Office of Natural Resources Revenue
c/o Luis Aguilar
Building 53, Entrance E-20
Denver Federal Center
West 6th Ave. and Kipling St.
Denver, CO 80225

May 4, 2017

Re: Comments on the Advance Notice of Proposed Rule Making and Proposed Repeal—Federal Oil & Gas and Federal & Indian Coal Valuation Rule

Docket Numbers ONRR-2017-0001 (RIN 1012—AA20) and ONRR 2017-0002 (RIN 1012—AA21)

Dear Mr. Aguilar:

Please accept these comments from The Wilderness Society on the above regulatory actions by the Office of Natural Resources Revenue (ONRR). The mission of the Wilderness Society is to protect wilderness and inspire Americans to care for our wild places.

I. Introductory Comments—No Repeal of the Valuation Rule should be Contemplated and Any Revision of the Rule Must Fully Abide by the Administrative Procedure Act.

The ONRR has issued two notices in the Federal Register, one an Advance Notice of Proposed Rulemaking (ANPR) to revise the oil and gas and coal valuation rule for royalty purposes adopted on July 1, 2016, and put into effect 180 days from the date of publication on January 1, 2017 (hereinafter the Final Valuation Rule), and the other a proposal to repeal the rule. 82 Fed. Reg. 16323 (Apr. 4, 2017); 82 Fed. Reg. 16325 (Apr. 4, 2017). If the rule was repealed it would be ONRR's intention to put in place the prior rule that had governed royalty evaluations, which was adopted in the 1980s.

Under no circumstances should the Final Valuation Rule be repealed. The basis for that view will be discussed in detail below. But fundamentally given the extensive rulemaking history for the Final Valuation Rule, which carefully demonstrated and documented its value, need, and timeliness, any repeal would be inappropriate. A new Administration which may have different views does not allow for repeal given the underlying statutory commands to ensure the American public receives fair market value for royalties from federal fossil fuels extraction. This is especially true of any essentially summary repeal, which is apparently what ONRR has in mind. 82 Fed. Reg. at 16323-325. Any such expedited effort would deprive the public of the statutorily required opportunities it has to participate in rulemaking.

While revisions of the rule can be considered, in doing so the ONRR must fully abide by the notice and comment procedures specified by the Administrative Procedure Act (APA). As will be discussed below, given the extensive prior rulemaking history that found that the Final Valuation Rule was fully justified and met current needs, modifications to the rule would require an extensive, public, rulemaking process.

II. Comments on the Advance Notice of Proposed Rulemaking and the Proposed Rule.

In the ANPR the ONRR states it is seeking comments on two scenarios: (1) comments on whether a new valuation rule should be promulgated if the Final Valuation Rule is repealed; and (2) comments on what changes should be made to the Final Valuation Rule if it is not repealed. 82 Fed. Reg. at 16326. In the repeal proposal, the ONRR is proposing to repeal the Final Valuation Rule "in its entirety," and the previously adopted rules effective prior to the January 1, 2017 would be reestablished. *Id.* at 16323. The following comments address both of these Federal Register notices.

As stated, in our view the Final Valuation Rule should not be repealed. The ONRR could, however, consider changes to the 2016 rule if it carefully follows the notice and comment procedures outlined in the APA. The regulations in place prior to January 1, 2017 were nearly 30 years old, having been put in place in the late 1980s. Reinstating these rules, as would occur with repeal, would clearly be inappropriate. They were already outdated prior to adoption of the Final Valuation Rule, and that is even more true now. They were not based on current energy markets and were not in line with modern technologies and practices in the coal, oil, and natural gas industries. And, as was amply demonstrated in the prior rulemaking, they shortchanged the American public from the full royalty benefits they deserve from development of federal fossil fuels. The Final Valuation Rule alleviated these problems, and therefore it should not be abandoned.

The prior rulemaking was a lengthy and exhaustive process that deserves acknowledgment and respect from the ONRR (as well as the Secretary of the Interior and the Administration). The prior rulemaking leading to the Final Valuation Rule extended over nearly six years. First, an ANPR was published on May 27, 2011. 76 Fed. Reg. 30878 (May 27, 2011). After that it took three and a half years before the proposed rule was published on January 6, 2015. 80 Fed. Reg. 608 (Jan. 6, 2015). During this time six public workshops were held and comments were received from over 300 commenters and 190,000 petition signatories. Thousands of pages of comments were received. The comment period on the proposed rule was extended to 120 days. The final rule was not published until a year and half after the proposed rule, on July 1, 2016, and was not effective until January 1, 2017. 81 Fed. Reg. 43338 (July 1, 2016). In putting the Final Valuation Rule in place, the ONRR stated, "[r]ecognizing lessees may have to change their systems, we set the effective date of this rule to 180 days from the date of publication." 81 Fed. Reg. at 43360. Clearly the Final Valuation Rule was put in place based on a very full and thorough public process with ample time for companies to adjust their systems to comply with it, which argues against any attempts to abandon it or modify it.

The Final Valuation Rule was developed using a careful, thoughtful, and deliberative process, as envisioned by the APA. This rule should not and cannot simply be abandoned, as the ONRR is proposing to do. Reinstating an outdated rule simply makes no sense—as fully documented in the prior rulemaking.

The ONRR recognizes that the Final Valuation Rule sought to achieve four important goals:

1. Offering greater simplicity, certainty, clarity, and consistency in product valuation;
2. Ensuring Indian mineral lessors receive maximum revenues from coal resources;
3. Decreasing lessee costs of compliance and the ONRR's cost to ensure compliance; and
4. Providing early certainty to ONRR and stakeholders.

82 Fed. Reg. at 16326. The purpose of the current ANPR is to essentially repeat what had already been accomplished with the Final Valuation Rule. *See* i*d.* (stating the purpose of the ANPR rulemaking process is to: (1) offer greater simplicity, certainty, clarity, and consistency in production valuation; (2) to be easily understood; (3) decrease industry's costs of compliance; and (4) provide early certainty to industry, ONRR, and stakeholders). Having <u>already</u> achieved these goals, there is no need to repeat a process that has already created these benefits by repealing the rule, and even a reconsideration of the rule is not appropriate if all it is doing is recreating what has already been done.

That would represent a massive waste of federal resources given what has already been invested in this rule. It also would not be in compliance with the provisions in Executive Orders 13771 and 13781 which require reducing regulation and regulatory costs and reorganization of the Executive Branch through non-wasteful practices that minimize new rulemaking.

In considering modifications to the Final Valuation Rule, the ONRR states that it has three goals. These are to:

1. Provide clear regulations that are consistent with meeting the responsibility to "ensure fair value for the public's resources."
2. To provide valuation methods that are efficient and practicable to use; and
3. To provide certainty that correct payment has been made.

82 Fed. Reg. at 16326.

We think the agency should consider (or reconsider) whether the Final Valuation Rule has <u>already</u> done all these things and achieved these goals. We urge you to review the 2015 proposed rule and the 2016 final rule and assess whether a sufficient explanation of, and adoption of, these provisions was already made when the Final Valuation Rule was adopted. We believe they were. If you disagree that the 2016 rule met these goals, you should provide a detailed explanation of why this is so before proceeding with any changes to the rule. Public comment must be allowed for before proceeding with any rule change. And again, the ONRR must ensure it is not engaging in a massive waste of previously thoughtfully invested resources, as required by Executive Orders 13771 and 13781.

As noted by former Secretary of the Interior Sally Jewell when the Final Valuation Rule was adopted:

> These improvements were long overdue and urgently needed to better align our regulatory framework with a 21st century energy market place, offering a simpler, smarter, market-oriented process. As the steward of America's oil, natural gas and coal production on public lands, Interior has an obligation—and is fully committed—to ensuring that the American taxpayer receives every dollar due for the production of these domestic energy resources. This valuation rule is important because it ensures, in part, that our federal coal program is properly structured to obtain all revenue due to taxpayers. The updated rule will increase the effectiveness and efficiency of the valuation process, and provide greater clarity and consistency for lessees and revenue recipients.

https://www.doi.gov/pressreleases/interior-department-announces-final-regulations-ensure-american-public-receives-every.

It certainly is not clear that the Final Valuation Rule had not already provided regulations that ensure fair value is received for public resources, provided for efficient and practicable valuation methods, and provided certainty that correct payments would be made, as the ONRR says are the goal of the ANPR.

Much of the impetus for the proposed repeal of the Final Valuation Rule seems to be to address the litigation that was filed on December 29, 2016 by coal and oil and gas companies challenging the rule.[1] 82 Fed. Reg. at 16323. But we would note that these legal challenges only contest "certain provisions of the Final Valuation Rule." *Id.* If the whole rule is not being challenged, there certainly is no need to dispose of the whole rule just to react to these lawsuits.

The ONRR also claims that it has "since identified several areas in the rule that warrant reconsideration to meet policy and implementation objectives." 82 Fed. Reg. at 16323. Yet it does not state what these are. Apparently the ONRR is reacting to dissatisfaction with the rule in the new Administration, but a new Administration—enlisting the support of the ONRR—cannot simply abandon lawfully adopted regulations that have gone fully in to effect. And as will be discussed elsewhere in these comments, there are a host of statutory requirements that require oil, gas, and coal valuation rules ensure the American public receives fair value for the extraction of its resources, and these statutory requirements cannot be ignored just to please a new President.

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[1] *Cloud Peak Energy, Inc. v. U.S. Dep't of the Interior,* Petition for Review of Final Agency Action, Case No. 16CV315-F (United States District Court for the District of Wyoming, Dec. 29, 2016); *American Petroleum Inst. v. U.S. Dep't of the Interior,* Petition for Review of Final Agency Action, Case No. 16CV316-F (United States District Court for the District of Wyoming, Dec. 29, 2016).

Even if some aspects of the Final Valuation Rule warrant reconsideration, that is not license to abandon the entire rule. Clearly, at most, the ONRR should be considering selected changes to the Final Valuation Rule, done carefully with full public involvement through the APA notice and comment process, not wholesale abandonment of it.

Another significant driver in the push to repeal the rule seems to be coming from certain Executive Orders (EO) that are mentioned in the Federal Register notice for the proposed repeal. 82 Fed. Reg. at 16323. EOs 12866, 13563, and 13771 are mentioned. However, the Federal Register notice indicates these EOs <u>will</u> be complied with, partly because they are inapplicable and thus do not govern this rule rulemaking. EO 12866 only applies to "significant rules" and this is not a significant rule; EO 13563 is applicable and directs improved regulatory procedures; and EO 13771 is inapplicable because under the circumstances presented here "it does not require the repeal of two other existing rules, and the agency is not required to offset its cost against the cost of other fiscal year 2017 rules." *Id.* at 16324. It is worth noting that the guidance for implementing EO 13771 issued by the Office of Management and Budget provides that an agency should, among other things, identify regulations that are "outdated, unnecessary, or ineffective" and "impose costs that exceed benefits." <u>https:// www.whitehouse.gov/the-press-office/2017/04/05/memorandum-implementing-executive-order-13771-titled-reducing-regulation</u>.

Given the newness of the Final Valuation Rule it certainly is not outdated. And the proposed and final Federal Register notices for the Final Valuation Rule made it clear the rule was necessary and effective and that its benefits exceeded its costs. If the ONRR is going to overcome these published facts arguing against repeal, it needs to develop and present for public comment any rebuttals or updates to them. We would also note that the final Federal Register notice for the Final Valuation Rule made it clear that EOs 12866 and 13563 had been complied with in developing the rule. 81 Fed. Reg. at 43367. Given the prior compliance with these EOs, there is no need to update this review, especially since the later issued EO 13771 is not applicable to this rule.

The ONRR claims in the repeal proposal that repeal would be consistent with EO 13771 (even though as mentioned it is inapplicable to this rulemaking) because:

1. It would preserve the regulatory status quo since the pre-existing regulations would be revived;
2. It would avoid costs to government and industry of converting to a new royalty reporting and payment system;
3. It would eliminate the need for the litigation; and
4. It would enhance lessees ability to timely and accurately pay royalties "because they would continue to use a well-known system that has been in place for decades."

82 Fed. Reg. at 16323. These assertions are misguided.

First, the Final Valuation Rule <u>is</u> the status quo. It was adopted in July, 2016, provided 180 days for companies to get their systems ready for compliance, and went fully into effect on January 1 of this year as a legally binding rule lawfully developed under the APA. Moving back to the prior rule is not the status quo; it has been fully supplanted. Making a claim that we would be returning to a status quo that does not even exist anymore is disingenuous. Moreover, in developing the Final Valuation Rule—as shown by the lengthy commentaries in both the proposed rule and the final rule—the ONRR made it clear that the new rule was: (1) prudent and economic and offered greater simplicity, certainty, clarity, and consistency in product valuation; (2) decreased both industry's and the ONRR's cost of ensuring compliance; and (3) provided early certainty to the ONRR and stakeholders. 82 Fed. Reg. at 16326. And eliminating any need for litigation is an abdication of the government's duty to defend federal laws that have been lawfully (and fully) adopted and put into place. Last, returning to an antiquated system for royalty payments that is totally out of sync with modern industry technologies and practices is just an excuse to shortchange the government (and the public) from getting full royalty payments that are lawfully owed.[2] Clearly the government's first priority in this rulemaking should be to ensure the public receives full royalty payments for the extraction of its minerals from the federal public lands and minerals estate, not just making it easier for industry to pay royalties. And clearly the Final Valuation Rule was already consistent with EO 13771.

ONRR's incorrect view that moving back to a rule that has been fully overturned would somehow be moving back to a "status quo" is probably driven by the February 27, 2017 "postponement" of the effectiveness of the Final Valuation Rule that the ONRR published in the Federal Register. 82 Fed. Reg. 11823 (Feb. 27, 2017). This illegal postponement has convinced the court hearing the challenges to the Final Valuation Rule to stay the litigation while ONRR seeks a repeal of the rule. *See Cloud Peak Energy, Inc. v. United States Dep't of the Interior,* Unopposed Motion for Stay, Civil Case No. 16-cv-315-F (United States District Court for the District of Wyoming, Apr. 26, 2017) and *id.* at Order Granting in Part Unopposed Motion for Stay (Apr. 27,2017). We would note that in these documents it seems clear the ONRR is pursuing a repeal—not modification—of the rule. This raises grave concerns about a "predetermined outcome" for this rulemaking. Having a predetermined outcome prior to public comment is a certain way to create legal infirmity in this rulemaking and the ONRR should avoid that. Any summary effort to repeal this rule, as the court documents indicate is happening, must be abandoned.

We would also note that the legality of the postponement has been challenged by the States of New Mexico and California. *People of the State of California v. United States Dep't of the Interior,* Complaint for Declaratory and Injunctive Relief, (United States District Court for the Northern District of California, Apr. 26, 2017); attached hereto as Exhibit 1. As the Plaintiffs in that case state,

> An agency cannot "postpone" the effective date of a rule when that effective date has already come and gone. Further, the legal basis on which the agency relied for the postponement, Section 705 of the Administrative Procedure Act ("APA"), does not apply to rules that have already gone into effect. ONRR's attempt to delay the Rule after it became effective is facially invalid, and constitutes an attempted end-run around the APA's notice-and-comment requirements.

[2] See 30 U.S.C. §§ 189, 207(a), 226(b), 359; 43 U.S.C. § 1334; 25 U.S.C. § 396d (all putting in place requirements or authorizations to make payments to the government for mineral extraction).

The ONRR should fully consider this case as it moves forward with this rulemaking. If this litigation is successful, it would call into question the validity of any effort to repeal the Final Valuation Rule.

When an agency seeks to amend or repeal a rule it must use the same procedure it used when it adopted the rule in the first place. *See Perez v. Mortgage Bankers Assoc.*, 135 S.Ct. 1199, 1206 (2015) (stating the APA mandates "that agencies use the same procedures when they amend or repeal a rule as they used to issue the rule in the first instance" (citation omitted)). And a rule, new or otherwise, must meet the arbitrary and capricious standard established by the APA. "Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Motor Vehicle Mfr. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983). Here, the ONRR must ensure that any modifications to the Final Valuation rule meet these standards by ensuring it fully considers the statutory requirements to ensure a fair return to American taxpayers, ensures that the interests of the United States are met and that the public welfare is safeguarded, it fully considers the factual determinations and conclusions that were made in the prior rulemaking, and it ensures that any "difference in view" that is driving any changes is not implausible.

One of the most important aspects of the Final Valuation Rule is the elimination of non-arms-length sales with subsidiaries/affiliates as the basis for determining royalties that are owed for coal, a tactic which in the past has greatly reduced royalty assessments. Instead, the Final Valuation Rule required arms-length sales so that full and proper royalties would be paid for coal. This is an important mechanism for ensuring the government gets a fair return for the sale of its fossil fuels, and this requirement must be maintained even if changes are made to the Final Valuation Rule.

This is an issue that is brought up in the request for comments if the Final Valuation Rule is not repealed. 82 Fed. Reg. at 16326-27. The ONRR is interested in hearing comment on "[h]ow best to value non-arm's-length coal sales and/or sales between affiliates" and "[w]hether ONRR should update the valuation regulations governing non-arm's-length dispositions of Federal gas, and if so how." In our view, as demonstrated amply in prior public comments and the ONRR's assessment of the proposed rule and final rule, all non-arm's-length transactions should be prohibited in the valuation rule. Only arms-length transactions should be considered in determining the value of the minerals for royalty purposes. This is the only way to ensure the public receives fair value and a fair return for is resources.

III. Executive Order 13783 Must be Considered.

We also want to note another EO that is not mentioned in either the ANPR or the proposal to repeal the Final Valuation Rule. And that is EO 13783, "Promoting Energy Independence and Economic Growth," which was issued on March 28, just before the Federal Register notices for these actions were released. EO 13783 should certainly be considered in this rulemaking. Among other things it directs all federal agencies to review all existing regulations and policies ("agency actions") that potentially "burden" domestically produced energy resources. EO 13783 § 2(a). Based on this, agency actions could be suspended, revised, or rescinded, or a notice and comment procedure to do so could be started. *Id.* § 2(g). However, "[s]uch review shall not include agency actions that are mandated by law, necessary for the public interest, and consistent with the policy set forth in section 1 of this order." *Id.* § 2(a).

There is no doubt that the ONRR is mandated by law to put in place strong valuation rules so that appropriate royalties can be received from federal fossil fuels development. With respect to coal, the Secretary of the Interior must receive "fair market value" from the coal that is leased and at a minimum a 12.5 percent royalty must be paid based on the "value of the coal." 30 U.S.C. §§ 201(a) and 207(a). And as mentioned, oil and gas leases must also "be conditioned upon the payment of a royalty at a rate of not less than 12.5 percent in amount or value of the production removed or sold from the lease." *Id.* § 226(b). And, coal, oil, and gas leases all must be conditioned so as to protect the interests of the United States and provide for the safeguarding of the public welfare. *Id.* § 187. *See also* footnote 2, *infra*, (describing these and other statutory requirements).

There also is no doubt that the public interest would not allow for the Final Valuation Rule to be suspended or rescinded, although revision may be permissible. As just stated, protecting the public welfare is a cornerstone of the federal mineral leasing program. As shown by Secretary Jewell's comments and ONRR's commentary on the proposed and final rule, it can be said that protecting the public interest is foundational to why the Final Valuation Rule was adopted and put in place. Clearly this rule cannot be repealed only to be replaced by a rule the agency has <u>already</u> determined is out of date and does not meet today's needs or standards, and EO 13783 does not permit such actions that are contrary to the public interest.

And then there are the policies of section 1 of EO 13783 which must also be complied with before any suspension, revision, or recension of an agency action can be contemplated. The "clean and safe development of our Nation's vast energy resources" is national policy. As is the "prudent development of these natural resources." And even the review of agency actions mandated by the EO is not to be "beyond the degree necessary to protect the public interest or otherwise comply with the law." It is also national policy under the EO to "promote clean air and clean water for the American people." "[N]ecessary and appropriate" regulations that "achieve environmental improvements for the American people" should be developed "through transparent processes that employ the best available peer-reviewed science and economics." These are some of the policies provided for in section 1 of EO 13783 that must be complied with if any change to a regulation is contemplated.

It is clear that simply abandoning the Final Valuation Rule and reinstating a rule that is known to be insufficient for meeting 21st century needs is not permitted by the policies in EO 13783. Such a course of action would not further the "clean and safe development" of our energy resources; it would not contribute to the "prudent" development of our natural resources; as discussed, this course of action would be contrary to law and not in the public interest; it would not promote clean air and clean water; and abandonment of the rule would not achieve environmental improvements for the American people based on the best available science or economics. Repeal of the Final Valuation Rule is prohibited under the terms of EO 13783.

IV. Our Comments Submitted on the Proposed Valuation Rule should be Reconsidered.

Additionally, we would like to discuss the comments we submitted on the proposed Valuation Rule on May 8, 2015. Those comments are included herewith as Exhibit 2. We supported the proposed, and Final Valuation Rule. As we noted, the ONRR, under the valuation rule, has a responsibility to recover the full value owed to the taxpayer. We noted several of the federal laws that require the government to ensure fair value is achieved for the extraction of public minerals.[3] The proposed rule represented a "market solution to what was previously an unbalanced and distorted market place in favor of energy producers." Moreover, we noted that in addition to ensuring fair value is paid to the government and taxpayers, the valuation rule should also recognize and take account of the fact that there are opportunity costs when public lands and resources are developed for minerals at the expense of other economically valuable uses of these lands, such as recreation, wildlife habitat, scenery, ecosystem services, and various community benefits.

In our comments on the proposed valuation rule we highlighted several specific issues that needed to be addressed in the rule. These included:

1. The need for the removal of the Deep Water Gathering Policy, which had an inappropriate definition of transportation costs and allowed for improper deductions from oil and gas royalty payments. May 8, 2015 Comments at 3-4 (hereinafter Draft Rule Comments).

2. The need to remove transportation exceptions that had allowed exceptions to oil and gas royalty payments if transportation costs were greater than 50 percent in some cases, and which deprived the public of fair value for resources extracted from public land. Draft Rule Comments at 4. These transportation allowances were used to allow exceptions for pipeline losses and line fill, which subsidized losses after the royalty point, and the rule changes helped ensure a fair return to taxpayers.

3. Relative to coal, and as mentioned above, the proposed rule, and the Final Valuation Rule removed benchmarks, instead requiring use of the first arm's-length sale to determine royalties for coal, a proposal which we favored. Draft Rule Comments at 5. In addition, the proposed and final rule allowed for valuation based on gross proceeds from the arm's-length sale of electricity, instead of allowing non-arm's-length sales (such as when the coal lessee or its affiliates use the coal to generate electricity) to govern royalty payments. These were important steps in valuing coal at its fair market price.

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[3] *See*, *e.g.*, 43 U.S.C. § 1701(a)(9) (stating it is the policy of the United states that "the United States receive fair market value for the use of the public lands and their resources unless otherwise provided by statute"); 30 U.S.C. §189 (giving the Secretary of the Interior authority to "prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes" of the Mineral Leasing Act); 30 U.S.C. § 187 (requiring due diligence, skill, and care in the operation of leased properties and the prevention of undue waste, as well as other provisions that ensure production on leased lands provides for the "protection of the interests of the United States" and the "safeguarding of the public welfare"). 25 U.S.C. §§ 396 and 396d and 30 U.S.C. § 359 were also cited.

4. We also expressed concern in our comments about not enforcing washing or transportation allowance limits on coal, as was done for oil and gas. Draft Rule Comments at 5. We felt the transportation exemptions for coal provided an avenue for producers to defray costs that would be put in place by the first-arm's-length sale requirement and that this would reduce the effective royalty rate. "Therefore by not implementing a similar transportation limit to that imposed on oil and gas lessees, ONRR may in effect be undercutting any potential progress towards achieving accurate efficient revenue for the taxpayer." *Id.*

5. We also expressed support for the "default provision" that the Final Valuation Rule put in place. Draft Rule Comments at 6. The default provision was needed because of several situations where accurately determining value was not possible, or was thwarted. While concern has been expressed that this provision creates uncertainty as to the royalties owed or there is a need for definiteness in economic matters, the default provision is only used as a last resort where royalty payments grossly deviate from what was expected. "If there is uncertainty, it is likely to be the result of a failure to pay fair market value on the part of the lessee." *Id.* n.5.

In addition to these points we also noted in our comments that there is a need to reconsider the alarmingly low royalty rates paid on both coal and oil and gas (12.5 percent, with studies by Headwaters Economics showing that the effective rate for coal royalties is only 4.9 percent).[4] We also pointed out there was a need to consider climate change issues in the valuation rulemaking. The need to consider these and the numbered issues just discussed—specifically getting fair value—were brought out by the 2007 Royalty Policy Committee Report that was cited in our comments, and which should be reconsidered by ONRR.

All of these issues previously raised by The Wilderness Society should be considered in any modifications that are proposed to the Final Valuation Rule. Again, these comments are attached herewith as Exhibit 2.

V. Reports by Experts on Coal Markets should be Considered.

The APA requires agencies to give "consideration" to relevant comments. 5 U.S.C. § 553(c) ("the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented ...."). Agencies must respond to comments that are material to issues raised in a rulemaking proceeding.[5] To be material, comments must be such that, "if true . . . would require a change in [the] proposed rule."[6]

[4] *See* Haggerty, Mark. "An Assessment of U.S. Federal Coal Royalties Current Royalty Structure, Effective Royalty Rates, and Reform Options". A Research Paper by Headwaters Economics. January 2015. Accessed on May 3, 2017. https://headwaterseconomics.org/wp-content/uploads/Report-Coal-Royalty-Valuation.pdf.

[5] *Portland Cement Ass'n v. Ruckelshaus*, 486 F.2d 375, 393-94 (D.C. Cir. 1973), *cert. denied*, 417 U.S. 921 (1974).

[6] *Louisiana Federal Land Bank Ass'n, FCLA v. Farm Credit Administration,* 336 F.3d 1075, 1080 (D.C. Cir. 2003).

The following reports provide information relevant to the need for full and fair valuation of federal coal, including, at a minimum, improving valuation of coal disposed of in non-arm's-length transactions and no-sale situations.

a. *Sightline Institute, Unfair Market Value II Report, June 2016.* http://www.sightline.org/research_item/unfair-market-value-ii/

Conditions under which federal coal is exported, and volatile market conditions, make full and fair valuation of federal coal particularly important. This report by Clark Williams-Derry of Sightline Institute outlines export market conditions that affect the market valuation of coal that should be captured by federal coal owners, including through better valuation of coal disposed of in non-arm's length transitions. In the past, the U.S. coal industry took full advantage of the brief spike in the seaborne coal market, in many cases earning hefty profits by exporting coal to Asia. The industry is continuing its aggressive pursuit of coal exports and hopes to position itself to realize even greater profits should seaborne coal prices rise again. Ensuring that the federal coal owners receive full and fair value for their resources and have certainty that correct payment was made was the intent of this report.

This report, an update of Sightline's 2014 analysis of exports of federal coal, offers data and methods to review the finances and economics of federal coal exports, and how export dynamics affect the value of federal coal sold to private companies. The key findings of this report include:

> **Overheated Asian coal markets sparked a U.S. export boom.** After a 2009 spike in Chinese coal imports sent Pacific Rim coal prices skyrocketing, coal companies operating in the western United States took advantage of high prices to boost exports, particularly from mines in Montana, Utah, and Colorado.
>
> **U.S. exporters relied on federal coal.** Major West Coast coal exporters relied heavily—and in some cases almost exclusively—on coal produced from federal coal leases to supply overseas customers.
>
> **Asian coal markets have collapsed.** Declining coal imports in China and India, coupled with burgeoning coal supplies from Indonesia, Australia, and Russia, flooded seaborne coal markets with inexpensive coal. Starting in 2011, international coal prices fell for five consecutive years, forcing many US exporters to pull out of Asian markets.
>
> **U.S. coal producers still hope for an export rebound.** Despite the collapse in seaborne coal prices, US coal companies have continued to pour money and resources into export projects—suggesting that coal industry executives were making calculated gambles that export markets could re-inflate.
>
> **The potential for future exports boosts the value of federal coal.** The possibility that seaborne coal prices might someday rise gives the purchasers of federal coal leases a valuable "option" to profit from future price increases.

The federal government should consider coal exports when setting the "fair market value" of federal coal. As the Department of the Interior and the ONRR review the federal coal program royalties and valuation, they should consider the unique dynamics of coal exports—

including the “option value” of potential future coal exports— when determining the fair market value of federal coal leases. The Sightline Institute Report raises important issues related to the export market and federal coal, and its analyses and recommendations should be considered and responded to in any reconsideration of the Final Valuation Rule.

b. *Headwaters Economics. 2015. The Impact of Federal Coal Royalty Reform on Prices, Production, and State Revenue.* https://headwaterseconomics.org/energy/coal/coal-royalty-reform-impacts/

In its report, The Impact of Federal Coal Royalty Reform on Prices, Production, and State Revenue, Headwaters Economic considers ONRR’s proposal to change the method for determining the price used for valuation for non-arm’s length sales of federal coal and proposes two additional methods for how valuation could be improved. Headwaters proposes that the gross commodity value of federal coal required for royalty valuation is best revealed by the net delivered price paid by domestic power generators, coke plants, other industrial consumers, and for coal delivered free along ship at export terminals. “To understand how this policy option would work, Headwaters estimated the likely change in federal royalty revenue by comparing actual mine prices utilized for royalty valuation between 2008 and 2014 based on ONRR reported sales value, sales volume, and royalty statistics, to actual net delivered prices using data form the Energy Information Administration (EIA) and proprietary data purchased from SNL Energy.”

They found, on page 2 of this report, that “using net delivered prices for royalty valuation would have earned about $140 million in additional revenue between 2008 and 2014, a 20 percent increase over actual collections.” Their analysis showed that this change would have had a marginal increase in the cost of delivering coal to consumers (1.6% increase in the net delivered price) and a very small change in demand for coal (a 0.2% decrease in production).

Using the Net Delivered Price provides greater transparency for coal owners. Though ONRR’s use of the first arm’s length transaction for royalty assessment may be the simplest way to improve ease of compliance, “this reform would do little, if anything, to improve transparency or ensure a fair return. Due to data limitations, we could not assess the likely revenue outcomes of this proposed reform . . . . By comparison, a regulation that utilizes net delivered prices of federal coal for royalty valuation offers significant improvements in transparency and is also the most effective and fair way to ensure a fair return to the federal landowner for coal sold in through non-arm’s length transactions at the mine.”

The proposal put forth by Headwaters should be considered if the ONRR wants to know “[h]ow best to value non-arm’s-length sales and/or sales between affiliates” or “[w]hether ONRR should update the valuation regulations governing non-arm’s-length disposition of Federal gas,” as it states in the Federal Register notice.

VI. Transparency

In response to requests from commenters asking for more transparency to the public for coal valuation about royalty payments from sales of publicly-owned oil, gas and coal, the Final Valuation Rule notes on page 43339 that “The U.S. Department of the Interior (Department) created a data portal as part of the Extractive Industries Transparency Initiative—a global, voluntary partnership to strengthen the accountability of natural resource revenue reporting and build public trust for the governance of these vital activities. You can access the data portal at https://useiti.doi.gov.” We were pleased to read that "The (U.S. Interior) Department remains committed to the principles and goals of EITI including transparency and good governance of the extractive sectors...," and hope that ONRR and the Department of the Interior will continue to provide information on the royalty payments made by U.S. oil, gas, and coal lessees through the USEITI portal and the information provided will continue to improve.

VII. Conclusion.

Thank you for considering these comments. We look forward to remaining engaged in any rulemaking related to the Valuation Rule as this process moves forward.

Sincerely,

Bruce Pendery

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IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

PEOPLE OF THE STATE OF CALIFORNIA, ex rel. XAVIER BECERRA, ATTORNEY GENERAL; STATE OF NEW MEXICO, ex rel. HECTOR BALDERAS, ATTORNEY GENERAL,

Plaintiff,

v.

UNITED STATES DEPARTMENT OF THE INTERIOR; OFFICE OF NATURAL RESOURCES REVENUE; RYAN ZINKE, Secretary of the Interior; and **GREGORY GOULD,** Director, Office of Natural Resources Revenue,

Defendants.

Case No. ________________________

COMPLAINT FOR DECLARATORY AND INJUNCTIVE RELIEF

(Administrative Procedure Act, 5 U.S.C. § 551 *et seq.*)

INTRODUCTION

1. On July 1, 2016, the Office of Natural Resources Revenue ("ONRR"), a division of the U.S. Department of the Interior ("DOI"), finalized the "Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform" rule ("Rule") in order to clarify the process for calculating royalties on oil, gas, and coal extracted from federal and Indian lands. 81 Fed. Reg.

43,338 (July 1, 2016). ONRR finalized the Rule after five years of public engagement including public workshops and an extended notice-and-comment period.

2. The Rule responded to dramatic changes that have taken place in domestic energy markets by providing much-needed updates to existing regulations. Significantly, the Rule addressed a coal industry practice of depressing commodity values by selling coal to affiliated companies at artificially low prices. *Id*. at 43,339. By offering greater simplicity, clarity, and consistency in product valuation, the Rule sought to ensure that American taxpayers received royalties reflecting the fair market value for natural resources extracted from public lands. 80 Fed. Reg. 608 (Jan 6, 2015).

3. The effective date of the Rule was January 1, 2017. However, nearly two months after the Rule went into effect, ONRR issued a notice "postponing" the effectiveness of the Rule until the resolution of pending litigation that had been filed against the Rule. ONRR has instructed oil, gas, and coal lessees to operate under regulations that predated the Rule—the very regulations that the agency determined were unclear, inconsistent, and unfair to taxpayers.

4. An agency cannot "postpone" the effective date of a rule when that effective date has already come and gone. Further, the legal basis on which the agency relied for the postponement, Section 705 of the Administrative Procedure Act ("APA"), does not apply to rules that have already gone into effect. ONRR's attempt to delay the Rule after it became effective is facially invalid, and constitutes an attempted end-run around the APA's notice-and-comment requirements.

5. Accordingly, Plaintiffs People of the State of California, ex rel. Xavier Becerra, Attorney General, and State of New Mexico, ex rel. Hector Balderas, Attorney General ("Plaintiffs") seek a declaration that Defendants' action violated the APA, and an injunction requiring Defendants to vacate the postponement and immediately reinstate the Rule.

JURISDICTION AND VENUE

6. This Court has jurisdiction pursuant to 28 U.S.C. § 1331 (action arising under the laws of the United States), 28 U.S.C. § 1361 (action to compel officer or agency to perform duty owed to Plaintiffs), and 5 U.S.C. §§ 701-706 (Administrative Procedure Act). An actual

controversy exists between the parties within the meaning of 28 U.S.C. § 2201(a), and this Court may grant declaratory relief, injunctive relief, and other relief pursuant to 28 U.S.C. §§ 2201-2202 and 5 U.S.C. §§ 705-706.

7. Venue is proper in this Court pursuant to 28 U.S.C. § 1391(e) because this is the judicial district in which Plaintiff People of the State of California, ex rel. Xavier Becerra, Attorney General resides and this action seeks relief against federal agencies and officials acting in their official capacities.

INTRADISTRICT ASSIGNMENT

8. Pursuant to Civil Local Rules 3-5(b) and 3-2(c), there is no basis for assignment of this action to any particular location or division of this Court.

PARTIES

9. Plaintiff, PEOPLE OF THE STATE OF CALIFORNIA, brings this action by and through Attorney General Xavier Becerra. The Attorney General is the chief law enforcement officer of the State and has the authority to file civil actions in order to protect public rights and interests, including actions to protect the natural resources of the State. Cal. Const., art. V, § 13; Cal. Gov. Code §§ 12600-12612. This challenge is brought pursuant to the Attorney General's independent constitutional, statutory, and common law authority to represent the public interest.

10. Fifteen percent of California's land area—15.2 million acres of public lands and 592,000 acres of Native American tribal land—is managed by the federal government. These lands contain approximately 600 producing oil and gas leases covering more than 200,000 acres and 7,900 usable oil and gas wells. California is a leading state in terms of oil extraction on public lands, producing about 15 million barrels annually, and also produces approximately 7 billion cubic feet of natural gas. Since 2008, California has received an average of $82.5 million annually in royalties from federal mineral extraction within the state.

11. Plaintiff STATE OF NEW MEXICO brings this action by and through Attorney General Hector Balderas. The Attorney General of New Mexico is authorized to prosecute in any court or tribunal all actions and proceedings, civil or criminal, when, in his judgment, the interest of the state requires such action. N.M. Stat. Ann. § 8-5-2.

12. New Mexico is second only to Wyoming in the number of producing oil and natural gas leases on federal land. More than one-third of New Mexico's land is federally administered. Annually, New Mexico produces approximately 1,220 billion cubic feet of natural gas (5% of the U.S. total), of which approximately 60% is from federal and Indian lands; 85,200 million barrels of crude oil (4% of the U.S. total), of which approximately 45% is from federal and Indian lands; and about 22 million short tons of coal (2% of the U.S. total). Since 2008, New Mexico has received an annual average of $470 million in federal mineral extraction royalties.

13. The People of California and the State of New Mexico have an interest in the proper management of their respective States' natural resources and in receiving an appropriate share of royalty payments from oil and gas that is produced on federal lands within their States. ONRR's delay of the Rule has impacted or will impact the amount of royalties received by the States on the extraction of these resources. Plaintiffs have suffered legal wrong by ONRR's illegal action and have standing to bring this suit.

14. Defendant UNITED STATES DEPARTMENT OF THE INTERIOR is an agency of the United States government and bears responsibility, in whole or in part, for the acts complained of in this Complaint. The DOI is responsible for managing the collection and calculation of royalties and other payments due on oil, gas and coal produced on federal and Indian lands. 30 U.S.C. §§ 187, 1701.

15. Defendant OFFICE OF NATURAL RESOURCES REVENUE is an agency of the U.S. Department of the Interior and bears responsibility, in whole or in part, for the acts complained of in this Complaint. ONRR is the federal agency charged with managing and ensuring full payment of revenues owed for development of the nation's federally-owned natural resources. 30 CFR § 1201 *et seq*.

16. Defendant RYAN ZINKE is the Secretary of the Interior, and is sued in his official capacity. Mr. Zinke oversees the responsible development of energy supplies, including natural resource extraction, on public lands and waters, and has authority to promulgate regulations establishing the value of federal oil and gas production, and federal and Indian coal production. 25 U.S.C. § 396(d); 30 U.S.C. §§ 189, 359; 43 U.S.C. § 1334.

17. Defendant GREGORY GOULD is the Director of ONRR, and is sued in his official capacity. Mr. Gould is responsible for the collection and disbursement of billions of dollars annually in revenues from energy production on all federal and Indian lands. 30 CFR § 1201.100.

STATUTORY BACKGROUND

18. The Administrative Procedure Act governs the procedures and practices of administrative law, including the procedural requirements that agencies must employ when making decisions. 5 U.S.C. § 553. The APA places on agencies the obligation to engage in a notice-and-comment process prior to formulating, amending, or repealing a rule. *Id.* §§ 551(5), 553. This process is designed to "give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments." *Id.* § 553(c).

19. Section 705 of the APA states: "When an agency finds that justice so requires, it may postpone the effective date of action taken by it, pending judicial review." 5 U.S.C. § 705.

20. Under the APA, a "reviewing court shall…hold unlawful and set aside" agency action found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law…in excess of statutory jurisdiction, authority, or limitations, or short of statutory right," or "without observance of procedure required by law." 5 U.S.C. § 706.

FACTUAL AND PROCEDURAL BACKGROUND

21. Each year ONRR collects billions of dollars in royalties on coal, oil and gas extracted from public lands. A significant portion of this revenue is distributed to states through direct disbursements and grants. 30 U.S.C. § 191(a). Since 2008, California and New Mexico have received tens or hundreds of millions of dollars respectively in royalties from federal mineral extraction within their states.

22. Existing regulations governing the valuation of federally-owned natural resources largely date back to the 1980s and fail to take into account dramatic changes that have occurred in the industry and marketplace for these minerals. 80 Fed. Reg. at 608. As a result, taxpayers receive inadequate returns from the extraction of domestic energy resources. *Id.*

23. In 2007, the DOI's Royalty Policy Committee issued a report recommending that ONRR clarify its regulations governing gas valuation and revise its regulations for "calculating

prices used in checking royalty compliance for solid minerals, with particular attention to non-arm's-length transactions." *Id*.

24. In 2011, ONRR began a five-year rulemaking process to update existing regulations for oil, gas, and coal produced from federal leases and coal produced from Indian leases. 76 Fed Reg. 30,878, 30,881 (May 27, 2011). The agency conducted outreach to stakeholders and tribes including six public workshops, and considered the information gained through this outreach in crafting a revised set of regulations. 81 Fed. Reg. at 43,338.

25. On January 6, 2015, ONRR issued a Proposed Rule to amend the valuation regulations. In particular, ONRR stated that its intent was "to provide regulations that (1) offer greater simplicity, certainty, clarity, and consistency in product valuation for mineral lessees and mineral revenue recipients; (2) are more understandable; (3) decrease industry's cost of compliance and ONRR's cost to ensure industry compliance; and (4) provide early certainty to industry and ONRR that companies have paid every dollar due." 80 Fed. Reg. at 608.

26. ONRR accepted public comment on the Proposed Rule through May 8, 2015 and received more than 1,000 pages of written comments from over 300 commenters. 81 Fed. Reg. at 43,338. For example, the California State Controller's Office submitted comments on the Proposed Rule on May 5, 2015, acknowledging "the impact of ONRR's proposals for gas valuation on California's revenue interests" and "applaud[ing] its effort to pursue some long-overdue reforms." A coalition of non-governmental organizations submitted comments on May 8, 2015, acknowledging that the Proposed Rule took important steps to "close an accounting loophole that in recent years has enabled coal companies to sell federal coal to [their] own subsidiaries, pay royalties on the initial sale, then reap windfall profits when those subsidiaries sell the same coal at a much higher price without any additional royalty."

27. After carefully considering public comments, ONRR finalized the Valuation Rule on July 1, 2016. 81 Fed. Reg. 43,338. ONRR estimates that the Rule would increase royalty collections by between $71.9 million and $84.9 million annually. *Id*. at 43,359.

28. The Rule was issued pursuant to ONRR's authority to collect, account for, and verify natural resource and energy revenues—authority granted by Congress through statutes including

the Mineral Leasing Act (30 U.S.C. § 181 *et seq*.), the Outer Continental Shelf Lands Act (43 U.S.C. § 1331 *et seq*.), and the Federal Oil & Gas Royalty Management Act of 1982 (30 U.S.C. § 1701 *et seq*.). 81 Fed. Reg. at 43,369.

29. The Rule contains a number of provisions designed to ensure the accurate calculation of royalties and commodity values. By amending the processes for valuating non-arm's-length coal sales, the Rule seeks to prevent an industry practice of minimizing royalty payments by selling coal to subsidiaries for less than market value. 80 Fed. Reg. at 609. The Rule further allows ONRR to consider downstream commodity prices, thus ensuring sufficient collection of royalties on exported minerals that garner higher prices overseas than they would in the domestic market. *Id*. Additionally, the Rule gives ONRR discretion to set a "reasonable value of production" where there is evidence that a lessee has engaged in fraudulent practices when determining commodity values. 81 Fed. Reg. at 43,341.

30. On December 29, 2016, various coal and oil industry groups challenged the Rule in U.S. District Court for the District of Wyoming. *Cloud Peak Energy, Inc. v. United States Dep't of the Interior,* Case No. 16-cv-315–NDF (D. Wyo.); *American Petroleum Inst. v. United States Dep't of the Interior,* Case No. 16-cv-316–NDF (D. Wyo.); *Tri- State Generation and Transmission Ass'n, Inc. et al., v. United States Dep't of the Interior,* Case No. 16-cv-319–NDF (D. Wyo.). On March 24, 2017, prior to the submission of any briefing on the merits, the district court granted the federal government's request for a 90-day stay of the litigation.

31. On January 1, 2017, the Rule went into effect. 81 Fed. Reg. at 43,338.

32. On February 22, 2017, James D. Steward, Deputy Director of ONRR, issued a letter entitled "Stay of the Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform Final Rule," which announced that the agency had "decided to postpone the effective date of the 2017 Valuation Rule" and directed federal and Indian lessees to value, report and pay royalties under preexisting rules. The Deputy Director cited Section 705 of the APA as the basis for this postponement and stated that the agency would publish a Federal Register notice to this effect.

33. On February 27, 2017, ONRR issued a delay notice for the Rule in the Federal Register, citing Section 705 of the APA and the pending litigation. 82 Fed. Reg. 11,823 (Feb. 27, 2017) ("Postponement of Effectiveness of the Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform 2017 Valuation Rule") ("Delay Notice"). Specifically, ONRR stated that: "In light of the existence and potential consequences of the pending litigation, ONRR has concluded that justice requires it to postpone the effectiveness of the 2017 Valuation Rule pursuant to 5 U.S.C. 705 of the Administrative Procedure Act, pending judicial review." *Id*. The agency attempted to justify the delay by arguing it would be easier for industry to maintain existing accounting practices. *Id*. ONRR further noted that "[a]lthough the 2017 Valuation Rule took effect on January 1, 2017, Federal and Indian Lessees are not required to report and pay royalties under the Rule until February 28, 2017." *Id*.

34. ONRR's action was swiftly rebuked by members of Congress. Senator Maria Cantwell (ranking member of the Senate Energy and Natural Resources Committee) and Representative Raúl Grijalva (ranking member of the House Committee on Natural Resources) both sent letters to the DOI decrying the illegal postponement as a contravention of the APA and demanding that the agency reinstate the Rule.

35. On April 4, 2017, ONRR published an "advance notice of public rulemaking" in the Federal Register seeking comment on whether the Rule is needed and what, if any, revisions should be made to it. 82 Fed. Reg. 16,323 (Apr. 4, 2017). On the same day, ONRR published a proposal to repeal the Rule "in its entirety" in order to "maintain the current regulatory status quo," notwithstanding that the Rule had been illegally stayed. 82 Fed. Reg. 16,325 (April 4, 2017).

FIRST CAUSE OF ACTION

(Violation of the APA, 5 U.S.C. §§ 553, 705)

36. Paragraphs 1 through 35 are realleged and incorporated herein by reference.

37. By applying Section 705 of the APA to a rule that was already in effect, Defendants contradicted the plain meaning of "postpon[ing] the effective date" of a rule. 5 U.S.C. § 705.

38. Because the Rule was already in effect prior to its postponement, Defendants have effectively revoked the Rule without completing the notice-and-comment procedures required by the APA. 5 U.S.C. § 553.

39. Accordingly, Defendants' action was unlawful and contrary to the requirements of the APA. 5 U.S.C. §§ 553, 705.

SECOND CAUSE OF ACTION

(Violation of the APA, 5 U.S.C. § 706)

40. Paragraphs 1 through 39 are realleged and incorporated herein by reference.

41. Defendants, by invoking APA Section 705 to "delay" the Rule after it had already gone into effect, acted in a manner that was arbitrary, capricious, an abuse of discretion, not in accordance with law, and in excess of their statutory authority. 5 U.S.C. § 706.

THIRD CAUSE OF ACTION

(Violation of the APA, 5 U.S.C. § 706)

42. Paragraphs 1 through 41 are realleged and incorporated herein by reference.

43. Defendants did not, in issuing the Delay Notice, adequately consider economic and environmental harms to the public as required by the four-part test for postponing a rule pursuant to Section 705 of the APA.

44. The grounds offered by Defendants do not justify the delay of the Rule.

45. Delay of the Rule is therefore arbitrary and capricious, an abuse of discretion, not in accordance with law, and in excess of Defendants' statutory authority. 5 U.S.C. § 706.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs respectfully request that this Court:

1. Issue a declaratory judgment that Defendants acted arbitrarily, capriciously, contrary to law, abused their discretion, and failed to follow the procedure required by law in their delay of the Valuation Rule, in violation of the APA;

2. Vacate Defendants' unlawful postponement of the Rule;

3. Issue a mandatory injunction compelling Defendants to reinstate the Rule;

4. Award Plaintiffs their costs, expenses, and reasonable attorneys' fees; and

5. Award such other relief as the Court deems just and proper.

Dated: April 26, 2017

Respectfully Submitted,

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May 8, 2015

Armand Southall, Regulatory Specialist
Office of Natural Resources Revenue
U.S. Department of the Interior
P.O. Box 25165
MS 61030A
Denver, CO 80225

Re: Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform

Dear Mr. Southall:

On behalf of The Wilderness Society please accept and fully consider these comments regarding the proposed Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform published by the Office of Natural Resources Revenue (ONRR).

The Wilderness Society (TWS), as America's leading public lands conservation organization, is committed to protecting America's wild places for current and future generations. Since 1935, TWS has worked to protect wilderness-quality lands across the United States. Our goal is to ensure that future generations will enjoy the clean air and water, wildlife, natural beauty, opportunities for recreation, and spiritual renewal that pristine forests, rivers, deserts, and mountains provide.

TWS supports the Department of the Interior's commitment to manage our public lands in a fair and balanced manner as evidenced by the Department's initiatives to improve imbalanced or outdated rules and policies. Such initiatives include the oil and gas leasing reforms, mitigation policy, methane emissions rule and other actions that Department is undertaking to balance resource extraction and production with conservation of our public land heritage. Providing greater balance among the many uses of our public lands will provide great sustainability of our resources for the long-term.

Overall, we support ONRR's initiative to update the regulatory process by which oil, gas and coal are valued for the purposes of royalty payments. As the chief revenue collection authority on public lands, ONRR has a responsibility to recover the full value owed to the taxpayer. The proposed rule is a critical step in reforming the valuation process ONRR employs in revenue management and will provide greater clarity in the future. This is a market solution to what was previously an unbalanced and distorted market place in favor of energy producers.

The proposed rule represents a necessary commitment to more efficiently and responsibly developing energy resources on public lands, but we believe a long-term plan should guarantee revenues collected are based on the fair market price and that they are a part of the overall process by which public lands used in resource development are managed and restored. This recommendation is consistent with achieving a valuation method that accounts for the true costs of fossil energy.

In the current rule, there is no accounting for lost opportunity costs that come from development. When federal land is developed, there are important inherent qualities of the land and surrounding habitat that are lost, such as scenery, recreation opportunities, wildlife habitat, water and air quality or the actual land itself. The revenues gained from development do not compensate for the value of the land that is lost.

Land conservation, through recreation and tourism and human uses of public land, is a vital source of revenue for many communities. While there are always alternatives for development—whether that be other federal lands or private land, or even other energy resources—there are no alternatives for the land that is lost to development. The cost of development should incorporate the lost benefits of conservation, ecosystem services and recreation opportunities to the public in order to provide a fair return from such a use.

We strongly recommend ONRR proceed with this rulemaking in a manner that strikes a balance between protecting economic, environmental and taxpayer interests. We have set out the following detailed recommendations to fully realize a successful rulemaking.

I. DOI must ensure that Americans receive a fair return from resource extraction

The Federal Land Policy and Management Act (FLPMA) of 1976 requires the Department of Interior to ensure that "the United States receive fair market value of the use of the public lands and their resources."[1] FLPMA along with other authority – the Mineral Leasing Act of 1920 – authorizes DOI's control over resources on public lands and requires the Secretary to develop and implement a mechanism for establishing and collecting a fair market value, specifically providing for DOI to "prescribe necessary and proper rules and regulations to do any and all things necessary to carry our and accomplish the purposes of the leasing statutes."[2] With regards to oil and gas for example DOI has the responsibility to ensure conservation of the resource, prevent waste, and obtain a fair return to the government, including ensuring that the United States receives proper royalties on production from federal leases.[3]

[1] 43 U.S.C. § 1701(a)(9).
[2] Mineral Leasing Act of 1920, 30 U.S.C. §189 (see also 25 U.S.C. §§396, 396d (tribal lands))
[3] Mineral Leasing Act of 1920, 30 U.S.C. §§ 187, 359

This is an important reform in that it ensures that if economic development is occurring on public lands, the public is appropriately compensated. Issues with regard to achieving fair market value from mineral leases on public lands were clearly identified by in a report by a subcommittee of the Royalty Policy Committee in 2007. That report called for an update to Federal oil regulations last changed in 2000, Federal gas regulations in effect since 1988 (with minor changes since then) and Federal and Indian coal regulations which have largely been untouched since 1989. The oil, gas, and coal market places have undergone significant changes in the intervening years and therefore require changed regulations.

Recommendation: ONRR should go forward with the proposed rule and ensure that the public is receiving fair value for resources developed on public lands.

II. Federal Oil and Gas

Leasing land for oil and gas extraction is one of the predominant uses of our federal public lands. Currently, more than 36 million acres of federal land and minerals are under lease by the oil and gas industry. These leases last at least 10 years whether the company drills or not, and if wells are drilled, then leases can be extended for decades, precluding other activities like recreation, cattle grazing or hunting. The lands under lease also take away the opportunities to manage these lands for conservation purposes, including protecting watersheds and wildlife habitat. The exclusionary nature of other uses and the prevalence of oil and gas leasing on our public lands should be factored into calculations of royalty payments so that the American people receive a fair return from this use.

To this end, ONRR is proposing changes such as eliminating unused valuation options. For Federal natural gas leases ONRR would remove the valuation methodology for non-arm's-length sales in favor of process that would value it on the sale price of the first arm's length sale price, optional index prices or weighted pools. These changes serve ONRR's objective of providing greater clarity to the process with the ultimate goal of increasing accuracy.

The Wilderness Society supports these changes as part of an overall effort to provide greater clarity and transparency to the valuation process. The following are comments on specific proposed reforms for collection of royalties for the extraction of oil and gas from our public lands.

A. Removal of Deep-Water Gathering Policy

The removal of the Deep-Water Gathering Policy, which allowed for oil and gas lessees to deduct from their royalty payments the expenses associated with gathering resources extracted from deep-water leases, will stop improper deductions. These expenses do not fit the definition of transportation costs in the rule but were nonetheless allowed. The removal of this exception will allow ONRR to collect somewhere between $17.4M and $23.6M more in royalty payments from these leases. This policy change will remove what amounts to a subsidy for oil and gas lessees and put the regulations in line with the courts the Interior Board of Land Appeals[4]. Additionally this proposal will provide costs savings from reduced administrative needs to the extraction industry. ONRR estimates the industry will save upwards of $3.36M annually. In effect this proposal will insure the public receives payment much closer to fair market value while actually reducing some costs for the oil and gas industry.

B. Removal of Transportation Exceptions

The removal of the exception policy enabling transportation allowances greater than 50% for Federal oil and gas leases (see proposed 30 C.F.R. 1206.109(d)(2) and 30 C.F.R. 1206.152(e)(1)) eliminates a loophole that reduced payments. The current regulations allow transportation costs to be deducted from royalty payments as long as they remain below 50% of the resource value. Lessees could and did file for exceptions to this rule, enabling their effective royalty payment to drop much further. The proposed rule eliminates this exception and will result in an additional $4.17M in royalties from gas leases and $6.43M in oil leases on an annual basis. The decreased profitability of a moving oil and gas across large distances is commendable in that it incentivizes domestic consumption and ensures that transportation costs are not used as a means to deprive the public of the fair market value of resources extracted from public land.

Importantly, ONRR is proposing to remove transportation allowances for pipeline losses in oil and gas leases either actual or theoretical (see proposed 1206.112(c)2(ii). This change will insure the royalty value is based on what was removed from the lease and not subsidize losses occurring after the royalty point. Further, this change applicable to non-arm's length transportation contracts will provide incentive against waste and loss in transport of oil and gas, which is a key objective of public lands leasing and has environmental benefits. The change will also result in increased revenues of $4.7M annually for the taxpayer.

ONRR is also proposing to eliminate oil transportation exceptions for the costs associated with line fill. The proposed reform would create a mechanism for determining transportation allowance for arm's length transportation absent a written contract. (See proposed 1206.111 and 1206.112). The new line fill policy clarifies change and enforces existing ONRR policy that all costs associated with marketing the oil are not deductible. This will increase revenues an estimated $1.71M (if applied to the 2010 royalty volume and using the mid-range price per barrel ONRR estimate) and, as ONRR points out, these deductions are for costs incurred after the royalty point to enable transport to market. This deduction has only been in place since 2004 and its removal is in keeping with the overall goal of achieve a fair return for the taxpayer. The methodology change also included in this section is also crucial as it incentivizes documentation and provides increased authority for ONRR to protect the taxpayers' interests.

[4] See *California Co. v. Udall*, 296 F.2d 384 (D.C. Cir. 1961) and *Kerr-McGee Corp.*, 147 IBLA 277 (1999)

III. Federal and Indian Coal

A. Greater Clarity for Coal Valuation

The Royalty Policy Committee specifically called for changes to coal valuation its 2007 report to provide greater clarity. The report recommended, "By the end of FY 2008 MMS should review, and (as appropriate) revise and implement the regulations and guidance for calculating prices used in checking royalty compliance for solid minerals, with particular attention to non-arms-length transactions," (Recommendation 4-27).

The proposal would amend non-arm's length to remove benchmarks in favor of the first arm's length sale methodology use in oil and gas leases. Additionally if there is no arm's length sale (such as when the lessee or its affiliate uses the coal to generate electricity) the valuation for royalty purposes will now be based off of the gross proceeds from the arm's length sale of electricity. ONRR estimates these changes to result in potential increase or decrease of coal royalties of $1.06M.

These reforms provide better a better regulatory regime for both industry interests and the public. It reduces the burdensome administrative process on the industry by removing the benchmarking system, providing the industry a clearer method of royalty calculation. Further, it provides increased revenue for the taxpayer. TWS supports this change's inclusion in the final rule.

Federal and Indian coal valuation has provided royalties drastically below that of the market price of coal and depicts a far greater gap than that of oil and gas leases also addressed in the proposal. We support ONRR's efforts to rectifying these gaps in valuation that exist between the value of coal for royalty purposes and that at which it is sold on the open market. The shift away from benchmarks to the first arm's length sale is an admirable step in valuing at the fair market price.

B. Transportation Allowances for Coal

We are concerned that ONRR chose not to enforce a washing and transportation allowance limit on coal lessees similar to those in place on gas and oil lessees (see Rule 1206.252). By not imposing a limit on the deduction allowance such as the 50% of value limit on the other two resources ONRR is providing perverse incentives to export coal and shifting the market in favor of coal extraction from Western leases as opposed to Appalachian locations. Moreover while the royalty exemptions currently is not use prolifically (most coal sales for the purposes of valuation take place close the mine) it will take on greater importance as regulations move the point in time at which the coal is valued closer to its sale to the final consumer. Transportation exemptions may provide an avenue for producers to defray the costs imposed by the changes made to non-arms length sale valuation process and reduce the effective royalty rate. Therefore by not implementing a similar transportation limit to that imposed on oil and gas lessees, ONRR may in effect be undercutting any potential progress towards achieving accurate and efficient revenue for the taxpayer.

Recommendation: We urge ONRR to provide parity among the various royalty regimes, which was a priority that was the subject of much of the rest of the proposed rulemaking. ONRR should make transportation and washing costs cap at 50% of the value of the resource if not lower.

IV. The Default Valuation Provision

The new "default provision" would allow ONRR to determine value if it decides: a contract does not reflect total consideration; the gross proceeds accrued do no reflect reasonable consideration due to misconduct or breach of the duty to market for mutual benefit; or, ONRR cannot ascertain the value of the production because of a variety of factors including but not limited to a lessee's failure to provide documents. This default provision stems from the Secretary's broad authority and discretion over the valuation factors. It further provides a mechanism by which ONRR can adjust collection revenues if, under the new rules, the revenues are still deemed to not reflect fair market value.[5] The ultimate goal of these regulations is to encourage proper royalty payments through the normal means. This provision serves as an important backstop and we fully support its inclusion in the final rule.

V. Potential Future Reforms

As stated in the federal register notice for this proposed rule, "detailed comments that elaborate on specific situations where further valuation changes should be considered would be particularly useful to ONRR as it proceeds with this rulemaking as well as any future rules that may be considered." The following are specific recommendations on future rules that ONRR could initiate to provide a more equitable return on oil, gas and coal leasing of our federal public lands.

A. Reformation of Royalty Rates

The proposal by ONRR is a good first step towards correcting many of the problems with oil, gas and coal leases on Federal and Indian lands. The current rule adds an estimated $76.5M of net costs to billion dollar industries. Unfortunately, the rule proposed does not correct the staggeringly low royalty rates charge against these value calculations, which have remained at 12.5% since the 1980s. BLM and BOEM has recognized that there is an issue specifically regarding oil and gas leases, in that they are not provided a fair market return and commissioned a report to investigate the issue further in 2012[6]. The

[5] Critics of this change will argue that its addition will create uncertainty as to the royalties owed and moreover that definiteness is crucial to the economics of resource extraction. However, the default provision is a last resort in situations where royalty payments grossly deviate from the expected. If there is uncertainty, it is a likely to be the result of a failure to pay fair market value on the part of the lessee.

[6] http://www.boem.gov/Oil-and-Gas-Energy-Program/Energy-Economics/Fair-Market-Value/Fair-Return-Report.aspx

report was in response to a similar GAO report and concluded that rates were among the lowest in the world.[7]

Nor does it change the rental rates, the cost per acre that companies are charged to reserve land upon which they can extract, where some producers pay only $1.50 per acre and rates have not been changed since 1987. A Center for Western Priorities report finds that taxpayers are missing out $56M annually from these low rental rates.[8] These low rates and fees mean that the American public does not get adequate payment for the extraction of public resources and it puts clean energy alternatives at a disadvantage by giving fossil fuel producers a windfall reduction in costs.

Recommendation: The changes included in the proposal and others that have yet to be made focus on ensuring the Federal government in turn the taxpayer receives a fair return as a lessor in natural resource production on our public lands. This is an opportunity to ensure that in times of tightening budgets and concern over our nation's financial future we are not negligently managing our public resources and revenue derived therefrom. We appreciate the notice of a proposed rulemaking recently published that could lead to adjustments in royalty rates for oil and gas by the Interior Secretary, through the BLM.[9] We look forward to participating in that rulemaking process and providing the agency with comments and recommendations to ensure that the American people receive a fair return on the oil and gas resources extracted from BLM-managed lands.

B. Account for the Impacts of Climate Change

The proposal also fails to adequately discourage fossil fuel extraction and production and undermines the efforts of the President's Climate Action Plan. In failing to address the royalty rate problem and leaving loopholes the proposal will result in a regulatory regime that still promotes energy sources that result in greenhouse gas emissions, and moreover providing a discount at the taxpayers expense. The President's Climate Action Plan and Executive Order require federal agencies to consider the climate change impacts of their actions and "reform policies that may, perhaps unintentionally, increase the vulnerability of natural or built systems, economic sectors, natural resources, or communities to climate change related risks (EO 13653 Sect. 2 Pt. II)." This proposed rule does not adequately reform policies, which have grave consequences on our communities and public lands.

Recommendation: In this reform proposal and in future proposals, The Wilderness Society recommends that ONRR provide regulations for assessment of the climate

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[7] GAO Report: *Oil and Gas Royalties: A Comparison of the Share of Revenue Received from Oil and Gas Production by the Federal Government and Other Resource Owners*. 2007. Available at: http://www.gao.gov/new.items/d07676r.pdf

[8] "A Renter's Market" Center for Western Priorities http://www.westernpriorities.org/RentersMarket/

[9] Oil and Gas Leasing; Royalty on Production, Rental Payments, Minimum Acceptable Bids, Bonding Requirements, and Civil Penalty Assessments. 80 Fed. Reg. 22148 (Apr. 21, 2015).

change impacts of oil, gas and coal extraction on public lands and take these costs into account when considering adjustments to royalty rates. Specifically, with regards to this rule ONRR should look at what impact this will have on the greenhouse gas emissions and how those emissions might impact the public lands the resources are being derived from.

C. Increase Reporting and Process Transparency

The proposal leaves many of the reporting requirements the same. This is of particular concern because ONRR's data from royalties is one of the primary sources of data on methane releases into the atmosphere from oil and gas operations on public lands. Greater transparency is needed to properly quantify these releases and limit the releases that occur through venting and flaring.

Recommendation: The reform to valuation process is an opportunity for ONRR to adjust its reporting requirements. The proposed rule specifically addresses this fact in the "default method" in that lack of documentation is a justification for its invocation. In addition, however the reform should request further reporting and increased transparency in the process.

D. Transportation Allowances Encouraging Export

One major concern is that transportation exceptions incentivize the exportation of our energy resources for sale on foreign markets. Subsidizing transportation costs prior to the first arm's length sale does not serve the taxpayers interest if the resource is then exported.

Recommendation: Future reforms should consider lowering oil, natural gas and coal transportation exemptions beyond what is currently allowed. Future reforms should further reduce these exemptions for any resource that is exported.

E. Use of the Default Provisions

ONRR chose not to estimate the cost impact of adding a default valuation methodology, noting that they were unlikely to utilize it. The knowledge of its existence may provide industry incentive to properly value extraction from public lands and no longer engage in what the Center for American Progress declared as an "elaborate network of subsidiaries and affiliates to maximize the subsidies that can be gained through existing federal royalty regulations."[10] Hesitancy of invoking this default proposition guts the methodologies efficacy and limits the extent to which the rule will close the first arm's length sale loophole.

[10] "Cutting Subsidies and Closing Loopholes in the U.S. Department of the Interior's Coal Program", Center for American Progress
https://www.americanprogress.org/issues/green/report/2015/01/06/103880/cutting-subsidies-and-closing-loopholes-in-the-u-s-department-of-the-interiors-coal-program/

Recommendation: ONRR should provide the economic analysis for the default provision to provide greater clarity into its impact and effect on the market. Secondly ONRR should be willing to use it according to the criteria outline in the proposed rule.

CONCLUSION

The Wilderness Society supports the current reform effort proposed by ONRR. It is the fundamental duty of ONRR to ensure that Americans receive a fair return for the extraction of our public lands. We recommend further action to ensure that energy leases revenues are reflective of both the regulations that proposed and of the true consequences they impose on the tax payer. Please keep us apprised of future actions in relation to this rule and do not hesitate to contact us with any questions you may have.

Sincerely,

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