Institute *for*
Policy Integrity
NEW YORK UNIVERSITY SCHOOL OF LAW

May 4, 2017

VIA ELECTRONIC SUBMISSION

Attn: Armand Southall, Regulatory Specialist, (303) 231-3221, armand.southall@onrr.gov, Office of Natural Resources Revenue

Re: RIN 1012-AA20; Docket No. ONRR-2017-0001; Repeal of Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform

The Institute for Policy Integrity ("Policy Integrity") at New York University School of Law[1] submits the following comments on the Office of Natural Resources Revenue ("ONRR") proposal to repeal the July 1, 2016 Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform Rule ("Reform Rule").

Policy Integrity is a non-partisan think tank dedicated to improving the quality of government decisionmaking through advocacy and scholarship in the fields of administrative law, economics, and public policy. We write to make the following comments:

1. Repealing the Reform Rule would **violate the "fair market value" requirement** of the Federal Land Policy and Management Act and duty to collect natural resource revenues under the Mineral Leasing Act, the Outer Continental Shelf Lands Act, and the Federal Oil & Gas Royalty Management Act.
2. Repealing the Reform Rule **without (a) analyzing the extensive record** developed to issue the rule or (b) **providing reasons for repealing** the rule would violate the Administrative Procedure Act (APA).
3. ONRR's stay of the Reform Rule violates the APA.

We also attach here (a) Policy Integrity's earlier comments on the proposed Reform Rule[2] and (b) Policy Integrity's comments in response to ONRR's Advanced Notice of Proposed

[1] This document does not purport to present New York University School of Law's views, if any.

[2] Institute for Policy Integrity, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform (May 8, 2015) ("Policy Integrity Comment"), *available at* https://onrr.gov/Laws_R_D/PubComm/PDFDocs/AA13/NYU-Law-Report-Institute-for-Policy-Integrity.pdf, attached as **Exhibit A**.

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Rulemaking (RIN 1012-AA21).[3] Those two sets of comments are consistent with our comments and recommendations here and we request that they be included in the rulemaking record.

I. The Reform Rule Is Necessary to Ensuring that the Federal Government and States Receive "Fair Market Value" for the Use of Public Land.

ONRR is statutorily charged with collecting, accounting for, and verifying natural resource and energy revenues.[4] In that role, ONRR has the duty to obtain a "fair market value" for the use of public lands.[5] ONRR is prohibited from accepting a bid for coal mining on federal land that is for "less than the fair market value."[6] And ONRR is required (a) to have a system that allows it "to accurately determine oil and gas royalties"[7] and (b) to "ensure the prompt and proper collection and disbursement of oil and gas revenues owed to the United States and Indian lessors and those inuring to the benefit of States."[8]

The Reform Rule was adopted to ensure ONRR complies with these statutory responsibilities.[9] It was designed "to offer greater simplicity, certainty, clarity, and consistency in product valuation and reporting for mineral lessees."[10] The Reform Rule accomplished its purpose through two major reforms: first, by closing a loophole that allowed lessees to pay royalties based on the value of the minerals as sold through captive (instead of arm's length) transactions, and second, by allowing for the audit and identification of transportation cost allowances. If ONRR repeals the Reform Rule, ONRR will be unable to fulfill its statutory mandate under the Federal Land Policy and Management Act to obtain the "fair market value" for use of federal land and resources. The Reform Rule must not be repealed.

A. ONRR should not repeal the provisions closing the loophole.

The Reform Rule closed a loophole that resulted in effective royalty rates far below the statutory minimums. Royalty rates are negotiated on a lease-by-lease basis, but federal statutory minimums are set at: 12.5 percent for surface coal, oil, and natural gas; 8 percent

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[3] Institute for Policy Integrity, Comment Letter on Advance Notice of Proposed Rulemaking (May 4, 2017), attached as **Exhibit B**.
[4] Mineral Leasing Act, 30 U.S.C. §§ 181–287; Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331–1356; Federal Oil & Gas Royalty Management Act, 30 U.S.C. § 1701. *See* 81 Fed. Reg. at 43,369.
[5] 43 U.S.C. § 1701(a)(9).
[6] 30 U.S.C. § 201(a)(1).
[7] *Id.* § 1711(a).
[8] *Id.* § 1701(b)(3).
[9] Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform; Final Rule, 81 Fed. Reg. 43338, 43338 (July 1, 2016) ("Reform Rule").
[10] *Id.*

for subsurface coal; and 12.5 percent for offshore oil and natural gas in the Gulf of Mexico.[11] Despite these statutory minimums, between 2008 and 2012, the average effective royalty rate received by the federal government for all federal coal leases, based on the gross market value of coal, was 4.9 percent.[12] Wyoming, for example, which held 86 percent of coal lease sales on federal land during this period, had an effective average royalty rate of 5 percent.[13] New Mexico had a rate of 6.8 percent.[14] North Dakota (at 0.7 percent) and Oklahoma (at 2.2 percent) have the lowest effective rates; Kentucky (at 7.8 percent) has the highest effective rate.[15] As a result, taxpayers were shortchanged by approximately $850 million between 2008 and 2012.[16]

The disparity between the statutory minimum and actual royalty rates paid resulted from several factors. The most important factor was that companies were taking advantage of the "benchmark" system to pay royalties only on lower domestic sales prices obtained through captive transactions rather than on the real (market) price obtained through the ultimate arm's length sale. Though the benchmark system had required lessees to value their coal on the basis of an arm's length transaction, it nonetheless allowed lessees to use "captive" transactions because of the complex valuation methods used to calculate the benchmark price.[17] Under the system, if a lessee sold the minerals to an affiliate in a non-arm's length sale, the lessee was required to value the sale based on a series of benchmarks, to be applied in a specific order.[18] The first benchmark was "the gross proceeds accruing to the lessee in a sale under its non-arm's-length contract, provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under comparable arm's length contracts."[19] The problem was that it was difficult to obtain information about "comparable" sales because that information is considered proprietary information.[20] Disputes had arisen "over which sales are comparable, particularly because of the inherent ambiguity in applying the comparability factor."[21]

As a result of these ambiguities, companies like Peabody Energy and Cloud Peak Energy were able to used affiliate purchases to hide their overseas sales profits, and pay royalties

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[11] 30 U.S.C. § 207(a) (surface coal mines); 43 C.F.R. § 3473.3-2(a)(2) (underground coal mines); 30 U.S.C. § 226(b)-(c) (onshore oil and gas); 43 U.S.C. § 1337 (offshore oil and gas).
[12] *See* Headwaters Economics, An Assessment of U.S. Federal Coal Royalties 1 (2013) ("Headwaters Report"), *available at* https://headwaterseconomics.org/wp-content/uploads/Report-Coal-Royalty-Valuation.pdf.
[13] *Id.* at 16-17.
[14] *Id.*
[15] *Id.*
[16] *Id.* at 25.
[17] *See* Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform; Proposed Rule, 80 Fed. Reg. 608, 616-7 (Jan. 6, 2015).
[18] *See* 80 Fed. Reg. at 617.
[19] *Id.*; *See also id.* at 621, 628.
[20] *Id.* at 617.
[21] *Id.* at 628.

only on the initial domestic sale price.[22] According to the U.S. Energy Information Administration ("EIA"), 42 percent of all coal produced in Wyoming in 2012 was sold through "captive" transactions.[23] In a 2013 Cloud Peak admitted that, "[i]f the federal government were to materially alter" the benchmarks system, its "profitability and cash flows could be materially adversely affected."[24]

Because the royalty rates that ONRR was receiving were so much lower than the federal statutory minimums, the Government Accountability Office has repeatedly called on Interior to reform the system.[25] In addition, reforming the royalty system had bipartisan congressional support.[26]

ONRR responded to these concerns by issuing the Reform Rule and eliminating the benchmarks.[27] The Reform Rule confirms that "values established in arm's-length transactions are the best indication of market value."[28] And it directs lessees to value their oil and gas based on the first arm's-length-sale prices, index prices, or "volume weighted average of the values established" in the Reform Rule.[29] It directs lessees to value their coal based on the value of the first arm's length sale.[30]

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[22] Patrick Rucker, "Asia coal export boom brings no bonus for U.S. taxpayers," REUTERS (Dec. 4, 2012), *available at* http://www.reuters.com/article/2012/12/04/us-usa-coal-royalty-idUSBRE8B30IL20121204; Headwaters Report at 9-10.
[23] U.S. Energy Information Administration, *Annual Coal Report 2012* ("Annual Coal Report"), Table 8 at 14, *available at* http://www.eia.gov/coal/annual/.
[24] Cloud Peak Energy, 2013 10-K, *available at* http://investor.cloudpeakenergy.com/sec-filings.
[25] U.S. Gov't Accountability Office, Oil and Gas Resources: Interior's Production Verification Efforts and Royalty Data Have Improved, but Further Actions Needed (GAO-15-39) (2015); U.S. Gov't Accountability Office, Actions Needed For Interior to Better Ensure A Fair Return (GAO-14- 50) (2013); U.S. Gov't Accountability Office, The Federal System for Collecting Oil and Gas Revenues Needs Comprehensive Reassessment (GAO-08-691) (2008) at 7-10; U.S. Gov't Accountability Office, Oil and Gas Revenues (GAO-07-676R) (May 2007); *see also* Tom Sanzillo, Institute for Energy Economics & Financial Analysis, The Great Giveaway: An Analysis of the Costly Failure of Federal Coal Leasing in the Powder River Basin at 3 (2012) (estimating that the federal government lost $28.9 billion in revenues over 30 years due to BLM's failure to receive fair market value for coal mined in the Powder River Basin, which produces 44 percent of the nation's coal); John M. Broder, "Undervalued Coal Leases Seen as Costing Taxpayers," N.Y. Times (June 11, 2013); U.S. Department of the Interior, Office of the Inspector General, Evaluation: Coal Management Program (June 2013), *available at* http://www.documentcloud.org/documents/712402-inspector-generals-report-on-coal-leases.html.
[26] Press Release, Wyden, Murkowski Seek Answers on Coal Royalty Payments (Jan. 2013), *available at* https://www.wyden.senate.gov/news/press-releases/wyden-murkowski-seek-answers-on-coal-royalty-payments.
[27] *See, e.g.*, 81 Fed. Reg. at 43346 (gas), 43354-55 (coal).
[28] 81 Fed. Reg. at 43349.
[29] 81 Fed. Reg. at 43346 (gas), 43373 (oil).
[30] *Id.* at 43354-55 (coal).

In the proposed repeal, ONRR does not explain why it now believes that the benchmark system should be restored. ONRR merely states that the petitioners in three cases filed challenging the rule (referred to here as the *Cloud Peak* litigation), raised "serious questions concerning the validity or prudence of certain provisions."[31] See also *infra* 8-11. But those lawsuits provide no basis for restoring the benchmark system. In those lawsuits, petitioners complained that the elimination of the benchmarks would make it difficult to determine how to comply with their legal obligations,[32] but ONRR addressed those concerns at length in the Reform Rule.[33] ONRR's responses at the time of finalizing the Reform Rule were sensible and defensible.

Allowing companies to continue to use the benchmarks would arbitrarily reduce royalties and violate ONRR's responsibility to obtain a "fair market value" for the use of public lands[34] and to "accurately determine oil and gas royalties."[35] The benchmarks system deprives the federal and state governments of revenue and restoring it would be financially irresponsible. ONRR's decision to eliminate the benchmarks was crucial to eliminating the loophole problem and the Reform Rule should not be repealed.

B. The Reform Rule's changes to allowances provide important protections to taxpayers and should not be repealed.

Another reason for the disparity between statutory minimum royalty rates and actual royalty rates was the application of allowances to reduce the price that was used to determine the value of royalties.[36] For example, the regulations allow lessees to deduct transportation and washing costs.[37] Lessees can also obtain a royalty rate reduction if "the leases cannot be successfully operated under the terms provided therein" due to economic hardship or to promote development (the "hardship reduction").[38] Royalty rate reductions

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[31] Repeal of Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform, 82 Fed. Reg. 16323, 16323 (Apr. 4, 2017).

[32] Pet. for Review of Final Agency Action ("Tri-State Pet.") § 13, *Tri-State Generation and Transmission Ass'n, Inc. v. Dep't of Interior*, No. 16 Civ. 319 (Dct. Wy. Dec. 29, 2016), ECF No. 1; Pet. for Review of Final Agency Action ("Am. Pet.") at 4-5, *Am. Petroleum Institute v. Dep't of Interior*, No. 16 Civ. 316 (Dct. Wy. Dec. 29, 2016), ECF No. 1; Pet. for Review of Final Agency Action ("Cloud Peak Pet.") at 7, *Cloud Peak Energy Inc. v. Dep't of Interior*, No. 16 Civ. 315 (Dct. Wy. Dec. 29, 2016), ECF No. 1.

[33] *See, e.g.*, 81 Fed. Reg. at 43341, 43355.

[34] 43 U.S.C. § 1701(a)(9).

[35] 30 U.S.C. § 1711(a).

[36] Headwaters Report at 8.

[37] *See, e.g.*, 81 Fed. Reg. at 43,394.

[38] 30 U.S.C. § 209 (Interior may "waive, suspend, reduce" royalties whenever "necessary" to "to promote development, or whenever in his judgment the leases cannot be successfully operated under the terms provided therein"); *see also* 30 C.F.R. 203.1 (authority to reduce or eliminate royalties for mining on outer continental shelf "to promote development, increase production, or encourage production of marginal resources"); 43 CFR 3473.3-2 (e) ("The Secretary, whenever he/she determines it necessary to promote development or finds that the lease cannot be successfully operated under its terms, may waive, suspend or reduce the rental, or reduce the royalty but not advance royalty, on an entire leasehold, or on any deposit,

occurred on 36 percent of leases since 1990, and lowered royalty payments by $294 million.[39]

There were serious problems with the way that ONRR implemented these allowances. For example, lessees were permitted to "net" the transportation costs when reporting sales rates, which made it difficult to determine how much of the allowance was legitimately due to transportation costs.[40] Indeed, lessees admitted in their comments on the proposed Reform Rule that they had been including non-transportation costs in the allowance, and thus had been inappropriately inflating their transportation costs with non-transportation expenses.[41] In addition, allowing—and encouraging—transportation cost allowances leads to increased transportation-related externalities (including particulate matter emissions, public fatalities, noise, and congestion), which are harmful to the public and the environment.[42]

When ONRR began considering reforming royalty rates, multiple commenters recommended that ONRR eliminate the allowances because they provided improper incentives to energy companies to find the most efficient means of transportation or to locate resource production closer to end users.[43]

Though the Reform Rule did not eliminate the transportation allowance as requested in the comments, the rule did make two important changes that should be maintained. First, the Reform Rule eliminated the provision that allowed lessees to "net transportation from their gross proceeds" when calculating the amount of royalties they owe.[44] The rule requires lessees to instead report those costs as a separate entry on Form ONRR–2014.[45] Second,

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tract or portion thereof, except that in no case shall the royalty be reduced to zero percent."); 43 C.F.R. § 3485.2 (c)(1) (authorization to "waive, suspend or reduce" royalties "for the purpose of encouraging the greatest ultimate recovery of Federal coal, and in the interest of conservation of Federal coal and other resources, whenever in his judgment it is necessary to promote development, or if he finds that the Federal lease cannot be successfully operated under its terms"); *see also* Headwaters Report at 8.

[39] *Id.* at 8, 14.

[40] *See* 81 Fed. Reg. at 43344.

[41] *See id.*

[42] *See* Jayni Hein, Priorities for Federal Coal Reform at 13-14, Institute for Policy Integrity (June 2016), *available at* http://policyintegrity.org/files/publications/Priorities_for_Coal_Reform.pdf.

[43] *See, e.g.*, Policy Integrity Comment, Ex. A; Center for American Progress , Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform at 12-13 (May 8, 2015), *available at* https://www.regulations.gov/document?D=ONRR-2012-0004-0266; Wilderness Society, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform at 4-5, 8 (May 11, 2015), *available at* https://www.regulations.gov/document?D=ONRR-2012-0004-0298; Sierra Club, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform (May 8, 2015), *available at* https://www.regulations.gov/document?D=ONRR-2012-0004-0250; *see also* Utah Physicians for a Happy Environment, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform (May 11, 2015), *available at* https://www.regulations.gov/document?D=ONRR-2012-0004-0299.

[44] 81 Fed. Reg. at 43352-53 (oil); *id.* at 43344-445 (gas).

[45] *Id.* at 43344-445 (gas); *id.* at 43352-53 (oil); *id.* at 43353 (coal).

the Reform Rule also eliminated lessees' ability to deduct transportation costs that are more than 50 percent of the value of the lessee's gas and oil production.[46]

These were much-needed reforms because, as ONRR explained, requiring lessees to report transportation costs separately "increases transparency" and helps ONRR "verify that such costs are a reasonable and actual cost that lessees incur for transportation."[47] In addition, the 50% cap on transportation allowances helps reduce the ability to inappropriately inflate transportation costs.

The fact that transportation allowances can encourage harmful and inefficient behavior also supports ONRR's decision to undertake this reform. Executive Order 12866 instructs agencies to "assess both the costs and the benefits of the intended regulation and, recognizing that some costs and benefits are difficult to quantify, propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs."[48] In 2003 guidance, the Office of Management and Budget explained that those costs may include "negative externalities (e.g., pollution)."[49] And pursuant to statute, ONRR must take the costs of such harmful externalities into account in setting royalty rates. For example, the Federal Land Policy and Management Act requires ONRR to protect the environment[50] and manage public lands to allow for multiple uses, including "uses that take[] into account the long-term needs of future generations for renewable and nonrenewable resources, including, but not limited to, recreation, range, timber, minerals, watershed, wildlife and fish, and natural scenic, scientific and historical values."[51]

As mentioned above, when lessees can deduct too much for transportation they may be encouraged to transport their oil, gas or coal far from the place of production, which is inefficient and costly and imposes harmful externalities on society.[52] ONRR needs to be able to review and audit transportation allowances and cap the total transportation

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[46] *Id.* at 43352 (gas); *id*. at 43343 (oil).
[47] *Id.* at 43345.
[48] Executive Order 12866, Regulatory Planning and Review (1)(b)(6), 58 Fed. Reg. 51735 (Sept. 30, 1993).
[49] Circular A-4, Regulatory Analysis at 21 (Sep't 17, 2003), 68 Fed. Reg. 58366 (Oct. 9, 2003).
[50] 43 U.S.C. § 1701(a)(8).
[51] *Id.* § 1702(c) (" 'Multiple use' means the management of the public lands and their various resource values so that they are utilized in the combination that will best meet the present and future needs of the American people; . . . the use of some land for less than all of the resources; a combination of balanced and diverse resource uses that takes into account the long-term needs of future generations for renewable and nonrenewable resources, including, but not limited to, recreation, range, timber, minerals, watershed, wildlife and fish, and natural scenic, scientific and historical values; and harmonious and coordinated management of the various resources without permanent impairment of the productivity of the land and the quality of the environment with consideration being given to the relative values of the resources and not necessarily to the combination of uses that will give the greatest economic return or the greatest unit output.").
[52] *See* Institute for Policy Integrity, Reconsidering Coal's Fair Market Value at 12, *available at* http://policyintegrity.org/files/publications/Coal_fair_market_value.pdf (Oct. 2015).

allowance because that allows ONRR to come closer to fulfilling its duty to account for these externalities.[53]

In the proposed repeal, ONRR has not provided any basis for repealing these reforms to the transportation allowances. Instead, ONRR cited the *Cloud Peak* litigation as justification for the repeal. But that litigation does not support a repeal of these reforms. In that litigation, petitioners complained that the changes in the transportation allowances were "artificial" and that they "upset[] settled investment-backed expectations."[54] That argument is meritless. As ONRR explained in the Reform Rule, "just because the rule may "upset[] expectations based on prior law," does not make it impermissible.[55]

The reforms to the transportation allowances should not be repealed. ONRR is required to obtain a "fair market value" for taxpayers and Indian nations for the use of public lands,[56] and ONRR must maintain the transportation allowance reforms in order to serve that legal mandate.

II. ONRR Cannot Repeal the Reform Rule Without Analyzing the Record Compiled to Issue the Reform Rule and Providing a Reasoned Explanation for the Repeal.

This proposal is defective because ONRR did not (a) analyze the extensive record prepared to support the Reform Rule or (b) provide a "reasoned explanation" for ONRR's decision to repeal the rule. As a result of ONRR's failure to provide any reasoning, the public has no information about the legal bases for ONRR's repeal plans and has been deprived of the opportunity to provide any meaningful critique of those plans.[57] If ONRR intends to repeal the Reform Rule it must analyze the Reform Rule record, re-propose the repeal, and provide that explanation. Any other repeal would be arbitrary and capricious.

A. ONRR must review the record underlying the Reform Rule and provide a "reasoned explanation" for the repeal.

The APA requires agencies to give "general notice of proposed rule making" and to provide "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."[58] An

[53] *See* Policy Integrity Comment, Ex. A.
[54] Am. Pet. at 7.
[55] 81 Fed. Reg. at 43343.
[56] 43 U.S.C. § 1701(a)(9).
[57] *See Prometheus Radio Project v. F.C.C.*, 652 F.3d 431, 452-53 (3rd Cir. 2011) (failure to provide sufficient information in proposal prejudices public's ability to meaningfully engage in the rulemaking).
[58] 5 U.S.C. § 553(b), (c).

agency must then "examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made."[59]

That requirement applies equally to an agency's decision to repeal a rule.[60] In order to comply with that requirement for a repeal, the agency must "supply a reasoned analysis for the change."[61] The agency must "display awareness that it is changing position" and "show that there are good reasons for the new policy."[62] This helps ensure "that an agency will not undo all that it accomplished through its rulemaking without giving all parties an opportunity to comment on the wisdom of repeal."[63]

ONRR did not comply with this requirement. First, ONRR did not "examine the relevant data"[64] underlying the Reform Rule. In enacting the Reform Rule, ONRR received "more than 1,000 pages of comments from over 300 commenters and 190,000 petition signatories."[65] And as ONRR acknowledged in court filings, in order to reconsider the rule it will be required to review "several hundred thousand documents from an approximately 7 year period."[66] But in this proposed repeal, ONRR failed to review that record.

Instead, ONRR has proposed to start a process to "reconsider whether the changes" in the Reform Rule "are needed" *after* it repeals the rule.[67] But the APA does not allow ONRR to repeal first and reconsider later. Instead, to repeal a rule, ONRR must demonstrate "awareness that it *is* changing position" and "show that there are good reasons for the new policy."[68] An agency that fails to examine the record underlying the prior decision will be unable to explain why, or even if, there are "good reasons" for the change.[69] The statute requires ONRR to develop a record and provide notice of its analysis to the public prior to

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[59] *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co*., 463 U.S. 29, 43 (1983) (internal quotation marks omitted); *Citizens' Comm. to Save Our Canyons v. United States Forest Serv.*, 297 F.3d 1012, 1035 (10th Cir. 2002) (agency must examine "the relevant data" and articulate "a satisfactory explanation for its action including a rational connection between the facts found and the choice made" (internal quotation marks omitted)).
[60] *See* 5 U.S.C. § 551(5) (a rulemaking includes "repealing a rule"); *Consumer Energy Council of Am. v. FERC*, 673 F.2d 425, 446 (D.C. Cir. 1982), *aff'd*, 463 U.S. 1216 (1983) ("[T]he APA expressly contemplates that notice and opportunity to comment will be provided prior to agency decisions to repeal a rule.").
[61] *State Farm Mut. Auto. Ins. Co.*, 463 U.S. at 42.
[62] *FCC v. Fox TV Stations, Inc.*, 556 U.S. 502, 515 (2009).
[63] *Consumer Energy Council of Am.*, 673 F.2d at 446.
[64] *State Farm Mut. Auto. Ins. Co*., 463 U.S. at 43.
[65] Press Release, Interior Department Announces Final Regulations To Ensure American Public Receives Every Dollar Due for Production of Oil, Gas & Coal on Public Lands (June 30, 2016), *available at* https://www.doi.gov/pressreleases/interior-department-announces-final-regulations-ensure-american-public-receives-every.
[66] Dec. of Gregory J. Gould § 6 ("Gould Dec."), Unopposed Mot. For Temp. Stay, *Cloud Peak v. U.S. Dep't of the Interior*, No. 16-00315 (D. Wy. Mar. 22, 2017), ECF No. 29.
[67] 82 Fed. Reg. at 16323.
[68] *Fox Television Stations, Inc.*, 556 U.S. at 515.
[69] *Id.*

finalizing a rule.[70] If ONRR intends to repeal the Reform Rule, ONRR must analyze and consider all of the comments and documents submitted as part of the record that was developed to support the Reform Rule, in addition to any record that is developed regarding reasons for a repeal, *before* proposing to repeal the rule.

Second, even assuming ONRR could repeal a rule without analyzing the record underlying the rule (which it cannot do), ONRR is also required to *explain* the reasons for this repeal. ONRR must "inform the court and the petitioner of the grounds of decision and the essential facts upon which the administrative decision was based."[71] As explained above, in order to comply with this requirement for a repeal, ONRR must provide "good reasons" for the change and explain its reasons "for disregarding facts and circumstances that underlay or were engendered by" the prior rule.[72] If the agency's new position, "rests upon factual findings that contradict those which underlay its prior policy," the agency will need to provide "a more detailed justification than what would suffice for a new policy created on a blank slate" in order to satisfy the requirement to provide a "reasoned explanation."[73]

ONRR cited the fact that "three different sets of petitioners" filed petitions for review challenging the rule in the *Cloud Peak* litigation and that the petitioners "raise serious questions concerning the validity or prudence of certain provisions,"[74] but that is not an explanation. The petitioners in the *Cloud Peak* litigation claimed that the rule is arbitrary and capricious, but ONRR has not said whether—or why—it agrees with the petitioners. ONRR has also not said what its position is on the "questions" it believes were raised in the litigation. In any event, the *Cloud Peak* litigation could provide no basis to repeal the Reform Rule. Other than a cursory list of complaints in the petitions for review, petitioners in the *Cloud Peak* litigation have not filed briefs in the case fleshing out any of their arguments. Moreover, no judge has ruled on the merits of petitioners' complaints.

As a result of the lack of any explanation, the public has no idea what the grounds are for ONRR's proposed repeal. The public does not know whether the decision to repeal "rests on factual findings that contradict the agency's previous record," and thus has no ability to comment on whether ONRR's decision satisfies the standard for "a more detailed justification than what would suffice for a new policy created on a blank slate."[75] The public also does not know if ONRR believes there is a "good reason" to disregard the facts and

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[70] *See* 5 U.S.C. § 553(b) (requirement that an agency engage in notice and comment for a rulemaking); 5 U.S.C. § 551(5) (a rulemaking includes "repealing a rule").
[71] *Fox Television Stations, Inc.*, 556 U.S. at 515-16.
[72] *Id.*
[73] *Id.* at 515. *See also Wyoming v. U.S. Dep't of Interior*, No. 09-CV-118J, 2010 WL 4814950, at *40 (D. Wyo. Nov. 18, 2010) (Johnson, J.) (setting aside agency's change its position where agency could not point to "any new commercial or scientific data" to support the new policy).
[74] 82 Fed. Reg. at 16323.
[75] *Fox Television Stations, Inc.*, 556 U.S. at 515.

circumstances underlying the Reform Rule.[76] The *Cloud Peak* litigation certainly has not provided any. "The process of notice and comment rule-making is not to be an empty charade," but instead "a process of reasoned decision-making" in which "interested parties" are afforded "the opportunity . . . to participate in a meaningful way."[77] ONRR must comply with the requirement to (a) analyze the record underlying the Reform Rule and (b) provide a reasoned explanation for any proposed repeal.

B. ONRR must explain why it has chosen (1) to impose $3.61 million in administrative costs on lessees and (2) to cancel the royalties that the federal government and states stood to receive.

ONRR's analysis of the cost and royalty impact of the proposed repeal is also hopelessly flawed. In the proposed repeal, all that ONRR stated is that the repeal will not cause a "major" increase in state, federal, or consumer costs because it will simply "negate the cost and royalty impact" of the Reform Rule.[78]

But this statement ignores the costs that a repeal will impose on industry as well as the impact of lost royalties on the federal government and states. The Reform Rule promised to save industry $3.61 million per year by eliminating the costly administrative process that is necessary to use the benchmarks.[79] ONRR has not explained why it is appropriate to impose this cost on lessees. In addition, the Reform Rule promised to increase royalties by an estimated $78.39 million per year.[80] The loss of the royalties will be felt particularly hard by the affected States. Wyoming, for example, produces a large percentage of the nation's federal coal and stands to lose significant funding for schools, road construction, and municipal budgets with this repeal.[81] ONRR has not explained why it is appropriate to deprive federal and state governments of these royalties.

Before repealing the Reform Rule, ONRR must address the cost of the repeal and the impact that the repeal will have on royalty payments and explain why those are justified.

In addition, in the proposal, ONRR stated that this repeal is "not significant," within the meaning of Executive Order 12866.[82] But OIRA determined that the Reform Rule was

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[76] *Id.* at 516.
[77] *Conn. Light & Power Co.*, 673 F.2d at 528.
[78] 82 Fed. Reg. at 16323, 16324.
[79] 81 Fed. Reg. at 43338, 43359-67; *see also* Headwaters Report at 9.
[80] 81 Fed. Reg. at 43360
[81] *See* FACT SHEET: FEDERAL COAL ROYALTIES AND THEIR IMPACT ON WESTERN STATES, *available at* https://www.wyden.senate.gov/download/?id=af917fa6-4e2c-4839-bc70-05d5e495b985&download=1; *see also* Headwaters Report at 24 (estimating that Wyoming and Montana would have received an additional 5.6 billion in additional revenue over 2008 to 2012 if royalties "had been valued based on the gross market price over this same period").
[82] 82 Fed. Reg. at 16323, 16323.

significant within the meaning of that Executive Order when it was issued.[83] It is illogical that a reform that was judged significant when it was promulgated can now be judged insignificant upon repeal and ONRR should explain what it believes justifies this change.

III. ONRR's Stay of the Reform Rule Combined with This Proposal to Repeal the Rule Violates the APA.

In February 2017, prior to this proposed repeal, ONRR postponed (stayed) the effectiveness date on the Reform Rule,[84] even though that date had already passed on January 1, 2017.[85] The stay is supposed to remain in place until the *Cloud Peak* litigation is resolved.[86] ONRR did not seek public comment on the stay. We are submitting comments relevant to the stay here for preservation purposes.

First, ONRR was not authorized to stay the Reform Rule without notice and comment. Indefinite stays are "tantamount to a revocation" and as a result are subject to the same notice-and-comment rules that apply to repeals.[87] The stay here is indefinite and should have been subject to notice-and-comment. Though the stay is only supposed to last as long as the *Cloud Peak* litigation takes to be resolved, ONRR has now obtained a judicial stay of the *Cloud Peak* litigation which is supposed to last as long as this repeal rulemaking lasts.[88] The law is settled that any suspension that "will remain in effect indefinitely unless and until the agency completes a full notice and comment rulemaking" should be considered a revocation and subject to the APA.[89] That is what is happening here. Because ONRR did not seek any input from the public on the decision to stay the rule, that decision violated the APA.

Second, even if ONRR had gone through the notice-and-comment procedures, it did not have authority to issue the stay. To issue the stay, ONRR invoked its authority under 5 U.S.C. § 705, which provides that: "When an agency finds that justice so requires, it may postpone the effective date of action taken by it, pending judicial review." But that provision does not allow ONRR to stay the rule *after* its effective date. Section 705 "permits an agency to postpone the effective date of a not yet effective rule, pending judicial

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[83] 81 Fed. Reg. at 43367.
[84] Postponement of Effectiveness of the Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform 2017 Valuation Rule, 82 Fed. Reg. 111823 (Feb. 27, 2017).
[85] 81 Fed. Reg. at 43338.
[86] *Id.*
[87] *NRDC v. EPA,* 683 F.2d 752, 763 n. 23 (3rd Cir. 1982); *see also Envt'l Def. Fund, Inc. v. Gorsuch*, 713 F.2d 802, 818 (D.C. Cir. 1983); *Envt'l Def. Fund, Inc. v. EPA*, 716 F.2d 915, 921 (D.C. Cir. 1983) (a deadline's imminence does not give the agency "good cause" to suspend a rule without complying with the APA's notice and comment requirements); *Sierra Club v. Jackson*, 833 F. Supp. 2d 11, 27 (D.D.C. 2012).
[88] *See* Unopposed Mot. for. Stay, *Cloud Peak Energy Inc. v. Dep't of Interior*, 16 Civ. 00315 (Dist. Wyo. April 26, 2017), ECF No. 32; *see also* Order, *Cloud Peak Energy Inc. v. Dep't of Interior*, 16 Civ. 00315 (Dist. Wyo. April 27, 2017), ECF No. 33.
[89] *Pub. Citizen v. Steed*, 733 F.2d 93, 98 (D.C. Cir. 1984).

review."[90] It does not allow an agency to stay a rule that is already in effect.[91] The Reform Rule went into effect on January 1,[92] but ONRR did not stay it until February 22.[93] This makes the stay illegal.

Third, even if it had authority to issue the stay, ONRR may only issue a stay under section 705 if it can show (1) the likelihood that petitioners will prevail on the merits of their petitions for review and (2) the likelihood that the petitioners "will be irreparably harmed absent a stay."[94] In addition, ONRR must address the "prospect that others will be harmed if the court grants the stay" and "the public interest in granting the stay" before granting it.[95] ONRR failed to analyze these factors when it issued the stay. ONRR has not addressed this standard.

It is unlikely that the stay can satisfy that standard. First, as described above, see *supra* 2-8, petitioners are not likely to succeed in the *Cloud Peak* litigation. The Reform Rule was eminently reasonable and fixed a gaping loophole that was depriving taxpayers of millions of dollars of royalties. Second, petitioners do not face irreparable harm. The only harms that the petitions asserted in the *Cloud Peak* litigation were essentially monetary and it is "well settled that economic loss does not, in and of itself, constitute irreparable harm."[96] Third, ONRR must also consider whether postponing the effective date of the rule will "substantially harm other parties," and the loss of $78 million in royalties per year will certainly harm the affected federal and state governments. And, fourth, staying the rule is not in the public interest. Reforming the royalty rules was needed to ensure that ONRR is obtaining the "fair market value" for resources on public land. ONRR has that mandate precisely because that is how it protects the public interest in management of federal lands. Staying the Reform Rule will mean that ONRR is not complying with its statutory duty to protect those interests.

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[90] *See Safety-Kleen Corp. v. EPA*, 1996 U.S. App. LEXIS 2324 *2-3 (D.C. Cir. Jan. 19, 1996) (per curiam).
[91] *Id.*
[92] 81 Fed. Reg. at 43338.
[93] 82 Fed. Reg. at 16323.
[94] *Sierra Club*, 833 F. Supp. 2d at 30 (collecting cases); *Jeffrey v. Office of Pers. Mgmt.*, 28 M.S.P.R. 434, 435–36 (Merit Systems Protection Board 1985).
[95] *Sierra Club*, 833 F. Supp. 2d at 30; *Jeffrey*, 28 M.S.P.R. at 435–36.
[96] *Mexichem Specialty Resins, Inc. v. EPA*, 787 F.3d 544 (D.C. Cir. 2015); *Affinity Healthcare Servs. v. Sebelius*, 720 F. Supp. 2d 12 (D.D.C. 2010).

ONRR should lift the illegal stay and not repeal the Reform Rule.

Respectfully,

Bethany Davis Noll, Senior Attorney, Institute for Policy Integrity, NYU School of Law
Jayni Foley Hein, Policy Director, Institute for Policy Integrity, NYU School of Law

Exhibit A

May 8, 2015

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

Re: Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform (Docket No. ONRR-2012-0004; RIN 1012-AA13)

The Institute for Policy Integrity at New York University School of Law[1] appreciates the opportunity to submit this regulatory report to the Office of Natural Resources Revenue regarding the proposed changes to regulations governing the valuation of oil, natural gas, and coal produced from federal onshore and offshore leases. Policy Integrity is a non-partisan think tank dedicated to improving the quality of government decisionmaking through advocacy and scholarship in the fields of administrative law, economics, and public policy.

Policy Integrity's report focuses on one serious deficiency in the federal management of natural resources: the fiscal terms of federal leases do not require developers to internalize the environmental and social costs of fossil fuel extraction. Interior has the statutory authority and obligation to make changes to the current leasing program in order to earn a fair return for the American people and protect the environment. We recommend that Interior: (i) raise minimum bids to account for option value, and evaluate methods to quantify option value for both offshore and onshore leasing; (ii) ensure that rental rates incorporate the environmental and social externalities associated with exploration and resource development; (iii) increase royalty rates to reflect the environmental and social costs of production, and (iv) eliminate royalty relief provisions that provide improper incentives to energy companies. The Office of Natural Resources Revenue may be particularly interested in the recommendations set forth on pages 24 to 28 to eliminate certain royalty relief provisions and ensure that all reported sales, for royalty purposes, are truly "arm's length" transactions.

[1] No part of this document purports to present New York University School of Law's views, if any.

We hope you find the attached white paper beneficial as you prepare the final rule. Please feel free to contact our office with any questions.

Sincerely,

Jayni Foley Hein, Policy Director, Institute for Policy Integrity, NYU School of Law
Peter Black, Law Student, Regulatory Policy Clinic, NYU School of Law
Alicia Nieves, Law Student, Regulatory Policy Clinic, NYU School of Law

Institute *for* Policy Integrity

new york university school of law

Harmonizing Preservation and Production: How Modernizing the Department of Interior's Fiscal Terms for Oil, Gas, and Coal Leases Can Ensure a Fair Return to the American Public

May 2015

Jayni Foley Hein[1]

Executive Summary

Spurred by advances in technology such as hydraulic fracturing and directional drilling, domestic oil and natural gas production has risen steadily for the past five years, providing an important source of energy and revenue for the federal government and states.[2] The U.S. Energy Information Administration projects that U.S. crude oil and natural gas production will continue to rise through 2020, and that the United States will become a net natural gas exporter by 2017.[3]

The Department of the Interior ("Interior") oversees more than 260 million surface acres and 700 million subsurface acres of mineral resources onshore, and more than 1.7 billion acres offshore in the waters of the Outer Continental Shelf.[4] Federal energy production generates one of the largest non-tax sources of revenue for the United States,

[1] Policy Director, Institute for Policy Integrity at New York University School of Law. No part of this document purports to present New York University School of Law's views, if any.

[2] U.S. Energy Information Administration, *International Energy Statistics: Gross Natural Gas Production 2009 to 2010*, available at http://www.eia.gov/cfapps/ipdbproject/iedindex3.cfm?tid=3&pid=3&aid=1&cid=regions&syid=2009&eyid=2010&unit=BCF. From 2007 through 2012, monthly crude oil production increased by 39 percent, and monthly natural gas production increased by 25 percent. U.S. Energy Information Administration, *Oil and gas industry employment growing much faster than total private sector employment* (Aug. 2013), available at http://www.eia.gov/todayinenergy/detail.cfm?id=12451.

[3] U.S. Energy Information Administration, *Annual Energy Outlook 2015* at ES-4 (April 15, 2015),available at http://www.eia.gov/forecasts/aeo/pdf/0383(2015).pdf.

[4] U.S. Gov't Accountability Office, *Actions Needed For Interior to Better Ensure A Fair Return* (GAO-14-50) (2013) at 2.

accounting for more than $14 billion in fiscal year 2013.[5] However, Interior does not systematically evaluate or update its fiscal terms for oil, gas, and coal production on federal lands.[6] In fact, some of its fiscal terms—including royalty rates for onshore oil and gas production—have not changed since 1920.

The U.S. Government Accountability Office has repeatedly called for Interior to reform its fiscal system, which may be depriving tax payers of hundreds of millions of dollars each year from domestic energy production.[7] Among myriad issues, minimum bids are often set too low and fail to account for the option value of energy resources, which is the value of waiting for more information on energy prices and extraction risks before deciding whether and when to lease the public's energy resources to private companies. Lease sales are often uncompetitive, exacerbating the problem of low minimum bids.[8] Low rents do not account for the externalities associated with exploratory drilling and mining, nor the lost value of the public's use and enjoyment of federal lands during the rental period.[9] Further, outdated royalty rates fail to account for externalities and contribute to a relatively low U.S. government take, compared to many states and foreign countries.[10] Together, these deficiencies mean that Interior fails to obtain a fair return for development of the public's natural resources, contrary to the agency's mandate under the Federal Land Policy and Management Act, Mineral Leasing Act, and Outer Continental Shelf Lands Act.

This report focuses on one serious deficiency in the federal management of natural resources: the fiscal terms of federal leases do not require developers to internalize the environmental and social costs of fossil fuel extraction. In line with their statutory mandates under the Federal Land Policy and Management Act and the Outer Continental

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[5] U.S. Gov't Accountability Office, *Updated Guidance, Increased Coordination, and Comprehensive Data Could Improve BLM's Management and Oversight* (GAO-14-238) (May 2014) at 1, available at http://www.gao.gov/assets/670/662993.pdf.

[6] U.S. Gov't Accountability Office, *The Federal System For Collecting Oil And Gas Revenues Needs Comprehensive Reassessment* (GAO-08-691) (2008) at 7-10.

[7] *Id*; U.S. Gov't Accountability Office, *Actions Needed For Interior, supra* note 6; U.S. Gov't Accountability Office, *Oil and Gas Revenues* (GAO-07-676R) (May 2007); *see also* Tom Sanzillo, Institute for Energy Economics & Financial Analysis, *The Great Giveaway: An Analysis of the Costly Failure of Federal Coal Leasing in the Powder River Basin* (2012) (estimating that the federal government lost $28.9 billion in revenues over 30 years due to BLM's failure to receive fair market value for coal mined in the Powder River Basin, which produces 43 percent of the nation's coal); John M. Broder, "Undervalued Coal Leases Seen as Costing Taxpayers," *N.Y. Times* (June 11, 2013); U.S. Department of the Interior, Office of the Inspector General, EVALUATION: COAL MANAGEMENT PROGRAM (June 2013), available at http://www.documentcloud.org/documents/712402-inspector-generals-report-on-coal-leases.html.

[8] Juliet Eilperin, "Powder River Basin Coal Leasing Prompts IG, GAO Reviews," *Washington Post* (June 24, 2012); Brian Grow, Joshua Schneyer, and Janet Roberts, "Special Report: Chesapeake and Rival Plotted to Suppress Land Prices," *Reuters* (June 25, 2012).

[9] *See* Center for Western Priorities, A RENTERS MARKET: OUTDATED OIL & GAS RENTAL RATES FAIL TAXPAYERS (2014).

[10] *See* Center for Western Priorities, A FAIR SHARE: THE CASE FOR UPDATING FEDERAL ROYALTIES (2013); HEADWATERS ECONOMICS, AN ASSESSMENT OF U.S. FEDERAL COAL ROYALTIES (2013); Law Library of Congress, Global Legal Research Center, REPORT: CRUDE OIL ROYALTY RATES IN SELECTED COUNTRIES (Jan. 2015), available at http://www.loc.gov/law/help/crude-oil-royalty-rates/crude-oil-royalty-rates.pdf.

Shelf Lands Act, the U.S. Bureau of Land Management ("BLM") and Bureau of Ocean Energy Management ("BOEM"), each within the Department of the Interior, must account for these social and environmental costs when leasing and managing federal natural resources.

Interior's failure to value the environmental and social externalities associated with fossil fuel development on federal lands means that energy companies receive a financial windfall. The American public pays for the externalities associated with development that are not priced into the leasing contract and not otherwise addressed by environmental or tort law. These costs include local air pollution from exploration, development, and transportation to and from the well site; fugitive methane emissions, which contribute to climate change; habitat disruption; noise pollution; infrastructure wear and tear; and water contamination, among others. Failing to account for these costs in the terms of federal leases shifts them onto tax payers, who already receive an improvidently low return for the right to exploit federal mineral resources.

Interior has the statutory authority and obligation to make changes to the current leasing program in order to earn a fair return for the American people and protect the environment. This report first discusses Interior's "dual mandate" both to develop energy resources and to preserve federal lands, as well as its requirement to secure fair market value for its leases. Next, the report describes how the current fiscal terms fail to earn a fair return for the public, and provides suggestions for reform. Specifically, Interior should:

- Raise minimum bids to account for option value, and evaluate methods to quantify option value for both offshore and onshore leasing;
- Ensure that rental rates incorporate the environmental and social externalities associated with exploration and resource development; and
- Increase royalty rates to reflect environmental and social costs that result from production.

The federal fiscal system for oil, gas, and coal leasing is long overdue for an update that could earn hundreds of millions of dollars for tax payers each year and help ensure that the extent and timing of energy production on federal lands is efficiently balanced with conservation goals. This report's commonsense recommendations to modernize the fiscal terms of federal energy leases would help to provide a fair return for the public's valuable natural resources, and would harmonize the government's dual mandate of preservation and production.

I. STATUTORY BACKGROUND: THE FEDERAL LEASING SYSTEM

The Department of the Interior, through BLM and the BOEM, offers land to private parties for the extraction of oil, gas, and coal deposits through the sale of leases. BLM manages roughly 23,657 active oil, gas, and coal leases on 256 million onshore surface acres and 700 million onshore subsurface acres.[11] BOEM manages approximately 8,300 active oil and gas leases across 1.7 billion Outer Continental Shelf offshore acres.[12] Together, coal, oil, and natural gas produced on federal lands account for approximately 25 percent of the total fossil fuels produced annually in United States.[13]

Three primary statutes set forth Interior's duties with respect to national energy production and federal land management: the Federal Land Policy and Management Act and the Mineral Leasing Act for onshore development, and the Outer Continental Shelf Lands Act for offshore development. These statutes articulate three important principles: First, Interior must balance orderly production of energy on federal lands with environmental preservation and other competing uses. Second, Interior must receive "fair market value" for the right to explore and develop federal mineral resources. And third, Interior has the authority to establish and revise regulations for the primary fiscal terms of leases: bids, rents, and royalties. We review these three components in turn.

A. Federal Law Requires BLM and BOEM to Uphold the Dual Mandate to Both Produce Energy and Preserve Federal Lands.

The Onshore Dual Mandate

The Federal Land Policy and Management Act and the Mineral Leasing Act, as amended, give BLM authority to manage onshore federal lands and mineral resources. Enacted in 1976, the Federal Land Policy and Management Act provides that federal lands are to be used only for the advancement of the national interest.[14] The Act declares that:

> [P]ublic lands be managed in a manner that will protect the quality of scientific, scenic, historical, ecological, environmental, air and atmospheric, water resource, and archeological values; that, where appropriate, will preserve and protect certain public lands in their natural condition; that will

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[11] Department of the Interior, Bureau of Land Management, *Advance Notice of Proposed Rulemaking: Oil and Gas Leasing; Royalty on Production, Rental Payments, Minimum Acceptable Bids, Bonding Requirements, and Civil Penalty Assessments*, 80 Fed. Reg. 22148, 22149(April 21, 2015); Steve Tryon, BLM, *Presentation to the Production Accountants Society of Oklahoma* (Feb. 6, 2013), *available at* http://paso-tulsa.org/wp-content/uploads/2013/02/2-Steve-Tryon-BLM-Presentation-to-PASO.pdf.

[12] BOEM, Oil and Gas Leasing on the Outer Continental Shelf, *available at* http://www.boem.gov/uploadedFiles/BOEM/Oil_and_Gas_Energy_Program/Leasing/5BOEMRE_Leasing101.pdf.

[13] U.S. EIA, *Sales of Fossil Fuels Produced from Federal and Indian Lands*, *FY 2003 through FY 2012* (June 2014), available at http://www.eia.gov/analysis/requests/federallands/pdf/eia-federallandsales.pdf. Coal represented 51 percent of fossil fuel sales from production on federal lands in 2013, followed by natural gas (25%) and crude oil (22%). In fiscal year 2013, coal produced on federal lands accounted for 40 percent of the U.S. total, crude oil production from federal lands accounted for 23 percent of U.S. production, and natural gas production accounted for 16 percent. *Id*. at 4. Crude oil royalties accounted for the greatest share of federal revenue, compared to coal and gas. *Id*. The federal Gulf of Mexico produced 69 percent of the federal and Indian lands crude oil total in FY 2013. *See id.* at 1; Table 7.

[14] 43 U.S.C. § 1701(a)(1).

> provide food and habitat for fish and wildlife and domestic animals; and that will provide for outdoor recreation and human occupancy and use.[15]

The Federal Land Policy and Management Act sets forth the dual mandate of development and preservation. Agencies must both protect the environment[16] and manage federal lands in such a way as to provide for domestic sources of "minerals [including hydrocarbon energy resources], food, timber, and fiber."[17] The Act also requires agencies to develop land use plans,[18] and to manage public lands in accordance with them.[19]

The Federal Land Policy and Management Act also requires agencies to manage public lands to allow for multiple uses.[20] "Multiple use" is defined as:

> [T]he management of the public lands and their various resource values so that they are utilized in the combination that will best meet the present and future needs of the American people; . . . the use of some land for less than all of the resources; a combination of balanced and diverse resource uses that takes into account the long-term needs of future generations for renewable and nonrenewable resources, including, but not limited to, recreation, range, timber, minerals, watershed, wildlife and fish, and natural scenic, scientific and historical values.[21]

"Multiple use" also refers to the "harmonious and coordinated management of the various resources without permanent impairment of the productivity of the land and the quality of the environment with consideration being given to the relative values of the resources and not necessarily to the combination of uses that will give the greatest economic return or the greatest unit output."[22] The Act further requires that Interior "shall, by regulation or otherwise, take any action necessary to prevent unnecessary or undue degradation of the lands."[23] The statute's references to "multiple use" and direction to prevent "undue

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[15] 43 U.S.C. § 1701(a)(8).

[16] *Id.*

[17] 43 U.S.C. § 1701(a)(12).

[18] 43 U.S.C. § 1712(a).

[19] 43 U.S.C. § 1732(a).

[20] 43 U.S.C. § 1712(c)(1).

[21] *Id.* § 1702(c) (" 'Multiple use' means the management of the public lands and their various resource values so that they are utilized in the combination that will best meet the present and future needs of the American people; . . . the use of some land for less than all of the resources; a combination of balanced and diverse resource uses that takes into account the long-term needs of future generations for renewable and nonrenewable resources, including, but not limited to, recreation, range, timber, minerals, watershed, wildlife and fish, and natural scenic, scientific and historical values; and harmonious and coordinated management of the various resources without permanent impairment of the productivity of the land and the quality of the environment with consideration being given to the relative values of the resources and not necessarily to the combination of uses that will give the greatest economic return or the greatest unit output.").

[22] *Id.*

[23] 43 U.S.C. § 1732(b).

degradation" imply a cost-benefit calculus balancing resource extraction on the one hand against competing uses of the land and environmental protection on the other.

The Mineral Leasing Act of 1920 declares that it is the policy of the federal government and in the national interest to foster and encourage private enterprise in "orderly economic development of domestic mineral resources."[24] Among many provisions dedicated to oil, gas, and mineral leasing, the Mineral Leasing Act also provides that the Secretary of the Interior can issue regulations requiring that operators prevent "undue waste."[25] The Mineral Leasing Act also specifically requires oil and gas lessees (but not coal lessees) to "use all reasonable precautions to prevent waste of oil or gas developed in the land," on pain of forfeiture of the lease.[26] Thus, even when encouraging the "orderly economic development of domestic mineral resources," federal law requires Interior to ensure that valuable public resources are not wasted. Indeed, the word "orderly" itself conveys a congressional desire for careful, rational management of America's valuable energy resources.

Read together, the Federal Land Policy and Management Act and Mineral Leasing Act instruct Interior to harmonize the need for domestic mineral production with long-term environmental protection and stewardship of public lands.

The Offshore Dual Mandate

The congressional statement of policy in the Outer Continental Shelf Lands Act declares, much like in the Federal Land Policy and Management Act, that the Outer Continental Shelf is a vital natural resource held in trust by the federal government for the benefit of the American people.[27] It details Interior's dual mandate to conduct expeditious and efficient leasing while also protecting the environment and other uses of our nation's waters, including fishing and commercial shipping.[28] The Outer Continental Shelf Lands Act Amendments of 1978 state that one of the purposes of the Act is to "make such resource[s] available to meet the Nation's energy needs as rapidly as possible."[29] Another equally important purpose is to "encourage development of new and improved technology for energy resource production which will eliminate or minimize risk of damage to the human, marine, and coastal environments."[30]

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[24] 30 U.S.C § 21(a).

[25] 30 U.S.C. § 187. This section also imposes requirements regarding workplace safety and labor regulations, which fall outside the scope of this Report.

[26] 30 U.S.C. § 225. The legislative history of the Mineral Leasing Act and its subsequent amendments evidences Congress's concern with the waste of oil and gas and its desire for Interior to prevent it. *See Boesche v. Udall*, 373 U.S. 472, 481 (1963) (citing H.R. Rep. No. 398, 66th Cong., 1st Sess. 12-13; H.R. Rep. No. 1138, 65th Cong., 3d Sess. 19.).

[27] 43 U.S.C. § 1332(3).

[28] 43 U.S.C. § 1332(2)-(3).

[29] 43 U.S.C. § 1802(2)(A).

[30] 43 U.S.C. § 1802(3).

Section 18 of the Outer Continental Shelf Lands Act requires Interior to prepare and periodically revise a Program "indicating, as precisely as possible, the size, timing, and location of leasing activity" on the Outer Continental Shelf over the pertinent five-year program period.[31] The Act directs that management of the Outer Continental Shelf shall be "conducted in a manner which considers economic, social, and environmental values of the renewable and nonrenewable resources contained in the outer continental shelf, and the potential impact of oil and gas exploration on other resource values of the outer continental shelf and the marine, coastal, and human environments."[32] Congress further directed the Secretary of the Interior to "select the timing and location of leasing, to the maximum extent practicable, so as to obtain a proper balance between the potential for environmental damage, the potential for the discovery of oil and gas, and the potential for adverse impact on the coastal zone."[33]

The Outer Continental Shelf Lands Act, then, much like the Federal Land Policy and Management Act, strongly emphasizes the need to balance energy production with environmental protection.

B. Federal Law Requires that Interior Receive Fair Market Value for the Rights It Conveys.

The Fair Market Value Requirement for Onshore Energy Production

The Federal Land Policy and Management Act requires that the United States "receive fair market value of the use of the public lands and their resources unless otherwise provided for by statute."[34] The term "fair market value" is not defined in the statute itself. In 1982—the last time that Interior convened a working group to comprehensively review its "fair market value" procedures—the task force determined that "fair market value" was not merely the value of the oil or gas discovered or produced, but the value of "the right" to explore and, if there is a discovery, to develop and produce the energy resource.[35] Indeed, the statute refers not just to the value of the resources, but also to the value of using the lands.

The Mineral Leasing Act was enacted in 1920 to promote the orderly development of mineral resources and to provide Interior with the authority to determine where and when oil, gas, and coal leases would be issued.[36] The Mineral Leasing Act does not contain an explicit "fair market value" requirement. However, it states that the Secretary of the Interior can include coal, oil, or gas lease terms that she or he deems necessary "to insure the sale of the production of such leased lands to the United States and to the public at

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[31] 43 U.S.C. § 1344(a)(1).
[32] *Id*.
[33] *Id*. § 1344(a)(3).
[34] 43 U.S.C. § 1701(a)(9).
[35] U.S. Gov't Accountability Office, *Oil and Gas Revenues* (GAO-07-676R) (May 2007) at 3.
[36] 30 U.S.C. § 181, et seq.

reasonable prices, for the protection of the interests of the United States, for the prevention of monopoly, and for the safeguarding of the public welfare."[37]

Fair market value is defined in BLM's economic valuation handbook as "the amount in cash, or on terms reasonably equivalent to cash, for which, in all probability, the property would be sold by a knowledgeable owner willing but not obligated to sell to a knowledgeable purchaser who desired but is not obligated to buy."[38] Fair market value, then, is a somewhat subjective assessment that should be understood within the broader context and goals of the Federal Land Policy and Management Act and Mineral Leasing Act.

The Fair Market Value Requirement for Offshore Energy Production

The Outer Continental Shelf Lands Act requires that "[l]easing activities. . . be conducted to assure receipt of fair market value for the lands leased and the rights conveyed by the Federal Government."[39] While the Act does not provide a definition of "fair market value," the statute refers to the value of the lands and the rights pertaining thereto, rather than simply the resources to be extracted.

BOEM's regulation and enforcement manual describes its fair market value process and bid adequacy procedures as intending to "ensur[e] the public receives a fair return for OCS oil and gas leases."[40] Fair market value is defined in BOEM's manual identically to the description in BLM's handbook: "the amount in cash, or on terms reasonably equivalent to cash, for which, in all probability, the property would be sold by a knowledgeable owner willing but not obligated to sell to a knowledgeable purchaser who desired but is not obligated to buy."[41]

BOEM also uses specific criteria designed to provide adequate returns to the public for the rights issued. BOEM states that "[t]he assurance of FMV [fair market value] is a multi-phase process including national Program-level analysis, lease sale-level analysis, and, finally, analysis done before the issuance of an individual lease following a lease sale."[42] At the Program development stage, BOEM uses a "hurdle price analysis" to filter out

[37] 30 U.S.C. § 187.

[38] U.S. Bureau of Land Management, H-3070-2, ECONOMIC EVALUATION OF OIL AND GAS PROPERTIES HANDBOOK at I.C, *available at* http://www.blm.gov/style/medialib/blm/wo/Information_Resources_Management/policy/blm_handbook.Par.39460.File.dat/h3070-2.pdf.

[39] Outer Continental Shelf Lands Act ("OCSLA") Section 18(a)(4), 43 U.S.C. § 1344(a)(4).

[40] Department of the Interior, Bureau of Ocean Energy Management, REGULATION AND ENFORCEMENT MANUAL, 610.1: FAIR MARKET VALUE § 1 (Oct. 25, 2010); *see also Cal. ex rel. Brown v. Watt* ("*Watt II*"), 712 F.2d 584, 606 (D.C. Cir. 1983) (upholding Interior's five-year offshore oil and gas leasing plan and finding that it provided for a fair market return in accordance with OCSLA).

[41] *Id*.

[42] U.S. Bureau of Ocean and Energy Management, 2017-2022 Outer Continental Shelf Oil and Gas Leasing Draft Proposed Program (2015) [hereinafter "2017-2022 Draft Proposed Program"] at 8-1, available at http://www.boem.gov/2017-2022-DPP/.

program areas where delaying a sale may provide greater future economic value.[43] Following size, timing, and location decisions formulated at the Program development stages, BOEM assesses other fair market value components—such as bidding systems and fiscal and lease terms—at the lease sale stage to safeguard against leases being awarded for less than fair market value.[44]

In its most recent 2017 to 2022 Draft Proposed Program for Outer Continental Shelf oil and gas leasing, BOEM also recognized that option value can be an element of the fair market value of a lease.[45] Option value is the value of waiting to make an irreversible decision until critical new information arrives. One well-known example is stock options, which are valuable because they grant their holder the time to learn more about future stock prices before deciding whether to buy or sell. Uncertainty around future energy prices similarly creates option value, as does the uncertainty around extraction costs, such as whether technological developments may, in the future, reduce the environmental risks of oil spills. As part of its decision on size, timing, and location, BOEM acknowledged that it should consider the state of available environmental and social cost uncertainties, as well as resource price, technology, and regulatory uncertainties.[46]

As discussed in Part II, Interior should account for option value and externalities when pricing leases; this would best effectuate the dual mandates of the Federal Land Policy and Management Act and the Outer Continental Shelf Lands Act, and ensure a fair return to the American public.

C. Interior Has Broad Authority to Set Minimum Bids, Rents, and Royalties.

For onshore oil, gas, and coal exploration and production, the Mineral Leasing Act gives Interior discretion to determine where and when to issue leases.[47] If Interior determines that federal land is suitable for leasing, the Act establishes certain terms that all leases must contain, including bid, rental, and royalty provisions.[48] Interior has 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.[49] Pursuant to this authority, the Secretary of the Interior has promulgated regulations for onshore oil, gas, and coal leases.[50]

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[43] *Id*.

[44] *Id.*

[45] *Id*. at 8-3.

[46] *Id*. at 8-3 to 8-12.

[47] 30 U.S.C. § 226(a), (g); *Udall v. Tallman*, 380 U.S. 1, 4 (1965) ("Although the Act directed that if a lease was issued on such a tract, it had to be issued to the first qualified applicant, it left the Secretary discretion to refuse to issue any lease at all on a given tract").

[48] *See* 30 U.S.C. § 226(b)(c).

[49] 30 U.S.C. § 189.

[50] 30 U.S.C. § 187.

[50] Regulations governing the BLM's coal, oil, and gas programs may be found under Groups 3000 and 3100 of the Code of Federal Regulations. *See, e.g.*, 43 C.F.R. Parts 3100 (Oil and Gas Leasing), 3160 (Onshore Oil and Gas Operations), 3400 (Coal Management).

For offshore oil and gas exploration and production, the Outer Continental Shelf Lands Act grants Interior the power to determine where and when oil and gas leases will be issued. The Secretary of the Interior must prepare a five-year program consisting of a schedule of oil and gas lease sales indicating the size, timing, and location of proposed leasing activity that the Secretary determines will best meet national energy needs.[51] Preparing a five-year program involves extensive public comment and requires the Secretary to balance the potential for the discovery of oil and natural gas, the potential for environmental damage, and the potential for adverse effects on the coastal zone.[52] There is an additional public process for each lease sale to determine whether to hold the lease sale, and what terms and conditions will apply to those leases.

The fiscal components of the federal leasing program primarily consist of three terms defined in each lease: bids (also called "bonus payments"), annual rental payments ("rents"), and royalties. Total revenue from federal onshore production is divided approximately evenly between the federal government and each state in which the production takes place (the federal government receives 52 percent and the respective state receives 48 percent).[53] For offshore production, federal Outer Continental Shelf land ownership begins three nautical miles off the coast; the coastal state closest to federal offshore production receives 27 percent of revenues from leases in an area extending up to six miles off its coast.[54] Gulf-producing states (defined as Alabama, Mississippi, Louisiana, and Texas) receive up to 37 percent of revenues from certain Outer Continental Shelf Gulf leases.[55] Coastal states have advocated for greater revenue share due to impacts on coastal infrastructure and the environment.[56]

Federal leases must provide the American people with fair and adequate compensation for the rights surrendered and the resources extracted.[57] The remainder of this Part describes Interior's authority to set minimum bids, rents, and royalties at an amount that ensures receipt of fair market value. However, as Part II discusses in more detail, because Interior excludes many environmental and social considerations when setting each term, federal leases are currently undervalued.

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[51] OCSLA Section 18(a)(2), 43 U.S.C. § 1344(a)(2).

[52] OCSLA Section 18(a)(3), 43 U.S.C. § 1344(a)(3).

[53] 30 U.S.C. § 191(a)-(b). One exception is Alaska, which is entitled to 90 percent of the federal royalties for oil, gas, and coal production in the state. *Id*.

[54] 43 U.S.C. § 1337(g)(5). This provision was included in Section 8(g)10 of the OCSLA amendments of 1985 (P.L. 99-272).

[55] Gulf of Mexico Energy Security Act (2006), (Pub. Law 109-432).

[56] *See* Congressional Research Service, *U. S. Offshore Oil and Gas Resources: Prospects and Processes* (R40645) (April 26, 2010) at 19.

[57] 43 U.S.C. § 1344(a); 43 U.S.C. § 1701(a)(9).

Authority to Set Bids

Interior, through BLM, allocates onshore oil and gas leases for a primary term of ten years through a competitive bidding process.[58] Interested parties may nominate tracts for leasing, and tracts are then offered for leasing through an oral auction. Each bidder offers a fixed amount as an initial bid. An initial bid is a one-time payment made to the federal government by the lessee at the time oil, gas, or coal leases are granted. The bidder that makes the highest bid is awarded the lease, provided that the bid amount exceeds a set "minimum." If a qualified bid is not received for any tracts offered at a competitive auction, those leases are offered noncompetitively.[59]

The Mineral Leasing Act, as amended, gives the Secretary of Interior authority to set the national minimum bid for onshore oil and gas leases at $2 per acre or greater.[60] The Secretary of Interior may "establish by regulation a higher national minimum acceptable bid for all leases based upon a finding that such action is necessary: (i) to enhance financial returns to the United States; and (ii) to promote more efficient management of oil and gas resources on Federal lands."[61]

However, Interior has allowed the minimum bid for onshore oil and gas to remain at $2 per acre for nearly one hundred years.[62] The Mineral Leasing Act prohibits BLM from setting minimum bids on a tract-by-tract basis. It states that "[t]he Secretary [must] accept the highest bid . . . which is equal to or greater than the national minimum acceptable bid, without evaluation of the value of the lands proposed for lease."[63] Thus, while the Secretary of the Interior has the authority to raise the national minimum bid, BLM cannot require higher minimum bids for specific leases.[64] All leases offered at auction that do not receive any bids are offered the following day in a noncompetitive sale for the minimum bid price.[65] In the aggregate, about 40 percent of existing onshore leases were issued non-competitively. In 2014, about 10 percent of new leases were issued non-competitively.[66]

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[58] 30 U.S.C. § 226.

[59] *Id.*

[60] 30 U.S.C. § 226(b)(1).

[61] *Id.*

[62] U.S. GAO, *Actions Need for A Better Return*, *supra* note 6.

[63] 30 U.S.C. § 226(b)(1)(A).

[64] 30 U.S.C. § 226(b)(1)(B); 43 C.F.R. § 3120.5-2; *see also* U.S. Bureau of Land Management, HANDBOOK: H-3120-1 – COMPETITIVE LEASES (Feb. 18, 2013) at 27, available at http://www.blm.gov/style/medialib/blm/wo/Information_Resources_Management/policy/blm_handbook.Par.71542.File.tmp/3120%20Handbook.pdf.

[65] 30 U.S.C. § 226(b)(1); *see also* 43 C.F.R. Part 3110. A non-competitive lease offer is a legally binding offer filed along with certain fees paid in advance.

[66] Department of the Interior, Bureau of Land Management, *Advance Notice of Proposed Rulemaking: Oil and Gas Leasing; Royalty on Production, Rental Payments, Minimum Acceptable Bids, Bonding Requirements, and Civil Penalty Assessments*, 80 Fed. Reg. 22148, 22150 (April 21, 2015), available at http://www.gpo.gov/fdsys/pkg/FR-2015-04-21/pdf/2015-09033.pdf.

For coal leases, the Mineral Leasing Act states that "[n]o bid shall be accepted which is *less than the fair market value*, as determined by the Secretary, of the coal subject to the lease."[67] The minimum bid for a coal lease is currently set at $100 per acre.[68] Before each lease sale, BLM formulates an estimate of the "fair market value" of the coal lease offered. BLM's fair market value calculation is confidential and is only used to evaluate the bids received during the sale.[69] BLM accepts sealed bids prior to the date of the sale. The winning bid is the highest bid that meets or exceeds the coal tract's presale estimated fair market value.[70]

The bidding and allocation process for offshore oil and gas leases is similar to that for coal. BOEM first solicits nominations of tracts for leasing.[71] Leases are allocated through a competitive bidding process, with interested parties submitting sealed bids.[72] For offshore leases, the Secretary of the Interior "is authorized to grant [the lease] to the highest responsible qualified bidder or bidders by competitive bidding."[73]

Both BOEM and BLM (for onshore coal leases) primarily rely on two approaches to measure fair market value of its leases: the comparable approach and the net income approach.[74] The first approach uses comparable lease sales and uses prior bids (also called "bonuses") paid in similar mineral rights transaction.[75] The second approach uses projected revenue from the resource over time, under realistic conditions.[76] This "bid adequacy" process relies on evidence of market competition, as well as in-house estimates of tract value.[77]

However, as discussed in Part II, below, these two approaches to measuring a fair return do not properly account for the option value associated with federal leasing. And

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[67] 30 U.S.C. § 201(a)(1) (emphasis added).

[68] U.S. Gov't Accountability Office, *BLM Could Enhance Appraisal Process, More Explicitly Consider Coal Exports, and Provide More Public Information* (2013), http://www.gao.gov/assets/660/659801.pdf.

[69] U.S. Bureau of Land Management, *Coal Operations: Competitive Leasing Process* (last updated August 22, 2014), available at http://www.blm.gov/wo/st/en/prog/energy/coal_and_non-energy.html.

[70] *See, e.g.,* U.S. Bureau of Land Management, *Powder River Basin Coal Leases by Application* (last updated March 31, 2015), available at http://www.blm.gov/wy/st/en/programs/energy/Coal_Resources/PRB_Coal/lba_title.html.

[71] 43 U.S.C. § 1344(a)(2)(E).

[72] *Id.* § 1337(a)(1).

[73] *Id.*

[74] BOEM, ASSURANCE OF FAIR MARKET VALUE (2015); BLM, H-3070-2, ECONOMIC EVALUATION OF OIL AND GAS PROPERTIES HANDBOOK.

[75] U.S. Bureau of Land Management, H-3070-2, ECONOMIC EVALUATION OF OIL AND GAS PROPERTIES HANDBOOK at I.C, *available at* http://www.blm.gov/style/medialib/blm/wo/Information_Resources_Management/policy/blm_handbook.Par.39460.File.dat/h3070-2.pdf; *see also* BOEM, 2017-2022 Draft Proposed Program, *supra* note 44.

[76] *Id*.

[77] *See, e.g.,* U.S. Bureau of Ocean and Energy Management, *Summary of Procedures for Determining Bid Adequacy at Offshore Oil and Gas Lease Sales: Effective July 1999*, available at http://www.boem.gov/uploadedFiles/BOEM/Oil_and_Gas_Energy_Program/Energy_Economics/Fair_Market_Value/FMV174-3.pdf.

because many leases are uncompetitive, with only one qualified bidder, relying on comparable lease sales may simply perpetuate a pattern of receiving improperly low bids.

Authority to Set Rents

Pursuant to the Mineral Leasing Act, a company holding an onshore oil or natural gas lease on public land, but not currently producing and paying royalties from production on that land, must pay the federal government an annual rental fee of at least $1.50 per acre, per year during the first five years, and at least $2 per acre each year thereafter.[78] When resource production begins, this rental requirement converts to a minimum royalty.[79] The Secretary Interior has the authority to establish a higher minimum rent.[80] Current BLM regulations set annual rents at the statutory minimum rate. BLM cannot require higher rents on a lease-by-lease basis unless this regulation is revised.[81] BLM has not increased the rental rates since they were initially set in 1987.

For coal, the statutory minimum rent is $3 per acre, per year; Interior has authority to charge a higher rent.[82] By the terms of its regulation, BLM also has the power to specify "the amount of the rental . . . in the lease."[83] This gives BLM greater flexibility to adjust rental rates for coal leases than it currently has for onshore oil and gas leases.

For offshore leases, the Outer Continental Shelf Lands Act grants the Secretary of the Interior discretionary authority to set rents for individual leases.[84] BOEM has been delegated this authority by the Secretary, and can set rents on a lease-by-lease basis.[85] BOEM commonly uses escalating rental rates to encourage faster exploration and development of leases, and earlier relinquishment when exploration is unlikely to be undertaken by the current lessee.[86] BOEM states that rental payments "serve to discourage lessees from purchasing marginally valued tracts too soon because companies will be hesitant to pay the annual holding cost to keep a low-valued or currently uneconomic lease in their inventory."[87]

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[78] 30 U.S.C. § 226(d).

[79] *Id.*; 43 C.F.R. § 3103.2-2(c).

[80] *Id.* § 226(d).

[81] *See* 43 C.F.R. §3103.2-2.

[82] 30 U.S.C. § 207; *see also* Federal Coal Leasing Amendments Act of 1975, Pub. L. No. 94-377, 90 Stat. 1083, 1087 (codified as amended at 30 U.S.C. § 181 et seq.).

[83] 43 C.F.R. § 3473.3-1(a).

[84] 43 U.S.C. § 1337(b)(6) ("An oil and gas lease issued pursuant to this section shall… contain such rental and other provisions as the Secretary may prescribe at the time of offering the area for lease…").

[85] BOEM, 2017-2022 Draft Proposed Program, *supra* note 44 at 8-18.

[86] *Id*. at 8-19. For example, in a 2009 Gulf of Mexico lease sale, rental rates were set at $7 to $11 per acre (depending on water depth) for the first five years of the lease, escalating to $14 to $44 per acre in the later years of the lease. *See* BOEM, PROPOSED OUTER CONTINENTAL SHELF OIL & GAS LEASING PROGRAM 2012-2017 (Nov. 2011) at 77, available at http://www.boem.gov/uploadedFiles/Proposed_OCS_oil_Gas_Lease_Program_2012-2017.pdf.

[87] BOEM, 2017-2022 Draft Proposed Program, *supra* note 44 at 8-19.

Authority to Set Royalty Rates

When a lessee successfully extracts mineral resources from federal land, the federal government is entitled to a royalty on the production. Royalties account for approximately 80 percent of all federal revenue from federal oil, gas, and coal leasing.[88] The royalty rate is a percentage of the value of production; the royalty owed is the volume of production, times the unit value of production, times the royalty rate.

The Mineral Leasing Act sets a floor for onshore oil and natural gas royalty rates at no less than 12.5 percent.[89] Although Interior is authorized by statute to set a higher rate than 12.5 percent for competitive leases, BLM's existing regulations set a flat rate of 12.5 percent for such leases.[90] For non-competitive leases, the royalty rate is fixed by statute at 12.5 percent.[91]

The Mineral Leasing Act and the Federal Coal Leasing Amendments Act of 1976 set a royalty rate floor for coal production at 12.5 percent of the gross value of the coal produced from surface mines, and 8 percent for coal produced from underground mines.[92] The Mineral Leasing Act's coal royalty provision states that, "[t]he lease shall include such other terms and conditions as the Secretary shall determine."[93]

The Secretary of the Interior has the authority to increase the current royalty rates for oil, gas, and coal. Any new royalty rate would be applied to new leases and leases renewed in the future; leases currently in production are subject to renewal after the first 20 years of production, and every 10 years thereafter.[94]

With respect to offshore oil and gas leases, the Outer Continental Shelf Lands Act states that Interior must set royalties at or above 12.5 percent.[95] Interior is permitted to set a higher royalty rate.[96] If Interior raises royalty rates for offshore production, Congress can pass a resolution disapproving this change within 30 days of Interior's action.[97] In 2007, Interior increased the royalty rate for new offshore leases in the Gulf of Mexico from 12.5

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88 Office of Natural Resources Revenue, Reported Revenues: Federal Onshore in All States for FY 2012 by Accounting Year (2013), available at http://statistics.onrr.gov/.

89 30 U.S.C. § 226(b)(1)(A) ("A lease shall 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."). The royalty rate for leases in "special tar sands areas" is fixed at 12.5 percent. *Id*. § 226(b)(2)(A).

90 43 C.F.R. § 3103.3-1(a)(1).

91 30 U.S.C. § 226(c).

92 30 U.S.C. § 207(a); Federal Coal Leasing Amendments Act of 1976, Pub. L. 94-377, 90 Stat. 1083 (Aug. 4, 1976).

93 30 U.S.C. § 207(a).

94 *Id*. § 226(l).

95 43 U.S.C. § 1337(a)(1).

96 *Id.* Courts have upheld Interior's authority of to set royalty regulations. *See Amoco Prod. Co. v. Watson,* 410 F.3d 722, 728-9 (D.C. Cir. 2005); *Independent Petroleum Ass'n v. DeWitt*, 279 F.3d 1036, 1039-1040 (D.C. Cir. 2002). If Interior raises royalty rates for offshore production, Congress can pass a resolution disapproving this change within 30 days of Interior's action.

97 43 U.S.C. § 1337.

percent to 18.75 percent.[98] Interior made this change in response to advances in production technology, increased oil and gas prices, and the competitive market for offshore leases.[99] Interior estimated that the royalty rate increase from 12.5 percent to 18.75 percent would increase oil and gas revenues by $8.8 billion over the next 30 years.[100]

As the following section describes, Interior can use its authority to increase minimum bids, rents, and royalty rates based on option value and the consideration of environmental and social costs that will result from exploration and production. In any legal challenge, Interior's determination to adjust these fiscal terms would be subject to an arbitrary and capricious standard.[101] Interior's decision would likely be entitled to significant deference, as it has particular expertise in the stewardship and valuation of federal natural resources.[102]

II. INTERIOR SHOULD REVISE THE FISCAL TERMS FOR FEDERAL LEASES TO PROVIDE A FAIR RETURN TO THE PUBLIC AND EFFECTUATE ITS DUAL MANDATE.

The current federal leasing system fails to provide a fair return to the public. By excluding relevant environmental and social costs from the fiscal terms of leases, Interior fails to collect a fair market value for taxpayers and fails to adequately preserve federal environmental resources. In line with its statutory mandates under the Federal Land Policy and Management Act, Mineral Leasing Act, and Outer Continental Shelf Lands Act, Interior should:

- Secure a fair return for the American people by incorporating economic, environmental, and social option value into minimum bids for coal, oil, and natural gas leases;

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[98] *See* BOEM, PROPOSED OUTER CONTINENTAL SHELF OIL & GAS LEASING PROGRAM 2012-2017 (Nov. 2011) at 77, available at http://www.boem.gov/uploadedFiles/Proposed_OCS_oil_Gas_Lease_Program_2012-2017.pdf. Alaskan offshore leases utilize a 12.5 percent royalty rate. *Id*.

[99] *Id*.

[100] *See* Congressional Research Service, Outer Continental Shelf: Debate Over Oil and Gas Leasing and Revenue Sharing (2008), available at http://www.au.af.mil/au/awc/awcgate/crs/rl33493.pdf.

[101] *See Motor Veh. Mfrs. Ass'n v. State Farm Ins*., 463 U.S. 29, 43 (1983) (agency decisions are arbitrary if they entirely fail to consider an important aspect of the problem); *California v. Watt* ("*Watt I*"), 688 F.2d 1290, 1317 (D.C. Cir. 1981) (holding that courts can review Interior's leasing decisions for arbitrariness and failure to consider relevant factors).

[102] *See Boesche v. Udall*, 373 U.S. 472, 476-77 (1963) (noting that Interior has been vested with "general managerial powers over the public lands"); *N.W. Coal. for Alternatives to Pesticides v. Lyng,* 673 F. Supp. 1019, 1024 (D. Or. 1987) ("So long as the BLM's decisions are not irrational or contrary to law, it may manage the public lands as it sees fit") (citing *Natural Resources Defense Counsel v. Hodel*, 819 F.2d 927,980 (9th Cir. 1987); *see also Amoco v. Watson*, 410 F.3d 722 (D.C. Cir. 2005) (upholding BLM's order to an energy company to pay additional royalties, as "deference is particularly appropriate in the context of a complex and highly technical regulatory program, in which the identification and classification of relevant criteria necessarily require significant expertise and entail the exercise of judgment grounded in policy concerns.")(internal citations omitted).

- Raise annual rents to account for the foreseeable externalities of exploration and resource development; and
- Increase royalty rates to reflect environmental and social costs that result from production, and eliminate royalty relief provisions that provide improper incentives to energy companies.

A. Interior can secure a fair return for American tax payers by incorporating option value into the minimum bid price for coal, oil, and natural gas leases.

Option value derives from the ability to delay decisions until later, when more information is available. The concept's most familiar application is in the financial markets, where investors calculate the value of options to wait for more information on stock prices before deciding whether to buy or sell shares (i.e., stock options). A conceptually identical and well-established methodology exists to quantify the value of waiting to gain greater information about environmental, social, economic, and technological uncertainties.[103] In the leasing context, the value associated with the option to delay can be large, especially when there is a high degree of uncertainty about resource price, extraction costs, and/or the social and environmental costs of drilling. Accounting for option value does not always require waiting to issues leases; rather, it requires that the government is adequately compensated for the value of delay.

Interior currently fails to account for option value in setting minimum bids for natural resources leases. The minimum bid should be set at a level to ensure a fair return for U.S. tax payers on parcels acquired by private companies. Accounting for economic, environment, and social option value would very likely increase the minimum bid price above the current statutory minimums for oil, gas, and coal. Therefore, to ensure a fair return, Interior should raise national minimum bids to account for the full value of this option.

The federal government holds a perpetual option to develop energy resources, yet this option value is not accounted for in minimum bids.

The importance of option value to evaluating decisions under uncertainty has been widely recognized in the economics community for several decades.[104] The option value framework has long been applied to natural resource extraction decisions, including

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[103] Michael A. Livermore, *Patience is an Economic Virtue: Real Options, Natural Resources, and Offshore Oil*, 84 U. COLO. L. REV. 581, 589 (2013).

[104] *See generally*, Avinash K. Dixit & Robert S. Pindyck, INVESTMENT UNDER UNCERTAINTY (1994); James L. Paddock et al., *Option Valuation of Claims on Real Assets: The Case of Offshore Petroleum Leases*, 103 Q. J. ECON. 479 (1988); Jon M. Conrad & Koji Kotani, *When to Drill? Trigger Prices for the Arctic National Wildlife Refuge*, 27 RES. & ENERGY ECON. 273 (2005); Michael A. Livermore, *Patience Is an Economic Virtue: Real Options, Natural Resources, and Offshore Oil*, 84 U. COLO. L. REV. 581, 591 (2013); *see also* Anthony C. Fisher, *Investment under Uncertainty and Option Value in Environmental Economics*, 22 RES. & ENERGY ECON. 197 (2000); W. Michael Hanemann, *Information and the Concept of Option Value*, 16 J. ENVTL. ECON. & MGMT. 23 (1989).

offshore oil drilling. In fact, the petroleum industry routinely accounts for the value of waiting for more information on uncertain future oil prices and production costs, which explains the frequent practice of companies purchasing offshore leases but waiting long periods of time to begin drilling.[105] A 2011 Interior Department report estimated that about 70 percent of offshore leases and 57 percent of onshore leases were not under any active or planned development.[106]

Option value is relevant for both price uncertainty, as well as environmental and social uncertainty. Interior's current minimum bids fail to account for the option value associated with each of these categories of uncertainty.

First, with respect to price uncertainty, Interior holds—on behalf of the American public—perpetual options to develop or lease oil, gas, and coal tracts; the agency must decide when and where exercising those options will be most opportune. When Interior sells a lease, the federal government's perpetual option is converted to time-limited option held by the lessee, lasting for the duration of the lease. The lessee must act within a set time period—between five and ten years for both onshore and offshore leases[107]—or it will lose the right to develop the tract. A perpetual option is more valuable than a time-limited option, as it gives the option holder the power to wait, indefinitely, for more information (or for prices to rise) before making an irreversible decision. Thus, when the federal government sells a private lessee the right to develop a tract for a set period of time, it extinguishes the perpetual option that the government holds on behalf of the American people, and sells a time-limited option. Interior does not account for the lost value of its perpetual option in the price of its leases.[108] As a result, the public does not receive the full value of the right to exploit its resources.

BOEM currently uses a "hurdle price analysis" at the program stage that is designed to account for some resource price uncertainty;[109] however, it does not conduct similar analysis at the lease sale stage, and fails to account for environmental and social uncertainties in this analysis. BLM does not use a "hurdle price" analysis for any of its lease

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[105] *See* Michael Rothkopf et al., *Optimal Management of Oil Lease Inventory: Option Value and New Information* (Rutgers Center for Operations Research, Research Report 22-2006, 2006); Ryan Kellog, *The Effect of Uncertainty on Investment: Evidence from Texas Oil Drilling* (Nat'l Bureau of Econ. Res., Working Paper No. 16,541, 2010); Timothy Dunne and Xiaoyi Mu, *Investment Spikes and Uncertainty in the Petroleum Refining Industry* (Fed. Reserve Bank of Cleveland, Working Paper No. 08-05, 2008); *see also* William Bailey et.al., *Unlocking the Value of Real Options*, OILFIELD REVIEW, Winter 2003, at 4 (describing how companies including Chevron Texaco, Anadarko, and El Paso Corporation incorporate real options into their decision-making processes); Soussan Faiz, *Real-Options Application: From Successes in Asset Valuation to Challenges for an Enterprise wide Approach*, J. OF PETROLEUM TECH., Jan. 2001, at 42–47, 74 (analyzing Chevron Texaco's decision not to sell a marginally-performing lease because of its real options value).

[106] U.S. Dept. of Interior, *Oil and Gas Lease Utilization – Onshore and Offshore* (2011) at 4, 6, *available at* http://www.doi.gov/news/pressreleases/loader.cfm?csModule=security/getfile&pageid=239255.

[107] *See* 43 U.SC. § 1337.

[108] *Id.* at 585.

[109] BOEM's hurdle price analysis is designed to ensure that every area included in the Program is expected to "convey rights to at least one field where prompt exploration during the Program is consistent with an optimal allocation of resources." BOEM, 2017-2022 Draft Proposed Program, *supra* note 44.

sales. Rather, BLM uses the $2 per acre minimum bid for all oil and gas sales, thus failing to account for price uncertainty in these minimum bids altogether.[110]

Second, Interior fails to account for environmental and social uncertainty when evaluating tracts to offer at auction, as well as when setting minimum bids and assessing fair market value. The environmental, social, and economic uncertainties associated with drilling and mining are many, and include:

- Uncertainty about the magnitude of risk of catastrophic oil spills, especially in relatively dangerous or unfamiliar areas like deep-water zones and the Arctic;
- Uncertainty about the development rate of spill-prevention, spill-remediation, and pollution-prevention technologies, as well as technologies that may better protect worker safety;
- Uncertainty about competing uses of federally-leased areas, such as the potential for renewable energy projects; and
- Sensitivities to threats associated with drilling and mining, such as the toxicity of spills or leaks, climate and marine conditions that may exacerbate the damaging effects of spills, and consequences for land values near spills and production sites.

These uncertainties can and should be accounted for when evaluating which parcels to offer for leasing, as well as when setting minimum bids and evaluating bonuses received. The option value associated with each of these uncertainties, among others, is a component of the "fair market value" of the right to develop public resources.[111]

At the lease sale stage, BLM and BOEM have information about specific risks and environmental, social, and economic uncertainties relevant to the leases at issue. The agencies should account for this option value in order to earn a fair return and to avoid unnecessarily exposing the public to high-risk drilling. For example, where uncertainties are high, such as in more remote or extreme weather environments, as in the Arctic, the value of delay is greater. Thus, when done correctly, adjusting minimum bids to account for option value would help ensure that the government only leases when and where the present societal benefits outweigh the costs, including the value of delay.

Finally, some concerns with respect to low minimum bids would logically be tempered in a truly competitive market, with multiple bidders. However, the majority of coal lease sales conducted by BLM are uncontested, with no bidders other than the initial applicant that nominated the tract.[112] This lack of robust competition means that many coal

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[110] *See* 30 U.S.C. § 226(b)(1); 43 C.F.R. § 3120.5-2.

[111] *See* BOEM, 2017-2022 Draft Proposed Program, *supra* note 44 at 5-20, 8-3 to 8-19.

[112] U.S. Department of the Interior, Office of the Inspector General, EVALUATION: COAL MANAGEMENT PROGRAM at 8 (June 2013), available at http://www.documentcloud.org/documents/712402-inspector-generals-report-on-coal-leases.html ("The FMV determination is critical in coal leasing because a competitive market generally does not exist for coal leases, therefore, the FMV serves as a substitute for competition. For example, we found that over 80 percent

leases are sold for the statutorily-set minimum bid of $100 per acre, even though BLM has the power to require higher minimum bids on a lease-by-lease basis.[113] And for onshore oil and gas, about 40 percent of leases currently in force were offered noncompetitively, for the minimum bid of $2 per acre.[114] The non-competitive nature of many federal onshore lease sales all but guarantees that the full value of the government option is not captured in the bid price. Moreover, while robust competition might ensure that bidders account for some amount of price uncertainty, private actors do not have an incentive to account for environmental and social uncertainty, as they do not internalize the full cost of pollution or impairment of competing uses of the land. These effects are externalities, many of which do not rise to the level of legally actionable claims, or which would require costly and time-consuming litigation to recoup.

In short, Interior should increase minimum bids in order to recoup the option value associated with leasing federal resources.

Both BOEM and the D.C. Circuit Court of Appeals recognize the relevance of option value to federal natural resources management.

In a deliberate move towards greater rationality, BOEM recently recognized the utility of option value in its proposed offshore leasing plan for 2017 to 2022. Specifically, BOEM noted that: (i) environmental and social cost uncertainties can affect the size, timing, and location of offshore leasing; (ii) option value can be a component of the fair market value of a lease; and (iii) BOEM can raise minimum bids, rents, and royalties for leases to account for option value.[115] However, BOEM declined to quantify environmental option value, and instead only qualitatively addressed option value in its 2017-2022 draft program.[116]

In addition, the United States Court of Appeals for the D.C. Circuit recently affirmed the existence and validity of option value with respect to offshore oil and gas drilling. In *Center for Sustainable Economy v. Jewell*, Petitioner argued that OCLSA Section 18 required BOEM to explicitly consider and quantify the option value of delaying leasing in specific regions of the Outer Continental Shelf.[117] The Court's decision recognized the utility of option value to Interior's offshore leasing program:

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of the sales for coal leases in the Powder River Basin received only one bid in the past 20 years. No coal lease has had more than two bidders on a sale.")

[113] *Id.*

[114] U.S. Gov't Accountability Office, *Actions Needed For Interior to Better Ensure A Fair Return* (GAO-14-50) (2013) at 8.

[115] BOEM, 2017-2022 Draft Proposed Program, *supra* note 44 at 5-20, 8-3 to 8-19.

[116] *Id.*

[117] *Center for Sustainable Economy v. Jewell*, 779 F.3d 588 (D.C. Cir. Mar. 6, 2015). Policy Integrity served as counsel to Petitioner, Center for Sustainable Economy. *See also* Opening and Reply Briefs for Petitioner.

> More is learned with the passage of time: Technology improves. Drilling becomes cheaper, safer, and less environmentally damaging. Better tanker technology renders oil tanker spills less likely and less damaging. The true costs of tapping OCS energy resources are better understood as more becomes known about the damaging effects of fossil fuel pollutants. Development of energy efficiencies and renewable energy sources reduces the need to rely on fossil fuels. As safer techniques and more effective technologies continue to be developed, the costs associated with drilling decline. *There is therefore a tangible present economic benefit to delaying the decision to drill for fossil fuels to preserve the opportunity to see what new technologies develop and what new information comes to light*.[118]

Ultimately, the Court found that BOEM's failure to quantify option value was not arbitrary or irrational at this time because the methodology for quantifying option value is not yet "sufficiently established."[119] But importantly, the Court's holding indicates that quantitative methods might be developed in the future, and that such methods would be preferable to qualitative treatment of option value.[120] The court noted: "Had the path been well worn, it might have been irrational for Interior not to follow it."[121]

While the decision addressed offshore leasing, the Court's language on the utility of option value is equally applicable to both onshore and offshore leasing. And BLM, unlike BOEM, currently fails to address environmental and social option value in any manner, qualitatively or quantitatively.

RECOMMENDATIONS: Interior should raise minimum bids to account for option value, and evaluate methods to quantify option value for both offshore and onshore leasing.

First and foremost, Interior should evaluate how to incorporate option value into minimum bids for oil, gas, and coal leases, both onshore and offshore. Interior has the authority, pursuant to the Mineral Leasing Act and the Outer Continental Shelf Lands Act, to increase minimum bids. It can and should evaluate what level of bid increase is necessary in order to account for the value of the government's perpetual option for natural resources leasing.

Second, BOEM currently evinces a more sophisticated understanding and application of option value than BLM, as detailed in its latest draft program for offshore leasing. Interior should take steps to ensure that BLM catches up with BOEM's valuation methods and understanding of option value. Further, BLM should review and adopt BOEM's language on the utility of option value to both its program-level and lease sale

[118] *Id.* at 610 (emphasis added).

[119] *Id.* at 611.

[120] *Id*. at 612 ("Our holding is a narrow one . . . the agency is not permitted to substitute qualitative assessments for well-established quantitative methods whenever it deems such substitutions convenient.").

[121] *Id.*

decisions.[122] As the D.C. Circuit affirmed, there is "a tangible present economic benefit to delaying the decision to drill," and failing to account for this value undervalues public resources.[123]

Third, Interior should revise its regulations to encourage or require BLM and BOEM to account for option value when setting lease-specific minimum bids for coal leases and offshore oil and gas leases.[124] Consistent with the D.C. Circuit's opinion in *CSE v. Jewell*, and as BOEM directly articulated, option value can be a component of the fair market value of a lease. BLM and BOEM should also update their handbooks and guidance manuals to require the consideration of option value when setting fiscal terms of leases. For example, a "social hurdle price" could be calculated for each lease sale, or subsection of tracts in a lease sale, in order to account for environmental, social, and economic uncertainty.

Fourth, Interior should consider organizing a working group to evaluate methods to use and quantify option value for both offshore and onshore leasing.[125] Government agencies play an important role in quantifying important new categories of costs.[126] Indeed, the D.C. Circuit ruling strongly suggests that academic advancements in option value research could soon compel BOEM and BLM to quantify the option value associated with their leasing practices; the agencies should lead this effort now, so they do not have to play catch-up later. While developing such a methodology will have a discrete upfront cost, once created, this model could be used and refined in future government natural resources leasing decisions, and could earn the American public billions of dollars in net benefits from more optimal timing, location, and lease terms, as well as avoided catastrophic oil spills and other costs of high-risk drilling.

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[122] *See* BOEM, Draft Proposed Program, *supra* note 44 at 5-20, 8-3 to 8-19.

[123] *CSE v. Jewell,* 779 F.3d at 610.

[124] As described above, the Mineral Leasing Act effectively prohibits BLM from setting minimum onshore oil and natural gas bids on a tract-by-tract basis. It states that "[t]he Secretary [must] accept the highest bid . . . which is equal to or greater than the national minimum acceptable bid, without evaluation of the value of the lands proposed for lease." Thus, while the Secretary of the Interior has the authority to raise the national minimum bid, BLM cannot require higher minimum bids for specific leases, absent a legislative revision.

[125] For practical guides to calculating options value, see, for example, Prasad Kodukula & Chandra Papudesu, PROJECT VALUATION USING REAL OPTIONS: A PRACTITIONER'S GUIDE (2006) and Johnathan Mun, REAL OPTIONS ANALYSIS: TOOLS AND TECHNIQUES FOR VALUING STRATEGIC INVESTMENT AND DECISIONS (2d Ed. 2005). *See also* Michael Rothkopf et al., OPTIMAL MANAGEMENT OF OIL LEASE INVENTORY: OPTION VALUE AND NEW INFORMATION (Rutgers Center for Operations Research, Research Report 22-2006, 2006); Ryan Kellog, Th*e Effect of Uncertainty on Investment: Evidence from Texas Oil Drilling* (Nat'l Bureau of Econ. Res., Working Paper No. 16,541, 2010); Timothy Dunne and Xiaoyi Mu, *Investment Spikes and Uncertainty in the Petroleum Refining Industry* (Fed. Reserve Bank of Cleveland, Working Paper No. 08-05, 2008); William Bailey et. al., *Unlocking the Value of Real Options*, OILFIELD REVIEW, Winter 2003, at 4 (describing how companies including ChevronTexaco, Anadarko, and El Paso Corporation incorporate real options into their decisionmaking processes).

[126] *See* Richard L. Revesz, *Quantifying Regulatory Benefits*, 102 CAL. L. REV. 1423, 1425, 1436 (2014). For example, both the Social Cost of Carbon and Value of a Statistical Life (VSL) are examples of government agencies serving as catalysts for the quantification of important measures of regulatory costs and benefits.

In short, the initial investment required to quantify the option value associated with offshore leasing may be vastly outweighed by the long-term societal benefits. Such an approach would also be consistent with the Federal Land Policy and Management Act's dual mandate and the Outer Continental Shelf Lands Act's direction to weigh "economic, social, and environmental values."[127]

B. Interior should ensure that rents incorporate the commercial, environmental, and social externalities of exploration and resource development.

Interior has discretion to set oil, gas, and coal lease rental rates at an appropriate level, yet often charges no more than the statutory minimums. Accounting for the full lost value of the public's use and enjoyment of federal lands during the rental period, as well as the anticipated externalities associated with exploratory drilling would likely raise the rent price above the current statutory minimums. BLM's rental rates were last updated in 1987, and are lower than the rental rates charged by other oil and gas-producing states, such as Texas (which charges $5 per acre during the first three years, and $25 per acre thereafter if the lease still has no production).[128] Interior should consider raising minimum rental rates in order to receive fair market value for the rights it conveys.

Energy leaseholders impose uncompensated costs on the public as soon as exploration begins.

America's public lands offer millions of people a place to hike, camp, hunt, fish, and enjoy scenic beauty. They provide critical habitat for wildlife, drinking water, clean air, sites for renewable energy development, as well as natural resources including timber, minerals, oil, and natural gas. As soon as energy exploration begins, competing uses of federal land such as recreational enjoyment, commercial fishing, and renewable energy development are impaired, and continue to be foreclosed for the duration of production.

Energy companies also cause environmental and noise pollution through prospecting, exploratory drilling, and other activities undertaken in preparation for resource extraction. Often, companies do not pay for the full cost of this damage, because these negative effects are externalities, many of which do not rise to the level of actionable legal claims, or which would entail complex and costly litigation to establish causation and damages. During exploration, operators may use dynamite to create holes to find minerals, and drill test wells. Operators construct roads to and from the exploration site and build production facilities. Increased vehicular traffic due to drilling and mining operations contributes to wear and tear on roadways, as well as traffic-related fatalities. For example, a 2014 *Houston Chronicle* investigation found a 50 percent increase in motor vehicle

[127] *See* 43 U.S.C. § 1344(a)(1).

[128] *See* U.S. Government Accountability Office, *Interior Could Do More to Encourage Diligent Development* (GAO-09-74) at 13 (Oct. 2008), available at http://www.gao.gov/new.items/d0974.pdf.

fatalities in the West Texas counties associated with the Permian Basin, and an 11 percent increase in Eagle Ford Basin and Barnett Shale counties.[129]

Neither BLM nor BOEM presently attempt to quantify these costs or charge lessees for them. As a result, energy companies may conduct more prospecting operations than are socially optimal, because they do not bear all of the costs of this damage. Because many of these externalities occur before resources are extracted, yet after leases begin, these costs are logically recoverable at the rent stage. A socially efficient rent price would fully compensate the public for these costs.[130]

RECOMMENDATIONS: Interior should increase rents charged to account for impairment of recreational interests and environmental and social externalities.

First, the Secretary Interior has the authority to establish a higher minimum rental rate for oil, gas, and coal leases. To earn fair market value for the rights conveyed, Interior should raise the minimum rent price to account for the foreseeable externalities associated with holding leases, prospecting, and conducting exploratory drilling and mining.[131]

Second, because it has the authority to adjust rents for individual coal and offshore leases, Interior should use environmental impact statements or environmental assessments (required pursuant to the National Environmental Policy Act ("NEPA")), as well as company-provided exploration plans, to estimate the externalities associated with particular lease sales. Interior should charge higher rental rates for leases that are expected to result in greater local air pollution, commercial vehicle traffic, seismic exploration, injection well drilling, or other anticipated externalities during the rental period.

Third, current BLM regulations set annual rents for onshore oil and gas leases at the level of the statutory minimums: $1.50 per acre for the first five years, and $2 per acre thereafter.[132] BLM cannot require higher rents on a lease-by-lease basis for oil or natural gas tracts unless this regulation is revised.[133] Interior should initiate a rulemaking to provide BLM with the flexibility to adjust rents upwards in any future lease, to account for environmental externalities, foregone recreational use, or other factors.

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[129] Lise Olson, "Fatal truck accidents have spiked during Texas' ongoing fracking and drilling boom," *Houston Chronicle* (Sept. 11, 2014), http://www.houstonchronicle.com/news/article/Fracking-and-hydraulic-drilling-have-brought-a-5747432.php?cmpid=email-premium&cmpid=email-premium&t=1a9ca10d49c3f0c8a9#/0

[130] A price is socially efficient at the point at which the marginal cost to society equals the marginal benefit to society; that is, where net benefits are maximized.

[131] Indeed, private landowners may already price these effects into lease terms; certainly, it would be rational for private landowners who live on or near a potential lease site that they are offering for sale to account for such anticipated impacts as noise pollution, local air pollution, and vehicle traffic when negotiating the sale price.

[132] 30 U.S.C. § 226(d).

[133] *See* 43 C.F.R. § 3103.2-2.

Finally, Interior should attempt to quantify the recreational utility of given tracts of land, and account for this in the rent price. Some lease sites may have greater recreational users than others; this value should be accounted for in setting the rental rate. BLM and BOEM might use data on visitor history to particular regions or lease sites to help assess this social cost of leasing. The Federal Land Policy and Management Act, Mineral Leasing Act, and Outer Continental Shelf Lands Act require receipt of fair market value for the rights conveyed; this should include the value of the right to temporarily restrict or permanently impair recreational use.

C. Interior should increase royalty rates to account for environmental and social costs that result from production.

Energy companies currently benefit from inefficiently low royalty rates, because Interior's rates do not account for environmental and social impacts. Underscoring the need for comprehensive reevaluation, onshore royalty rates have not increased in nearly 100 years, even as U.S. oil and gas producers have benefitted from rapid technological innovation, political stability, and relatively high resources prices—factors which led to an increase in offshore royalty rates in 2007.[134]

***The royalty rates paid by energy companies do not compensate the federal government for the social and environmental costs of resource extraction*.**

During gas, oil, and coal production, drilling and mining cause local and global air pollution, including vented and fugitive methane. The United States loses at least 1 to 3 percent of its total natural gas production each year when methane is leaked, flared (burned), or vented to the atmosphere during the production, processing, transmission, storage, and distribution of natural gas and oil.[135] This is a waste of a valuable resource—contrary to the goals of the Mineral Leasing Act to avoid all "undue waste"—as well as a potent source of greenhouse gas pollution.[136] Further, air quality near well sites can reach ozone levels that fail to meet EPA standards.[137] Injection wells used to dispose hydraulic fracturing wastewater can induce earthquakes.[138] And wastewater stored in pits and tanks has the potential to leak, causing water contamination.[139]

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[134] *See* BOEM, PROPOSED OUTER CONTINENTAL SHELF OIL & GAS LEASING PROGRAM 2012-2017 at 77 (Nov. 2011), available at http://www.boem.gov/uploadedFiles/Proposed_OCS_oil_Gas_Lease_Program_2012-2017.pdf.

[135] *See* U.S. EPA, *Inventory of U.S. Greenhouse Gas Emissions and Sinks: 1990 – 2012* (April 15, 2014), available at http://www.epa.gov/climatechange/ Downloads/ghgemissions/US-GHG-Inventory- 2014-Main-Text.pdf.

[136] *See, e.g.*, Jayni Foley Hein, Institute for Policy Integrity at NYU School of Law, *Capturing Value: Science and Strategies to Curb Methane Emissions from the Oil and Natural Gas Sector* (Dec. 2014), available at http://policyintegrity.org/files/publications/Capturing_Value_-_Methane_Policy_Brief.pdf.

[137] Mead Gruver, "Wyoming's Natural Gas Boom Comes with Smog Attached," Associated Press (March 9, 2011), available at http://www.nbcnews.com/id/41971686/ns/us_news-environment/%20%20%22#.VUeFDiFVhBd.

[138] For example, a University of Texas study found that earthquakes occurred more frequently near injection well sites in the Barnett Shale region, with most of the epicenters located within two miles of

These concerns are not always adequately addressed through tort or environmental law. Fines and tort liability may address only major violations; even then, the harm will have already taken place. Further, what relief is available may entail costly and time-consuming litigation, where plaintiffs bear the burden of proving a violation.[140] Further, even if successful, plaintiffs may ultimately recover less than the total value of the damage.[141]

Interior's bonding requirements are also outdated and may be insufficient to cover the full cost of accidents or damage that occurs after production. Companies must pay bonds to BLM, pursuant to the Mineral Leasing Act, in order to ensure that they can perform reclamation of any federal land that may be disturbed by fossil fuel production. BLM's bond amounts were set in the 1950s and 1960s, and may be too low to ensure that companies can perform all necessary reclamation.[142] If a bond is not sufficient to cover well plugging and surface reclamation and there are no responsible or liable parties, the well is considered "orphaned," and BLM must use federal dollars to fund reclamation. Interior should review bonding requirements and revise them if necessary to ensure that reclamation costs are paid by responsible parties.

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injection wells. Cliff Frohlich, T*wo-year survey comparing earthquake activity and injection-well locations in the Barnett Shale, Tex*., 109 PROCEEDINGS OF THE NAT'L ACAD. OF SCIENCES 13934 (2012). The Ohio Department of Natural Resources attributed a series of earthquakes near Youngstown, Ohio in 2011 to injection into hydraulic fracking wastewater disposal wells. Ohio Dep't of Natural Res., *Preliminary Report on the Northstar 1 Class II Injection Well And The Seismic Events In The Youngstown, Ohio, Area* (2012), available at http://ohiodnr. com/downloads/northstar/UICReport.pdf.

[139] *See, e.g*., Michael Kiparsky and Jayni Foley Hein, *Regulation of Hydraulic Fracturing in California: A Wastewater and Water Quality Perspective Michael*, UC Berkeley (April 2013), available at https://www.law.berkeley.edu/files/ccelp/Wheeler_HydraulicFracturing_April2013.pdf; Stephen G. Osborn, et al., *Methane contamination of drinking water accompanying gas-well drilling and hydraulic fracturing,* 108 PROCEEDINGS OF THE NAT'L ACAD. OF SCIENCES 8172 (2011); M. Dusseault and M. Gray, et al., *Why oil wells leak: cement behavior and long-term consequences*, Society of Petroleum Engineers International Oil and Gas Conference and Exhibition in China, Beijing, China (2000).

[140] For example, in order to prove causation in a case claiming contamination from fracking activities, plaintiffs need to show that contaminants in question were not naturally present in groundwater or environment. *See* Kiparsky and Hein, *supra* note 140 at 33 (citing *William G. Strudley v. Antero Resources Corporation, et al*., 2012 WL 1932470 (Colo. Dist. Ct. May 9, 2012) (stating, "the Court required Plaintiffs, before full discovery and other procedures were allowed, to make a prima facie showing of exposure and causation," and ultimately dismissing the case for lack of evidence of causation)); *Lore v. Lone Pine Corp.,* 1986 WL 635707 (N.J. Sup. Ct. Nov. 18, 1986) (requiring plaintiffs to demonstrate a prima facie case of causation before allowing a case to proceed to discovery).

[141] Perhaps the most famous example of this is the Exxon-Valdez oil spill. The catastrophe occurred in 1989, but litigation regarding the damage went on for nearly twenty-five years. When the settlement finally concluded, not only had the aggrieved parties gone nearly a quarter-century without full compensation, but the settlement was reduced about five-fold by the U.S. Supreme Court. *Exxon Shipping Co. v. Baker*, 554 U.S. 471 (2008).

[142] BLM regulations establish minimum bond amounts: $10,000 for an individual lease, $25,000 to cover all leases of a single operator in a state, and $150,000 to cover all leases of a single operator nationwide. U.S. Government Accountability Office, *Bonding Requirements and BLM Expenditures to Reclaim Orphaned Wells* (GAO-10-245) (Jan. 2010), available at http://www.gao.gov/assets/310/300218.pdf.

Outdated royalty valuation processes also reveal the need for reform.

Surveys of state and foreign government royalty rates also suggest that Interior does not set royalty rates in a manner that guarantees a fair return to the American people.[143] Most energy-rich states in the United States set royalty rates for fossil fuel production between 15 and 20 percent; Texas has a 25 percent rate for oil and gas production.[144] A 2008 Government Accountability Office report found that the United States receives one of the lowest overall "takes" worldwide for oil, gas, and coal leases.[145] This is so, even as the United States is a very attractive place for companies to do business given its longstanding political stability, abundant oil and natural gas reserves, and ample existing infrastructure, including oil rigs, refineries, pipelines, and railways.[146]

A 2013 Government Accountability Office report also criticized Interior's lack of documented procedures for determining how it sets royalty rates for new leases.[147] The report points to the 2007 changes made by Interior to increase the royalty rate for new offshore leases in the Gulf of Mexico. Interior estimated that the royalty rate increase from 12.5 percent to 18.75 percent would increase oil and gas revenues by $8.8 billion over the next 30 years.[148] However, Interior did not comprehensively evaluate the entire federal oil and gas system, and therefore left onshore royalty rates unchanged, and did not produce written documentation of its analysis and the specific rationale for the increase.

In addition, when calculating royalties owed to the government, Interior's Office of Natural Resources Revenue has been called out for failing to account for higher export prices, especially for coal.[149] Companies may engage in "faux" arm's length transactions, for example, by selling coal to an affiliate which then sells the coal for a higher price overseas. Such companies then report only the initial domestic sale price to the agency, which uses that (lower) price to calculate the royalties due.[150] To ensure a fair return, Interior should

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[143] Center for Western Priorities, *A Fair Share: The Case for Updating Federal Royalties* (2013).

[144] *Id*. at 7.

[145] U.S. Gov't Accountability Office, *The Federal System for Collecting Oil and Gas Revenue Needs Comprehensive Reassessment* (GAO-08-691) ((Sept. 2008) at 5-8 (citing a June 2007 Wood McKenzie report finding that the United States ranked 93rd lowest out of 104 oil and gas fiscal systems evaluated).

[146] *Id*. at 6. Interior might also consider using a tiered rate that increases and decreases with the global price of oil and natural gas, or as production reaches certain thresholds, as some foreign countries do. *See* Law Library of Congress, Global Legal Research Center, REPORT: CRUDE OIL ROYALTY RATES IN SELECTED COUNTRIES (Jan. 2015), available at http://www.loc.gov/law/help/crude-oil-royalty-rates/crude-oil-royalty-rates.pdf.

[147] *Id*. at 17.

[148] *See, e.g.,* Congressional Research Service, *Outer Continental Shelf: Debate Over Oil and Gas Leasing and Revenue Sharing* (2008), available at http://www.au.af.mil/au/awc/awcgate/crs/rl33493.pdf.

[149] U.S. Gov't Accountability Office, *Coal Leasing: BLM Could Enhance Appraisal Process, supra* note 70; Tom Sanzillo, *The Great Giveaway, supra* note 9.

[150] A December 2012 Reuters report alleged that companies including Peabody Energy and Cloud Peak Energy use trading affiliates to hide profits from overseas sales of Powder River Basin coal, to ensure they only pay royalties to the federal government based on lower U.S. sales prices. Patrick Rucker, "Asia coal export boom brings no bonus for U.S. taxpayers," REUTERS (Dec. 4, 2012), available at http://www.reuters.com/article/2012/12/04/us-usa-coal-royalty-idUSBRE8B30IL20121204.

establish procedures to verify arm's-length transactions and curtail any improper gaming of the system. The Office of Natural Resources Revenue's proposed rule, released in January 2015, would clarify the definition of arm's-length transactions and give the agency more authority to police this practice.[151]

> ***RECOMMENDATIONS*: *Interior should increase royalty rates to reflect environmental and social costs that result from production, and modernize antiquated royalty relief provisions.***

First, Interior should comprehensively review onshore and offshore royalty rates at the same time, in order to assess how an increase in royalty rates might affect overall returns and better meet the mandates of the Federal Land Policy and Management Act, Mineral Leasing Act, and Outer Continental Shelf Lands Act. Onshore royalty rates are overdue for an increase, and many of the factors that led Interior to update its offshore royalty rates in 2007 have been present in the onshore market for nearly as long, such as technological advancement, political stability, and relatively high resource prices.

Second, Interior should consider increasing minimum royalty rates above current levels to account for foreseeable environmental and social costs of production. For all leases obtained competitively, BLM and BOEM are permitted to negotiate royalty rates with energy leaseholders on a lease-by-lease basis; however, most federal onshore and offshore leases are set at or near the statutorily prescribed minimum: 12.5 percent for onshore oil, gas and surface coal production, and 18.75 for offshore oil and gas in the Gulf of Mexico.[152]

A minimum royalty rate that would assure a fair return to the public should account for: (1) negative externalities imposed on the local environment and communities, (2) infrastructure demand (e.g., water, power, roadways, processing facilities, and pipelines); and (3) any foreseeable "waste" of the resource, such as vented or flared methane (which is primarily composed of natural gas) associated with natural gas, oil, and coal production.[153] For example, a royalty rate adjustment to account for anticipated vented or flared methane may be particularly appropriate, as the Mineral Leasing Act requires oil and gas lessees to "use all reasonable precautions to prevent waste of oil or gas developed in the land."[154]

Third, for individual leases, BOEM and BLM should assess foreseeable environmental and social costs by converting projections found in site-specific assessments and environmental impact statements, required by NEPA, into "externality adjustments"

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[151] Office of Natural Resources Revenue, *Proposed Rule: Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform*, 80 Fed. Reg. 608-613 (Jan. 6, 2015).

[152] 30 U.S.C. § 207(a) (surface coal mines); 43 C.F.R. § 3473.3-2 (underground coal mines); 30 U.S.C. § 226(b)-(c) (onshore oil and gas); 43 U.S.C. § 1337 (offshore oil and gas).

[153] *See, e.g.*, Jayni Foley Hein, Institute for Policy Integrity at NYU School of Law, *Capturing Value: Science and Strategies to Curb Methane Emissions from the Oil and Natural Gas Sector* (Dec. 2014), available at http://policyintegrity.org/files/publications/Capturing_Value_-_Methane_Policy_Brief.pdf.

[154] 30 U.S.C. § 225.

that may raise the royalty rate by a certain percentage.[155] This adjustment could be made on a lease-by-lease basis or for each lease sale, and could account for the type of resource to be extracted, method of production, and type and extent of the anticipated externalities. Relying on NEPA documents would appropriately narrow the agencies' attention to "reasonably foreseeable environmental effects of the action," rather than every conceivable possibility.[156]

Finally, Interior should eliminate existing royalty relief provisions that provide improper incentives to energy companies that run counter to the dual mandates of the Federal Land Policy and Management Act and the Outer Continental Shelf Lands Act. Specifically, Interior's Office of Natural Resources Revenue currently allows companies to subtract transportation and processing costs from the federal royalties they owe, including fuel costs, terminal operator fees, and more.[157] This does not provide any incentives for companies to locate production closer to refineries or end energy users, or to use more efficient modes of transportation. More generally, it does not provide incentives for the production to be located at the socially optimal place. Therefore, companies may emit more carbon dioxide in transporting oil, gas, and coal than is socially optimal, creating negative externalities. Interior should consider eliminating this royalty relief provision altogether, or strongly limiting its scope. This royalty relief provision runs counter to the explicit aims of the Mineral Leasing Act to prevent waste, and to the Federal Land Policy and Management Act's goal to protect the quality of "air and atmospheric" resources, and to "protect certain public lands in their natural condition."[158]

III. CONCLUSION

The fiscal terms of federal oil, gas, and coal leases do not require energy producers to internalize the foreseeable environmental and social costs of fossil fuel extraction. Failing to account for these costs in the terms of federal leases shifts them onto tax payers, who already receive an improperly low return due to outdated valuation regulations. To ensure that the American public receives a fair return, the Interior should revise its fiscal

[155] While raising royalty rates might have the effect of shifting some development to state and private lands, the most attractive federal parcels, where discovery and development prospects are strongest, would likely continue to be sold competitively at auction. Moreover, potential production decreases resulting from higher royalty rates, if any, could result in environmental and social benefits, such as reduced habitat and surface disruption, reduced hazardous air pollution, greater mineral resource conservation, and more. *See* Department of the Interior, Bureau of Land Management, *Advance Notice of Proposed Rulemaking: Oil and Gas Leasing; Royalty on Production, Rental Payments, Minimum Acceptable Bids, Bonding Requirements, and Civil Penalty Assessments*, 80 Fed. Reg. 22148, 22152 (April 21, 2015).

[156] *See Theodore Roosevelt Conservation P'ship v. Salazar*, 605 F. Supp. 2d 263, 274 (D.D.C. 2009) *aff'd*, 616 F.3d 497 (D.C. Cir. 2010); *Hammond v. Norton*, 370 F.Supp.2d 226, 245–46 (D.D.C. 2005). *See also Pub. Utils. Comm'n of Cal. v. FERC*, 900 F.2d 269, 282–83 (D.C. Cir. 1990) (finding that NEPA does not require agencies to consider environmental effects of actions that are not reasonably foreseeable, especially in light of the agency's discussion of how it would mitigate any effects that may occur in the future); *cf. NRDC v. Hodel*, 865 F.2d 288, 298–99 (D.C. Cir.1988) (finding a "few sentences" in the Final Environmental Impact Statement insufficient to address the effects of "reasonably foreseeable" actions).

[157] *See* 30 C.F.R. § 1206.109-1206.111.

[158] *See* 43 U.S.C. § 1701(a)(8).

terms to account for option value and environmental and social externalities. This report's recommendations would help to provide a fair market value for the public's natural resources, and harmonize the government's dual mandate of preservation and production.

Exhibit B

May 4, 2017

VIA ELECTRONIC SUBMISSION

Attn: Luis Aguilar, Regulatory Specialist, (303) 231–3418, Luis.Aguilar@onrr.gov, Office of Natural Resources Revenue

Re: RIN 1012-AA21; Docket No. ONRR-2017-0002; Advanced Notice of Proposed Rulemaking

The Institute for Policy Integrity ("Policy Integrity") at New York University School of Law[1] submits the following comments in response to the Office of Natural Resources Revenue's ("ONRR") Advance Notice of Proposed Rulemaking ("ANPR") requesting comments on whether revisions are necessary to the regulations governing coal, oil, and gas royalties.[2]

Policy Integrity is a non-partisan think tank dedicated to improving the quality of government decisionmaking through advocacy and scholarship in the fields of administrative law, economics, and public policy. We write to make the following comments:

1. ONRR just recently finalized substantial revisions to the regulations governing coal, oil, and gas royalties (the "Reform Rule").[3] There is no valid basis to repeal those revisions and ONRR should implement them before considering further revisions.
2. If ONRR repeals those revisions, ONRR should reform the regulations as follows:
    a. ONRR should eliminate the benchmarks and require lessees to pay royalties based on the "values established in arm's-length transactions,"[4] as laid out in the Reform Rule.
    b. ONRR should end the use of royalty relief provision for uneconomical mining and eliminate the transportation allowance. In the alternative, ONRR should increase transparency in both areas.
    c. ONRR should maintain the "default" provision.

[1] This document does not purport to present New York University School of Law's views, if any.

[2] Federal Oil and Gas and Federal and Indian Coal Valuation; Advance Notice of Proposed Rulemaking, 82 Fed. Reg. 16325 (Apr. 4, 2017).

[3] Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform; Final Rule, 81 Fed. Reg. 43338, 43338 (July 1, 2016).

[4] *Id.* at 43349.

We also attach here (a) Policy Integrity's earlier comments on the proposed Reform Rule[5] and (b) Policy Integrity's comments in response to ONRR's Proposed Repeal (RIN 1012-AA20).[6] These earlier comments are consistent with our comments and recommendations now and we request that they be included in this rulemaking record.

I. ONRR Should Implement the Reform Rule Before Considering Any Further Revisions.

On July 1, 2016, ONRR finalized the Reform Rule and it went into effect on January 1, 2017.[7] The final Reform Rule was the result of five years of study and public participation[8] and was designed "to offer greater simplicity, certainty, clarity, and consistency in product valuation and reporting for mineral lessees."[9] The Reform Rule accomplished its purpose through two major reforms: first, by closing a loophole that allowed lessees to pay royalties based on the value of the minerals as sold through captive (instead of arm's length) transactions, [10] and second, by allowing for the audit and identification of transportation cost allowances.[11]

As we explained in our comments on the proposed repeal, there is no valid basis to repeal the Reform Rule.[12] ONRR should implement the Reform Rule, study the implementation, and request public comment on the implementation before embarking on any further revisions.

There is one procedural "revision" that is needed now though. ONRR must confirm that the Reform Rule has been in effect since January 1, 2017. On February 22, 2017,[13] ONRR attempted to postpone the "effective" date of the Reform Rule, but that "postponement" was invalid for three reasons and the Reform Rule remains a valid and effective rule.

First, though ONRR invoked its authority under 5 U.S.C. § 705 to postpone the Reform Rule, the rule had already gone into effect on January 1, 2017, and could not be postponed after its effective date.[14] Second, even if ONRR could stay the Reform Rule under § 705, ONRR

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[5] Institute for Policy Integrity, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform (May 8, 2015), *available at* https://onrr.gov/Laws_R_D/PubComm/PDFDocs/AA13/NYU-Law-Report-Institute-for-Policy-Integrity.pdf, attached as **Exhibit A** ("May 2015 Policy Integrity Comments").
[6] Institute for Policy Integrity, Comment Letter on Proposed Repeal (May 4, 2017), attached as **Exhibit B** ("May 2017 Policy Integrity Comments").
[7] 81 Fed. Reg. at 43338.
[8] *Id.*
[9] *Id.*
[10] *See, e.g., id..* at 43346 (gas), 43354-55 (coal).
[11] *Id.* at 43352-53 (oil); *id.* at 43344-445 (gas).
[12] May 2017 Policy Integrity Comments, *supra*, Ex. B.
[13] Postponement of Effectiveness of the Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform 2017 Valuation Rule, 82 Fed. Reg. 111823 (Feb. 27, 2017).
[14] *See Safety-Kleen Corp. v. EPA*, 1996 U.S. App. LEXIS 2324 *2-3 (D.C. Cir. Jan. 19, 1996) (per curiam).

was not authorized to stay the Reform Rule without notice and comment. Indefinite stays, such as this one, [15] are "tantamount to a revocation" and as a result are subject to the same notice-and-comment rules that apply to repeals.[16] And, third, even if it had authority to issue the stay, ONRR must satisfy the injunction standard to justify the stay.[17] ONRR failed to analyze these factors when it issued the stay and the stay should be lifted.

II. If the Reform Rule Is Repealed, ONRR Should Reform the "Pre-Existing" Regulations Along Substantially the Same Lines as the Reform Rule.

ONRR has asked for comments on whether it should revise the "pre-existing" regulations if ONRR repeals the Reform Rule.[18] ONRR is statutorily charged with collecting, accounting for, and verifying natural resource and energy revenues[19] and—in the event of any repeal—should finalize a new reform that is substantially similar to the Reform Rule.

ONRR has the duty to "receive the fair market value" for the use of public lands.[20] ONRR is prohibited from accepting a bid for coal mining on federal land that is for "less than the fair market value."[21] And ONRR is required (a) to have a system that allows it "to accurately determine oil and gas royalties"[22] and (b) to "ensure the prompt and proper collection and disbursement of oil and gas revenues owed to the United States and Indian lessors and those inuring to the benefit of States."[23] Indeed, ONRR acknowledges in the ANPR that it has a "responsibility to ensure fair value for the public's resources."[24]

If the Reform Rule is repealed, ONRR should make the following reforms in order to comply with its statutory mandate:

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[15] *See* 81 Fed. Reg. at 43338 (explaining that the stay is supposed to last as long as the *Cloud Peak* litigation remains pending); Order, *Cloud Peak Energy Inc. v. Dep't of Interior*, 16 Civ. 00315 (Dist. Wyo. April 27, 2017), ECF No. 33 (staying the *Cloud Peak* litigation until the repeal rulemaking is completed).
[16] *NRDC v. EPA*, 683 F.2d 752, 763 n. 23 (3rd Cir. 1982); *see also Envt'l Def. Fund, Inc. v. Gorsuch*, 713 F.2d 802, 818 (D.C. Cir. 1983); *Envt'l Def. Fund, Inc. v. EPA*, 716 F.2d 915, 921 (D.C. Cir. 1983) (a deadline's imminence does not give the agency "good cause" to suspend a rule without complying with the APA's notice and comment requirements); *Sierra Club v. Jackson*, 833 F. Supp. 2d 11, 27 (D.D.C. 2012).
[17] *Sierra Club*, 833 F. Supp. 2d at 30 (collecting cases); *Jeffrey v. Office of Pers. Mgmt.*, 28 M.S.P.R. 434, 435–36 (Merit Systems Protection Board 1985).
[18] 82 Fed. Reg. at 16326.
[19] Mineral Leasing Act, 30 U.S.C. §§ 181–287; Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331–1356; Federal Oil & Gas Royalty Management Act, 30 U.S.C. § 1701. *See* 81 Fed. Reg. at 43,369.
[20] 43 U.S.C. § 1701(a)(9).
[21] 30 U.S.C. § 201(a)(1).
[22] *Id.* § 1711(a).
[23] *Id.* § 1701(b)(3).
[24] 82 Fed. Reg. at 16326.

A. ONRR should eliminate the benchmarks and require lessees to pay royalties based on the prices set in arm's-length sales of the resources instead.

Royalty rates are negotiated on a lease-by-lease basis, but federal statutory minimums are set at: 12.5% for surface coal, oil, and natural gas; 8% for subsurface coal; and 12.5% for offshore oil and natural gas in the Gulf of Mexico.[25] Despite these statutory minimums, between 2008 and 2012, the average effective royalty rate received by the federal government for all federal coal leases, based on the gross market value of coal, was 4.9%.[26] Wyoming, for example, which held 86% of coal lease sales on federal land during this period, had an effective average royalty rate of 5%.[27] New Mexico had a rate of 6.8%.[28] North Dakota (at 0.7%) and Oklahoma (at 2.2%) have the lowest effective rates; Kentucky (at 7.8%) has the highest effective rate.[29] As a result, taxpayers were shortchanged by approximately $850 million between 2008 and 2012.[30]

The disparity between the statutory minimum and actual royalty rates paid resulted from several factors. The most important factor was that companies were taking advantage of ONRR's "benchmark" system to pay royalties only on lower domestic sales prices obtained through captive transactions rather than on the real (market) price obtained through the ultimate arm's length sale.

Though the benchmark system had required lessees to value their coal on the basis of an arm's length transaction, it nonetheless allowed lessees to use "captive" transactions because of the complex valuation methods used to calculate the benchmark price.[31] Under the system, if a lessee sold the minerals to an affiliate in a non-arm's length sale, the lessee was required to value the sale based on a series of benchmarks, to be applied in a specific order.[32] The first benchmark was "the gross proceeds accruing to the lessee in a sale under its non-arm's-length contract, provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under comparable arm's length contracts."[33] The problem was that it was difficult to obtain information about "comparable" sales because that information is considered proprietary information.[34] Disputes had arisen "over which

[25] 30 U.S.C. § 207(a) (surface coal mines); 43 C.F.R. § 3473.3-2(a)(2) (underground coal mines); 30 U.S.C. § 226(b)-(c) (onshore oil and gas); 43 U.S.C. § 1337 (offshore oil and gas).
[26] *See* Headwaters Economics, An Assessment of U.S. Federal Coal Royalties 1 (2013) ("Headwaters Report"), *available at* https://headwaterseconomics.org/wp-content/uploads/Report-Coal-Royalty-Valuation.pdf.
[27] *Id.* at 16-17.
[28] *Id.*
[29] *Id.*
[30] *Id.* at 25.
[31] *See* Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform; Proposed Rule, 80 Fed. Reg. 608, 616-7 (Jan. 6, 2015).
[32] *See id.* at 617.
[33] *Id.*; *see also id.* at 621, 628.
[34] *Id.* at 617.

sales are comparable, particularly because of the inherent ambiguity in applying the comparability factor."[35]

As a result of these ambiguities, companies like Peabody Energy and Cloud Peak Energy were able to pay royalties only on the low price they obtained through a captive transaction with an affiliate, even though the affiliate resold the minerals to an overseas purchaser for a much higher profit.[36] According to the U.S. Energy Information Administration ("EIA"), forty-two percent of all coal produced in Wyoming in 2012 was sold through "captive" transactions, greatly reducing the amount of royalties that companies had to pay.[37] In 2013, Cloud Peak admitted that, "[i]f the federal government were to materially alter the benchmarks system, its "profitability and cash flows could be materially adversely affected."[38]

Because the royalty rates that ONRR was receiving were so much lower than the federal statutory minimums, the Government Accountability Office repeatedly called on Interior to reform the system.[39] In addition, reforming the royalty system has had bipartisan congressional support.[40] ONRR responded to these concerns by issuing the Reform Rule and eliminating the benchmarks.[41]

In the ANPR, ONRR has asked how "best to value non-arm's-length coal sales and/or sales between affiliates" if the Reform Rule is repealed.[42] The best way to value non-arm's length

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[35] *Id.* at 628.

[36] Patrick Rucker, "Asia coal export boom brings no bonus for U.S. taxpayers," *Reuters* (Dec. 4, 2012), *available at* http://www.reuters.com/article/2012/12/04/us-usa-coal-royalty-idUSBRE8B30IL20121204; *see also* Headwaters Report at 9-10.

[37] U.S. Energy Information Administration, *Annual Coal Report 2012* ("Annual Coal Report"), Table 8 at 14, *available at* http://www.eia.gov/coal/annual/.

[38] Cloud Peak Energy, 2013 10-K, *available at* http://investor.cloudpeakenergy.com/sec-filings.

[39] U.S. Gov't Accountability Office, Oil and Gas Resources: Interior's Production Verification Efforts and Royalty Data Have Improved, but Further Actions Needed (GAO-15-39) (2015); U.S. Gov't Accountability Office, Actions Needed For Interior to Better Ensure A Fair Return (GAO-14- 50) (2013); U.S. Gov't Accountability Office, The Federal System for Collecting Oil and Gas Revenues Needs Comprehensive Reassessment (GAO-08-691) (2008) at 7-10; U.S. Gov't Accountability Office, Oil and Gas Revenues (GAO-07-676R) (May 2007); *see also* Tom Sanzillo, Institute for Energy Economics & Financial Analysis, The Great Giveaway: An Analysis of the Costly Failure of Federal Coal Leasing in the Powder River Basin at 3 (2012) (estimating that the federal government lost $28.9 billion in revenues over 30 years due to BLM's failure to receive fair market value for coal mined in the Powder River Basin, which produces forty-four percent of the nation's coal); John M. Broder, "Undervalued Coal Leases Seen as Costing Taxpayers," N.Y. Times (June 11, 2013); U.S. Department of the Interior, Office of the Inspector General, Evaluation: Coal Management Program (June 2013), *available at* http://www.documentcloud.org/documents/712402-inspector-generals-report-on-coal-leases.html.

[40] Press Release, Wyden, Murkowski Seek Answers on Coal Royalty Payments (Jan. 2013), *available at* https://www.wyden.senate.gov/news/press-releases/wyden-murkowski-seek-answers-on-coal-royalty-payments.

[41] *See, e.g.*, 81 Fed. Reg. at 43346 (gas), 43354-55 (coal).

[42] 82 Fed. Reg. at 16326.

coal sales is to use the "values established in arm's-length transactions."[43] The way to do that—if the Reform Rule is repealed—is to again eliminate the use of "benchmark" prices and require lessees to pay royalties based on the prices set in arm's-length sales of the resources instead.[44] Lessees should be permitted to value their oil and gas based on the "(1) the first arm's-length-sale prices, (2) optional index prices, or (3) volume weighted average of the values established" in the Reform Rule[45] and to value their coal based on the value of the first arm's length sale.[46]

In the Reform Rule, ONRR estimated that eliminating the benchmarks would increase royalties by an estimated $78.39 million per year.[47] This will benefit states especially. Wyoming, for example, produces a large percentage of the nation's federal coal and stands to gain significant funding for schools, road construction, and municipal budgets with the elimination of the benchmarks.[48] In addition, the benchmarks system was cumbersome and costly for the lessees to use.[49] In the Reform Rule, ONRR estimated that lessees would save $3.61 million per year if they did not need to use the costly benchmarks system.[50]

Eliminating the benchmarks would thus go a long way towards improving "efficiencies for lessees, ONRR, and other stakeholders" and fulfilling ONRR's "responsibility to ensure fair value for the public's resources"—both goals that ONRR cited in the ANPR.[51]

B. ONRR should eliminate (1) royalty rate reductions and (2) transportation allowances.

Another reason for the disparity between statutory minimum royalty rates and actual royalty rates was the application of allowances to reduce the price that was used to determine the value of royalties.[52] For example, the regulations allow lessees to deduct transportation and washing costs.[53] Lessees can also obtain a royalty rate reduction if "the leases cannot be successfully operated under the terms provided therein" due to economic

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[43] 81 Fed. Reg. at 43349.
[44] *See, e.g.*, *id.* at 43346 (gas), 43354-55 (coal).
[45] *Id.* at 43346 (gas), 43373 (oil).
[46] *Id.* at 43354-55 (coal).
[47] 81 Fed. Reg. at 43360
[48] *See* FACT SHEET: FEDERAL COAL ROYALTIES AND THEIR IMPACT ON WESTERN STATES, *available at* https://www.wyden.senate.gov/download/?id=af917fa6-4e2c-4839-bc70-05d5e495b985&download=1; *see also* Headwaters Report at 24 (estimating that Wyoming and Montana would have received an additional 5.6 billion in additional revenue over 2008 to 2012 if royalties "had been valued based on the gross market price over this same period").
[49] *See* Headwaters Report at 9.
[50] 81 Fed. Reg. at 43359-67.
[51] 82 Fed. Reg. at 16326.
[52] Headwaters Report at 8.
[53] *See, e.g.*, 81 Fed. Reg. at 43,394.

hardship or to promote development (the "hardship reduction").[54] Royalty rate reductions occurred on thirty-six percent of leases since 1990, and lowered royalty payments by $ 294 million.[55]

1. Eliminate the "hardship reductions."

ONRR should eliminate the use of the hardship reduction for uneconomical mining because it subsidizes uneconomical production from public lands, at a loss to taxpayers. 30 U.S.C. § 209 allows Interior to grant reductions where mining would not otherwise be profitable, but the statute leaves any decision to grant a reduction to Interior's discretion.[56] If the mining is not profitable, then it makes no sense for Interior to exercise its discretion to subsidize that mining. Allowing reductions for unprofitable mining is directly at odds with managing the federal coal program to maximize the net return to taxpayers and it does not serve the purposes of the statute.

In the alternative, ONRR should make hardship reductions public. There is no basis for keeping the reductions confidential. As a subsidy that is granted in the "judgment"[57] of Interior, the public has a right to know what those subsidies are and whether Interior has exercised that discretion appropriately.[58]

Even if the individual rate reductions are considered protectable "confidential" information, ONRR should report the aggregate number of rate reduction requests it receives, the number of requests that have been granted and the justifications for those reductions, and the volume anticipated to be valued at the reduced rate. These aggregate numbers would not disclose any "confidential" data about individual mines, but they would provide important protections to the public. The public could use this information to begin

[54] 30 U.S.C. § 209 (Interior may "waive, suspend, reduce" royalties whenever "necessary" to "to promote development, or whenever in his judgment the leases cannot be successfully operated under the terms provided therein"); *see also* 30 C.F.R. 203.1 (authority to reduce or eliminate royalties for mining on outer continental shelf "to promote development, increase production, or encourage production of marginal resources"); 43 CFR 3473.3-2 (e) ("The Secretary, whenever he/she determines it necessary to promote development or finds that the lease cannot be successfully operated under its terms, may waive, suspend or reduce the rental, or reduce the royalty but not advance royalty, on an entire leasehold, or on any deposit, tract or portion thereof, except that in no case shall the royalty be reduced to zero percent."); 43 C.F.R. § 3485.2 (c)(1) (authorization to "waive, suspend or reduce" royalties "for the purpose of encouraging the greatest ultimate recovery of Federal coal, and in the interest of conservation of Federal coal and other resources, whenever in his judgment it is necessary to promote development, or if he finds that the Federal lease cannot be successfully operated under its terms"); *see also* Headwaters Report at 8.

[55] Headwaters Report at 8, 14.

[56] 30 U.S.C. § 209; *see also* 43 CFR 3473.3-2 (e).

[57] 30 U.S.C. § 209.

[58] *Multi Ag Media LLC v. Dep't of Agric.*, 515 F.3d 1224, 1232 (D.C. Cir. 2008) (the public has a "particular and significant interest" in information that the Department of Agriculture uses "in the administration of its subsidy and benefit programs, and there is a special need for public scrutiny of agency action that distributes extensive amounts of public funds in the form of subsidies and other financial benefits").

to assess whether the aggregate amount of reductions is valid and justified. ONRR has committed to increased transparency and accountability in the extractive industries[59] and this disclosure would help serve those ends.

2. Eliminate the transportation allowances.

If the Reform Rule is repealed, the transportation allowances should be eliminated in a new reform. There were several problems with the transportation allowances in the "pre-existing" regulations prior to the Reform Rule. Lessees were permitted to "net" the transportation costs when reporting sales rates, which made it difficult to determine how much of the allowance was legitimately due to transportation costs.[60] Indeed, lessees admitted in their comments on the proposed Reform Rule that they had been including non-transportation costs in the allowance, and thus had been inflating their transportation costs with non-transportation expenses.[61] In addition, allowing—and encouraging—transportation cost allowances leads to increased transportation-related externalities (including particulate matter emissions, public fatalities, noise, and congestion), which are harmful to the public and the environment.[62]

Executive Order 12866 instructs agencies to "assess both the costs and the benefits of the intended regulation and, recognizing that some costs and benefits are difficult to quantify, propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs."[63] In 2003 guidance, the Office of Management and Budget explained that agencies may need to include the costs of "negative externalities (e.g., pollution)" when analyzing regulations.[64] And pursuant to statute, ONRR must take the costs of such harmful externalities into account in setting royalty rates. For example, the Federal Land Policy and Management Act requires ONRR to protect the environment[65] and manage public lands to allow for multiple uses, including "uses that take[] into account the long-term needs of future generations for renewable and nonrenewable resources,

[59] ONRR Website, About Us, Overview, https://www.onrr.gov/About/default.htm ("With an increased focus on making data more accessible to the public, ONRR is leading the Federal government's implementation of the U.S. Extractive Industries Transparency Initiative (USEITI) and working to improve transparency and accountability across the Department. ") (accessed on May 3, 2017).
[60] *See* 81 Fed. Reg. at 43344.
[61] *See id.*
[62] *See* Jayni Hein, Priorities for Federal Coal Reform at 13-14, Institute for Policy Integrity (June 2016), *available at* http://policyintegrity.org/files/publications/Priorities_for_Coal_Reform.pdf.
[63] Executive Order 12866, Regulatory Planning and Review (1)(b)(6), 58 Fed. Reg. 51735 (Sept. 30, 1993).
[64] Circular A-4, Regulatory Analysis at 21 (Sep't 17, 2003), 68 Fed. Reg. 58366 (Oct. 9, 2003).
[65] 43 U.S.C. § 1701(a)(8).

including, but not limited to, recreation, range, timber, minerals, watershed, wildlife and fish, and natural scenic, scientific and historical values."[66]

When lessees can deduct too much for transportation they may be encouraged to transport their oil, gas, or coal far from the place of production, which is inefficient and costly and imposes harmful externalities on society.[67] Stated differently, the transportation allowances do not provide any incentives for companies to locate production closer to refineries or end energy users, or to use more efficient modes of transportation. As a result, companies may emit more pollution in transporting oil, gas, and coal than is socially optimal, creating negative externalities. This royalty relief provision runs counter to the explicit aims of the Mineral Leasing Act to prevent waste, and to the Federal Land Policy and Management Act's goal to protect the quality of "environmental, air and atmospheric" resources, and to "protect certain public lands in their natural condition."[68]

ONRR has already received multiple comments as part of the Reform Rule, recommending that ONRR eliminate the transportation allowances because they provided improper incentives to energy companies to find the most efficient means of transportation or to locate resource production closer to end users.[69] If the Reform Rule is repealed, ONRR should finalize a new reform and eliminate the transportation allowance for oil, gas, and coal.

In the alternative, ONRR should reinstate the changes to transportation allowances that were in Reform Rule. First, as in the Reform Rule, ONRR should again eliminate the

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[66] *Id.* § 1702(c) (" 'Multiple use' means the management of the public lands and their various resource values so that they are utilized in the combination that will best meet the present and future needs of the American people; . . . the use of some land for less than all of the resources; a combination of balanced and diverse resource uses that takes into account the long-term needs of future generations for renewable and nonrenewable resources, including, but not limited to, recreation, range, timber, minerals, watershed, wildlife and fish, and natural scenic, scientific and historical values; and harmonious and coordinated management of the various resources without permanent impairment of the productivity of the land and the quality of the environment with consideration being given to the relative values of the resources and not necessarily to the combination of uses that will give the greatest economic return or the greatest unit output.").
[67] *See* Institute for Policy Integrity, Reconsidering Coal's Fair Market Value at 12, *available at* http://policyintegrity.org/files/publications/Coal_fair_market_value.pdf (Oct. 2015).
[68] 43 U.S.C. § 1701(a)(8).
[69] *See, e.g.*, May 2015 Policy Integrity Comments, *supra*, Ex. A; Center for American Progress, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform at 12-13 (May 8, 2015), *available at* https://www.regulations.gov/document?D=ONRR-2012-0004-0266; Wilderness Society, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform at 4-5, 8 (May 11, 2015), *available at* https://www.regulations.gov/document?D=ONRR-2012-0004-0298; Sierra Club, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform (May 8, 2015), *available at* https://www.regulations.gov/document?D=ONRR-2012-0004-0250; *see also* Utah Physicians for a Happy Environment, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform (May 11, 2015), *available at* https://www.regulations.gov/document?D=ONRR-2012-0004-0299.

provision that allowed lessees to "net transportation from their gross proceeds" when calculating the amount of royalties they owe.[70] Lessees should be required to instead report those costs as a separate entry on Form ONRR–2014.[71] ONRR should require this for coal, oil, and gas lessees. Requiring lessees to report transportation costs separately "increases transparency" and helps ONRR "verify that such costs are a reasonable and actual cost that lessees incur for transportation."[72]

Second, ONRR should again eliminate lessees' ability to deduct transportation costs that are more than fifty percent of the value of the lessee's gas and oil production.[73] ONRR should also restrict the allowance for coal to fifty percent. The fifty-percent cap on transportation allowances reduces lessees' ability to inappropriately inflate transportation costs.[74]

As one final comment on this topic, externalities should also be accounted for in defining the term "fair market value." Any definition of "fair market value" should account for: (1) negative externalities imposed on the local environment and communities, (2) infrastructure demand (e.g., water, power, roadways, processing facilities, and pipelines); and (3) any foreseeable "waste" of the resource, such as vented or flared methane (which is primarily composed of natural gas) associated with natural gas, oil, and coal production.[75] Some of these adjustments have been considered as part of Interior's comprehensive review of the federal coal program.[76] If that process stalls, Interior should consider opening up another rulemaking process to decide how to define "fair market value" and take into account externalities.

C. ONRR should maintain the "default provision" as imposed by the Reform Rule.

ONRR has also asked "[w]hether ONRR should have a default provision clarifying how ONRR will exercise Secretarial authority to determine value for royalty purposes in cases where there is misconduct, breach of duty to market, or ONRR cannot otherwise verify

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[70] 81 Fed. Reg. at 43352-53 (oil); *id.* at 43344-445 (gas).
[71] *Id.* at 43344-445 (gas); *see also id.* at 43352-53 (oil); *id.* at 43353 (coal).
[72] *Id.* at 43345.
[73] *Id.* at 43343 (oil); *id*. at 43352 (gas).
[74] *See* May 2015 Policy Integrity Comments, *supra*, Ex. A.
[75] See Jayni Foley Hein and Peter Howard, Illuminating the Hidden Costs of Coal, Institute for Policy Integrity, NYU School of Law (Dec. 2015), *available at* http://policyintegrity.org/files/publications/Hidden_Costs_of_Coal.pdf; Jayni Foley Hein and Peter Howard, Reconsidering Coal's Fair Market Value, Institute for Policy Integrity, NYU School of Law (Oct. 2015), *available at* http://policyintegrity.org/files/publications/Coal_fair_market_ value.pdf; Jayni Foley Hein, Institute for Policy Integrity at NYU School of Law, *Capturing Value: Science and Strategies to Curb Methane Emissions from the Oil and Natural Gas Sector* (Dec. 2014), *available at* http://policyintegrity.org/files/publications/Capturing_Value_-_Methane_Policy_Brief.pdf.
[76] U.S. Dep't of Interior Press Release, Secretary Jewell Launches Comprehensive Review of Federal Coal Program, Jan. 1, 2016, *available at* https://www.doi.gov/pressreleases/secretary-jewell-launches-comprehensive-review-federal-coal-program.

value.” [77] The answer is yes. If ONRR repeals the Reform Rule, ONRR should still use a default provision, as laid out in that rule.

As ONRR explained in the Reform Rule, the “default provision” simply codifies ONRR’s undisputed “authority to determine the value of production for royalty purposes.”[78] It also provides certainty to lessees because it “specifically enumerates when, where, and how the Secretary will use that discretion.”[79] This will also ensure that one of ONRR’s goals in the ANPR is met: that lessees have “early certainty that correct payment has been made.”[80]

The default provision does not inject uncertainty into the program. As ONRR explained in the Reform Rule, the default provision will only be used under “very specific” circumstances that make it impossible for ONRR to otherwise determine the correct royalty rate.[81] For example, it would apply where a lessee failed to provide the required documents, the lessee engaged in “misconduct,” the lessee breached the “duty to market,” or “any other situation that significantly compromises the Secretary’s ability to reasonably determine the correct value.”[82] Lessees have control over whether these circumstances occur. Thus, if ONRR invokes the default provision in response to any of these circumstances it would hardly be a surprise. Moreover, because ONRR has always had the undisputed “authority to determine the value of production for royalty purposes”[83] the use of the default provision to determining those values does not change, in any material respect, lessees’ “certainty that correct payment has been made.”[84] If anything, it improves the certainty.

ONRR should lift the illegal stay and confirm that Reform Rule remains in effect.

Respectfully,

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[77] 82 Fed. Reg. at 16327.
[78] 81 Fed. Reg. at 43341.
[79] *Id.*
[80] 82 Fed. Reg. at 16326.
[81] 81 Fed. Reg. at 43341.
[82] *Id.*
[83] 81 Fed. Reg. at 43341.
[84] 82 Fed. Reg. at 16326.