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Via www.regulations.gov

Mr. Armand Southall
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Attn: Regulation Identifier Number (RIN) 1012–AA13
Docket No. ONRR–2012–0004

RE: Comments Regarding "Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform" 80 Fed. Reg. 608 (January 6, 2015)

Dear Mr. Southall:

Tri-State Generation and Transmission Association, Inc. (Tri-State) submits the following comments in response to the Office of Natural Resources Revenue (ONRR) proposed rule entitled "Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform," 80 Fed. Reg. 608 (January 6, 3015)(Proposal). The Proposal would, among other things, change the regulations governing valuation, for royalty purposes, of coal produced from Federal and Indian coal leases. Tri-State owns Western Fuels-Colorado, a mining subsidiary that supplies coal to two power plants in Colorado.

Tri-State is a not-for-profit wholesale electric power supply cooperative that generates power from a diverse mix of fuel sources, including coal, natural gas, hydropower, solar, and wind. This power supplies 44 member distribution systems serving consumers in many rural communities spread over more than 200,000 square miles throughout Colorado, Nebraska, New Mexico, and Wyoming. Tri-State's mission is to provide its member owners with a reliable, cost-based supply of electricity while maintaining a sound financial position through effective utilization of human capital and physical resources in accordance with cooperative principles.

<u>Overarching Concerns</u>

This Proposal upsets established and well-founded expectations and is not only unfair, but risks raising breach of contract and other legal claims. As specified in the existing regulations, lease terms and written agreements prevail over existing regulations. 30 C.F.R. §§ 1206.250(b), 1206.450(b). ONRR's Proposal contains the same reservation (proposed §§ 1206.250(c) and 1206.450(c)). ONRR cannot unilaterally decide to alter a key economic term of a lease agreement to extract additional financial consideration after the fact. But the Proposal appears to do just that.

ONRR's Proposal fails to meet the stated objective to "simplify processes and provide early clarity for royalties owed…" Rather, it substantially complicates the royalty valuation processes and fails to provide clarity for royalties. Instead, the Proposal establishes variable royalties that are not clear. The Proposal does not value coal royalties, as is intended under the existing rules, but creates requirements that add other costs not related to the Federal and Indian

Coal leases. In some cases, these added costs are not determined until after sales and delivery of electricity.

Cooperative (non-arm's length) Coal Valuation

The ONRR added a definition for "coal cooperative" (80 Fed. Reg. at 628). This definition is unnecessary. Contracts are either arm's length or non-arm's length (NAL). The definition of a NAL contract using the benchmark method includes any contract sold to an affiliate or related party. It does not matter that an affiliate or related party is a corporation or a cooperative, so no distinction is necessary. In fact, the ONRR later combines both a corporation and a cooperative together as cooperative, so no specific distinction exists between a for-profit company and a not-for-profit company that the ONRR clearly identified as selling coal to members at a value less than market value. The ONRR should only consider contracts as either arm's length or non-arm's length regardless of the company type. In addition, as the ONRR continues discussing methods determining the value of the coal from a "coal cooperative", there are instances where "corporation" could have a similar situation (sale to an affiliate with the first arm's length sale).

Currently, NAL sales are valued using the benchmark method, and primarily are based on the price of coal sold as reported to EIA. The current method makes sense and is utilized successfully. However, ONRR is proposing to force any coal lessee to track its coal to an arm's length contract that might occur anywhere else domestically or globally. ONRR would do so by deeming a sale by the lessee's affiliate as a sale by the lessee, by deleting the benchmarks and instead trying to calculate a net-back valuation method from the sale of electricity less applicable generation and transmission costs. Recognizing the questionable nature of these changes, ONRR's preamble "seek[s] input on the merits of eliminating the benchmarks" and asks whether "the royalty value of coal initially sold under NAL conditions should be based on the gross proceeds received from the first arm's length sale of that coal in situations where there is a subsequent arm's length sale." 80 Fed. Reg. at 628.

Tri-State finds the NAL benchmarks to be workable and strongly disagrees with ONRR's contention that the benchmarks are too difficult to implement. ONRR recently (2012) completed a Lease Account Status review at one of our mines and determined "the lease is in good standing". This suggests that ONRR staff is very capable of implementing the benchmark method to value coal royalties.

However, under the Proposal, the value of Federal and Indian coal is based on the "first arm's length contract", and is compounded by ONRR's failure to articulate how exactly lessees are to net-back that value from that point to the lease. As ONRR recognizes in proposed subsection (a), that gross proceeds must include "less an applicable transportation allowance…and washing allowance" to arrive at the royalty value at the lease. *See also* existing

30 C.F.R. § 1206.251 ("net-back method" deducts costs from gross proceeds to calculate "market value of coal at the lease or mine"). Without these deductions, lessees would be forced to pay royalty on more than the "value of coal," which ONRR has no authority to compel. 30 U.S.C. § 207(a). Computing these deductible costs, however, is inherently difficult. Transportation costs are not limited to rail costs and terminal fees, but include the following costs in transporting Federal coal domestically:

- Base railroad transportation rate, fuel surcharges and related accessorial charges. Rates are contractually negotiated and protected by confidentiality clauses in each contract and not available to the coal producer.
- Rail equipment costs.
- Dust and oxidation mitigation sprays applied to coal at mine.
- Management fees and related transaction costs

Notably, these fees and other costs would vary if the coal were trucked instead of shipped via rail. Regardless, it would be inappropriate to assess a coal lease with shipping/transportation costs in the coal royalty valuation calculations.

While ONRR's proposed valuation method appears to provide a deduction for transportation costs for coal sold, the Proposal fails to prescribe which transportation costs are allowable and which costs ONRR will deny. This stands in contrast to the specificity ONRR provided for the gas transportation allowances at 30 C.F.R. § 1206.178 (f) and (g). The complexity and imprecision of such net-back calculations is precisely why ONRR consistently takes the position that the net-back method should be the valuation procedure of last resort. *See, e.g.*, 54 Fed. Reg. 1,492 (Jan. 13, 1989) ("The MMS [Minerals Management Service] will use a net-back valuation method only when other methods of determining value, such as those specified in the rules, are inapplicable."); 53 Fed. Reg. 1,230 (Jan. 15, 1988) ("MMS agrees that the net-back method will not be used frequently. The net-back analysis *should only be used where less complex procedures are not feasible*.") (emphasis added).

Indeed, ONRR has similarly disfavored net-back methods for valuing oil and gas. *See, e.g.*, 53 Fed. Reg. 1,184 ("To routinely perform labor-intensive net-back calculations is impractical."); *id.* (use of net-back analysis "on a routine basis to verify oil value is impractical and unnecessary"); *id.* ("the other benchmarks which have higher priority will result in a reasonable value for royalty purposes and obviate the need to undertake a labor-intensive net-back method"). This aversion to net-back is reflected in ONRR's existing rules for oil and gas. *See* 30 C.F.R. §§ 1206.152 (unprocessed gas); 1206.153 (processed gas); 30 C.F.R. §§ 1206.102-1206.103 (oil). Likewise, and more importantly for present purposes, ONRR's Proposal acknowledges the difficulty of calculating multiple allowances to "trace" arm's length sales in the oil and gas context, and thus affords oil and gas lessees the option to value their oil and gas via other means. 80 Fed. Reg. at 608.

The solution for any disagreement in comparing other arm's length sales is not to scrap the benchmarks altogether, but rather for ONRR to provide further guidance on applying comparability factors. ONRR provides no explanation of why its proposed alternative is any better. Instead, the Proposal provokes only more questions. Tri-State urges ONRR to reject this proposed valuation methodology.

Sale of Electricity

ONRR proposes a different valuation standard altogether when Federal or Indian coal is not sold at all, but is transferred and directly used by a power plant owned by the lessee or its affiliate. In Section §1206.252 (c)(2), coal cooperatives transferring coal to an affiliated power plant who burns the coal must also value coal using this method. Currently, such coal would be valued under the same existing benchmarks applicable to all Federal and Indian coal not initially sold under an arm's length contract. The Proposal now summarily declares that in "no-sale situations" royalty is assessed against the gross proceeds of *electricity* generated and sold at arm's length by the coal lessee or its affiliate. 80 Fed. Reg. at 628. To net-back this value to the coal lease, ONRR would offer deductions for not only transportation and washing, but also "transmission and generation deductions" located in ONRR's separate regulations governing geothermal resources. Separately, if electricity is not sold arm's length, ONRR would just perform the valuation itself. No explanation or justification accompanies this proposal and no responses were found in the Advanced Notice of Proposed Rulemaking that shows anyone advocating for it. Not surprisingly, then, these provisions lack transparency and clarity and are seriously flawed and should not be finalized in their current form.

The mineral leasing laws applicable to Federal or Indian coal and the existing coal royalty valuation regulations contain *no* mention of electricity in valuing coal under any circumstances. ONRR is proposing to use electricity as a proxy for coal in lieu of comparable arm's length coal sales, yet ONRR fails to provide any factual evidence or analysis correlating the two distinct commodities. To the contrary, the Proposal's preamble admits that ONRR has "limited experience" with this methodology, and openly seeks "information on the costs of electric power generation and transmission and whether the Proposal would result in royalty increases or decreases." 80 Fed. Reg. at 639-640. Whatever authority ONRR perceives to value coal in no sale situations (e.g., under the lowest-priority current benchmarks, or its proposed "default provision"), it is inappropriate for ONRR to insert a substitute metric without support that it accurately reflects the value of coal.

As an example, jointly-owned electric generating stations, such as Craig Generating Station located in northwest Colorado (owned by Tri-State, Salt River Project Agricultural Improvement and Power District, Xcel Energy, PacifiCorp, and Platte River Power Authority) serve the energy needs of multiple regions and markets. Because gross proceeds for each utility will vary substantially, the Proposal would likely result in significantly different prices for exactly the same coal. Such a result would unfairly burden the customers of those utilities who are penalized by resulting higher fuel prices. In order to determine gross realizations based on energy sales, a utility would likely have to develop new models to track sales by customer class across multiple rate structures, and possibly further differentiate based on retail versus wholesale transactions. Additionally, such a requirement would be difficult to track and create unnecessary complexity. To require royalty valuation on the basis of gross electric proceeds introduces significant additional steps in the process for determining which facility to dispatch as part of its overall grid operations, increase both the mining and energy industry's compliance costs, and delay the timeframe for royalty valuation rather than providing the early clarity and reduced cost of compliance as stated.

Under the current requirements for valuation of coal royalties, each mine is required to submit audited financials to validate the reported gross proceeds on which the royalties are based. This process provides ONRR the assurance that the gross proceeds for the coal are appropriate and accounted for fully. ONRR's Proposal would require similar provisions for audited financials, but such audit provisions would be meaningless without requiring potentially significant revisions to existing contracts. In most cases (specifically pertaining to jointly-owned generating assets), the entity responsible for payment of royalties would not necessarily have access to audited financials from energy sales that would pertain to the same time period in which royalties would be incurred, thereby adding uncertainty and unnecessary delay to the coal royalty valuation process. Indeed as ONRR stated in this proposed rule, coal royalty valuation will continue to be complex, but ONRR's proposed revisions to both Federal and Indian coal royalty valuations unnecessarily complicates further an already complex process.

Variable revenues associated with energy sales and the expected difficulty for mining companies to try to determine the appropriate revenues for valuation, combined with the inability for mining companies to meet the audited financial requirements add significant complexity to the process of determining royalties and fail to provide clarity throughout the process. As such, this proposal fails to meet the most significant of ONRR's intended purposes for reforming its coal royalty valuations and ONRR should review other less complex options to value non-arm's length sales.

Standardized Transportation Schedules

ONRR states: "…The potential for creating standardized "schedules" for transportation and processing allowances to reduce the need to rely on case-by-case operator reporting and agency review of actual costs." (80 Fed. Reg. at 609)

There is a problem with "clarity" here. How would these schedules be valued? By area? By region? By product type? Would the values include any marketing limitation allowances on those mine locations that are less marketable (only one carrier available)? Would the values include different schedules for each industries' type of processing method? How often would they be changed or updated? The railroads/shipping carriers impose other charges such as fuel surcharges to reimburse them for additional fuel costs during times of higher fuel rates. Railroads enter into confidential contracts with each customer; none of this has anything to do with the valuation of the coal in situ.

These schedules would be undesirable for the industries involved due to the above questions raised. Therefore, this option would not likely be appropriate to impose as an alternative due to the complex nature of the different types of situations that the industries incur. In addition, actual costs incurred would be the preferable treatment of any/all of these allowances by product. These actual costs are definitive and proof that market value was established and paid. In other words, these can be audited without question in the future.

Potential Limitation of Transportation Allowance

The Proposal properly would not import into the Federal and Indian coal regulations the proposed federal oil and gas rules' provision limiting allowances to 50 percent of the value of oil or gas. Yet, the preamble asks whether ONRR should impose the same limitation for coal allowances. Coal currently is not subject to the existing or proposed caps on allowances for oil or gas, nor should it be. The costs of washing and transporting coal are significant, and the corresponding deductions are critical to maintain economic operations. Legally, they must be deductible from any gross proceeds-based valuation to maintain royalty on value of coal at the lease rather than on an impermissibly inflated basis. ONRR cannot and should not impose an arbitrary 50 percent or any other cap on coal allowances.

Reporting Confusion

ONRR's stated goals are to "improve the current regulations to ensure greater clarity, efficiency, certainty, and consistency in production valuation" (80 Fed. Reg. at 609). However, the proposed regulations will have exactly the opposite effect. As we interpret the regulations, at proposed § 1206.253, if the lessee is unable to determine the coal royalty valuation, the proposal allows ONRR to determine the coal royalty valuation. We believe the lessee is unable to make a coal royalty valuation due to the complexity and ambiguity of the proposed regulations. We also understand that ONRR is adopting more aggressive new policies on proper initial reporting and payment of royalties, with threats of substantial civil penalties for erroneous reporting (See 70 Fed. Reg. 28,862. May 20, 2014). If this civil penalty is applicable, it means that the lessee will be penalized for essentially giving up on trying to make a royalty valuation estimate, since we cannot make the estimate based on the confusing methods in this proposal. The ability of ONRR to create significant confusion and to penalize coal producers with Federal or Indian coal leases is inappropriate and unfair.

Concluding Comments

Tri-State and its affiliates support the ONRR's stated goals of simplifying Federal and Indian coal valuation and providing a fair return to the public, Tribes, and allottees. ONRR's Proposal, however, would only frustrate those objectives and result in burdens and regulatory uncertainty outweighing the purported benefits to industry, ONRR, and the public. Tri-State urges ONRR to re-evaluate this Proposal and target simplifying reporting and administrative burdens for all parties involved, and re-issue an amended proposed rule.

Though the current rules are not perfect, the fundamental considerations in the current rules and the distinct aspects of the coal market have not changed since the rules were adopted in 1989. ONRR should not simply substitute a different regime; the agency's justification must be as or more compelling than its justification for the existing coal valuation rules. Currently, ONRR's Proposal does not even attempt to explain many of its changes, or why they are warranted at this time.

The final rule should revert to affording lessees the opportunity to perform valuation in no sale and NAL situations based on existing arm's length sales, and recent sales of comparable coal from nearby mines. The order of the current Benchmark's should be changed to 1, 4, 2, 3, and 5. In those rare situations where there are no arm's length sales, ONRR should use a review of actual cost of production and evaluate a return on investment that is fair to the situation and/or the company under assessment.

Given each of the above significant concerns with the proposed change in valuation of NAL sales, Tri-State urges ONRR not to finalize the Proposal as currently written. Thank you for considering Tri-State's comments. Please contact me if you have any questions regarding the comments.

Sincerely,

Barbara A. Walz

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Policy and Compliance
Chief Compliance Officer

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Attachments