May 4, 2017

Office of Natural Resources Revenue
Building 53, Entrance E-20
Denver Federal Center
West 6th Ave. and Kipling St.
Denver, CO 80225
ATTN: Armand Southall and Luis Aguilar

Submitted via www.regulations.gov

Re: Comments on ONRR Proposed Actions:
Proposed Rule: Repeal of Consolidated Federal Oil and Gas and Federal and Indian Coal Valuation, Docket No. ONRR-2017-0001
Regulation Identifier Number: 1012-AA20
82 Fed. Reg. 16,323 (April 4, 2017)
and
Advanced Notice of Proposed Rulemaking: Consolidated Federal Oil and Gas and Federal and Indian Coal Valuation, Docket No. ONRR-2017-0002
Regulation Identifier Number: 1012-AA21
82 Fed. Reg. 16,325 (April 4, 2017)

Dear Mr. Southall and Mr. Aguilar:

The Sierra Club and Earthjustice submit these comments regarding the Office of Natural Resource Revenue's ("ONRR's") dual proposals that (1) would repeal the ONRR regulations finalized on July 1, 2016 (hereafter "the 2016 Rules")[1] that closed widely-exploited loopholes in the rules governing the calculation of royalties owed on coal, oil, and natural gas generated from federal lands and coal produced on Native American lands; and (2) solicit input on potential changes to the royalty regulations for federal coal, oil, and gas and Indian coal set out at 30 C.F.R. Parts 1202 and 1206 via an Advanced Notice of Proposed Rulemaking ("ANPR").

These comments address the rules controlling royalties owed on the production of publicly-owned coal; we do not address ONRR's proposals regarding oil and natural gas, or coal produced from tribal lands.

[1] The 2016 Rules can be found at 81 Fed. Reg. 43,338 et seq. (July 1, 2016).

As explained in greater detail below and in our attached comments submitted on ONRR's draft royalty valuation rules from 2015,[2] Sierra Club and Earthjustice urge ONRR to take the following actions:

1) Do not repeal the 2016 Rules that made common-sense changes to royalty calculations on the sale of publicly-owned natural resources;

Further, ONRR should update the 2016 Rules to reflect the following changes:

2) Move the point-of-valuation for federal coal sales from the first arms-length-transaction to the final point of sale;

3) Eliminate all washing deductions that allow coal companies to deduct the cost of washing coal before putting it in marketable condition from the royalties owed;

4) Eliminate or significantly limit allowable transportation deductions;

5) Revise the "default" valuation provisions to require ONRR to independently set the royalty where the lessee engages in fraud, deception, or fails to meet its obligations to give ONRR the information necessary to accurately calculate the royalties required to ensure taxpayers are fairly compensated for the sale of publicly-owned resources.

I. ONRR SHOULD NOT REPEAL THE 2016 RULES.

Consistent with its objectives of offering greater simplicity, certainty, clarity, and consistency in federal royalty valuations, ONRR should keep the 2016 Rules in place. As explained in our prior comments to ONRR on this topic, the 2016 Rules made critically important, common-sense changes to outdated valuation policies by closing an accounting loophole that in recent years has been widely-exploited by the coal industry. Those loopholes enabled coal companies to sell federal coal to wholly-owned subsidiaries, pay royalties on that artificially-low initial sale price, and reap windfall profits when those subsidiaries later sold the coal at far higher prices without any additional royalty. As ONRR explained in the proposed rule, "[i]n the years since we wrote these regulations, the Secretary of Interior's responsibility to determine the royalty value of minerals produced has not changed, but the industry and marketplace have changed dramatically."[3] Retaining the 2016 Rules would impose minimal costs on industry (a less than 1 percent increase in total federal coal, oil, and gas royalties compared to 2010 levels, with a $3.6 annual *reduction* in industry's reporting compliance costs), have no impact on the production levels for federal or Native American owned natural resources, and generate between $71.9 million and $84.9 million every year for American taxpayers.[4]

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[2] The comments submitted to ONRR by Earthjustice, Sierra Club, and Colorado 350 dated May 8, 2015 are attached hereto as Exhibit 1.

[3] 80 Fed. Reg. 608 (Jan. 6, 2015).

[4] 81 Fed. Reg. 43,359-43,360 (July 1, 2016).

Repealing the 2016 Rules would hurt taxpayers, hurt states that rely on royalty payments, and hurt the federal government. The proposed repeal would not reduce the number of applicable federal regulations, a stated goal of the Trump Administration, but would instead simply reinstate the old ones. It would provide no benefit to miners and others who work in these industries, as ONRR's own analysis shows that production will remain unchanged with or without these rules.[5] The only beneficiaries would be coal executives who get to pad their bottom line by depriving taxpayers tens of millions of dollars every year. By ushering in a return to the outdated regulations that less than a year ago ONRR concluded had not kept pace with industry changes, the Trump Administration's plan would deliberately take money from taxpayers and give it to coal companies.

The Trump Administration's proposal would transform what was once an unintentional loophole exploited by industry into a deliberate gift to coal, oil, and natural gas executives that profit by polluting our public lands. This is a transparently flawed proposal and should be rejected.

II. ONRR SHOULD UPDATE FOUR SPECIFIC ASPECTS OF THE 2016 RULES TO BETTER PROTECT TAXPAYERS ON THE SALE OF TAXPAYER-OWNED COAL.

While ONRR must retain the 2016 Rules to ensure that companies cannot use clever accounting to deprive U.S. taxpayers of royalties on coal sold in captive transactions, it must also update those rules to ensure that taxpayers garner the full market value of publicly owned coal.

A. ONRR should move the point of valuation to the final point of sale for all federal coal sales.

In order to better protect taxpayers on the sale of taxpayer-owned coal, ONRR should revise the 2016 Rules to move the point of valuation to the final sale. Valuing coal based on its delivered price, rather than mine price, yields significant benefits. Fundamentally, it eliminates the opportunity for companies to structure their transactions to artificially reduce the value of their coal to escape paying royalties on the higher final sale price of the coal. This in turn would eliminate disputes over whether initial sales are in fact arm's-length transactions and provide industry, ONRR, and the public with greater certainty and clarity around the amount of royalties owed. Additionally, such a regulatory change would ease the burden on ONRR to determine when company valuations are accurate or the result of misconduct or a clever corporate configuration. Rather than auditing a company's reported valuation for the first arm's-length sale (as directed under the 2016 Rules), or applying a complicated five-tiered benchmarking process (as ONRR proposes reverting to), moving the valuation to the final point of sale would simplify the inquiry and eliminate the need to rely on proprietary sales contracts.

[5] 81 C.F.R. 43,360 (July 1, 2016).

B. ONRR should eliminate all allowances for coal washing.

ONRR should eliminate deductions for coal washing. Both the 2016 Rules and the pre-existing rules, require coal royalties, like their oil and gas counterparts, to "be computed on the basis of the quantity and quality of Federal coal in marketable condition."[6] "Marketable condition" is defined as "coal that is sufficiently free from impurities and otherwise in a condition that it will be accepted by a purchaser under a sales contract typical for that area."[7] In this way, the regulations require lessees to bring the coal to a point at which it actually has value in the market, which may include washing the coal, and pay royalties on that value. A coal washing deduction, as permitted under current regulations,[8] is fundamentally inconsistent with this sound premise and should be eliminated.

C. ONRR should limit transportation deductions to no more than 50 percent of the final sale price in order to avoid subsidizing coal exports.

Ensuring fair payments to U.S. taxpayers from the sale of publicly owned coal also requires ONRR to limit deductions from the coal's final sale price for transportation costs to no more than 50 percent. Failure to do so could, in certain market conditions and where the coal is transported long distances, have the paradoxical result that the coal is valued at almost zero for royalty purposes. It is possible that limiting transportation deductions may make the sale of federal coal uneconomical in these circumstances. However, in fulfilling its obligation to obtain a fair return on the full market value of federal coal, the government has no legitimate interest in subsidizing uneconomical coal sales over long distances.

D. ONRR should make the "default" valuation provisions mandatory where the lessee engages in fraud, deception, or other misconduct.

ONRR should revise the 2016 Rules, 30 C.F.R. § 1206.253(c), to establish mandatory triggers for the default valuation under § 1206.254. The 2016 Rules established the default valuation mechanism to allow ONRR to make a direct valuation of coal when it determines the lessee has engaged in misconduct, sold the coal at a value that is unreasonably low, or failed to adequately document the transaction.[9] In such cases, ONRR "may decide" to establish the value of the coal,[10] using information such as comparable sales, public sources of price or market information, and any other information available to ONRR, including information

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[6] 30 C.F.R. § 1206.255(a).
[7] *Id.* § 1206.251.
[8] *Id.* § 1206.258(a) (allowing lessees to reduce the coal value for royalty purposes "for the reasonable, actual costs incurred to wash coal," provided the washing and transportation deductions combined do not reduce the value to zero).
[9] *Id.* § 1206.253(c)(1)-(3).
[10] *Id.* § 1206.253(c).

reported to it by lessees.[11] Default valuation is an appropriate response to lessee misconduct and should be made mandatory.

III. CONCLUSION

The proposed repeal of ONRR's 2016 coal, oil, and natural gas royalty valuation rules is a brazen and unnecessary gift to fossil fuel executives. Returning to flawed and outdated procedures that were easily gamed by regulated companies will cost states and taxpayers approximately $70 million to $80 million every year. Instead, ONRR should retain the bulk of the 2016 Rules while strengthening key provisions to ensure that taxpayers are better compensated when the government decides to sell fossil fuels from America's public lands.

Sincerely,

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[11] *Id.* § 1206.254.

EXHIBIT 1

May 8, 2015

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Submitted via www.regulations.gov

Re: Comments on Proposed ONRR Rule: Consolidated Federal Oil and Gas and Federal and Indian Coal Valuation Reform, Docket No. ONRR-2012-0004 Regulation Identifier Number: 1012-AA13

Dear Mr. Southall:

These comments are submitted on behalf of Earthjustice, Sierra Club, and 350 Colorado regarding the Office of Natural Resource Revenue's ("ONRR's") proposed regulatory changes on the collection of royalties from coal, oil, and gas produced on public lands. Proposed Rule, Consolidated Federal Oil and Gas and Federal and Indian Coal Valuation Reform set out at 80 Fed. Reg. 608 et seq. (Jan. 6, 2015). These comments address only the proposed changes to the manner in which ONRR determines federal coal royalties; we do not address ONRR's proposals regarding oil, natural gas, or coal produced from tribal lands.

ONRR's proposed rule takes important steps to close an accounting loophole that in recent years has enabled coal companies to sell federal coal to its own subsidiaries, pay royalties on the initial sale, then reap windfall profits when those subsidiaries sell the same coal at a much higher price without any additional royalty. These "captive sales," also referred to as "non-arm's-length transactions," have become commonplace in the industry and the result is that taxpayers are missing out on potentially hundreds of millions of dollars. ONRR is right to close this loophole that continues to gift industry an unintentional subsidy and allow coal companies to profit at the expense of American taxpayers.

Existing regulations, which have been in place since 1989, have simply not kept pace with industry practices. As ONRR explained in the proposed rule, "[i]n the years since we wrote these regulations, the Secretary of Interior's responsibility to determine the royalty value of minerals produced has not changed, but the industry and marketplace have changed dramatically."[1] The proposed rule would take an important step toward closing this loophole for captive sales by doing away with a burdensome, five-point benchmark methodology and instead determining royalties using the sale price from the first arm's-length transaction.

Although the proposed rule would make necessary improvements to the existing regulatory framework, in the final rule ONRR must adopt additional reforms to ensure that taxpayers receive a fair and full royalty on the sale of federally-owned coal. In keeping with ONRR's stated goals of updating its rules to bring "greater simplicity, certainty, clarity, and consistency" to royalty payments,[2] and to fulfill ONRR's obligation to the American taxpayers to obtain a fair return on federal coal, the Sierra Club, Earthjustice, and 350 Colorado call on ONRR to make additional reforms set out in detail below. In the final rule, ONRR should eliminate the royalty distinction between arm's-length and non-arm's-length transactions and instead calculate royalties for all federal coal based on the final sale price to a power plant or other end user.[3] This would eliminate disputes over whether initial sales are in fact arm's-length transactions, eliminate the current benchmark approach, and provide industry, ONRR, and the public with greater certainty and clarity around the amount of royalties owed. More fundamentally, basing the valuation on final market prices would ensure that royalties are paid on the full value of all federal coal. By additionally eliminating or limiting transportation deductions and doing away with allowances for coal washing, ONRR can ensure that American taxpayers obtain a fair return on a public resource.

I. Background: The Current Statutory and Regulatory Framework for Federal Coal Royalties

A. BLM Must Obtain a Fair Return for Coal on Public Lands

The Bureau of Land Management ("BLM") implements the federal coal leasing program across 570 million acres of public lands under the authority of the Mineral Leasing Act of 1920, 30 U.S.C. § 181 et seq., and the Federal Coal Leasing Amendments Act of 1976, Public Law 94-377, 90 Stat. 1083 (Aug. 4, 1976) (codified at 30 U.S.C. § 181 et seq.). The Mineral Leasing Act "was intended to promote wise development of these natural resources and to obtain for the public a reasonable financial return on assets that 'belong' to the public."[4] The regulations implementing the Act, including the valuation regulations addressed in ONRR's proposed rule, are designed to fulfill these fundamental purposes.

Coal mined from public lands generates revenue for the U.S. Treasury in primarily three ways: (1) a "bonus bid" established at the time of sale, prior to mining, typically expressed as a $/ton;

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[1] 80 Fed. Reg. 608 (Jan. 6, 2015).
[2] *Id.*
[3] For those portions of the proposed rule dealing with coal sold to affiliates to generate electricity, or coal sold between cooperative members, ONRR should retain the proposed valuation methods.
[4] *Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030, 1033 (D.C. Cir. 2008) (quoting *California Co. v. Udall*, 296 F.2d 384, 388 (D.C. Cir. 1961)).

(2) an annual per-acre rental fee paid during the life of the mine; and (3) royalties paid on the sale of coal after it is mined.

ONRR's proposed royalty changes apply only to this third category, which account for approximately two-thirds of the revenue from the federal coal program.[5] The "fair market value" bonus bids account for the other third.[6] The annual rental fees, currently set at $3/acre by regulation, comprise 0.1 percent of revenues from the program.[7]

While it is not necessary to provide a full review of the multitude of statutes, regulations, manuals, and handbooks that guide BLM's implementation of the federal coal program, it is instructive to summarize those provisions that govern revenues. The Mineral Leasing Act gives BLM the responsibility to lease mineral resources on public lands and requires the federal government recover, at a minimum, the "fair market value" of coal during the lease sale process.[8] The Federal Coal Leasing Amendments Act of 1976 amended the Mineral Leasing Act to require a royalty rate of not less than 12.5 percent of the sale value of coal for surface mines.[9] Regulations establish an 8 percent minimum royalty rate for coal from underground mines, but also allow BLM to reduce royalty rates for both surface and underground mines based on various hardship factors that mines may assert.[10] In addition, BLM may establish a different royalty rate—including a higher royalty rate—at the time a lease is readjusted,[11] *i.e.* after the initial 20-year lease term and every 10 years thereafter.[12] Actual average royalty rates for the top federal coal producing states in 2012 were: Wyoming – 12.2%; Montana – 11.6%; Utah – 6.9%; and Colorado – 5.6%. [13]

The current regulations on federal coal royalties have been in place for more than 25 years.[14] Ensuring that the royalty structure still serves its essential function of fairly and fully compensating U.S. taxpayers for the sale of federally-owned coal is critical in part because royalties generate the majority of the program's revenue. In 2013, the Department of Interior's

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[5] U.S. Government Accountability Office, *Coal Leasing: BLM Could Enhance Appraisal Process, More Explicitly Consider Coal Exports, and Provide More Public Information*, 22-23 (Dec. 2013), *available at* http://www.gao.gov/assets/660/659801.pdf (last visited May 6, 2015) (hereafter "GAO Report").
[6] *Id.*
[7] *Id.*; 43 CFR § 3473.3-1(a).
[8] 30 U.S.C. § 201(a)(1). For a full study on the failure of BLM to recover the "fair market value" as part of the leasing process, *see* Tom Sanzillo, *The Great Giveaway: An analysis of the costly failure of federal coal leasing in the Powder River Basin*, Institute for Energy Economics and Financial Analysis (June 2012), *available at* http://ieefa.org/study-almost-30-billion-in-revenues-lost-to-taxpayers-by-giveaway-of-federally-owned-coal-in-powder-river-basin/ (last visited May 6, 2015). This report concludes that BLM has undervalued federal coal sales by $28.9 billion over 30 years. *Id.* at 3.
[9] 30 U.S.C. § 207(a); *accord* 43 C.F.R. § 3473.3-2(a)(1).
[10] 43 C.F.R. §§ 3473.3-2(a)(2), 3473.3-2(e).
[11] *Id.* § 3473.3-2.
[12] *Id.* § 3451.1(a)(1).
[13] GAO Report, at 25. While most mining in Wyoming and Montana is surface mining that is subject to the 12.5% default minimum royalty, underground mining is generally used on federal leases in Colorado and Utah, which is subject to the 8% default minimum royalty. *See id.* at 12.
[14] 80 Fed. Reg. at 608.

Inspector General conducted a thorough audit of BLM's management of the coal program, specifically focusing on "the program's goal of obtaining a fair return for coal on public lands."[15] In its report, the Inspector General explained that since coal sales and royalties often generate more than $1 billion annually, ensuring taxpayers receive the proper amount of royalties can have significant financial implications.[16]

B. The Current Royalty Rules and Industry Practices Do Not Fairly Compensate Taxpayers for the Sale of Federal Coal

The existing coal valuation requirements are complicated for ONRR to administer, do not allow for meaningful public scrutiny, and have not kept pace with changes in the industry. These conditions have allowed coal companies to exploit unintentional loopholes and deprive U.S. taxpayers of millions of dollars.

ONRR currently calculates royalties from non-arm's-length transactions using a complicated series of five "benchmarks" based on sales from other coal companies in the same area and other information. Under the first benchmark, the lessee's sale price to its subsidiary is accepted for royalty determination purposes if it is within an undefined range of comparable arm's-length sales from other producers, selling similar-quality coal, in the same area.[17] If the first benchmark does not apply, or cannot be applied based on the information provided by the lessee, the second benchmark sets the royalty based on prices reported for that coal to a public utility commission.[18] If the second benchmark cannot be applied, the third benchmark sets the royalty based on prices reported to the U.S. Energy Information Administration ("EIA").[19] Where the first three benchmarks cannot be used, a fourth benchmark allows the royalty to be based on "other relevant matters" such as "published . . . spot market prices," or information submitted by the lessee concerning "unique" circumstances on the particular lease.[20] Finally, if none of the previous four benchmarks apply, then BLM uses a "net-back method or any other reasonable method."[21]

As explained in a report by Headwaters Economics, another major problem is that a lack of transparency within this complicated benchmark process makes it difficult for the public to play a meaningful role in enforcing the existing rules.[22] Among other items withheld from public review, BLM considers valuation methods and the underlying data to be proprietary

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[15] Office of Inspector General, U.S. Department of the Interior, *Coal Management Program, U.S. Department of the Interior*, 1 (June 2013), *available at* http://www.doi.gov/oig/reports/upload/CR-EV-BLM-0001-2012Public.pdf (last visited May 6, 2015) (hereafter "IG Report").
[16] *Id.*
[17] 30 C.F.R. § 1206.257(c)(2)(i).
[18] *Id.* § 1206.257(c)(2)(ii).
[19] *Id.* § 1206.257(c)(2)(iii).
[20] *Id.* § 1206.256(c)(2)(iv).
[21] *Id.* § 1206.257(c)(2)(v).
[22] Headwaters Economics, *An Assessment of U.S. Federal Coal Royalties: Current Royalty Structure, Effective Royalty Rates, and Reform Options*, 10 (Jan. 2015) (hereafter "Assessment Report"), attached hereto as Exhibit 1.

information, meaning the public does not have access to lease details including royalty rates, allowable cost deductions, and prices used for royalty assessments.[23]

Free from public scrutiny, industry has taken advantage of the complicated rules and existing regulatory loopholes, but the regulations have not kept pace with market changes. As reported by Reuters as early as 2012, coal companies operating in the Powder River Basin in Montana and Wyoming have exploited an existing loophole in the royalty regulations that allows coal companies to sell coal to subsidiaries at comparatively low prices, pay royalties on that artificially low price, and then turn huge profits by selling coal on the export market.[24] Although ONRR states in its proposed rule that "non-arm's length sales of Federal coal that is then resold at arm's length are rare,"[25] at least one coal exporter does not agree. In its comment letter on the proposed rule, Cloud Peak Energy, which has a separate "logistics company" through which it ships coal, states, "as ONRR knows, non-arm's-length transactions are quite common."[26]

Cloud Peak's assertion is supported by additional findings. The Reuters investigation, for example, concluded that this loophole allowed coal companies to keep an additional $40 million on coal export sales from Wyoming and Montana in 2011.[27] And as explained in detail in a recent report released by the Center for American Progress, the five largest coal companies operating in the Powder River Basin have created an astounding network of more than 500 subsidiary and affiliate companies through which they market and sell coal.[28]

This massive army of affiliates has sprung up largely in the last decade. According to data provided by the EIA, in 2012, 42 percent of coal mined in Wyoming was sold in a non-arm's-length transaction at least once, up from just 4 percent in 2004.[29]

Amid these conditions, captive transactions have increased by an order of magnitude, companies have frequently been allowed to take deductions for washing and transporting coal, and BLM has continued to voluntarily reduce royalty rates. The result, perhaps not surprisingly, is that the effective royalty rate has plummeted. Headwaters Economics' report concluded that between 2008 and 2012, the effective royalty rate on sales of publicly owned coal was just 4.9 percent, far below the average statutory rate of 12.3 percent.[30]

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[23] *Id.*

[24] Patrick Rucker, *Asia Coal Export Boom Brings No Bonus for U.S. Taxpayers*, Reuters (Dec. 4, 2012).

[25] 80 Fed. Reg. at 639.

[26] Colin Marshall, President, Cloud Peak Energy, Letter to Armand Southall at 5, 11 (April 29, 2015).

[27] Rucker, supra note 24.

[28] Nidhi Thakar et al., Center for American Progress, *Cutting Subsidies and Closing Loopholes in the U.S. Department of the Interior's Coal Program* (Jan. 6, 2015), *available at* https://www.americanprogress.org/issues/green/report/2015/01/06/103880/cutting-subsidies-and-closing-loopholes-in-the-u-s-department-of-the-interiors-coal-program (last visited May 7, 2015).

[29] *Compare* Energy Information Administration, *Coal Disposition by State* (2012) *with* Energy Information Administration, *Annual Coal Report: 2004* (2005).

[30] Headwaters Economics, *Assessment Report*, supra note 22 at 1.

ONRR commenced this rulemaking in 2011 to revise coal valuation for purposes of calculating royalties paid to government.[31] In the advanced notice of proposed rulemaking, ONRR signaled its response to criticism of coal valuation in non-arm's-length sales to affiliates:

> The ONRR continues to evaluate the effectiveness and efficiency of its regulations, particularly with regard to non-arm's length valuation and ramifications spurred by changes in the coal mining industry, including increasing vertical integration of mining and power production and increasing production by coal cooperatives.[32]

Almost four years passed before ONRR published its proposed rule on January 6, 2015. As described below, ONRR's proposal would simplify coal valuation for non-arm's-length transactions, but additional reforms are needed to address the systemic problem of undervaluing federal coal.

II. ONRR's Proposal Would Improve the Regulatory Framework, But Is Insufficient to Guarantee Full and Fair Royalty Payments on Federal Coal

ONRR's proposed reforms to federal coal valuation regulations would improve the existing regulatory framework by simplifying the valuation process for non-arm's-length sales. However, the reforms would fail to improve transparency, would not effectively limit industry's ability to misrepresent actual sale prices, and would be unlikely to recover additional revenue based on the full market value of federal coal.

A. ONRR's Proposal Would Improve Efficiency, But Still Lacks Transparency

For the portion of federal coal sales potentially affected by ONRR's proposal, the reforms would simplify coal valuation for lessees and ONRR, but would continue to shield the valuation process and the data upon which it is based from public view. As noted, ONRR proposes to reform only the manner in which federal coal is valued where the first sale after the coal leaves the mine is not an arm's-length transaction. For such sales, ONRR would eliminate the existing "benchmarks" and instead value the coal based on the sale price in the first arm's-length transaction, less the costs of transportation and other processes that may be necessary to bring the coal to marketable condition. In essence, ONRR proposes to value <u>all</u> coal based on "the gross proceeds received for the first arm's-length transaction," whether such transaction is at the mine or down the line.[33] Lessees would no longer have the option to value coal sold in non-arm's-length transactions based on comparable sales (industry's preferred valuation method), prices reported to public utility commissions or the EIA, spot market prices, or lease-specific

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[31] Advance Notice of Proposed Rulemaking, Federal and Indian Coal Valuation, 76 Fed. Reg. 30,881 (May 27, 2011).
[32] *Id.* at 30,882.
[33] 80 Fed. Reg. at 609.

information, as under the existing benchmarks.[34] These valuation methods are unwieldy and susceptible to gamesmanship, as ONRR lacks the resources to audit every fact-specific valuation proffered by coal lessees. In replacing these benchmark options with a single method of valuing coal, the proposed rule would simplify industry compliance and promote administrative efficiency for ONRR.

While the proposed reforms are an improvement over the status quo for the coal sales they affect, they fail to promote transparency and the ability for the public and ONRR to verify industry compliance that are essential to an effective regulatory system. The public often plays a significant and productive role in policing industry compliance with laws and regulations that protect the public interest.[35] However, access to information is a prerequisite to effective public oversight. While the proposed rule would value coal based exclusively on specific contract prices, such information is generally treated as proprietary and any coal valuation based on this information is shielded from public scrutiny.[36] Where the first arm's-length sale is to a domestic power plant, the contract price is reported to public utility commissions or EIA and is available to the public. However, where the first arm's-length sale is to an independent broker, the public is kept in the dark. The proposal's failure to adopt a coal-valuation method that can be evaluated by the public misses a key opportunity to engage the public in monitoring industry compliance. Thus, while the proposal takes a step in the right direction by simplifying the coal valuation process for non-arm's-length transactions, it does not allow for transparency that could help assure the accuracy and integrity of such valuations.

B. ONRR's Proposal Appropriately Establishes a "Default" Valuation Mechanism That Should be Mandatory

ONRR's proposal also would improve the existing regulatory framework by establishing a "default" valuation mechanism by which ONRR will make the initial determination of the coal's value where there is no arm's-length transaction,[37] or where ONRR determines that the lessee's reported value does not reflect reasonable consideration.[38] Among other things, ONRR may elect to use default valuation methods when it determines the lessee has engaged in misconduct, sold the coal at a value that is unreasonably low, or failed to adequately document the transaction.[39] In such cases, ONRR "may decide" to make a direct valuation of the coal,[40] using information such as comparable sales, public sources of price or market information, and any other information available to ONRR, including information reported to it by lessees.[41]

[34] 30 C.F.R. § 1206.257(c).
[35] *See, e.g.*, J. Maria Glover, The Structural Role of Private Enforcement Mechanisms in Public Law, 53 Wm. & Mary L. Rev. 1137, 1155-60 (2012).
[36] *See* Headwaters Economics, *Assessment Report*, supra note 22 at 10.
[37] 80 Fed. Reg. at 664 (proposed 30 C.F.R. § 1206.252(b)(2)(i)).
[38] *Id.* (proposed 30 C.F.R. § 1206.253(c)).
[39] *Id.* (proposed 30 C.F.R. § 1206.253(c)(1)-(3)).
[40] *Id.* (proposed 30 C.F.R. § 1206.253(c)),
[41] *Id.* (proposed 30 C.F.R. § 1206.254).

Sierra Club, Earthjustice, and 350 Colorado support ONRR's proposal to establish a default valuation mechanism, which provides the agency with needed authority to ascertain the value of federal coal where the government otherwise would fail to garner a fair return on its resource as the result of a lessee's misconduct. The sources of information upon which ONRR proposes to base its determination of the coal's value are appropriate and, to the extent they include publicly accessible information, would promote transparency. However, the triggers for default pricing identified in proposed 30 C.F.R. § 1206.253(c)(1)-(3) should be mandatory, rather than discretionary. When industry fails to abide by the terms of its commitment to market federal coal for the mutual benefit of the lessee and the federal government, thereby depriving the government of royalties on the full market value of its coal, the regulations should eliminate the lessee's privilege to continue to determine its own coal value and royalty payments. Under these circumstances, it is proper for ONRR to value the coal directly.[42] Moreover, by making ONRR's use of the default provision completely discretionary, the proposed rule would allow ONRR to disregard findings and evidence of industry misconduct, to the detriment of U.S. taxpayers. ONRR should revise proposed 30 C.F.R. § 1206.253(c) to establish mandatory triggers for the default valuation under proposed § 1206.254.

C. ONRR's Proposal Would Expand the Independent Broker Loophole and Fail to Increase Revenue from Federal Coal Leases

While ONRR's proposal would impart some needed reforms, it would fail to address the systematic under-payment of royalties on federal coal that is sold first to a broker—affiliated or unaffiliated—and then marketed to the electric sector domestically or abroad at much higher prices. With respect to independent brokers, the proposal does not alter existing practices since the sale from the lessee to the unaffiliated broker is defined as an arm's-length transaction.[43] In such cases, coal may be sold at or close to the mine, then marketed and re-sold at a much higher price. In failing to address these unaffiliated broker transactions, ONRR's proposal fails to garner royalties on the full market value of coal sold through such brokers.

Under the proposal, coal sales to affiliates constitute non-arm's-length transactions, such that some further transaction to an unaffiliated entity must form the basis for determining the coal's value. The proposal states that the value of the coal will be based on "the gross proceeds accruing to you or your affiliate less an applicable transportation ... and washing allowance" based on that first arm's-length transaction.[44] If, however, there is value added by the affiliate broker other than transportation and coal washing (e.g., marketing), royalties would be paid on that added value. The government thus collects revenue on this value when the coal is sold to an affiliated broker that is not captured when the coal is sold first to an independent broker. By potentially creating a competitive advantage for independent brokers, ONRR's proposal may simply have the effect of shifting market reliance toward independent brokers and away from

[42] Further, the evidence before ONRR of industry-wide misconduct in valuing coal in non-arm's-length transactions should be sufficient to invoke the default valuation mechanism across the federal coal leasing program.
[43] 80 Fed. Reg. at 609 ("at this time, ONRR is proposing no changes to the valuation of arm's length coal sales").
[44] *Id.* at 663-64 (proposed 30 C.F.R. § 1206.252(a)).

affiliated brokers. Thus, by closing the royalty loophole for affiliated brokers, ONRR's proposal may inadvertently expand the loophole for independent brokers. The rule as written may consequently perpetuate the government's under-collection of royalties on federal coal, where independent brokers sell the coal at a significantly higher price than the value of the coal at the mine on which royalties are paid.

Further, for all coal sales—both those affected and unaffected by the proposed rule—ONRR's reform proposal fails to require royalty payments on the value added between the first arm's-length sale and the final market price. As discussed in Section III.A, ONRR should base its valuation on final market prices for *all* coal sales, which would capture the full market value of the coal and close the broker loophole.

D. ONRR's Proposal Would Fail to Yield Revenue Reflecting the Full Market Value of Federal Coal

ONRR's assessment that its proposal is revenue neutral[45] confirms that the reforms would not yield payment of royalties on the full market price of coal, which may be substantially greater than the price received at the first point of sale. Preliminarily, ONRR's determination that its proposal would not generate additional revenue from affiliate sales cannot be verified, as current valuation and contract sales data are not disclosed to the public. Indeed, it is unclear whether ONRR itself has access to data about affiliate sales. In any event, it is likely that ONRR's proposal is revenue neutral. First, as described above, ONRR's proposal may have the effect of shifting sales to independent brokers, which are unaffected by the rule as proposed. Second, ONRR may assume that the only difference between the delivered price in the first arm's-length transaction and the mine price is transportation costs. If this assumption is correct for a majority of transactions, the comparable sales approach under the current benchmarks may already capture the market value of the coal sold at the mine.[46]

ONRR's revenue benefits assessment is not surprising, as ONRR's proposal fundamentally is designed to capture value of coal sold at the mine—the point of the coal's lowest possible value. However, the mine price does not reflect the full market value of the coal, which may be significantly higher, particularly in the international market. As described below, further reforms are warranted to capture that value.

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[45] 80 Fed. Reg. at 641.

[46] 30 C.F.R. § 1206.257(c)(2)(i). While transportation may be the only value added before the first arm's length transaction where that sale is directly to consumers, it is unlikely to be the case where there are numerous transactions before the final point of sale. As described in the previous section, both independent and affiliated brokers add additional value in the form of marketing. *See* Headwaters Economics, *The Impact of Federal Coal Royalty Reform on Prices, Production, and State Revenue*, 4, Fig. 2 (May 2015) (hereafter "Impact Report"), attached hereto as Exhibit 2. Evidence of this enhancement is that "often the market price less transportation costs is higher than the value of coal sold at the mine." *Id.* at 4.

III. Additional Reforms are Needed to Ensure a Fair Return on Federal Coal

While ONRR's proposed rule offers improvements of the current regulatory framework, Sierra Club, Earthjustice and 350 Colorado recommend additional reforms to ensure that royalties are paid on the full market value of federal coal. A "royalty" is a "share of the product or profit from real property, reserved by the grantor of a mineral lease, in exchange for the lessee's right to mine or drill on the land."[47] A royalty is not a tax on producers; it is the government's fair share of profits from the sale of a resource it owns. Like any private lessor, the government has a right to the benefit of the bargain it struck in leasing federal coal. As described above, changed circumstances, including increasing vertical integration of the coal industry and expanded exports, have deprived the government of a share in the full market value of federal coal. While federal leases for surface coal mines generally must include the statutory royalty rate of at least 12.5 percent,[48] these changes have driven effective royalty rates much lower. As calculated by Headwaters Economics using actual market prices for comparable coal between 2008 and 2012, the average effective royalty rates during this same period were only 5 percent in Wyoming, which accounted for 86 percent of all federal coal sales during the period, and just 4.6 percent in Wyoming.[49] To regain the benefit of the government's bargain, federal coal should be valued at the final point of sale, rather than at the mine, and deductions for transportation and coal washing should be limited. Such reforms are necessary to restore adequate federal and state revenues from coal mining.[50]

A. All Federal Coal Should be Valued at the Final Point of Sale, Rather Than at the Mine

ONRR's proposal takes the first step of recognizing the need to reform coal valuation for non-arm's-length transactions. However, to secure adequate royalty payments on the full market value of federal coal, ONRR should move the point of valuation to the final point of sale for all federal coal sales. Basing such valuation on publicly available index prices would improve simplicity and transparency, while reducing the opportunity for gamesmanship among the coal lessees.

As described in section II.C above, changing the point of valuation for non-arm's-length coal sales to affiliated brokers has the theoretical benefit of securing royalties on any value added to that coal, e.g. marketing, above transportation and coal-washing costs. In reality, however, the market is likely to quickly shift toward unaffiliated brokers that will have a competitive advantage under ONRR's proposal, thus nullifying any revenue benefit for the government.[51]

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[47] Royalty, Black's Law Dictionary (10th ed. 2014).
[48] 43 C.F.R. § 3473.3-2(a).
[49] Headwaters Economics, *Assessment Report*, supra note 22 at 16.
[50] Headwaters Economics, *Impact Report*, supra note 46 at 13-14.
[51] *See id.* at 19 ("[B]ecause the proposed rule would still allow for independent brokers to remarket coal to consumers without royalty liability, the proposed rule could create a preference for particular sale structures (potentially disadvantaging affiliated mining and logistics companies) without resulting in additional revenue.").

To avoid expanding of the revenue loophole for unaffiliated brokers, ONRR must shift the point of valuation to the final delivered price for all federal coal sales.

Valuing coal based on its delivered price, rather than mine price, yields significant benefits. Fundamentally, it eliminates the opportunity for companies to structure their transactions to artificially reduce the value of their coal to escape paying royalties on the higher final sale price of the coal. As described by Tom Sanzillo, the coal industry typically touts the excess profits it gains or hopes to gain from export sales.[52] While the government is not currently reaping any benefit from these profits, moving the point of valuation to the final sale price will enable the government to share in the market boon, if any, and bring the effective royalty rate back to—or close to—the regulatory floor of 12.5 percent that served as consideration for the original leases.

The revenue benefit to federal and state governments of changing the point of valuation to the final sale price of coal is undeniable. The gross market price for coal mined in Wyoming and Montana is more than double the reported price at the mine.[53] The differential based on global coal prices is even greater.[54]

At the same time, such a regulatory change would ease the burden on ONRR to determine when company's valuations are accurate or the result of misconduct or a clever corporate configuration. Rather than intensive auditing of the company's reported valuation for the first arm's-length sale, as ONRR proposes,[55] moving the valuation to the final point of sale would simplify the inquiry and eliminate the need to rely on proprietary sales contracts.

By basing the valuation on an index market price, ONRR would further promote simplicity and transparency, while easing regulatory compliance. Index pricing would eliminate the administrative burden for both ONRR and lessees of tracking individual coal sales to their final destination to establish actual contract prices. Instead, coal value for royalty purposes would be predictable and transparent, allowing for more efficient administration and public oversight of a process that currently takes place in a black box.

ONRR's proposal suggests appropriate sources for such index prices in its "default" valuation proposal.[56] In cases where ONRR proposes to value coal directly, ONRR suggests it would consider, among other things:

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[52] Tom Sanzillo, Institute for Energy Economics and Financial Analysis, *Coal Sold for Export Should Not Be Exempt from Federal Royalty Payments*, 12 (May 7, 2015), Docket No. ONRR-2012-0004-0226.
[53] Headwaters Economics, *Assessment Report*, supra note 22 at 16-17 (compare Table 4 "contract price" with Table 5 "gross market price."
[54] *See* Sanzillo, supra note 52 at 7-8.
[55] 80 Fed. Reg. at 664 (proposed 30 C.F.R. § 1206.253(a)(1)).
[56] *Id.* (proposed 30 C.F.R. § 1206.254).

> (a) The value of like-quality coal from the same mine, nearby mines, same region, or other regions, or washed in the same or nearby wash plant;
>
> (b) Public sources of price or market information that ONRR deems reliable, including but not limited to, the price of electricity; [and]
>
> (c) Information available to ONRR and information reported to it, including but not limited to, on Form ONRR-4430[.][57]

Such sources of information may also form the basis for index prices for all federal coal sales.

ONRR need not establish such index prices in this rule-making. However, the proposed default valuation provisions described under the proposed rule already has put the public and regulated industry on notice of such a pricing mechanism. Under the proposal, default pricing may be employed whenever ONRR "cannot determine if a lessee properly valued" the resource to allow ONRR to fulfill its obligation to ensure accurate accounting for royalties.[58] ONRR further identifies and invites comment on the sources of information for default pricing.[59]

B. ONRR Should Eliminate or Limit Transportation Deductions

To ensure the federal government does not subsidize coal sales across long distances, including overseas, the government should limit transportation deductions to no more than 50 percent of the final sale price.

Failure to limit deductions from the coal's final sale price for transportation costs could, in certain market conditions and where the coal is transported long distances, have the paradoxical result that the coal is valued at almost zero for royalty purposes.[60] It is possible that limiting transportation deductions may make the sale of federal coal uneconomical in these circumstances. However, in fulfilling its obligation to obtain a fair return on the full market value of federal coal, the government has no legitimate interest in subsidizing uneconomical coal sales over long distances, particularly to overseas consumers where domestic utilities or industrial customers will see no benefit. The government should not create incentives to offload federal coal in down market conditions.

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[57] *Id.* (proposed 30 C.F.R. § 1206.254(a)-(c)).
[58] 80 Fed. Reg. at 622.
[59] *Id.* at 640. To the extent that ONRR requires additional information to identify appropriate index prices, it may require lessees to report such information under the Department of Interior's broad Mineral Leasing Act "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 Act." *Devon Energy Corp.*, 551 F.3d at 1033 (quoting 30 U.S.C. § 189).
[60] Sanzillo, supra note 52 at 7.

On the other hand, the government *does* have a legitimate interest in creating incentives to keep coal in the ground in these circumstances. The extraction and burning of coal causes significant environmental harm, including by contributing significantly to global climate change. Particularly where no federal revenue is generated from the sale of the coal, the government's interest in avoiding these impacts should weigh decidedly against subsidizing uneconomical coal transactions.[61] Eliminating or limiting transportation deductions reduce such illogical subsidies.

As federal courts have recognized:

> The purpose of the Mineral Leasing Act was not to obtain sales for the gas from these reserves on Government land at any price. The Act was intended to promote wise development of these natural resources and to obtain for the public a reasonable financial return on assets that 'belong' to the public. The Secretary of the Interior is the statutory guardian of this public interest. He has a responsibility to insure that these resources are not physically wasted and that their extraction accords with prudent principles of conservation. To protect the public's royalty interest he may determine that minerals are being sold at less than reasonable value. Under existing regulations he can restrict a lessee's production to an amount commensurate with market demand, and thus protect the public's royalty interest by preventing depression of the market. He may also establish 'reasonable values' for royalty purposes.[62]

Fulfilling ONRR's role as "guardian of th[e] public interest" here means not creating an incentive to mine federal coal for which domestic demand is low and profit to the government is non-existent.

Limiting transportation cost deductions also would increase revenue to federal and state governments. If federal coal were valued based on net delivered prices with no limitation on transportation cost deductions under current market conditions, royalty revenue would increase 20 percent, yielding $139 million in additional revenue annually.[63] Limiting the

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[61] For a discussion of BLM's consideration of climate impacts in leasing decisions, *see* Nathaniel Shoaff & Marni Salmon, Sierra Club, *Incorporating the Social Cost of Carbon into National Environmental Policy Act Reviews for Federal Coal Leasing Decisions* (April 2015), *available at* http://content.sierraclub.org/environmentallaw/sites/content.sierraclub.org.environmentallaw/files/SCC%20White%20Paper%20FINAL.pdf (last visited May 7, 2015).

[62] *California Co. v. Udall*, 296 F.2d 384, 388 (D.C. Cir. 1961); *see also Indep. Petroleum Ass'n of Am. v. DeWitt*, 279 F.3d 1036, 1039-40 (D.C. Cir. 2002) (summarizing same); *Naartex Consulting Corp. v. Watt*, 722 F.2d 779, 790 (D.C. Cir. 1983) (quoting *California Co.*, 296 F.2d at 388).

[63] Headwaters Economics, *Impact Report*, supra note 46 at 13.

transportation cost deductions to 50 percent of the net delivered price would increase revenues by 73 percent, yielding $512 million in additional annual revenue.[64]

If ONRR elects to allow transportation cost deductions up to 50 percent of the delivered price of coal, it should consider establishing index prices for transportation. As with index pricing for coal valuation, establishing an index for transportation costs based on publicly available information would ease the administrative burden for both lessees and ONRR and would promote transparency by ensuring the public availability of transportation cost information.

C. ONRR Should Eliminate Coal Washing Deductions

ONRR should eliminate all allowances for coal washing. Coal valuation regulations, like their oil and gas counterparts, require royalties to "be computed on the basis of the quantity and quality of Federal coal in marketable condition."[65] "Marketable condition" is defined as "coal that is sufficiently free from impurities and otherwise in a condition that it will be accepted by a purchaser under a sales contract typical for that area."[66] In this way, the regulations ensure that lessees are responsible for bringing the coal to a point when it actually has value in the market, and paying royalties on that value.

A coal washing deduction, as permitted under current regulations,[67] is fundamentally inconsistent with this sound premise. As ONRR recognizes, "[c]oal washing means any treatment *to remove impurities* from coal."[68] Because it is the lessee's responsibility to pay royalties on coal that is "*free from impurities*,"[69] the coal washing allowance should be removed from ONRR's regulations.

IV. Conclusion

Sierra Club, Earthjustice, and 350 Colorado support ONRR's efforts to streamline and improve valuation procedures applicable to non-arm's-length transactions. We urge ONRR to adopt the additional reforms described in this letter to ensure a fair return to U.S. taxpayers from all federal coal sales.

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[64] *Id.*
[65] 30 C.F.R. § 1206.255(a).
[66] *Id.* § 1206.251.
[67] *Id.* § 1206.258(a) (allowing lessees to reduce the coal value for royalty purposes "for the reasonable, actual costs incurred to wash coal," provided the washing and transportation deductions combined do not reduce the value to zero).
[68] *Id.* § 1206.251 (emphasis added).
[69] *Id.* (emphasis added).

Sincerely,

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