

# STATE OF WEST VIRGINIA

## FULL PERFORMANCE EVALUATION OF THE

### Division of Natural Resources

#### Public Land Corporation

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#### **The Cabwaylingo Coal Lease with Vantage Mining Corporation has Several Irregularities Indicating that the Lease Should be Reevaluated or Possibly Voided**

#### **Issue 1: The Cabwaylingo Coal Lease with Vantage Mining Corporation has Several Irregularities Indicating that the Lease Should be Reevaluated or Possibly Voided.**

On January 14, 1999 the Public Land Corporation (PLC) approved the execution of a coal lease with Vantage Mining Corporation. This lease was for over 8,000 acres of coal beneath the Cabwaylingo forest on the “Alma Seam”. As part of the lease provisions, Vantage agreed to pay the PLC one million dollars up front and \$100,000 each year as a minimum royalty payment. The Legislative Auditor’s review of this transaction reveals several irregularities which raises concerns in the transactions procedures of the PLC, and raises the question that the contract should at least be reevaluated and possibly voided. The Legislative Auditor’s Office found the following problems regarding this transaction:

- Several of the allowed deductions from the 6% royalty payments are unusual for unaffiliated parties, **the deductions make it unlikely of receiving any royalties on a tonnage basis and therefore the state is likely locked into receiving minimum payments which cannot exceed \$4 million. If the lease had standard deductions from the 6% royalty payments, the lease**

**could earn in royalty payments significantly more than the \$4 million in minimum payments** depending on the amount of coal mined and coal prices.

- The PLC Executive Secretary informed members of the PLC Board that the manner in which the state's royalty payments was determined is the same as in previous leases. This was incorrect. The Vantage lease has deductions that are not included in the Pen Coal lease and the Panther State Forest lease. This difference is less favorable to the state with no apparent justification. The misinformation may have persuaded members to vote in favor of the Vantage lease.
- The lease was not reviewed by a coal lease expert prior to the execution of the lease, and the lack of knowledgeable personnel suggests that the PLC had no economic analysis performed to know how much coal could be mined in order to maximize the state's interest.
- Notice of the PLC meeting was filed late with the Secretary of State causing the public notification in the State Register to be filed one day after the meeting was held. **This violation may give legal justification to invalidate the Vantage lease agreement under West Virginia Code §6-9A-3.**
- Although not required, the PLC did not hold a public hearing prior to the execution of the lease but did hold at least one public hearing for a much smaller lease of 45 acres.

This lease was reviewed by the Governor's Office which also found problems with many of the lease provisions. The Legislative Auditor requested a review of the royalty calculation by a representative of the Property Tax Division within the State Tax Department. This review indicates that the Vantage lease contains deductions that are unusual for unaffiliated parties, and would provide no chance of the State receiving royalty payments on a tonnage basis.

## **The State is Likely Locked into Receiving Minimum Payments**

During the January 1999 Board meeting, the Cabwaylingo coal lease was voted on and approved by the Board. Prior to voting, the Board was provided a presentation by Vantage Coal executives regarding details of the lease. Board members asked several questions about how the mining would be conducted and also asked questions about Article Five of the lease which spells out the Tonnage Royalty. Article Five contains language which gives the PLC 6% royalty on the "Gross Sale Price" or \$1.25 per ton whichever is higher. However, the 6% is paid only after the operating expenses and taxes listed below are removed.

- Freight charges from the mine portal to the preparation plant chosen by lessee
- Government imposed taxes, including without limitation:
  - (i) West Virginia Severance Tax

- (ii) Federal Black Lung Tax
- (iii) Federal Reclamation Tax
- (iv) West Virginia Reclamation Tax

- All freight and delivery charges on coal mined and shipped from the “Lease Premises” which are paid by the lessee to third parties for hauling coal from the mine site or preparation plant to a Foreign Shipping Point
- All loading and unloading charges paid by Lessee at such Foreign Shipping Point, and
- All costs of treatment of the coal produced from the “Leased Premises” against the effects of freezing which are paid by Lessee.

According to PLC meeting minutes, the Chairman of the Board “asked questions about the taxes on page three of the lease” that are deducted from the gross sale price as listed above. The Executive Secretary responded “**the same information was in the Pen Coal lease.**” **This is incorrect.** The Pen Coal lease does not deduct any taxes from the gross sale price. Another Board member asked “if that was included in all leases” and a Vantage representative responded “**that it was generally included**”. **This also is incorrect.** An analysis by the Legislative Auditor’s Office of the Pen Coal lease and the Panther State Forest lease found that neither lease contains the same deductions from the 6% royalty payments. The Pen Coal lease deducts only transportation costs from the gross sale price, and the Panther State Forest lease does not allow any deduction of operating costs. This misinformation may have led the Board to vote for approving the lease.

In addition, at the request of the Legislative Auditor’s Office, a Tax Department review of 52 coal leases in its data file indicates that several of the deductions in the Vantage lease are unusual for a lease between two unaffiliated parties. This is shown in Table 1.

<b>Table 1</b> <b>Tax Department Review of 52 Coal Leases in Its Data Files</b>	
Vantage Lease Deductions	Frequency in the Data Files
Deduction of Freight Charges from the mine Portal to the Preparation Plant.	0% (unusual)
Deduction of government imposed taxes such as: <u>West Virginia Severance Tax</u> ; <u>Federal Black Lung Tax</u> ; <u>Federal Reclamation Tax</u> ; and <u>West Virginia Reclamation Tax</u> .	0% (unusual)
Deduction of all freight and delivery charges.	15% (not unheard of)

Deduction of loading and unloading charges.	10% (not unheard of)
Deduction of all costs of treatment of coal against the effects of freezing.	2% (Unusual)

The Tax Department’s review also indicated that “*with all the deductions starting with severance at 5%, there appears to be no chance of any net realization on a tonnage royalty basis*” [emphasis included]. This essentially means that **the lease confines the state into receiving minimum payments which cannot exceed \$4 million**. However, the minimum payment is relatively large (\$100,000 annually), therefore the Tax Department indicated that “*the Vantage Mining lease may be more advantageous [than the Pen Coal lease] but this is subject to getting a legal opinion on the sanctity of the minimums*” [emphasis included].<sup>1</sup> **It is the Legislative Auditor’s opinion that if the lease had standard deductions, a 6% royalty rate could earn significantly more than \$4 million in minimum payments.** This depends on the amount of coal mined and coal prices. The Governor’s Office had the Coal Appraisal reviewed by a mining engineer. The engineer stated that the report about the coal seam was insufficient to render an opinion on the transaction, and that the available reserves are probably several time larger than what Vantage indicated during the lease negotiations. This raises the question of what basis did the PLC make its decision to limit the state to a maximum amount of \$4 million? Discussion during the meeting is clear that the lease had not been prepared by a person knowledgeable in coal leases. One Board member specifically asked the Executive Secretary:

*“If he had in-house personnel to review the lease agreement?” The Executive Secretary stated that he was the only one. The Board member asks “If he had other staff that was knowledgeable of coal leasing?” Mr. Jones indicated that he did not.*

**The Director of DNR at that time who sits as Chairman of the Board asked if the lease had been reviewed by the DNR attorney and the answer was again no.**

### **Board Meeting which Executed Lease Violated the Open Meeting Requirement**

Although the Executive Secretary stated that the meeting was “*a public open meeting and any citizen could come to this meeting*”, the members discussed what reaction the public would have to the lease agreement. The Legislative Auditor found that according to the Secretary of State the notice of the meeting was filed late causing the notice to be published in the State Register on January 15<sup>th</sup>, 1999 one day after the meeting was held. Therefore, the meeting did not comply with WVC §6-9A-3 which requires that notices of meetings “**appear in the state register at least five days prior to the date of the meeting.**” The meeting was not held in compliance with the DNR’s own Title 58 rule regarding open governmental proceedings. Simply stated, the meeting during which the Vantage Coal lease was voted violated the open meetings statute. WVC §6-9A-3 also provides that:

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<sup>1</sup> *The Tax Department’s analysis was provided as a statement of fact and not intended to be an opinion from the Department on whether the lease provides the state market value.*

***“Upon petition by any adversely affected party any court of competent jurisdiction may invalidate any action taken at any meeting for which notice did not comply with the requirements of this section.”***

## **Lease Analysis by the Governor’s Office**

A review of the Vantage Coal lease by the Governor’s Office found other deficiencies in addition to the problems with royalty payments. Specifically there were five areas noted in the analysis which did not conform to standard practices. Listed below is a synopsis of the five areas of concern. A copy of the entire letter can be found in Appendix B of this report.

- **Duty to Mine:** The lease contains no provision requiring Vantage Coal to mine all of the Alma Seam. Partial mining could result in loss of income, inhibit developing the unmined portion, and preclude mining forever.
- **Waiver of Water Replacement:** The lease contains no provision to replace water supplies in the area should the mining impact water sources such as wells.
- **Wheelage:** Provides Vantage the right to transport coal from other operations “through or under the leased premises” free of charge.
- **Tonnage Royalty:** Allows Vantage to deduct operating costs prior to paying the 6% royalty thus reducing the amount paid per gross ton.
- **Recoupability:** Allows Vantage to recoup the annual royalty from the PLC. This royalty could eventually total 4 million dollars.

The Executive Secretary in a response to a Governor’s Office request for information dated June 28, 2001 states:

*Upon reviewing the enclosed data and our response to your questions, you will find that the board members gave the leasing process a thorough due diligent review before making their decision to vote in the affirmative for the motion made to sign the lease.*

However, it is obvious from meeting minutes that the Board realized the lease had not been prepared or reviewed by an experienced person and there was risk of problems. Despite these concerns, the Board approved the lease.

## **Vantage Lease Compared to Pen Coal Lease and Alpine Coal Lease**

A review of the coal leases with Pen Coal, and Alpine Coal establishes that some of the same problematic terms found by the Governor’s Office in the Vantage contract can be found in

these leases as well. Neither lease contains the lease provisions found in the Vantage Coal lease regarding royalty payments. Table 2 below contains a brief analysis of the two leases compared to the provisions granted in the Vantage lease.

<b>Table 2 Comparison of Coal Leases</b>			
<u>Lease Provisions</u>	<u>Vantage Lease (Cabwaylingo) Aug 11, 1999</u>	<u>Alpine Lease (Panther State Forest) Nov 5, 1992</u>	<u>Pen Lease (Cabwaylingo) Nov 3, 2000</u>
<b>Duty to Mine:</b>	Not required.	<u>Not required.</u>	Required.
<b>Waiver of Water Replacement:</b>	Waived	<u>Not Waived.</u>	<u>Not Waived.</u>
<b>Wheelage:</b>	Releases Wheelage Rights.	<u>Releases Wheelage Rights.</u>	<u>Releases Wheelage Rights.</u>
<b>Tonnage Royalty:</b>	Pays royalty after operating expenses are deducted.	Does <u>not</u> deduct operating expenses.	Deducts only transportation expenses.
<b>Recoupability:</b>	Allows Vantage to recoup cost of royalty payments.	Not allowed.	Not allowed.

\* Underlined areas indicate a provision similar to the Vantage lease as noted by the Governor’s Analysis.

Although both the Pen Coal and Alpine Coal leases contain some of the same provisions as the Vantage Coal lease, neither contain the provision which allows royalties to be significantly reduced after certain taxes and expenses have been deducted. Likewise neither contain the recoupability clause allowing the coal company to cease paying royalties after a certain dollar amount is reached. The prospectus for the Cabwaylingo coal leases contained the recoupability clause prior to the companies bidding on the leases. The Panther State Forest prospectus did not contain such provisions. The DNR responded to inquiries regarding the preparation of the leases in the following manner:

*The Cabwaylingo leases were drafted in-house by staff of the Real Estate Management Office. In drafting the leases, staff reviewed examples of prior leases on file with the Public Land Corporation, including one drafted with the assistance of an independent consultant, and examples of coal leases from “Jones Legal Forms”. Staff made other revisions to the leases during the negotiation process.*

The Legislative Auditor’s review of the file provided by the PLC found a draft Vantage lease which did not contain deductions from the 6% royalty payments with notes to add the deductions as attachments. These deductions were contained in Vantage Coal’s original bid and were added to the draft leases.

**The Public Land Corporation Statute Should be Strengthened**

WVC §20-1A-5 specifically requires the PLC to hold public hearings and notify members

of the legislature prior to the sale, exchange or transfer of public lands. However, the succeeding section WVC §20-1A-6 which sets forth the requirements for the development of natural resources contains no such requirement. The construction of this statute considers land and mineral rights separately and does not require the same notification of the public and the legislature when leasing public lands for the development of natural resources such as coal, gas or oil.

Land or mineral rights are considered real property for the purposes of any real estate transaction. WVC §20-1A allows natural resource transactions to be treated differently from property sales. §20-1A-5 of the code contains several requirements regarding the sale, transfer or exchange of public properties. Specifically WVC §20-1A-5 requires:

- Written reasons and supporting data regarding such sale or exchange
- A public hearing be held in the county or counties affected.
- Provide notice to all members of the Legislature and political subdivisions having zoning or other land use regulatory responsibility thirty days prior to the public hearing.
- A published notice of Public Hearing within the affected counties.
- A copy of the notice be posted on public lands two weeks prior to the public hearing.

The succeeding section WVC §20-1A-6 defines the “*Competitive bidding and notice requirements before the development of natural resources on certain lands.*” Nothing within this section requires public hearings, notification of members of the legislature, or the promulgation of procedural rules. **Given that the development of natural resources can have a significant impact upon the citizens and an area of the state and the value can exceed the sale of land, the Legislative Auditor recommends that the statute should be as stringent for the development of natural resources** than it is for the sale and transfer of property.

In addition, §20-1A-4(f) of the code also requires that the PLC promulgate rules “regarding procedures for conducting public land sales by competitive bidding, modified competitive bidding and direct sales.” The PLC has not complied with this requirement. The DNR responded to inquiries explaining that this was not complied with because:

*The PLC has never drafted and filed regulations for the sale, transfer or exchange of land because the procedures set forth in Chapter 20-1A-1 et seq. are sufficiently detailed to give notice of the statutes’ mandates with regard to the sale, transfer of land.*

## **Conclusion**

The Cabwaylingo coal lease with Vantage Mining Corporation was approved by members with incorrect and inadequate information. The lease was not prepared by staff experienced in such leases, nor does the PLC have staff knowledgeable to conduct a thorough economic analysis to ensure that the state receives fair market value for its resources as required by law. Though not



specifically required by the code, a public hearing was held in 1998 for the leasing of 45 acres of coal in Braxton county according to the DNR annual report, while the Cabwaylingo lease is for over 8,000 acres of coal yet no public hearing was held. The deduction of operating costs and taxes denies the state 6% royalties on tonnage of coal which could be significantly greater than the \$4 million in minimum payments that the state is locked into receiving. Several of the deductions are not typical for coal leases involving unaffiliated parties. Furthermore, **the PLC meeting which executed the lease violated the open meetings statute, which may be sufficient to invalidate the Vantage lease agreement.** The Legislative Auditor recommends the following:

**Recommendation 1:**

*The Vantage Coal lease agreement executed by the PLC should be renegotiated or possibly voided.*

**Recommendation 2:**

*The Legislature should consider amending the PLC statute to ensure that the requirements for leasing gas, oil and mineral rights are just as stringent as those required for land sales, transfers or exchanges.*

**Recommendation 3:**

*The PLC should be required to have leases prepared and reviewed by individuals knowledgeable in coal leases, analysis of coal appraisals and all other aspects of leasing mineral rights.*

**Recommendation 4:**

*The PLC should comply with West Virginia Code §20-1A-4(f) by promulgating rules regarding procedures for conducting public land sales by competitive bidding, modified competitive bidding and direct sales.*