BLACK BUTTE COAL CO.

IBLA 89-299 Decided October 26, 1989

Appeal from a decision of the Director, Minerals Management Service, adjudicating the extent of the allowable deductions for transportation and processing expenses on coal lease W-6266. MMS-84-0009-MIN.

Affirmed.

1. Coal Leases and Permits: Royalties--Federal Oil and Gas Royalty Management Act of 1982: Royalties--Mineral Leasing Act: Royalties

The computation of an allowance for transportation and processing costs under the terms of a coal lease permitting the deduction of those costs from the value of the coal may be upheld as reasonable where it is based on the sum of the annual operating and maintenance expenses, the annual depreciation of transportation and processing equipment, and a return on undepreciated investment based on the prime interest rate.

APPEARANCES: Mary Anne Sullivan, Esq., George W. Miller, Esq., and Jonathan L. Abram, Esq., Washington, D.C., for appellant; Howard Chalker, Esq., Peter J. Schaumberg, Esq., and Geoffrey Heath, Esq., U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE GRANT

This is the second appeal to come before the Board involving the computation of royalty for coal mined on appellant's lease. 1/ In our prior decision in this matter, cited as Black Butte Coal Co., 103 IBLA 145, 95 I.D. 89 (1988), we found that:

> The language of section 5(b)(1) of the lease clearly states that value for royalty computation purposes shall be the price received by the lessee as adjusted for transportation and processing costs

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1/ By order dated June 5, 1989, we granted appellant's motion to expedite our review of this case.

> to reflect the value of the coal at the point where coal is delivered from the pit. Section 5(b)(2) of the lease confirms that deductions from the gross value of the coal are authorized for costs of preparing and transporting the coal incurred by the lessee between the point where the coal is first delivered from the pit and the point of sale.

103 IBLA at 152, 95 I.D. at 93. Applying this language from the lease terms, we modified the prior decision of the Director, Minerals Management Service (MMS), and held that "the point of delivery from the pit occurs when the coal has been loaded into the trucks for transportation from the pits to grizzlies at the overland conveyor or at the processing plant." 103 IBLA at 154, 95 I.D. at 94.

The earlier Board decision also dealt with the issue of what indirect costs of transportation and processing of the coal may be allowed as a deduction. We affirmed the decision of the Director to the extent he disallowed deductions for royalties, reclamation fees, black lung tax, Wyoming severance tax, and county ad valorem taxes, finding that these charges were allocable to the mining phase of operations. With respect to the question of whether a share of profit may be allocated as an indirect cost of transportation and processing, we declined to rule on the issue in the absence of an adverse decision by the Director regarding this aspect of indirect costs.

This appeal is brought from the decision of the Director, MMS, on remand further adjudicating the extent of appellant's allowable deduction for transportation and processing costs. The Director rejected appellant's request to deduct a proportional share of the profits of the enterprise attributable to transportation and processing of the coal. Instead, the Director permitted a deduction for a return on undepreciated investment based on the prime interest rate. 2/

Appellant contends in its statement of reasons for appeal that the Director improperly limited the indirect costs of transportation and processing to the return on capital invested in the physical equipment utilized. Noting that the lease provides that royalty is payable on the value of the coal at the point where coal is delivered from the pit, 3/ appellant argues that transportation and processing add value to the mined coal and that the share of profit attributable to these functions is a proper element of the value added which should be deducted from the sale price. Appellant

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2/ The Director also permitted a deduction for the annual depreciation of the processing and transportation equipment owned by the lessee as well as the annual operating and maintenance expenses. These deductions are not at issue on appeal.

3/ Section 5(b)(1) of the lease provides in relevant part:

"The gross value shall be considered to be the price received by the Lessee, adjusted for transportation and/or processing costs so that it is a measure of the value of the Coal at the mine mouth (or in the case of strip mining that point where the Coal is delivered from the pit) * * *."

points out that if it were required to contract with a third party for providing the transportation and processing services, it would be necessary to
pay that firm's profit for providing the services. Further, appellant submits the affidavit of an economist setting forth his conclusion that the "net income on the books of a competitive enterprise necessarily reflects the costs to the company of the time, creative effort and capital invested in it" and that a proportional share of the net income is properly treated as an indirect cost of transporting and processing the coal.

In answer to appellant's brief, MMS notes that it is not disputing that an allowance for the profit attributable to transportation and processing is proper. Rather MMS contends that the difficulty with calculating the cost of capital for transportation and processing on the basis of a proportional share of the firm's profits is that the result is dependent on the sale price of the coal rather than the actual cost of capital. Further, MMS asserts that the long-established method of determining a return on the undepreciated balance of capital investment used to calculate transportation and processing costs is the same method used in calculating such allowances for other coal leases and in calculating transportation allowances for oil and gas leases.

In reply, appellant argues that use of this approach which is called for by the regulations governing transportation and processing allowances fails to distinguish the language of the regulations from the lease language. Appellant contends this method improperly ignores the unique language of the carefully negotiated Black Butte lease which requires computation of the value of the coal at the point of delivery from the pit.

[1] Although the royalty valuation regulations for coal in effect at the time the Director issued his decision are silent with respect to the matter of a transportation allowance, see 30 CFR 203.250 (1988), 4/ the existence of such an allowance has been widely recognized in other Mineral Leasing Act and Outer Continental Shelf Lands Act cases involving valuation of Federally leased oil and gas for royalty purposes. Thus, in the absence of a market for oil at the wellhead where production would ordinarily be sold and valued, the deduction of a transportation allowance from the market value of the oil at the nearest open market has been upheld. United States v. General Petroleum Corp., 73 F. Supp. 225, 263 (S.D. Cal. 1946), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); Arco Oil & Gas Co., 109 IBLA 34 (1989); Shell Oil Co., 52 IBLA 15, 88 I.D. 1 (1981); C & K Petroleum, Inc., 27 IBLA 15 (1976); Kerr-McGee Corp., 22 IBLA 124 (1975); The Superior Oil Co., 12 IBLA 212 (1973). The net-back, work-back, or net-realization method has been used to compute the value of minerals where there is no market at the point of production because of the necessity of transporting or processing the minerals to make them saleable or where the market at that point is not reflective of the proceeds realized by the lessee from sale of the mineral after transportation and/or processing.

4/ New royalty valuation regulations for coal leases have recently been promulgated effective Mar. 1, 1989. 54 FR 1492-1532 (Jan. 13, 1989).

See Marathon Oil Co. v. United States, 604 F. Supp 1375 (D. Alaska 1975), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987); Ashland Oil, Inc. v. Phillips Petroleum Co., 554 F.2d 381 (10th Cir. 1975), cert. denied, 434 U.S. 921 (1977).

Although a number of cases have upheld the net-back method of valuation for royalty purposes, few have dealt with the details of how costs are to be calculated. In Marathon, the application of an 8-percent rate of return on investment was challenged on appeal but the court of appeals found the issue was not ripe for review in the circumstances of the appeal. 807 F.2d at 766. However, both the district court and the circuit court found explicitly that use of the net-back method was not inconsistent with the terms of the leases requiring determination of the value of production at the lease. 604 F. Supp. at 1387, 807 F.2d at 765-66. In United States v. General Petroleum Corp., supra, the Department had allowed depreciation on capital investment in addition to the actual cost of operating the gathering system, but had refused to allow any return on capital investment, asserting that it was not allowable under the net-realization analysis. The court held that a "return on the lessees' depreciated investment in the wet-gas gathering system at Kettleman Hills should have been allowed." 73 F. Supp. at 257. 5/ The court found that the rate of interest prevailing in the community for sums of this size at the time in question was approximately 4 percent and that interest at that rate established "just compensation." 73 F. Supp. at 264. 6/

The Board has held that the Department has discretionary authority in determining the factors to be used in computing a transportation allowance. Shell Oil Co., supra; The Superior Oil Co., supra. In sustaining computation of a transportation allowance based on an assigned fair rate of return on the lessee's investment, we noted that a fair rate of return depends substantially on economic conditions at the time involved and concluded appellant had not shown that the assigned rate was unreasonable. 52 IBLA at 26, 88 I.D. at 6. We think MMS has established a rational basis for use of its rate of return on capital investment as a measure of the cost of capital and for rejecting the proportional profits method of computation on the ground

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5/ One of the grounds cited by the court in support of its allowance of a return on investment was the argument advanced by appellant in this case that if the lessees had hired a third party to provide this service they would have to pay the contractor a reasonable return on capital investment in addition to the actual operating expenses. 73 F. Supp. at 257.

6/ We note that the recently revised coal valuation regulations provide for calculation of a transportation allowance based on "operating and maintenance expenses, overhead, and either depreciation and a return on undepreciated capital investment * * * or a cost equal to the depreciable investment in the transportation system multiplied by the rate of return * * *." 30 CFR 206.262(b)(2), 54 FR 1529 (Jan. 13, 1989). The regulations further provide that the rate of return shall be the "industrial rate associated with Standard and Poor's BBB rating." 30 CFR 206.262(b)(2)(v), 54 FR at 1529.

it is dependent on factors other than the cost of capital (e.g., the price of coal). 7/ Further, we find this method of computing the allowance to be consistent with the language of the coal lease.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed.

C. Randall Grant, Jr.
Administrative Judge

I concur:

James L. Burski
Administrative Judge

7/ While appellant challenges the assignment of the prime rate as affording too small a return considering the economic risks attendant upon the enterprise, appellant has not suggested a specific higher rate of return which might be justified. Moreover, we would point out that only the risk factor attendant upon the transportation and processing is properly considered, since no deduction can be allowed for the mining costs. Indeed, to the extent that mining can be seen as entailing greater economic risks than transportation or processing, the proportional profits method clearly distorts the respective returns which might be expected with respect to the capital invested in mining vis-a-vis the capital invested in the less financially risky aspects of transportation and processing.