



The Honorable John Hickenlooper
Governor of Colorado
136 State Capitol
Denver, CO 80203-1792

Dear Governor Hickenlooper,

On behalf of the [Institute for Energy Economics and Financial Analysis](#) (IEEFA), I urge you to reject Arch Coal's proposal that the company be allowed to reduce its coal royalty payments on its West Elk mine.

Arch's request would cost the State of Colorado as much as \$12-16 million and it would not stimulate coal production. Arch Coal in effect is asking you to forego state revenues for a financially marginal company in a declining industry with a bleak outlook.

IEEFA monitors and comments on federal coal lease and royalty payment policy. Over the past five years or so, we have published reports, submitted testimony, conducted numerous briefings for public officials, and written a host of letters addressing proposals like this one. Our seminal 2012 report on the federal coal lease program, [The Great Giveaway](#), has been cited widely by policy experts and the press.

Arch Coal is seeking to reduce its royalty payments on revenues it earns at the West Elk mine. It is asking that the payments be reduced from 8 percent to 5 percent of revenues for a five-year period retroactive to February 2015. Arch justifies its request by saying that it is incurring rising costs at the mine due to the increased complexity of mining coal at West Elk as the property reaches maturity. By our estimate, Arch could conceivably mine approximately 25-30 million tons of coal over the five-year period, causing Colorado to forego as much as \$12-\$16 million in revenue (the federal government would forego an equal amount).

The Department of Interior's Bureau of Land Management is supporting the proposal, based on its view that the federal lease program allows the Secretary of the Interior to reduce royalty rates "for the purpose of encouraging the greatest ultimate recovery of coal" whenever necessary "to promote development, or whenever ... the leases cannot be successfully operated under the terms" of the lease. 30 U.S.C. § 209.

IEEFA advises against allowing Arch Coal's request for the following reasons:

1. **Arch Coal cannot justify a public subsidy on the grounds of the company's overall financial situation—in fact it does not need the money.** Arch Coal has recently emerged from bankruptcy virtually free from debt. The profit margin on its western coal operations now stands at \$11.65 per ton, up from an average of \$5.00 per ton over the last several years.

In its most recent [earnings press release](#), Arch said it expects the cost of production at West Elk mine to decrease and the price of coal from the mine to increase in the coming year. This statement is in direct contrast to the presentation that the company has made to the BLM, in which it asserts that the mine operation is suffering from financial hardship. Neither the company nor BLM has attempted to reconcile this material inconsistency, nor have they publicly released any financial information to support Arch's claim of financial hardship.

Unfortunately, BLM has a history of withholding such financial information. Both the U.S. General Accountability Office (GAO) and the Department of the Interior Inspector General have published audits critical of BLM's disclosure practices. IEEFA's [2012 report](#) on the federal coal lease program included extensive evidence of BLM's failure to open the bureau's activity to public scrutiny. If this information has been provided to the State of Colorado, you would be doing a public service by releasing it.

2. **Colorado taxpayers should not bear the brunt of flaws in the federal coal lease program, which continues to encourage an increase in coal mining in an oversupplied market.** Coal production in the U.S. has declined by 37 percent since 2008. This overall downturn has affected every mine and every coal producer in the country. Energy markets are now more competitive than ever, with natural gas and renewable energy by and large cheaper than coal in many places. Coal plants are being retired due to age, environmental compliance and a general inability to compete. No new coal plants are slated for construction in the United States. Private capital is supporting new natural gas, solar and wind projects. As demand dwindles, there are no market signals to support new mine development. The BLM and Arch have both acknowledged that coal markets are weak.

The BLM's support for Arch's request for royalty reduction flows from its interpretation of the rules of the coal lease program. However, these rules no longer serve as a viable business model for the federal government, the coal companies or the State of Colorado. They encourage the mining of coal even when there is no market for it. Adding more coal to an oversupplied market is bad business, poor natural resource management and unsound fiscal policy.

Peabody Energy's attempt last year to sell three of its western coal properties, including the Twentymile property in Colorado, provides a stark illustration of the weakness of the market. After Peabody announced an agreement to sell the mine to Bowie Resource Partners, the sale collapsed when no investors stepped forward to finance it. The Twentymile mine in effect was worth zero. Peabody Energy, like Arch Coal, is now seeking approval by the BLM for lease-agreement changes in hopes of improving the value of the mine.

3. **Reducing the royalty payments at West Elk will not improve the future of the mine or bring in more sales to generate more royalty revenues for the state.** The principal customers for thermal coal like that mined at West Elk are utilities across

the U.S., which are moving away from coal-fired power and toward power fueled by natural gas and renewable energy. These trends are apparent in Colorado, which has seen several recent coal-fired plant closure announcements.

The West Elk property mines about 5 million tons per year. To replace the revenue rate to Colorado to 5 percent (rather than the current 8 percent rate), West Elk would have to mine at least 2 million more tons per year going forward, a 40 percent increase in production. This is a highly unlikely scenario, since overall coal production in the U.S. is expected to continue to decline. While some western mines may see small increases as production shifts between mines, it is unlikely West Elk will see so precipitous an increase in its output.

West Elk has had five relatively consistent customers in 2016-17: The Apache Station (AZ), Avon Lake (OH), Crystal River (FL), Intermountain (UT) and Victor J. Daniel Jr. (MS). A close look at these five plants shows that Crystal River is set to retire two of four coal-fired (units 1 and 2, 869 MW) in April 2018 and that Intermountain (UT) has 2 coal-fired units of 900 MW each slated to retire in 2025. Conversion to natural gas has been publicly discussed (but not finalized) at both Avon Lake and Apache Station.

Arch Coal is selling its eastern U.S. coal mines, which produce metallurgical coal at marginal profitability, ridding itself of surplus capacity. While Arch may also intend to sell the West Elk mine, improving its marginal profitability through royalty reductions is unlikely to improve its chances for sale. Arch's leadership, like that of many other coal companies, has failed to grasp the fact that the industry is in long-term structural decline. The market for coal mines in the east is weak and non-existent in the west.

4. Even if West Elk can sell coal for export, Colorado will not benefit. Arch has claimed that West Elk has a potential export market. U.S. coal producers exported a peak 125 million tons in 2012. Today, that number is closer to 60-70 million tons—and that's in a good year. Most of the coal exported coal from the U.S. is metallurgical and thermal coal from eastern mines. Overall last year, 5 million tons of U.S. thermal coal was exported to Asia. The Energy Information Administration's long-term energy outlook sees some expansion in exports over the long term, but Arch faces stiff competition from at least six other coal producers in the western region. Even if Arch were to secure a greater market share of the export market, Colorado will not receive increased revenues. The current royalty rules exempt the enhanced revenues from export sales from the 5 percent levy, so Colorado would receive only 5 percent of the domestic price of West Elk coal for these sales. This distills another flaw in the current program. If improving Arch's bottom line at West Elk through royalty relief on domestic sales allows the company to sell more coal for export, Colorado will not share in that benefit.

As governor, you must of course consider the impact of your decision on company employees, the local tax base and economy of surrounding communities, issues that

IEEFA also takes seriously. Coal mining and coal-fired electricity have made significant contributions to the economy of Colorado. However, time and change have now rendered coal less competitive. It is a hard but true reality that many mines, including West Elk, need to close. Their customer base is shrinking, and many analysts and even some coal company CEOs know the industry must go through a period of consolidation before it can recover.

Rather than reducing royalties paid by Arch Coal, Colorado should maintain them at the current level and use the income to support fiscal and economic needs that feed the economic growth and quality of life in Colorado. Royalty income to the state might be best used at this time to assist with a rational plan for the phase-out of coal mining in Colorado. Plans need to be formulated to assist employees, maintain tax bases and grow the economy with companies and industries that have solid business models, are growing and for which the outlook is positive.

Sincerely,

A handwritten signature in black ink, appearing to read "Tom Sanzillo".

Tom Sanzillo
Director of Finance, Institute for Energy Economics and Financial Analysis
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