Workshop for Coal Valuation

TRANSCRIPT OF PROCEEDINGS

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Abbee Scarber, CCR-T

APPEARANCES

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Ed Sullivan, Peabody Energy
Scott Crosier, Peabody Energy
Chris Wittenauer, Peabody Energy
Ross Allen, Argus Media
Mike Matthews, State of Wyoming
Doug Downing, Ark Land Company

MR. ADAMSKI: So we'll just start with some brief introductions. My name is Richard Adamski, and I'm the Program Manager for Asset Valuation in Denver.

MR. HOVANEC: I'm John Hovanec. Formally the Program Manager for Asset Valuation.

MR. THROCKMORTON: What are you now?

MR. HOVANEC: I'm not sure. I have some what of a deputy position, but that's what I'm doing.

MR. THROCKMORTON: I'm Mike Throckmorton, I'm with Asset Valuation.

MR. ADAMSKI: Might as well just go around the room since we have such a small crowd.

MR. CROSIER: Scott Crosier with Peabody Energy here in St. Louis, and I met both John and Mike in the past through some coal sub-committee meetings.

MR. SULLIVAN: I'm Ed Sullivan, also with Peabody here in St. Louis. I've been around the business for a while.

MR. WITTENAUER: I'm Chris Wittenauer, with Peabody, I've not been around the business for a while.

MR. ALLEN: Ross Allen, with Argus Media. Publisher Argus Coal Daily.

MR. MATTHEWS: Mike Matthews, State of Wyoming.

MR. DOWNING: Doug Downing, Ark Land Company.

MR. ADAMSKI: We actually have a good mix in the room, and it's represented of the individuals that commented on the Advance Notices, that's great.

I just have some opening remarks that kind of just set the stage for really, the questions that we want to get into a little bit with John.

Good morning, and welcome to our public workshop. We're here to discuss possible revisions to the Federal and Indian Coal valuation regulations.

The purpose of the Federal and Indian coal valuation rules is to ensure that the American public and Indian tribes and the allottees, receive every royalty dollar due on coal resources. Through these public workshops and the Advance Notices of Proposed Rulemaking, the Office of Natural Resources Revenue is requesting comments and suggestions from the affected parties and the interested public before proposing changes to the existing regulations governing the valuation, for royalty purposes, of coal produced for Federal and Indian leases.

This is the second public workshop that we're having for coal. The first was last week in Denver, and again, we had about the same number of people show up for the public workshop, and actually had some really good comments to some of the questions.

In proposing changes to the current royalty valuation regulations, ONRR has three goals in mind:

1) Provide clear regulations that are easy to understand that are consistent with fulfilling the Secretary's responsibility to ensure fair value for the public and Indian resources.

2) Provide methodologies that are as efficient as possible for lessees to use.

3) Provide early certainty that correct payment has been made.

The potential benefits from our discussions today include: Simplifying and clarifying aspects of the rules. Decreasing industry's cost of enforcement. Streamlining audits by proving more certainty. Reducing potential litigation. So, we do appreciate your comments and we take those into consideration going forward.

So, just a line up of the issues that I will kind of be asking for comments today:

1) examining possible alternatives to the current methods used to value arm's-length sales;

2)Examining possible alternatives to the current methods used to value non-arm's-length sales;

3)Coal Comparability factors;

4)Examining possible alternatives to the

current methods used to value sales by coal cooperatives;

5)Use of index prices to value coal;

6)Examining possible alternatives to the requirement to track actual costs for determining transportation allowances;

7)Examining possible alternatives to the requirement to track actual costs for determining washing allowances;

8) And finally, just as a formatting type of thing, merging Federal and Indian rules or changing Indian rules.

Okay, as you noticed, in the corner we do have an official court reporter today, Abbee. So just before making a comment, I know everybody introduced themselves at the beginning, but if you could just start off that way with stating your name and who you're with, that would catalog the comments.

So based on the feedback that we get you know, from the public workshops and again the ANPR comments, we are looking like we are now going to proceed with accomplishing a proposed role and we're shooting for late next year to get something in, we'll see how that turns out. Any general questions before we start? Great, I'll turn it over to Mr. Hovanec now and

get into the actual issues.

MR. HOVANEC: Okay, well for most of you here, it's been 20 years, ONRR had 20 years experience in valuing coal under the current Federal and Indian valuation regulations. The lessons learned from this experience suggest that the current Federal and Indian coal valuation regulations could be improved to provide greater certainty that royalties have been paid correctly and to reduce the burden to both industry and government. We're interested in determining ways to simplify, clarify, and provide consistency in product valuation. We have examined the written comments submitted for the Advance Notice of Proposed Rulemaking, which closed July 26th for the Federal and Indian coal valuation and we're interested in further input regarding the perceived need to modify current coal valuation regulations to meet the above stated objectives. We received comments from 11 parties representing a good cross section of stakeholders.

So, in general, we'll start with valuation. Generally, commenters agreed that the current use of the arm's-length sales prices to value arm's-length coal sales is working. However, I guess the question would be, would the use of alternatives such as dollars per energy content be reasonable? All right. So basically,

you know, the cross section said, yeah, why don't we continue to use the methodology that we have, but we just want to explore whether there would be other alternatives that we could use. And I'll just add a comment, that I know that we had discussed this in coal subcommittee meetings some time ago, and so I'll just leave it at that. So this is not a completely new topic. Any comments to that? Ed.

MR. SULLIVAN: Ed Sullivan with Peabody. John, I do recall it having been discussed in a number of coal subcommittee meetings, and the problem that we arrived at through those series of meetings, was that it just wasn't workable, we tried. We looked at it from a number of different ways. The State of Wyoming was very helpful in analyzing the data that was made available, but I think the conclusion of, as you put it, a cross section of the state quarters, was that it's just not a workable solution. The industry, from our perspective, has adopted and has become comfortable with the methodology that's currently being utilized, and from our perspective, the change would not simplify or make it any more efficient, from a company's perspective to evaluate its royalty obligations, to meet its royalty obligations, and to explain to its customers how those royalty obligations would be calculated. So we don't,

as Peabody, don't see a need to go down that path or a benefit to go down that path.

MR. HOVANEC: Just because I know what some of the issues were related to in terms of say, a dollar per or cents per BTU, what were some of the issues that derailed that?

MR. SULLIVAN: It was that the variability of the quality -- we'll look at Wyoming for instance -- but throughout the Federal coal lease portfolio, the variability of the BTU quality of the coal that's sold. Coal, it's not a linear function, and coal is not necessarily sold on a linear basis, BTU basis. So I really think it would deprive both the federal government, the state government, the producer, and the customer of the certainty that the departments looking for. It just doesn't come through that process because of the variability, and as you recall, if you get into these cents per unit valuations, the industry and the government were down that path many, many years ago with the true royalty rate, meaning a cents per ton basis, and it was determined 30 years ago, perhaps maybe more, that that just wasn't workable because it was depriving the federal government and the state government of their due share of royalties when the price of coal increased. The determination was made that we'd go to a percentage

royalty rate, and that keeps the royalty pay to the federal government and to the states on a level basis, as compared to the price of coal that a producer gets when it sells to the ultimate customer. We think it works.

MR. HOVANEC: All right. Well lets now move to probably the more challenging of the current valuation methodologies, and that's talking about non-arm's-length sales. ONRR is examining possible alternatives to the current prioritized benchmark valuation methodology. While some commenters generally agreed that no changes were necessary, one commenter concluded that rules need a complete overhaul, and usually, and so -- Relating to non-arm's-length, and generally we know what some of the issues are, current methodologies for valuing non-arm's-length sells, ONRR seeks input on whether the current prioritized benchmark method works well, and if not, which parts do not work well and how could the system be improved? Also, should the factors for determining comparability of arm's-length contracts to non-arm's-length contracts be amended, clarified, or removed?

MR. SULLIVAN: Ed Sullivan with Peabody. Let me make one general statement that I already should have, let me just go back. I would just like to note

that Peabody does associate itself with the comments that were -- the written comments submitted by the National Mining Association to the ANPR. We're generally in agreement with most of those comments, and the general thrust of that comment letter being that the industry as a group generally, not universally, does not believe that modifications are necessary. But if modifications are to be made, we have some specific comments on them.

Now to move on to the non-arm's-length benchmarks, this is one of the areas that, again, from Peabody's perspective, the industry has worked with the department over the course of the last 20 years through this process, and we have become -- we have adopted those and understand them, and we are able to utilize them to the most efficient method of determining value. And we think to change it now would be a mistake. It adds no certainty, it actually creates uncertainty, and if you're looking for certainty across the board of stakeholders, although change is often good, sometimes change is unnecessary.

Now, to the extent that would be appropriate, would be that the first benchmark would be modified. It should be modified back to the way it had been discussed previously, years ago. With respect to utilizing a

producers arm's-length transactions of -- comparable arm's-length transaction -- from the same operation, to value non-arm's-length transactions from that operation. We believe that's the best marker of what value is, arm's-length from the same type of coal, from the same operation, sold by the same producer or an affiliate of that producer, but from that operation. That would be a minor modification to that first benchmark, but that should still be the first benchmark.

MR. HOVANEC: Okay. I guess if you were to -- If we were to amend the first benchmark, to say that you could use your arm's-length sales, which is obviously, you know, we've heard this before, and I think we've discussed this before, and I guess my question to you is, in utilizing an arm's-length sale, what about the position that that arm's-length sale could be below the cost that the operator would incur to actually mine the coal. So if you had an arm's-length sale that your selling, it's actually below your actual operation's cost, how does that fit in?

MR. SULLIVAN: Why would I do that John?

MR. DOWNING: When would that ever happen?

MR. HOVANEC: Well, I wouldn't bring it up if it hadn't happened. It's not what I would consider the best business policy. I think for most of us, we do

understand this business, and we understand that modifying that first benchmark -- I just had to bring it up because those situations do occur, not frequently.

MR. SULLIVAN: Ed Sullivan, Peabody. And one thing to remember, and I know you've heard this in the past, you've heard it from me in the past, 7/8 of that dollar is ours. We're not giving away something that -- We're not in the business to give away something, to deprive a royalty owner of their royalties, it deprives us a heck of a lot more than it would the royalty owner. If there were such a situation, it's a special situation, there's a reason for that, and I would think that ONRR should investigate it and find out what happened there.

MR. HOVANEC: Okay, good. Thank you, all right. Now, we're also seeking input on whether separate valuation methods need to be developed for sales by coal cooperatives or situations where there is a no-sale situation, like consumptions of the lessee, and I think that one of the things that -- and I know that we discussed this before, but I'll put it out on the table just to reiterate and get the same comments back -- but we would like to also have some input to index pricing, and whether that would simplify and enhance the regulations. Public comments have been

mixed, from do not use, to may use in some areas, to feasible to use. The ONRR invites specific comments as to whether index pricing could possibly be used to value Federal or Indian coal production.

MR. SULLIVAN: I guess my comment there would be we would take the position that it's not workable. There aren't sufficient indices available for the varieties of coals, the regions that coal is sold from, the mining operations coal are sold from. There are a limited number of indices out there, an adjustment would have to be made from each indices, for BTU, for SO2, for moisture perhaps, for ash. I think by utilizing, going down that path, you complicate the valuation process even more than it is now. There would be an awful lot of adjustments that would have to be made. Whether you make those adjustments from the front-end or the back-end, if it were the back-end, you'd have to readjust all your prior filings, as we do now -- which is something we want to comment on a little later -- but it just doesn't make a lot of sense to us to utilize that because again, to make an adjustment from a set index, you'd have to come up with some type of formula, and it's not a linear progression, from BTU an 8400 is not just a linear digression of an 8800 product, it's just not. I think it deprives again, I think it

deprives the stakeholders of certainty. It also both deprives I believe, it would deprive the state governments and federal governments of a share of royalty that they're entitled to. And another point to that, with respect to Indian coal, I don't know that there's an index out there that values Indian coal.

MR. ALLEN: Ross Allen, Argus Media. We publish a wide variety of indexes around the world for coal, and we also aren't aware of any index on Indian coal; that is correct. However, we are looking for new indexes to both assess and perform price discovery on that.

We actually provide robust price discovery across the energy states. ONRR uses our crude and has used our crude indexes for similar kind of conditions. The traded price discovery process, has been an effective one since the first trade in 1999 for Powder River Basin 8800 product. That is a traded specification that is generic across the basin. It is typically the most traded specification, although, we do have 8400 specifications, traded and price discovered. The price discovered process is transparent and robust. We have our methodologies, our ethics policies, our compliance policies all published on our website, 24/7 365, for public review.

So I think it's important to recognize that there are effective indexes available to the industry to use for calculations like this, and for sales process for trading and for a number of other functions. In other jurisdictions -- Columbia comes immediately to mind -- royalty calculations are based entirely off index. Where the calculations are based off of, in that case, the API of two, minus a freight calculation for royalty calculation basis. That allows the royalty stakeholders, the owner side of that equation, to have some certainty that wash trades aren't going into the calculation method and things like that. I don't believe anybody believes that would happen here, but I do want to point out that in other jurisdictions indexation has a very effective, transparent, and robust way of protecting all stakeholders across the spectrum.

MR. HOVANEC: Yeah, if there's any way that you could also provide some comments -- and I guess when we were talking about the no-sales situations or cooperative sales -- that may have some application to, or if there are others please comment on those. And again, that's just as part of this process, we've discussed this before in the coal subcommittee, and again this is another one of the topics that was brought forward.

MR. MATTHEWS: Mike Matthews, State of Wyoming. I would point out that the index prices are geographically sensitive, and we don't believe, currently, there are any index prices that would reflect the value of coal in southwest Wyoming.

MR. HOVANEC: Even with what's currently being published by the Argus or other --

MR. MATTHEWS: We believe the prices in southwest Wyoming, are typically higher than the index prices for Powder River Basin.

MR. ALLEN: I just wanted to add to my comments, that every market has a benchmark price. In crude BTI, I trade the basis to that. In other cases, markets and royalty calculations have used a benchmark price with some discount or premium to that price, so that you have a market base and a transparent number that you're using. It's publicly available to anybody who chooses to look for that index. While also having a nearer to the coal phase, or nearer to the production type value added to it, or subtracted from it. So in the case of the higher sold for crude oils, the BTI for example, it has been a discount and traded to a premium. That's how markets work.

Mr. SULLIVAN: John, if I could. While we do appreciate the indices out there, and Peabody does use

them for certain business purposes. We do not feel there's an adequate availability of indices across the spectrum of Federal coal that's out there. As you know, there is none for Indian coal. But we would argue that while other industries may use it, coal is not oil and gas, and we've tried to make that point abundantly clear for a number of years. That while what's good for oil and gas, isn't necessarily good for the coal industry, or the solids industry, but to take that one step further, the areas in which we hold Federal coal leases themselves, or will hold in the future, don't currently have indices available. Yes, perhaps indices could be developed in the future, but if we're looking at doing something now, we have to look at what's available now, and what's available now, is the current valuation methodology that works. For example, we do have Federal coal in Colorado, and across the spectrum of coals in Colorado, there are no sufficient indices. We have Federal coal or will have Federal coal in New Mexico, and to my knowledge, there is no Federal coal or Index coal index available. So we just have a problem because we don't have enough data to fully evaluate that, to see whether or not to test it to see whether or not it was comparable to the methodology that's currently being used.

MR. CROSIER: Scott Crosier with Peabody. Just one small addition to that, the value of the coal is what better indicator of that is the sales price. I mean, an index -- It's your sales value that's going to be the most accurate indicator of what the true value of that coal is, and if you have a longer term supply agreement that may be a better deal for the customer, and in this case, these indices we made, what are we going to do, pay more on the front-end than what we're actually receiving? So then we're basically -- So it's basically costing more for the customer, more for that sale of coal.

MR. HOVANEC: Okay, before I turn this over to Mike, I want to bring up, in terms of -- I wanted to bring up one more subject relating to the benchmarks. As you know there are four benchmarks currently, there is the first benchmark which we've heard some comment about, and I just wanted to touch base and ask about the second and third in terms of their usefulness or any comments relating to the second and third benchmarks. Because generally, it's either the first or it's a non-arm's and we move down the scale, so we were looking for some general comments about that. And I think as Rich is pointing to prices reported, the second benchmark prices reported to the Public Utilities

Commission, and prices reported to the EIA or the Energy Information Administration.

MR. SULLIVAN: My experience has been that you don't utilize those too often, you usually go from one down to four, or you don't have one that fits. That's why the modification to one is important to us, so that we have a benchmark that works in virtually all cases, perhaps not in your cooperative scenario. But, while we don't see a lot of utilization from those two benchmarks that you're referring to, I do not believe that they need to be eliminated, because they are important markers of what a customer will have reported it has paid for its fuel source. So I think it's important to -- I think they could be important to you in certain given situations, I just don't think you find that given situation to occur a lot. So I wouldn't necessarily say they should be eliminated.

MR. HOVANEC: All right. I'm going turn it over to Mike.

MR. THROCKMORTON: So as you know, coal operators are allotted transportation and washing allowances, so now we'd like to exam possible alternatives to requirement to track actually costs, for determining coal transportation. Written comments during the Advanced Notice of Proposed Rulemaking were

generally supportive of the status quo.

Comments on washing allowances during the Advanced Notice of Proposed Rulemaking were divided. Two commenters oppose the concept of granting a washing allowance. Although, others support the status quo, and would continue basing the allowance on actual costs.

In the interest of simplifying the determination and verification of transportation and washing allowances, ONRR requests any alternative methods to tracking and using actual transportation costs, including any methods that would adjust for location differences.

MR. SULLIVAN: Mike, Peabody believes that the washings and transportation allowances should continue in their current form, and they should be valued as the actual cost of those services. Let me just hit on the thought of eliminating. The those of eliminating those allowances is well, highly unfair. The value of the coal is already increased to that customer, that customers already paying a higher price for that washed coal then he would for unwashed coal. The royalty on that washed coal, is, therefore, a greater dollar number to the feds and states because it is based on 12 1/2 % or 8% of that higher price that the customer is paying for that washed product. If you were

to eliminate it and include the cost of washing on that price, the federal government and state would be double believe dipping. They'd be taking advantage of the higher value of that the coal that was produced, and then also charging a royalty on the cost of the washing. So it would be highly unfair to eliminate them. The best -- It goes hand-in-hand with what Scott said earlier, as to the best indicator of what value coal is, is what the price of an arm's-length transaction would generate. The same thing holds true for a washing allowance, the best indicator of what that allowance should be, is what the cost of that washing process is. Now, yes, it will vary from operation to operation, and that's appropriate. If you were to set a fixed washing allowance, and say this is what you're entitled to and no more, then that deprives a producer of the ability to perhaps more efficiently wash the coal, be able to wash more coal, be able to wash more coal in a shorter period of time, and, therefore, be able to push more coal out the door and the sell to a greater audience, and, therefore, generate even more income on the royalty side. If you don't allow that innovation, that improvement, that additional investment and capital for washing, you may inhibit that producer from producing at greater production level. So we think that the best

indicator is the actual cost of washing, and that's where the allowance should come in.

MR. THROCKMORTON: Some folks might say that washing's part of placing the coal into our condition. Does Peabody take that view?

MR. SULLIVAN: No.

MR. CROSIER: We could sell the coal without washing it.

MR. SULLIVAN: We do.

MR. THROCKMORTON: But those that do --

MR. SULLIVAN: They get a higher price for that improved product.

MR. DOWNING: Mike, without that deduction there might be some mining operations on Federal coal that would cease. You just can't compete.

MR. THROCKMORTON: Any other comments on transportation or washing allowances?

MR. SULLIVAN: On the transportation side, again, trying to establish a fixed transportation rate is, again, unfair. It won't work and it isn't truly reflective of what a transportation cost would be. I mean if it's a delivered product to a customer at his plant, and I've incurred freight costs, it varies by customer. It varies by railroad, in the PRB there's two railroads for certain mines, and not all of their rates

are the same. It varies by whether you're using a tariff or whether you've got a contract rate. It varies on how many tons you're going to commit to that railroad for a given period of time for them to move. Your transportation is truly a function of the production, location, and the destination of where it's going, if it's sold at a delivered price. If you're talking about a deduction about in-mine transportation -- which I don't think you are -- that would vary about where the face is, where the high wall is, where you're producing from, and where your load out is. But it's a mine specific number, that doesn't lend itself well to a fixed number.

Now, if you'd like to talk about other allowances that I would like to see the department perhaps consider, I'd like the department to clay clarify that dust treatment that is being encouraged and insisted upon by the railroad to their customers, and the customers come back and ask the producer to put a dust control agent on it or topper on it, that should be added as a transportation allowance, and not be royalty bearing, because it is truly a cost of transportation. It is a cost that the transport, the rail carrier, has imposed upon the customers. They haven't imposed it upon the mine, it's not to put the coal in a marketable

condition, it's for a transportable condition for the railroad. I would think that that should be explicitly excluded from the royalty.

MR. THROCKMORTON: Would that include antifreeze?

MR. SULLIVAN: I'd love to see it go right down and talk about side release agent, freeze proofing, and SPON COMP -- spontaneous combustion prohibitors. Those all, in my mind, are costs of moving the coal and delivering the coal, but not value of the coal.

MR. THROCKMORTON: Any other comments?

MR. SULLIVAN: And while I have the floor, I do recall back around 1989 when we went through a massive re-haul over all of the valuation ratings, and if they're going to be reopened in this manner, I would like the department to go back and reconsider what they did back 1989 and then reverse to nine months later in 1990, and took out the cost of black lung and AML from the royalty.

MR. HOVANEC: No, wait --

MR. SULLIVAN: You opened this up. This is a workshop. These are things that I would like to see the department reconsidered. They considered it in the past, they did it in the past, and for a reason some of us still remember, they had to backtrack on it. But

those things truly aren't value enhancers, they are akin to taxes, and what you do is end up paying royalties on those taxes, which I know we do. In fact, that's the final one I'll hit. The royalty on royalty, that should be taken out. I don't think it's within your scope to do so, but for the irritative process for paying royalty on top of royalty is outrageous to me. Royalty rate's 12% but the Federal royalty we pay is about 14 .2%, that never made sense to me. But as the result of the irritative process of paying royalty on royalty, you end up paying more royalty than what, we believe, the law requires. And with that on allowances, that's about all I have.

MR. HOVANEC: I'm glad you and Bill are not in the same room, we would have gone the full term.

MR. THROCKMORTON: Now, let's talk about Indian coal valuation. One commenter strongly suggested that the Indian and Federal regulations not be combined. Another recommended against Indian changing the regulations because lessees, states, and tribes would be burdened to learn the new regulations, at additional cots to all.

The ONRR requests specific details on why Federal and Indian valuation regulations should or should not be combined.

MR. SULLIVAN: We won't make any comment on Indian coal at this St. Louis Coal Workshop. We will have somebody available on Thursday in Albuquerque for your workshop there. My understanding is that the tribes that we do business with, that we lease coal from will also be in attendance, and we would generally lend support to their comments.

MR. THROCKMORTON: Anyone else on Indian coal?

Okay, finally ONRR is interested in receiving comments on any other alternative valuation methodologies that would provide clarity, efficiency, and early certainty that correct payment has been made. Just anything else, you've got the opportunity now.

MR. SULLIVAN: As we said at the beginning, we are -- Peabody-- is of the opinion that the system's working. It may not be the most effective or least cumbersome system, but we believe it's working. We believe that at least from our perspective, fair and appropriate royalties are being paid in a timely manner. That any alternative valuation method will not add to simplicity, will add to confusion, will add to uncertainty, and will do a disservice to the stakeholders involved, that after 20 years of now become fully -- I hate to use the word comfortable, so I'll use

it anyway -- fully comfortable with the system that we're all involved in, it doesn't make a lot of sense to us to open that to inefficients that could arise to the confusion and to the uncertainty.

MR. CROSIER: We do have some thoughts on how to maybe improve on the reporting side of things, once we get -- if we get -- to that topic.

MR. THROCKMORTON: Well, you know, Scott, why don't you make those comments now. I don't think we're going to have any questions on reporting.

MR. CROSIER: I mean, one of the biggest complaints that our folks have who do our reports internally, is that, for example, if you start in a given year, the fact that you have to take every adjustment back to the original production period each time you have an adjustment, by the time you get to the a end of the year you could have adjusted January 12 times by the time you get to that year. Why there's not some type of rule that allow you to have a threshold if you have adjustments fall below this threshold, you only have to make that adjustment at the end of the year in the December time period. Because as your accumulate these over time, we can have a $5.00 adjustment we have to take back for 12 months, and it's costing you money to process that submission, it's costing us money to

even generate it for a $5.00 value adjustment that equates to, you know, a few cents of royalties. The whole reporting structure is probably the most cumbersome part of the process. If you're trying add efficiency, the first place to look is at the reporting side. And everybody in my group that does any reporting on Federal leases would basically would say that to the T, because they're like when are they going to fix this? That's what they ask. When is this going to get fixed? This is ridiculous, and I have to take a $5.00 adjustment back 12, 13 months to a period that's long since gone. The cost of processing it far exceeds the benefit associated with it.

MR. SULLIVAN: For both us and them.

MR. THROCKMORTON: Yes.

MR. DOWNING: Would it be worthwhile Mike, to have the folks that actually do the royalties to have a meeting to get their actual input?

MR. HOVANEC: Well, depending on -- I don't know whether they're going to recreate the RPC process. Maybe down the road they would, but the coal subcommittee was definitely a good forum for that, and this is kind of a spin from -- This is the first time we've been out talking about any kind of rule. So yeah, we would be interested in that. I mean, I can tell you

that, you know, adjustments and the scope of the adjustments was not really known until the production and royalty report was created. Now we have some data to essentially analyze what the affect in terms of the number of lines, in terms of how much dollar is out there. So, I would be very interested in that. As I mentioned to Ed, I think one of the goals we have is it's been 11 years, pretty soon going on 12 years since we've been using the current system, or the current process. So we're looking to create, you know, revisions to that system, and that would be one of the things that clearly we could address, you know. And we do want to hear those kinds of comments. I think though it has to be a separate forum, and I don't know, I guess we can bring this back and we'll definitely do that, because now we've heard that in two meetings, and I'm sure we'll hear it in a third meeting in Albuquerque, and it's fine, I mean you know.

MR. DOWNING: If you want to make an improvement, that's the place to make it.

MR. CROSIER: There's a lot of extra time on both sides, both the industry side and the government side, in processing those submissions. There's a lot of time that could be saved on both sides if we could come up with a somewhat efficient process, I mean there is an

easy way to go about it. Furthermore, and along those same lines, and I'm sure you heard this from Hartford (phonetic), the fact that some -- like our federal estimates, you know, 90% rule or something. How when you have a small amount, and then because you have a quality adjustment 12 months down the road, and you guys want to go back and charge us interested on it? Well the events didn't happen until --

MR. HOVANEC: Well we haven't been -- Hartford (phonetic) didn't say anything about interest, and that's mostly because -- and just for those that don't know, this is a different business, and actually you have in the production and royalty report, you do have some sort of allowances in terms of being able to select whether it's interest bearing or not, and for the most part, under the old system they were called Ark 31's, and they got pretty much billed them all until you could prove otherwise. Well it flipped --

MR. CROSIER: If you recall, we sat down and had a long discussion about that.

MR. HOVANEC: Those are some of the things that -- and I would tell you from a being a regulator and also representing the stakeholders, that there's a balance between okay, trust me, which I feel, and actually the position of the stakeholders is okay, when

did you receive the money, and those types of things. Balancing out between the materiality of the adjustment, and the fact from that a trust responsibility or fiduciary responsibility there has to be some oversight.

MR. CROSIER: But I think if you have adequate rules, I don't think the trust factor doesn't even have to come into play. I don't think there's anybody in this room, Arch, we know how to report our royalties, we're trying to streamline the process, which I think is what I believe both of our goals is.

MR. HOVANEC: I would agree. I would think that that would be one of the topics, and that I think part of the comments would be that this would be another area that we want to look at. Because obviously, whatever we can do to create certainty, and again, when this whole process was created 12 years ago, I was there, and it was created primarily in terms of not issuing the bills and making you appeal it, that has flipped back, okay? So essentially we didn't issue the bills, and then through the auditing processes and through the reporting processes, we would actually be able to see what those numbers really look like. Now we have that date, and I would tell you that it's an area that is not very well known, relative to the business. I mean, when you look at adjustments, you say well what

drove that adjustment, you have to really be fairly studious to understand that process, because that relates to, you know, a number of aspects relating to your contracts, and just generally some of the facts that you don't have published numbers, you know, indices, whether it's a consumer price index, or actually even knowing what your severance cost was, that has to be passed through. So there are a number of things that would need to be mapped out and understood in order to create a balance. But, you know, it's been one of the issues I've had on my mind, because again, I've been looking at those numbers for the past five or six years once I started getting the data back.

So, you know, that would be a good area to talk about. Some of the other areas we were talking about in terms of regrouping, is creating more flexibility for allocation methods, so that you could actually use really the tool, and that would cut down -- whether it's FIFO, LIFO, or one of the other processes. But any other comments, we would also like to hear that too because that would be helpful.

MR. CROSIER: Thank you.

MR. MATTHEWS: Mike Matthews, State of Wyoming. I would like to echo our support for the comments Peabody made on the need to change the rigs.

We would also support to that light, the comments of the Wyoming Mining Association, on the need that for these rates to be reworked, we agree, I mean there is certainty in the rates now, why fix something that isn't broke. An additional comment would be where I might different from Peabody, I think there's a difference between a royalty interest which is an ownership interest, and a tax, which is a burdened industry.

MR. HOVANEC: So when you say which change regulations, you're talking about the current valuation?

MR. MATTHEWS: I think he eloquently expressed it. We agree, we've got something that's working.

MR. THROCKMORTON: Last question. Definitions of terms that apply to multiple sections of product valuation regulations, is there any benefit to housing these terms up front in Section 1206 Subpart A -General Provisions, along with general principles that commonly apply to all the product valuation regulations, oil and gas, coal?

MR. SULLIVAN: All right. Just too well T' d up. We believe, that the solids are different from oil and gas, coal is different than oil and gas. To intermingle the two even more than they already are, is only going to add to the confusion, in my mind, as to

how the regulations that apply to coal are to be applied. I think it will bleed the treatment of oil and gas over into coal. So I'm concerned with the prospect of what you're proposing to do, I'd like to see what you're thinking about before I say no, because I also believe a section that just would be for coal, that would be helpful to have it in one place. If you're going to do that and change those definitions in some manner, that causes concern as well. I'd like to know what definitions we're talking about and what changes you'd make to them, and how that would be implemented. But as a general statement, I look at coal being regulated here, I look at oil and gas being regulated here. I know there are many in the department that look at these are the resources, the mineral resources, of the Federal Government and they ought to be regulated here. But we would prefer our little piece of the universe.

MR. THROCKMORTON: Okay, any other comments?

MR. SULLIVAN: I had some comments that I didn't make further on the indexes fix, if I could just give you an example, and it's something when Scott was speaking it rang a bell to my mind, is this whole notion of using indices to price your coal. It would make it, in my mind, very difficult to try to base load a new

mine with what we call a base load contract for a new mine. Before I'll put the capital in there, I need to have a customer onboard, multiple customers onboard for a long term business of significant tonnage. To do that, I have to negotiate with that customer, and arrive that price the that works for that customer. That price, up front, maybe higher than what an index would say it should be. But over time, the way a contract like that may be structured, is if it's a 20 year contract, over time that may benefit the customer because the price doesn't escalate, perhaps, as much a market price would, or paid perhaps as much as an index would. What that would do, would discourage -- if you went to pure index -- that would discourage a potentially long-term high-tonnage customer to make that commit to me, to allow me to put the capital in to open a new mine. I'm concerned things of what could happen.

What it would also lead my mind to, is customers coming in and looking at short-term contracts, not wanting to is sign up for three or four years because they don't know what the index would be in three or four years out. I could give them a price and say okay, but it's going to escalate by CPI over that four year period but here's your number, X plus one, X plus 2, over our CPI. If my customer comes in and say, I

want a four year deal, I say okay, here's your price this year, because that's what the index says. The index will tell me what next year is, okay I got that, maybe two years out, okay I got that, we'll lock it in. Four years out, five years out, it's really speculative as to what that index is going to be. So the customer would go towards a short-term business, which creates uncertainty for me, for him, for the state, for the federal government, as to how many tons are actually going to be sold. So I've got a concern, and it may be just me looking over my shoulder, but I've got a concern that these are potential things that I don't worry about today, that I would worry about then.

The other side of this, is that if I assume -- obviously the indexes would change over time-- but I assume if you put a fixed number on there, on a BTU basis, that would also be subject to change. Subject to the department coming in and saying okay, now is the time we had set it at a buck, now we're going to go to a $1.10, would my existing contracts be grandfathered at that buck or would they be subject to immediate change then, if their subject to immediate change, my customers not going to be happy. He's not going to sign up for a piece of business that creates that level of uncertainty, because that buck could have gone to two

bucks, he doesn't know. So I'm concerned about the variability of those things. Again, the best marker of value is an arm's-length transaction between two unrelated parties. The notion of fixed, the notion of index, causes me great concern. As does the variability of it over time, where the department would say okay we're going to change, and what happens to my existing ones. I think if you go down this path, grandfathering or some transition period has to be something that's looked at very earnestly.

MR. THROCKMORTON: Cloud Peak made a similar comment at the Denver meeting.

MR. SULLIVAN: I don't even talk to those people.

MR. THROCKMORTON: Okay.

MR. HOVANEC: Any other comments?

MR. ADAMSKI: We really appreciate your coming. Even though it's a small group of comments, they are very important comments, and they do represent a majority of the industry. So we do appreciate you showing up today, your comments. Like I said, we're going to get back take a look at everything after it's all said and done, and we'll be starting the process of putting out a proposal, and again, once we do come up with a proposal, that will again be for written

comments. Once get specific, then you can get more specific and your issues and things like that also.

So, thanks so much. We'll see some of you in Albuquerque I guess on Thursday, and that's our last public workshop for coal, and the three for oil and gas preceded these and they're finished already.

MR. SULLIVAN: I want to thank you folks for coming to St. Louis and having an opportunity to speak to you.

(The above proceedings ended at 9:41 a.m.

REPORTER'S CERTIFICATE

I, Abbee Scarber, Certified Court Reporter, do hereby certify that there came before me at the Marriott St. Louis Airport, 10700 Pear Tree Lane, St. Louis, Missouri 63134

IN WITNESS WHEREOF, I have hereunto set my hand and seal this 25th day of October, 2011.

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Abbee Scarber, CCR-T

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