Comments Submitted by Black Hills Corporation to the Office of Natural Resources Revenue Supporting the Proposed Repeal of Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform
Regulation Identifier Number (RIN) 1012-AA20

Black Hills Corporation ("BHC" or "Black Hills") is an investor-owned, vertically integrated energy company based in Rapid City, South Dakota. BHC serves 1.2 million natural gas and electric customers in eight states, and its non-regulated businesses generate wholesale electricity and produce natural gas, oil, and coal. BHC wholly owns Wyodak Resource Development Corporation (WRDC), which operates a coal mine near Gillette, Wyoming. WRDC is permitted to mine over 6,000 acres of land and employs about 100 workers.

BHC is pleased that the Office of Natural Resources Revenue is proposing to rescind the coal valuation rule that was final as July 1, 2016, and effective from January 1, 2017 ("2017 Rule") until ONRR stayed the rule in late February. As addressed in detail below, the 2017 Rule is unworkable for Black Hills, as a vertically integrated utility. The changes adopted in the 2017 Rule eliminate the longstanding regulatory benchmarking process and would require Black Hills to pay royalties on the gross proceeds of retail and wholesale electric sales, rather than on the value of the coal it mines. While increased costs to shareholders and customers are a concern, the primary concern is that it would have been impossible to calculate royalties owed, thus creating serious uncertainty and enforcement risk. Accordingly, Black Hills and other industry members filed pending litigation in federal district court challenging the Rule. Black Hills also filed a request with ONRR that it postpone the effective date of the Rule to alleviate the insurmountable implementation challenges.

Because the portion of the rule that eliminates the benchmarking system would have the most impact on Black Hills, our comments focus on that component.

A. Black Hills is Unable to Comply with the 2017 Rule:

As addressed in detail below, the 2017 Rule requires that coal cooperatives and vertically integrated lessees value coal based on the sales price of electricity generated by the coal. The 2017 Rule ignores the fact that once coal-fired electricity is generated and sent to the grid, it is fungible, and it is impossible to distinguish it from wind, hydro, and other thermal electricity. This, in turn, makes it impossible to pay royalties based on the value of the electricity. Further, the 2017 Rule ignores the value added by converting coal to electricity between the mine and the first customer subject to an "arms'-length transaction." Finally, the Rule also arbitrarily applies generation and transmission allowances from the geothermal resource valuation regulations, with no analysis of their applicability to coal-fired generation.

BHC subsidiary Wyodak Resources Development Corporation (WRDC) owns the Wyodak Mine near Gillette, Wyoming. Coal mined at Wyodak is used in one of the following ways: (1) burned in adjacent mine-mouth power plants owned or co-owned by BHC subsidiaries; (2) sold to BHC's utility co-owners of these adjacent power plants to power the co-owners' share of the plants; (3) used to power BHC's auxiliary load at its share of the adjacent power plants; or (4) sold to third parties at the mine.

In 2015, over four million tons of coal were mined at WRDC, and much of that was used to power BHC's and its co-owners' shares of the adjacent power plants at the Gillette Complex, which houses the Wyodak, Neil Simpson II, Wygen I, Wygen II, and Wygen III coal-fired generating stations. This mine-mouth production is a cost-saver for our customers due to the reduction in coal transportation costs and other efficiencies, and also allows us to burn low-sulfur Powder River Basin coal. As addressed below, however, this efficient mine-mouth production is incompatible with the 2017 Rule, because (1) legally, the royalty value of coal as does not equate to the value of electricity produced from the coal, and (2) a specific ton of coal that is mined and used to generate electricity cannot be traced to any particular generated electrons given the variable input sources and timing of use.

Electricity that BHC's subsidiaries generate at the Gillette Complex is subject to various retail and wholesale sales. About 60% of the megawatts produced at BHC's Gillette plants are ultimately used to serve retail customer load at two of BHC's affiliate utilities. Customer rates are based on system average costs, which include purchased power, as well as the cost of operating units (coal and gas) based on a fleet-wide average price. Included in this aggregate price is the power Black Hills's affiliates generate at their gas plants and wind facilities, as well as power that is purchased from the market. Retail customers are given the first right from the "margin stack," which means that Black Hills's utility affiliates serve retail customer load with the least expensive unit of power on an ongoing basis. This electricity is provided to customers under state utility commission tariffs.

About 40% of the megawatts generated at the Gillette Complex are sold on the wholesale market, either pursuant to long-term power purchase agreements, or under other wholesale contracts. As with the retail sales, wholesale sales are based on the "system average" aggregation, where megawatts sold are a mixture of coal, gas, and wind megawatts.

Section 1206.252(b)(1) of the 2017 Rule would require that the value of the coal "for royalty purposes is the gross proceeds accruing to [Black Hills] for the power plant's arm's-length sales of the electricity less applicable transportation and washing deductions[.]" This language is patently arbitrary, because it assumes that a power plant is an entity and engages in power marketing. This is rarely the case in the utility industry.

Even if that section could be clearly read to apply to the power plants that Black Hills affiliates own, because of the way Black Hills generates electricity and serves its electric customers, as addressed above, paying coal royalties based on the value of electricity is impossible. Attempting to calculate the value of each "first arm's-length transaction" for electricity sales is fruitless, because the fungible coal megawatts generated at Black Hills's power plants are immediately commingled with the fungible gas and wind megawatts in the Black Hills system.

Further, even if the electricity generated from coal could somehow be tracked, tracing and valuing each "first arm's length transaction" would be overwhelmingly absurd. Black Hills's utility affiliates have tens of thousands of retail electric customers in Wyoming, South Dakota, and Montana. Each customer's monthly electric bill, which is issued under the applicable tariff, would arguably be the "first arm's-length transaction." In addition, Black Hills's generation dispatch and marketing group continuously engages in wholesale trading with contracts ranging from large power purchase agreements to real-time trades to balance its system. Even if the coal megawatts could somehow be assigned to each of these contracts, it would require Black Hills to calculate royalties on tens of thousands of contracts at least monthly.

To further complicate the 2017 Rule interpretation, Section 1206.252(b)(2) applies where "you or your affiliate do(es) not sell the electricity at arm's-length (for example you or your affiliate deliver(s) the electricity directly to the grid." In this scenario, ONRR would "determine the value of the coal under [the Rule's default provisions]." It is impossible to know exactly what ONRR intended with the "delivered directly to the grid" category or what else it may have assumed was included in the non-exhaustive parenthetical that listed only electricity "directly to the grid" category. It could be read to include all of the power generated at the Gillette Complex, which would subject much of the royalty payments attributable to the Wyodak mine to ONRR's unfettered discretion.

Section 1206.252(b)'s lack of clarity, coupled with its failure to acknowledge general power generation and marketing principles, makes it impossible to comply with. It would leave Black Hills with uncertainty and confusion, and subject it not only to ONRR compliance risk, but to regulatory risks when estimating and justifying royalties for state utility regulatory purposes.

In addition to those fundamental flaws in equating the value of coal to the value of electricity, the 2016 Rule also refers to the geothermal regulations to assign transmission and generation costs where the "first arm's-length transaction" was a sale of electricity. These regulations simply do not apply to coal-fired generation, which is done with entirely different methods and at a magnitude hundreds of times greater. From an operational standpoint, geothermal and coal-fired generation are not even comparable, let alone interchangeable. There is simply no basis for equating the two.

B. <u>Numerous Provisions in the 2017 Rule are Arbitrary</u>

In addition to the significant impact the "gross proceeds of the first arm's-length transaction" would have on Black Hills, these additional provisions in the 2017 Rule are also problematic from an industry and legal standpoint:

- The new "default" valuation provision that allows ONRR to unilaterally establish royalty value under a multitude of vague circumstances, undermines the certainty of even a lessee's arm's-length coal sales prices as value, and creates the risk that ONRR may impose a higher royalty value many years after production and initial payment;
- Mandatory valuation of coal production via an inherently unreliable "netback" method that courts and the Department have historically used only as a "last resort" if no other methodology, such as comparable sales, is available to establish a reasonable value at or near the mine;
- Inadequately defined transportation allowances particularly for coal sold for ultimate delivery at distant locations;
- For all coal not sold by the lessee at arm's length, failure to provide any index or other option to use reliable alternative valuation methods established near the lease like those available for oil and gas valuation;
- Unsupported singling out of coal cooperatives for special treatment, including royalty valuation calculations that are impossible to perform, and disregard of well-established legal principles governing "affiliated" entities; and

- Refusal to recognize for valuation purposes any contract for the sale of coal that is legally enforceable yet may be unwritten or unsigned by all parties

For all of these reasons, Black Hills supports ONRR's proposal to rescind the 2017 Rule.

C. Regulations that Predate the 2017 Rule are Adequate

The 2017 Rule purported to address "dramatic changes" in the industry and the marketplace as well as to provide "greater simplicity, certainty, clarity and consistency in product valuation." Yet, ONRR failed to provide evidence of any significant changes in the domestic coal market over the last 28 years that merit a wholesale rewrite of the valuation regulations. Nor has ONRR demonstrated the need for greater consistency or clarity. While there have been some controversies over royalty payments since the establishment of the 1989 coal regulations, the controversies have largely declined over the years as the agency and lessees became more familiar with the coal valuation regulations. Most of the disagreements today relate to line item adjustments for transportation and processing as opposed to disputes regarding valuation methodologies.

The comprehensive 1989 rulemaking that established the coal valuation regulations was the result of several years of consideration and efforts to develop an appropriate set of rules for the determination of value of coal for royalty purposes. The rulemaking represented a compromise on all sides. While few stakeholders were completely satisfied, there was general recognition that the final regulations represented a workable compromise.

Such a deliberative process should not be undone without significant evidence that the existing rules are inadequate. Complexity of rules in and of itself does not justify wholesale changes, especially when the existing rules provide relative certainty for both regulators and the regulated community. The 2017 rule, if not rescinded, would upend the established and well-known methods for coal valuation and instead insert arbitrariness and uncertainty. Black Hills is pleased that ONRR recognized in the proposed rescission that the existing rules "enhance the lessees' ability to timely and accurately report and pay royalties because they would continue to use a well-known system that has been in place for decades."

Further, while the "benchmarking" scheme currently is place is not perfect, it is a system that provides certainty. For royalty purposes, coal mined at Wyodak and burned in Black Hills's power plants is priced to all except one of the partially or fully owned BHC power plants at the pass-through utility commission-approved fuel adjustment clause rate or "Statement R" price. "Statement R" is a fuel recovery formula that has been approved by both the South Dakota and Wyoming utility commissions. Black Hills supports leaving in place the historical benchmarks so that it can continue to employ its "Statement R" pricing mechanism, as acknowledged in the second benchmark, which allows ONRR to specifically consider "prices reported . . . to a public utility commission."

This system creates a fair and certain royalty payment that allows Black Hills to offer its customers the efficiency benefits associated with a mine-mouth power plant. Complicating the royalty payment scheme with rules that require that coal royalties be paid on the value of a commodity other than coal has proven unworkable, and Black Hills encourages ONRR to continue to employ its historical, workable system.

D. <u>Support for Reconstituting the Royalty Policy Committee</u>

Just days before the proposed rescission was published, Secretary of the Interior Zinke announced he was reconstituting the Royalty Policy Committee (RPC). The RPC was originally established in 1995 to provide expert advice to the Secretary on the management of the nation's federal and Indian minerals revenue program. The open dialogue created by the RPC over the years has provided the Secretary with valuable insights that have been applied to improve implementation of existing regulations and policies and to assist in determining whether changes to regulations and policies are needed.

Despite the critical role of the RPC, however, its charter expired in 2014. Per the new charter, the role of the RPC will be to advise the Secretary on issues related to the determination of fair market value and the collection of revenue from energy and mineral resources on federal and Indian lands as well as the potential impacts of proposed policies and regulations related to revenue collection from energy development. Given the expertise and the stakeholder representation (states, Tribes, industry, academia, and public interest groups), Black Hills, along with industry groups and their members, believes the RPC is the right venue to begin discussions about whether any revisions are needed, including revisions advocated by the mining industry in the past such as allowing the use of comparable arm's-length sales from the producer's own mine in the first benchmark.

E. <u>Conclusion</u>

The final rule did not simplify existing coal valuation regulations, and would have instead served only to frustrate that objective and result in burdens and regulatory uncertainty that outweigh any purported benefits to industry, ONRR, or the public. Even more critical, Black Hills is simply unable to comply with it. Given these legal issues and implementation hurdles, ONRR is appropriately pursuing this rescission.

Black Hills Corp, (NYSE: BKH) is a growth-oriented, vertically integrated energy company based in Rapid City, South Dakota, with a tradition of improving life with energy and a vision to be the energy partner of choice. The company serves 1.2 million natural gas and electric customers in eight states: Arkansas, Colorado, Iowa, Kansas, Montana, Nebraska, South Dakota, and Wyoming. Black Hills Corp.'s non-regulated businesses generate wholesale electricity and produce natural gas, oil, and coal.