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COAL ROYALTY VALUATION: THE FEDERAL PERSPECTIVE

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I. INTRODUCTION

The Federal Coal Leasing Amendment Act of 1976 (FCLAA) provides that the federal surface coal royalty will be 12.5% "of the value of coal as defined by regulation." From this innocuous beginning, this country has embarked upon a federal regulatory odyssey with respect to coal valuation, which, thus far, has taken us from (i) the value of coal (FCLAA), (ii) to gross value, (iii) to gross proceeds.

Federal administrative kingdoms are being built at the expense of coal operators and coal customers alike. The ingenuity and creativity of the bureaucratic mind are constantly at play, most particularly since the promulgation by the Minerals Management Service (MMS) of its "gross proceeds" definition on January 13, 1989. While it may be harsh to say that this recent evolution of coal valuation standards is motivated solely by avarice and greed, it is difficult to escape the conclusion that the current regulatory infrastructure bears scant resemblance to the centuries old concepts and constructions attendant to

3. Id.
5. 30 C.F.R. § 206.251 (1994). The current regulations upon which this article is premised became effective July 1, 1994.
mineral royalties, or to the prior seventy years of federal stewardship with respect to coal production royalties.

The ensuing discussion will address select federal coal valuation issues and the evolving administrative practice before the MMS. Because such an undertaking is exceedingly broad and, at the same time, marked by a paucity of answers, the valuation issues section will be limited to providing a perspective with respect to the MMS “policy” concerning such issues. The administrative appeals section will attempt to expose certain procedures and practices before the MMS. In both sections, the topic progression is chronological, rather than indicating an inferred importance. Additionally, there are numerous other MMS related and post-MMS issues and practices that will not be discussed.  

II. HISTORICAL DEVELOPMENT OF COAL VALUATION

Historically, mineral production royalties evolved from the “King’s share” to the more traditional concept of economic rent paid to the mineral lessor for the right to extract the mineral. The common law concepts and attributes attendant to a mineral production royalty are well established. A “royalty” has been variously described as including:

(a) a percentage paid to the British crown, of gold or silver taken from mines, or a tax enacted in lieu thereof;
(b) the share of the product or profit reserved by the owner for permitting another to use the property; and
(c) the amount paid by the lessee, or operator, to the owner of land, mineral rights or mine equipment, based on a certain amount per ton or a percent of total mineral production.

In the federal context before the enactment of FCLAA in 1976, the only applicable statutory provision provided that the federal coal

7. Examples of additional MMS and post-MMS topics which are not discussed in this Article include: reporting procedures, including estimated royalty payments; washing allowances; transportation allowances; non-arm’s length contracts; penalties; administrative offsets; Indian royalties; and administrative appeals and judicial challenges beyond the MMS jurisdiction.

production royalty would be a minimum of five cents per ton. In turn, as all federal coal leases since 1920 had been issued on a “cents per ton” basis, the United States Geological Survey’s (USGS), now the MMS, royalty determinations had been primarily limited to ascertaining the number of tons produced.

In the early 1970s, there was a perception that the federal government and its citizenry were not receiving a fair economic return from the development of federal coal reserves. In that context, the USGS began to experiment with percentage based, or ad valorem, production royalties, which were premised upon the sales price of the coal. In 1973, the USGS proposed new “Coal Mining Operating Regulations,” to include Section 211.61, which was entitled “Basis for Royalty Computation.” Therein, the USGS endeavored to posit a “sales price” basis for the determination of federal production royalties. In 1975, the USGS published additional proposed operating regulations, which, in Section 211.61, first recited a “value” basis for royalty computations. On May 17, 1976, final “Coal Mining Operating Regulations” were promulgated, to include Section 211.63, which was entitled “Value basis for royalty computation” and provided (i) that the value of the coal for royalty purposes would be the “gross value” at the point of sale and (ii) that the gross value would be the “sale or contract unit price” times the number of units sold.

On August 4, 1976, just three months after the promulgation by the USGS of the first value based royalty regulations, FCLAA was enacted and provided, in part, that:

A lease shall require payment of a royalty in such amount as the Secretary shall determine of not less than 12½ per centum of the value of coal as defined by regulation, except the Secretary may determine a lesser amount in the case of coal recovered by underground mining operations.

9. 30 U.S.C. § 207 (repealed by Section 6 of FCLAA (1988)).
10. See U.S.G.S. Operating Regulations to Govern Coal-Mining Methods and the Safety and Welfare of Miners on Leased Lands on the Public Domain, § 18 (Third Printing 1968). The U.S.G.S. is currently known as the MMS.
Armed with such bland statutory authority, as referenced at the outset of this article, the USGS/MMS and the Bureau of Land Management (BLM) have crafted coal valuation standards, which have evolved from (i) the value of coal,\textsuperscript{15} (ii) to gross value,\textsuperscript{16} (iii) to gross proceeds.\textsuperscript{17} The net effect of this evolution is the current regulatory definition of “gross proceeds,” promulgated on January 13, 1989, providing that:

\textit{Gross proceeds} (for royalty payment purposes) means the total monies and other consideration accruing to a coal lessee for the production and disposition of the coal produced. Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as crushing, sizing, screening, storing, mixing, loading, treatment with substances including chemicals or oils, and other preparation of the coal to the extent that the lessee is obligated to perform them at no cost to the Federal Government or Indian lessor. Gross proceeds, as applied to coal, also includes but is not limited to reimbursements for royalties, taxes or fees, and other reimbursements. Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Federal or Indian royalty interest may be exempt from taxation. Monies and other consideration, including the forms of consideration identified in this paragraph, to which a lessee is contractually (sic) or legally entitled but which it does not seek to collect through reasonable efforts are also part of gross proceeds.\textsuperscript{18}

The extension of the MMS’s “gross proceeds” concept is the ensuing pronouncement that:

If the MMS determines that the gross proceeds accruing to the lessee \textit{pursuant to an arm’s length contract} do not reflect the reasonable value of the production because of misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor, then MMS shall require that the coal production be valued pursuant to paragraph (c)(2)(ii), (iii), (iv), or (v) of this section. . . . \textit{When MMS determines that the value may be unreasonable}, MMS will notify the les-

\textsuperscript{}\emph{ed}.

\begin{itemize}
  \item 15. \textit{Id}.
  \item 17. 30 C.F.R. \$ 206.251 (1994). \textit{See} app. I (summarizing the proposed and final USGS/MMS and BLM coal valuation regulations).
  \item 18. 30 C.F.R. \$ 206.251 (1994).
\end{itemize}
see and give the lessee an opportunity to provide written information justifying the lessee’s reported coal value.19

The extreme of this “gross proceeds” audacity is the MMS’s regulatory assertion that:

Value shall be based on the highest price a prudent lessee can receive through legally enforceable claims under its contract. Absent contract revision or amendment, if the lessee fails to take proper or timely action to receive prices or benefits to which it is entitled, it must pay royalty at a value based upon that obtainable price or benefit. Contract revisions or amendments shall be in writing and signed by all parties to an arm’s-length contract, and may be retroactively applied to value for royalty purposes for a period not to exceed two years, unless MMS approves a longer period. If the lessee makes timely application for a price increase allowed under its contract but the purchaser refuses, and the lessee takes reasonable measures, which are documented, to force purchaser compliance, the lessee will owe no additional royalties unless or until monies or consideration resulting from the price increase are received. This paragraph shall not be construed to permit a lessee to avoid its royalty payment obligation in situations where a purchaser fails to pay, in whole or in part or timely, for a quantity of coal.20

The foregoing can and should be referred to as a regulatory fiction—an artificial valuation mechanism. Contrary to the federal oil and gas infrastructure, there is absolutely no common law or mandated statutory basis for the MMS’s regulatory precepts. In short, it is an MMS fabrication. Be this as it may, the MMS regulatory “blueprint” is both creative and embryonic; the MMS is making it up as they go along. Unfortunately, it has taken only six years since January 13, 1989, to reverse six centuries of royalty principles and precedent. This evolution is an odyssey because no one knows where this inquisition will lead or how invasive it may yet become.

20. Id. at § 206.257(i) (emphasis added).
III. Thesis

By way of prospective, the MMS thesis with respect to the 1989 Coal Product Valuation Regulations\(^\text{21}\) is that federal production royalty will be assessed (i) on all payments which are received, or should have been collected, by a lessee and (ii) on all costs which are paid by a third party and are attributable to the production and/or sale of federal coal. Stated differently, the application of this "gross proceeds" thesis is simplistic and can be reduced to the following two-pronged inquiry:

1. Did the lessee receive a payment?
2. Did the buyer pay for or contributed anything which is not included in the purchase price?

If the answer to either question is "yes," the MMS will likely assert that federal production royalty is owing. It can certainly be argued that this prospective MMS thesis accords scant recognition to such market realities as sales price, fair market value, or a sale at the current market price.

Additionally, the MMS is attempting to infuse three concepts into federal coal valuation. First, the MMS establishes a fiduciary relationship standard between the lessor and lessee in the marketing of federal coal, as opposed to the traditional reasonable and prudent operator standard. Second, an implied marketing covenant, whereby the lessee is required to obtain on behalf of the lessor the best price, the most preferred terms, and the highest revenue return to the lessor in the marketing of federal coal is established. Finally, a third-party beneficiary right is conferred with respect to the benefits of the lessee's coal sales agreements.

At present, the MMS is brazenly endeavoring to structure an "all benefits, no risk" production royalty relationship. In so doing, it is,

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again, apparently irrelevant that there is no common law or mandated statutory basis for the MMS’s nurturing of such precepts.

Unfortunately, resolution of federal coal valuation issues is seldom premised upon right and wrong, fairness, equity, or even judicial precedent. Additionally, a political reality that must be acknowledged is that the respective states realize fifty cents on each dollar of federal production royalty. In the final analysis, there is no political downside for the MMS and the respective states to adopt expansive, aggressive interpretations with respect to coal valuation issues.

A. Discussion of Select MMS Coal Valuation Issues

This section will address select federal coal valuation issues that are emerging issues currently under extensive discussion in the coal industry. There are numerous other current valuation issues, and the parade will continue, with as yet unfathomed extensions and further outright reversals of current interpretations.

For purposes of this discussion, the 1989 Coal Product Valuation Regulations,\(^\text{22}\) as amended by the 1990 Exclusions Withdrawal,\(^\text{23}\) will be accepted, without further diatribe.\(^\text{24}\) However, one frustration is the MMS’s propensity to quote its preamble statements as gospel when they support its confirmation of regulatory construction and, conversely, to totally ignore them when they do not advance the MMS’s expansion of policy.

Having been lulled into a false sense of compromise, the coal industry chose not to challenge the 1989 Coal Product Valuation Regulations and its “gross proceeds” cornerstone. Consequently, if such a challenge is to be asserted, it would have to be brought by an individual coal operator within six years after the right of action arose (being January 13, 1989, or January 12, 1995), or it may be time-


\(^{23}\) Id.

barred. With respect to the MMS’s withdrawal of the compromise “crumb” concerning the 1989 exclusion of abandoned mine land fees, black lung excise taxes, and severance taxes from valuation, the coal industry challenge to the 1990 Exclusions Withdrawal was unsuccessful.

1. Marketable Condition

The concept of first marketable condition is a “cultural” issue with the MMS, in that it is one of the underlying concepts upon which the coal product valuation program is premised. In theory, the MMS would like to mandate that all coal must be at least primarily crushed, sized and loaded, thereby rendering a 2x0 steam coal product, or the cost thereof will be charged and/or inferred as a component of the gross proceeds. Unfortunately, this mandate is artificial and, sometimes, just plain incongruous in a given factual context. However, as it is a cultural issue, the MMS premise is that the regulations are “blind,” and the MMS will not accede to any erosion of or backing off from this artificial state of first marketability.

This MMS fabrication has evolved subsequent to the promulgation of the 1989 Coal Product Valuation Regulations and is a blatant example of “creeping” interpretation. The current regulatory definition of “marketable condition” merely provides that:

‘Marketable condition’ means coal that is sufficiently free from impurities and otherwise in a condition that it will be accepted by a purchaser under a sales contract typical for that area.

In turn, Section 206.257(h) recites that the lessee is required to place coal in marketable condition at no cost to the federal government and that:

Where the value established pursuant to this section is determined by a lessee’s gross proceeds, that value shall be increased to the extent that the gross proceeds has been reduced because the purchaser, or any other person, is providing certain services, the cost of which ordinarily is the responsibility of the lessee to place the coal in marketable condition. 28

Within these circular references, the subjective (not blind) test should be to ascertain, on a case by case basis, what “services” are the responsibility of the lessee in order to place the subject coal in “marketable” condition. 29 In the first instance, this test must recognize that marketable condition is a market based or driven standard and that there are multiple coal market segments. Second, administrative notice must be taken: (i) that coal supply exceeds coal demand; (ii) that unlike oil and gas, coal is not a fungible commodity and must be marketed aggressively in accordance with a given buyer’s specification, sizing, tonnage and delivery requirements; (iii) that as the buyer’s coal requirements are often specification or sizing specific, coal is not susceptible to entry into unlimited markets; and (iv) that an “artificial valuation” multiplied by “nothing” (no coal sale) equals “nothing” (no federal royalty). Third, absent fraud or other misconduct, the primary criterion must be the specific coal product that a specific buyer is willing to purchase for its equally specific consumption, other use, or resale requirements. Fourth, and equally salient, administrative paranoia should not constitute a basis for obviating the exigencies and realities of the coal marketplace.

In this context, the MMS chose to ignore its own conclusion in the Preamble to the 1989 Coal Product Valuation Regulations, wherein it stated that:

[T]he conditioning of coal for market does not consist of a uniform set of processes. Rather, the marketable condition requirement is as flexible as the requirements of different market segments. 30

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29. Id.
In turn, while the above subjective test reflects the more reasoned and realistic parameters of the coal marketplace, the MMS also tends to ignore its own comparable test for marketable condition as recited in the 1989 Preamble:

Therefore, the test of marketable condition relies on: (1) the market segment that coal is sold into; (2) the customary requirements of preparation or conditioning normally expected by that market segment; and (3) the typical level of preparation or conditioning by coal producers in that area.\(^{31}\)

The regulatory definition of "gross proceeds" does in fact provide that gross proceeds include "payments to the lessee" for services such as crushing, sizing, screening, storing, mixing, and loading. (if performed by the lessee/operator \textit{and} reimbursed by the coal buyer).\(^{32}\)

However, it must be recognized that there is absolutely no regulatory provision that mandates that a coal operator must undertake primary crushing, sizing and loading to produce a marketable coal product.

Examples of prospective fact patterns that are at variance with the MMS's cultural interpretation of marketable condition include:

(a) a lessee/operator with a pre-FCLAA (1976) coal sales contract (when federal production royalties were on a fixed cents per ton basis), in which the sales price does not include the cost of crushing, sizing and screening. For quality control and blending purposes, the buyer would buy only and continue to buy only 6x0 coal and undertakes such coal processing in its own receiving yard. The purchaser will not buy 2x0 coal.

(b) an operator with a pre-FCLAA (1976) coal sales contract, in which the sales price does not reflect the capital cost of a coal processing or load-out facility, which the buyer financed and installed. The coal seller operates and maintains the load-out facility and either includes or does not include the cost thereof in the sale price for royalty purposes.

\(^{31}\) Id.  
\(^{32}\) 30 C.F.R. § 206.251 (1994).
(c) an operator with a pre- or post-FCLAA (1976) coal sales contract, in which the sales price does not reflect the cost of a sophisticated coal sampling facility. For its specific control purposes, the buyer needs to know the coal’s specifications on an advance and detailed basis. The buyer paid for the construction and installation of the sampling facility. The seller operates and maintains the sampling facility and either includes or does not include the cost thereof in the sale price for royalty purposes.

(d) an operator with a pre- or post-FCLAA (1976) sales arrangement for the sale of 6x0 coal to a custom processing facility, which processes the coal to custom specification and resells it into industrial and other markets. The purchaser will not buy 2x0 coal and actually pays more for the 6x0 coal than the going rate for 2x0 coal.

(e) an operator who sells 6x0 coal to another coal operator, which the second operator processes through its integrated crushing and rail load-out facility and resells to its own customers. The second operator will not buy 2x0 coal for re-processing through its integrated facility, because double processing of 2x0 coal occasions excess fines and reduces the value and the market for the product.

In each example, the MMS would ignore such long-standing and/or market driven arrangements and instead, attempt to infer as a component of gross proceeds the cost attributable to rendering the equivalent of a 2x0 coal product. This maxim controls regardless of whether the contractual relationship between the parties has since terminated, the contract contains no contractual pass-through clause, or the coal was sold on the spot market.

There is no basis in the current regulations for the MMS’s expansive interpretation of “marketable condition” nor for its interference in the private contractual agreements between the lessee/operator and its coal buyers. In essence, the MMS purports to rewrite long-standing legal and contractual sales arrangements and even to mandate what coal product can be sold and to whom.

While administrative audits and appeals are pending on the issue of “marketable condition,” it has yet to be judicially resolved.
2. Co-Mingled Coal

One would not anticipate that there would be current or significant disputes concerning co-mingled coal. Actually, co-mingling is more of an allocation or methodology problem than a valuation issue. Be this as it may, the MMS can be reluctant to acknowledge the express terms of coal supply agreements or to read more than one purportedly pertinent clause. In its San Juan Coal Co. decision, and in overruling the MMS's weighted-average methodology for co-mingled coal, the Interior Board of Land Appeals ("IBLA") held that the sale or contract price must be determined based on the terms of the coal supply agreement. The IBLA further held that when the provisions thereof specify the sale or "unit price" for separate sources of coal, the applicable pricing provision for federal production must be used to determine the gross value for federal royalty purposes. In the San Juan case, as may be surmised, the price for the non-federal coal was higher than that for the federal coal.

In addition, the allocation of co-mingled coal, be it federal, state and/or private, is critical in the assessment of (i) which contractual coal is subject to federal production royalty, (ii) what is the percentage of federal coal to total production tonnage, and (iii) whether the federal tonnage was produced on a pre- or post-ad valorem basis. While these distinctions should be rudimentary, such allocations can be surprisingly illusive.

This co-mingled coal or allocation methodology applies to the discussion of each of the ensuing valuation issues. Its application with respect to contract settlement payments is readily obvious.

3. Non-Cash Consideration

The arena of "non-cash consideration" or "cost avoidance" is difficult. Unfortunately, straightforward business decisions and transactions

33. San Juan Coal Co., IBLA 90-482 (June 15, 1992).
become suspect, especially over time and with the benefit of hindsight or midstream rule changes.

While the definition of "gross proceeds,"\textsuperscript{34} when read in conjunction with Sections 206.257(b)(1), (b)(2), (e), and (g), requires that value for royalty purposes will not be less than the gross proceeds accruing to the lessee for the disposition of produced coal, ascertaining the value accruing to the lessee can be vexing. Examples of such non-cash consideration might be asserted to include:

(a) the acquisition of federal coal reserves by the buyer, with or without the dedication of reserves;

(b) the grant of a mine construction loan by the buyer, with or without the dedication of reserves;

(c) the purchase of capital equipment (power shovels, draglines, bulldozers, front-end loaders, etc.) or mine facilities (crushers, silos, administrative buildings, change houses, garages, etc.) by the buyer, with the ensuing operation and maintenance thereof by the operator;

(d) the structuring of a sale/leaseback arrangement between the operator and the buyer;

(e) the sale of coal to a non-affiliated utility at a purportedly favorable price, in return for the sale of electricity to the operator at a reduced rate; or

(f) the sale of coal to a non-affiliated utility at a purportedly favorable price, in exchange for the acquisition by the utility of gas supplies from an affiliate of the operator.

In reconciling such non-cash consideration situations, each case must be considered on an \textit{ad hoc} basis and resolved based upon the specific facts, circumstances, and intent of the parties. Unfortunately,

\textsuperscript{34} 30 C.F.R. § 206.251 (1994).
the operator's regulatory burden will be formidable,\(^{35}\) and an operator should have no misgivings as to his chances of prevailing at the MMS level.

4. Added Value

Since 1976, the cost of additional coal preparation or of additives to the coal prior to sale were permissible deductions from “gross value” in determining value for federal royalty purposes.\(^{36}\) Exceptions to this standard were (i) treatment with chemicals to prevent freezing, (ii) treatment with oil to suppress dust in transit, and (iii) other preparation of the coal which did not enhance the quality of the coal.\(^{37}\) In practice, the test was whether the additional preparation enhanced the inherent quality of the coal product.

The current gross proceeds definition\(^ {38}\) places a different spin on this prior practice by providing that gross proceeds include “payments to the lessee” for additional “services” such as (i) treatment with substances including chemicals or oils and (ii) other preparation of the coal to the extent that the lessee is obligated to perform them at no cost to the federal government.\(^ {39}\) In terms of prospective application, it must be recognized that the coal industry has gone (i) from a “permissibility of deduction/exception” standard to an “inclusion of payment” standard or (ii) from an “inherent coal quality” standard to an artificial “marketable condition” standard.

With respect to traditional chemical and oil treatment, the pre-1989 Coal Product Valuation Regulations “exclusion” was limited to (i) chemicals to prevent freezing and (ii) oil to suppress dust in transit.\(^ {40}\) The current regulatory reference to “treatment with substances including chemicals and oils” is significantly broader.\(^ {41}\) Does the cur-

\(^{36}\) See 30 C.F.R. § 211.63 (formerly 41 Fed. Reg. 20252, 20271 (1976)).
\(^{37}\) Id.
\(^{38}\) 30 C.F.R. § 206.251 (1994).
\(^{39}\) Id.
\(^{40}\) 30 C.F.R. § 206.250(h) (1988).
\(^{41}\) See definition of “gross proceeds” at 30 C.F.R. § 206.251 (1994).
rent “inclusion” standard extend to buyer-requested chemical or oil treatment to produce quicker ignition, or higher heat content, or cleaner product burn? Will future fuel stock mixes not be allowed at all, or will they be reviewed on a percentage of additive basis? In such instances, it is best (i) to have the buyer itself undertake any desired enhancement, (ii) to have the buyer contract with a third party to provide the required enhancement, or (iii) to have the operator and buyer enter into a separate service agreement for the required enhancement. The parties should take pains to recite the buyer’s specific and specialized enhancement requirements.

With respect to coal enhancement and beneficiation generally, and especially in terms of future coal product mixes, Section 206.265 provides that if the lessee enhances the value of the coal (i) after the coal has been placed in marketable condition (potentially, a wasteful and costly exercise) and (ii) prior to its use, sale or other disposition, then the value of the feedstock coal will be determined under the non-arm’s length valuation provisions in Section 206.257(c), first pursuant to Section 206.257(c)(2)(i-iv), or second pursuant to Section 206.257(c)(2)(v).42 To date, these determinations have been difficult. The coal industry has asserted that the coal value should be premised upon the spot market price or limited to the recent price for other coal sold from the same mine. True to form, the MMS seeks a higher return for the intrinsic value of its coal. A return to a “take-in-kind” royalty standard would solve this issue.

In addition to the foregoing, Section 206.264 provides a weak attempt at guidance if a federal coal lease is to be developed by in-situ or surface gasification or liquefaction technology.43 In essence, the lessee is to propose a valuation methodology, and the MMS will issue a valuation determination.44

A value-added determination is clearly a work-out situation. Depending on the direction of preliminary discussions, it may be more

42. 30 C.F.R. § 206.265 (1994). Among other provisions, this determination will include a limitation on the rate of return on investment equal to twice the Standard and Poor’s BBB bond rate.
43. 30 C.F.R. § 206.264 (1994).
44. Id.
To submit a "request for value determination" pursuant to Section 206.257(f). Having done so, the MMS is required to "expeditiously" render its valuation determination, and this MMS decision is subject to appeal. Depending upon the import of the enhancement or beneficiation issue, the lessee/operator may want to request a "full force and effect" order from the secretarial level, which would be appealable directly to a United States district court.  

5. Exclusions From Value

The 1990 Exclusions Withdrawal did not necessarily exhaust the exclusions from valuation discussion. Pursuant to the 1989 Coal Product Valuation Regulations, as amended by the 1990 Exclusions Withdrawal, it is conceded that fees and taxes that are incurred attendant to the "production" of the coal are royalty bearing. This would include abandoned mine land (AML) fees and state severance taxes.

One such prospective exclusion is "excess moisture," which is more of a tonnage determination issue than a valuation issue. In any event, the question is whether the federal production royalty is due and payable on coal produced or whether the lessee is also required to pay royalty on the water absorbed by the coal after the overburden is removed, prior to shipment. In the ground, coal contains a certain percentage of inherent moisture, which is "equilibrium moisture." Once the coal has been uncovered, it absorbs additional moisture, which is "excess moisture." For example, a 2,000 pound ton of coal shipped from the Powder River Basin may only consist of 1,950 pounds of coal removed from the federal lease, to include the coal's equilibrium moisture; the excess moisture would be the additional fifty pounds. It can be argued that this excess moisture weight, and the increased dollar value of the coal occasioned by the excess moisture weight, should be excluded from the tonnage and valuation base upon which federal royalty is calculated.

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45. 30 C.F.R. § 243.3 (1994).
46. Excess moisture is moisture determined to be the difference between total moisture and inherent moisture.
In essence, a coal operator is selling both coal and water to the buyer. The buyer knows this, and this reality is standard within the coal industry. The Internal Revenue Service (IRS) and the Office of Surface Mining Reclamation and Enforcement (the MMS’s sister agency) recognize and allow such excess moisture weight exclusions in the calculation of black lung excise taxes and AML fees, respectively. Both agencies concluded that because the excess moisture is absorbed after the coal is produced, the respective taxes and fees cannot be assessed upon the total weight of the coal. By assessing royalty on the total weight of the coal, the MMS is in violation of its own 1989 Coal Product Valuation Regulations.

While the Preamble to the 1990 Exclusions Withdrawal does reference black lung excise taxes (BLET) as being a component of value to be included in gross proceeds, the revisions to the 1989 Coal Product Valuation Regulations, which were effectuated thereby, had the effect of removing any reference to BLET from the 1989 Coal Product Valuation Regulations. Consequently, the only current tax-related reference is in the gross proceeds definition, wherein gross proceeds are recited to also include “reimbursements for royalties, taxes or fees.”

In the context of this generic provision, as the value for royalty purposes is again limited to the value of the produced coal, only “taxes” which are attributable to the mining and/or the production of coal can be royalty bearing. In turn, the Black Lung Benefits Revenue Act of 1977 (BLBR Act of 1977), which was promulgated subsequent to the passage of FCLAA, provides that the BLET is only pay-

49. The following sections demonstrate this violation: 30 C.F.R. § 206.251 (1994) (definitions of “coal” and “gross proceeds,” with gross proceeds being the total consideration for “coal produced”); 30 C.F.R. § 206.257(b)(2) (1994) (in conducting MMS audits, MMS examines whether the contract reflects the total consideration for “coal produced”); 30 C.F.R. § 206.257(b)(5) (1994) (value does not include payments which were not for the purchase of “coal production”); 30 C.F.R. § 206.257(g) (1994) (value will not be less than the gross proceeds accruing to the lessee for “produced coal”).
52. See supra note 49.
able upon the transaction of sale, and is otherwise controlling with
respect to the nature, purpose, collection, and refund of BLETs.\textsuperscript{54}

In capsule, the pertinent statutory sources supporting for the "ex-
clusion" of the BLET as a component of value include:

(a) 26 U.S.C. Section 4121 (a), which provides that the
BLET (like other manufacturers' excise taxes) is im-
posed solely upon and at the point of sale of the
coal;

(b) 26 U.S.C. Section 4216 (a), which provides that in
determining the "price" for which the coal is sold,
the BLET itself is to be excluded; and

(c) 26 U.S.C. Section 6416 (a), which provides that no
credit or refund of an "overpayment" of BLET will
be allowed to the operator/seller without the buyer/
payor's written consent.

In effect, the BLET is imposed solely upon the "sale" of coal by
the operator\textsuperscript{55} and is never part of the value of the produced coal.\textsuperscript{56}
The BLET is an end-user tax or a flow through tax. The coal buyer
pays the BLET to the IRS through the operator/seller.

The statutory and regulatory framework of manufacturers' excise
taxes is long-standing and pervasive. Contrary to the bland statutory
authority of Section 6 of FCLAA to define "value" by regulation, the
provisions of manufacturers' excise tax statutes and, specifically, of the
BLBR Act of 1977\textsuperscript{57} are singular and express as to the creation and
imposition of a BLET. The BLET is a manufacturers' excise tax, or an
end-user tax, and is imposed on the transaction of sale. If there is no
sale of the produced coal, the BLET is not owed. The BLET adds
absolutely nothing to the value of the coal and is merely the vehicle
for collecting an end-use tax to fund our nation's black lung welfare

\textsuperscript{55} Id.
\textsuperscript{56} Id. at § 4216(a).
program. To that extent, it can be said that the BLET does add to the buyer’s overall cost to “consume” the coal. In confirmation of this premise, it has been judicially held that a manufacturer’s excise tax “payment” is the property of the buyer, not that of the operator/seller. As such, it cannot constitute a component of value for the produced coal.

To date, although the BLET issue is on appeal before the IBLA, neither of these prospective exclusions from gross proceeds has been judicially reviewed.

6. Contract Settlements

Contract settlement is the hottest of the current valuation issues. It has taken on proportions that neither the coal industry nor the MMS anticipated. The dollar amounts can be large, and the fact patterns in dispute are seemingly endless.

From the MMS’s perspective, contract settlements include (i) lump-sum payments, (ii) non-cash consideration, and/or (iii) the modification of contract terms. The MMS has asserted that examples of such agreements include:

(a) Take-or-pay payments;
(b) Capacity charges;
(c) Payments for advanced development costs;
(d) Prepaid reserve amounts;
(e) Contract buy-downs;
(f) Contract buy-outs;
(g) Altered take commitments;
(h) Producer damages;
(i) Excess royalty reimbursements;
(j) Deficient price adjustments; and
(k) Contract disputes.

This issue is so pervasive and emotional within the coal industry that it defies adequate treatment herein. However, it can be stated pur-
suant to the *Diamond Shamrock* case\(^6\) that a federal oil and gas royalty is only due upon the "production" of the oil and gas itself. In fact, the MMS accepted and promulgated the 1989 Coal Product Valuation Regulations, premised upon this holding.\(^6\) The current conflict concerns the regulatory construction of Section 206.257(b)(6),\(^6\) which provides that:

The *value of production* for royalty purposes shall not include payments received by the lessee pursuant to a contract which the lessee demonstrates, to MMS’s satisfaction, were not part of the total consideration paid for the purchase of coal production.\(^6\)

In the Preamble to the 1989 Coal Product Valuation Regulations, the MMS designated "General Comment 6: Royalty on Take-Or-Pay and Other Similar Type Payments."\(^6\) Therein, the MMS acknowledged that:

In the July 15, 1988 notice (53 FR 26951), MMS requested further comments as to whether the following payments identified by industry should be subject to royalty:

1. Damages recovered under a court judgment for the purchaser's breach of the sales contract;
2. Payments made under a force majeure clause;
3. "Settlement" payments made to terminate a sales contract before the contractually-specified termination date; this includes situations where there may or may not be a follow-on contract;
4. Payments for assignment of an interest in the lease;
5. Payments not designated as part of the purchase price but made on a periodic or regularly scheduled basis under the contract;
6. Payments not designated as part of the purchase price, which may or may not vary with the amount of coal delivered, and paid on a one-time or not regularly scheduled basis under the contract in a specific sum or calculated under a prescribed formula;

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63. *Id.* (emphasis added).
(7) Payments or reimbursements for services or processing costs customarily the responsibility of the lessee, including that required to put the product in marketable condition.

Many industry and several State comments agreed that absent any physical removal of the resource from the leased property, no royalty should be due on any type of payment received by the lessee. . . .

In the same General Comment 6, and in the context of the foregoing, the MMS cited the Diamond Shamrock case as follows:

Many comments cited the August 17, 1988, Fifth Circuit Court of Appeals decision in Diamond Shamrock Exploration Co. et al. v. Hodel, 853 F.2d 1159 (5th Cir. 1988), where the Court ruled in the context of natural gas royalties that royalty payments are not due on receipt of take-or-pay payments, but are only due when the purchaser takes so-called “make-up” gas (gas taken in excess of minimum quantities in later periods against the purchase price of which previous take-or-pay payments are credited).\(^6\)

In its Response to General Comment 6, the MMS stated that:

The Department has not further appealed the Fifth Circuit’s decision in Diamond Shamrock, and will apply the rationale of that decision for purposes of coal royalty valuation. Therefore, MMS’s final coal regulations have been revised from previous proposed rules by revising the definition of ‘gross proceeds’ in 30 C.F.R. 206.251 to exclude the phrase ‘* * * payments or credits for advanced prepaid reserve payments subject to recoupment through reduced prices in later sales; payments or credits for advanced exploration or development costs that are subject to recoupment through reduced prices in later sales; take-or-pay payments; and reimbursements, including but not limited to * * *.’ Of course, as discussed further below, if any of such payments at some point is used as a payment for produced coal, then they would still be subject to royalty as gross proceeds for produced coal.

* * * *

Instead, the regulations at 30 C.F.R. 205.257(b)(6) will provide lessees the opportunity to rebut the presumption that payments received by the lessee are not part of the total consideration paid for coal and, hence, are not royalty bearing. Since the question at issue is not whether a payment was made but, instead, whether that payment is part of the consideration paid for coal, MMS would expect any rebuttal to address the commercial rela-

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66. Id.
relationship between the buyer and the seller (lessee). Specifically, MMS would require substantial explanation of why the value paid by a purchaser, under a coal sales contract, is not equitable (sic) to the value received by the lessee for the sale of coal. 67

In addition to the foregoing General Comment 6, the MMS also included a separate comments section with respect to Section 206.257(b)(6). 68 Therein, having reiterated that there is a presumption that payments received by the lessee are "payments for coal production," the MMS stated that:

However, payments must indeed be payments for coal production before any royalty is owed. Therefore, lessees will have the opportunity to come forward with arguments as to why a particular payment under a coal sales contract is not part of the value of the coal production. 69

In this context, the MMS stated that it would consider such factors as (i) the terms of the sale contract, (ii) the lessee’s rationale for its claim that the payment is not part of the value of production, (iii) how the purchaser characterizes the transaction (particularly if it is a public utility subject to state public utilities commission regulations), and (iv) any other relevant matters. 70 The MMS then recited five "other factors," to include, in pertinent part:

(3) ‘Settlement’ payments made to terminate a sales contract before the contractually-specified termination date will usually not be considered payments for produced coal. If there is a follow-on contract, MMS will review the circumstances to determine if some or all of the payment is royalty bearing.

* * * *

(5) Damages recovered under a court judgment, or included in a liquidated damages clause, that are for the purchaser’s breach of a sale contract are usually not considered payment for produced coal, if they correspond to or are a reasonable estimate of the producer’s lost profit. 71

69. Id. (emphasis added).
70. Id.
71. Id. (emphasis added).
As of January 13, 1989, the irrefutable construction of Section 206.257(b)(6) was (i) that to be royalty bearing, the contract settlement payment had to be received for produced coal, which is coal physically severed and removed from the ground, and (ii) that the settlement payment had to be recouped by the same buyer through "make-up" production as a price off-set. Thereafter, this MMS position was consistent and frequently reiterated.

However, on May 3, 1993, the MMS issued a "Dear Payor Letter" to the oil and gas industry, wherein it declared its "interpretation" that, in essence, contract settlement payments will be royalty bearing. According to the MMS, the May 3, 1993 Dear Payor Letter only explains "how" the existing valuation regulations apply to contract settlement payments, especially with respect to (i) past pricing disputes, (ii) take-or-pay payments, (iii) contract buy-downs, and (iv) contract buy-outs. The MMS explained that this interpretation and policy are consistent with judicial decisions because royalties are not owed unless and until payment-related production occurs. However, under the heading of General Principle, the May 3, 1993 Dear Payor Letter also provides that the payment will be royalty bearing "if the mineral to which the payment is attributable is produced and sold either to the original purchaser or a substitute purchaser."

While this letter was not sent to federal coal payors, it does signal an attempted reversal of the MMS's long-standing regulatory construction concerning contract settlement payments. The letter has recently been sent to federal coal payors on a case by case basis, as the purported authority for a given MMS Demand Letter and Bill for Collection.

Without addressing the applicability of this new-found MMS interpretation to the oil and gas industry, it must be concluded that the

73. See app. 3, May 3, 1993, "Dear Payor Letter" from the MMS to federal oil and gas industry payors, regarding "monies received under contract settlements."  
74. Id.  
75. See app. 4.  
76. See Independent Petroleum Association of America v. Babbitt, No. 93-2544-RCL,
May 3, 1993, Dear Payor Letter (i) clearly violates Section 206.257(b)(6) of the 1989 Coal Product Valuation Regulations, (ii) is at variance with the MMS’s consistent regulatory construction thereof, and (iii) is contrary to administrative decisions which have been rendered by the MMS itself.77 As such, rather than the May 3, 1993 Dear Payor Letter explaining how the existing valuation regulations apply, it can only be interpreted as mandating how the original 1989 Coal Product Valuation Regulations will now be applied. If this is the case, the May 3, 1993, Dear Payor Letter must also be rejected for failure to have complied with the Administrative Procedures Act.78

Again, the stakes are high. Even though the MMS has selected a few oil and gas test cases to bring this issue before a United States district court,79 it does not appear that it will be resolved in the near future. To date, and with respect to federal coal audits, few contract settlements have resulted in an MMS Demand Letter and Bill for Collection. Because the coal fact patterns are generally more favorable than the oil and gas cases, the MMS has been reluctant to select any coal test cases to bring the issue before a United States district court. Depending upon a given coal operator’s contract settlement issue, the immediate decision to be made is whether one wants to be pro-active and have a hand in the resolution of this issue or whether one wants to adopt a passive position and hope to be the beneficiary of dicta based upon someone else’s more favorable fact pattern.

7. Miscellaneous Valuation Issues

Once one has run through the foregoing federal valuation issues, the remaining issues are more mine specific and arise from the vaga-
ries attendant to a particular operation. In such instances, the standard against which these valuation issues will be resolved is pivotal; for example, one might ask (i) whether payment or other consideration was received “for” produced coal, or (ii) whether payment or other consideration was “in any way attributable to” the production of coal. As one might suspect, the MMS has asserted the latter standard, with some interesting results. While the results may not be unexpected, the MMS has asserted that coal consumed in a mine office stove is royalty bearing and that coal which has historically been made available to and taken by the mine work force for its personal use is also royalty bearing.

Contractual payments and reimbursements are less obvious and, sometimes, defy logic. The inherent fallacy in the MMS perception is that not every payment provided for in a coal sales agreement is for the purchase of coal. Some provisions relate to the business dealings or the commercial relationship between the seller and the buyer, in which the MMS has no vested interest.

By way of example, the MMS has asserted the following contractual payments and reimbursements to be royalty bearing:

(a) The payment of interest by the buyer is royalty bearing where the operator/seller had paid increased royalty based upon a contract price increase (e.g., decrease in the Federal depletion allowance, a readjusted royalty increase from cents-per-ton to an ad valorem rate, etc.) and the buyer’s pass-through reimbursement is delayed or even contested for several years. The MMS received its value for the produced coal when the operator/seller made the increased royalty payment, to possibly have included its own interest thereon. The ensuing payment of contractual interest by the buyer is to compensate the operator/seller for its lost time value of money, thereby keeping the operator/seller whole. It has absolutely nothing to do with the value of the produced coal. The produced coal is not worth more or less because of the contractual interest provisions between the parties. In point of fact, it is a private contractual/business matter solely between the operator/seller and the buyer.

(b) The reimbursement of attorneys fees by the buyer is royalty bearing where the fees were incurred by the operator/seller in the pros-
ecution of an MMS appeal on behalf of the buyer. Pursuant to a pass-
through clause in the coal sales agreement, the amount at risk in the
MMS appeal would be borne by the buyer. The operator/seller’s attor-
neys fees were incurred by the buyer to protect its own monetary in-
terest. The operator/seller was merely made whole. Such costs had
absolutely nothing to do with the value of the produced coal. If the
seller/buyer had decided to just pay the original MMS demand, that
payment would have constituted the value of the produced coal. That
same value was not increased because an appeal was pursued and attor-
neys fees were incurred. If the buyer could have prosecuted the appeal
and incurred the same fees from the buyer’s own attorneys, would the
buyer’s attorneys fees have been royalty bearing? If there had been no
pass-through clause and the operator/seller had incurred the same fees
for its own account, would the seller’s attorneys fees have been royalty
bearing? If the seller/buyer had been upheld on appeal, would the
MMS be entitled to collect royalties on the same reimbursed attorneys
fees, even though the MMS had been reversed on appeal? In any one
of these three hypotheticals, was the “value of the produced coal”
actually increased? No, it is what it is.

(c) The reimbursement of “surety bond costs” by the buyer,
which were also incurred by the operator/seller in the prosecution of an
MMS appeal on behalf of the buyer, is royalty bearing. Again, the
amount at risk in the MMS appeal would be borne by the buyer. Either
an appeal bond had to be posted or the MMS demand amount had
to be paid, in order to prosecute the appeal. The surety bond costs
were incurred by the buyer to protect its own monetary interest. The
operator/seller was simply made whole. Such costs had absolutely noth-
ing to do with the value of the produced coal.

In each instance, it is submitted that the payment or reimbursement
should not be deemed to be royalty bearing, because it is not a compo-
nent of value for the produced coal. But alas, we are back to the two-
pronged MMS thesis:

(1) Did the lessee receive a payment?

(2) Did the buyer pay for or contribute anything which is not
included in the purchase price?
This standard is simply wrong!

B. MMS Administrative Appeal Procedures and Practice

There is surprisingly little law or regulation with respect to the MMS’s procedures and practice applicable to coal production royalties. Other than the previously discussed FCLAA authorization for the Secretary to define coal “value” by regulation, there are no specific statutory mandates which pertain to the MMS administration of coal royalty audits, collection, or enforcement. Even with respect to regulatory provisions, the subject coverage is not extensive, when contrasted with the statutory and regulatory infrastructure attendant to oil and gas production royalties.80

The 1989 Coal Product Valuation Regulations do include provisions with respect to: (i) the quality and quantity measurement standards for reporting and paying royalties,81 (ii) the purview of an MMS audit;82 (iii) requests for value determination;83 (iv) the confidentiality of information;84 and (v) MMS requests for contract submission.85 Except for the foregoing product valuation provisions of Part 206, the remainder of the MMS Subchapter A—Royalty Management regulations86 provides only limited, general provisions which would be applicable to coal, to include:

(a) forms and reports;87
(b) records and files maintenance;88
(c) production accounting.89

82. 30 C.F.R. § 206.257(b)(2) (1994).
83. Id. at § 206.257(f).
84. Id. at § 206.257(k).
86. 30 C.F.R. pts. 201-243.
(d) coal audits;\textsuperscript{90}
(e) collection of royalties, rentals, bonus and other monies due the federal government,\textsuperscript{91} to also include late payments or under-payment charges (interest);\textsuperscript{92} and
(f) audit delegation to states.\textsuperscript{93}

Except for (i) pulling the foregoing regulatory provisions together in one place, (ii) reiterating select 1989 Preamble excerpts, and (iii) including examples, figures and forms of perceived application, the AFS Payor Handbook, Solid Minerals, provides little further guidance with respect to the MMS’s substantive administration of royalty audits, collection, or enforcement. Of specific applicability to this discussion, the relatively new Chapter 10, Coal Product Valuation, dated October 26, 1992, should not be overlooked. Beyond this, there is not much MMS policy which has been reduced to written form or which is otherwise available to coal royalty payors.\textsuperscript{94} In essence, one must rely upon empirical experience or acquiesce to the MMS’s ad hoc directives, demands, and/or orders.

In the context of this dearth of substantive provisions, this section will discuss the MMS appellate procedures and practice. It should not come as a surprise that there is even less written either providing for or discussing exactly those practices and procedures. The two primary regulatory sources are (i) 30 C.F.R. Part 243, Appeals—Royalty Management Program,\textsuperscript{95} and (ii) Part 290, Appeals Procedures.\textsuperscript{96}

\textsuperscript{94} Under date of April 20, 1993, the MMS released “draft” proposed regulatory revisions to 30 C.F.R. pts. 206, 217 and 241, to include provisions with respect to the audit process, record-keeping, access to information, audit completion, and administrative appeals. To date, these draft revisions have not been published in the Federal Register as “proposed” regulatory revisions and, purportedly, have been withdrawn by the MMS.
\textsuperscript{95} 30 C.F.R. §§ 243.1 to -.4 (1994).
\textsuperscript{96} 30 C.F.R. §§ 290.1 to -.7 (1994).
1. Statute of Limitations

The federal statute of limitations provides that the United States must bring an action for money damages which is founded upon “contract” within the later of (i) six years after the right of action accrues or (ii) one year after a final decision has been rendered in the applicable administrative proceeding.97 Exceptions to this rule include: (i) if the operator pays part of the MMS demand or acknowledges that the demand is owed, the MMS right of action is renewed; (ii) the period of limitation does not begin to run while facts material to the right of action are not known or could not reasonably have been known; (iii) if the operator files a suit against the United States, the statute does not bar the MMS from filing a counterclaim if the claim arises out of the same transaction or occurrence; and (iv) the statute does not preclude the MMS from seeking to offset an unrelated claim against the operator’s claim.98

It has been held by the United States Court of Appeals for the Tenth Circuit in Phillips II99 that this six year period begins to run on the day that the payment was originally due. The court also held that the statute of limitations does not begin to run upon completion of an MMS audit and that the MMS’s workload is not a cause to toll the running of the statute of limitations.100 Conversely, the United States Court of Appeals for the Fifth Circuit has recently held that as MMS Demand Letters and Bills for Collection only seek monies due under a contract, such contractual obligations cannot be considered compensatory and, therefore, are not subject to nor barred by the six year period.101

98. Id.
In the context of coal audits, finality is illusive. There always seems to be another "adjustment" with the buyer, another form to be submitted, or another payment to be made and, sometimes, relatively long periods after the original due date for the subject payment. Often, it seems that an audit closure letter is never forthcoming, but, rather, one audit period and the next request for information simply roll into one another.

Unfortunately, the MMS has been steadfast that the six year judicial statute of limitations is not applicable in administrative actions or appeals. This MMS position leads to the incongruity that while the foregoing six-year limitation would be available to a lessee/operator as an affirmative defense in a judicial proceeding, this judicial bar will not be recognized by the MMS as an equivalent administrative bar. Thus, the lessee/operator must exhaust its administrative remedies to be able to assert this acknowledged judicial defense.

This mindset is symptomatic of the MMS's bureaucratic disdain for the vested interests of the coal lessee/operator in the MMS appellate process.

2. Production of Documents

Similar to the uncertainty which attaches to the presence or absence of a statute of limitations with respect to administrative coal demands, the parameters concerning the production of documents are equally amorphous. The current federal coal lease form provides in Section 6 that the "lessee shall keep open at all reasonable times for the inspection of any duly authorized officer of lessor . . . all books, accounts, maps, and records relative to operations. . . ." More specifically, under Subpart E (Solid Minerals—General) of 30 C.F.R. Part 212 (Records and Files Maintenance), Section 212.200(a) provides that all records must be maintained by a lessee "for [six] years after the records are generated unless the record holder is notified, in writ-
ing, that records must be maintained for a longer period." 104 This section goes on to require that once an audit or investigation is underway, records must be maintained until the record holder is released by written notice of the obligation to maintain the records. In terms of the categories of records that are subject to production, Section 212.200(b) simply provides that "the MMS shall have access to all records of the operator/lessee pertaining to compliance with federal royalties." 105 This is certainly a pervasive requirement. As noted above with respect to the application of the statute of limitations, audit closure is difficult to achieve. Consequently, the audit-related obligation to continue to maintain and/or to be required to produce records can extend well beyond the original six-year period.

In practice, the MMS requirements for the maintenance and production of "records relevant to royalties" would include:

(a) an operator's royalty-related records must be kept for a minimum of six years; 106
(b) if an operator elects to keep the records for longer than the required six years, such "whiskered" records are also subject to a request for production; 107
(c) the MMS may direct an operator to retain royalty-related records for longer than six years; 108 and
(d) if the MMS has initiated an audit, all royalty-related records must be kept until the MMS issues a release in the audit closure letter. 109

To date, it has not been judicially decided whether the MMS can order a coal operator to conduct a "self-audit" or to create new reports. 110

104. 30 C.F.R. § 212.200(a) (1994).
105. Id. at § 212.200(b).
106. Id. at § 212.200(a).
108. 30 C.F.R. § 212.200(a) (1994). See also Phillips Petroleum Co. v. Lujan (Phillips II), 963 F.2d 1380 (10th Cir. 1992).
Unlike the FOGRMA statutory authority, the MMS does not have subpoena power with respect to the records of a federal coal lessee/operator.

3. Requests for Value Determination

Once it becomes apparent that a sticky valuation issue is developing, and again contingent upon magnitude of exposure and “policy” precedent involved, a lessee/operator may want to consider the submission of a Request for Value Determination. In so doing, it may be possible to avoid the purported resolution of the issue during the audit process, where policy level considerations are precluded. Then too, running the audit gauntlet can easily take a couple of floundering years, between the conduct of the audit itself, the subsequent requests for information, the MMS Issues Letter, the operator’s response thereto, and the eventual Demand Letter and Bill for Collection, which would be the first administratively appealable decision.

Rather, a lessee/operator may request a value determination from the MMS. In so doing, the lessee/operator proposes a value determination method and submits the data that it believes is relevant to its proposal. Because the regulation expressly requires that the MMS must “expeditiously” render its value determination, this process would significantly reduce the delay factor.

Another benefit from the resolution of valuation issues through value determination is the fact that this MMS decision would be appealable. Depending on the nature of the valuation issue, the Request for Value Determination might be addressed to the MMS Director, with a specific request that the decision be rendered as a full force and effect order at the secretarial level, thereby permitting the lessee/

113. Id.
114. Id.
operator to proceed directly to United States district court if the determination is adverse.\textsuperscript{116}

A Request for Value Determination is not suited to the resolution of all valuation issues. However, within certain parameters, it does provide a pro-active vehicle for policy level determinations on an expedited basis.

4. MMS/State Audits

The 1989 Coal Product Valuation Regulations define an “audit” as “a review, conducted in accordance with generally accepted accounting and auditing standards, of royalty payment compliance activities of lessees. . . “\textsuperscript{117} Interestingly, Section 217.200, within Subpart E (Audits and Inspections), provides the only direct and current regulatory provision for the conduct of coal audits. That section provides, in part, that coal audits may be required annually or as directed by the Associate Director for Royalty Management and “shall be performed by a qualified independent certified public accountant or by an independent public accountant . . . and at the expense of the operator/lessee.”\textsuperscript{118}

Based upon the express provisions of Section 217.200, one might wonder whether the MMS or a state auditor is even authorized to conduct its own on-site audit? Unfortunately, such a prohibition does not follow. In its 1990 \textit{Arch Mineral} decision,\textsuperscript{119} the Tenth Circuit noted that under the Mineral Lands Leasing Act of 1920, the Secretary is “authorized to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of this Chapter. . . .”\textsuperscript{120} Based thereon, the court held such language to be “a broad grant of authority.” The court further held that

\textsuperscript{116} 30 C.F.R. § 243.3 (1994).
\textsuperscript{117} 30 C.F.R. § 206.251 (1994).
\textsuperscript{118} 30 C.F.R. § 217.200 (1994).
\textsuperscript{119} Arch Mineral Corp. v. Lujan, 911 F.2d 408 (10th Cir. 1990).
\textsuperscript{120} Id. at 415. See also 30 U.S.C. § 189 (1979).
"the collection of royalties and rents is certainly one of the purposes of the Act."\textsuperscript{121}

In practice, the MMS or state auditors do conduct their own on-site audits. More specifically, the MMS has entered into a Memorandum of Understanding with the respective states,\textsuperscript{122} so that coal audits are now conducted primarily by state auditors. However, the state auditors are not authorized to make policy or interpretative decisions; this function is solely reserved to the MMS.

The audit process is initiated by an "audit engagement letter." It usually befalls an oil and gas auditor to conduct the coal audit, or, at least, it is usually conducted by someone who has little experience within the coal industry. The consequence is that oil and gas concepts are visited upon the coal audit, and the nuances of the coal industry and the realities of coal marketplace are lost. In addition, the auditors have little or no authority to make independent decisions and no incentive to be other than excessively aggressive.

The upshot is that most coal audits leave the lessee/operator frustrated, and the prospects for an ensuing audit appeal are all but predestined. This is unfortunate, because the majority of audit issues should be resolved at the audit level.

5. MMS "Issues Letter"

There is no regulatory requirement for the MMS to submit an "Issues Letter" to the lessee/operator. However, if the audit does indicate that additional royalty may be owing, the MMS will prepare an Issues Letter or a "preliminary findings letter," which will inform the lessee/operator of the MMS's preliminary determinations and the basis for its conclusions, and will request the operator's response thereto. While mistrust and/or skepticism prevent some operators from responding, it is suggested that every opportunity should be taken to resolve such issues before the MMS position becomes unduly rigid. Depending upon the magnitude of the audit issues, direct meetings with the MMS

\textsuperscript{121} Arch Mineral Corp., 911 F.2d at 415.
\textsuperscript{122} 30 C.F.R. §§ 229.1 to -10 (1994).
are recommended, as many as necessary and at successively higher levels, as is the written submission of the lessee/operator’s legal position.

The optimist will observe that there is little to lose by responding forcefully to an MMS Issues Letter, because if one does not, the MMS will issue its Demand Letter and Bill for Collection premised upon the position stated in the Issues Letter. The pessimist’s rejoinder would be that the lessee/operator’s response will only afford the MMS the opportunity to tighten-up or redefine its original determination. In this manner, because the basis for the MMS demand may not have been substantiated very well at this initial juncture, it would be more susceptible to a successful challenge upon higher review. Overall, a proactive approach is recommended; if not, one can almost insure the worst. Then too, once an MMS position has been immortalized in a Demand Letter and Bill for Collection, it is significantly harder to reverse it, because someone will have to admit that he was wrong, and human nature resists such candor.

6. MMS Decision (Demand Letter) or Order

In the audit context, at some indeterminate point after (i) the conclusion of the audit, (ii) the issuance of the MMS Issues Letter, and (iii) the lessee/operator’s response thereto, as well as prospective information requests and meetings, the MMS will issue a Demand Letter and Bill for Collection. This MMS Demand Letter constitutes the first audit decision that is subject to administrative appeal.123 Section 290.2 provides that “any party to a case adversely affected by a final order or decision of an officer of the [MMS] shall have a right to appeal to the Director, [MMS]. . . .” The determination of who constitutes an “adversely affected party” is subjective and is to be decided on a case by case basis.124

123. 30 C.F.R. § 290.2 (1994).
If the lessee/operator agrees with the Demand Letter and the demand amount as recited in the Bill for Collection, the only requisite step is to tender payment in accordance with the Bill for Collection.

If one does not agree with either the Demand Letter or the amount stated in the Bill for Collection, to avoid being bound thereby, an appeal to the MMS Director must be filed. The Notice of Appeal must be filed within thirty days from receipt of the Demand Letter, by filing the notice with the office of the MMS official who issued the decision or order. If the decision or order was issued by the Assistant Secretary for Land and Minerals Management or by the Secretary, one’s administrative remedies are deemed to have been exhausted, and further challenge is directly to United States district court.

Of all of the MMS procedures, only this thirty-day period within which to file a Notice of Appeal is mandatory, subject to a grace-period exception. If the lessee/operator is going to file an appeal, it is strongly advised that the Notice of Appeal be submitted safely within the designated thirty-day appeal period. There is no specific format for this notice. If the operator/lessee fails to timely file a Notice of Appeal, it is bound by the MMS Demand Letter/Bill for Collection or other order.

By a Notice published March 16, 1994, the authority of the MMS Appeals Division was delegated to the MMS Royalty Management Program (RMP) to render decisions on “routine appeals” from decision and orders that are issued by the RMP. The stated purpose of this delegation was to streamline the appeals process and to reduce the time for a final agency decision. Such routine appeals are defined as:

(a) Appeals not timely filed as required by MMS regulations.

126. 30 C.F.R. § 290.3 (1994).
128. 30 C.F.R. §§ 290.3(a)(1),(2) and 290.5(a) (1994). See also Walter Van Norman, Jr., 114 IBLA 56 (1990); Conoco, Inc., 115 IBLA 105 (1990).
129. 30 C.F.R. § 290.5(b) (1994).
(b) Appeals from an assessment for a required report filed late.\textsuperscript{132}
(c) Appeals from an assessment for failure to file a required report.\textsuperscript{133}
(d) Appeals from an assessment for an incorrectly completed report.\textsuperscript{134}
(e) Appeals from an assessment of interest for unpaid and underpaid amounts due.\textsuperscript{135} This category is limited to factual issues involving the time value of money and non-precedent-setting appeals. Appeals with complex issues will be referred to the Director of MMS for a decision.
(f) Appeals in which the appellant neglects to file a statement of reasons to justify modification of the RMP order or decision.\textsuperscript{136}
(g) Appeals in which the order or decision is being rescinded.\textsuperscript{137}

It is anticipated that this procedure will result in the summary denial of such routine cases, thereby hurdling the MMS administrative appeal process and, if desired, permitting the appellant to proceed directly to the IBLA.

7. MMS Appeals

Reference to the MMS appeal procedures and practice as an appellate process is a misnomer. Rather, the MMS appeal process is a four-stage exercise in the confirmation of MMS “policy.” This process consists of the issuance of the MMS (i) Issues Letter, (ii) Demand Letter/Bill for Collection, (iii) Field Report, and (iv) Appeal Decision. Through the first three stages, the MMS action is somewhat understandable, as the MMS is acting as an advocate for its evolving valuation policy. It is almost to be expected because, as previously noted, specific statutory pronouncement is minimal and the regulatory provisions are skeletal.

\textsuperscript{137} Id.
The real exposition is reflected by the fourth stage, or the actual MMS Appeal Decision. One would anticipate that the MMS Appeals (and Litigation Support) Division would be at least quasi-independent and function with some degree of judicial temperament. Alas, this is not the case. While a draft decision is, indeed, prepared by the MMS Appeals Division, the decision is then "surnamed." Surnaming entails the routing of the draft decision for review and approval (i) to the very office that rendered the original decision or order, (ii) to the Office of Policy and Management Improvement, (iii) to the Solicitor’s office, and (iv) to the Director’s office. It is accepted that the Solicitor’s office has a veto power over the issuance of the MMS Appeal Decision, unless overruled by the Director. This is the same Solicitor’s office that will act as the advocate for the MMS before the IBLA or in United States district court. In this way, the MMS assures that its policy is consistent or evolving in the manner espoused by the MMS itself. The galling part is that these same MMS Appeal Decisions are subsequently cited as authority or precedent for the validity of a given MMS policy.

The foregoing is the “appellate” course of action if the MMS knows what “policy” it desires to “confirm.” If the policy does not currently exist or is still subject to internal determination, an MMS Appeal Decision will not be rendered, and the case will be stalled until the policy is confirmed. For these reasons, some appeals have been at issue before the MMS Appeals Division since 1986-1987. It is also accepted that if a given case fact pattern is not favorable to the MMS policy to be confirmed, the case will be stalled until a more favorable fact pattern is presented; then, the second case will be cited as precedent in deciding the stalled case. A delay in excess of two years is commonplace in rendering MMS Appeal Decisions.

This inordinate delay is exacerbated by the MMS’s promulgation on March 29, 1994, effective April 1, 1994, of revised interest rate regulations for solid minerals pursuant to 30 C.F.R. Sections 218.202 (-c) and (d).138 Prior to this revision, the interest rate on late payments or underpayments for solid minerals, to include coal, was premised.

upon the "Treasury Current Value of Funds Rate" as published by the Department of the Treasury and was computed as simple interest. The revised regulation now provides that the interest rate for solid minerals is the "underpayment rate established by Section 6621(a)(2) of the Internal Revenue Code," with the attendant policy assertion by the MMS that the interest is to be compounded. The net effect is that the coal interest rate increased from 3% to 7% on April 1, 1994, to 8% on July 1, 1994, and to 9% on October 1, 1994. For late payments or underpayments which straddle April 1, 1994, the MMS has declared by way of Preamble "example" that the prior simple interest will be added to the original principal, and that the new compounded interest rate is applicable to that combined principal/simple interest amount. One would think that simple interest is simple interest and that the compounded interest could be computed only against the original principal from and after April 1, 1994. This is yet another example of the MMS endeavoring to FOGMA-tize the coal industry. While this redesignation from the Treasury Rate to the IRS Rate, to include the purported compounding thereof, is subject to administrative appeal, it has not yet been judicially decided.

Because of the four to five year administrative delay before the MMS and the IBLA, and because of an overall delay of six to seven years before a decision is rendered by a United States district court, it was not uncommon that the amount of interest owed would exceed the original principal. Now, with the advent of higher and purportedly compounded interest, consideration should be given to paying the demanded principal "under protest," in order to stop the interest hemorrhage. In each appeal, a time value of money standard should be applied. Unfortunately, if the lessee/appellant prevails in whole or in part on appeal, the MMS will not pay interest on its time value use of the lessee/appellant's money.

141. See MMS Summary of the OCS, Onshore, and Solid Mineral Interest Rates, which have been in effect from December, 1979, through the present.
143. 30 C.F.R. § 243.2(a) (1994).
Within the foregoing context, the coal lessee/operator must prosecute its MMS “appeal,” in order to exhaust this “administrative remedy” and proceed to file a subsequent administrative appeal before the IBLA, which is the alter ego of the Secretary. Both administrative remedies must be exhausted before one can raise the merits of the challenge before a United States district court.\footnote{Id. at § 243.3.}

In the prosecution of an MMS “appeal,” Section 243.2(a) provides for the suspension of monetary-demand decisions or orders upon the submission of an MMS approved surety instrument.\footnote{Id. While the usual form of surety instrument is a surety bond, a certificate of deposit or Treasury bill may also be posted, with the interest earned accruing to the lessee/operator.} Such a surety instrument will include the principal amount owed, plus any accrued interest, and the projected interest for a one-year period.\footnote{30 C.F.R. § 243.2(c)(1) (1994).} The surety amount is amended annually to cover the additional estimated interest for another one-year period.\footnote{Id. at § 243.2(c)(2).}

Although the appellant is to file its Statement of Reasons either with its Notice of Appeal or within the same thirty-day appeal period,\footnote{30 C.F.R. § 290.3(a)(1) (1994).} the common practice was to request in the Notice of Appeal a thirty or sixty-day extension to file the Statement of Reasons. In turn, Section 290.3(b) states that the officer with whom the appeal is filed is to transmit the appeal and accompanying papers to the MMS Director (MMS Appeals Division), with a full report (MMS Field Report) and his recommendations on the appeal.\footnote{Id. at § 290.3(b).} No time requirements are imposed upon the MMS to transmit the appeal and its Field Report, and this step usually took from six to eighteen months.

More recently, the MMS issued an August 3, 1993, Dear Payor Letter, which announced that the MMS had identified a number of improvements to the appeals process, to include: (i) permitting appellant sixty days from receipt of the decision or order to file its Statement of Reasons, with time extensions being granted only upon a

\begin{itemize}
  \item \textbf{144.} \textit{Id.} at § 243.3.
  \item \textbf{145.} \textit{Id.} While the usual form of surety instrument is a surety bond, a certificate of deposit or Treasury bill may also be posted, with the interest earned accruing to the lessee/operator.
  \item \textbf{146.} 30 C.F.R. § 243.2(c)(1) (1994).
  \item \textbf{147.} \textit{Id.} at § 243.2(c)(2).
  \item \textbf{148.} 30 C.F.R. § 290.3(a)(1) (1994).
  \item \textbf{149.} \textit{Id.} at § 290.3(b).
\end{itemize}
showing of good cause;\textsuperscript{150} (ii) establishing internal MMS time frames for the preparation of the MMS Field Report, without the disclosure of such internal time frames; and (iii) allowing appellant only twenty-one days from the date of the letter transmitting the MMS Field Report to file a "response" thereto.\textsuperscript{151} While this August 3, 1993, Dear Payor Letter recites that the foregoing and other recommendations would be implemented "in the near future," such implementation has only been accomplished internally within the MMS. In effect, the implementation of these "improvements" has been by directive in MMS correspondence to the lessee/appellant. Thus, the historic procedural rights of the lessee/appellant and the practice before the MMS Appeals Division were markedly changed by the unceremonial issuance of the August 3, 1993, Dear Payor Letter.

While Section 290.4 provides that oral argument will be allowed on motion in the discretion of the MMS Director (MMS Appeals Division), oral argument is not part of the practice before the MMS Appeals Division.

Beyond the foregoing, very little is specifically provided, and one must rely upon empirical experience. In effect, one should be pro-active at each stage, even after the Statement of Reasons and/or Response to the MMS Field Report have been filed. If a settlement can be reached at any juncture, it merely remains to withdraw the pending appeal.

8. Expediting Appeals Before the MMS Appeals Division

Before an appeal is actually filed with the MMS Appeals Division, a pro-active role can facilitate the resolution of the claim, thus obviating the necessity to file an appeal. Depending upon the issues and

\textsuperscript{150} If a request for extension of time to file a Statement of Reasons is to be submitted, it must be filed within the first 30 days after the decision or order is received, or within the 30-day notice of appeal period. Normally, the request for extension is submitted with and included in the notice of appeal. In cases involving complex issues, an additional 30-day extension is commonly granted.

\textsuperscript{151} See app. 4, MMS Dear Payor Letter dated August 3, 1993, regarding "improvements to the appeals process."
precedential or monetary impact, the coal lessee/operator may request that the decision or order be issued as a “full force and effect” order at the Secretarial level, thereby permitting the lessee/operator to proceed directly to United States district court.\textsuperscript{152} Currently, the MMS is considering the designation of a limited number of test cases, so that select valuation issues may be resolved more quickly.

However, once an appeal has been filed with the MMS Appeals Division, there is little that the appellant can do to expedite the actual processing thereof. While there is no specific procedure for such, there would be nothing to prevent an appellant from submitting a motion for expedited consideration. This would be a request for extraordinary relief at the MMS Appeals Division level, and the attendant burden in presenting a basis for the motion is likely to be equally high.

As discussed briefly above, the MMS did identify a number of improvements in its August 3, 1993, Dear Payor Letter which were intended to reduce the current appeals processing delay.\textsuperscript{153} These improvements include:

(a) requiring the appellant to file its Statement of Reasons within sixty days from receipt of the MMS decision or order;

(b) requiring the responsible MMS office to simultaneously send its Field Report to the MMS Appeals Division and to the appellant;\textsuperscript{154}

(c) requiring the appellant to file a Response to the MMS Field Report “within 21 days of the date of the letter transmitting the field report to the appellant.”\textsuperscript{155}

\textsuperscript{152} 30 C.F.R. § 243.3 (1994).

\textsuperscript{153} See app. 4, MMS Dear Payor Letter dated August 3, 1993, regarding “improvements to the appeals process.”

\textsuperscript{154} Previously, the MMS Field Report was only sent to the MMS Appeals Division, which would forward a copy to the appellant. In the past, it could be anywhere from six to eighteen months before the appellant would receive a copy of the MMS Field Report.

\textsuperscript{155} This time sequence is totally inadequate. It is common for correspondence from the MMS Appeals Division to be dated upwards to a week earlier than it is actually post-marked (presumably, awaiting mailing; the MMS maintains that its correspondence is not dated until after it has been signed). Then too, the delivery of correspondence from the MMS Appeals Division seems to travel by a slow boat, taking upwards to another week for delivery. While 21 days is a relatively short time frame to begin with, it certainly should not begin to run until the copy of the MMS Field Report is received by the appellant and should be subject to extension for good cause shown. The prior rule of thumb was that the
(d) establishing internal MMS time frames for each phase of the appeals process;\textsuperscript{156}

(e) establishing a new MMS automated appeals tracking system to consolidate the various systems currently being used throughout the MMS to record and monitor appeals cases; and

(f) designating an appeals coordinator in each MMS operating division to facilitate inquiries by the appellant.

This August 3, 1993, Dear Payor Letter recites that “most of these near term initiatives are in the process of implementation and will take effect on September 1, 1993.”\textsuperscript{157} To date, nothing further has been publicly released to this effect. Rather, it can only be assumed that the MMS has, in fact, internally implemented the foregoing procedures, presumably effective September 1, 1993.

Looked at with a different spin, the MMS appeals processing system is broken, and something needs to be fixed. The existence of a dual administrative appeal system between the MMS and the IBLA cannot be justified. It is not at all uncommon for it to take more than four to five years to exhaust these administrative remedies. At the end, it is usually the appellant who is exhausted. This fact was recognized and studied by the MMS in 1993, and resulted in the issuance of a report concerning the implementation of an “Alternate Dispute Resolution Program.”\textsuperscript{158} In conjunction therewith, a joint Appeals/Alternative Dispute Resolution Work Group, being comprised of MMS, state, Indian and mineral industry representatives, has been constituted to further review prospective alternatives to “fix” the appeals process.

\textsuperscript{156} Such internal time frames are not specified, which prevents the appellant from planning or anticipating accordingly, and reflect the uneven level of the playing field. While the MMS is motivated by its own schedules and workload, it somehow presumes that the appellant is not equally occupied with the conduct of operations and the realities of the coal business. It would seem that both parties should be on the same rigid or elastic leash.

\textsuperscript{157} See app. 8.

\textsuperscript{158} Final Report, MMS Alternate Dispute Resolution Program, March, 1994.
9. Dispute Resolution Through the MMS Office of Enforcement

A true trace of sanity in this process is the MMS Office of Enforcement. While the name is somewhat misleading, once an appeal has been filed, the MMS Office of Enforcement is empowered to cut through what might otherwise constitute bureaucratic red-tape, discuss the merits of an MMS claim, and, prospectively, enter into a settlement agreement with respect thereto.

This does not mean that all MMS claims are even susceptible to settlement. However, it does provide a forum where both the regulatory and business aspects of an MMS claim can be evaluated and, if appropriate, settled. There is no downside to being pro-active. It can be a win-win situation and save a great deal of cost and frustration in the process. As all such settlements are forwarded to the MMS Director for approval and execution of the actual Settlement Agreement, the footing for any such settlement is firm.

If a settlement is reached, it merely remains to withdraw the pending appeal after the Settlement Agreement has been executed.

10. MMS Settlement Agreements

In due course, it can only be hoped that a greater number of MMS claims can be settled, rather than having to run the appeals gauntlet, so that everyone can get back to more productive matters. If a settlement is reached at any stage in the appeal process, a Settlement Agreement can be prepared by either the MMS or the appellant. It is usually appreciated if the appellant is willing to prepare a “fair” initial draft for review by the MMS, presumably by the MMS Office of Enforcement or by the Solicitor’s office.

In so doing, the KISS philosophy is strongly encouraged. One need only recite the appropriate chain of documentation as respective “Whereas” clauses and include the substantive terms of the settlement.

159. This office is located in Building 85, Federal Center, Denver, Colorado, 80215, (303) 231-3749.
If a payment is to be made, it is recommended that one negotiate and include a provision that the appellant will not be required to undertake a "restructured accounting."

IV. CONCLUSION

The MMS has embarked upon an aggressive coal royalty valuation odyssey, for which there is no common law nor mandated statutory basis. Accordingly, any form of deference to MMS interpretations, policy pronouncements and even regulatory rulemaking is tantamount to feeding steroids to King Kong. The coal industry must be vigilant first and pro-active second. The stark issue is "what we will yet permit the Federal Coal Product Valuation Program to become?"
V. APPENDICES

APPENDIX 1

MMS(USGS)/BLM COAL VALUATION REGULATIONS

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Comment: Paragraph (b) (6) of the proposed rule provided that the royalty value would not include payments received by a lessee pursuant to its contract if the lessee demonstrates to MMS's satisfaction, that such payments were not part of the total consideration paid for the purchase of coal.

Most comments received by MMS were addressed earlier in the general comment response to MMS's position with respect to take-or-pay and similar type payments. However, one comment raised particular issues that require separate responses here. The commenter stated that the proposed regulation, as worded, appears to defeat judicial review because the demonstration (that a payment is not royalty bearing) is "to MMS's satisfaction," instead of an objective finding of fact. The commenter concluded that "Royalty determinations are subject to judicial review under the Administrative Procedure Act as actions that have not been committed to agency discretion by law, and MMS cannot adopt an unreviewable standard in the face of this congressional mandate for review."

MMS Response: There is no attempt to circumvent the requirements of the Administrative Procedure Act. The MMS decisions generally are subject to the administrative appeal process. Adverse decisions may ultimately be taken to the Federal court system for relief.

The MMS has adopted this paragraph (b)(b) as proposed. Under this section, there is a presumption that payments received by the lessee from its purchaser are payments for coal production. The lessee can rebut that presumption, but the burden is on the lessee to come forward with the justifications for its position that the payment was not for coal production. The MMS always has had a consistent policy that royalty is due on no less than the lessee's gross proceeds, which includes all payments for production. Herefore, that policy resulted in royalty demands on virtually all payments from the purchaser to the seller. However, payments must indeed be payments for coal production before any royalty is owed. Therefore, lessees will have the opportunity to come forward with arguments as to why a particular payment under a coal sales contract is not part of the value of the coal products.

Because there are so many different types of coal sales contract clauses, MMS cannot include in this rulemaking comprehensive criteria which could be considered in deciding whether a lessee has met its burden to demonstrate a particular payment is not royalty bearing. However, MMS will certainly consider such factors as the terms of the sales contract, the lessee's rationale for its claim that the payment is not part of the value of production, how the purchaser characterizes the transaction (particularly if it is a public utility subject to state public utilities commission regulation), and any other relevant matters. Other factors could include the following:

1. The unit sale or contract price. Including prices that explicitly vary with the level of production, are considered royalty bearing.
2. Payments not designated as part of the purchase price, but made on a periodic or regularly scheduled basis, generally are royalty bearing.
3. "Settlement" payments made to terminate a sales contract before the contractually-specified termination date will usually not be considered payment for produced coal. If there is a follow-on contract, MMS will review the circumstances to determine if some or all of the payment is royalty bearing.
4. Payments or reimbursements for services or processing costs customarily the responsibility of the lessee, including that required to put the product in marketable condition, will usually be considered payment for produced coal.
5. Damages recovered under a court judgment, or included in a liquidated damages clause, that are for the purchaser's breach of a sales contract are usually not considered payment for produced coal, if they correspond to or are a reasonable estimate of the producer's lost profit.

The provisions of paragraph (b)(6) will not be applicable to any types of payments which other sections of the rules expressly include as part of the royalty value, such as payments for the costs of placing production in marketable condition.

APPENDIX 2
Dear Payor:

The Minerals Management Service's (MMS) product valuation regulations always have required that royalty be paid on a value which cannot be less than the "gross proceeds" accruing to the lessee for the disposition of minerals produced from Federal or Indian leases. During the past several years, many lessees have entered into agreements with their purchasers settling various issues pertaining to the sale of production from Federal and Indian leases which have arisen under their contracts. These settlements frequently involve a lump-sum payment by the purchaser to be relieved of some or all of its obligations under the sales contract.

The purpose of this letter is to provide MMS Royalty Management Program (RMP) interpretation of how the various gross proceeds regulations apply to monies received under contract settlements. The RMP interpretation clarifies that lessees and other payors are required to pay royalties on contract settlement payments to the extent payments are attributable to minerals produced from the lease. Under this interpretation, some or all of a settlement payment is or will become royalty bearing if production to which specific money is attributable occurs.

Enclosure 1 is an explanation of how RMP's interpretation applies to payments made with respect to four issues or elements that are commonly the subject of contract settlement agreements, specifically:

1. Past pricing disputes;
2. Accrued take-or-pay liabilities;
3. Contract "buydowns;" and
4. Contract "buyouts."

If settlement payments pertain to other elements not specifically addressed in Enclosure 1, or if payments are received as a consequence of judicial litigation regarding sales contract obligations, the payments will be examined using principles consistent with those set forth in Enclosure 1.

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APPENDIX 3
Enclosure 2 contains examples illustrating how RHP’s interpretation applies to common types of contract settlement payment situations. These illustrations are not meant to be exhaustive; they simply highlight the key elements of the interpretation. The royalty consequences discussed in each of the examples apply only to the specific hypothetical given.

The enclosed RHP interpretation and examples do not address the issue of how lump-sum contract settlement payments are to be allocated among the several elements that are the subject of the settlement agreement between the seller and the purchaser, which is a necessary prerequisite to applying the interpretation set forth in Enclosure 1. In calculating royalties due on a contract settlement payment, payors need to allocate portions of the settlement payment to each issue resolved in the agreement; e.g., past pricing disputes, take-or-pay, buyout, and buydown. This should be based on the settlement agreement itself, or supporting documents used in the settlement negotiations, if such documents are available and if the allocation reflected in them is reasonable. In reviewing the reasonableness of a payor’s allocations, RHP will apply its experience thus far derived from reviewing a substantial number of settlements. That experience has been that for past pricing disputes, the settlement has been for a high proportion of the accrued liabilities for that element. For take-or-pay, the settlement has reflected a small proportion of the take-or-pay liability accrued under the original contract. If RHP determines that the parties’ allocation is unreasonable, RHP will determine an appropriate allocation.

The RHP will request from lessees, other royalty payors, and purchasers information regarding contract settlements related to Federal and Indian leases. The United States District Court for the Northern District of Oklahoma recently affirmed MMS’ right to examine all such information in United States v. Samson Resources Co., Civil No. 92-C-1030 B (March 19, 1993).

Lessees and other royalty payors should use this interpretation to determine the royalties due on amounts received under contract settlement agreements. Royalties due should be reported on the Report of Sales and Royalty Remittance, Form MMS-2014, according to the instructions given in Enclosure 3.

If you have further questions regarding this interpretation of the regulations, please contact Mr. Martin T. Grieshaber at (303) 275-7240. If you have questions concerning the conduct of audits using this interpretation, please contact Mr. Kenneth H. Moyers at (303) 231-5129 or (303) 231-3185.

Sincerely,

James W. Shaw
Associate Director for
Royalty Management

3 Enclosures
Enclosure 1

The Minerals Management Service (MMS)
Royalty Management Program (RMP) Interpretation on
Royalty Liability on Contract Settlement Payments

GENERAL PRINCIPLE

For Federal and Indian leases, royalties are due on payments received under contract settlement agreements to the extent the payments are attributable to production from the lease. In Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988), the Court of Appeals for the Fifth Circuit ruled that royalties are not due on take-or-pay payments until the production to which the take-or-pay payment is attributable (under the Court’s holding, so-called “make-up” gas) occurs.

Consistent with that ruling, the RMP interpretation and policy is that a payment or a portion of a payment is royalty bearing if the mineral to which the payment is attributable is produced and sold either to the original purchaser or a substitute purchaser, as part of the “gross proceeds” received for disposition of that production under applicable regulations. (See former MMS regulations at 30 CFR §§ 203.200 (1987) (coal, gross value), 206.103 (1987) (onshore oil and gas), 206.150 (1987) (offshore oil and gas), 206.300 (1987) (geothermal, total consideration), and current regulations at 30 CFR §§ 206.102 (oil), 206.152 (unprocessed gas), 206.153 (processed gas), 206.257 (coal), 206.352, 206.355, and 206.356 (geothermal) (1992).

SPECIFIC APPLICATION TO ELEMENTS OF CONTRACT SETTLEMENT PAYMENTS

PAST PRICING DISPUTES

That portion of the settlement payment made to resolve disputes regarding the proper price owed for minerals produced and sold from the lease before the settlement agreement (including, but not limited to, reimbursements for production-related costs, tax reimbursements, appropriate Natural Gas Policy Act price category, or nonpayment of contract purchase price by the purchaser, etc.) is royalty bearing when the lessee receives the payment.

APPENDIX 4
TAKE-OR-PAY

Settlement payments that are expressly subject to future recoupment through make-up deliveries are royalty bearing when and to the extent recouped.

Where payments are made to settle past take-or-pay liabilities and the purchaser has the right to recoup the settlement payment through future deliveries of make-up production under an original, amended or successor contract, royalty is due on that portion of the settlement payment allocable to resolution of the take-or-pay obligation as the payment is applied to the make-up production.

Settlement payments that are not expressly subject to future recoupment through make-up deliveries may be royalty bearing.

Where payments are made to settle past take-or-pay liabilities, but the payment is not expressly recoupable through future deliveries of make-up production under an original, amended or successor contract, the royalty liability will be determined based on the status of the purchaser's make-up rights at the time of settlement and the circumstances involving future production from the lease.

Specifically, if the purchaser had make-up rights at the time of settlement and production continues from the lease, the portion of the settlement payment allocable to resolution of the take-or-pay obligation relates in part to the gas which the purchaser had the right to take under the make-up provisions of the original contract. Thus, if volumes that would have been make-up volumes; i.e., volumes in excess of the minimum take requirement under the original contract, are produced and taken by either the original or a substitute purchaser during the original contract's make-up period, then the portion of the settlement payment attributable to those volumes becomes royalty bearing as the volumes that would have been make-up volumes are produced. In this case, the payment is tied to a volume of production that may be produced after the settlement is effective. Royalties on the attributed portion of the settlement payment are due as this production occurs and are in addition to the royalties otherwise due on the product based upon the disposition to the purchaser of those volumes.

If the original purchaser's make-up rights were expired at the time of settlement, the portion of the settlement payment allocable to the resolution of past take-or-pay liabilities is not royalty bearing.
CONTRACT "BUYDOWNS"

That portion of the settlement payment made to reduce the price to be paid for future production to be taken by the original purchaser under an amended or successor contract is royalty bearing as future production occurs. The portion of the settlement payment allocable to this element is attributable to the production required to be taken during the remaining term of the original contract. Specifically, if the settlement agreement, or the payor's documents or workpapers generated contemporaneously with the settlement agreement, includes a methodology to allocate this portion of the settlement payment to determine the amount attributable to each MMbtu of volume for which the price was bought down, MMS will accept that allocation method if it is reasonable. If there is no such acceptable allocation, payors should use the following alternative method: the amount allocated to the buydown element is divided by the total MMbtu required to be taken under the amended or successor contract during the remaining term of the original contract. Under either the payor's allocation method or the allowed alternative method, the resulting unit dollars per MMbtu are then added to the proceeds paid under the amended or successor contract to establish the gross proceeds received for the volumes (up to the required minimum under the amended or successor contract) produced and sold under that contract during the remaining term of the original contract as and to the extent that they are produced. This total sum establishes the minimum royalty value for the production. Royalties are due on this value as production occurs.

CONTRACT "BUYOUTS"

Payments made to extinguish a purchaser's obligation to take volumes in the future under the contract being reformed or terminated are royalty bearing to the extent that production of the "bought-out" volumes (i.e., the reduction in the minimum take volume under the original contract) continues from the lease under any successor contract with any purchaser during the term of the original contract. The payment is royalty bearing because it compensates the lessee for lower prices in the future for the production foregone by the original purchaser. Some or all of the portion of the settlement payment allocable to this element is attributable to the bought-out volumes produced during the remaining term of the original contract. Specifically, if the settlement agreement (or the payor's documents or workpapers generated contemporaneously with the settlement agreement) includes a methodology to allocate this portion of the settlement payment to determine the amount attributable to each MMbtu of bought-out volumes which is produced and sold to a substitute purchaser, MMS will accept that allocation method if it is reasonable. If there is no such acceptable allocation, payors should use the following alternative method: the amount allocated to this element is

2 MMbtu is the volume unit for natural gas, which is the subject of most of the settlement agreements. If another mineral is involved, the appropriate unit of volume would be substituted.
divided by the total volume bought-out for the remaining term of the original contract. Under either the payor's allocation method or the allowed alternative method, the resulting unit dollars per MMbtu are then added to the proceeds paid under the substitute contract to establish the gross proceeds received for the bought-out volumes produced and sold under that contract as they are produced.

Payments made to extinguish a purchaser's obligation to take volumes in the future are not royalty bearing if there is no production in the future during the term of the original contract to which the payment can be attributed.
Enclosure 2

**CONTRACT SETTLEMENT EXAMPLES**

**General Assumptions**

- S = seller/lessee
- P₁ = original purchaser
- P₂ = new or substitute purchaser

Original contract: 10-year term, 1 million MMBtu/year minimum take, $5/MMBtu contract price

**Example 1**

**Assumptions**

1. P₁ owes S $250,000 for FERC Order 94 series reimbursements.
2. P₁ has an accrued take-or-pay liability of $3 million; the make-up period under the original contract has expired.
3. In year 5 of the contract, P₁ and S enter into a settlement agreement:
   - P₁ pays S $5 million
   - P₁'s minimum take requirement is reduced to 500,000 MMBtu/year and P₁ takes that volume
   - P₁'s price is reduced to $2/MMBtu
   - The term is 5 years from date of settlement
   - There is no successor contract for bought-out volumes during the next 5 years.

**Royalty Consequences**

A. Any settlement amount allocable to resolution of the FERC Order 94 past pricing dispute is royalty bearing upon payment.

B. The portion of the settlement payment allocable to take-or-pay is not royalty bearing because no make-up volumes are produced.

C. The portion of the settlement payment allocable to reduction in price of the remaining 500,000 MMBtu/year from $5 to $2 (buydown) is royalty bearing as production occurs over the next 5 years. Therefore, royalty is due on $2/MMBtu plus the amount allocated to each MMBtu of production in accordance with the method described in the interpretation.

D. The portion of the settlement payment allocated to buyout is not royalty bearing because no bought-out volumes are produced under any successor or substitute contract during the remaining term of the original contract in this example.
EXAMPLE 2

Assumptions are the same as example 1 except for bolded text:

1. P₁ owes S $250,000 for FERC Order 94 series reimbursements.

2. P₁ has an accrued take-or-pay liability of $3 million; the make-up period under the original contract has expired.

3. In year 5 of the contract, P₁ and S enter into a settlement agreement:
   - P₁ pays S $5 million.
   - P₁'s minimum take requirement is reduced to 500,000 MBtu/year, but P₁ takes more than that volume.
   - P₁'s price is reduced to $2/MMBtu.
   - The term is 5 years from date of settlement.
   - There is no successor contract for bought-out volumes during the next 5 years.
   - The new contract with P₁ allows a new make-up period for take-or-pay settlement payment.

Royalty Consequences (same as example 1 except for B.)

A. Any settlement amount allocable to resolution of the FERC Order 94 dispute is royalty bearing upon payment.

B. The portion of the settlement payment allocated to take-or-pay becomes royalty bearing because P₁ takes in excess of 500,000 MBtu/year within new make-up period; the volumes taken in excess of 500,000 MBtu/year are make-up volumes. Royalties should be paid as the settlement payment is recouped through the delivery of the make-up gas volumes.

C. The portion of the settlement payment allocable to reduction in price of the remaining 500,000 MBtu/year from $5 to $2 is royalty bearing as production occurs over the next 5 years. Therefore, royalty is due on $2/MMBtu plus the amount allocated to each MBtu of production in accordance with the method described in the interpretation.

D. The portion of the settlement payment allocated to buyout is not royalty bearing because no bought-out volumes are produced under any successor or substitute contract during the remaining term of the original contract in this example.
EXAMPLE 3

Assumptions same as Example I except bolded text:

1. \( P_1 \) owes \( S \$250,000 \) for FERC Order 94 series reimbursements.

2. \( P_1 \) has an accrued take-or-pay liability of \( \$3 \) million; the make-up period under the original contract for accrued take-or-pay liability has not expired; 3 years remain.

3. In year 5 of the contract, \( P_1 \) and \( S \) enter into a settlement agreement:
   - \( P_1 \)'s minimum take requirement is reduced to \( 500,000 \) MMBtu/year and \( P_1 \) takes that volume.
   - \( P_1 \)'s price is reduced to \( \$2/\)MMBtu.
   - The term is 5 years from date of settlement.
   - The make-up rights for take-or-pay payments under the original contract are extinguished.

4. \( P_2 \) purchases \( 400,000 \) MMBtu/year at \( \$2/\)MMBtu for 5 years.

Royalty Consequences (same as example I except D.)

A. Any settlement amount allocable to resolution of the FERC Order 94 dispute is royalty bearing upon payment.

B. The portion of the settlement payment allocable to take-or-pay is not royalty bearing because no “make-up” volumes are taken in excess of original contract volumes.

C. The portion of the settlement payment allocable to reduction in price of the remaining \( 500,000 \) MMBtu/year from \( \$5 \) to \( \$2 \) is royalty bearing as production occurs over the next 5 years. Therefore, royalty is due on \( \$2/\)MMBtu plus the amount allocated to each MMBtu of production in accordance with the method described in the interpretation.

D. In accordance with the method described in the interpretation, the portion of the settlement payment allocated to buyout is divided by the bought-out volume for the remaining term of the original contract \( (2,500,000 \) MMBtu \( \times \) 5 years \( ) \) to establish a unit incremental value \( (\$/\)MMBtu), which is then added to the proceeds paid for the \( 400,000 \) MMBtu/year of bought-out volumes which \( P_2 \) takes over 5 years, and is royalty bearing as production occurs.
**Example 4**

Assumptions same as Example 3 except bolded text:

1. P₁ owes S $250,000 for FERC Order 94 series reimbursements.

2. P₁ has an accrued take-or-pay liability of $3 million; the make-up period under the original contract for accrued take-or-pay liability has not expired; 3 years remain.

3. In year 5 of the contract, P₁ and S enter into a settlement agreement:
   - P₁ pays S $5 million
   - P₁'s minimum take requirement is reduced to 500,000 MMBtu/year and P₁ takes that volume
   - P₁'s price is reduced to $2/MMBtu
   - The term is 5 years from date of settlement.
   - The make-up rights for take-or-pay payments under the original contract are extinguished.

4. P₂ purchases 600,000 MMBtu/year at $2/MMBtu for 5 years

Royalty Consequences (A. and C. are same as examples 1 and 3; B. and D. are not)

A. Any settlement amount allocable to resolution of the FERC Order 94 dispute is royalty bearing upon payment.

B. In accordance with the method described in the interpretation, the portion of the settlement payment allocated to take-or-pay is divided by the make-up volume to which P₁ had the right to take under the original contract (600,000 MMBtu ($3,000,000 ÷ $5/MMBtu)) to establish an incremental value. This value will be added to the otherwise applicable royalty value for the 100,000 MMBtu/year of "make-up" gas for 3 years and is royalty bearing as that production occurs.

C. The portion of the settlement payment allocable to reduction in price of the remaining 500,000 MMBtu/year from $5 to $2 is royalty bearing as production occurs over the next 5 years. Therefore, royalty is due on $2/MMBtu plus the amount allocated to each MMBtu of production in accordance with the method described in the interpretation.

D. In accordance with the method described in the interpretation, the portion of the settlement payment allocated to buyout is divided by the bought-out volume for the remaining term of the original contract (2,500,000 MMBtu ($500,000 MMBtu/year × 5 years)) to establish a unit incremental value ($/MMBtu), which is then added to the proceeds paid for the 500,000 MMBtu/year of bought-out volumes which P₂ takes over 5 years, and is royalty bearing as production occurs.
Enclosure 3

Please refer to the following matrix when paying additional royalties related to contract settlement payments. Note that Transaction Code (TC) 31 is to be used. Instructions for using this TC are not included in your Payor Handbook. For this TC, you must complete the following fields for each line:

- Accounting Identification Number
- Product Code
- Selling Arrangement
- Sales Month
- Transaction Code
- Sales Quantity
- Sales Value
- Royalty Quantity
- Royalty Value
- Payment Method Code

If under the interpretations contained in this letter you determine that certain payments you received now have a royalty liability because those payments are allocable to ongoing production, you should report and pay for the production from the date of the settlement to the current month in accordance with the instruction under Category 2a. You should continue to report future production as outlined in Category 2b or you may elect to make a lump sum payment. In this instance, you should follow the guidelines outlined in Category 3.

Future volume adjustments for settlement payments made using the guidelines in the matrix may require the correction of one or both lines depending on the situation. Please follow the reporting requirements outlined in the Payor Handbook or contact your Royalty Reports and Payments Branch Representative.

If you have any questions concerning reporting on the Report of Sales and Royalty Remittance Form MHS-2014, please contact Barbara Lambert on 303-231-3289.
## Royalty Reporting Matrix

<table>
<thead>
<tr>
<th>Category</th>
<th>Instructions</th>
<th>Sales Month</th>
<th>Value</th>
<th>Volume</th>
<th>TC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Past Pricing Disputes</td>
<td>On the Form RMS-2014, report a separate line for each current Accounting Identification Number (AID) to which the production relates. If they do not exist, then use your most recent AID(s).</td>
<td>Month payment received.</td>
<td>Settlement payment amount.</td>
<td>Total volume related to payment.</td>
<td>31</td>
</tr>
<tr>
<td>Take-or-Pay, Buyouts and Buydowns</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2a. Production occurred from the date of the settlement to present and the monies are attributed to each month since settlement.</td>
<td>On the Form RMS-2014, report a separate line for each current Accounting Identification Number (AID) to which the production relates. If they do not exist, then use your most recent AID(s).</td>
<td>Actual production month.</td>
<td>Incremental value multiplied by the monthly production.</td>
<td>Actual monthly volume.</td>
<td>31</td>
</tr>
<tr>
<td>2b. Production will occur in the future. Requires 2 lines to be reported on the Form RMS-2014.</td>
<td>Report per instructions in Payor Handbooks.</td>
<td>Actual production month.</td>
<td>Sales price under the amended or successor contract.</td>
<td>Actual monthly volume.</td>
<td>01</td>
</tr>
<tr>
<td></td>
<td>On the Form RMS-2014, report a separate line using the same AID/Product Code/Selling Arrangement as the related TC 01 line.</td>
<td>Actual production month.</td>
<td>Incremental value multiplied by the monthly production.</td>
<td>Actual monthly volume.</td>
<td>31</td>
</tr>
<tr>
<td>3. Lump-Sum Payments for Buyouts/Buydowns or Take-or-Pay for future periods.</td>
<td>On the Form RMS-2014, report a separate line for each current Accounting Identification Number (AID) to which the production relates. If they do not exist, then use your most recent AID(s).</td>
<td>Current sales month being reported.</td>
<td>Settlement payment amount.</td>
<td>Report a volume of 1.</td>
<td>31</td>
</tr>
</tbody>
</table>
Dear Royalty Payor or Reporter:

The Minerals Management Service (MMS) has recently completed a thorough review of its administrative appeal process as provided for in 30 CFR 290 (1992). In conducting our review, we sought the comments and recommendations from our constituents, industry, States and tribes, and from our own staff on ways to improve the process. We are pleased to announce that the MMS has identified a number of improvements to the appeals process which will be implemented in the coming weeks. Each change is briefly summarized below.

1. **Filing Statements of Reasons (SOR).**

   When MMS issues an Order to Pay (Bill for Collection) or an Order to Perform to the reporter, the language in the order will inform the reporter that in the event the order is timely appealed, the SOR providing the appellant’s argument for reversing or modifying the order will be due within 60 days of the receipt date of the order. However, in response to industry requests, for certain complex issue appeals mainly from audit offices, appellants will now have 90 days from the receipt date of the order to supply any SOR. (Before this change, appellants had only 60 days to file SORs, but extensions were common).

   Time extensions to these filing periods will not be permitted unless requested in writing by the appellant, with justification showing good cause for the time extension, and submitted to the designated Deputy Associate Director, at the address shown on the order. We expect that delays in processing the appeal for lack of information will be significantly reduced by this change.

2. **MMS Field Reports.**

   When the responsible MMS office completes the field report after an appeal is filed, the report will be sent simultaneously to the MMS Appeals and Litigation Support Division and to the appellant. (Currently, field reports are sent out later in the process by the Appeals and Litigation Support Division). MMS will consider any response to the field report provided by the appellant if it is received by MMS at the appropriate address within 21 days of the date of the letter transmitting the field report to the appellant. This accelerated process of information sharing will more quickly clarify the factual record and reduce the time needed to process the appeal.

APPENDIX 8
3. **Time Frames for MMS.**

MMS has established internal time frames for each phase of the appeals process. Starting with the preparation of the field report and progressing through the issuance of the final decision, each step of the process will be monitored to eliminate unnecessary delay. Because of the current appeals workload, however, it may take some time to see the full benefit of these improvements.

4. **MMS Appeals Tracking System.**

A new common MMS appeals tracking system is being established that will consolidate the various systems currently being used throughout MMS to record and monitor appeals cases. Starting when the appeal is filed by the appellant, a docket number will be assigned to the case and entered into an automated tracking system. We expect that this system will allow MMS to be more responsive to an appellant's requests on the status of an appeal.

5. **MMS Appeals Coordinator.**

An appeals coordinator is being designated in each MMS operating division along with select members of the State and Tribal Royalty Audit Committee to facilitate inquiries by the appellant. The coordinator will be identified in the acknowledgment letter to the appellant upon receipt of the appeal. More effective communication and follow up on the appeal status will result because of the designated MMS contact point for appeal inquiries.

As we implement these recommendations in the near term, we will continue to seek ways to further improve the appeals process over the long term. We already have received many suggestions that merit further consideration, and we welcome any suggestions you may have. Most of these near term initiatives are in the process of implementation and will take effect on September 1, 1993. We ask for your continued support as we endeavor to streamline government and improve the MMS administrative appeals process.

Sincerely,

[Signature]

Lucy R. Queques
Associate Director for Policy and Management Improvement