3485 - REPORTS, ROYALTIES, AND RECORDS

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.01 Purpose.

The purpose of this Manual Section is to set forth the Bureau of Land Management's (BLM) policies related to reports received by the BLM, royalty procedures, and maintenance of paper and automated records; specifically, policies related to the processing of applications for production royalty rate reductions for Federal coal leases.

.02 Objectives.

The objectives of this Manual Section are to provide guidance relating to reports received by the BLM, royalty procedures, and maintenance of paper and automated records. Specifically included is guidance for the processing of the five Categories of royalty rate reductions; contents of a royalty rate reduction applications; criteria for approval of applications; setting terms and conditions; and administration and monitoring of approvals.

.03 Authority

A. Freedom of Information Act (5.U.S.C. 552).

B. The Mineral Leasing Act (30 U.S.C. 209 (1982)).

C. 43 CFR Part 2.

D. 43 CFR Part 4.

E. 43 CFR Group 3485.

.04 Responsibility.

The responsibilities of BLM and MMS are outlined below (also see BLM Manual Section 3400.04):

A. The Director exercises the authority of the Secretary of the Interior for those areas of the Federal coal management program delegated to the Director by the Secretary. As such, the Director has the responsibility, as prescribed by Section 39 of the Mineral Leasing Act (30 U.S.C. 209) to approve the waiver, suspension, or reduction of the rental and royalties for producing Federal coal leases. This authority has been redelegated to the State Directors. The Director retains the authority to concur with State Directors' decisions through program oversight controls and conflict resolution procedures.

B. The Deputy Director (Associate) exercises the Director's authority in the Director's absence or at the Director's request.

C. The Assistant Director, Energy and Mineral Resources is responsible for supervision of national program review and oversight and approval of recommendations for change in the national policy.

D. The Deputy Assistant Director, Energy and Mineral Resources reports to and shares management responsibility with the Assistant Director.

E. The Chief, Division of Solid Mineral Operations is responsible for national program review and oversight of the royalty components of the Coal Management Program. The Chief develops policies, guidance, procedures, and regulations for nationwide implementation on Federal and Indian Lands.

F. The State Directors are responsible for State program review and oversight and for ensuring that the policies outlined in this Manual Section are adhered to in program implementation. State Directors are also responsible for ensuring that Solid Leasable Minerals System (SLMS) data is entered and maintained timely and accurately. The State Directors are also responsible for:

1. Designating the Deputy State Director for Mineral Resources to form an Evaluation Team and determining whether adequate in-house engineering and evaluation expertise are available for program implementation.

2. Reviewing category 5 qualifications petitions, category-specific royalty rate reduction applications, BLM evaluation team analyses, and decision documents.

3. Transmitting a copy of the application, when deemed necessary, to the MMS Financial Accounting Division for review of financial data for a determination of whether the lease accounts are current.

4. Transmitting any proposed decisions and pertinent facts and rationale for those decisions to the Chief, Division of Solid Mineral Operations (WO-660), for policy review and Washington Office coordination.

5. Consulting with the State Governor regarding category 5 area qualifications and individual royalty rate reduction decisions under any category.

6. Taking final action on applications and notifying MMS and the appropriate State officials in writing of approved royalty rate reductions, effective dates, terms, and durations. Notifying the MMS, that a royalty rate reduction has expired and that the royalty rate has automatically reverted to that specified in the lease term.

G. The Deputy State Directors for Mineral Resources serve as the team leaders of Evaluation Teams that review and analyze royalty rate reduction applications. Evaluation Teams are composed of at least one experienced mining engineer, geologist, and economic evaluation team staff member. The Deputy State Directors are also responsible for:

1. Coordinating the evaluation of the application made by BLM and MMS personnel.

2. Reviewing the application for regulatory and statutory compliance.

3. Reviewing the category 5 applications and determining if the existing royalty rate differentials between Federal and non-Federal coal reserves significantly affect the recoverability of the Federal coal reserves.

4. Preparing the BLM State Director's decision document which determines the rate, term, and duration of the royalty rate reduction Documenting in writing, the background and rationale for the decision forwarding the decision document to the BLM State Director for signature, and placing that documentation on file.

5. Preparing the necessary documentation for transmittal to the BLM Washington Office whenever it is necessary to invoke a conflict resolution process with the State Governor.

6. Reviewing written reports from the BLM District Office and reporting to the BLM State Director, as necessary.

7. Reviewing applications submitted under expanded recovery and extension of mine life categories and certifying to their best professional judgment whether bypass of the resources would occur if a royalty rate reduction is not granted.

8. Reviewing the annual recertifications submitted for approved royalty rate reductions. Based on this review, recommending to the BLM State Director that the rate reduction either be continued or terminated.

9. Verifying the biennial recertification submitted for approved category 5 royalty rate reductions using the application processing procedures. Based on this review, recommending to the BLM State Director that the rate reduction either be continued or terminated. The recertification process should be conducted within a 6-month period following the second anniversary date of an approved royalty rate reduction. Approved recertification shall be retroactive to the anniversary date.

H. The District Managers are responsible for determining whether the lease(s) contained in the application is part of the ongoing mining operation specified in the application or will be in production within 12 months. The District Managers are also responsible for:

1. Analyzing the likely effects of the rate reduction on the conservation of the resource and enhancement of recovery as a result of approval or denial of the royalty rate reduction.

2. Making a determination that the mine is operating at an acceptable level of efficiency in relation to current standard industry operating practices in that area.

3. Monitoring the ongoing mining operation with an approved royalty rate reduction during regular inspections to ascertain whether conditions that warranted the approved rate reduction continue to exist and whether the information submitted in the application is compatible with the actual mining situation observed and current standard industry operating practices.

4. Ensuring correct production allocation for royalty purposes as part of the production verification activities for the lease(s)

5. Submitting a written report of the circumstances to the BLM Deputy State Director for Mineral Resources for review and appropriate action when it is determined that the conditions, that warranted the approved rate reduction have changed or no longer exist.

I. Minerals Management Service (MMS) is responsible for collecting royalty and rental payments. The MMS is also responsible for:

1. Consulting, upon request by BLM, on any royalty rate reduction application containing financial data.

2. Reviewing the applicant's financial and accounting records for the operation.

3. Auditing the applicant's accounting records.

4. Reporting on the findings of the MMS review of the financial data.

5. Reviewing and reporting on the rent and royalty payments status to the BLM State Director for all applications received.

.05 References.

A. Secretarial Order 3087 (December 3, 1982) and Change 1 (February 7, 1983).

B. BLM-MMS Memorandum of Understanding, dated:
January 4, 1989.

C. 93 I.B.L.A. 317; Peabody Coal Company; 1986.

D. Solicitor's Opinion: M-36920, 87 I.D. 69 (1979).

E. The BLM study "The Competitive Position of Federal Coal in North Dakota, Alabama, and Oklahoma."

.06 Policy.

See BLM Manual Section 3400.06.

.07 File and Records Maintenance.

Many files and records relating to royalty rate reduction applications contain economic data and data from which lease-specific recoverable coal reserve determinations can be calculated. These data are proprietary and must be handled in accordance with the provisions of 43 CFR 2, 43 CFR 3481.3, and BLM Manual Section 1278. Unauthorized release of proprietary data may violate 18 U.S.C. 1905. All data, documents, and analyses shall be retained in the case file until the termination or expiration of any approved royalty reduction or resolution of any appeal; thereafter, these documents are to be handled in accordance with the standard BLM records retention policies.

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.1 Reports. (Reserved)

.2 Royalties.

.21 Advance Royalty. (Reserved)

.22 Overriding Royalties. (Reserved)

.23 Royalty Reductions.

A. Royalty Reduction Policy.

1. A royalty rate reduction may be granted for the purpose of encouraging the greatest ultimate recovery of Federal coal, and in the interest of conservation of Federal coal and other resources, whenever it is determined to be necessary to promote development or a finding is made that the Federal coal lease cannot be successfully operated under its terms. Two essential elements of Section 39, of the Mineral Leasing Act (MLA) (30 U.S.C. 209), must both be met to qualify for a rate reduction:

a. The royalty rate reduction would encourage the greatest ultimate recovery.

b. The royalty rate reduction would be in the interest of conservation of natural resources,

2. After a lessee qualifies under the two criteria of .23A1, above, a rate reduction may be granted only whenever, in the Secretary's judgment, it is necessary:

a. To promote development; or

b. The lease cannot be successfully operated under the lease terms.

3. Upon application, a royalty rate reduction for a Federal and lease may be granted to promote development by:

a. Providing incentive to extract Federal coal resources not recoverable under the current standard industry operating practices and that would be bypassed.

b. Providing incentive to extract Federal coal resources that would be forgone when a mine ceases operations permanently; or

c. Granting temporary relief for Federal coal leases in States or Areas where: the Federal Government is not market dominant; coal would be bypassed or not developed due to the royalty rate differential; these conditions are evident throughout a State or Area; and royalty rate reduction is not likely to result in undue competitive advantages over neighboring States or Areas.

4. Also upon application, a royalty rate reduction for a Federal coal lease may be granted for temporary relief for Federal coal leases that cannot be successfully operated under the lease-specific production royalty rate when it can be shown that the Federal coal resource is not economic, i.e., the ease operating costs have exceeded lease production revenue and this condition is projected to continue.

5. The Federal production royalty, but not advance royalty, may be reduced on a Federal coal lease or portion thereof segregated for royalty purposes.

6. Royalty rate reductions may be considered under any of the following five Categories:

a. <u>Category 1, Expanded Recovery</u>: A royalty rate reduction granted to a preset level of 8 percent or 5 percent for surface and underground operations, respectively, using the expanded recovery criteria of this Manual Section.

b. <u>Category 2, Extension of Mine Life</u>: A royalty rate reduction grated to a preset level of 8 percent or 5 percent for surface and underground operations, respectively, using the extension of mine life criteria of this Manual Section.

c. <u>Category 3, Financial Test - Unsuccessful Operations</u>: A royalty rate reduction granted to as low as 2 percent using the financial test for unsuccessful operations criteria of this Manual Section.

d. <u>Category 4, Financial Test/Expanded Recovery/Extension of Mine Life</u>: A royalty rate reduction granted to as low as 2 percent using the financial test for either expanded recovery or extension of mine life criteria of this Manual Section.

e. <u>Category 5, Statewide or Area-wide</u>: A royalty rate reduction granted to as low as 2 percent using the Statewide or Area-wide royalty rate reduction criteria of this Manual Section.

B. Legal Considerations.

The qualification criteria for a royalty rate reduction are derived from the laws, regulations, Solicitor's Opinions, Interior Board of Land Appeals (IBLA) decisions, court decisions, and Departmental policy.

1. The IBLA has ruled that the limiting word in the language of Section 39 is "necessary" because "any liberality in granting royalty rate reduction requests would seriously undermine Congress' intent in establishing a minimum production royalty." (Peabody Coal Company, 93 IBLA 317, 325 (1986).

2. The provisions of 30 U.S.C. 209 specify no circumstance in which the secretary is required to reduce the royalty rate. The authority conferred by 30 U.S.C. 209 is discretionary, and thus enables the BLM to exercise professional judgment to make decisions which best protect the economic and resource interest of the United States as owner of the mineral estate (Peabody Coal Company, supra at 326, 328 and 334).

3. When a Federal coal lessee applies for a royalty rate reduction under 30 U.S.C. 209 (1982), BLM cannot disregard the fact that the lessee's contracts with its customers provide for passing the royalty through to them. This fact is relevant to a determination of the royalty relief and must be consider 30 U.S.C. 209 (1982) (Peabody Coal Company, 93 IBLA 317 (1986)).

4. If a lessee could establish the failure to reduce the royalty rate would force its customers to curtail their demand to the extent that operations on the lease would cease, the existence of the pass-through provision would not stand as an obstacle to relief (Peabody Coal Company, 93 IBLA 341 (1986).

5. On the basis of material that a lessee submits in its application for a royalty rate reduction, BLM must be able to find that there is a reasonable probability operations would cease, or development recovery, or conservation of the resource would be jeopardized before it can consider exercising its discretion to grant relief. Also, the BLM must judge that the leased deposits could not be operated more efficiently than by the existing lessee. BLM must conclude, on the basis of the materials submitted, that granting a reduction would best serve the interests of the Federal Government (Peabody Coal, I.D. at 321, 326, and 327).

C. General Requirements.

1. Ongoing Mining Operation. Leases need not be producing at the time a royalty rate reduction is submitted, as currently allowed under 43 CFR 3485.2(c)(2)(ii). If the Federal lease included in a royalty rate reduction application is not part of nor adjoining an operating mine the detailed financial data required by 43 CFR 3485.2(c)(2)(ii) may be obtained from another mine which is in close proximity and for which the BLM State Director has deemed to have similar operating characteristics.

2. Minimum Lease Production royalty Rates Set by Statute and Regulation. The MLA requires a statutory minimum production royalty rate of 12-½ percent for surface-mined coal (30 U.S.C. 207, 1982); the production royalty rate of 8 percent for underground-mined coal is set by regulation (43 CFR 3473.3-2(a)(2)). The statutory and regulatory minimum rates, or higher rates, specified in the lease documents at the time of issuance or readjustment, are unaltered by any approved temporary royalty rate reduction.

3. Royalty Rate Reduction Floor. Although neither the MLA nor the regulations under 43 CFR Group 3400 set the minimum production royalty allowable under a royalty rate reduction, no Federal coal lease production royalty rate may be reduced below 2 percent of the value of the coal.

4. Reduction at Time of Lease Issuance or Readjustment. Royalty rate reduction applications shall be acted upon separately from lease issuance or lease readjustment. In no case may a reduction in royalty rate, as determined in accordance with 43 CFR 3485.2(c), be specified in the terms of an initial lease issuance, or in lease readjustment terms. Any royalty rate reduction relief afforded must occur apart from establishment of basic lease terms (Solicitor's Opinion: M-36920, 87 I.D. 69, 1979, and Peabody Coal, I.D. at 324 and 325).

5. Effect on Advance Royalty. A royalty rate reduction shall have no effect on the payment of advance royalty in lieu of production in commercial quantities. Advance royalty must be paid at the production rate(s) specified in Federal coal lease or logical mining unit (LMU) approval documents. The utilization of advance royalty payments as a cost shall not be permitted under any financial test category application.

6. Effective Date and Excess Royalties.

a. If approved, the royalty rate reduction shall take effect at the start of the first royalty reporting period following receipt by the BLM State Office of a complete application.

b. Excess royalties paid on production between the submittal of the royalty rate reduction application and the approval date shall be recouped as a credit from prospective production royalty payments. In no case shall a lessee by entitled to or ever receive cash refund once a royalty rate reduction has been approved. A lessee may recoup past royalty overpayments only from succeeding period royalty obligations for the same lease account for which a royalty rate reduction has been granted. Reporting of royalty recoupments shall be made in accordance with the Minerals Management Service's (MMS's) Payor Handbook.

7. Associated Minerals. The income from any associated minerals, including byproducts, co-produced minerals, or other recovered products upon which a Federal royalty is paid, also shall be included when evaluating a royalty rate reduction application under either financial test category.

8. Production During Mine Development. Production from an operation in a developmental stage shall not be considered for a royalty rate reduction.

9. Bonus Royalty. There is no authority for reduction of the "bonus portion" of a production royalty, just as there is no authority for refund of a cash bonus. The "bonus portion" of the production royalty can be determined by subtracting the statutory/regulatory minimum royalty rate from the royalty rate specified in the lease.

10. Reduced Royalty Minimums.

a. The preset minimum reduced royalty rate for either category 1 or category 2 is 8 percent and 5 percent for surface and underground respectively. If the lease has a "bonus" royalty, the "bonus" portion is added to the 8 percent surface and underground minimum reduced royalty, respectively.

b. The minimum reduced royalty rate for either category 3 or category 4 is 2 percent. If the lease has a "bonus" royalty, the "bonus" portion is added to the 2 percent minimum reduced royalty.

c. The minimum royalty rate for category 5 is the established competitive royalty rate or 2 percent, whichever is greater? If the lease has a "bonus" royalty, the "bonus" portion is added to the greater of the established competitive royalty rate or 2 percent.

11. Effect on Lease Production Royalty Rate. A royalty rate reduction does not constitute a change in the permanent production royalty rate specified in the lease document.

12. Accounting and Auditing of Financial Data. In accordance with the BLM-MMS Memorandum of Understanding (January 4, 1989), any royalty rate reduction application containing financial data may be routed to the MMS for consultation and determination on accounting, auditing, financial and product-value factors. Upon request by BLM, the MMS shall review the applicant's financial and accounting records for the operation and provide the BLM with a written report on the findings of the MMS review.

13. Lease Account Status. The MMS shall also review and report on the rent and royalty payment status to the BLM State Director for all applications received. No application shall be approved unless the rent and royalty (including advance royalty) payments are current.

14. Cost Reduction Measures.

a. In determining whether a royalty rate reduction is warranted, the BLM shall consider whether operations are being conducted in a reasonable and prudent manner and whether the lessee has taken steps to lower lease operating costs.

b. The BLM State Director may disapprove applications where the operator is clearly utilizing mining practices inconsistent with current standard industry operating practices or has made little or no effort to reduce operating costs and/or to increase operating revenue.

15. Duration, Recertification and Termination. The reduced royalty rate shall be only applicable to the Federal coal included in the application. Any other leased Federal coal will be mined at the rates specified in the lease terms.

a. Duration. For royalty rate reductions approved under the expanded recovery (category 1) and extension of mine life (category 2), the term of the rate reduction shall last as long as the Federal ease coal reserves identified in the approved application are being mined. Royalty rate reductions granted under either financial test category (categories 3 and 4) shall carry a term of 2 years. For royalty rate reductions approved under category 5, the term of the rate reduction shall be the shorter of either: as long as the Federal lease coal reserves identified in the approved application are being mined (provided that the applicant can continue to justify the need for a reduction in its biennial recertification); or until the next biennial recertification of the approved reduction in a recently disqualified area.

b. Recertification.

(1) Lessees receiving a reduced royalty rate under any category, except category 5, must submit, on or before the anniversary date, a certified statement that the conditions that justified the granting of the reduction continue to exist. Failure to submit this annual certification shall result in the immediate termination of the royalty rate reduction, at which time the production royalty rate shall automatically revert to the production royalty rate specified in the lease.

(2) For approved royalty rate reductions in category 5, the lessee must submit a recertification on the second anniversary date, and biennially thereafter, consisting of an updated justification, rationale, an supporting data of the same detail as provided in the original application.

c. Termination. The BLM State Director may terminate any approved royalty rate reduction that is no longer necessary (including individually approved applications under category 5). In addition, if an area is subsequently disqualified under category 5, each approved category 5 royalty reduction in that disqualified area shall terminate on the second anniversary of the effective date for that approved royalty rate reduction.

16. Transferability.

a. Royalty rate reductions approved under the expanded recovery (category 1) and extension of mine life (category 2) are transferable with the lease, provided all lease payments are current and the lease accounts are in good standing.

b. For royalty rate reductions approved under either of the two financial test categories (categories 3 and 4), a business transaction interpreted by the BLM State Director to be a de facto transfer of ownership of the lease will void the royalty rate reduction unless the lessee certifies in a manner acceptable to the BLM State Director that such transfer results in no change in the lease operating costs, lease production revenue, or accounting procedures.

c. The new lessee (transferee) may apply for a new royalty rate reduction under the applicable regulations and policy. This restriction applies to:

(1) Any total or partial transfer of interest in any lease for which a royalty rate reduction had been granted.

(2) The sale of a controlling interest in any company holding an interest in the lease.

d. Royalty rate reductions approved under category 5 are transferable with the lease provided that the new lessee (transferee certifies in a manner acceptable to the BLM State Director that such transfer results in no significant change to the royalty rate reduction qualifying conditions as specified in the transferor's approved application.

17. Final Certification of Financial-Test Applications.

a. Within 120 days following the expiration of a royalty rate reduction approved under either of the two financial test categories (categories 3 and 4), the lessee must provide a certified financial statement showing whether, and to what extent, the operation achieved positive net lease income over the course of the 2-year term of the approved royalty rate reduction. Additionally, for applications approved under the financial test category for unsuccessful operations (category 3) the certification must show whether and to what extent net lease income exceed the loss reported in the applicant's historical 12-month test period.

b. For royalty rate reductions granted under the financial test category for expanded recovery/extension of mine life. The certified financial statement must identify any operating margin above cash operating costs that exceeded the permissible operating margin approved for the term of the royalty rate reduction.

c. Any net lease income, or operating margin above cash operating costs, earned above the allowable level shall be reported to the MMS up to an amount corresponding to full recovery of the Federal Government's appropriate royalty share. The MMS shall assess charges for late payments and any late reports in accordance with MMS procedures.

18. Expiration and Reapplication Procedures.

a. Upon expiration of the term of the approved royalty rate reduction or upon termination by the BLM State Director, the production royalty rate reverts automatically to the production royalty rate specified in the lease document, without subsequent notification to the lessee.

b. Any application to continue a previously approved royalty rate reduction beyond its initial term shall be considered a "new " application. jA "new" application to continue a previously approved royalty rate reduction may not be submitted prior to 120 days before expiration of the term of the approved royalty rate reduction.

D. Establishing Royalty Rate Differentials for States or Areas.

1. Petition Process and Content.

a. Petition Process.

(1) The BLM shall accept petitions requesting a qualification determination to be performed for specific States or Areas. Those petitions must be filed in the appropriate BLM State Office and specifically request a determination under category 5 criteria.

(2) Petitions may be accepted from entities including Federal coal lessees, trade associations, and State Governors. The petition must represent a significant interest in Federal coal within the area specified in the petition before the BLM initiates a category 5 area qualification determination.

b. Petition Content.

(1) Petitions must contain statements that establish:

(a) The existence of royalty rate differentials between Federal and non-Federal coal leases.

(b) That these royalty rate differences are evident within the entire area defined in the petition.

(c) The non-Federal royalty rates are significantly lower than the Federal royalty rate, thus causing Federal coal reserves to be bypassed or to remain undeveloped.

(d) That such royalty rate differential is causing or has caused Federal coal to be bypassed.

(2) Statements contained in a petition regarding the existence of royalty rate differentials should be supported by information on specific non-Federal coal lease royalty rates, non-Federal coal production, and non-Federal recoverable reserves included in an approved Surface Mining Control and Reclamation Act (SMCRA) permit.

(3) The non-Federal coal royalty rates should be segregated by type of coal (i.e., bituminous, subbituminous, lignite, etc.), and by mining method (surface or underground). A historical perspective regarding the setting of non-Federal coal royalty rates should be included, if available.

(4) The petitioner shall be given an opportunity for correction of inadequacies regarding the above information.

2. <u>Statewide or Area-wide Qualification Procedures</u>.

a. Given the presence of sufficient information suggesting that a State or Area should be considered under category 5, the following are criteria that should be identified in an analysis to determine the eligibility of States or Areas in the petition.

b. To qualify for royalty rate reduction consideration, the BLM analysis conducted for States or Areas must conclude that:

(1) The Federal Government is not market dominant.

(2) Federal royalty rates are above the current market royalty rate for non-Federal coal in the area.

(3) Federal coal would be bypassed or remain undeveloped due to the royalty rate differential.

(4) The above conditions exist throughout the State or Area.

(5) A category 5 royalty rate reduction is not likely to result in undue competitive advantage over neighboring areas.

c. The State or Area included in the petition will not qualify for a category 5 royalty rate reduction, unless all five of the above-specified criteria are affirmed by the BLM.

d. After a State or Area qualifies under these five criteria, a competitive royalty rate shall be established by the BLM for the qualified State or Area. Following the establishment of the royalty rate to be used for reductions under category 5 for States or Areas, applications shall be accepted for consideration for royalty relief under category 5.

e. A determination of competitive royalty rates for specific States or Areas shall be made by the BLM State Director, considering the assessment of a BLM evaluation team. The BLM State Director may solicit comparable information regarding royalty rates for non-Federal coal reserves having recent production within or surrounding the area under consideration.

f. The non-Federal coal royalty rate information should be segregated by rank of coal (i.e., bituminous, subbituminous, lignite, etc.) and by mining method (surface or underground). A weighted average of the non-Federal coal royalty rates for each rank of coal, segregated by mining method, should be used in establishing the competitive royalty rate for royalty rate reductions under category 5. The weighted average royalty rate may be established using non-Federal lease production.

g. In establishing a comparable, competitive Federal royalty rate for category 5 royalty rate reductions, the BLM evaluation team's assessment may factor in other costs associated with the leasing of Federal coal (such as annual rental fees) provided that the assessment fully explains such cost item and how the items contribute to the uncompetitiveness of the Federal coal reserve and to the potential bypass of the Federal reserve.

h. Alternatively, non-federal production by mine or producing non-Federal reserves may be used in lieu of non-Federal lease production statistics. If information (such as lease specific production or producing reserves) on non-Federal leases cannot be obtained, then the BLM may base the competitive royalty rate on a simple average of the prevailing royalty rates for leased non-Federal recoverable coal reserves associated with current or recent production.

i. A competitive royalty rate shall be established for each State or Area that has qualified for a reduction under category 5.

j. Prior to notification of the Governor or petitioner, the BLM State Director shall submit the geographic area qualification decision document that includes:

(1) The geographic area boundary determination.

(2) Competitive royalty rate analysis by region and findings of the neighboring area impact analysis to the Washington Office for review and BLM Director's concurrence.

k. Upon concurrence, this competitive royalty rate shall be published locally in each qualified State or Area and the rate shall be used for all category 5 royalty rate reductions within each respective State or Area.

l. A review of the competitive royalty rate is to be conducted at the Discretion of the BLM State Director when found that an adjustment is necessary but no later than 5 years. The adjusted rate should be determined from new information on non-Federal coal royalty rates associated with non-Federal production or recent production and calculated according to the above procedures.

m. When the review of an area is necessary, BLM State Office personnel shall:

(1) Conduct a reassessment of the conditions in approved areas, using the qualification criteria.

(2) Make a new, updated royalty rate determination.

n. In conducting the reassessment of the qualifying area, if the BLM State Director determines that any of the five qualifying criteria is no longer met, thus disqualifying the area, then category 5 royalty rate reduction applications and lessee recertification shall not be accepted by the BLM in the disqualified area. Also, for previously approved category 5 applications in the disqualified area, the royalty rate shall automatically revert to the rate established by statute or regulations or as specified in the lease document on the second anniversary date.

E. Application Content.

1. All royalty rate reduction applications must identify the Federal lease number and lease record-title holder and must be filed in triplicate with the appropriate BLM State Director.

2. Each application must demonstrate that the royalty rate reduction will encourage the greatest ultimate recovery of the resource and is in the interest of conservation of the resource.

3. Each application must illustrate how the royalty rate reduction will promote development and/or explain why the lease cannot be successfully operated under the existing royalty rate.

4. Every application must also state and explain the basis for the need for a royalty rate reduction and specify the royalty rate requested.

5. The BLM may require supplementary information before processing an application and shall refrain from processing an application deemed to contain insufficient , unreasonable, or unsubstantiated information until requested modifications have been made and the application is deemed complete, containing sufficient information to ensure a fully documented decision.

F. Evaluation Criteria.

Each royalty rate reduction application shall be evaluated by the BLM based upon the following criteria. Evaluation criteria will differ for applications submitted under each of the five categories of royalty rate reductions.

1. Expanded Recovery (Category 1) and Extension of Mine Life (Category 2). Evaluation of applications submitted under either expanded recovery (category 1) or extension of mine life (category 2), shall be based on:

a. Lease-specific geologic conditions and associated mining engineering factors presented in an approved mining plan (or approved resource recovery and protection plan).

b. On a comparison of lease production royalty rate terms with those of a non-Federal lease that would be part of the near-term mining sequence within the same operation if the preset reduced royalty rate levels of 8 percent and 5 percent for surface and underground coal leases, respectively, are requested.

c. If a further royalty rate reduction below these preset levels is requested under the expanded recovery or extension of mine life criteria, the application shall be evaluated under category 4, a hybrid financial test that is based on promoting development and financially unsuccessful operations requiring submission of lease operating-cost and revenue data.

d. Only those resources within an approved mining plan that meet either test described above shall be considered for a royalty rate reduction under the expanded recovery and extension of mine life categories. Under the expanded recovery or extension of mine life category, an application must state the extent and location of the additional resources that would be mined as a result of the reduced royalty rate. These resources must be judged by the BLM to be either:

(1) Economically unrecoverable without a royalty rate reduction, based on adverse geologic and engineering conditions using current standard industry operating practices; or

(2) Less economically recoverable than resources on non-Federal leases with lower royalty rates that would be part of the near-term mining sequence within the same operation, all geologic and mining conditions being the same or similar.

e. If a determination is made that a reduction in the production royalty rate would encourage the greatest ultimate recovery of the resource, be in the interest of conservation, and promote development, then the application may be approved by the BLM State Director.

f. For royalty rate reductions which are based solely on geological and mining engineering factors, the BLM State Director shall be responsible for determining whether the rate reduction is justified, based on BLM engineering and geologic reports, resource conservation considerations and MMS input on the lease-account status.

2. Unsuccessful Operations: Financial Test (Category 3).

a. Applications under category 3, the financial test category for unsuccessful operations, must present lease operating-cost and revenue data that show the mine to have operated at a loss for the most recent historic 12-month test period and a projection that this condition will continue for the next 24 months.

b. Applicants for a category 3 royalty rate reduction must submit for analysis financial data showing that "the lease cannot be successfully operated under the terms therein." Evaluation of whether an operation has "successfully operated" does not imply that the Federal royalty rate must be reduced to guarantee profitable conditions throughout the life of a mine.

c. For applications under this category, a comprehensive evaluation shall be conducted considering historical and projected direct annual operating costs (no consideration will be given to "indirect" costs) and revenue associated with the mine and lease to determine the royalty rate reduction needed to reduce losses on lease operations for the prospective 2-year royalty rate reduction period.

d. The BLM shall conduct the financial analysis and review the mining operations.

(1) In accordance with the BLM-MMS Memorandum of Understanding (January 4, 1989), MMS expertise will be utilized in evaluating whether the accounting and financial information submitted by the applicant is consistent with the ongoing mining operation, as characterized by the BLM.

(2) The BLM review shall determine if there is a probability that the leased Federal coal will remain unmined for the foreseeable future unless a temporary royalty rate reduction is granted.

e. The BLM also must establish that the royalty rate reduction will encourage the greatest ultimate recovery and conservation of the natural resources and is necessary.

3. Expanded Recovery/Extension of Mine Life: Financial Test (Category 4). The financial test associated with expanded recovery/extension of mine life requires submittal of less detailed financial data than the financial test for unsuccessful operations.

a. The BLM State Director shall review all data and MMS input and base approval or disapproved on answers to the following questions:

(1) Does financial data show that the projected operating margin above cash operating costs for the lease resources to which the royalty rate reduction would apply is less than the average operating margin above cash operating costs for mines in that region having recent representative spot sales and new long-term contract sales? Or, if such sales price data is either unavailable or not representative of the market, is the lessee's operating margin above cash operating costs less than the margin that appears to be needed for alternative reserve development and production in that region? Alternatively, the BLM authorized officer may use, in lieu of the above described options, the Long-Term Treasury Securities' average percentage yield to maturity (the maturity should be similar to the term of the royalty rate reduction) as most recently published by the Federal Reserve Bank as an acceptable operating margin above cash operating costs for the lease resources to which the royalty rate reduction would apply.

(2) Is the lowering the royalty rate necessary to prevent the permanent loss of these resources?

b. If both questions can be answered in the affirmative, the BLM State Director may reduce the royalty rate to the higher of:

(1) The rate requested by the qualifying applicant.

(2) A rate, based on a projection of the data supplied, that would result in an operating margin above cash operating costs equal to either the average of operating margins above cash operating costs for mines in that region having recent spot sales and new long-term contract sales, or the estimated margin needed for alternative reserve development and production in that region when recent sales data is lacking.

(3) A rate, based on a projection of the data supplied that would result in an operating margin above cash operating costs equal to the Long-Term Treasury Securities' average percentage yield to maturity (the maturity should be similar to the term of the royalty rate reduction as most recently published by the Federal Reserve Bank.

c. In cases of bypass, a rate equivalent to the royalty rate on the non-Federal lease that would be mined if the Federal lease resources are bypassed. This decision and its underlying analysis will be documented and explained in the BLM State Director's Decision Document.

4. Statewide or Area-wide Royalty Rate Differentials. Evaluation of applications submitted for reductions for category 5, Statewide or Area-wide royalty rate differentials, shall be based on an assessment by BLM that Federal coal reserves shall be bypassed or remain undeveloped due to the differential between Federal coal and non-Federal coal royalty rates. The applications must also specify which Federal coal reserves, if any, are sold under contracts or agreements that contain royalty pass-through clauses. If further royalty rate reduction (below the established competitive royalty rate) is required, then an application may be submitted for consideration under the financial test category for unsuccessful operations (category 3) or other appropriate category.

G. Processing Procedures.

1. Detailed Processing Procedures. (Reserved)

2. State Director's Area Qualification Decision Document. For category 5, the BLM State Director's Decision Document shall be consistent with 93 IBLA 327 and include:

a. The geographic area boundary determination.

b. The qualification decision for the geographic area.

c. The competitive royalty rate analysis by region within the State

d. The findings of the neighboring area impact analysis.

3. State Director's Decision Document. No proprietary data shall be included in the BLM State Director's Decision Document. The BLM State Director's Decision Document shall be consistent with 93 IBLA 327, and include:

a. The determination on the royalty rate reduction application.

b. The reduced royalty rate and duration (if the application is to be approved).

c. Findings on greatest ultimate recovery and conservation of natural resources, and promoting development or successful operations, specifying that those requirements are or are not met, and if they are met, how they are met.

d. The MMS finding on the lease-account status, (if appropriate) the MMS findings based on the financial analysis, and the independent CPA report.

e. A finding on the persuasiveness of the certification provided by the lessee concerning expanded recovery or extension of mine life (if applicable), or for either financial test category, and the reasons therefor.

f. The basis underlying a decision (the record of decision) to either approve or disapprove the royalty rate reduction shall be provided as part of the decision document and shall be consistent with 93 IBLA 327.

g. For applications evaluated under expanded recovery or extension of mine life category, the decision document shall contain the BLM analysis of the mine operations.

4. Final Processing of Category 5 Petitions.

a. Once the BLM State Director has determined that the petition is complete and that all supplementary information has been received, the BLM State Director shall forward their draft decision and accompanying analyses on the petition to the Division of Solid Mineral Operations (WO-660) for review and the ensure national policy consistency in processing of petition and for forwarding to the BLM Director for concurrence.

b. Following concurrence by the BLM Director of category 5 Statewide or Area-wide qualification, the BLM State Director shall consult with the appropriate State Governor or designated official on the pending decision. The State Governor shall be provided 30 days for response to such consultation.

(1) After obtaining State Governor's input for category 5, the BLM State Director shall publish both the competitive royalty rate for each qualifying area within the State and the area boundaries. This notice shall also contain sufficient and explanation of the calculation of each qualified area competitive royalty rate necessary for public review and comment on the comparability of Federal and non-Federal royalty rates.

(2) The BLM State Director may begin processing category 5 royalty rate reduction applications.

5. Final Processing of Applications.

a. Once the BLM State Director has determined that the application is complete and that all supplementary information has been received, the BLM State Director shall forward their draft decision and accompanying analyses on the petition to the Division of Solid Mineral Operations (WO-660) for review and to ensure national policy consistency in processing of applications and for forwarding to the BLM Director for concurrence.

b. Following concurrence by the BLM Director, the BLM State Director shall consult with the appropriate State Governor or designated official on the pending decision.

(1) The State Governor shall be provided 30 days for response to such consultation.

(2) After obtaining BLM obtaining BLM Director's concurrence and State Governor's input the BLM State Director may notify the applicant of the decision on the application.

.24 Reworking Waste Piles or Slurry Ponds. (Reserved)

.3 Records.

.31 Records Maintained. Current and accurate records must be maintained.

A. Operators/Lessees.

1. Type, quality, and weight of all coal mined, sold, used on the premises, or otherwise disposed of, and all coal in storage and inventory.

2. Prices received for all coal sold; and to whom and when sold.

B. Licensees.

All coal mined and/or removed.

.32 Retention Period.

All data, documents, and analyses shall be retained in the case file until the termination or expiration of any approved royalty reduction or resolution of any appeal; thereafter, these documents are to be handled in accordance with the standard BLM records retention policies.

.4 BLM Computer Systems.

Whenever any action is taken or information is updated, it is critical that those associated elements of the Solid Leasable Minerals System (SMLS) and the Case Recordation System (CRS) are updated immediately and accurately.

Glossary of Terms

-A-

approval date: for a royalty rate reduction, this means the date of formal notification by the BLM State Director to a lessee that a royalty rate reduction application has been approved.

-B-

bypass: for the purpose of royalty reduction, "bypass coal" means the permanent physical loss of coal, or that the coal would not be economically recoverable by the applicant or subsequent parties and the coal would, in BLM's judgment, not be recovered.

bonus royalty: a "bonus" royalty bid made, in excess of statutory or regulatory minimum-production royalty, in a competitive lease sale in lieu of a cash bonus, that is considered a component of fair market value which the Secretary is required to obtain by statute.

-C-

cash operating costs: lease operating costs less allowable depreciation and amortization.

category 1: a royalty rate reduction granted using the expanded recovery criteria of this Manual Section.

category 2: a royalty rate reduction granted using the extension of mine life criteria of this Manual Section.

category 3: a royalty rate reduction granted using the financial test for unsuccessful operations criteria of this Manual Section.

category 4: a royalty rate reduction granted using the financial test for either expanded recovery or extension of mine life criteria of this Manual Section.

category 5: a royalty rate reduction granted using the Statewide or Area-wide royalty rate reduction criteria of this Manual Section.

certification: a statement that attests to the accuracy and truthfulness of a document prepared by the applicant or by another party.

cost of inventory reduction: the cost of producing Federal coal sold from stockpiles.

-D-

developmental stage: any period when activities conducted on the Federal coal lease by the operator or lessee that are largely to prepare for or significantly expand approved commercial production including, but not limited to, tunneling, drifting, or stripping of overburden.

-E-

effective date: the start of the first royalty reporting period following receipt by the BLM State Office of a complete royalty reduction application package approved in compliance with this Manual Section and other directives.

expanded recovery: a category of royalty rate reductions which allows for recovery of Federal coal that would be left unmined or otherwise bypassed during extraction of Federal coal resources covered in an approved mining plan. The only coal eligible for consideration under this category is either: (a) economically unrecoverable using current standard industry operating practices; or (b) less economically recoverable, based on a comparison of lease production royalty terms, than non-Federal coal that is part of the near-term mining sequence within the same operation, all geologic and associated engineering factors being the same or similar.

extension of mine life: a category of royalty rate reduction that would extend the period during which mining would occur by allowing for the recovery of incremental Federal coal that is economically unrecoverable under current standard industry operating practices without a royalty rate reduction.

-F-

financial test: a method of determining eligibility for royalty rate reduction that relies primarily on the submission of lease operating-cost and lease production-revenue data.

-I-

in the interest of conservation of natural resources: this phrase has been interpreted by the courts at 653 F.2d 595 (1981) to encompass all natural resources, and is not limited to the conservation of coal. Conservation of coal resources means timely and orderly development and prevention of waste.

-L-

<u>lease operating costs</u>: in general, means those costs directly related to the extraction of coal on a Federal coal lease. Explicitly included are such costs as production royalties, excise taxes, and depreciation and amortization for capitalized assets. Explicitly excluded, among others are costs for off-site overhead expense, lease bonus, depletion allowance, state and Federal income taxes, marketing costs, and accountants' fees.

<u>lease production revenue</u>: gross revenue derived from the sale or other disposition of leased Federal coal.

-M-

<u>market dominance</u>: for the purpose of this Manual Section, means the ability of the Federal Government to influence or control the royalty rates set in leases for both Federal and non-Federal reserves issued throughout a specific geographic area for a mineral commodity. For instance, in market dominant areas, the Federal Government has sufficient influence to be able to assume the role of the "royalty rate leader" in the area.

For category 5 royalty rate reductions, a market dominance determination should include consideration of the following factors:

(1) The percentages of leased Federal and leased non-Federal (State and private) recoverable reserves.

(2) The percentage of Federal to non-Federal (State and private) production.

(3) The degree to which the Federal Government can exert influence over the establishment of royalty rates in the area.

<u>mining plan</u>: a plan filed by a lessee with the BLM as required for the mining f coal on a Federal lease, showing the mining methods) to be used, sequence and timing of extraction, percent of coal recovered, schedule for reclamation, and other details of the mining operation as required by Section 7(c) of the MLA and 43 CFR 3480. By regulation, the "mining plan" is the resource recovery and protection plan (R2P2).

-N-

<u>met lease income</u>: Federal lease production revenue minus Federal lease operating costs.

-O-

<u>ongoing mining operation</u>: a Lease is a part of an ongoing mining operation if the lease is included in the same approved mining plan.

<u>operating margin above cash operating costs</u>: a rate of return corresponding to the following formula: (P-C)/C Where P – Selling Price and C – Cash operating costs. Note the term (P-C) is equivalent to "net lease income" before depreciation and amortization are subtracted from lease operating costs.

-R-

<u>royalty pass-through</u>: any agreement that permits an operator to recover the cost of Federal production royalties paid for coal extracted from a Federal lease by passing that portion of the cost above the contract price to the purchaser.

<u>royalty reporting period</u>: the lease-specific time interval for payment of Federal production royalty, which is usually monthly.

-U-

<u>unsuccessful operations</u>: Many successful operations show a profit in some years and a loss in other years. Recognizing this, an operation is unsuccessful whenever it can be demonstrated that aggregate Federal lease operating costs exceeded Federal lease production revenues for the most recent 12-month historical test period and are projected to continue to do so for a prospective 24-month period.

Appendices (1 through 3)

Secretarial Order 3087 (December 3, 1982) and
Change 1 (February 7, 1983)

United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

Order No. 3087

Subject: Organizational Restructuring of the Department of the Interior Minerals Management Functions

Section 1. Purpose. The purpose of this Oder is to abolish the Minerals Management Board, to describe the permanent organizational placement of the Minerals Management Service (MMS) and to consolidate onshore minerals management functions. This organizational restructuring will consolidate minerals management functions to achieve management efficiencies and to integrate multiple land use responsibilities to permit comprehensive resource planning and management.

Section 2. Authority. This Order is issued in accordance with the authority provided by Section 2 of Reorganization Plan No. 3 of 1950 (64 Stat. 1262).

Section 3. Minerals Management Board. The Minerals Management Board, established by Secretarial Order 3071, January 19, 1982, is abolished.

Section 4. Organizational Placement. The Minerals Management Service reports to the Assistant Secretary – Energy and Minerals who exercises Secretarial direction and supervision over the MMS.

Section 5. Transfer of Functions. All functions related to royalty and mineral revenue management, including collection and distribution, within the Bureau of Land Management (BLM) are the responsibility of the MMS. All MMS onshore minerals management functions on non-Indian lands, including resource evaluation approval of drilling permits and mining or production plans, inspection and enforcement, are transferred to the BLM. Those functions now performed by the MMS which are being transferred to the BLM will, in the case of their application to Indian lands, be similarly transferred from the MMS to the Bureau of Indian Affairs.

This Order does not change the responsibilities of the Office of Surface Mining Reclamation and Enforcement under the Surface Mining Control and Reclamation Act.

Section 6. Revocation. Secretarial Order No. 2948, dated October 6, 1972, Division of Responsibility between the BLM and the USGS for Administration of the Mineral Leasing Laws – Onshore, is hereby revoked.

Section 7. Administrative Provisions. The Assistant Secretary – Policy, Budget and Administration, will take appropriate steps to affect the transfer of administrative and other functions, personnel, funds and property to implement the provisions of this Order.

Section 8. Effective Date. This Order is effective immediately. Its provisions will remain in effect until publication in the Departmental Manual or until it is amended, supersede or revoked, whichever occurs first. However, in the absence of the foregoing actions, the provisions of this Order will terminate and be considered obsolete on June 1, 1983.

James G. Watt
Secretary of the Interior

Date: 12/3/82

UNITED STATES DEPARTMENT OF THE INTERIOR
Office of the Secretary
Washington, D. C. 20240

Order No. 3087, Amendment No. 1

Subject: Organizational Restructuring of the Department of the Interior Minerals Management Functions

Section 5 of the Secretary's Order No. 3087, dated December 3, 1982, is amended to read as follows:

"Sec. 5. Transfer of Functions. All functions related to royalty and mineral revenue management are the responsibility of the Minerals Management Service. Those collection and distribution functions within the Bureau of Land Management which are related to royalty and mineral revenue management are transferred to the Minerals Management Service. All Minerals Management Service onshore minerals management functions on Federal and Indian lands, including resource evaluation, approval of drilling permits and mining o production plans, inspection and enforcement, are transferred to the Bureau of Land Management.

This Order does not change the responsibilities of the Office of Surface Mining Reclamation and Enforcement under the surface Mining Control and Reclamation Act."

Secretary of the Interior

Date: Feb 8 1983

93 I.B.L.A 317; Peabody Coal Company; 1986

IN REPLY REFER TO:

United States Department of the Interior

OFFICE OF HEARINGS AND APPEALS
INTERIOR BOARD OF LAND APPEALS
4015 WILSON BOULEVARD
ARLINGTON, VIRGINIA 22203

PEABODY COAL CO.

IBLA 84-380 Decided September 11, 1986

Appeal from a Decision of the Colorado State Office, Bureau of Land Management, denying an application for royalty rate reduction for coal lease C-19885.

Affirmed as modified.

1. Administrative Authority: Estoppel—Appeals—Board of Land Appeals—Federal Employees and Officers: Authority to Bind Government—Public Lands: Administration—Secretary of the Interior.

   Under 43 CFR 4.1, the Board of Land Appeals is empowered to consider and determine issues raised on appeal as fully and finally as might the Secretary. In considering the significance of actions taken by BLM, the Secretary is not estopped by the principles of res judicata or finality of administrative action from correcting or reversing an erroneous decision by his subordinates or predecessor-in-interest. It necessarily follows that the Board, in exercising the Secretary's review authority, is not required to accept as precedent erroneous decisions made by the Secretary's subordinates.

2. Coal Leases and Permits: Leases—Coal Leases and Permits: Royalties—Mineral Leasing Act: Royalties

   Under 30 U.S.C. § 209 (1982), BLM is authorized to reduce the royalty for a coal lease below the minimum

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Specified by statute whenever it is necessary to do so in order to promote development, or whenever the lease cannot be successfully operated under the terms provided therein.

3. Coal Leases and Permits: Leases and Permits: Royalties—Mineral Leasing Act: Royalties

   The provisions of 30 U.S.C. § 209 (1982) specify no circumstances in which BLM is required to reduce the royalty of a coal lease. Under the statute, no entitlement to a reduction can ever arise. BLM remains free to accept the economic consequences of denying a reduction. The discretionary authority conferred by sec. 209 enables BLM to exercise prudent business judgment to select the alternative which best protects the economic interest of the United States as owner of the mineral resource.

4. Coal Leases and Permits: Leases—Coal Leases and Permits: Royalties—Mineral Leasing Act: Royalties

   The “bonus royalty” bid received in a competitive coal lease sale is properly considered a component of a fair market value which the Secretary is required to obtain by terms of statute, 30 U.S.C. § 201(a)(1) (1982), and, hence, there is no authority for reduction of that “bonus royalty” just as there is no authority for refund of a “cash bonus” from a lease sale. However, where protection of the interests of the United States requires a reduction in royalty to ensure successful operation of a lease, 30 U.S.C., § 209 (1982 authorizes reduction of the statutory minimum component of the royalty.

5. Coal, Leases and Permits: Leases—Coal Leases and Permits: Royalties—Mineral Leasing Act: Royalties

   When a coal lessee applies for a royalty reduction under 30 U.S.C. § 209 (1982) , BLM cannot disregard the fact that the lessee’s contracts with its customers provide for passing the royalty through to them. This fact is relevant to a determination of the necessity for royalty relief and must be considered if BLM is not to overstep the authority conferred by 30 U.S.C. § 209 (1982).

APPEARANCES: Michael H. Hyer, Esq., Denver, Colorado, for appellant; Lyle K. Rising, Esq., Office of the Regional Solicitor, for the Bureau of Land Management.

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OPINION BY ADMINISTRATIVE JUDGE ARNESS

Peabody Coal Company (Peabody) appeals from a December 6, 1983, decision of the Colorado State Office, Bureau of Land Management (BLM), denying its application for a 3-year reduction in the royalty rate for coal lease C-19885 from 17.08 to 5 percent. This lease covers approximately 125.16 acres located in lots 5, 6, 7, and 8, sec. 1, T. 5 N., R. 87 W., sixth principal meridian, Routt County, Colorado.

The existing royalty rate of 17.08 percent was selected by Peabody itself as the result of unusual circumstances leading to the issuance of the lease. At the time appellant's lease was issued in 1979, a court had enjoined the Department from issuing coal leases unless there was an on-going mining operation in connection with which the coal could best be removed as part of an orderly mining sequence in order to avoid by-pass of the coal body and a resultant failure to develop the resource. Natural Resources Defense Council v. Hughes, 454 F: Supp. 148 (D.D.C. 1978). The court explained the need for this exception as follows:

> Because of local ownership and reserve patterns, past federal coal leasing practices, and reclamation and other environmental concerns, the failure of the Department to issue a lease to an existing mining operation that could mine an unleased federal coal deposit as part of its ongoing operation may isolate that tract from other coal deposits. This isolation creating "by-passed" coal can make that tract too expensive, either economically or environmentally, to mine in the future. Potentially significant energy supplies which would have been mined with a minimal increment of environmental impact will be lost. Federal royalty receipts, part of which are passed on to the States in which the coal is mined, will also be lost.

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Id. At 156. The coal deposit which is subject to appellant's lease was deemed suitable for a "by-pass" leasing arrangement consistent with the court's order because of its location next to appellant's working, non-Federal coal mine.

Nevertheless, issuance of the lease posed a dilemma: although a competitive lease sale was required by statute, see 30 U.S.C. § 201 (1982), 1/ the terms of the court order limited the prospects for competitive bidding on the tract. Thus, the Department had to establish the fair market value of the lease at the time of the sale in order to ascertain the minimum bid which could be accepted. Normally, Federal leases are issued at a fixed statutory royalty rate to the bidder who submits the highest cash bonus exceeding the minimum bid established by BLM. Had the subject lease been issued in this manner, appellant would have been required to pay a minimum bonus bid of $4,884.90 acre. However, as part of an experimental leasing policy tried by the Department for a short time, bidders were permitted to bid for a higher royalty rate instead of submitting so large a cash bonus. Consequently, appellant was offered the following choice: (1) a lease with a 12-½ percent royalty rate accompanied by a minimum bonus bid of $4,884.90 per acre, or (2) a lease with a 17.08 percent royalty on production coupled with a minimum bonus bid of $25 per acre.

The lease was offered competitively on April 10, 1979. Peabody was the only participant, bidding a $35.35 per acre bonus payment and a 17.08 percent

1/ The terms of 30 U.S.C. § 201(a)(1) also expressly provide: "No bid shall be accepted which is less than the fair market value, as determined by the Secretary, of the coal subject to the lease."

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Bonus royalty. The lease was issued to Peabody effective June 1, 1979. In consideration of Peabody's promise to pay a 17.08 percent royalty and $35.35 per acre, the Government did not exercise its right under 30 U.S.C. § 201 (1982) to require Peabody to pay $4,884.90 for a lease with a 12-½ percent royalty. Peabody now seeks reduction of this royalty to 4 percent.

At first, there may appear to be no avail reason for BLM to relinquish its contractual rights in order to grant such a request from a lessee. However, there may be circumstances where adherence to the original royalty rate would more adversely affect the economic interest of the United States as owner of the mineral deposit than would a reduction of the royalty . The ultimate issue in the adjudication of any royalty reduction request is whether BLM may properly conclude, on the basis of the material submitted by an appellant, that granting a reduction would best serve the interests of the Government.

While the lease is held by Peabody, the coal deposit is within the mine permit area of the Seneca II mine operated jointly by Peabody and Western Utility Operation. In October 1982, mining progress onto the extreme northwest corner of the lease. Although not dedicated to a particular buyer, the coal mined under lease C-19885 is marketable under an existing supply agreement to deliver coal from the Seneca II mine to the nearby Hayden Power Plant. However, because Peabody considers the development of additional markets for this coal essential to the prosperity of its operations, on December 21, 1982, it requested a 3-year royalty rate reduction to 5 percent based on a perception the higher royalty rate would render future sales on the open market unprofitable..

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BLM forwarded the application with its supporting documents to the compliance Division, Minerals Management Service (MMS), for an accounting and audit evaluation. MMS recommended that the request for royalty reduction be denied. After reviewing the application and MMS's recommendation, BLM concluded that "the factors or elements used in the royalty rate calculation (at the time of the lease sale) are still correct and [Peabody] has not shown that the lease cannot be successfully exploited" (Decision at 7). BLM grounded its denial of Peabody's application on a lack of sufficient justification for the request.

In its statement of reasons, Peabody asserts that BLM erred by making the conclusion that the economic factors employed in 1979 to determine the royalty rate may still be relieved upon. Peabody argues the high rate strongly discourages development and that BLM's reference to the royalty "pass through" clause in the coal supply agreement with Hayden Power Plant as a decisive factor was an abuse of discretion, contrary to Department policy, and was inconsistent with BLM's adjudication of other royalty reduction requests. Moreover, Peabody challenges BLM's decision as an irregular "ad hoc" determination made without adequate procedural standards.

Appellant's reference to a Departmental policy raises an initial issue about the scope of this Board's review of BLM's decision. In Kenneth H. Burch, 37 IBLA 346 (1978), we held that under 43 CFR 4.1, the existence of a Secretarial policy limits review by the Board to the question whether the section under review is consistent with that policy. In Blue Star, Inc., 41 IBLA 333, 335 (1979) we observed that an Assistant Secretary "has the

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power to act with finality on matters within his or her own province," and dismissed for lack of jurisdiction an appeal from a decision made at the direction of an Assistant Secretary. The Blue Star decision, however, opined that after an appeal was filed with this Board, subsequent action by an Assistant Secretary could not oust this Board's a jurisdiction under the Blue Star holding.

(1) Under 43 CFR 4.1, this Board is empowered to consider and determine the issues raised in this appeal "as fully and finally as might the Secretary." In considering the significance of actions taken the BLM which have not been reviewed by higher officials, we must bear in mind that the Secretary of the Interior "is not estopped by the principles of res judicata or finality of administrative action from correcting or reversing an erroneous decision by his subordinates or predecessors in interest." Industries, Inc. v. Morton, 542 F.2d 1364, 1367 (9th Cir. 1976). "It necessarily follows that this Board, in exercising the Secretary's review authority, is not required to accept as precedent erroneous decisions made by the Secretary's subordinates." Pathfinder Mines Corp., 70 IBLA 264, 278, 90 I.D. 10, 18 (1983), aff'd, Pathfinder Mines Corp. v. Clark, 620 F. Supp. 336 (D. Ariz.), appeal docketed, No. 85-2834 (9th Cir. Nov. 18, 1985).

The issues raised by Peabody in this appeal are matters of first impression with this Board. While we may certainly take cognizance of actions taken by Departmental officials in other cases, our determination of this appeal is governed only by the pertinent statutory and regulatory

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Provisions. Thus, analysis of the legal issues must begin an examination of those authorities.

(2) Discretionary authority to grant reductions in production royalties is provided in section 39 of the Act, as amended, 30 U.S.C. § 209 (1982:

> The Secretary of the Interior, for the purpose of encouraging the greatest ultimate recovery of coal, oil, gas, oil shale, gilsonite (including all vein-type solid hydrocarbons), phosphate, sodium, potassium and sulphur, and in the interest of conservation of natural resources, is authorized to waive, suspend, or reduce the rental, or minimum royalty, or reduce the royalty on an entire leasehold, or on any tract or portion thereof segregated for royalty purposes, whenever in his judgment it is necessary to do so in order to promote development, or whenever in his judgment the leases cannot be successfully operated under the terms provided therein. [Footnote omitted.]

A request for Federal coal lease royalty reduction is properly made by submission of an application containing specified information. 43 CFR 3485.2(c(2); CF. 43 CFR 3473.3-2(D) (1982). 2, 3/ The authorized BLM

2/ Implementation of section 39 of the Mineral Leasing Act, was first addressed in Circular 1341 at 55 I.D. 67 (1934). However, this reference merely identified the existence and general purpose of the statute and Federal coal lease royalty reduction s were not mentioned. In 1948, regulations were adopted to establish fundamental procedures to be used when applying for reduction of the royalty rate set by a lease for any of the Mineral Leasing Act minerals. These guidelines have been continued to the present with only minor changes and are now found at 43 CFR 3503-2(d). See 13 FR 5641 (Sept. 29, 1948); 29 FR 4509 (Mar. 31, 1964); 35 FR 9708 (June 13, 1970). When a Federal coal management program was developed royalty reduction guidelines specifically designed for Federal coal leases were promulgated and codified at 43 CFR 3473.3-2 (1979). These regulations were transferred to 30 CFR Part 211 (1982) when MMS assumed responsibilities for the coal program, and now appear at 43 CFR 3485.2, since responsibility for royalty reductions has again been transferred to BLM. See 47 FR 33179 (July 30, 1982), 48 FR 41589 (Sept. 16, 1983).

3/ The Department has consistently held that in no case may royalty rates below the statutory minimum be prescribed as the initial or readjusted terms.

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Officer must consider the request and determine whether relief is warranted. 43 CFR 3480.0-6(d)(6), 3485/2(c)(4).

When Congress established a minimum production royalty rate of 12-½ percent for Federal coal leases other than those where coal is recovered by underground mining, 30 U.S.C. § 207 (a) (1982), the Department considered whether this action precluded BLM from granting reductions below that amount under Section 209. The Department concluded that section 209 conferred authority to reduce rates below the statutory minimum. Solicitor's Opinion, 87 I.D. 69 (1979. Any liberality in granting reduction requests, however, would seriously undermine Congress' intent in establishing a minimum production royalty. BLM was mindful of this concern when it issued regulations for its coal management program, and BLM stated the Department's policy in exercising the authority conferred by section 209: "This authority to reduce production royalty below that specified in the lease will be used sparingly, if at all, only upon a convincing showing of hardship, and only for a temporary period or periods on any lease." 44 FR 42584, 42607 (July 19, 1979) (emphasis added).

Why should a lessor ever unilaterally reduce a royalty below the amount it is entitled by law and by contract to receive?: Simply because there may be

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tn. 3 (continued)
of any lease. The relief afforded must occur apart from establishment of the basis lease terms. Sunoco Energy Development Co., 84 IBLA 131, 137 (1984); Mid-Continent Coal & Coke Co., 83 IBLA 56, 63 (1984); Costal States Energy Co., 81 IBLA 171, 179-80(1984); Solicitor's Opinion, 87 I.D. 69 (1979). See Coastal States Energy Co. v. Watt, 629 F. Supp. 9 (D. Utah 1985), affirming Coastal States Energy Co., 70 IBLA 386 (1983); but see FMC Corp., 74 IBLA 389 (1983), Reversed sub nom. FMC Corp. v. Watt, C. 83-047(D. Wyo.), appeal docketed, No. 84-2175 (10th Cir. Aug. 29, 1984), cross appeal docketed, No. 84-2208 (10th Cir. Sept 5, 1984).

Circumstances in which the lessor would avoid a greater economic detriment by doing so. If, for example, the authority conferred by section 209 did not exist, a lessee could seek permission to cease operations under 30 U.S.C. § 207 (1982). BLM would then collect only an advance royalty in lieu of a production royalty. A lessee might also choose to relinquish its lease. If the leased deposits can be leased to someone else who can operate more efficiently, the interest to the public as owner of the deposits would be best served by allowing the original lessee to fail. Often, however, Federal leases comprise part of a larger mining operation, and no other operator could perform more efficiently than the existing lessee. Section 209 provides BLM an alternative to accepting relinquishment of a lease or advance royalty in lieu of production royalty. Thus, section 209 enables BLM to maintain a flow of royalty income, although at a diminished level.

(3) Section 209 specifies no circumstances, which requires BLM to reduce royalty. Under the statute, no entitlement to such a reduction can ever arise. BLM remains free to accept the economic consequences of denying royalty relief, which may vary from case to case. These consequences may be sufficiently severe to compel a lessee to seek suspension of the condition of continued operation under 30 U.S.C. § 207(b) (1982). Or a lessee might be impelled to relinquish the lease. The discretionary authority conferred by section 209 enables BLM to exercise prudent business judgment to accept the alternative that best protects the economic interest of the United States as owner of the miner resource. 4/ It necessarily

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4/ The Federal Government is not the primary beneficiary of BLM's prudent exercise of discretion. Although the United States is the owner of the mineral resource, it keeps only 10 percent of the royalties Peabody pays.

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Follows that if the circumstances of a given case do not confront BLM with such a choice, the case presents no opportunity for BLM to exercise the discretion conferred by section 209. This conclusion is underscored by the fact that section 209 requires BLM to make one of two alternative threshold determinations before its discretionary authority can be invoked: (1) that a reduction "is necessary to promote development," or (1) "the leases cannot be successfully operated under the terms provided therein." On the basis of material that an appellant is required to submit in its application, BLM must be able to find three is a reasonable probability operations would cease or development, recovery, or conservation of the resource would be jeopardized before it can even consider exercising its discretion to grant relief. Otherwise, the Federal mineral owner has nothing gain by reducing the royalty.

Although appellant emphasizes the phrase "to promote development" in the statutory authorization for reducing royalty, appellant fails to notice the statute includes the limiting word "necessary." Because a royalty operates as a direct cost on development, reduction of royalty would almost always promote development, all other things being equal. Thus, the statute cannot be read to authorize reduction of a royalty whenever doing so would promote development; indeed, the statute only authorizes such action where it is necessary. Keeping in mind that such reductions are to be granted for

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tn. 4 (continued)
Under 30 U.S.C. § 191 (Supp. II 1984), the State of Colorado receives 30 percent and the remaining 40 percent is deposited in the Reclamation Fund established under 43 U.S.C. § 391 (1982). The State's entitlement under 30 U.S.C. § 191 (Supp. II 1984) gives it standing to seek judicial review of Departmental decision affecting the amount the State would receive. E.g., Arkla Exploration Co. v. Watt, 548 F. Supp. 466, 472-73 (W.D. Ark. 1982). BLM therefore bears a responsibility to the beneficiaries of the statutory royalty provision to ensure that receipts are not unlawfully diminished.

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“the purpose of encouraging the greatest ultimate recovery of coal,” and “in the interest of conservation of natural resources,” it would not be proper to reduce the royalty if the coal would ultimately be recovered and natural resources conserved in the absence of such a reduction. Unless an applicant shows that these goals cannot be met without a royalty reduction, the statute confers no authority on the Department to grant such a reduction.

Focusing on the second alternative threshold requirement, appellant suggests that the phrase “successfully operated” should be construed to allow a reasonable profit for the lessee. This argument implies that royalty should be reduced whenever a lessee’s profits fall below a “reasonable level. There can be no quarrel with appellant’s expectation of a profit. A business certainly has such a motive when it enters into a contract or lease. It is the lessee, however, not the Government, who assumes the risk arising from changing market conditions and increases in the costs of operations. There is no evidence that Congress enacted section 209 to make BLM the guarantor of its lessee’s profits. Rather, as stated above, section 209 operates to give the government additional options to protect its interest as owner of the mineral deposit if the ultimate recovery from that deposit is threatened or when the ease cannot be operated successfully.

Assuming that royalty reductions are usually based on current operational difficulties, Peabody’s plea that substantially different economic conditions forecast severe financial difficulty for this leased coal deposit is put into perspective by the observation made in one of the few Departmental decisions reviewing denial of royalty reduction of a Federal coal lease:

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It does not follow, merely because costs have gone up by a considerable amount since the date of the issuance of the lease, that it is impossible to operate successfully under this lease or that a reduction in the royalty rate is necessary if the land is to be developed for coal mining purposes.

Sheridan-Wyoming coal Co., A-25845 (June 27, 1950) at 2. The operator in that case showed that increased costs of production indicated the lease could not be profitability developed under the prevailing royalty rate. That argument was rejected and the petition for reduction was denied. The denial was affirmed on appeal.

In addition to the preceding statutory considerations governing the adjudication of applications for royalty relief generally, one other factor effects the disposition of appellant's application. Appellant's lease was not issued for the minimum royalty with a cash bonus; instead of paying a large cash bonus, appellant decided to select a bonus royalty. A bonus offered in the lease bidding process is a payment reflecting the anticipated market value of the coal deposit. Whether the bonus payment is represented by an added royalty percentage or an initial cash outlay, it is an expected expense of developing the lease. There are important differences, however, when a lease is issued on the basis of a non-refundable cash bonus bid, the fair market value of the lease is primarily reflected in the amount of the cash bonus rather than the royalty. Accordingly, reducing the royalty for such a lease usually does not significantly jeopardize receipt of fair market value. If the fair market value has already been substantially met by a cash bonus, the bonus payment, not being a variable cost, does not inhibit

Continued development or threaten the successful operation of a mine. 5/ The effect of a bonus royalty is quite different; it defers BLM's realization of fair market value until the lease has been completely mined. It also adds to a lessee's variable costs, i.e., the costs which can be avoided by curtailment of production.

We Congress was considering coal program amendments to the Mineral Leasing Act of 1920, the Department objected to language which would have precluded the Department form issuing leases on the basis royalty bids. Letter from jack Horton, Assistant Secretary of the Interior, to James A. Haley, Chairman, Committee on Interior and Insular Affairs, House of Representatives (Mar. 13, 1975), H.R. Rep. No. 94-681, p. 28 reprinted in, 1976 U.S. Code Cong. & Ad. News, 1964-65. As finally enacted, 30 U.S.C. § 201 (1982) contains no such prohibition.

Nevertheless, very few bonus royalty leases have issued, and no adjudicative precedent has been established by the Department regarding management of the bonus royalty. The problems relating to bonus royalty leases, however,

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5/ In Chillicothe Sand & Gravel Co. v. Martin "Marietta Corp., 615 F.2d 427, 431, n.5 (7th Cir. 1980), the court defined fixed and variable costs:

"Fixed costs are those costs which, in the short run, do not vary with changes output. Fixed costs generally include items such as management expenses, interest on bonded debt, and other items of irreducible overhead. Variable costs are those costs which in the short run vary with changes in output, including items such as raw materials, labor directly used in production and per unit royalties. Average cost is the sum of fixed cost and total variable cost, divided by output. The definitions of fixed and variable costs are limited to the short run because all costs are considered variable in the long run.

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Have attracted concern, both within the Department and outside. On February 20, 1981, the Director, Office of Coal Leasing, Planning and Coordination, Geological Survey, issued a memorandum setting forth the policy recommendations for 11 coal leases issued at above-minimum royalties. This memorandum was approved by the Deputy Assistant Secretary, Land and Water Resources, on February 25, 1981. Different guidelines have been proposed, but not yet adopted. Draft Revision Royalty Reduction Guidelines for Federal Coal, Phosphate, Potassium, Sodium, Sulphur, and Tar Sand Leases, 50 FR 6062 (Feb. 13, 1985). The policy affecting these leases has been considered by the Government Accounting Office (GAO) in a report dated August 10, 1982. Need for Guidance and Controls on Royalty Act Reductions for Federal Coal Leases, GAO/EMD-82-86. In addition, at pages 211-16 of a report dated February 1984, the Commission on Fair Market Value Policy for Federal Coal Leasing discusses bidding systems for Federal leases, and offers a critical analysis of royalty bidding. The report makes particular reference to coal leases such as appellant's. Although the report recommends that leasing be done on the basis of bonus rather than royalty bidding, it is clear the Department must administer existing bonus royalty leases in a manner consistent with statutory requirements. It must also administer those leases so as to maintain the integrity of the royalty bidding system as long as the statutory authority to conduct royalty bidding remains in effect.

The most significant legal obstacle to reducing the royalty in a bonus royalty lease is the statutory requirement that the Government obtains fair market value as determined at the time of acceptance of the lease. See 30 U.S.C. § 201(a)(1) (1982). Usually this requirement is satisfied when a

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Lessee submits a nonrefundable cash bonus bid. Consequently, the recovery of fair market value is generally not an issue when the bidder of such a lease requests a royalty reduction. Peabody, however, elected to satisfy this requirement with a bonus royalty, deferring BLM's realization of fair market value until the end of the lease term. Therefore, any reduction of royalty in this case may cause a diminution of BLM's realization of the fair market value as that value was determined at the date of lease issuance.

There is one way in which a royalty in a bonus royalty lease can be reduced so as not to violate the requirement that the Government receive fair market value. First, the cash bonus equivalent of the bonus royalty would be calculated as of the date of lease issuance; second, the lessee would be required to submit that about plus interest compounded to the date of application. By proceeding in this fashion, the royalty can be reduced below the 12-½ percent minimum level to the level necessary to ensure successful operation of the lease. Of course, the impracticality of such an approach is obvious. A lessee seeking a reduction might not be in a position to make the required payment, or might choose instead to cease operations or relinquish the lease, thereby diminishing or terminating the flow of royalty payments to the United States. Enforcing the fair market value requirement in this manner could therefore thwart the intent of section 209 that BLM protect the best interest of the United States as the owner of the mineral resource.

Another attempt to reconcile royalty reduction with the fair market value requirement is offered by the 1981 Coal Leasing memorandum cited above. This memorandum suggests dividing the total royalty into two components:

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(1) the statutory minimum of 12-½ percent and (2) the reminder which is termed the bonus royalty. Appellant suggests that under this analysis, the 12-½ percent component of the royalty may be reduced without diminishing the bonus, so the Government's receipt of fair market value would be unaffected. Analysis, however, demonstrates that this approach tends to obscure the fact that appellant is seeking nearly a complete waiver of the statutory royalty. (Only a .43 percent royalty would be left.) One need only compare the consequences of reducing appellant's royalty to 5 percent with the result produced by reducing the royalty of a cash bonus lease to 5 percent. 6/ In the latter situation the royalty would decline from 12.5 percent to 5 percent, a reduction of 7.5 percent. To reduce appellant's 17.08 percent royalty to 5 percent, a 12.08 percent cut is required, which is 4.58 percent more than the 7.5 percent cut required for the same result, if the lease had been a cash bonus lease. This 4.58 percent difference corresponds to the bonus component of the royalty, which appellant had agreed to pay instead of the $4,884.90 per acre bonus bid which represented the fair market value of the lease. Granting appellant's request therefore means that the Government has either surrendered the statutory royalty or waived the bonus royalty. If the former is true, it cannot be in the best interest of the lessor. If the latter, then it is impossible to reconcile the requested reduction of appellant's royalty under section 209 with enforcement of the fair market value requirement of section 201.

6/ **This comparison is justified because the royalty level necessary to allow for successful operation of the leased deposit is the same for appellant's bonus lease as it would be had appellant taken a cash bonus lease instead. Because the cost of a cash bonus is a fixed cost which cannot be avoided by curtailment of lease operations, it has no relevance in considering a lessee's short-term incentive to continue mining. Except for the difference in royalty rates, the variable costs of mining are the same under either lease.**

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Although appellant's application necessarily poses a conflict between these two statutory provisions, the fair market value requirements in section 201 and the relief authority in section 209 have one common objective: the enhancement of the interest of the United States as the owner of the mineral resource. The fair market value requirement was imposed to prevent the United States from leasing resources at less than fair market value. Section 209 ensures the Government will be able to take necessary action when a lease encounters difficulty, in order to see that the economic interests of the United States are not jeopardized.

(4) When the Department saw a similar conflict between section 209 and Congress' specification of a statutory minimum royalty, the Department concluded that section 209 authorized reductions below the specified level. Solicitor's Opinion, supra, 87 I.D. at 69. This construction of the statute assured the Department's ability to take what action was necessary to protect its economic interest. To hold that the fair market value requirement found in section 201 precludes the reduction of any royalty for a bonus royalty lease could frustrate the evident purpose of section 209. Such a construction could force an action which might be economically harmful rather than beneficial. Therefore, it is concluded the statutory objectives are more properly served by holding that, to the extent the interest of the United States may require lowering the statutory minimum royalty (as opposed to the bonus royalty) to whatever level is necessary to ensure successful operation of a lease, section 209 provides such authority. But this holding rests on the premise that section 209 gives BLM authority to grant such relief only when it is in the economic interest of the United States to do so. If the

Statutory authority granted under section 209 were any broader, the fair market value requirement established in section 201 would be defectively nullified. Section 209 cannot be construed so as to provide a loophole for lessees to circumvent the requirement that the Government receive fair market value for a lease as determined by conditions in effect as the time of lease issuance.

There is a second consideration which affects granting reduction of bonus royalty leases: the need to assure the integrity of the royalty bidding program. This concern voiced by the Solicitor is not "spacious" as Peabody suggests (Appellants Reply to BLM's Response at 3). When the Department requested that the coal leasing amendments be drafted to permit royalty bidding, it seemed such a system would encourage greater competition for Federal leases. But if the winner of a bonus royalty lease would later obtain a reduction of royalty below the rate bid by the next highest bidder, such action would be unfair to all potential bidders and would ultimately work against the interest of the United States as the owner of the mineral resource. If appellant were correct in contending that section 209 authorizes the reduction of royalty to a level necessary to provide a lessee with some degree of profit, bidder for royalty bonus leases would have no incentive to base their bids upon market values. Rather, they would be induced to bid royalty rates at whatever level was necessary to win the lease, knowing their bids would not set the rate under which they would ultimately be required to operate.

It is not suggested Peabody selected the 17.08 percent royalty for this lease with the intent to avoid the cash bonus and later have the royalty reduced to a more profitable level. It is clear, however, that the availability of relief undermines the incentives which are necessary for a fair and successful royalty bidding system. Although denying royalty relief may in a particular case work to the disadvantage of the United States, the availability of relief for bonus royalty leases may so modify the incentives of the participants in royalty bidding that the United States would possibly be better served by exercising its discretionary authority to categorically exclude bonus royalty leases from relief under section 209. For the purposes of this appeal, however, the Solicitor contends it is not necessary to go so far in order to deny Peabody's application:

> **To allow Peabody to ("be relieved of keeping its bargain") is to invite acceptance of high royalty rates, instead of cash bonuses, know that the company can always obtain a royalty reduction if it guesses wrong on future market conditions. By analogy, if BLM were to sell the fee interest in coal lands for the fair market value at the time (say, 1979) and then 3 years later the buyer wanted a rebate of the purchase price due to cha[n]ged market conditions, the BLM would not even entertain the idea, nor would any private landowner, nor would any court. Neither should BLM do so here. What BLM can do is apply its royalty reduction standards, which requires that the operator show operation to be possible only at a loss. There is nothing in that standard which allows subsidizing management's erroneous prediction as to market conditions.**
>
> (Solicitor's Brief at 7).

Having stated the general legal considerations governing the adjudication of a request for reduction of royalty in bonus royalty leases, the particular contentions raised by appellant's application can be addressed. As a threshold matter, appellant's application must provide a basis for concluding

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The lease cannot be successfully operated at the existing royalty rate, or that a reduction of that rate is necessary to promote development of the lease.

Appellant asserts it has shown the existence of an unusual economic condition not encountered when the royalty rate was established in 1979. The application, however, discusses only marketing problems and no assertion is made concerning operation, engineering, or resource-related difficulties arising from conditions on the tract or the nature of the coal. Peabody complains the royalty rate is substantially higher than royalties paid on nearby coal reserves and that inclusion of this federal coal under its existing coal supply agreement would jeopardize the amount ordered because of its higher price. However, the Seneca II mine has been generally operated by appellant at a profit despite an average price per ton well below the market for the coal sold to Hayden Power Plant. While the low price may be due to pricing provisions in the supply agreement, a September 22, 1981, amendment to the agreement permits Peabody to charge the buyer for increases in actual rents and royalties paid to obtain the coal. Even with the added royalty expense for coal from lease C-19885, the total price per ton of such coal delivered to Hayden Power Plant appears to be below the prevailing market. Hence, the coal extracted from lease C-19885 and sold to Hayden Power plant would be unaffected by a royalty reduction.

A royalty reduction would therefore merely reduce the uncertainty associated with the opening of new markets. Peabody's prediction for profitable mining of the lease deposit for sale on the open market rests upon its analysis of profit margins and rates of return. Peabody claims that, despite its

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advantageous position to mine C-19885, under the Seneca II mine operations, its projected rates of return with a 17.08 percent royalty, are below minimum levels necessary to justify continued investment in the lease. However, MMS experts reviewed the financial data presented by Peabody and concluded the adjusted rate of return, based on a cash flow determination including depreciation and depletion factors, would be acceptable under industry standards. MMS therefore recommended denial of the request.

Peabody refers to the August 10, 1982, report prepared by the Comptroller General, General Accounting Office, concerning controls on royalty rate reduction for Federal coal leases, and claims BLM's decision violated due process criteria because the decision process lacked proper guidelines or standards. The applicable statute, however, establishes threshold requirements that must be met before royalty reduction can be granted: unless Peabody's application shows that one of the two alternative threshold requirements established by section 209 has been met, this argument raises no issues of dispositive significance.

The GAO report discussed problems encountered by the Department in developing its procedures for reviewing royalty reduction requests. GAO recommended the development of a better defined policy statement and responsive regulations and advocated better use of existing financial expertise in the evaluation process. No new regulations implementing the royalty reduction program have been formally promulgated. Accordingly, it appears BLM has chosen to adhere to the standards stated in the statute and reflected in the regulations found in 43 CFR subpart 3480, cited previously. As suggested by

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The GAO report, the Acting State Director (the authorized officer reviewing the request) sought the experts' advice of the Royalty Compliance Division, MMS. However, MMS' recommendation did not constitute the sole basis for the decision. Instead, the Acting State Director independently applied the facts to the standards found in the statute and, relying upon the provided expert opinion, rendered his determination. This process does not constitute an "ad hoc" decision rendered without guidelines. The criteria and process for review are enumerated in statute and regulation. Appellant has not identified an improper deviation from the outlined review process.

Appellant, however, contends BLM failed to consider its application in a manner consistent with the policy approved by the Deputy Assistant Secretary in 1981. The Solicitor's response to Peabody's appeal fails to address this important issue. Indeed, the Solicitor
S only oblique reference to this important issue. Indeed, the Solicitor's only oblique reference to this issue appears on page 4 of its reply brief: "Until the release of this [GAO] report [dated Aug. 10, 1982}, the Department had relieved on internal guidelines and opinions from the Office of the Solicitor to determine the validity of royalty-reduction requests." Despite the apparent implication that this policy was no longer considered applicable after the issuance of the GAO report, the record contains no evidence the described policy has been revoked. This is not the only issue raised by appellant to which the Solicitor has made no response. Appellant has also alleged that BLM has not been consistent in its consideration of reduction requests for bonus royalty leases, citing in particular requests granted for two leases held by Western Energy Company (Western Energy).

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As earlier stated, the 1981 Coal Leasing memorandum attempted to analyze the problem posed by a grant of relief to holders of bonus royalty leases by dividing the royalty into two components: (1) the statutory minimum royalty of 12-½ percent, and (2) the remainder, characterized as the bonus royalty. The reason for dividing the royalty rate into two components arose from an effort to make the bonus royalty leases analogous to those lease won by a lump-sum bonus bid. Any amount exceeding the 12-½ percent statutory minimum royalty would be analogous to the lump-sum bonus bid. Because an initial cash bonus bid could not be passed to a customer in the same way a royalty could if the lessee's contract with the customer had a royalty pass-through provision, the 1981 coal, Leasing memorandum suggested that, in recalculating the worth of the coal lease by the discounted cash-flow method, it should be assumed the bonus royalty cannot be passed to customers just as a lump-sum bonus bid could not be passed through, even though a lessee's contracts with its customers might contain such a pass-through provision. It should be noticed that this assumption was made only for the purpose of making a discounted cash-flow analysis of the value of the deposits; it does not necessarily follow that the memorandum precluded BLM from taking the pass-through provision into account in making a final determinatio0n as to the necessity for royalty relief.

[5] Although Peabody objects to consideration of the fact that appellant's contracts with its customers provide for passing-through the royalty, no statutory basis exists for disregarding a fact of relevance.

to a determination of the necessity for royalty relief. If BLM is not to overstep the scope of authority conferred by 30 U.S.C. § 209 (1982), it must determine the necessity for relief on the basis of fact, not fiction. The existence of a royalty pass-through provision is a fact which BLM is not free to disregard. Appellant contends that "a lessee is denied ipso facto any possible remedy under [30 U.S.C. § 209] if there is a royalty pass thro9ugh provision" (Appellant's Reply to BLM's Response at 2). This contention is not correct. If a lessee could establish that failure to reduce royalty would force its customers to curtail their demand to the extent that operations on the lease would cease, the existence of the pass-through provision would not stand as an obstacle to relief. 7/

BLM Disposition of a request for royalty relief from Western Energy with respect to coal lease M-35735 shows BLM did take into account the distinction between bonus royalty and statutory minimum set forth in the 1981 memorandum. That lease was issued with a royalty rate of 21 percent. In 1981, 1982, and 1983, BLM reduced that rate to the statutory minimum, 12-½. By decision dated November 9, 1984, from which Western Energy appealed, BLM determined the rate should be reduced only to

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7/ A notice setting forth draft guidelines for use in handling applications for royalty reductions in Federal leases for renewal including coal was published Feb. 13, 1985. 50 FR 6062. Those draft guidelines would require BLM to take into account royalty pass-through provisions that applicants for royalty relief may have in their contracts with customers. As part of its appeal, Peabody has submitted copies of comments on the draft guidelines, citing the hardship that such consideration of pass-through provisions imposes upon the economy in the West. BLM, however, cannot be blamed for this. BLM did not negotiated the royalty pass-through provisions in appellant's commitment with its customer; nor BLM a party to those agreements.

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16.6 percent. Later, however, BLM moved to vacate its decision and Western Energy asked to withdraw its appeal. The Board remanded the case by order and did not consider the issues raised by that appeal. Western Energy Co., IBLA 85-177 (order dated June 11, 1985).

Accordingly, BLM's decision denying royalty relief is affirmed because appellant has failed to satisfy either of the threshold requirements to enable BLM to exercise its discretion to reduce Peabody's royalty. Even if appellant's applications can be construed as meeting one of the threshold requirements, royalty relief could not be properly granted in the exercise of BLM's discretion because appellant's application does not clearly indicate that the economic interest of the United States as owner of the deposit would be more favorably affected by granting the relief than by denying it.

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 as modified by this opinion.

Franklin D. Arness
Administrative Judge

We concur:

Wm. Philip Horton
Chief Administrative Judge

C. Randall Grant, Jr.
Administrative Judge

Appendix 3 - Solicitor's Opinion: M-36920, 87 I.D. 69 (1979)

Note: This appendix is an accessible reproduction of the original.

REDUCTION OF PRODUCTION ROYALTIES BELOW STATUTORY MINIMUM RATES*

M-36920

December 11, 1979

Mineral Leasing Act: Royalties

Sec. 39 of the Mineral Leasing Act authorizes the Secretary to reduce the royalty on coal, oil and gas, oil shale, phosphate, sodium, potassium, and sulphur leases in the interest of conservation whenever in his judgment it is necessary to do so in order to promote development, or whenever in his judgment the leases cannot be successfully operated under the terms provided therein.

Mineral Leasing Act: Royalties

Sec. 39 of the Mineral Leasing Act authorizes the Secretary to reduce production royalties on coal, oil and gas, phosphate, sodium, potassium, and sulphur leases below the statutory minimum rates established for those minerals.

Mineral Leasing Act: Royalties—Coal Leases and Permits: Royalties

The Federal Coal Leasing Amendments Act of 1975 left in effect the Secretary's authority under sec. 39 of the Mineral Leasing Act to reduce production royalties on coal leases below the statutory minimum rate.

Mineral Leasing Act: Generally—Mineral Leasing Act: Royalties

The initial terms of any new competitive mineral lease must conform to the statutory minimum production royalty rate then applicable to that type of mineral lease. Competitive and noncompetitive mineral leases for coal, phosphate, potassium, sodium, and oil shale are subject to periodic readjustment of their terms and conditions. Such readjustments must conform to the statutory minimum production royalty rates then applicable.

Mineral Leasing Act: Generally—Mineral Leasing Act: Royalties

The lease readjustment process and the sec. 39 royalty reduction process may not be merged into a single process where this would result in a readjusted production royalty rate below the applicable statutory minimum. The sec. 39 determination must be made independently.

Mineral Leasing Act: Generally—Coal Leases and Permits: Leases—Coal Leases and Permits: Royalties—Sodium Leases and Permits: Preference Right Leases—Sodium Leases and Permits: Royalties—Potassium Leases and Permits: Leases—Potassium Leases and Permits: Royalties—Phosphate Leases and Permits: Leases—Phosphate Leases and Permits: Royalties

In determining whether a permittee is entitled to a preference right lease the Secretary must consider all legal and economic conditions affecting the proposed operation of the lease as of the time of the determination, including the applicable statutory minimum production royalty rate. A preference right lease must provide for a production royalty rate in conformity with the statutory minimum rate applicable at the time of issuance.

TO: SECRETARY.
FROM: SOLICITOR.
SUBJECT: REDUCTION OF PRODUCTION ROYALTIES BELOW STATUTORY MINIMUM RATES.

The minimum production royalty provisions in sec. 6 of the Fed-

*Not in chronological order.

eral Coal Leasing Amendments Act of 1975, 30 U.S.C. § 207(a) (1976), *as amended*, have focused attention on the Secretary's authority to grant relief from royalty rates in existing and future leases. One of the issues raised is whether or not royalties may be reduced below the prescribed statutory minimum rates. This issue is not limited to coal leases, but arises also with respect to oil and gas and other mineral leases which have minimum production royalty rates prescribed by the Mineral Leasing Act of 1920, *as amended* (the Act).[1]

I have concluded that sec. 39 of the Act, *as amended*, 30 U.S.C. § 209 (1976), permits reduction of production royalty rates below the statutory minimums fixed in other sections of the Act. I have further concluded that any such reduction below the statutory minimum rate may only occur subsequent to the fixing of not less than the minimum rate in the initial terms of the lease itself. On those mineral leases subject to periodic "readjustment," royalties may not be reduced below the prescribed minimums during the readjustment process, but may be reduced thereafter pursuant to sec. 39.

I. Statutory Minimum Production Royalty Rates

A. Coal Leases

The current minimum production royalty rate[2] for coal leases is set out in section 7(a) of the Act, *as amended*, 30 U.S.C. § 207(a) (1976):

> A coal lease * * * shall require payment of a royalty in such amount as the Secretary shall determine of not less than 12½ per centum of the value of coal as defined by regulation, except the Secretary may determine a lesser amount in the case of coal recovered by underground mining operations. * * * Such * * * royalties * * * will be subject to readjustment at the end of * * * twenty years and at the end of each ten-year period thereafter if the lease is extended.

This rate was established by sec. 6 of the Federal Coal Leasing Amendments Act of 1975 (FCLAA). The FCLAA amended sec. 7 of the 1920 Act[3] which had fixed the previous minimum production royalty for coal leases at $.05 per ton.

[1] The minerals subject to the Act are listed in sec. 1 of the Act, *as amended*, 30 U.S.C. § 181 (1976). They are coal, phosphate, sodium, potassium, oil and gas, oil shale, native asphalt, solid and semisolid bitumen, and bituminous rock. Sulphur in Louisiana and New Mexico is also subject to leasing although it does not appear in sec. 1, but was added by the Act of Apr. 17, 1926, 44 Stat. 301, 30 U.S.C. §§ 271–276 (1976). The royalty reduction provisions of sec. 39 of the Act, 30 U.S.C. § 209 (1976), cover only coal, phosphate, sodium, potassium, oil and gas, oil shale, and sulphur. It is with this group of minerals that this opinion is concerned.

[2] This opinion discusses minimum *production* royalty rates under the Act. This term should not be confused with so-called "minimum royalties" which are a production incentive assessed against certain nonproducing leases under various sections of the Act, *e.g.*, sec. 10, 30 U.S.C. § 212 (1976) (phosphate); sec. 17, 30 U.S.C. § 226(d) (1976) (oil and gas). The distinction is recognized in sec. 39 of the Act, 30 U.S.C. § 209 (1976), which authorizes the Secretary to "waive, suspend or reduce" the minimum royalty, but only to "reduce" the production royalty, on a mineral lease.

[3] Act of Feb. 25, 1920, c.85, 41 Stat. 439.

B. Oil and Gas Leases

The minimum production royalty rate for competitive oil and gas leases is fixed by sec. 17(b) of the Act, *as amended*, 30 U.S.C. § 226(b) (1976), at not less than 12½ percent of the amount or value of production. This figure has not changed since 1920.

The royalty rate for noncompetitive oil and gas leases is fixed by sec. 17(c) of the Act, *as amended*, 30 U.S.C. § 226(c) (1976), at a flat 12½ percent. This provision was first enacted as sec. 3 of the Act of Aug. 8, 1946, 60 Stat. 951. This rate serves as both a maximum and a minimum for production royalties on oil and gas leases issued for lands not within the known geologic structure of a producing oil or gas field.

In both cases, the 12½ percent rate has produced little controversy over the years. The typical royalty rate included in competitive leases has averaged well above that figure.

C. Other Mineral Leases

Many of the leasable minerals have no minimum production royalty rate provided for by statute. This is true of several of the minerals subject to the Act, including oil shale, asphalt, and competitively leased sulphur.[4]

Most of the minerals subject to the Act are, however, subject to statutory minimum rates. Phosphates are subject to a minimum production royalty rate of 5 percent of the gross value of the lease output.[5] Sodium leases are subject to a 2 percent minimum rate,[6] as are potassium leases.[7] Preference right (noncompetitive) leases of sulphur lands are subject to a 5 percent flat rate on the gross value of the lease output.[8]

These rates, in the case of phosphates and sodium, were established in 1920 by the original Mineral Leasing Act,[9] and in the case of sulphur and potassium, by statutes passed in 1926 and 1927 respectively.[10]

II. Royalty Reduction Provisions

A. Current Law

In 1946 the previous royalty relief and reduction provisions were consolidated and supplemented by the revision of sec. 39 of the Act, *as amended*, 30 U.S.C. § 209 (1976). This section lays out the circumstances and criteria under which the Secretary may proceed to grant relief to a mineral lessee. The section reads in pertinent part:

> The Secretary of the Interior, for the purpose of encouraging the greatest ulti-

[4] 43 CFR 3503.3–2(a)(1)(i) does, however, set a minimum rate of 5 percent for competitive sulphur leases by regulation. And 43 CFR 3562.3–6(a) sets a minimum rate of $0.25/ton for certain Oklahoma asphalt leases.

[5] 30 U.S.C. § 212 (1976).

[6] 30 U.S.C. § 262 (1976).

[7] 30 U.S.C. §§ 282, 283 (1976).

[8] 30 U.S.C. § 272 (1976).

[9] Act of Feb. 25, 1920, c. 85, §§ 11, 24, 41 Stat. 440, 447.

[10] Act of Apr. 17, 1926, c. 158, § 2, 44 Stat. 301; Act of Feb. 7, 1927, c. 66, §§ 2, 3, 44 Stat. 1057.

mate recovery of coal, oil, gas, oil shale, phosphate, sodium, potassium and sulfur, and in the interest of conservation of natural resources, is authorized to waive, suspend, or reduce the rental, or minimum royalty, or reduce the royalty on an entire leasehold, or on any tract or portion thereof segregated for royalty purposes, whenever in his judgment it is necessary to do so in order to promote development, or whenever in his judgment the leases cannot be successfully operated under the terms provided therein.

Of particular interest is the breadth of the Secretary's authority upon his finding of necessity. The provision for waiving, suspending or reducing the rental or minimum royalty [11] indicates that Congress intended sec. 39 to override even explicit dollar figures in the Act. The intended relief with respect to his authority to reduce *production* royalties can hardly be any less broad in view of the explicit purpose of this section to encourage production.

B. Prior Law

(1) Former 30 U.S.C. § 226 (1940)

The first royalty relief provision was enacted as part of sec. 17 of the Mineral Leasing Act of 1920.[12] That section, after providing for a minimum production royalty rate of 12½ percent for competitive oil and gas leases, went on to provide:

Whenever the average daily production of any oil well shall not exceed ten barrels per day, the Secretary of the Interior is authorized to reduce the royalty on future production when in his judgment the wells can not be successfully operated upon the royalty fixed in the lease.

This provision marks the first appearance of the requirement that in order to grant relief the Secretary must find that the wells cannot be otherwise successfully operated. It was, however, a very limited relief provision, applying only to small operations on oil leases. No such limitation appeared in a 1935 amendment to sec. 17 which added the following relief provision for gas leases:

[I]n the case of leases valuable only for the production of gas the Secretary of the Interior upon showing by the lessee that the lease cannot be successfully operated upon such rental or upon the royalty provided in the lease, may waive, suspend, or reduce such rental or reduce such royalty.[13]

The requirement that the lease be a small production operation was not extended to gas wells. The Secretary was empowered to grant relief to *any* gas lessee upon the lessee's *showing* that he could not otherwise operate successfully. These two relief provisions of sec. 17 were replaced in 1946 with the revision and consolidation of all relief provisions in sec. 39, 30 U.S.C. § 209 (1976).

(2) Former 30 U.S.C. § 209

The first relief provision of *general* applicability to appear was sec. 39 of the Mineral Leasing Act, enacted in 1933.[14] As enacted, sec.

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[11] *See* note 2, *supra*.

[12] Act of Feb. 25, 1920, c. 85, § 17, 41 Stat. 443, codified at former 30 U.S.C. § 226 (1940).

[13] Act of Aug. 21, 1935, c. 599, § 1, 49 Stat. 676–677.

[14] Act of Feb. 9, 1933, c. 45, 47 Stat. 798.

39 merely provided for the suspension of acreage *rental* payments when the Secretary, "in the interest of conservation," directed or allowed suspension of coal, oil, or gas lease operations. This provision for relief "in the interest of conservation" has remained as one of the criteria for *royalty* reductions in all subsequent revisions of sec. 39.

In 1946 Congress amended sec. 39 to essentially its present form, combining and consolidating the relief provisions from sec. 17 and sec. 39, and expanding the Secretary's authority.[15] This revision eliminated differing standards for oil wells producing more or less than ten barrels per day, and separate criteria for reducing and suspending rental payments royalties on leases valuable only for the production of gas. For the first time there were also provisions for royalty reductions on coal leases. Specific criteria were established for the granting of all royalty reduction relief. The criteria of "in the interest of conservation" and "whenever * * * the leases cannot be successfully operated" were adopted from the earlier secs. 17 and 39 and made applicable to coal leases, and to all oil and gas leases. To these was added, as an alternative to finding that the lease "cannot be successfully operated," a criterion permitting the Secretary to grant relief, "whenever * * * necessary * * * in order to promote development" consistent with the interests of conservation and encouraging the greatest ultimate recovery. This alternative gave the Secretary greater discretion in granting relief, although still requiring him to find that such relief would be "in the interest of conservation."

A 1948 amendment added oil shale, phosphate, sodium, potassium and sulphur leases to the coal and oil and gas leases covered in 1946.[16] The only subsequent amendment to this section simply stated that the Secretary's authority to waive, suspend or reduce royalties did not extend to advance royalties.[17]

III. Royalty Reduction Below Statutory Minimums

A. Statutory Language

The issue with respect to these statutes is whether Congress intended the royalty reduction authority in sec. 39 to be limited by the provisions establishing minimum production royalty rates. The language of sec. 39 itself does not indicate any such limitation. "The Secretary * * * is authorized to waive, suspend, or reduce the rental, or minimum royalty, or reduce the royalty on an entire leasehold, or on

[15] Although Congress initially approached the revision of sec. 39 as a consolidation of existing relief provisions, it actually went on to increase the scope of the Secretary's relief powers. *See United Mfg. Co.*, 65 I.D. 106, 118 n.4 (1958).

[16] Act of June 3, 1948, c. 379, § 7, 62 Stat. 291.

[17] Act of Aug. 4, 1976, P.L. 94–377, § 14, 90 Stat. 1091.

any tract or portion thereof segregated for royalty purposes." This language authorizes the reduction of rentals as well as royalties on mineral leases. Since the rentals for phosphate leases and sodium leases were fixed at a flat rate by statute [18] before the enactment of sec. 39, it is clear that sec. 39 must authorize rental reductions on those leases below the statutory rates. This conclusion about rental reductions under sec. 39 strongly implies that production royalties may similarly be reduced below the prescribed statutory minimum rates.

An examination of the history of sec. 39 supports this view. For example, the 1946 royalty reduction provisions of sec. 39 made no distinction between competitive and noncompetitive oil and gas leases. In fact, the section stated: "The provisions of this section shall apply to *all* oil and gas leases issued under this chapter." (Sec. 10 of Act of Aug. 8, 1946, 30 U.S.C. § 209 (1976); italics added.)

Yet the same 1946 amendments to the Act which revised and established sec. 39 also established the fixed 12½ percent royalty rate for noncompetitive oil and gas leases. This can only mean that Congress specifically contemplated the reduction of royalties on noncompetitive leases below the statutory 12½ percent. That such relief was also authorized with respect to competitive leases can scarcely be doubted.

B. Recent Congressional Interpretations

In enacting the Federal Coal Leasing Amendments Act of 1975, Congress echoed this view of sec. 39 with respect to coal royalties. Senator Lee Metcalf, floor manager of S. 391, in discussing the proposed 12½ percent minimum coal royalty rate stated:

> Furthermore, section 39 of the Mineral Leasing Act, as amended, would continue to allow the Secretary to reduce the minimum royalty below 12.5 percent on a tract "for the purpose of encouraging the greatest ultimate recovery of coal." Thus an operator could pay a lesser royalty on that portion of the coal lease which might normally be uneconomical to mine given a 12.5-percent royalty, in the interests of conservation of the resource.
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> * * * * *
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> In other words, the flexibility built into the minimum royalty provisions in S. 391 allow [*sic*] the Secretary to encourage maximum recovery of coal while also generating a fair return to the public.[19]

Similar language appeared in the June 24, 1976, letter from Senator Metcalf and Congresswoman Mink, the floor manager of the bill in the House, to President Ford urging him to sign the bill into law.[20] In vetoing the bill President Ford, who objected to the "high royalty rate" established by the bill, did not address the applicability of sec. 39 as a relief measure. In the debate

[18] Act of Feb. 25, 1920, c. 85, § 24, 41 Stat. 447, 30 U.S.C. § 262 (1976); Act of Feb. 7, 1927, c. 66, § 3, 44 Stat. 1057, 30 U.S.C. § 283 (1976).

[19] 122 Cong. Rec. 19376 (June 21, 1976).

[20] 122 Cong. Rec. 21357 (June 29, 1976).

over whether to override the veto Congresswoman Mink pointed out:

> The veto message * * * fails to mention that under section 39 of the Mineral Leasing Act, a section unchanged by S. 391, the Secretary will be authorized to "waive, suspend, or reduce" the minimum royalty for production from both surface and underground mines.[21]

And Congressman Roncalio, a member of the Committee that reported the bill, took pains to emphasize that:

> If 12.5 percent is too high for marginal or deep coal * * * the Secretary of the Interior can reduce that 12.5 percent to 7 percent, 5 percent, or 3 percent. He has always had the right to do that. Nothing in this bill takes that highly discretionary right away from the Secretary. He can cut the royalty down to whatever he wishes.[22]

Thus, it was the position of the two floor managers of the FCLAA, and of a committee member from a leading federal coal state, that sec. 39 of the Mineral Leasing Act authorized and would continue to authorize royalty reductions below statutory minimum rates at the discretion of the Secretary.[23]

C. Departmental Interpretations

Since the enactment of the amended sec. 39 in 1946, the Department has maintained that the Secretary has the authority to reduce royalties below the statutory minimums. Applications for such reductions have been received and a number of them have been granted. A comprehensive compilation [24] covering the period from July 1, 1957 through June 30, 1977, indicates that during that period 21 applications for royalty reductions on oil and gas leases were granted. Three of these reductions were to a flat rate below the 12½ percent statutory minimum. Two of these were granted in 1957 and the third in 1976. One is still in effect. The other 18 oil and gas royalty reductions were to a 1 percent per barrel per day per well rate, generally resulting in an effective royalty rate well under 12½ percent. Most of these were granted prior to 1965 and are still in effect.

During that same twenty-year period, royalty reductions were granted on other mineral leases as well. Some of these provided for rates below the minimums while others did not. The one sodium lease and 41 potash lease royalty reductions granted during that period did not reduce production royalties below the 2 percent statutory minimum for those minerals. However, all three phosphate lease royalty re-

[21] 122 Cong. Rec. 25456 (Aug. 4, 1976).

[22] 122 Cong. Rec. 25459 (Aug. 4, 1976).

[23] Congressman Ruppe, who took the opposing view, apparently based his opinion entirely on an interpretation he had received informally from individuals at the Department of the Interior. 122 Cong. Rec. 25461 (Aug. 4, 1976). This interpretation differed from the Department's position on this issue both before and since that time. *See* Part III.C., *infra*.

[24] Letter from Secretary Andrus to Congressman Runnels, Subcommittee on Mines and Mining (Feb. 27, 1978).

ductions granted during that time, two of which are still in effect, provided for an effective royalty rate below the 5 percent statutory minimum for phosphate leases.[25] Such reductions pursuant to sec. 39 were known even before the period covered by the 1978 compilation. In a May 31, 1974, memorandum to the Director, Office of Mineral Policy Development, the Assistant Solicitor for Minerals noted: "This is the interpretation of section 39 which has been followed by the Geological Survey and the rest of the Department through the years. This practice was known in 1953." [26]

The only deviation from this view appears to have occurred between 1976 [27] and 1979 and seems to have been proposed as a matter of policy. After the enactment of the Federal Coal Leasing Amendments Act of 1975, a revision of the coal leasing regulations was undertaken. While 43 CFR 3503.3-2(d) (1978), which had applied to coal as well as to other leasable minerals except oil and gas, had tracked the language of 30 U.S.C. § 209 (1976) by authorizing the Secretary to "reduce the royalty," the proposed coal regulation added the following reservation: "except that in no case shall a royalty be reduced below 12½ percent for surface mined coal, or 5 percent for underground coal." [28]

This language was drafted, in part, through a misunderstanding of the effect of the FCLAA increase in minimum production royalty rates on the Secretary's sec. 39 authority. Although the Department realized during the drafting process that sec. 39 remained applicable and would continue to support a discretionary reduction below the new minimum rates, the limiting language was allowed to stand in the proposed regulations as a policy decision not to exercise the Secretary's discretion to achieve reductions below those minimum rates. The preamble to the proposed regulations made this clear.[29] After receiving comments on the proposed regulations, the Department decided to return to its former approach to sec. 39, permitting royalty reductions below the statutory minimum rates. The final regulations were revised accordingly. The preamble to the final regulations stated:

> The final rulemaking reinstates the authority of the Secretary to reduce the royalty below the statutory minimum that must be fixed in each lease, in the exercise of his authority under section 39

[25] The compilation did not cover applications for reductions in coal royalties under sec. 39 during this period. Very few applications for reductions in coal royalty rates have been received in the past, owing to the low minimum rates in effect prior to passage of the FCLAA in 1976.

[26] Memorandum from Assistant Solicitor—Minerals to Director, Office of Mineral Policy Development (OMPD). "Reduction of Royalties on OCS Oil and Gas Leases" (May 31, 1974). This interpretation of sec. 39 was also discussed in a memorandum from the Assistant Solicitor—Minerals to OMPD dated May 20, 1974, "Reduction of Royalties on OCS Oil and Gas Leases and the Environmental Impact of Profit Sharing Provisions."

[27] *See* note 23, *supra*.

[28] Proposed 43 CFR 3473.3-2(d)(1), 44 FR 16844 (Mar. 19, 1979).

[29] 44 FR 16808 (Mar. 19, 1979).

of the Mineral Leasing Act (30 U.S.C. 209).[30]

The limiting language in the proposed regulation was deleted from 43 CFR 3473.3–2(d)(1) as it was finally adopted. The Department reaffirmed its longstanding interpretation that sec. 39 authorized reductions below the minimum coal royalty rates when necessary. 43 CFR 3503.3–2(d)(1) continues to provide for such royalty reductions for the other leasing act minerals, except oil and gas which are covered by similar language in 43 CFR 3103.3–7.

IV. Timing of Reduction of Royalty Rate Below Statutory Minimum

Having concluded that 30 U.S.C. § 209 (1976) permits the reduction of production royalties below the statutory minimum rates, we turn to the question of when such a reduction may be granted. The question arises in three different leasing situations: new competitive leases; the readjustment of existing leases; and the issuance of preference right leases.

A. New Leases

The terms of any new competitive lease must recognize the statutory minimum rates. The rate established in the initial lease can be no lower than the established minimum. This follows from the mandatory language used by Congress in each of the royalty statutes:

> A coal lease * * * shall require payment of a royalty * * * of not less than 12½ per centum. [31]
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> * * * * *
>
> [O]il or gas * * * shall be leased * * * [at] such royalty as may be fixed in the lease, which shall be not less than 12½ per centum. [32]
>
> * * * * *
>
> * * * All [phosphate] leases shall be conditioned upon * * * payment * * * of such royalties as may be specified in the lease, * * * at not less than 5 per centum. [33]

Such initial adherence to the statutory minimums is the only way in which such minimums can be effectively applied. The reason the initial lease must prescribe a royalty rate at or above the statutory minimum is in order to make that minimum an effective constraint on the leasing powers of the Secretary as Congress intended. The Secretary can alienate interests in land belonging to the United States only in conformity with the conditions prescribed by Congress. *Union Oil Co. of California* v. *Morton*, 512 F.2d 743, 748 (9th Cir. 1975). Those conditions include the statutory minimum production royalty rates. The Congressional purpose was twofold: first, to insure that the public received a fair return on any initial lease; and sec-

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[30] 44 FR 42606 (July 19, 1979).

[31] 30 U.S.C. § 207(a) (1976).

[32] 30 U.S.C. § 226(b) (1976).

[33] 30 U.S.C. § 212 (1976). Similar mandatory language is used with respect to the other Leasing Act Minerals.

ond, to insure that mineral leases which could not be operated economically from the outset under minimum conditions would not be issued. This point was made during the debate in Congress at the time the statutory minimum production royalty rate was raised. 122 Cong. Rec. H–158 (daily ed., January 21, 1976). The effect, then, is to encourage the leasing and development of productive mineral lands, while discouraging the uneconomic development of more marginal lands. An initial reduction as an incentive to production is not authorized. *Montana Power Co.*, 72 I.D. 518, 519 (1965).

In order to carry out these Congressional policies reflected in the minimum production royalty statutes, each lease must conform to the statutory requirements at the outset. Only when difficulties in the conservation and recovery of the leased mineral later occur may a reduction below the minimum rate be justified. This procedure is required by the relief provision itself, and is made particularly clear in light of the original relief provision in the 1920 Mineral Leasing Act. That provision, then sec. 17, authorized the Secretary, when necessary, to "reduce * * * the royalty *fixed in the lease*." (Italic added). This approach, although not this language, is continued under the current Act, which provides for the reduction of royalty "on * * * [the] leasehold." Sec. 39 relief is available only *after* a lease has already been issued in compliance with the statutory royalty requirements.

The policy reason for insisting upon this distinction between the initial royalty terms of a lease and their subsequent reduction was discussed by the Interior Board of Land Appeals in *Kerr-McGee Corp.*, 12 IBLA 348 (1973). In that appeal, a coal mining company seeking a preference right lease petitioned the Department for a reduced royalty rate at issuance of the lease based on difficult mining conditions encountered during the development stage. The Department sought to impose its standard royalty rate for the region, $.20/ton. In rejecting the company's petition the Board pointed out: "[A]ny royalty rate now established commits the Government resources for the next 20-year period." [34]

The Board held that only after issuance of the lease, commencement of production, and a showing of actual necessity under sec. 39 criteria, would a reduction be available. This policy approach protects the interests of the public in receiving a fair return over the life of the lease. In contrast, if a reduction were incorporated in the initial terms of the lease, the Government would be unable later to raise the royalty rates if the circumstances on which the reduction was based were to cease. The holding in *Kerr-McGee* recognized the role of sec. 39 as essentially a relief provision, to be applied to modify the fixed lease terms when, and only so long, as

[34] 12 IBLA at 351 (1973).

necessary.[35] Consequently a reduced royalty rate below the statutory minimum will not be granted as an incentive to operations on a new lease but must be applied for after the lease terms have been fixed. *Duncan Miller*, A–30711 (Nov. 16, 1966). Based on the statutory language and the purposes of the royalty and relief provisions, I conclude that a reduction in production royalty rates below the statutory minimum may not occur at the issuance of a lease.

B. Lease Readjustment

Most competitive and noncompetitive mineral leases, other than oil and gas, are issued for a primary term of years after which their provisions may be readjusted periodically.[36] The question of the timing of royalty reductions here arises in connection with the Secretary's power to "readjust" the provisions of leases upon the expiration of each lease readjustment period.

[35] It should be noted that in *Kerr-McGee*, the Department had proposed royalty rates well above the statutory minimum of $.05/ton, and the company was seeking a reduction not below the minimum rate. If a reduction in the initial lease terms was not appropriate under these circumstances, *a fortiori* it would not be appropriate where the lessee sought an initial royalty rate *below* the statutory minimum rate.

[36] Coal leases issued under sec. 7 of the Act, 30 U.S.C. § 207 (1970), prior to the FCLAA were not issued for a "primary period," but for an indeterminate period subject to diligent development and continued operation requirements. These leases were issued subject to readjustment at 20-year intervals. The readjustment of these leases is intended to be included in this discussion even though there is no actual renewal of the lease itself associated with the readjustment.

With respect to coal leases, 30 U.S.C. § 207(a) (1976) read in pertinent part: "[R]oyalties and other terms and conditions of the lease will be subject to readjustment at the end of its primary term of twenty years and at the end of each ten-year period thereafter if the lease is extended."

A similar "readjustment" is authorized for leases of phosphate, sodium, potassium and oil shale.[37] At the time of readjustment, the Secretary may reduce or raise royalty rates as he determines is appropriate. Reduction of royalty rates at this time, however, cannot be to a rate below the prescribed statutory minimum. The reason for this is that discussed in *Kerr-McGee*, the protection of the Government's royalty interest through the period of the lease. Since the readjusted terms of the lease govern for the length of the ensuing extension period until the next readjustment date, they must be set in accordance with the statute. Moreover, the Secretary must apply the law that is currently in effect in setting the readjusted terms of any lease; he has no authority to readjust a lease contrary to Congress direction regarding lease terms.

[37] 30 U.S.C. §§ 212, 262, 283 and 241 (1976), respectively. While the word "readjustment" is not specifically used in connection with sodium leases, it is clear that this is what is meant by "renew for successive periods of ten years *upon such reasonable terms and conditions as may be prescribed by the Secretary,*" 30 U.S.C. § 262 (italics added). *See* 43 CFR § 3522.1–1. No "readjustment" provision exists for oil and gas leases.

It was in part for this reason that the Secretary promulgated 43 CFR 3451.1(a)(2) to require, as they came due, the readjustment of all existing coal leases with royalty rates below the new minimums to conform to the new FCLAA 12½ percent minimum rates. The Deputy Solicitor concluded last year that the minimum production royalty provisions required the Secretary to "place on readjusted leases a royalty of not less than 12½ per centum of the value of [surface mined] coal," and that the sec. 39 relief provisions could only be "subsequently" exercised to grant a reduction below this minimum.[38] The rationale supporting this approach to the readjustmen of coal leases is equally valid for the other leasable minerals subject to readjustment.

Thus, while the Secretary is given some leeway in his readjustment of lease terms under the extension provisions, he must conform his readjustment to the requirement of the then current statutory minimum production royalty rates. Any reduction below such rates must take place pursuant to sec. 39, and independent of the establishment of the readjusted lease terms. The readjustment process and the sec. 39 relief process may not be merged into a single process where this would result in a readjusted rate below the relevant statutory minimum production royalty rate.

C. Preference Right Leases

Certain mineral leases are still granted on a preference right basis. Like new leases and readjusted leases, preference right leases must adhere to the statutory minimum rates in their initial terms. Two reasons exist for treating preference right leases in this way. The first is the *Kerr-McGee* rationale discussed above, to protect the Government's royalty interest over the course of the ensuing lease period.[39] The second is the requirement for issuance of a preference right lease, that the lease applicant have discovered "commercial quantities,"[40] or "valuable deposits"[41] of the mineral. No preference right lease may be issued until the applicant has shown that his discovery meets the applicable legal standard. Upon the Secretary's determination that such a showing has been made, the applicant is entitled to the lease as a matter of right. *NRDC* v. *Berklund*, 458 F. Supp. 925, 928 (D.D.C. 1978), *aff'd*, —— F.2d —— (No. 78-1757, D.C. Cir., Nov. 9, 1979). In making this determination, the Secretary must consider all legal and economic conditions affecting the proposed operation of the lease. The Secretary is not limited to considering only those conditions which, at the time of the issuance of the prospecting permit, had been considered in the determination of whether a permittee was

[38] Memorandum from Deputy Solicitor to Deputy Under Secretary, "Royalty Terms Upon Readjustment of Coal Leases" (May 2, 1978).

[39] *Kerr-McGee* in fact involved a preference right lease.

[40] 30 U.S.C. § 201(b) (1970) (coal).

[41] 30 U.S.C. § 211(b) (phosphate); 30 U.S.C. § 262 (sodium); 30 U.S.C. § 272 (sulphur); 30 U.S.C. § 282 (potassium).

entitled to a noncompetitive lease. *Montana Eastern Pipe Line Co.*, 55 I.D. 189, 191 (1935). Neither is his consideration limited to legal and economic requirements as of the date of the lease application. Rather, the Secretary's determination is based upon the law and economic situation as of the date of adjudication of the application. *NRDC* v. *Berklund*, *supra; Utah International, Inc.* v. *Andrus*, C 77-0225 (D. Utah, June 15, 1979). Thus, the Secretary must apply the current minimum production royalty statutes as part of his evaluation of the applicant's showing of "commercial quantities" or "valuable deposits." A proposed lease operation that is unable to meet the minimum production royalty rates from the outset would not qualify for a preference right lease under either of these standards. A lease will not be granted where it cannot be operated except with royalty relief. The minimum royalty rates must appear in the initial terms of any properly granted preference right lease.

Thus, any royalty reduction under sec. 39 of the Mineral Leasing Act below the prescribed minimum rates must occur at times other than the setting of the initial or readjusted terms of the mineral lease. This is true whether the initial lease is issued competitively or to a preference right applicant.

V. Conclusion

The royalty reduction provisions of sec. 39 of the Mineral Leasing Act, *as amended* (30 U.S.C. § 209 (1976)), authorize the Secretary to reduce production royalties on mineral leases below the statutory minimum rates set out in other sections of the Act. Thus, reductions below the statutory minimums may be made at the Secretary's discretion in conformance with the requirements of sec. 39. In no case, however, may such reductions be prescribed as a part of the initial or readjusted terms of any lease. The relief afforded by sec. 39 is meant to occur apart from the establishment of the basic lease terms for any given lease period.

FREDERICK N. FERGUSON
DEPUTY SOLICITOR

APPEAL OF THEODORE J. ALMASY ET AL.*

4 ANCAB 151

Decided *February 27, 1980*

Appeal from the Decision of the Bureau of Land Management AA-8103-2, 44 FR 25939 (May 3, 1979).

Affirmed in part.

1. Alaska Native Claims Settlement Act: Conveyances: Valid Existing Rights: Third-Party Interests

Valid existing rights which are protected under § 14(g) of the Alaska Native Claims Settlement Act (ANCSA), 85 Stat. 688, *as amended,* 43 U.S.C. §§ 1601-1628 (1976 and Supp. I 1977) are in all cases derived from and created by the State or Federal Government.

*Not in chronological order.