



THE SECRETARY OF THE INTERIOR
WASHINGTON

FEB 07 2013

The Honorable Ron Wyden
Chairman, Committee on
Energy and Natural Resources
United States Senate
Washington, DC 20510

Dear Chairman Wyden:

Thank you for your letter of January 3, 2013, expressing concerns regarding the Department of the Interior's Federal coal royalty management, and requesting data and other information in response to seven specific questions. Enclosures 1 and 2 provide detailed responses to your specific requests.

The Department shares your concern that this matter be should taken seriously and be thoroughly investigated to determine if there is any merit to the allegations contained in the December 4, 2012, *Reuters* article referenced in your letter. To that end, I have directed the Department's Office of Natural Resources Revenue (ONRR) to assemble a team of experts that includes our State auditing partners in Wyoming and Montana to address coal sales from the Powder River Basin through a risk-based audit and compliance action plan. I have also asked the Department's Office of the Inspector General to investigate the allegations regarding coal sales in the Powder River Basin to affiliated export purchasers or broker/marketers, and aggressively pursue any company found in violation of the laws and regulations related to the valuation of Federal coal.

The issues surrounding Federal coal export sales underscore why royalty valuation reform is necessary and presents an opportunity for the Department to pursue broader royalty reforms. In an effort to strengthen and simplify royalty valuation regulations, on May 27, 2011, the Department published an Advanced Notice of Proposed Rulemaking for Federal and Indian coal and Federal oil and gas royalty valuation. Based on the comments we received, the changes we are considering would reinforce that for purposes of determining royalties, the gross proceeds from arm's-length transactions are the best indication of market value. The proposed changes could dramatically improve compliance and reduce administrative costs for industry and the Government. It will additionally ensure proper royalty valuation by creating a more transparent royalty calculation method that is more market oriented and less burdensome to both industry and the Government.

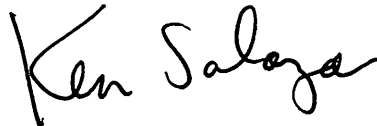
The Department is also committed to working closely with Congress on legislative changes to improve our management of the Federal and Indian mineral resources and to fulfill our stewardship responsibilities to the Nation. These good-government reforms include adjustments to royalty rates to achieve better returns for taxpayers, efforts to support and encourage the diligent development of existing leases, and the modernization and simplification of the royalty

management statutes to improve revenue collection processes, eliminate unwarranted industry subsidies, and reduce unnecessary administrative burdens for both the Department and industry.

Proceeding with royalty valuation reforms supports the efforts underway since this Administration's first day – to promote a balanced and responsible approach to energy development on our public lands and waters, and achieve dependable oversight and sensible reform of the mineral leasing and royalty management programs.

I look forward to working with you and Senator Murkowski on this issue to ensure that taxpayer assets are protected.

Sincerely,

A handwritten signature in black ink that reads "Ken Salazar". The signature is written in a cursive, flowing style with a large initial "K".

Ken Salazar

Enclosures

Response to Questions Contained in the January 3, 2013, Letter from Senators Wyden and Murkowski Regarding U.S. Coal Export Sales from Federal Leases

Question 1:

Hundreds of millions of tons of coal are mined every year from federal and tribal lands; the Office of Natural Resources Revenue (ONRR) conducts audits and compliance reviews on royalty payments three years after the payments are due:

- a. Please provide a detailed list of any violations of applicable law or regulations – and resulting fines – related to royalty payments for coal mined on federal and tribal lands that occurred during the five most recent audit years.
- b. Please provide a detailed list of any violations of applicable law or regulations – and resulting fines – related to royalty payments for coal mined on federal and tribal lands that occurred in years that are not yet subject to audit or compliance reviews.

Response to Question 1:

- a. Enclosure 2 details the audit collections by violation of applicable laws and regulations for Fiscal Years 2008 through 2011. The ONRR is in the process of validating the collection numbers for FY 2012 and we plan to post the amount of additional royalty collections on our website when that validation is complete. Enclosure 2 does not provide information on resulting fines because the audit process results in Orders to Report and Pay additional royalties. As required by statute, if companies do not comply with the Orders, then they are subject to civil penalties, i.e., fines. Please provide a detailed list of any violations of applicable law or regulations – and resulting fines – related to royalty payments for coal mined on federal and tribal lands that occurred in years that are not yet subject to audit or compliance reviews.
- b. The ONRR has developed an action plan outlining the steps ONRR will take to ensure that companies properly report and pay royalties for coal production from Federal leases for years that were not yet subject to audit. (The ONRR would be pleased to share the action plan with your staff). Based on the compliance activities completed in the action plan, ONRR will determine if any violations of applicable laws or regulations occurred and, if applicable, proceed with Orders to Report and Pay additional royalties.

Question 2:

BLM reports that more than 94% of federal coal is produced by mines in Wyoming, Montana, Colorado and Utah; Energy Information Administration data show exports from these states have more than tripled to 21.2 million tons between 2009 and 2011.

- a. What steps will the ONRR take to ensure that federal and tribal coal leases (royalty payors) are reporting the proper product value for coal sold internationally?
- b. What steps will the ONRR take to ensure that, in a case where the royalty payor sells coal to an affiliated trading entity, the entire consideration received by the royalty payor is reflected in the reported gross proceeds?

Response to Question 2:

The regulations governing the value of coal for royalty purposes are contained at 30 CFR part 1206 subpart F—Federal Coal (2012). Under the current coal valuation regulations, if a company sells its coal to an independent or unaffiliated company – known as an arm’s-length contract – the coal is valued based on the sale price where the coal is sold and on the quantity and quality of the coal produced from the mine. If, however, a company sells to an affiliate – known as a non-arm’s-length contract – the current regulations provide five benchmarks to determine the appropriate value for royalty purposes. The benchmarks are applied sequentially and include such factors as comparable arm’s-length sales in the area, prices reported for that coal to a public utility commission, prices reported for that coal to the Energy Information Administration, other relevant matters including publicly available spot market prices, and a netback method. The regulations also provide that under no circumstances can the value of the coal be less than the gross proceeds accruing to the lessee.

To ensure that companies are reporting and paying the proper value under the regulations, ONRR has a comprehensive compliance and audit program that includes State and tribal auditors under contract with ONRR under Sections 202 and 205 of the Federal Oil and Gas Royalty Management Act of 1982. Audits are already underway on several coal companies in the Powder River Basin that were selected based on ONRR’s risk-based compliance strategy. Most of those audits are being conducted by ONRR’s auditing partners in Wyoming and Montana.

In addition, ONRR has convened a task force – which includes State auditors – to address coal sales to overseas markets through a risk-based audit and compliance action plan. The action plan outlines the steps ONRR will take to ensure that companies properly paid all of the royalties for Federal coal production sold to export markets.

Question 3:

The *Reuters* story raised questions about whether sales prices reported to the ONRR reflect the true arm’s-length value of federally leased coal sold on the international market. What steps will the ONRR take to ensure that, in cases where the royalty payor sells coal to an affiliated trading entity, the reported sales price reflects proper product values, including any premium received in the case of an international sale?

Response to Question 3:

The first step ONRR will undertake is to conduct a comprehensive analysis of reported data for calendar years 2009 through 2011. In this analysis, ONRR and its State and tribal audit partners will review sales summaries and sales contracts in identifying whether additional documentation is needed to determine if the transactions are either arm’s-length or non-arm’s length, i.e., affiliate sales. The ONRR will then use this analysis to review completed and current audits and compliance reviews to ensure that companies properly valued production and complied with applicable regulations under 30 CFR part 1206 subpart F—Federal Coal (2012). The review will then expand to include, on a risk-based approach, non-audited or reviewed mines and leases and calendar years 2001 through 2008. Initially, these efforts will focus on the Powder River Basin, but ONRR plans to expand its review to coal mines and leases that are not in the Powder River Basin.

If at any time during audits, compliance activities, or implementation of the action plan ONRR finds that Federal coal lessees are not complying with Federal laws and regulations we will issue enforcement actions and expand the time periods covered by our audits. If companies knowingly or willfully provided false information in their reports, knowingly failed to pay proper royalties due, or knowingly failed to permit an audit, ONRR can issue substantial civil penalties. If criminal activity is suspected, ONRR will refer investigations to the Office of the Inspector General.

Question 4:

In fiscal year 2012, the ONRR conducted 325 audits and 891 compliance reviews on federal mineral leases that accounted for \$3.1 billion in revenue for U.S. taxpayers, equal to nearly one-third federal energy royalties collected in fiscal year 2011. What percentage of these audits and compliance reviews pertained to coal leases, and what amount of under-collection was identified?

Response to Question 4:

For clarification, while ONRR did conduct 325 audits and 891 compliance reviews on Federal mineral leases in FY 2012, the \$3.1 billion in additional collections covers the time period FY 1982 through FY 2011.

In FY 2012, ONRR completed 21 coal audits, which accounts for 6.5 percent of ONRR's total conducted audits; and completed 40 coal compliance reviews, which accounts for 4.5 percent of ONRR's total conducted compliance reviews. It is important to note that the FY 2012 compliance activities reviewed \$233 million or (30 percent) of the total reported coal royalties of \$786 million for calendar year 2009. The ONRR is in the process of validating the additional royalty collection numbers for FY 2012 and we plan to post the amount of additional royalty collections on our website when that validation is complete.

Question 5:

The 2009 Omnibus Appropriations Act (P.L. 111-88) codified civil and criminal penalty authority that the ONRR may use against lessees of Federal and Indian coal that violated federal leasing laws.

- a. Has the ONRR used its civil and criminal penalty authority in the past?
- b. Please provide a detailed list of instances when the civil and criminal authority has been used.
- c. How does the ONRR plan to use its civil penalty authority with future violators?

Response to Question 5:

- a. The 2009 Omnibus Appropriations Act codified at 30 U.S.C. 1720a civil and criminal penalty authority starting in FY 2010 and each fiscal year thereafter. Under its 3-year audit cycle, ONRR is just now beginning to audit time periods that provide this new authority. The ONRR has not yet issued any violations involving coal production; however, ONRR is currently investigating several solid minerals operators and anticipates that it will assess FOGMA civil penalties in the near future.

Consistent with Departmental policy, ONRR refers all suspected criminal violations to the Office of Inspector General (OIG) for investigation. To the best of our knowledge, the OIG has not filed criminal charges under FOGDRA against any lessees of Federal or Indian coal to date. However, the OIG has investigated mineral revenue allegations of criminal wrongdoing under Title 18 of the United States Code and, based on an ONRR referral, is conducting such an investigation involving a Federal coal lessee at this time.

- b. A detailed list of instances cannot be provided at this time. As explained above, ONRR has not yet assessed civil penalties and the OIG has not filed criminal charges against coal operators for FOGDRA violations. The ONRR will provide your office a detailed list of any future assessments.
- c. The ONRR continues to train employees and states and tribes with delegated audit authority to recognize and properly refer violations of Federal leasing laws within the context of Federal or Indian mineral revenues particularly with respect to solid minerals violations. The ONRR's Enforcement staff will vigorously investigate such violations and assess substantial civil penalties in the same manner as we have for oil and gas violations. Additionally, ONRR will continue to work in partnership with the OIG to develop evidence to support the prosecution of suspected criminal violations.

Question 6:

Concerns over royalty collections in the case of exports have only recently come to light; however, more than 118 million tons of coal produced in Utah, Colorado, Wyoming and Montana were exported between fiscal years 2001 and 2011. Does ONRR plan to audit previous fiscal years to ensure that the public received the full royalty payments that they were owed in cases where the coal was exported?

Response to Question 6:

The ONRR's plan of action begins with a review of coal production, royalty, and sales activities for calendar years 2009 through 2011 for the Powder River Basin. The review of Powder River Basin will then expand to include, on a risk-based approach, calendar years 2001 through 2008 and also coal mines and leases that are not located in the Powder River Basin.

Question 7:

When a royalty underpayment has occurred, it is critical that the Department has the proper tools to recover funds for American taxpayers and affected states.

- a. If underpayment of royalties has occurred, what recourse is available to the Department?
- b. Specifically, does current law and regulation permit remedying such underpayments in a way that accurately reflects the time-value of the money that should have been collected but was not?

Response to Question 7:

The ONRR pursues additional royalties owed resulting from audits and compliance reviews by notifying the official company representative and issuing an Order to Report and Pay the additional royalties. Under 30 CFR part 1218, ONRR assesses the company late payment interest after receiving the additional royalty payment. The Order to Report and Pay provides companies with appeal rights under 30 CFR part 1290. If companies do not comply with the

Order to Report and Pay, or if they do not timely appeal the Order, ONRR can assess civil penalties under 30 U.S.C. 1720a and take the following additional actions:

- Refer the debt to the Department of the Treasury for collection;
- Report the debt to the Internal Revenue Service for tax refund offset or if written-off, as taxable income;
- Refer the debt to the Department of Justice for litigation;
- Refer the debt for administrative offset;
- Demand payment from lease surety;
- Report delinquency to a credit bureau, including the amount of the debt, date of delinquency, state of collection, current balance, and high balance; or
- Refer the debt to a private collection agency.

Response to Question 1a:

This enclosure contains the additional coal royalty collections from audits and compliance reviews by violation of applicable laws and regulations for Fiscal Years 2008 through 2011. The table shows royalty collections received each FY from the compliance activities conducted during that FY.

Total Additional Coal Royalty Collections from Audits and Compliance Reviews by Fiscal Year						
Violation	Fiscal Year					Total
	2008	2009	2010	2011	2012	
Assessments		X				
Coal Advance Royalty	X	X	X	X		
Failure to Pay Rent / Minimum Royalties	X	X	X			
Failure to Report & Pay Royalties	X	X				
Incorrect Pricing		X	X	X		
Incorrect Processing Allowance	X					
Incorrect Production Volumes	X					
Incorrect Royalties	X			X		
Incorrect Royalty Rate				X		
Reporting Error	X			X		
Royalty Collections	\$1,370,037.02	\$13,484,668.92	\$5,961,699.83	\$6,129,033.44	TBD*	\$26,945,439.21

Source: ONRR's Compliance Information Management database. Data retrieved from database on January 11, 2013.

* The ONRR is in the process of validating the collection numbers for FY 2012 and we plan to post the amount of additional royalty collections on our web site when that validation is complete.