The Coal Mining Lease

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Coal production in Oklahoma provides many landowners the opportunity to lease their land holdings to mining companies. The coal leasing procedure and many of the lease provisions are similar to typical oil and gas leases. However, contrast to oil and gas production, the mining of coal prohibits the continuation of existing agricultural enterprises. During and for some time after coal mining operations, the landowner is unable to use the land as it was used prior to mining operations.

In typical oil and gas lease arrangements, the landowner is interested primarily in the dollar value of the lease and the rate received for any production. Any surface damage or inconvenience caused by the drilling for or production of oil and gas affects only a small area. This is not the case with the production of coal by strip mining.

The concept of opportunity cost becomes important in coal leasing as the landowner must compare the value of the coal lease against expected revenues from agricultural or other production practices. The decision for a landowner to lease land for mining is complex. Difficulty is created by a multitude of economic, legal, and geologic factors. Much of the difficulty arises because of the lack of information concerning the various sections of the lease document. Better understanding of the lease provisions would remove the uncertainty.

The printed form furnished by most coal companies contains all of the necessary provisions to allow the coal company to mine and remove the coal. The primary obligation imposed upon the coal company by the lease is to pay royalty on the coal if and when it is removed and sold. The normal printed lease contains no guarantees as to minimum royalties, dates of mining, depths of mining, or the extent of coal reserves situated under the land. A landowner who cannot make an educated estimate of the coal reserves under the proposed lease is unable to evaluate potential royalty revenues and compare them with expected future returns from using the land in agricultural production.

When a coal company is determining whether or not coal is, "economically recoverable," it is considering the quality of coal to be mined, the depth of overburden (matter on top of the coal, i.e. top soil or rocks) it must remove, and the thickness of the coal seam or seams it will be able to recover. Additionally, the company considers the availability of equipment and its capacity to remove over-burden, the availability of financing, the customers for the particular coal to be mined, the availability of transportation from the property to the customer, and it considers the price per ton received for the coal. These factors determine the amount and value of "economically recoverable" coal available for mining and the corresponding royalties a company can pay to the landowner. The landowner who is not aware of what factors determine the amount of "economically recoverable" coal finds it difficult to negotiate with coal company representatives. Leases should be reviewed carefully to ensure that they are limited to coal mining and do not include rights to other minerals except those removed in the process of coal mining.

Several major factors included in a typical, coal lease arrangement are discussed in the following sections. This discussion is not intended to offer recommendations on how to handle each provision. Rather, the discussion is designed to present a framework of information for the landowner to use in the decision process before signing a coal lease. The landowner also should obtain information from other sources. More complete information will lead to more effective decision making and greater satisfaction in the final leasing arrangements.

Location of Coal

The typical, coal lease arrangement gives the coal company rights to the landowner's entire tract of land. Often coal reserves exist under only a portion of the total land surface. Nevertheless, the arrangement takes the entire land area out of production while only a portion accrues payment for mined reserves of coal. Knowledge of the location of coal reserves is desirable to the landowner so that possible disruption, pollution, revenues, and future land uses can be identified. Usually the mining company can identify the areas where coal reserves exist with respect to the total land base.

For example, if coal is located in the center of an individual's property, even though only a small percentage of the land is mined, the entire holding maybe rendered useless for efficient production. In contrast, off-center or corner locations could be mined with little or no disruption to the remaining acres. Disruption or displacement of pipes, sprinkler systems, ponds, and buildings must also be considered.

Strip mining of coal can produce water, air, and noise pollution and contamination of underground water supplies. The excavation of the trenches may cause dust and smoke problems. A strip mine operation is noisy. Heavy equipment may operate around the clock to mine the ore. Land sometimes needs to be softened by periodic blasting. Therefore, close proximity of homes to a blast site could be very undesirable.

The landowner should strive to be knowledgeable of where the coal reserves exist and what percent of the total land will actually be disturbed in production. Generally, the landowner will have to rely upon the information furnished by the coal company. To insure validity of the information, written guarantees of production, acreage, and depth may be desirable.

Landowners are often disappointed to learn that the coal company has moved off of their property after mining only the shallow (economically recoverable) coal reserves and leaving the deeper reserves unmined. A similar disappointment may occur if coal reserves exist on only a small fraction of the land leased. The landowner should identify opportunity costs if land were taken out of its current use without receiving any royalties. The present value of returns from mining may exceed the present value of returns in current or future production uses. In such cases, the landowner may decide to lease the entire tract of land even though coal production will occur only on a portion of the land.

As a general rule, if a landowner elects to lease a tract of land, the royalties received will exceed any agricultural revenues. To insure this, however, the dollar value of the lease compared to the returns in the land's current production capacity must be calculated.

The owner must decide the potential future uses of the land if different from current uses. Uses such as alternative crops, cattle operations, urban development, industrial site selection, and recreation potentials should be considered. The present value of the future returns should be determined at an appropriate interest rate.

Estimated Production and Quality

A second major consideration for the landowner is an estimate of how much coal production will take place since royalty payments are on a per ton basis. Once the location of coal reserves can be determined and the value of non-mining land uses estimated, it is necessary for the landowner to determine the approximate volume of coal expected to be mined. Coal seams vary in thickness from a few inches to several feet. Consequently, the amount of coal mined per acre or per lease varies from site to site. Another factor will be the quality of the coal seam since the price of coal varies greatly as a result of its BTU and sulfur, ash, and moisture content.

Obtaining the above information (perhaps from the interested coal company) will enable the landowner to estimate the value of projected production, thus arriving at an estimate of the royalties to be received from coal production. These estimated receipts should then be compared to estimated agricultural production loss.

In estimating receipts from mining, the landowner should understand the provisions made in the event of changing coal prices. If the beginning of actual mining operations is not projected for several years, the market price for coal is likely to change. A fixed price-per-ton rate would prohibit the landowner from realizing the benefits from increased prices of coal. However, the fixed rate would protect the landowner in the event of falling coal prices. Many leases state that the landowner's share changes proportionately with the market rate; however, some do not. Landowners may want to hedge against inflation with an escalator clause if a primary term of many years is sought by the coal company.

Tax counsel should be obtained to determine how coal royalties have to be reported. Tax savings might be possible by arranging the timing and method of payment of royalties.

The next consideration involves minimum guaranteed payments regardless of cost of production, quality of coal, or volume of coal. The landowner needs to protect against the possibility of having land tied up even when the company does not mine any coal. This could happen if the coal could not be mined economically. The owner must be guaranteed at least the value of the land in its alternative uses during the time excavation occurs.

The price per ton paid to a landowner depends not only on volume and quality but on the depth of the coal. Some sites possess coal that outcrops from the ground or lies a few feet under the soil. In other locations, mines have to be stripped 100 feet or more to locate the coal. The deeper the coal company must mine, the higher are its production costs. Consequently, a lower price per ton may be offered to the landowner. Landowners should find out how deep their coal is located to aid in negotiating the price received.

Given information on volume, quality, and depth, a landowner will be in a better position to negotiate with coal companies. Once again, most of the information discussed here will have to be furnished by the coal company, and the only way to insure the accuracy is to require guarantees in writing.

Haul Road Easements

One of the rights acquired by the coal company in its lease is the right to transport the coal out of the strip pits and across the property. Generally, the coal company will attempt to mine the coal reserves closest to its processing plant and work in an outward direction. Thus, the coal company is building the haul road behind its production so that the trucks can return on the permanent road to the processing plant. Provisions for the haul road should be considered in the negotiations with the coal company.

Several factors should be considered in negotiating for a haul road. First, the landowner should determine if a haul road is necessary and where on the property it should be located. A haul road running along the perimeter of the land would be far less of a problem than one running through the center of the property. If the haul road runs directly across a property, disrupting conventional agricultural operations, more acres of land than just those being mined would be lost for other uses. An irrigation system, for example, might be destroyed by a road cutting the irrigated acres in half, forcing the owner to abandon irrigation on half of the acreage. In this case, the haul road should be valued according to loss of production or the cost of maintaining production.

If the road will interfere with in-place pipelines, fences, or storage facilities, the value of re-routing or rebuilding must be estimated. If a fence has to be constructed along the road at the owner's expense, this cost should be considered. If the road will take blocks of land out of production, another possible solution is to negotiate for the lease of not only the land to be mined but the additional acres affected by the road.

This becomes a bit more complicated if the coal company will be mining in conjunction with other adjacent properties. In this instance, it may be necessary for the coal company to haul coal recovered from other properties across one owner's land. In any event, in dealings with a small coal company, it will only be necessary that they reach the county section line. However, in dealing with a coal company that uses large off-the-road vehicles to transport its coal to the processing plant, a haul road may remain on the property for many years following reclamation and completion of the mining of the coal.

Primary Term

The primary term is defined as the period of time in which production must be initiated. Regardless of whether there are bonus payments for the execution of the lease, the typical lease will require that the coal company either (1) actually commence mining of the property or (2) pay an annual delay rental in order to continue the lease throughout the remainder of the primary term. The length of the primary term is usually negotiated between the coal company and the landowner and varies from a few months to fifty years.

From the landowner's point of view, several questions should be answered relative to the primary term. In addition to the length of the primary term, the timing of the disruption should be estimated. Planning agricultural operations would be easier if the producer had some general indication of when mining operations would begin. The lease should provide for some kind of notice to the landowner prior to the commencement of mining operations so that no new crops would be planted on the property to be mined. This would also provide an opportunity to move or dispose of the cattle grazing on the land.

Another important consideration relative to the primary term is what actually constitutes the initiation of coal production. Most leases stipulate that coal production must begin prior to the end of the primary term. Once begun, however, the land can be tied up until production activities are completed. The landowner needs to know what constitutes the initiation of production and should have it spelled out in the lease. For example, does production begin with the presence of machinery or with the first actual recovery of coal reserves?

The question arises as to the relative importance of the length of the primary term. By using techniques of discounting, the present value of the annual rentals can be estimated. The result is the present value of the lease in the absence of actual mining operations. Ideally, the producer should estimate the present value of a lease with several different lengths of primary term.

Reclamation

One of the primary concerns of landowners considering coal leasing is the provision for reclamation of mined land. Strip mining disrupts the topography at the coal production site. Therefore, landowners are interested in what efforts will be made to restore the land's topographic characteristics.

Knowledge of how productive the land will be following mining and when the land will be returned to agricultural production is important in making comparisons of alternative values of the land. Land, which is retumed to its original condition at a specified date, can then be used as previously planned. On the other hand, if land is not returned to its original state or is reclaimed slower than expected, it will not be as productive and will result in losses. Such losses need to be considered when negotiating the terms of the lease.

Several key points of primary interest to landowners are: (1) How many pits will be left in the land? (2) Will the topsoil be conserved and subsequently replaced? (3) What type of crop or grass will be planted on the restored land? (4) What types and amounts of fertilizer will be added to the land by the coal company?

Federal laws[1] and Oklahoma state laws[2] establish certain guidelines for land reclamation. The coal mining company will obtain a mining permit prior to mining and pay a bond to assure that the land is reclaimed. The Oklahoma Department of Mines and Mining enforces reclamation laws and holds the bond until the requirements are satisfied. Current Oklahoma laws impose strict penalties on coal companies not engaging in land reclamation. Legal obligations of the coal company for reclamation should be fully understood by the landowner.

Reclamation provisions beyond those required by law are subject to negotiation, and general contour, slope, impoundments, fencing, ground cover, and fertilizer should be negotiated. The typical coal lease includes a brief description of the type of reclamation along with some aspects of timing. The timing is an important consideration as it is an indication of how long the land might be out of agricultural production. To guarantee quick release of its bond, the company will probably reclaim the land soon after production ends, but the landowner may wish to specify a time limit for reclamation in the lease. The Department of Mines does not enforce reclamation provisions in leases beyond those required by law, nor does it recognize lease provisions which conflict with legal requirements.

The Title

Current coal leases require that the landowner have the lawful right to lease the land. The owner must prove that the land to be leased is tree of all liens except those noted on the lease and furnish an abstract of the title. If the title is defective in any way, the coal company will require that the defects are remedied at the owner's expense.

An alternative to the general warranty provision is to permit or require the coal company to examine the title prior to consummation of the lease. In this instance the landowner would not be required to warrant title to be free of encumbrances and would be relieved of the burden of possible substantial financial responsibility that may arise from a general warranty.

If the surface and all of the mineral rights are not owned by the same person, it becomes important to understand

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1 The Surface Mining Control and Reclamation Act of 1977, 30 U.S.C.A. § 1201 et seq.

2 Coal Reclamation Act of 1979, Title 45, Section 742.1 et seq.

and distinguish between royalty paid to the mineral owner and surface damage paid to the surface owner. In the normal lease, no distinction is made between these two items, and compensation is made in the form of a royalty payment that is defined to cover everything.

The normal royalty agreement is intended to compensate for (1) the purchase of the coal, (2) permanent damage done to real estate as a result of the strip mining, (3) temporary damage and inconvenience caused by the strip mining operations, (4) haul road easements, and (5) any other consideration or right that may have been granted by the coal company under the terms of the lease.

When mineral rights and surface rights are not owned by the same person, and the mineral rights are leased, the surface owner must allow right of access. Thus, it becomes especially important for the surface owner to carefully negotiate the terms of the lease agreement to assure adequate compensation for temporary and permanent surface damages caused by the mining operation, the value of foregone agricultural or other activities, haul road easements, and any other impact on surface ownership rights.

Default Provisions

This section deals with default provisions pertaining to the possible default by the coal company and the landowner's recourse. Examples might include the failure of the coal company to meet annual rentals or to initiate production prior to the expiration of the primary term. In these situations the only remedy is to cancel the lease, but often this is only permitted if the company remains in default for a period of 30 to 60 days following written notification by the landowner.

Coal companies do not want to have a lease cancelled for a simple clerical error or the loss of a check in the mail. Accordingly, coal companies will normally insist that the landowner notify them in writing of their default and allow a reasonable time in which to correct the default before terminating the lease. This also applies to default or failure by the coal company in making the monthly royalty payments after production has commenced. Default provisions should indicate how notice may be delivered so that it is not too difficult to track down a company in default. Consideration should be given at this point to financial status and general reputation of the coal company with whom the landowner deals. If the owner is dealing with one of the well established and financially sound coal mining companies, there is probably little risk or concern that the royalties actually owed will not be paid.

Conclusions

Leasing land for coal mining can be profitable, but it is also complex. The following guidelines have been presented to help simplify the decision-making and negotiating process:

1. Know the location and acres of coal reserves.
2. Consider alternative land uses (present and future) and calculate the present value of the land for each alternative use up to 50 years.
3. Know the number of tons of coal available for mining from the property.
4. Determine the quality, value, and depth of the coal.
5. Limit the surface rights, strata, and type of minerals covered in the lease to those needed for the lease purposes.
6. Calculate the opportunity cost of a haul road easement and be prepared to charge for it.
7. Consider the advantages of fixed and variable rates per ton.
8. Consider negotiating minimum guaranteed payments regardless of coal production.
9. Understand the primary term of the lease and negotiate for a suitable term.
10. Establish how and when reclamation will occur.
11. Build default provisions into the lease.
12. Consider an attorney's advice on title requirements.

As a practical matter, the landowner should require the coal company to guarantee the negotiated terms in writing.

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