of the U.S. According to the recent NMA presentation, coal mined for export at the mine mouth has no inherent value advantage to a coal company (on domestic sales), except what is achieved through participation with subsidiaries. The key to success for the parent company is in the effective

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[23] The most recent presentation of industry views on royalty issues can be found in: National Mining Association, Industry Concerns: Office of Natural Resources Revenues Federal Coal Valuation Regulations, November 3, 2014. (NMA)

[24] The recent GAO audit of the program and the Inspector General's report both make clear that DOI does not take into consideration export revenue when calculating the fair market value of the lease. The royalty payment then becomes the ONLY mechanism that can be relied upon the by the U.S. government to secure any share of these coal transactions. For the discussion of excess profits see the Gartrell Platts articles cited above.

[25] UBS Investment Research, *Some Coal Export and Port Capacity Math*, UBS, May 21, 2012.

[26] Cloud Peak Energy exports approximately 4+ million tons per year. This amount, while small in terms of total output for the PRB and only 5% of Cloud Peak's annual production, has accounted for almost 18% of its annual revenues. The other significant importer out of Montana and under federal lease is the Gunvor Group/First Energy mine at Bull Mountain. It remains the strongest exporter. Gunvor/First Energy does not report its financial performance as it is privately held.

[27] CPE spun off from Rio Tinto in 2009. The first time the company segments actual revenues and costs by segment is in the company's Q4 2012 filing. Prior to that the company only discusses the structure in a qualitative manner.

integration of operations— the full value of the coal on the global market is released using the integrated resources of the corporate enterprise as a whole. [28]

Thus, the current regulatory treatment of royalties and its attendant accounting protocols allow the company to make one set of profit and loss presentations for the purpose of royalty payments and another set of financial presentations for investors (and presumably taxing authorities). The regulatory treatment results in revenue and expense definitions that minimize gross proceeds for royalty assessments. The investor presentations define revenue and expenses differently, designed to maximize profitable estimates, thus bolstering investor confidence.

Conflation of royalties and taxes

In its objection to the proposed reforms, the National Mining Association calls the proposed closing of the royalty loophole a "tax" and object to the idea of federal taxation. However, the NMA has conflated the concept of taxation and royalties. In reality, these are two distinctly different costs of doing business. A royalty payment is not a tax. In the federal coal-leasing program, the federal government owns the coal and has entered into a lease that requires a per-ton royalty payment. Private leases between landowners and coal companies are common in the industry.[29] The fact that the owner is the government, rather than a private landowner, does not change this aspect of the business relationship and make a royalty payment into a "tax."

When the federal government and the coal industry decided to exempt the export revenue from royalty fees the federal government lost money. Where the market—in this case the global market—has historically provided a substantial revenue uptick for the company, the U.S. taxpayer, as owner of the coal, does not share in the gain. The regulatory exemptions confound and ultimately defeat the simple relationship of risk and reward specified in the lease agreement.[30]

Business partners frequently reassess their positions and make changes accordingly. No one in the private sector refers to royalty payments as job-killing burdens. Lease agreements, including royaltiesk are simply a necessary and ordinary way coal company's gain access to desirable coal on lands not owned by the mining company. Any landowner would and should charge the highest royalty payment that the market would bear. In this role the federal government is acting as a participant in the market place, not as a tax collector.

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[28] The industry argument that royalties on exported coal constitute a tax on an integrated operation would have more plausibility if the coal industry were not taking advantage of market disequilibrium between domestic and global coal sales. The royalty payment to the United States government is not designed to expropriate value based on the budget needs of the state (a tax). It is designed so the federal government as owner can capture its fair share of revenue after granting maximum latitude to the lessee. The coal industry casts the royalty payment as confiscatory. This is wrong

[29] Part of the business model for Natural Resource Partners (NRP) is as an owner of mines. As an owner it leases to coal producers who pay it a royalty. Royalty income for NRP is fundamental to their business model. See the description of their business in Form 10-K, February 29, 2012.

[30] In its analysis the NMA states that new rules will subject the industry and government to uncertainty. New rules will need to be implemented. The uncertainty and confusion will result from industry efforts to use further legal and accounting gimmickry to prevent effective collection of royalty payments under a new regime. Coal companies and the coal industry have a right to marshal such opposition. It is not an obligation for them to do so.

Recommendations

The proposed regulations take important steps toward correcting the provisions in the federal coal-leasing program that have costs taxpayers millions of dollars and amounted to a "great giveaway." The regulations should also be amended to close loopholes that would remain in the program even under the proposed reforms.

Specifically, we recommend that the following provisions of the proposed regulations be enacted:

1. **Ending the practice of exempting royalty payments on exported coal.** Eliminating the exemption from royalty payment on coal exports is a logical and efficient way for the federal and state government to respond to changing markets. The ONRR proposal to redefine the relevant point of sale for export transactions[31] as the first arm's length-sale effectively solves the existing problem.

2. **Allowing flexibility by ONRR on transport costs.** ONRR's proposal to use a reasonableness standard on transportation costs is sound. A clearer set of internal standards needs to be worked out.

3. **Maximum flexibility for ONRR is advisable.** The proposal by ONRR that it be given the authority to ignore the methods proposed in the regulations and to impose its own methods is sound, given the program experience and high likelihood that coal producers will seek new and inventive ways to avoid the royalty payments. The logic here is important: although the royalty exemption problem is effectively solved by banning non-arm's-length sales, it is likely that coal producers will design second sales or other constructs to enhance their profits and avoid royalty payments. This has to be policed and ONRR has to have the tools to do so.

In addition, we recommend that the regulations be amended along the following lines:

1. **The regulations should do no harm, that is, they should not reduce revenue to the federal and state governments.** Under no circumstances should the royalty payment to the federal and state governments amount to zero. When this is allowed to occur, the signal from the market is that there is no market. At this level there is no reason for the owner of the coal to allow mining to take place.

   Therefore, the base revenue for royalty purposes should never be less than the EIA spot price, publicly published price or contracted prices presented by the producer and accepted by ONRR. From the federal government's point of view it makes no sense to ship the coal at all if it is not going to produce any income.

2. **No deductions should be allowed to pay for coal company speculation and risks in the export markets.** Under no circumstances should deductions be allowed for: overseas port fees, overseas freight costs, liquidated damages, take-or-pay penalties or any other costs associated with counterparty risk. This issue is all quite vague in the proposed regulations. All of these costs flow from decisions by the coal producers to take on more risk in order to sell coal overseas. The costs of failure of a coal producer to find overseas markets for its

[31] The royalty system for the treatment of domestic sales of coal should remain the same, using the same benchmarks. The new proposed regulatory schema should only be applied to export sales.

coal should not be the burden of the U.S. taxpayer. The use of the lease to underwrite speculation should not be sanctioned.

3. **External review of the system should be required.** Congress, the executive branch, DOI, BLM and ONRR routinely ignore the need for independent, publicly available reviews of the coal-leasing program and its component parts. A system needs to be set up for the next five years to review ONRR's implementation of the new regulations, the royalty program, industry reaction, revenue impacts and other related matters.

   In the larger scheme of things, it should not take demands from Congress for an audit from the Government Accountability Office (GAO), or complaints and revelations to the Department of Interior Inspector General for the government to institute independent reviews and reports on the matter of exporting federally leased coal. Regular, routine public reviews protect the public from efforts by the coal industry to weaken these regulations through lobbying and other means, and they protect the coal industry from ONRR overreach.