SAN JUAN COAL COMPANY

IBLA 99-120 Decided July 8, 2004

Appeal from a decision of the Associate Director for Policy and Management Improvement, Minerals Management Service, denying appeals from two demand letters of the Lakewood Compliance Division, Royalty Management Program, Minerals Management Service, requiring that the cost of primary crushing be included in the value of Federal coal for royalty purposes. MMS-97-0084-COAL and MMS-97-0199-COAL.

Affirmed.

1. Coal Leases and Permits: Royalties

MMS properly requires that the costs of primary crushing be included in the value of coal produced from a Federal lease for Federal royalty purposes when the record establishes that such crushing is necessary to place the coal in a marketable condition, and the producer fails to demonstrate otherwise by a preponderance of the evidence. This is so even where the producer of the coal crushes it at its own expense after it has been produced and sold at the mine and the cost of crushing is reimbursed by the purchaser.


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OPINION BY ADMINISTRATIVE JUDGE HUGHES

The San Juan Coal Company (San Juan) has appealed from the August 27, 1998, decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), denying its appeals from two demand letters of the Lakewood Compliance Division, Royalty Management Program, MMS, dated March 7 and July 25, 1997, requiring San Juan to include the costs of off-site primary crushing in the royalty value of Federal coal produced from Federal coal lease NM-0315559. ¹

The lease in question covers 2,044.15 acres of Federally-owned land in T. 32 N., Rs. 12 and 13 W., New Mexico Principal Meridian, San Juan County, New Mexico, within the La Plata Mine. San Juan is the current lessee. ² The royalty in question was for production from the La Plata Mine from August 1, 1986, through December 31, 1995.

It is undisputed that San Juan sold run-of-mine coal at the mine site to the Public Service Company of New Mexico and the Tucson Electric Power Company (hereinafter, collectively, PNM). ³ Following production, the coal was stockpiled. PNM paid San Juan Transportation Company (an affiliate of San Juan) to haul the coal to a primary crushing facility, located adjacent to PNM’s San Juan Generating Station. The crushing facility is owned and operated by San Juan and had been in operation since prior to the first production and sale of coal from the Federal coal lease at issue here in August 1986. San Juan crushed the coal there; purchaser PNM burned it at the generating station; and PNM reimbursed San Juan for the costs of the crushing.

It is undisputed that, during the entire period from August 1, 1986, through December 31, 1995, San Juan excluded from the royalty value of the coal the payments it received as reimbursement for costs it incurred to crush the coal. This was because San Juan regarded those payments not as compensation for the production and sale of the coal, but for the separate service (which it also performed) of processing that and other coal for PNM’s use in its electrical generating operation.

¹ The lease is also referred to in the record as Federal lease No. M40-315559-0.

² San Juan refers to itself as a “sub-lessee.” (Statement of Reasons (SOR) at 6.) There does not appear to be any doubt that it is responsible for payment of royalties on the Federal lease.

³ MMS referred to these entities collectively as the “Utilities.”
In its March and July 1997 demand letters, MMS required San Juan to pay additional royalties owing to the assertedly improper exclusion of the primary crushing costs from the value of the coal for Federal royalty purposes.  MMS determined therein that the reimbursement for these costs constituted part of the “gross proceeds” received by San Juan for the production and sale of the coal and should therefore have been included in the royalty value of the coal, because the crushing was necessary to place the coal in marketable condition:

This issue is a matter of gross proceeds received for non-San Juan Mine coal from a Federal lease and the marketable condition in which the coal was delivered. The position of MMS is that Federal coal sold at the La Plata Mine is not in marketable condition. In its contract, [PNM] require[s San Juan] to process and crush the coal. [PNM] reimburse[s San Juan] for those processing costs. Therefore, MMS requires that [San Juan] pay royalties on these reimbursed processing costs.

(Demand Letter, dated Mar. 7, 1997, at 8.) In finding that San Juan was required to crush the coal, MMS relied on relevant portions of the original and amended coal sales agreement. Its March 7, 1997, demand letter states:

[T]he Agreement states:

Section 2.1(a) . . . it is the obligation of [San Juan] (i) to mine coal from the Coal Leases, (ii) to process and crush both run-of-mine coal from the Coal Leases and non-[San Juan] coal in the facilities of [San Juan] and (iii) to deliver and sell all such processed coal to [PNM]. * * *

\[^{4/}\] In its March 1997 demand letter MMS required the payment of additional royalties of $620,720 based on its determination, following audit, that primary crushing costs had not been included in the royalty value of that coal for the period from Apr. 1, 1991, through Dec. 31, 1995. Payment was required by Apr. 11, 1997.

MMS’ July 1997 demand letter was based on its determination that San Juan had also excluded such costs dating back to the initiation of mining operations at the La Plata Mine on Aug. 1, 1986. MMS estimated that royalty had been underpaid by $2,871,607, and offered San Juan the option of computing the actual additional royalties and paying that amount or paying the estimated additional royalties.

We find nothing supporting San Juan’s suggestion that the July 1997 demand letter was issued in retaliation for its earlier appeal of the March 1997 demand letter. (SOR at 3, 4 n.3.)
And, “Amendment Number Three to Coal Sales Agreement” dated April 30, 1984, which sets forth the terms and conditions under which coal from the La Plata Leases will be mined by [San Juan] and delivered to [PNM], states:

Section 2.1(b) During the term and pursuant to the provisions of this Agreement, [San Juan] shall mine, process, sell and deliver coal from * * * the La Plata Leases.

Section 4.1(b)(iii) [San Juan] agrees that it will process and crush, in the facilities of [San Juan], all La Plata coal that [PNM] cause[s] to be delivered to the San Juan [Generating] Station.

(Demand Letter dated Mar. 7, 1997, at 9 (emphasis supplied).) 5/

San Juan appealed separately from MMS’ March and July 1997 demand letters, pursuant to 30 CFR Part 290 (1998), and the appeals were docketed by the Director, MMS, as MMS-97-0084-COAL and MMS-97-0199-COAL.

In his August 1998 decision, the Associate Director concluded that MMS had properly required San Juan to include the crushing costs in the royalty value of the coal produced and sold from the La Plata Mine, during the relevant time period and accordingly required San Juan to recalculate and pay additional royalties on that coal. He thus denied San Juan’s appeals from the two MMS demand letters. San Juan appealed to this Board.

The royalty in question was for production from the La Plata Mine from August 1, 1986, through December 31, 1995. Due to a regulatory change effective on March 1, 1989, it is necessary to analyze separately two time periods, one from August 1, 1986, to February 28, 1989, and the second from March 1, 1989, through December 31, 1995.

[1] MMS properly held that royalty value included the costs of primary crushing for the period from August 1, 1986, through February 28, 1989. See Trapper Mining, Inc., 144 IBLA 204, 206-10 (1998); Lone Star Steel Co., 117 IBLA 96 (1990). The regulations in place at that time provided that “the value of coal for

5/ We note that section 5.1 of the Coal Sales Agreement also provides that coal delivered by San Juan to PNM “shall be * * * processed by [San Juan],” such that it meets certain size specifications. (Agreement at 21.)
Federal royalty purposes shall be the gross value at the point of sale.” 30 CFR 203.250(f) (1988). For arm’s length transactions, the “gross value” was the “contract price times the number of units sold.” 30 CFR 203.250(g) (1988). Although the regulations provided in some circumstances for a deduction from gross value “[i]f additional preparation of the coal is performed prior to sale” (30 CFR 203.250(f) (1988)), they expressly provided that the “[c]osts of primary crushing,” among others, “shall not be deducted from the gross value in determining value for royalty purposes.” 30 CFR 203.250(h) (1988). We read that rule as providing that costs of primary crushing shall be borne by the lessee and not deducted from value in determining royalty.

In the case of coal extracted, removed, and sold from a Federal coal lease after March 1, 1989, the regulations provide that the “value of coal that is sold pursuant to an arm’s-length contract shall be the gross proceeds accruing to the lessee.” 30 CFR 206.257(b)(1). Further, “under no circumstances shall the value for royalty purposes be less than the gross proceeds accruing to the lessee.” 30 CFR 206.257(g). Finally, the term “gross proceeds” has been defined expressly to include “payments to the lessee for certain services such as crushing * * * to the extent that the lessee is obligated to perform them at no cost to the Federal Government.” 30 CFR 206.257(h).

The question of whether costs of crushing must be included in the royalty basis turns on whether the lessee was obligated to perform them at no cost to the government as part of its responsibility to place the coal in marketable condition. The preamble to the 1989 rulemaking reflected MMS’ view that the cost of primary crushing would be a cost of putting coal into “marketable condition”:

Marketable condition is the form and condition of leasehold production resulting from the application of normal mining processes. The established market demands and expects that lease production be in such a condition that it can be accommodated by existing buyer facilities used for receipt, handling, and consumption of leasehold production. With respect to coal, processes commonly applied by mine operators (or lessees) to prepare coal for the market include all operations which extract, sever, or otherwise separate coal from its in-place position in the geologic strata; crushing (to limit upward size), sizing, storing, blending, and loading for shipment (including oiling);
and all transportation requirements in and about the mine beginning at the point of extraction and including movement to all plants and facilities in which normal mining processes are applied.

(54 FR 1498 (Jan. 13, 1989) (emphasis supplied)). From this it is clear that the only circumstances in which costs of crushing could be excluded from royalty basis would be where the coal from the lease is in “marketable condition” without primary crushing. See Trapper Mining, 144 IBLA at 210-11; see Exxon Corp., 118 IBLA 221, 242, 98 I.D. 110, 120-21 (1991) (dehydrated gas); Order, Beartooth Oil & Gas Co. v. Lujan, No. CV 92-99-BLG-RWA (D. Mont. Sept. 22, 1993), at 5, 10 (uncompressed gas). 6

Coal is deemed to be in “marketable condition” when it is “sufficiently free from impurities and otherwise in a condition that it will be accepted by a purchaser under a sales contract typical for th[e] area.” “Area” is defined as the “geographic region in which coal has similar quality and economic characteristics.” 30 CFR

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6/ It is well established, both by Departmental regulation and caselaw, that the value of Federal coal for royalty purposes properly includes all of the costs necessary to place the coal in a marketable condition, since all of the efforts necessary to do so must be undertaken, by or on behalf of the producer, at no cost to the United States. 30 CFR 206.251 (defining “[g]ross proceeds”) and 206.257(b)(1) and (h) (1997); 30 CFR 203.250(h) (1988) (formerly 30 CFR 203.200(h) (1986)); Trapper Mining Inc., 144 IBLA at 207-16; Peabody Coal Co., 141 IBLA 219, 221-22 (1997); Peabody Coal Co., 139 IBLA 165, 170-72 (1997).

Thus, where it is necessary to crush or otherwise process coal following its extraction and removal in order to place it in a condition suitable for the marketplace, the value of the coal for royalty purposes must include the reimbursement received by the producer for such processing. This is so even where the coal has, in fact, already been sold at the mine site by the producer. MMS is properly entitled to conclude that the true market value of the coal is established after it is processed and prepared for use by the purchaser, in other words, that the true market sale occurs after the coal is processed and prepared for use. Trapper Mining Inc., 144 IBLA at 205-06, 209-10, and 215; see FMC Corp., 54 IBLA 77, 79-81 (1981) (citing United States v. Southwest Potash Corp., 352 F.2d 113, 116-18 (10th Cir. 1965), cert. denied, 383 U.S. 911 (1966)).

The royalty value would thus encompass not only the original contract sales price of the coal at the mine site but also the costs later incurred to place it in a marketable condition for delivery to the purchaser, since such costs cannot be deducted from the royalty value of coal, no matter when they are incurred. To do otherwise would be to improperly require the United States to shoulder part of those costs. Trapper Mining Inc., 144 IBLA at 209-10, 215.
Thus, the question for determination here is whether the coal produced and sold from San Juan's lease to PNM was in “marketable condition” at the time of sale and accepted by a purchaser under a typical sales contract for the area, without primary crushing.

San Juan argues that MMS failed to undertake a reasoned analysis considering the regulatory definition of “marketable condition” set out at 30 CFR 206.251 (1997). (SOR at 29-31, 37-39.) It asserts that MMS instead simply presumed that, by virtue of the fact that run-of-mine coal was being sold to an electrical utility for use in its generating station, the coal at issue here was not in a marketable condition until after it had been crushed, effectively adopting a per se rule.

We are not persuaded that MMS simply presumed that the coal at issue here was not marketable in its uncrushed state. MMS recognized in the preamble to its valuation regulations that it must make a specific determination in each case as to what “mining processes” are necessary to place coal in a marketable condition. See 54 FR at 1498. It did so here, concluding that primary crushing was necessary to place appellant’s coal in a marketable condition, even after its sale at the La Plata mine site, because the purchasing utilities required, as a necessary part of that and all other similar sales, that the run-of-mine coal be crushed before being finally delivered for use at its electrical generating station. (Mar. 7, 1997, Demand Letter at 8-10; July 25, 1997, Demand Letter at 3-4.) Thus, MMS did not rely on any presumption of non-marketability.

Appellant argues that it was not necessary to primary crush the Federal coal at issue here in order to place it in a marketable condition, since the market for the coal was PNM, which purchased the coal, as well as other Federal and non-Federal coal produced by San Juan (from its La Plata and San Juan mines) and other producers (from their own mines) in the area, in its uncrushed state. (SOR at 4-5, 38-40.) However, the fact that the “sale” to PNM occurred at the mine site prior to primary crushing is not dispositive of the question here. The fact that the primary crushing occurred here after the coal was sold to PNM does not undermine the fact that the monies later paid to appellant were intended to specifically cover the costs of such crushing. In such circumstances, they are properly deemed to accrue to the coal lessee “for the production and disposition” of that coal. Trapper Mining Inc., 144 IBLA at 209-10, 215. Such monies are accordingly “part of the total consideration paid for the purchase of coal production.” 30 CFR 206.257(b)(5). We are persuaded as well by the fact that 30 CFR 206.251 (1997) defines “[g]ross proceeds,” for royalty valuation purposes, as “the total monies and other consideration accruing to a coal lessee for the production and disposition of the coal produced.” (Emphasis added.) The term “disposition” is broad enough to include proceeds received other than at the point of sale.
Nor, unlike the dissent, do we find the concept of the “market segment that coal is sold into” to be of any special significance here. That phrase appears in the preamble to the 1989 rulemaking:

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

(54 FR at 1498 (emphasis supplied).) Further, the preamble notes that “the marketable condition requirement is as flexible as the requirements of different market segments.” Id.

It is clear from the fuller context in which this language appears that, in referring to “market segments,” the preamble is addressing cases where coal is sold into market segments with specific production requirements:

Marketable condition is the form and condition of leasehold production resulting from the application of normal mining processes. The established market demands and expects that lease production be in such a condition that it can be accommodated by existing buyer facilities used for receipt, handling, and consumption of leasehold production. With respect to coal, processes commonly applied by mine operators (or lessees) to prepare coal for the market include all operations which extract, sever, or otherwise separate coal from its in-place position in the geologic strata; crushing (to limit upward size), sizing, storing, blending, and loading for shipment (including oiling); and all transportation requirements in and around the mine beginning at the point of extraction and including movement to all plants and facilities in which normal mining processes are applied.

Processes which are not identified with common mine operations or practices include both surface and in-situ coal gasification or liquefaction operations, any other operations involving the chemical alteration of coal, and operations involving the physical processing of coal to a condition of quality beyond that normally attributed or associated with coal marketed from the same area.

Id. Based upon this language, among other things, the Board recently affirmed an MMS decision requiring inclusion within gross proceeds of fees paid by coal

The preamble acknowledges that there may be unusual market segments establishing unusual production requirements:

However, the conditioning of coal for the 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. For example, some types of coal sold to certain market segments are not normally screened. Instead, the run-of-mine coal is passed through a crusher to reduce the large pieces. The result of this size reduction is prepared coal that can be accommodated by both seller (lessee) and buyer's coal handling facilities. In other situations where coal fines present problems, the marketable condition requirement for coal will include screening, to eliminate the specified coal fines fraction.

(54 FR at 1498) The preamble thus allows for a case-by-case analysis of the marketability requirements, according to any peculiar demands of the market segment it is being sold into:

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.

Id. However, the preamble warns lessee/producers that MMS will not accept gross proceeds that are not calculated according to the peculiar marketability demands of a market segment. Most relevant to the case at issue, it expressly warns that run-of-mine coal that is sold into the market segment associated with use for steam coal utilization is not to be viewed as being in marketable condition without treatment:

Therefore, under no circumstances will MMS accept the gross proceeds established under any sale of coal that does not meet the market's minimum requirement for marketable condition. Specifically, the sale of run-of-mine coal for steam coal utilization by an electric utility does not constitute coal in marketable condition. In this situation, MMS will add to the gross proceeds the cost of those normal
mining processes which are ordinarily the responsibility of the lessee. This provision is explicitly set forth at [30 CFR 206.257(h).]

(54 FR at 1498-99 (emphasis supplied).)

We note that, far from establishing a dispensation for coal processing costs based on specifics of the “market segment” that a particular lease might supply coal to, the quoted language actually appears to serve as a warning to lessees who sell coal into a market segment with unusual processing costs that those costs must be included in gross proceeds even though they might not have been expected in other market segments. Nothing in the record suggests that sales to PNM did not fall within the category of sales for steam coal utilization by an electric utility, where (as MMS specifically warns), crushing is a normal processing step.

In fact, the record clearly demonstrates that PNM is the “market segment” for the coal at issue here, as well as the other coal produced by appellant and other suppliers in the area. (54 FR at 1498.) This was MMS’ conclusion, and it is not disputed by appellant. (SOR at 38-39.) Moreover, the coal at issue here is plainly not in a marketable condition at the mine site, since, in each of those cases, the coal must first be primary crushed before it can be used by PNM in its electrical generating operations. Indeed, appellant admits that all of the coal, whether it comes from its La Plata and San Juan mines or the other producers’ mines, is first crushed before it is used by PNM at its generating station. (SOR at 9; see also MMS Answer at 11 (citing “1999 Keystone Coal Industry Manual” (Ex. 2 attached to Answer)).) Further, such crushing is clearly required by PNM under the coal sales agreement. Thus, it is clear that crushing is part of the “customary requirements of preparation or conditioning normally expected by the relevant market segment” which the coal was sold into and part of the “typical level of preparation or conditioning by coal producers in the area.” (54 FR at 1498.)

In these circumstances, it does not matter whether the coal is sold to PNM and then crushed, as in the case of the La Plata and other coal, or crushed and then sold to PNM, as in the case of the San Juan coal. (MMS Field Report (MMS-97-0084-COAL), dated Sept. 18, 1997, at 4.) In either case, crushing is necessary to place the coal in a condition suitable for the marketplace, which is PNM. \(^7\)  Trapper Mining Inc., 144 IBLA at 215 n.14. MMS was required to prove no

\(^7\) Appellant also argues that MMS’ valuation of the coal at issue here, for royalty purposes, based on its downstream value after crushing is contrary to the dictates of 30 CFR 206.255(a) (1997). (SOR at 35-37.) We find no violation. That regulation provides that “royalty shall be computed on the basis of the quantity and quality of (continued * * *)
more. The burden then devolved upon appellant to demonstrate, by a
preponderance of the evidence, that it was not necessary to crush the coal in order to
render it suitable for sale. KMF Mineral Resources, Inc., 151 IBLA 35, 40 (1999);
Seagull Energy Corp., 148 IBLA 300, 309 (1999). It has failed to carry that burden. 8/

Thus, we hold that MMS properly determined that it was necessary to primary
 crush the coal at issue here in order to place it in a marketable condition. The costs
of doing so, which were incurred by appellant, are therefore properly included in the
royalty value of the coal, regardless of whether the coal was crushed by appellant
before or after its sale to PNM. Trapper Mining Inc., 144 IBLA at 209-10, 215.

San Juan contends that MMS’ March 1997 demand letter was an abrupt
departure from its earlier view, reached at the conclusion of a 1992 audit concerning
the period from August 1, 1986, through March 31, 1991. Such departure, it argues,
is not justified in the record and does not comport with elementary notions of
fairness. San Juan also argues that MMS was barred from extending that

\[\text{\# (\text{** \text{continued}})}\]

Federal coal in marketable condition measured at the point of royalty measurement
as determined jointly by BLM [(Bureau of Land Management)] and MMS.” 30 CFR
206.255(a) (1997) (emphasis added). Appellant can point to no specific joint
determination by BLM and MMS that the “point of royalty measurement” was at the
mine site, prior to crushing. See Affidavit of David J. Lazenby, dated Oct. 20, 1997
(Ex. 17, Appendix B, attached to SOR), at 2 (“[N]either [BLM] nor [MMS] has ever
explicitly discussed with San Juan representatives where the ‘point of royalty
measurement[ ]’ \# \# is to be located”). Rather, appellant seems to indicate that this
point is presumed to be the point of sale, and thus at the mine site here, and that
MMS must now seek BLM’s concurrence to effect a “change.” (SOR at 36.) No such
presumption exists. The fact that the point of sale, which is “typically” at or near the
mine site, is “[o]ften” the point of royalty determination does not raise such a
presumption. (SOR at 35-36 (quoting from 54 FR at 1509).) Absent any evidence of
a joint determination adopting the point of sale at the mine site as the royalty
measurement point, we cannot find that MMS violated the regulation by adopting a
different royalty measurement point. Further, as the regulatory preamble quoted by
appellant also makes clear, MMS is, in any event, required to ensure that royalty is
properly computed on the basis of the value of the coal after it has been rendered in a
marketable condition, which may occur downstream of the point of sale. (54 FR
at 1509.)

\[\text{\# (\text{** \text{continued}})}\]

Appellant has also failed to substantiate that the value of the coal at issue here
(excluding crushing costs), which it used to pay royalty, is equal to or higher than the
royalty value of coal produced from “other [F]ederal leases in the region.” (SOR
at 44.) Nor has it shown that this other royalty value has been accepted by MMS.
requirement in its July 1997 demand letter to that earlier audit period, by reason of administrative finality, laches, estoppel, and/or statute of limitations. Appellant accordingly asks us to give only prospective effect to MMS’ requirement that it include such costs in valuing the coal produced and sold from the La Plata Mine for royalty purposes.

We find in MMS’ March and July 1997 demand letters no departure from an earlier ruling or even an established practice by MMS to the effect that primary crushing costs are not royalty-bearing and reject appellant’s argument that MMS’ determination that such costs are royalty-bearing should now be given only prospective effect. (SOR at 47 (citing Retail, Wholesale and Department Store Union, AFL-CIO v. National Labor Relations Board, 466 F.2d 380, 390 (D.C. Cir. 1972)); see generally SOR at 45-54.)

MMS had audited appellant’s original royalty payments, and concluded in a March 1992 audit report (Ex. J, Appendix A, attached to SOR) that the coal was properly valued on the basis of the contract sales price paid for the uncrushed coal at the mine site. (SOR at 21-28, 32-35.) We recognize that MMS’ 1992 audit was designed to assess the propriety of appellant’s product valuation for royalty purposes, and thus to ultimately determine whether the royalties computed and paid for coal produced and sold from the La Plata Mine, during the August 1, 1986, through March 31, 1991, audit period were in accordance with applicable Federal regulations. (Letter to San Juan from MMS, dated May 22, 1991 (Ex. 5, Appendix B, attached to SOR), at 1; Audit Plan (Ex. 4, Appendix B, attached to SOR), at 3 to 5.) Nor do we deny that MMS became familiar with the coal sales agreement at issue here, and the fact that, while appellant was, in addition to the primary contract sales price, reimbursed for the costs of primary crushing coal produced and sold during the audit period, it did not include such costs in its value of the coal for Federal royalty purposes. See SOR at 11, 16-17.

Nevertheless, we cannot say that MMS specifically addressed the question of whether primary crushing costs should be considered royalty-bearing, or ultimately concluded that the exclusion of such costs from the royalty value of the coal, with respect to the audit period, was in accordance with applicable Federal regulations, either because such costs were not necessary to place the coal in a marketable condition or for some other reason. See Audit Plan (Ex. 4, Appendix B, attached to

2/ We also cannot find, in the present case, any “acceptance of the lessee’s royalty valuation as conclusive by an official authorized to bind the Department” which appellant would regard as precluding MMS from later requiring a recalculated royalty payment, based on its altered valuation. (SOR at 25 (quoting from Conoco Inc., (continued * * *))
SOR), at 6. The pre-audit survey stated that it was intended to “identify know[n]/expected royalty payment problem areas such as * * * payments based on incorrect product valuations.” MMS states that, “[d]uring the 1992 audit by [MMS], the processing costs for coal mined from the La Plata [Federal] lease were not reviewed.” (MMS Field Report (MMS-97-0199-COAL), dated Jan. 29, 1998, at 4.) Appellant quotes the following language in the March 1992 Audit Report, concerning royalty payments for coal produced and sold from the La Plata Mine during the audit period: “[MMS] believe[s] San Juan is in substantial compliance with the lease terms, Federal laws, regulations, and directives for the period April 1986 through March 1991.”\(^9\) (March 1992 Audit Report (Ex. J, Appendix A, attached to SOR), at 2.)

Substantial compliance is not full compliance. In any event, MMS specifically informed appellant in the cover accompanying the March 1992 Audit Report that in “situations where subsequent evidence indicates the possibility of * * * underpayment, this letter does not preclude further examination of records and transactions of previously audited periods.” (Letter to San Juan, dated Mar. 9, 1992 (Ex. J, Appendix A, attached to SOR).) Thus, MMS put appellant on notice that the

\(^9\) (* * * continued)

110 IBLA 232, 243 (1989)), emphasis added.) Rather, we believe that, in issuing its March 1992 Audit Report, MMS was careful to notify appellant that it was not precluded from later addressing subsequent evidence of an undervaluation of coal produced and sold from the La Plata Mine, during the audit period. (Letter to San Juan, dated Mar. 9, 1992 (Ex. J, Appendix A, attached to SOR).)

\(^{10}\) Appellant also points to a number of internal documents which were generated by MMS during the course of its audit. One of these is a Jan. 28, 1992, memorandum from Tom Holamon, an MMS auditor (Ex. 3, Appendix B, attached to SOR), in which he reported a statement by another MMS employee (Herb Wincentzen) to the effect that the royalty value of the coal at issue here, produced and sold during the audit period, need not be the “downstream value” of the coal, after it is transported, processed, and finally delivered to PNM. Since appellant admits that this and other internal MMS documents were not obtained until after MMS’ March 1997 demand letter, SOR at 13 (citing Ex. 16, Appendix B, attached to SOR), such documents cannot, under any circumstances, be used to estop MMS from requiring the payment of additional royalty. Nor do they undermine the fact that MMS, in the end, did not rule at the conclusion of the audit that it was proper to exclude primary crushing costs from the royalty value of the coal.

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1992 audit could be reopened later in order to correct instances of underpaid royalty, even those which had occurred during the audit period.  

MMS’ March 1992 determination cannot be considered a final decision of the Department concerning the propriety of the exclusion of primary crushing costs from the royalty value of the coal, thus precluding MMS from later reconsidering the matter under the doctrine of administrative finality. There was no final decision by MMS here specifically approving the exclusion of primary crushing costs from the royalty value of the coal produced and sold from the La Plata Mine, during the audit period.

Nor is there any basis to equitably estop MMS from requiring the payment of additional royalty for coal produced and sold during the period from August 1, 1986, through December 31, 1995. Appellant clearly knew, or should have known, that MMS had not irrevocably decided that all royalty had been paid: MMS expressly so informed it in March 1992. Had it been aware starting in August 1986 that primary crushing costs would be considered royalty-bearing, appellant alleges that it might well have altered its coal production decisions in a way that was more economically advantageous, by shifting its operations to non-La Plata Federal coal or otherwise (SOR at 35; see Affidavit of Chris Ellefson, dated May 15, 1997 (attached to SOR), at 5-6.) However, we find no affirmative misconduct by MMS, in the form of a crucial

\[11/\] Appellant argues that MMS is prohibited from requiring it to pay additional royalty with respect to the period from Aug. 1, 1986, through Mar. 31, 1991, by its own regulations. (SOR at 23.) Appellant, however, does not point to any regulatory provision, but rather to a statement in the preamble to MMS’ promulgation of the new coal royalty valuation regulations, effective Mar. 1, 1989. Thus, it refers to the fact that the preamble states that audits “are normally considered final when the lessee accepts the audit findings or its appeal rights are exhausted,” and that MMS “is not prevented from reopening an audit if there is evidence of substantial omission or fraud.” (SOR at 22-23, quoting from 54 FR at 1504.) Appellants thus concludes that MMS’ 1992 audit was final, in the absence of any evidence of fraud or substantial omission in the audit, and may not be revisited. The regulatory preamble is not binding on MMS, and, in any case, we are not persuaded that it precludes MMS from deciding whether appellant properly excluded primary crushing costs from the royalty value of the coal produced and sold during the audit period. The finding in MMS’ 1997 order certainly identifies a substantial omission.

\[12/\] In addition, even if we could point to a final decision, we believe that revisiting the question of royalty valuation is necessary in the interest of ensuring that the Department, in the end, reaps the proper royalty to which it is entitled under applicable Federal regulations. See Dugan Production Corp. (On Reconsideration), 117 IBLA 153, 155 (1990).
written misstatement, on which appellant reasonably relied in taking the course of action it pursued here. Such is necessary for the Board to invoke the extraordinary remedy of estoppel, thus precluding MMS from meeting its legal obligation of requiring the payment of additional royalty owed to the United States. Hugh D. Guthrie, 145 IBLA 149, 153 (1998) (citing United States v. Ruby Co., 588 F.2d 697, 703 (9th Cir. 1978), cert. denied, 442 U.S. 917 (1979)); David E. Best, 140 IBLA 234, 236 (1997) (citing Heckler v. Community Health Services of Crawford County, Inc., 467 U.S. 51, 65 (1984)).

Appellant also argues that MMS is barred by the equitable doctrine of laches and the applicable statute of limitations, 28 U.S.C. § 2415(a) (2000), from requiring it to pay additional royalty with respect to coal produced and sold from the La Plata Mine more than 6 years prior to MMS’ July 1997 demand letter, thus encompassing the entire period covered by that letter (from Aug. 1, 1986, through Mar. 31, 1991). (SOR at 32-34.) Appellant asserts that MMS’ delay in issuing the July 1997 demand letter has compromised its ability to defend itself against the requirement to pay additional royalty with respect to a period of time more than 6 years before July 1997, and is thus unreasonable. (SOR at 19, 32-33 (citing Affidavit of David J. Lazenby, dated Oct. 20, 1997 (Ex. 17, Appendix B, attached to SOR), at 3).) Appellant explains that it is normally only required to maintain its royalty records for 6 years, except when an audit is being conducted, in which case it must maintain the records until it is “released by written notice of the obligation to maintain records.” (SOR at 32 (quoting 30 CFR 212.200(a) (1997)).) Appellant notes that, at the conclusion of the 1992 audit, MMS specifically released it from the obligation to maintain its records, concerning the Aug. 1, 1986, to Mar. 31, 1991, audit period, longer than 6 years, and that these records were no longer available at the time of the July 1997 demand letter. (SOR at 32-33 (citing Letter from MMS, dated Mar. 9, 1992 (Ex. J, Appendix A, attached to SOR)).) Appellant accordingly concludes that, given the unreasonable delay by MMS and the resulting unavailability of its records, MMS’ July 1997 demand letter is barred by the equitable doctrine of laches.

Although MMS did, at the conclusion of the 1992 audit, release appellant from the obligation to maintain records more than 6 years, it specifically notified appellant that the conclusion of the audit did not preclude it from later determining that there was still an underpayment of royalty, based on another examination of the transactions during the audit period. (Letter to San Juan, dated Mar. 9, 1992 (Ex. J, Appendix A, attached to SOR).) Thus, appellant was well advised to retain its records longer than the 6-year period. More importantly, we find no offer of proof or other evidence indicating that destruction of records impaired appellant’s ability to dispute the correctness of MMS’ calculation of additional royalty.
In any event, we cannot conclude that MMS is barred by any delay which results in seeking to collect additional royalty after the required period for record maintenance has expired, either in furtherance of 30 CFR 212.200(a) (1997) or under the doctrine of laches. Marathon Oil Co., 119 IBLA 345, 351, 351 n.9, 352-53 (1991) (citing United States v. California, 332 U.S. 19, 40 (1947), and United States v. Tri-No Enterprises, Inc., 819 F.2d 154, 158-59 (7th Cir. 1987)).

Appellant argues that MMS is barred by 28 U.S.C. § 2415(a) (2000) from requiring the payment of additional royalty owed with respect to coal production more than 6 years prior to issuance of its July 1997 demand letter, which would encompass the entire Aug. 1, 1986, to Mar. 31, 1991, audit period. We have long held that this statute of limitations does not bar administrative efforts to collect additional royalty, but expressly applies only to a civil action initiated by a “complaint,” filed by the United States in Federal court, seeking to collect money damages arising from a contract express or implied in law or fact. Shell Oil Co., 150 IBLA 298, 306 (1999), and cases cited therein.

MMS properly included the costs of primary crushing in the royalty value of the Federal coal produced from Federal coal lease NM-0315559 during the period from August 1, 1986, through December 31, 1995.

To the extent that they are not expressly considered, all errors of fact or law raised by appellant have been considered and rejected. 13/ Accordingly, 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.

_____________________
David L. Hughes
Administrative Judge

13/ We also deny appellant’s request for a hearing (SOR at 55) in the absence of any demonstration of the existence of an outstanding dispute concerning a material fact relevant to disposition of the instant appeal. 43 CFR 4.415; Felix F. Vigil, 129 IBLA 345, 347 (2000); Woods Petroleum Co., 86 IBLA 46, 55 (1986).
ADMINISTRATIVE JUDGE HEMMER CONCURRING:

I concur in the opinion of Judge Hughes. I wish, however, to describe my own route to that conclusion.

The issue in this case, simply stated, is whether a Federal coal lessee may exclude from royalty value monetary consideration for the delivery of crushed coal to its purchasers by virtue of the fact that the monetary consideration was set forth in two contractual provisions, rather than one. It seems clear to me that a careful reading of the gross proceeds rule should be sufficient to answer that question. The Minerals Management Service (MMS) rule specifically states that “gross proceeds” includes “payments to the lessee for certain services such as crushing * * * to the extent the lessee is obligated to perform them at no cost to the Federal Government or Indian lessor.” 30 CFR 206.250 (emphasis added). That this has been the consistent statement of the Department of the Interior since it first published value-based royalty regulations for coal closes this case in my view.

We have a three-part decision, however, because the dissent apparently reads the “to the extent language” in the last quoted sentence as evidence that MMS meant to create an exception to the rule regarding crushing that could be applicable in this case. The dissent looks then to the preamble language in an effort to establish an intent on the part of MMS with respect to crushing. I disagree with such a method of construction to a simply stated rule, particularly in light of the dozens of comments to which MMS was responding in the critical rulemaking; I do not read MMS’ response to comments to suggest any intention on MMS’ part to open a door closed in 1976.

Since the question of MMS’ intentions has been opened in this case, however, I believe that a more thorough reading of the history of coal royalty valuation rules than has been thus far presented answers the question quite directly. The rules themselves have evidenced a straightforward and consistent regulatory approach which requires reimbursements for crushing to be included in the gross value or gross proceeds upon which royalty is calculated.

I begin with the change in royalty provisions in Federal coal leases from a cents-per-ton to a percentage-of-proceeds basis brought about by the United States Congress in 1976. Prior to amendments to the Mineral Leasing Act (MLA) in the Federal Coal Leasing Act Amendments of 1976 (FCLAA), Publ. L. No. 94-377, the MLA allowed the Department to issue coal leases requiring royalty to be paid on a cents-per-ton basis. 30 U.S.C. § 207 (1970). San Juan’s coal lease contained such a cents-per-ton provision. See Statement of Reasons (SOR) at 7; Ellefson Aff. Ex. A (1963 Lease sec. 2(c)).

Because most federal coal leases contained a royalty clause requiring royalty to be paid on a cents-per-ton basis until the 1970s, a royalty value regulation was largely
unnecessary. However, under its discretionary authority the Department, through MMS’ predecessors in royalty collection, began to issue leases with ad valorem rates, or rates based upon a percentage of the value of coal. The Department first proposed a valuation provision based on the “sale price” of coal on April 30, 1973. 38 FR 10686, 10692. The Department proposed other regulations regarding value-based royalties twice in 1975. 40 FR 4428, 4437 (Jan. 30, 1975); 40 FR 41122, 41137 (Sept. 5, 1975). In 1976, shortly before the enactment of the FCLAA, the Department adopted the first value-based coal royalty regulations in a final rule.

The critical aspect of this final rule for my consideration is that it determined almost 30 years ago that coal royalty would be based upon sale price of the product after crushing. I do not find any intention on the part of MMS to change this construction of the ad valorem provision of a coal lease in its 1989 rulemaking or any time before or after that date. The 1976 rule stated:

Value Basis for Royalty Computation.

(a) Where only crushing, storing, and loading are performed prior to the point of sale, the value of the coal for royalty purposes shall be the gross value at the point of sale * * * .

(b) The gross value shall be the sale or contract price times the number of units sold * * * .

30 CFR 211.63 (1977); 41 FR 20260, 20271 (May 17, 1976).

In 1976, FCLAA amended the MLA to require royalties for coal leases to be based on an ad valorem provision, 30 U.S.C. § 207 (2000), consistent with oil and gas provisions in the MLA and the Outer Continental Shelf Lands Act, 30 U.S.C. § 226 (2000) (onshore oil and gas); 43 U.S.C. § 1337 (2000) (offshore). In amending the royalty provision of the MLA, Congress explained that the cents-per-ton leases had resulted in the “public * * * being paid a pittance for its coal resources.” H.R. Rep. No. 94-681, 1976 U.S.C.C.A.N. 1953. Congress directed that royalties on all federal coal leases be based on a percentage of the value of the coal produced, requiring the lessee to pay a royalty of “not less than 12-1/2 per centum of the value of coal as defined by regulation.” 30 U.S.C. § 207 (2000). This provision was enacted to be consistent with the MLA’s royalty provisions for oil and gas leases which required that for such onshore oil and gas leases “[r]oyalty shall be 12-1/2 per centum in amount or value of the production removed or sold from the lease.” 30 U.S.C. § 226(b)(2) (2000).

Congress was directly influenced by existing Departmental regulations in leaving to the Secretary the discretion to determine value by promulgating rules. During the course of FCLAA’s passage through Congress, an Assistant Secretary of the Department of
the Interior testified regarding his understanding of the 1976 rules, in supporting the language eventually adopted in FCLAA.

[T]he language in lines 12 through 15 would impose a minimum royalty based on a percent of the sale price of coal. We recommend deletion of this provision. Royalties are usually based on a percent of the “value” of the coal rather than the “sale price” of the coal because coal that is produced often is not actually sold and because the sale price, for one reason or another, may be less than the fair market value.


The Department amended the “gross value” rules for coal royalties in 1982; however, it retained the terms of the 1976 rule requiring royalty to be paid on crushed coal. 30 CFR 211.63 (1982). In a notice of proposed rulemaking published in 1981, the Department made clear that it was retaining the existing definition of “gross value” and rejecting the notion of excluding certain Federal fees from the term:

Gross Value, for the purpose of royalty calculations, means the unit sale or contract price times the number of units sold, subject to the procedures in 30 CFR 211.63(g) under which gross value is determined.

46 FR 61424, 61428 (Dec. 16, 1981). The Department promulgated final rules for gross value provisions in coal leases in 1982, stating that it had decided not to amend the term: “The Secretary has concluded that the current method for computing royalties will be retained.” 47 FR 33154, 33158 (July 30, 1982). The 1976 rule remained in effect. See 30 CFR 211.63 (1982).

In 1983, the Department amended the gross value rules, dividing the definition into two parts, 30 CFR 203.200(f) and (h) (1986), but retained the concepts set forth in 30 CFR 211.63, as promulgated in 1976. Thus, the rule specified again that “costs of crushing, storing, and loading,” among other costs, “shall not be deducted from the gross value in determining value for Federal royalty purposes.” 30 CFR 203.200(h) (1986). This regulation remained in effect until 1989. See 30 CFR 203.200(f) and (g) (1988).

FCLAA provided that leases would be readjusted after an initial 20-year term and every 10 years thereafter. 30 U.S.C. § 207(a) (2000). Because so many leases had been issued for coal with cents-per-ton royalty provisions, the majority of coal leases could not be converted to leases with ad valorem royalty provisions until such time as they were readjusted. FMC Wyoming Corp. v. Hodel, 816 F.2d 496 (10th Cir. 1987), cert. denied, 484 U.S. 1041 (1988). It was some years before the Federal courts resolved the many legal challenges to the Department’s attempts to readjust coal leases with cents-per-ton royalty provisions, or an ad valorem provision lower than 12.5 percent, to the statutory
ad valorem royalty rate of 12.5 percent. E.g., FMC Wyoming Corp. v. Hodel, 816 F.2d at 496; Coastal States Energy Co. v. Hodel, 816 F.2d 502 (10th Cir. 1987). It was during the period in which this and other litigation was moving through the Federal courts that the MMS, created in 1983, undertook a review and revision of the Department’s entire royalty valuation program for Federal and Indian oil and gas and coal leases. In 1986, MMS issued an advance notice of proposed rulemaking advising the public of its plans to reconsider its rules regarding “proposed methods of valuing, for royalty purposes, coal, oil and gas and associated products from Federal and Indian leases.”

As part of this comprehensive rulemaking, MMS announced its plans to adopt the gross proceeds concept for coal leases, which had been in place since 1942 for oil and gas, 30 CFR 221.47 (1943), consistent with the prior “gross value” concept of the coal rules. 30 CFR 203.200 (1987). On January 15, 1987, MMS published a notice of proposed rulemaking, specifying that one of its purposes was to place “coal product valuation regulations in a format compatible with the valuation regulations for all leasable minerals.” 52 FR 1846. The proposed rule “restate[d] the long-standing principle that under no circumstances can the value, for royalty purposes, be less than the gross proceeds accruing, or which could accrue, to the lessee * * *.” Id. at 1844.

For the first time, the draft rule proposed deducting from royalty value the costs of reimbursements for black lung taxes and reclamation fees. The debate over this proposed deduction issue was controversial and led to extensive discussions and multiple Federal Register publications. The decision on this topic is not relevant here, except to demonstrate that the debate focused on exclusion or inclusion of such fee payments; never did MMS change the basic construct in the rule that royalties were to be paid on coal in a crushed state.

On July 15, 1988, MMS published a second notice of proposed rulemaking, once again outlining the controversy over Federal, State, and local fees. 53 FR 26942. On January 13, 1989, Secretary Hodel published final coal product value rules. The final rules retained the proposed rule’s deductions for black lung taxes and reclamation fees and, in addition, permitted deduction of state and local severance taxes from a lessee’s gross proceeds on Federal leases. (MMS expressly exempted Indian leases from this change.) 54 FR 1525; 30 CFR 206.257 (1989). The preamble stated that “these fees do not add to the value of coal.” 54 FR at 1512.

On February 13, 1990, Secretary Lujan issued proposed rules eliminating the deductions and providing for coal royalty to be assessed on the total consideration

\[suit]/ San Juan’s lease royalty provision was readjusted in 1983 to establish that royalty would be “12.5 percent of the value of coal produced.” (SOR at 7; Ellefson Aff. Ex. A (1963 Lease sec. 6).)
received by the lessee without deduction for taxes or fees, as had been the case before the 1989 rules. 55 FR 5026. MMS conducted three public hearings on the matter, and accepted further comments, which were as controversial as before. 55 FR 35428. On August 30, 1990, MMS promulgated a final rule that deleted the portion of the 1989 rule allowing deductions of severance taxes, reclamation fees and black lung taxes, referring to it as an “aberration” in royalty valuation. 55 FR 35432. It noted that while coal is marketed differently from oil and gas, “it nonetheless does not change the fundamental economic notion that the minimum ‘value’ of the coal resources owned by the people of the United States is what the purchaser actually paid for the coal.” Id.

Critical to the issues here, throughout these successive public rulemaking notices, MMS specified that the change to “gross proceeds” in the coal royalty valuation rule was to “assure regulatory consistency” throughout the product valuation rules, and that the rules since 1976 had included total consideration for the sale of coal. 52 FR 1844; 53 FR 26947. The final 1989 rule includes this discussion, stating that the concept embodied in the gross proceeds term has been in place in the “gross value” rules since 1976. 54 FR 1505. MMS specified that the adoption of gross proceeds was to be consistent for all products and that it was based on consideration between the buyer and seller rather than a decision between themselves as to what receipts or services would be royalty-bearing.

Market-based valuation is a universally accepted point of determining value. It is neither intrinsic nor subjective but, instead, is an economic event measurable by the price paid for the product, including all consideration passing between buyer and seller. This characteristic of market-based valuation is critical, because it describes the necessity to account for all monies paid for the purchase of coal, not just those price components arbitrarily deemed by the buyer or seller to represent value. In other words, the true measure of value, and its meaning as used by the Department in royalty valuation, is the price that willing coal purchasers agree to give to willing coal producers, in arm’s-length transactions, for the acquisition of coal.

55 FR 35431 (emphasis added).

The 1989 and 1990 rulemakings made clear that “gross proceeds” for all products was to be the same, thus endorsing the decades of consistent Departmental and Federal court analysis of the concepts of “gross proceeds” and gross value. Thus, it is imperative that we understand how this Department has implemented that concept for now over 40 years. The cases have been consistent in ensuring that payments for production cannot be excluded from royalty value. California Company v. Udall, 296 F.2d 384 (D.C. Cir. 1961). In Kerr! McGee Oil Industries, Inc., 70 I.D. 464 (1963), the Department squarely established that a lessee’s proceeds included the actual consideration received by the lessee/seller under gas sales contracts with a buyer.
We cannot accept the assumption upon which appellants have based all of their contentions, namely, that the value received for the gas is limited to the amount which they stipulated in their contracts with the buyers to be the contract prices and that this Department can look no further to ascertain whether other payments to be made to the seller actually represent consideration for the gas also.

* * * * * * *

If this simple bookkeeping device could have the effect contended for by the appellants, it would be possible for them to break down the so-called basic contract price of 22 cents per Mcf into other costs or expense that the sellers must bear. Carried to an extreme, but a logical extreme under appellants’ rationale, the basic contract price could be reduced simply to the profit that appellants would make per Mcf of gas sold, with all other payments to appellants being designated as reimbursements to them for various items of cost or expense.

70 I.D. at 469-70 (emphasis added); see also at 471, citing U.S. v. Ohio Oil, 163 F.3d 633 (10th Cir. 1947), cert. denied, 333 U.S. 833 (1948).

This concept was adopted in the 1990 coal rule. 55 FR 35431. The gross proceeds concept is meant to prevent a lessee and seller from writing contract provisions so as to isolate from royalty value costs that are directly tied to production, by denominating them as payments for something other than production. This Board has consistently followed this principle in royalty cases. Wheless Drilling Co., 13 IBLA 21, 31, 80 I.D. 599, 604 (1973) (gas); Knife River Coal Mining Company, 29 IBLA 26 (1977) (coal); Knife River Coal Co., 43 IBLA 104 (1979) (coal); Tricentrol United States, Inc., 105 IBLA 392, 394-95 (1988); BWAB, Inc., 121 IBLA 188, 193 (1991) (oil and gas); Pennzoil Oil & Gas, Inc., 109 IBLA 147 (1989), aff’d, 751 F. Supp. 602 (E.D. La. 1990), aff’d 928 F.2d 1139 (TECA 1991) (tertiary price incentives for oil); Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1981), aff’d, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984). Most recently, we analyzed this principle again in Nexen Petroleum U.S.A., Inc., 157 IBLA 286 (2002), and it was affirmed by the United States District Court for the Eastern District of Louisiana. Nexen Petroleum U.S.A., Inc. v. Norton, Civ. No. 02-3543 (Mar. 31, 2004), appeal filed, No. 04-30435 (5th Cir.).

Thus, it is readily apparent that the gross value rule adopted in 1976, requiring the payment of royalties on crushed coal, has remained in place for almost 30 years, the only change relevant here being that the term is now “gross proceeds.” Significantly, any question that MMS meant to change this particular aspect of the rule was answered directly and in the negative. In the portion of its 1989 final rule responding to
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comments, MMS described “comments that included examples of situations that the
commenters believed should not be subject to royalty under the final rules.” 54 FR
1495. Among these situations are “[s]ervices provided by the purchaser that are
typically the responsibility of the lessee.” Id.

Several lessees explained that because of the proximity of the mine to the
power plant and because of long-standing operating relationships between
the mine and power plant, the utility was crushing the coal on behalf of the
lessee. * * * The commenters insisted that these services, which represent
noncash elements of value and would be subject to royalty under these
final rules, should be royalty exempt since these agreements preceed the
effective date of these rules.

Id. (emphasis added). MMS disagreed with those comments and stated that its position

with regard to any form of consideration paid under a coal supply contract,
for the sale of produced coal, is that such consideration is part of the value
of coal and is therefore subject to royalty. In this regard, the final rules
represent a continuation of existing policy * * *. The MMS has an
established record under prior royalty valuation rules of aggressively
pursuing royalty collections in those situations where the lessee has been
receiving noncash benefits from its customer under coal sales agreements.
Likewise, MMS has operated under a long-standing policy of accepting
nothing less than the gross value received by the lessee for the sale of coal.

Id. (emphasis added).

This exchange makes clear that both MMS and the affected industry commenters
believed that a lessee was responsible for crushing coal at no cost to the lessor and that,
even where it was performed by the purchaser, it would be a noncash element of value
to the lessee, the cost of which would be added to the lessee’s royalty-bearing receipts
under the gross proceeds rule. In response to a direct request for an exemption from
that rule, MMS refused. MMS believed that non-cash reimbursements by the purchaser
to crush the coal must be royalty-bearing value because it was a service the lessee is
required to perform. There can be no question that MMS would expect that cash
reimbursements to a lessee for performing that service and delivering crushed coal
would likewise be royalty-bearing. If MMS exercised its discretion to determine royalty
value by explicitly refusing, in the course of a rulemaking, to provide an exemption from
the gross proceeds rule, this Board cannot do so by adjudication.

A contrary position is all the more difficult to understand given that even the
rulemaking preamble language upon which the dissent relies was cited by this Board
within the last year as a basis for concluding that coal shipping costs reimbursed to the

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lessee are royalty-bearing. In Exxonmobil Coal and Minerals Company, 159 IBLA 106 (2003), the Board cited that language in concluding that such costs, in that case loading for shipment, are costs of placing coal in marketable condition at no cost to the lessor.

With respect to coal, processes commonly applied by mine operators (or lessees) to prepare coal for the market include all operations which extract, sever, or otherwise separate coal from its in-place position in the geologic strata: crushing (to limit upward size), storing, blending, and loading for shipment.

159 IBLA at 109, citing 54 FR 1498, 1499 (Jan. 13, 1989) (first emphasis added). Acknowledging, as does the majority opinion, the MMS language on the same page of the rulemaking that the “sale of run-of-mine coal for steam coal utilization by an electric utility does not constitute coal in marketable condition,” 54 FR at 1498-99, the dissent nonetheless concludes that this statement contradicts MMS’ explanation on the same page that marketable condition is a flexible concept. While I agree with the majority’s conclusion that no contradiction is found as a result of the “market segment” discussion in the preamble, I also believe that such a contradiction is belied by the plain words of the rule, by the history of the rule, and by the consistent interpretation of the rule, most recently by this Board in the Exxonmobil decision.

I also believe that any perception of a “contradiction” in MMS’s dense and extensive preamble elevates preamble language over the plain language of the rule. It cannot be disputed that the MMS has the discretion to determine royalty value. MMS exercised this discretion by establishing the gross proceeds rule. As evidenced by the comments noted above, readers understood that coal should be crushed at no cost to the lessor. Poring over dozens of Federal Register pages to find a possible phrase which might negate what is otherwise plain language in a rule is not an appropriate means of deciding a matter where MMS has the discretion to determine the rule in the first place. The burden should be on the lessee to prove that its production is not subject to the rule. I find nothing in the record to satisfy that burden. San Juan delivered coal to a utility purchaser and received compensation for crushing coal, albeit in separately denominated contractual provisions. I fail to see how this is anything but “total monies and other consideration for the production and disposition of the coal produced.” 30 CFR 206.250. I would not take away the appellant’s burden or MMS’s discretionary rulemaking authority and place both on this Board.

Accordingly, I concur in the result.

Lisa Hemmer
Administrative Judge

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ADMINISTRATIVE JUDGE IRWIN DISSENTING:

In my view, there are two principal difficulties in this case. The first is that MMS was not justified in auditing this lease for the 1986-1991 period, having conducted and completed a comprehensive audit of it for that period before. The second is, even if MMS is justified in doing so, it has improperly applied the regulation that allows it to increase a lessee's gross proceeds because the purchaser of the coal, or any other person, is providing a service whose cost ordinarily is the lessee's responsibility in order to meet the lessee's obligation to place the coal in marketable condition.

I. MMS has not shown substantial omission or fraud as a basis for re-opening the audit

MMS informed San Juan in May 1991 that it would conduct an audit of its federal coal leases in northwestern New Mexico for the period April 1, 1986 - March 31, 1991. As a test for compliance, MMS selected San Juan's La Plata Mine lease for a comprehensive audit that was estimated to involve 400 staff hours. MMS's audit plan included reviewing the 1980 sales contract and its pricing provisions, as amended. MMS concluded that San Juan had accurately reported volumes sold and correctly paid royalties due and advised San Juan by letter in March 1992 that it believed San Juan was in substantial compliance with lease terms and with federal laws, regulations, and directives. MMS stated that, since the audit was complete, San Juan was no longer required to maintain records beyond the minimum six years required by 30 CFR 212.200(a).

When MMS adopted its current coal product valuation regulations in 1989, it responded to three industry commenters concerning the proposed definition of “audit” who “requested clarification regarding who conducts audits of royalty payments and on what date an audit would be deemed final.” MMS stated that it was the prime auditing authority for federal and Indian leases and that the “results of an audit are normally considered final when the lessee accepts the audit findings or its appeal rights are exhausted. The Federal Government is not prevented from reopening an audit if there is evidence of substantial omission or fraud.” 54 FR 1492, 1504, col. 2 (Jan. 13, 1989).

MMS’s March 1992 letter to San Juan, however, significantly extended the grounds for re-opening an audit by stating that “[i]n situations where subsequent evidence indicates the possibility of fraud, collusion, or underpayment, this letter does not preclude further examination of records and transactions of previously audited periods” (emphasis added). MMS cited this sentence in its July 1997
demand letter to San Juan covering the period August 1, 1986 - March 31, 1991, in explanation for stating:

During the prior audit by the Dallas Area Compliance Office * * * (DCD), the processing costs for coal mined from the La Plata lease were not reviewed. The DCD only audited the La Plata Federal Lease No. M40-31559-0. Because the processing costs were deducted from the San Juan Mine leases' royalty calculations and were not shown as part of the La Plata lease royalty calculation they were not included in DCD's review. The fact that the DCD audit did not identify this issue does not eliminate [San Juan's] obligation to pay royalties on these reimbursed costs.

MMS added that it is not estopped from collecting royalties because of erroneous or incomplete information given by an employee.

In my view, MMS's July 1997 letter does not cite evidence of “substantial omission or fraud” on San Juan’s part. Nor does the August 27, 1998, MMS decision under review. It states that it discovered during the second audit that the costs for processing coal from the La Plata Mine lease

were paid by the Utilities as part of the San Juan Mine coal invoice. The processing costs for La Plata coal were deducted from the San Juan Mine royalty calculations as Outside Coal Revenue. However, San Juan neglected to then include the reimbursement of those processing costs in the value used to calculate the royalty for the La Plata Mine. As a result, the proceeds used to calculate the royalty paid on the coal mined by San Juan did not reflect the full value of that coal.

Decision at 2.

Rather than finding evidence of substantial omission or fraud, it is apparent MMS changed its mind about the March 1992 conclusions of its previous audit because it thought it made a mistake. If the MMS audit cycle or an MMS audit is to have any meaning, however, there must be a point of closure, even if MMS later discovers it overlooked something or might have garnered more royalties with a different approach to the circumstances. It is not fair for MMS to be able to re-visit a lessee’s royalty payment record even after it has reviewed that record, found the lessee in compliance, and told the lessee that it may dispose of the relevant records. If MMS may re-open an audit any time it finds an “underpayment,” as distinct from of “substantial omission or fraud,” then letters such as it sent San Juan in March 1992 are virtually worthless and an audit is never final.

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II. **MMS has mis-applied 30 CFR 206.257(h) to the circumstances of this case**

The preceding discussion only applies to the period August 1, 1986 - March 31, 1991, covered by MMS’s previous audit and MMS’s July 25, 1997, demand letter. However, for the April 1, 1991 - December 31, 1995, period covered by MMS’s March 7, 1997, demand letter, I believe MMS has incorrectly concluded that San Juan reduced its gross proceeds by the amount it was paid to crush its La Plata Mine coal at the utilities’ generating station and has improperly increased the value of the coal by that amount.

MMS’s 1989 coal product valuation regulations provide that San Juan’s royalty is based on the value of the coal it sells times the rate in its coal lease, in this case, 12.5%. 30 CFR 206.257(a). Because it has an arm’s-length contract with the utilities, the value is the “gross proceeds” that accrue to San Juan. 30 CFR 206.257(b)(1). San Juan’s gross proceeds are “the total monies and other consideration accruing to [it] for the production and disposition of the coal” it produces. This includes payments it receives for services such as crushing, “to the extent [it] is obligated to perform [these services] at no cost to the Federal Government * * *.” 30 CFR 206.251 (definition of “gross proceeds”).

San Juan is required to place its coal “in marketable condition at no cost to the Federal Government.” 30 CFR 206.257(h). “ Marketable condition” means “in a condition that will be accepted by a purchaser under a sales contract typical for that area.” 30 CFR 206.251 (definition of “marketable condition”). “ Area” means “a geographic region in which coal has similar quality and economic characteristics.” 30 CFR 206.251 (definition of “area”).

When, as in this case, value for royalty purposes is based on a lessee’s gross proceeds, the value is to be increased to the extent the gross proceeds have been reduced “because the purchaser, or any other person, is providing services, the cost of which ordinarily is the responsibility of the lessee [in order] to place the coal in marketable condition.” 30 CFR 206.257(h) (emphasis supplied).

In adopting this regulation, MMS explained that marketable condition is the form and condition of the coal that result “from the application of normal mining processes.” For coal, the “processes commonly applied” to prepare coal for the market include extraction; “crushing, sizing, storing, blending, and loading for shipment;” and all transportation requirements in and about the mine. “Processes which are not identified with common * * * practices include * * * the physical processing of coal to a condition of quality beyond that normally attributed or associated with coal marketed from the same area.” 54 FR 1492, 1498, col. 3 (Jan. 13, 1989).
MMS observed:

    However, the conditioning of coal for the 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. For example, some types of coal sold to certain market segments are not normally screened. * * *

    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.

Id.

Then, however, MMS continued:

    Therefore, under no circumstances will MMS accept the gross proceeds established under any sale of coal that does not meet the market's minimum condition. Specifically, the sale of run-of-mine coal for steam coal utilization by an electric utility does not constitute coal in marketable condition. In this situation, MMS will add to the gross proceeds the cost of those normal mining processes which are ordinarily the responsibility of the lessee. This provision is explicitly set forth at § 206.257(h).

Id. at 1498-99 (emphasis supplied).

    It is apparent that this paragraph contradicts MMS's statement that “the conditioning of coal for the market does not consist of a uniform set of processes” and its three-part test for determining marketable condition.

    In distinguishing the market for coal from the market for oil and gas, MMS stated:

    It is EEI's [Edison Electric Institute] conclusion that “Coal is not a commodity like oil. The market for Western coal is user specific and is custom-produced according to quantity and quality.” * * *

* * * Federal western coal is used in large part only for electric generation, whereas this is only one of many uses for oil and gas. Related to their varied uses is the fact that oil and gas prices are
dictated in large part by international market forces. Coal, on the other hand, is affected more by specific markets because it is not a fungible. For example, many large western mines are developed to supply coal to a particular powerplant which is designed specifically to burn that coal.

Id. at 1513, col. 1.

It is precisely because the markets for Western coal are user-specific that MMS must apply the three-part test it set forth in defining marketable condition. It did not do so in this case, however. Although MMS stated in its field reports that it considered the utilities’ generating station “the relevant market to review” during its audit, in the August 27, 1998, decision San Juan has appealed MMS states that “[p]rimary crushing is a standard mining operation required by the steam electric utility market segment the coal is sold into and is generally necessary in order for a mine to handle, store, and load coal” (Decision at 5, emphasis supplied) and underlines the “Specifically, the sale of run-of-mine coal for steam coal utilization by an electric utility does not constitute coal in marketable condition” statement from the preamble to the regulations quoted above (id. at 3).

This application of 30 CFR 206.257(h) makes the entire steam electric utility industry into a “market segment.” It vitiates the definitions of “marketable condition” of coal – “in a condition that it will be accepted by a purchaser under a sales contract typical for that area,” and of “area” – “a geographic region in which coal has similar quality and economic characteristics,” upon which the requirement of § 206.257(h) that a lessee is required to place coal in marketable condition at no cost to the federal government is based. It ignores the fact that “coal ** * is affected more by specific markets” than oil or gas. It replaces an analysis of whether a particular process that “ordinarily is the responsibility of the lessee” is actually one of “the customary requirements of preparation or conditioning” and is part of “the typical level of preparation or conditioning by coal producers in that area” with the categorical statement that some kinds of purchasers always require that process, even if without that process the coal “will be accepted by a purchaser under a sales contract typical for that area.”

In this case, MMS acknowledged that “the market segment [the] coal is sold into” (factor 1 of the three-part test) is the utilities’ power plant. The record shows “the customary requirements of preparation or conditioning normally expected by that market segment” (factor 2): the utilities purchase not only La Plata Mine coal, but coal from three other mines, in run-of-mine condition. Except with respect to coal from the fifth mine supplying their needs, the San Juan Mine, the utilities’ contracts do not require the suppliers to crush the coal.
The record contains no further information on “the typical level of preparation or conditioning by coal producers in that area” (factor 3). In an effort to remedy this, MMS states on appeal:

An additional indication that uncrushed coal in this market area is not in marketable condition is a review of the practices of other mines in the region. For example, the BHP-Navajo mine is adjacent to the La Plata mine. Its coal is crushed to a top size of approximately three-quarter-inch before washing. Other mines in this region also crush coal prior to shipment. See the attached 1999 Keystone Coal Industry Manual (Exhibit 2) that shows that coal from most mines in New Mexico is crushed before shipment.

Answer at 11. The Manual lists six mines, including San Juan Coal Company’s two mines. It does not indicate to whom the BHP-Navajo mine sells its coal, i.e., what market segment it produces for. The pages of the Manual MMS provides do not include a key; they appear to show that one Pittsburg & Midway tipple ships 3” coal, and another P&M preparation plant ships 2” coal, but it is not clear to whom they ship. The Lee Ranch Coal Co. tipple ships size “340” coal. Although Lee Ranch is one of the utilities’ suppliers, it is not clear that this tipple is the utilities’ source, whatever size “340” coal is. This information does not support a conclusion that the market segment for the utilities’ generating station requires crushed coal.

Thus, I would conclude that although crushing is a service the cost of which “ordinarily is the responsibility of” a lessee, in the market segment involved in this case coal is in marketable condition without crushing.

MMS argues that our decision in Trapper Mining, Inc., 144 IBLA 204 (1998), supports its decision. The facts in this case are different, however. In that case, only two of seven mines supplied run-of-mine coal to the utility. 144 IBLA at 213, n. 12. We held, for that market, that run-of-mine coal was not in marketable condition. The record in this case establishes that four of the five mines that supply the plant provide run-of-mine coal without crushing it.

That conclusion in Trapper Mining, Inc. applied to the facts of that case under the 1989 regulations. Even if MMS may revisit its earlier audit of the period from August 1, 1986, until those regulations became effective, I believe under the circumstances of this case that San Juan likewise does not owe royalty on payments for crushing under the previous regulations. 30 CFR 203.200(f) (1986) (later redesignated as 30 CFR 203.250(f) (1988)) provided that “[w]here Federal royalty is calculated on a percentage basis, the value of coal for Federal royalty purposes shall be the gross value at the point of sale, normally the mine, except as provided at
In this case, the utilities purchased the coal (and San Juan disposed of it) at the mine, then paid San Juan to transport it to their generating station and to crush it – along with the coal from the other mines – on space they leased to San Juan there.

I would reverse MMS’s August 27, 1998, decision.

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Will A. Irwin
Administrative Judge

Subsection (h) provided that additional preparation of coal performed prior to sale that enhanced the quality of the coal could be deducted from gross value, but primary crushing, storing, and loading could not be deducted:

If additional preparation of the coal is performed prior to sale, such costs shall be deducted from the gross value in determining value for Federal royalty purposes. The District Mining Supervisor will allow such deductions only when, in his judgment and subject to his audit, the operator/lessee provides an accurate account of the costs incurred. However, the following shall not be deducted from the gross value in determining value for Federal royalty purposes: costs of primary crushing, storing, and loading; treatment with chemicals to prevent freezing; treatment with oil to suppress dust in transit; and, other preparation of the coal which in the judgment of the District Mining Supervisor does not enhance the quality of the coal.

This provision was stated more clearly in the previous version of the regulation, 30 CFR 211.63(a) (1982):

Where only crushing, storing, and loading are performed prior to the point of sale, the value of the coal for royalty purposes shall be the gross value at the point of sale. However, if additional processing of the coal is performed prior to sale, such as washing to remove waste, bone, or other impurities, the processing cost above the cost of primary crushing, storing, and loading may be deducted from the gross value in determining value for royalty purposes.