

STATE OF WEST VIRGINIA

FULL PERFORMANCE EVALUATION OF THE

Division of Natural Resources

Public Land Corporation

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

**OFFICE OF LEGISLATIVE AUDITOR
Performance Evaluation and Research Division
Building 1, Room W-314
State Capitol Complex**

**CHARLESTON, WEST VIRGINIA 25305
(304) 347-4890**

September 2001

PE01-16-215

JOINT COMMITTEE ON GOVERNMENT OPERATIONS

House of Delegates

Vicki V. Douglas, Chair
Earnest (Earnie) H. Kuhn, Vice Chair
Scott G. Varner
Larry Border
Otis Leggett

Senate

Edwin J. Bowman, Chair
Billy Wayne Bailey Jr., Vice Chair
Oshel B. Craigo
Sarah M. Minear
Vic Sprouse

Citizen Members

Dwight Calhoun
John A. Canfield
W. Joseph McCoy
James E. Willison
(Vacancy)

Aaron Allred, Legislative Auditor
Office of the Legislative Auditor

John Sylvia, Director
Performance Evaluation and Research Division

Brain Armentrout, Research Manager
Michael Midkiff, Senior Research Analyst

September 2001

WEST VIRGINIA LEGISLATURE
Performance Evaluation and Research Division

Building 1, Room W-314
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0610
(304) 347-4890
(304) 347-4939 FAX



John Sylvia
Director

September 16, 2001

The Honorable Edwin J. Bowman
State Senate
129 West Circle Drive
Weirton, West Virginia 26062

The Honorable Vicki V. Douglas
House of Delegates
Building 1, Room E-213
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0470

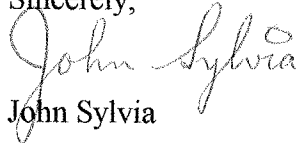
Dear Chairs:

Pursuant to the West Virginia Sunset Law, we are transmitting a copy of the Full Performance Evaluation of the *Division of Natural Resources*, which will be presented to the Joint Committee on Government Operations on Sunday, September 16, 2001. The issue covered herein is "The Cabwaylingo Coal Lease with Vantage Mining Corporation has Several Irregularities Indicating that the Lease Should be Reevaluated or Possibly Voided."

We delivered a draft copy to the Division of Natural Resources on September 7, 2001. We conducted an exit conference with the Division on September 10, 2001. We received the agency response on September 13, 2001.

Let me know if you have any questions.

Sincerely,


John Sylvia

JS/wsc

TABLE OF CONTENTS

Executive Summary	3
Review Objective, Scope and Methodology	7
Issue 1: The Cabwaylingo Coal Lease with Vantage Mining Corporation has Several Irregularities Indicating that the Lease Should be Reevaluated or Possibly Voided	9

LIST OF TABLES

Table 1: Tax Department Review of 52 Coal Leases in Its Data Files	11
Table 2: Comparison of Coal Leases	14
Appendix A: Transmittal Letter to Agency	17
Appendix B: Letter Regarding Vantage Mining Company Lease Dated August 11, 1999	21
Appendix C: Agency Response	27

Executive Summary

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 Tax Department's analysis is intended to be a statement of fact and not an opinion from the Department of whether the lease provides market value to the state.

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.

Review Objective, Scope and Methodology

This Performance Evaluation of the Department of Natural Resources (DNR), Public Land Corporation is required and authorized by the West Virginia Sunset Law, Chapter 4, Article 10 of the West Virginia *Code* as amended. The Public Land Corporation is responsible for maintaining the title to public lands not specifically held by other state agencies. The agency can sell, transfer or exchange property as well as lease mineral rights.

Objective

As stated in the *Code*, a performance evaluation is to determine for an agency whether or not the agency is operating in an efficient and effective manner and to determine whether or not there is a demonstrable need for the continuation of the agency.

Scope

The performance evaluation covers the period from 1994 to 2001. The Legislative Auditor examined documents provided by the Public Land Corporation regarding Coal leases, other information provided by the DNR, public records from the Secretary of States Office, and various sections of the code. In addition, the West Virginia Property Tax division was contacted regarding coal contracts.

Methodology

Information compiled in this report has been acquired from the West Virginia *Code*, information from the other state government sources, the Public Land Corporation, annual reports, and meeting minutes. This evaluation was conducted in compliance with Generally Accepted Government Auditing Standards (GAGAS).

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.

Table 1 Tax Department Review of 52 Coal Leases in Its Data Files	
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].¹ **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

¹ 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.

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 15th, 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:

“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.

Table 2 Comparison of Coal Leases			
<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>
Duty to Mine:	Not required.	<u>Not required.</u>	Required.
Waiver of Water Replacement:	Waived	<u>Not Waived.</u>	<u>Not Waived.</u>
Wheelage:	Releases Wheelage Rights.	<u>Releases Wheelage Rights.</u>	<u>Releases Wheelage Rights.</u>
Tonnage Royalty:	Pays royalty after operating expenses are deducted.	Does <u>not</u> deduct operating expenses.	Deducts only transportation expenses.
Recoupability:	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 of 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.

APPENDIX A

Transmittal Letter to Agency

WEST VIRGINIA LEGISLATURE
Performance Evaluation and Research Division

Building 1, Room W-314
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0610
(304) 347-4890
(304) 347-4939 FAX



John Sylvia
Director

September 7, 2001

Ed Hamrick, Director
Division of Natural Resources
Building 3, Room 669
1900 Kanawha Boulevard
Charleston, WV 25305-0060

Dear Director Hamrick:

This letter is to transmit a copy of the Performance Evaluation on the Division of Natural Resources, Public Land Corporation. The exit conference has been scheduled for September 10, 2001 at 2:30 p.m. in room W-314. We would appreciate your written response by September 12 so that it can be included in the final printing of the report.

If you have further questions please contact me or Michael Midkiff Research Analyst.

Sincerely,

A handwritten signature in cursive script that reads "Brian Armentrout".

Brian Armentrout
Research Manager

BA/mhm

Joint Committee on Government and Finance

APPENDIX B

**Letter Regarding Vantage Mining Company
Lease Dated August 11, 1999**



STATE OF WEST VIRGINIA
OFFICE OF THE GOVERNOR
CHARLESTON 25305

JUL 2001
DNR
Directors Office

BOB WISE
GOVERNOR

July 31, 2001

RECEIVED

AUG 07 2001

Legislative Manager

VIA HAND DELIVERY

Mr. Ed Hamrick, Director
West Virginia Division of Natural Resources
Chairman, Board of Directors
Public Land Corporation
Building 3, Room 669
Charleston, West Virginia 25305

Re: **Vantage Mining Company Lease dated August 11, 1999**

Dear Mr. Hamrick:

I am in receipt of and have reviewed documents provided to this office by Jim Jones, Executive Director of the Public Land Corporation, in response to the request of Governor Wise for information relating to the August 11, 1999 Lease Agreement with Vantage Mining Company. As you know, the Lease involves an 8,123-acre mineral tract underlying Cabwaylingo State Forest.

While the provisions in the Lease clarified some of the initial concerns regarding the transaction, they also raise new and disturbing questions about its advisability and propriety, particularly given the Public Land Corporation's affirmative duty to maximize any return the State may earn from the resources it owns. Moreover, the provisions in this particular Lease lead us to question the advisability of similar leases entered into by Mr. Jones.

Mr. Jones stated publicly several times that this Lease was a lucrative deal for the State. I could not disagree with him more. Indeed, I have reviewed the Lease in detail and have found its principal operating terms so detrimental to the State's best interests that I question whether it should have been entered into at all. Certain fundamental provisions were so flawed that they fail to provide the State with the most basic protections one would expect in a normal arms-length business transaction; specifically, I note the following:

July 31, 2001
Page Two

1. **Duty to Mine:** It is obvious that the value of mineral ownership to its owner can only be derived from the full use or development of the asset. The partial mining of a mineral leasehold could effectively destroy further efforts to mine the rest of the leasehold, which would result in loss of potential income to the mineral owner. Despite this principle, in Article Four, Vantage Mining is

[not] required or obligated to mine and remove any specified amount or quantity of coal during the term of th[e] Lease . . . and [the Public Land Corporation] hereby expressly waives, releases and discharges [Vantage Mining] from any express or implied obligations to develop the coal

In other words, under this Lease, Vantage Mining could mine only the best coal, leaving lower-quality coal behind, thus increasing the State's difficulty in developing the unmined portion, if not precluding mining forever. There is no conceivable reason why the State should allow Vantage Mining to take only the best, most profitable coal and leave behind the rest.

2. **Waiver of Water Replacement:** Access to water is a critical need for residents in many parts of this State, and especially so in southern Wayne County. I could find no evidence in the file that would adequately assure the residents of that county that its water supplies would not be affected by the proposed mining operations in a leasehold of such size. If Vantage Mining had given such assurances, there would have been no reason for it to demand a waiver of its duty to provide water replacement.

The fight to secure water replacement was quite recently underscored when Delbarton Mining, like Vantage Mining a subsidiary of Massey Energy, was cited by the Department of Environmental Protection because its mining operations caused water loss to Mingo County residents living in the vicinity of Naugatuck. Delbarton Mining was ordered to provide water replacement for more than 90 homes and pay all operation and maintenance costs for 30 years. Interestingly, the area affected by the mining operations is only about twenty miles from Cabwaylingo State Forest.

3. **Wheelage:** The Lease grants Vantage Mining "the exclusive right, free of charge, to haul or transport, through or under the Leased Premises, coal mined from other tracts." Again, a valuable – and potentially lucrative – right was given away without compensation. The imposition of wheelage charges is standard in the industry. In fact, the original draft of the Lease contemplates a charge per ton for coal transported through or under the leased premises. The relinquishment of this right is all the more egregious when one considers the last paragraph in Article Four, which states that Vantage Mining "intends to mine coal from the leased premises in conjunction with mining operations on the lands now or hereafter owned or leased by [Vantage Mining] or companies or other entities affiliated with [Vantage Mining]."

July 31, 2001
Page Three

It is therefore clear that Vantage Mining has now secured a right – free of charge – to move coal from other properties through or under the State Forest. Again, it is inconceivable why this valuable right was simply given away.

4. **Tonnage Royalty:** Mr. Jones stated publicly that the tonnage royalty earned by the State was 6% of the gross sales price, or \$1.25 per ton, whichever is greater. This pronouncement is misleading because it ignores the manner in which the gross sales price is calculated. Notably, under the terms of the Lease the following operating costs ordinarily borne by the mining company are deducted from the gross sales price: (1) freight charges from the portal to the preparation plant; (2) certain state and federal taxes; (3) freight, delivery, and unloading charges for shipment to the foreign shipping point (defined as a non-related company); and (4) de-icing charges.

In other words, under the Lease Mr. Jones negotiated, the State will pay Vantage Mining to haul the coal from the mine portal to its preparation plant, pay its severance and reclamation taxes, pay all costs for transportation to some other non-related company, presumably the end user of the coal, and finally, in case the coal freezes at any time during this process, the State will pay to de-ice it.

The extent of these concessions is stunning. Quite obviously, the effective tonnage royalty earned by the State will be far less than the 6% of the gross sales price Mr. Jones publicly claimed. It is both inexplicable and unconscionable that this State's resources are sold for less than what they could demand in the market, especially considering the current demand for coal.

5. **Recoupability:** The Lease provides for payment of an annual royalty eventually totaling \$4 million over the term of the Lease. However, that entire amount may be recouped by Vantage Mining through credits earned for mining royalties. Complete recoupability of the minimum royalty is not a standard term in mining leases; indeed, it was not in the draft lease. Typically, the amount of recoupability is a negotiated term between the parties and may result in an agreement to limit the amount and duration of such right. Again, in the executed Lease this potential advantage was apparently given away.

Beyond the aforementioned deficiencies in the basic terms of the Lease, there were other problems with this transaction. In order to investigate the economic rationale for entry into this Lease, I forwarded the Coal Appraisal relied upon by the Public Land Corporation to justify this transaction to a mining engineer for review and explanation. In his opinion, the data contained in the report about the coal seam was insufficient for him to render an opinion about the advisability of this transaction. In light of that deficiency, one must wonder how the Public Land Corporation could have ever properly weighed the economic advisability of entering into this Lease in the first place. In addition, it is his

July 31, 2001

Page Four

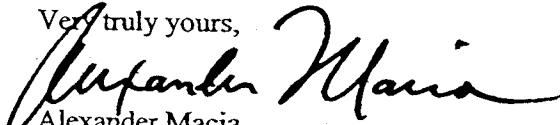
opinion that the available reserves are probably several times larger than what Vantage Mining claimed at the hearing before the Public Land Corporation. Concisely stated, taking these two issues together, it appears that the Public Land Corporation could not have engaged in any meaningful review of the economics of this transaction and may have been relying upon faith rather than analysis.

To my knowledge, the Public Land Corporation was under no compulsion to enter into this particular Lease, nor to make the concessions it ultimately granted. Consequently, given the nature of some of those concessions, the Governor has ordered the following remedial action: (1) Prepare an explanation why this Lease was executed in its final form; (2) conduct a review of all other leases entered into by the Public Land Corporation; (3) propose statutory amendments to ensure public input is solicited under these circumstances; (4) propose internal operational guidelines to guarantee a meaningful and complete review of all technical and legal aspects of such leases; and (5) provide this office with a review of all legal options available regarding this Lease.

Previously, we were concerned that the State might not be realizing the full potential value of its resources and was unwittingly conferring upon Vantage Mining a windfall at taxpayer expense. Now, regrettably, we are certain that such a windfall was conferred upon that company.

I look forward to your timely response to the above.

Very truly yours,



Alexander Macia
General Counsel

APPENDIX C

Agency Response



DIVISION OF NATURAL RESOURCES

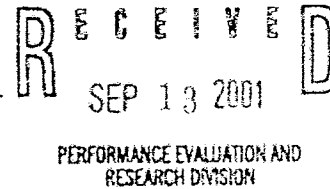
Capitol Complex, Building 3, Room 669
1900 Kanawha Boulevard, East
Charleston, WV 25305-0660
TDD (304) 558-1439
TDD 1-800-354-6087
Fax (304) 558-2768
Telephone (304) 558-2754

Bob Wise
Governor

Ed Hamrick
Director

September 13, 2001

Mr. Brian Armentrout
West Virginia Legislature
Performance Evaluation & Research
Building 1, Room W-314
Charleston, WV 25305



Dear Mr. Armentrout:

First, I would like to thank your office for allowing us an extension of time in which to submit our response. My staff and I have carefully reviewed the Legislative Auditor's Performance Evaluation regarding the coal lease executed in August 1999 with Vantage Mining Company. There are a few points of clarification and/or correction the DNR would like to provide which are outlined and discussed below. As you may know, due to requests by the Governor's Office and public outcry over the Vantage Mining lease, our agency was obliged to conduct it's own investigation of these matters. My final impression of the entire transaction is that a much higher quality product would have resulted if the PLC had the benefit of its own expert consultation and legal advice during the negotiation process. While the PLC followed all statutory procedures set forth in W.Va. Code § 20-1A-6, there are several problematic provisions of the lease that the DNR and current PLC seek to address by renegotiating the lease.

As discussed later in this response, our agency has made important internal policy changes for the leasing process that provide the opportunity for public comment and community involvement. The DNR will be submitting these policies in the form of legislative proposals so that future administrations will also be bound these requirements. Moreover, instead of merely meeting the "fair market value" requirement of W.Va. Code § 20-1A-6, the PLC's policy will be to maximize the return on any mineral right it decides to sell. To further that goal, the PLC will retain the services of professionals trained and experienced in the area of mineral rights to assist the Real Estate Office and the Board during the drafting and negotiation of all future coal leases. This should eliminate the possibility that the Board unwittingly agrees to concessions that are disadvantageous to the PLC and the state of West Virginia.

Method and Manner of Royalty Payments

Your report accurately outlines the deductions taken prior to calculating the gross sales price. However, we believe some further explanation on the entire payment structure is necessary. There are two types of payments required in the Vantage Mining Lease: tonnage royalty and minimum annual royalty. The minimum annual royalty is \$1,000,000.00 upon execution of the lease and \$100,00.00 per year for each remaining year that the lease is in effect. These amounts must be paid regardless of whether or not any coal is mined. The lessee is also obligated under the lease to pay tonnage royalty in the amount of 6% of gross sales price or \$1.25 per ton, whichever is higher.

The minimum annual royalty payment is credited against the tonnage royalty. When tonnage royalty actually paid and total minimum annual royalty actually paid equals \$4,000,000.000, the lessee is no longer required to pay **minimum annual royalty**. However, lessee's obligation to pay tonnage royalty continues under the lease.

The DNR does not dispute the report's assertion that "if the lease had standard deductions, a 6% royalty rate could earn more than \$4 million in minimum payments." Although it is difficult to predict the outcome of contract negotiations, the lease most likely would have been more profitable if the PLC had the benefit of this type of analysis before execution of the Vantage Mining lease. Unfortunately, a bad deal, in and of itself, is not a legally sufficient ground to rescind the lease. The West Virginia Supreme Court has held that "[e]quity will not grant rescission of a coal mining lease on the ground that mining thereunder is unprofitable." Syllabus point 2, Babcock & Coke Co. v. Brackens Creek Coal Land Co., 128 W.Va. 676, 37 S.E.2d 519 (1946).

With regard to the contract or lease price, W.Va. Code §20-1A-6 requires only that minerals be sold at "not less than fair market value, as determined by an appraisal made by an independent person or firm." We are currently evaluating whether or not the payment structure of the lease at the time of execution was less than fair market value. This may require the PLC to procure another coal appraisal or have the original appraisal report performed by the WV Geological and Economic Survey supplemented. If it is determined that the lease price was not fair market value for the coal, this would likely be a legally sufficient basis on which to seek rescission of the lease.

Open Meeting Requirement

With regard to the report's contention that the PLC's Board meeting (where the lease was executed) violated the open meeting requirement, this violation was not intentional. Indeed, the PLC believed it had complied with the deadline to publish timely notice of the meeting. On January 5, 1999, the PLC mailed the notice of filing for the PLC meeting scheduled for January 14, 1999. See attached documents, labeled as "A." I have also attached a copy of the work report for the secretary who prepared and placed them in the state house inter-departmental mailing system on January 5, 1999.

W.Va. Code § 6-9A-3 requires the notice to be filed far enough in advance so that the notice appears in the state register 5 days prior to the meeting. In order to be published at least 5 days prior to the meeting (January 9), the Secretary of State's office

required agencies to file the notice on or before January 6, 1999. Staff from the Secretary of State's office informed my counsel today that the notice was not received until January 7, 1999, two days after it was placed in inter-departmental mail. It was not until this report was received that the PLC became aware that the notice was not published in time.

Statutory Procedures

As discussed in your report, the statutory guidelines for mineral rights leases do not require a public hearing prior to the lease of minerals, oil or gas. The only procedural requirements found in W.Va. Code § 20-1A-6 are competitive bidding and public notice prior to the execution of any lease, both of which were complied with by the PLC. Your report correctly notes that "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."

The lease you are referring to is the Coastal Coal Company lease executed on October 20, 2000. The Public Lands Corporation held title only to the mineral rights under the subject 43.5 acres. The PLC did not own the surface areas or any lands connected thereto. Therefore, even though state law does not require a public hearing for mineral leases, the PLC believed a public hearing was legally prudent in this situation because the surface landowner had a clear legal interest in the coal lease transaction. The situation differs from the Vantage Mining lease arrangement because the state owns Cabwaylingo State Forest where the mining is to take place. Nevertheless, the Legislative Auditor's point is well taken. The DNR agrees that public hearings should be statutorily required prior to mineral leases, particularly given the environmental and economic impact such leases have on the community.

Regarding the Legislative Auditor's specific recommendations, the DNR has already taken significant action that satisfy many of those requests. These are as follows:

Recommendation 1 – Renegotiation or Rescission of Lease

As Director of DNR and Chairman of the Public Lands Corporation, I recently wrote a letter to Vantage Mining requesting that the parties re-visit the coal lease. On August 31, the Public Lands Corporation voted to support my effort to renegotiate the lease. Hopefully, we will be able to delete or amend some of the troublesome provisions of the lease (i.e. deduction of taxes and operating costs and waiver of water replacement). However, if such attempts are unsuccessful, I believe the Board will most likely discuss the appropriateness of rescission.

Recommendation 2 – Legislative Changes

The DNR has also adopted internal policies that would require the same procedures and safeguards for mineral leases that currently apply to land sales, transfers or exchanges. The DNR, with the support of the PLC Board, plans to submit those policies as proposed legislation to the West Virginia Legislature. See document labeled " B."

Recommendation 3 - Professional Advice & Counsel for Future Leases

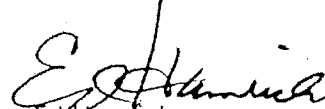
One vital component of the DNR's internal policies and proposed legislation is that the PLC will have the benefit of professional legal and industry advice prior to and during all lease preparation and negotiations.

Recommendation 4 - Adoption of Rules for the Sale, Exchange & Transfer of Land

The DNR agrees that rules and procedures for the sale, transfer and exchange of land should be promulgated. The DNR is in the process of drafting these rules and will have them ready to submit at the next legislative session.

The DNR appreciates the time and effort the Legislative Auditor devoted to this pressing public concern. Your investigation and the continued oversight and input of the Governor's Office has brought to light many areas in which our agency's processes can be improved.

Sincerely,



Ed Hamrick
Director of DNR

Attachments

cc: Alisa Bailey, Commissioner of Commerce
Alex Macia, General Counsel to Governor Bob Wise



DIVISION OF NATURAL RESOURCES

Capitol Complex, Building 3, Room 643

1900 Kanawha Boulevard East

Charleston WV 25305-0661

Telephone (304) 558-3225

Fax (304) 558-3680

TDD (304) 558-1439

TDD 1-800-354-6087

Cecil H. Underwood
Governor

John B. Rader
Director

January 5, 1999

The Honorable Ken Hechler
Secretary of State
Capitol Complex
Charleston, WV 25305

Dear Mr. Secretary:

Transmitted herewith for filing in the State Register is a notice of a Public Land Corporation Board Meeting to be held on January 14, 1999, beginning at 1:30 p.m. in the Division of Natural Resources Conference Room, State Capitol Complex, Building 3, Room 674, Charleston, West Virginia.

The purpose of the meeting is to discuss several items of business pertaining to state-owned real estate.

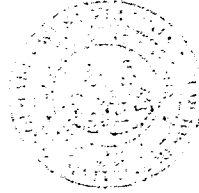
Sincerely,

James H. Jones, Executive Secretary
Public Land Corporation

JHJ:st

Enclosure

cc: Hoy Murphy (w/enclosure)



DIVISION OF NATURAL RESOURCES

Capitol Complex, Building 3, Room 643

1900 Kanawha Boulevard East

Charleston WV 25305-0661

Telephone (304) 558-3225

Fax (304) 558-3680

TDD (304) 558-1439

TDD 1-800-354-6087

Cecil H. Underwood
Governor

John B. Rader
Director

FOR RELEASE: January 6, 1999

PUBLIC LAND CORPORATION TO MEET

The Public Land Corporation Board of the State of West Virginia will meet on January 14, 1999, at 1:30 p.m., in the Division of Natural Resources Conference Room, State Capitol Complex, Building 3, Room 674, Charleston, West Virginia.

The meeting is being called to discuss business pertaining to state-owned real estate.

* * *

DAILY WORK REPORT
Sandy Thornhill
From: 1/1/99 To: 1/16/99
Page 1

[Signature]
James H. Jones
Supervisor

[Signature]
Employee

DAY/ DATE	MLS. TRAV.	HRS. WKD.	PROJECT	WORK DESCRIPTION	TOT. HRS.	TOT. MLS.
1/1/99 Friday				Holiday	8	
1/4/99 Mon		2.5 hrs	Administrative	Coordinated Kimberly's and Carol's work; opened and stamped mail; filled out Work Report; proofed work for Kimberly, Carol and Technical Staff; attested and placed seal on agreements		
		.5 hr	Administrative	Typed, made copy and hand carried memo and debt management quarterly report to Mike Bryant for second quarter for Jim		
		.5 hr	Stonewall Jackson Lake S.P.	Mailed memo to Cordie Hudkins for Joe RE: Corps of Engineers		
		4 hrs	PLC	Typed memos, final copy of last board meeting minutes; and outline and index to go to board members for next meeting; made changes on same		
		.5 hr		Lunch	8	
1/5/99 Tue.		4 hrs	Administrative	Coordinated Kimberly's and Carol's work; opened and stamped mail; filled out Work Report; proofed work for Kimberly, Carol and Technical Staff; attested and placed seal on agreements; discussed with Jim temporary job duties while Kim is absent; typed memo to staff regarding temporary job duties and distributed same; typed memo to Anne Johnson re: Temporary change of computer representative from our office and mailed same; discussed procedure for compiling monthly with Kim Painter and discussed with Jim location of Lease Payment Chart; circulated general information in office; posted information on bulletin board for information		
		.5 hr	Panther State Forest WMA	Made copy and hand carried letter to Attorney General to Director for signature for Chris RE: Earl Justice Property Request for Attorney Assignment		
		3 hrs	PLC	Typed memo to Board Members and sent packet of information in item regarding subject to be discussed at upcoming meeting; typed cover sheet for November 1997 board meeting and updated dates sheet; typed and mailed letter to Ken Hechler filing notice of upcoming board meeting w/ cc to Hoy Murphy		
		.5 hr		Lunch	8	
1/8/99 Wed.		4.5 hrs	Administrative	Coordinated Kimberly's and Carol's work; opened and stamped mail; filled out Work Report; proofed work for Kimberly, Carol and Technical Staff; attested and placed seal on agreements; worked with Carol to order needed supplies for office and checked with Purchasing on typewriter contract; called Richard regarding set up of new printer; discussed replacement of Kimberly's heater with Jim; reminded staff to turn in Evaluation Sheet; made changes on August monthly; typed cover memo to Director on same and gave to Jim for review; edited and printed out September monthly and distributed to staff for editing		
		.5 hr	Panther State Forest WMA	Made copy and mailed letter to William Steele of AGO for Chris RE: Earl Justice Property Attorney Assignment		
		.5 hr	Gauley Mountain Fire Tower Site	Made copy and gave to Amy cable agreement to Charles R. Dillion of American Electric Power for execution for Joe RE: APCO; mailed same		
		.5 hr	Panther State Forest WMA	Made copy and mailed letter and check to Lowell D. Greenwood for Chris w/ cc to Dennis Dowler and Scott Knight for Chris RE: Chase Danny Looney Property		
		.5 hr	PLC - Calhoun County	Made copy and mailed structure agreement to Gwendolyn Simmons for file for Steve w/ original to Permanent File		

CHAPTER 20-1A-6

In addition to the requirements for the competitive bid leasing of coal, oil or gas under state forestlands or wildlife management areas as set out in WV Code 20-1A-6, listed below are the procedures and guidelines that shall be followed by the Public Land Corporation.

1. Prior to any final decision of the DNR and PLC to put any coal, oil or gas up for open competitive bidding by legal advertising procedures as set out in WV Code, Chapter 59, Article 3-1, it shall provide for a public hearing to be held at a reasonable time and place within the county in which the DNR- and PLC- owned coal, oil or gas is located to allow all interested members of the public to attend the hearing, to submit statements and testimony and to question the DNR and PLC officials at that meeting about the proposed bidding and leasing activity.
2. Written notice of the public hearing shall be sent to the county clerk to be made available for public inspection in the county courthouse of the county in which the DNR- and PLC-owned coal, oil or gas is located during two successive weeks before the date of the scheduled public hearing.
3. Not less than thirty days prior to such public hearing, provide notice to all members of the Legislative, to the head of the governing body of any political subdivision having zoning or other land use regulatory responsibility in the geographic area within which the DNR coal, oil or gas is located and to the head of any political subdivision having administrative or public services responsibility in the geographic area within which the DNR coal, oil or gas is located.
4. Cause to be published a notice of the required public hearing. The notice shall be published as a Class II legal advertisement in compliance with the provisions of Article 3, Chapter 59 of this code and the publication area shall be each county in which the affected land, coal, oil and gas is located. The notice shall contain the time and place of the public hearing to be held, along with a brief description of the affected surface land, coal, oil and gas.
5. Cause a copy of the required notice to be posted in a conspicuous place on the surface DNR lands under which the affected coal, oil or gas is located, for members of the public to observe. Such notice shall remain posted for two successive weeks prior to the date of the public hearing.
6. Designate the staff representative of the corporation who shall conduct the required public hearing. The corporation's staff representative shall have full knowledge of all the facts and circumstances surrounding the proposed coal, oil or gas leasing by competitive bid methods. The staff representative of the corporation shall make a report of the public hearing available for inspection by the public or, upon written request of any interested person,

provide a written copy thereof and to all individuals previously receiving written notice of the hearing within thirty days following the public hearing.

7. If the evidence at the public hearing establishes by a preponderance that the analysis and appraisal provided for in Section 20-1A-6 do not reflect the true, fair market value, the Public Land Corporation staff shall cause another analysis and appraisal to be made. If the evidence at the public hearing establishes by a preponderance that the proposed leasing of coal, oil, or gas does not meet the criteria set forth in Chapter 20-1A-6, the Public Land Corporation shall not proceed with the competitive bid leasing of said coal, oil or gas without judicial approval.

The staff representative of the corporation conducting the public hearing shall make the results of the hearing available to the corporation board members for its consideration prior to the board making decisions regarding the affected coal, oil or gas.

8. After the public hearing is completed and all required time frames have been complied with and the board has reviewed and considered all comments from the public hearing, at that time, the board shall decide whether to authorize the staff to proceed with the required legal advertising for the competitive bid leasing of the coal, oil or gas. If the board authorizes the staff to proceed, then at that time, the staff shall request the WV Attorney General's Office to assign a Special Assistant Attorney General to the PLC to council the PLC staff in its carrying out of the competitive bid and leasing process. The Special Assistant Attorney General shall be knowledgeable and experienced in coal, oil and gas law, bidding and leasing document preparation. Also at that time, the staff shall hire an independent coal, oil and gas engineering consultant to assist the staff and council with all technical aspects of the review and analysis of all bids submitted, in negotiation of the lease document with the successful bidder and the periodical inspection of the production process once the lease is finalized, executed by all parties and recorded in the county clerk's office, and the Lessee begins construction and production operations. Once the Lessee commences the production of coal, oil or gas and royalties become due the PLC and paid, the staff shall hire an independent auditing firm to periodically review the Lessee's books and accounts for compliance of payment of appropriate royalties due the PLC for its coal, oil or gas so produced under the lease agreement.