A Rulemaking to Close Loopholes and Cut Subsidies for the Federal Coal Program

How Modernizing the Federal Coal Program Benefits Taxpayers

By Nidhi Thakar May 6, 2015

Through royalty loopholes and deductions, the federal government is providing more than $1 billion per year in taxpayer-funded subsidies to coal companies operating on public lands—money that could be used for schools, roads, and aging infrastructure in coal states.[1] The Department of the Interior, however, has proposed a rule that—if strengthened—could end these giveaways and deliver a better return to U.S. taxpayers from the mining of publicly owned coal.

The U.S. Department of the Interior's Office of Natural Resources Revenue's, or ONRR's, proposed rule would ensure that royalties are paid on the first arm's-length transaction of a coal sale so that coal companies can no longer use their affiliates to dodge royalty payments.[2] But this rule does not go far enough to guarantee that taxpayers are receiving every dollar due on their publicly owned resources. More significant reforms are needed to improve efficiency and transparency in the federal royalty-collection process and to ensure that royalties are paid on the true market value of coal—not just the price paid by a middleman broker. The Department of the Interior should strengthen its proposed rule to value coal for royalties at the delivered price, or the price paid by a power plant or exporter; cap transportation deductions at no more than 50 percent of the value of the coal; and eliminate washing allowances. These simple and common-sense changes to the proposed rule would help ensure that American taxpayers and coal-originating states receive their fair share of revenue.

The need for royalty reform

- **The federal coal royalty system is outdated.** ONRR's regulations on how royalties are assessed have not been updated since 1989—more than 25 years ago—even though the industry and market have changed drastically since then.[3]

- **The federal government is not collecting the full value of coal mined from federal lands that is owed to U.S. taxpayers.** Reports by the Department of the Interior's Office of Inspector General and the Government Accountability Office that reviewed the federal coal-leasing program have unearthed evidence of a lease-sale process that is largely noncompetitive and relies on a valuation system that is not transparent and is at risk of industry manipulation.[4]

- **Coal companies have built a complex system of affiliates to evade paying federal royalties.** A 2012 Reuters investigation revealed that companies were engaging in non-arm's-length transactions to sell coal to their own subsidiary companies at depressed prices and cloaking these sales as arm's length in order to pay a lower royalty.[5] This practice allowed companies to pocket at least $40 million more on coal exports from Wyoming and Montana alone in 2011.[6] Data from the U.S. Energy Information Administration, or EIA, shows that 42 percent of all coal produced in Wyoming in 2012 was sold through a captive transaction—or a transaction between a parent and an affiliate company—up from just 4 percent in 2004.[7] In 2013, all coal mined for export in Montana was sold through a captive transaction.[8]

- **The effective royalty rate for federal coal is significantly lower than the rate set by law.** Headwaters Economics—an independent, nonprofit research group—found that the effective royalty rate paid by coal companies for federal coal is 4.9 percent, due to royalty rate reductions, cost deductions, and other subsidies.[9] By law, companies are required to pay a royalty of at least 12.5 percent on surface-mined coal and 8 percent on underground-mined coal.[10]

- **State governments are concerned about captive transactions.** In 2012, the Montana Department of Revenue filed suit against Cloud Peak Energy, alleging that the company intentionally undervalued federal coal sold to two affiliates between 2005 and 2007 in order to pay reduced state taxes.[11] In neighboring Wyoming, Department of Audit Director Michael Geesey formally asked ONRR to change current regulations to prevent coal company sales to "affiliates, partners, marketing agents, and trade and export associations" from qualifying as arm's-length transactions.[12]

An opportunity to reform the federal coal royalty system by closing loopholes and cutting subsidies

- **The public supports reforming the royalty system for coal production on public lands.** Nearly two-thirds of Americans oppose providing federal subsidies to companies that mine coal on America's public lands, including 67 percent of Democrats, 66 percent of independents, and 62 percent of Republicans.[13] By a nearly two-to-one margin, voters want these subsidies ended.[14]

- **Royalties should be assessed on the delivered price of federal coal.** For Wyoming and Montana's Powder River Basin in particular, there is a significant difference between the price of coal when it leaves the mine and the price of coal when it is delivered to consumers such as power plants. For example, the average mine-mouth price of Powder River Basin coal is $11.55 per ton, but it is sold for more than triple that price—roughly $37 per ton—when it ultimately reaches market downstream in the Midwest.[15] The net delivery price reflects the true value of coal, and the royalty should be assessed on this price.

- **ONRR should put at least a 50 percent cap on transportation allowances.** Currently, coal companies can claim unlimited transportation allowances, while the oil and gas industry is subject to a 50 percent cap.[16] Transportation costs are inherent to the value of federal coal and reflect the price of doing business, so these allowances should be capped at 50 percent of the value of the coal or eliminated altogether.

- **ONRR should eliminate washing allowances because they are a cost of doing business.** Washing is a process used to remove impurities of coal in order to make it marketable. The costs of making coal marketable should not be deductible from a lessee's royalty obligations.

Benefits of CAP's proposal

The Center for American Progress' royalty reform proposal recommends applying a netback pricing method, which reflects the gross price of coal at its final point of sale, with caps on transportation allowances and the elimination of washing subsidies. This system would provide numerous benefits, including:

- **A straightforward and simple way to assess royalties on federal coal.** CAP's proposal uses publicly available EIA data to determine the final sale price of coal for royalties. This alleviates burdensome closed-door royalty assessments by ONRR while also ensuring that taxpayers are receiving a royalty on the true market value of coal.

- **Greater certainty that royalties are paid on federal coal.** By using publicly available data to assess royalties, the industry, ONRR, and the public can have confidence that companies have paid every dollar due to American taxpayers for publicly owned coal.

- **Equal application to all coal companies.** A netback pricing model provides greater consistency in how sales are valued for royalties and assuages any concerns that ONRR's proposed rule would disadvantage vertically integrated companies.[17] Under this system, all companies—whether they are vertically integrated or not—would pay a royalty on the final net delivery price of coal, minus allowable deductions.

- **Increased revenues for the federal government and states.** Royalties received by the federal government from coal production are split roughly equally between the U.S. Treasury Department and coal-originating states.[18] Applying a royalty to the delivered price of federal coal and eliminating transportation and washing allowances could generate up to $1 billion more annually, providing states that produce federal coal a significant source of funding for schools, highways, and new infrastructure.[19]

- **Limited impact on coal production and prices for federal coal.** Under CAP's proposal, if transportation deductions were limited to 50 percent of the delivered price of coal and royalties were assessed on the true value of coal—reflected by the delivered price—demand for coal in the domestic power sector would decrease by only 1 percent, and gross delivered prices for federal coal would only rise by roughly $1.17 per ton. Meanwhile, annual revenues to federal coal-producing states and the federal government would increase by $512 million.[20]

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Endnotes

1 Mark Haggerty, "An Assessment of U.S. Federal Coal Royalties: Current Royalty Structure, Effective Royalty Rates, and Reform Options" (Bozeman, MT: Headwaters Economics, 2015), available at http://headwaterseconomics.org/wphw/wp-content/uploads/Report-Coal-Royalty-Valuation.pdf.

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3 See 30 C.F.R. § 1206.257.

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12 Letter from Michael Geesey to Hyla Hurst, July 26, 2011, available at http://www.onrr.gov/laws_R_D/PubComm/PDFDocs/AA00/AA00%20Wyo%20%20Dept%20of%20Audit.pdf.

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14 Ibid.

15 Energy Information Administration, "Despite lower crude oil prices, U.S. crude oil production expected to grow in 2015," December 12, 2014, available at http://www.eia.gov/todayinenergy/detail.cfm?id=19171. Average Midwest market price is based on a CAP analysis of data obtained from Energy Information Administration, "Form EIA-923 detailed data," available at http://www.eia.gov/electricity/data/eia923/ (last accessed May 2015).

16 30 C.F.R. § 1206.109(c); 30 C.F.R. § 1206.156(c).

17 Taylor Kuykendall, "Critics of Federal Coal Leasing Program Say Reform 'Urgently Needed'," SNL, January 6, 2015, available at https://www.snl.com/InteractiveX/Article.aspx?cdid=A-30471504-14128.

18 30 U.S.C §§ 191, 191a, 355.

19 Haggerty, "An Assessment of U.S. Federal Coal Royalties."

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