Peabody

C-EI-ECS-7-78(b)

United States Department of the Interior

OFFICE OF THE SECRETARY
OFFICE OF AUDIT AND INVESTIGATION
CENTRAL REGION
1841 Wadsworth
Lakewood, Colorado 80215

June 28, 1978

RECEIVED
JUN 30 1978
HOPI TRIBE
CHAIRMANS
OFFICE

Memorandum

To: Area Director, Phoenix Area Office
Area Director, Navajo Area Office

From: Regional Audit Manager

Subject: Coal lease 14-20-0603-9910 between Peabody Coal Company and Navajo-Hopi joint tribal interests (Black Mesa lease) and 14-20-0603-8580 between Peabody Coal Company and the Navajo Tribe (Kayenta lease).

Pursuant to a request from Geological Survey, we have completed an audit of royalties paid by Peabody Coal Company on coal mined under the subject coal leases. A copy of the audit report is enclosed for your information.

During the audit, certain aspects of the coal leases were deemed to be of sufficient import that they should be brought to your attention. First of all, even though the coal that is mined under these two leases comes from the same geographical region, the royalties collected on the coal are not equivalent. The difference is due to the way the two leases are written. The Black Mesa lease stipulates that royalty rates of 6.67 percent and 5.33 percent (depending on whether the coal is sold and utilized off or on the reservation) will be applied to the monthly gross realization. Gross realization is defined as gross sales price at the mine site without any deductions. Under this arrangement, as gross realization increases, total royalties due also increase.

The Kayenta lease, although it is also based on the gross realization method, has a much different arrangement and considers increases in gross realization only up to a certain point. Royalties due under this lease are based on predetermined charges applied to a graduated scale of average monthly gross realization values as set forth below:

	Average Monthly Gross Realization		
	Less than $4 per ton	$4 or more per ton but less than $5 per ton	$5 or more per ton
Sold & utilized off the reservation	25¢	30¢	37½¢
Sold & utilized on the reservation	20¢	24¢	30¢

30/78
Chairman
Vice Chairman
Executive Director
Navajo Tribal Secretary

EXHIBIT 118-B(10)

HP014302

It is obvious from the above schedule that once gross realization exceeds $5 per ton there will be no further corresponding increase in royalties. This is precisely what is occurring; in February 1977, the gross sales price of coal mined on the Kayenta lease and sold to the Salt River Project (SRP) (utilized on the reservation) increased from approximately $3.09 per ton to approximately $5.72 per ton with a corresponding increase in royalties from 20¢ per ton to 30¢ per ton. Since that time, the price of coal sold to SRP has increased to over $6.50 per ton without any corresponding increase in royalties. Regardless of how much the price of the coal increases, under the current royalty provisions, there can not be any increase in royalties until February 1984, when the lease terms allow for renegotiation of the royalty provisions. Currently, the majority of the coal mined on the Black Mesa lease is sold to the Southern California Edison Company (SCE) (utilized off the reservation) at a gross sales price of over $7.00 per ton and consequently yields a royalty of approximately 47¢ per ton. In contrast, coal mined on the Kayenta lease is sold to the SRP at a gross sales price of over $6.50 per ton and yields a royalty of 30¢ per ton. During calendar year 1977, the Navajo Tribe would have collected additional royalties in excess of $1,000,000 from the Kayenta lease if the Black Mesa lease royalty rate of 6.67 percent (which was applied to sales to SCE) would have been used instead of the predetermined rate from the above schedule. It must be noted that royalty provisions of the Black Mesa lease differentiate between coal sold and utilized off and on the reservation. Coal sold to the SRP is utilized on the reservation and under Black Mesa lease terms would require royalty payments of 5.33 percent, not the 6.67 percent as used above. We have used the 6.67 percent only to point out the difference in royalties received from the two leases even though the coal is produced in the same geographical area and is approximately the same quality. However, even using the 5.33 percent, there would have been additional royalties of approximately $482,000.

It is interesting to note that from May through December 1977, additional large amounts of coal were mined on the Kayenta lease and sold to the SRP. These collateral purchases were made ostensibly to stockpile coal in anticipation of a forthcoming coalminer's strike. Peabody Coal Company delivered 743,687 tons of additional coal at a price of about $18 per ton for a gross realization of $13,237,503. Royalties collected on these deliveries amount to $223,106 (743,687 X 30¢) or an effective royalty rate of 1.66 percent of the gross realization of the coal ($223,107 ÷ $13,411,537).

Notwithstanding the disparity between the two coal leases in terms of royalties received, neither of the lease royalty rates accurately reflect or compare with current rates in effect. Since August, 1976, all coal leases issued on Federal lands have stipulated rates of 8 percent and 12½ percent of gross realization for underground mining

EXHIBIT 118 B (11)

HP014303

and strip mining, respectively. Stated differently, the best rate of the two leases is only a little more than half of what the Government is receiving from new strip mining coal leases.

Based on the apparent inequitableness of the royalty rates, not only between the subject coal leases but also as these rates compare to royalty rates included in new Federal coal leases, we believe it would be in the best interest of the Navajo and Hopi Tribes that an attempt be made to amend these coal leases as soon as possible. The Kayenta lease does not allow adjustments to the lease until February 1, 1984 while the Black Mesa lease doesn't include any type of an adjustment prerogative. However, despite this lack of renegotiation authority, in our opinion, this is an appropriate time for BIA to exercise its trust responsibility and attempt to have these leases amended with a view towards ameliorating the existing royalty rates. The reason for this presumption is that Peabody Coal Company in June 1976, and February 1977, renegotiated its two coal supply contracts with its respective utility companies thereby increasing the sales price of its mined coal. More importantly, the renegotiated contracts allow Peabody to pass along to the utility companies any increases in production costs, including royalty increases. Stated differently, a request for a royalty rate increase for the Tribes would have no economic impact on Peabody's operations since increased royalties would merely be included in the sales price of the coal sold to the utility companies.

Recommendation

We recommend that BIA take whatever steps necessary to ensure that renegotiation proceedings are initiated between Peabody Coal Company and the Tribes with a view towards increasing existing coal royalty rates to a more realistic and equitable level.

Delbert J. Fickas

cc: Chief, Conservation Division,
Geological Survey
Director, Trust Responsibilities,
Bureau of Indian Affairs
Honorable Peter McDonald, Chairman
The Navajo Tribal Council
Mr. Abbott Sekaquaptewa, Chairman
Hopi Tribe

Enclosure

EXHIBIT 118B (12)

118B(12)

HP014304