



TRI-STATE GENERATION AND TRANSMISSION ASSOCIATION, INC.

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May 4, 2017

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Denver, CO 80225

ATTN: Regulation Identifier Number (RIN) 1012-AA20

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

Dear Mr. Southall:

Tri-State Generation and Transmission Association, Inc. (Tri-State) submits the following comments in response to the Office of Natural Resources Revenue (ONRR) proposed rule entitled "Repeal of Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform," 82 Fed. Reg. 16323 (April 4, 2017). Tri-State supports the proposed repeal of the 2017 Valuation Rule for the reasons set forth below.

Tri-State is a not-for-profit wholesale electric cooperative whose power supply portfolio includes a diverse mix of fuel sources, including coal, natural gas, hydropower, solar, and wind. Tri-State is cooperatively owned by 43 not-for-profit rural electric distribution cooperatives and public power districts (Member Systems). Tri-State's Member Systems serve consumers in many rural communities spread over approximately 200,000 square miles throughout Colorado, Nebraska, New Mexico, and Wyoming. Tri-State and its Member Systems are representative of many providers of electric power to rural America.

Tri-State owns Elk Ridge Mining and Reclamation, LLC, a mining subsidiary that supplies coal to two power plants in Colorado and operates federal coal leases. Tri-State is also a member of Western Fuels-Wyoming, Inc., which owns and operates mines supplying coal to power plants in Wyoming. Tri-State is a lessee of record for a federal coal lease in Wyoming.

Tri-State's mission is to provide its Member Systems with a reliable, cost-based supply of electricity while maintaining a sound financial position through effective utilization of human capital and physical resources in accordance with cooperative principles.

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Summary of Comments

- The 2017 Rule improperly values coal sold under non-arm's-length contracts using a netback from electricity sales. This valuation method is contrary to the Mineral Leasing Act and longstanding agency practice, is unworkable, and arbitrary and capricious. Furthermore, ONRR should not use geothermal generation and transmission allowances as surrogates for costs of electricity generation and transmission.
- The 2017 Rule's valuation methodology creates substantial uncertainty regarding what lessees must do to achieve compliance and is therefore arbitrary and capricious and contrary to law.
- ONRR's coal transportation allowances are improperly vague and overly cumbersome to calculate.
- The 2017 Rule arbitrarily discriminates between federal mineral lessees by treating coal lessees differently than oil and gas lessees and by treating coal cooperatives differently than other coal lessees.

I. **The 2017 Rule Should Be Repealed Because It Improperly Values Coal Sold Under Non-Arm's-Length Contracts Using A Netback From Electricity Sales.**

To value coal sold under a non-arm's-length agreement, the 2017 Rule rejects the several benchmarks provided under the regulation effective January 1, 1989 (Old Rule) and requires use of a netback from electricity sales if the coal is sold to an affiliated power plant. 30 C.F.R. §1206.252.

A. **This Valuation Method Is Contrary To The Mineral Leasing Act And Longstanding Agency Practice.**

The 2017 Rule's valuation method is contrary to the directive in the Mineral Leasing Act, 30 U.S.C. § 207, that royalty shall be based on the "value of coal," the lease product. The coal and the electricity from which the ONRR netback procedure attempts to derive the value of the coal are inherently different substances. Royalty would properly be due on the value of the coal used for production of the energy which was expended to generate electrical energy, not on the value of the electricity which was generated. The Interior Board of Land Appeals addressed this very issue in the context of oil used for electric generation and held that royalty could not be assessed on the value of electricity but must be assessed on the value of the oil, the lease product. *Petro-Lewis Corp.*, 108 IBLA 20, 39-41, 1989 WL 255495, *10-11 (1989).

In addition, using a netback method to value coal for royalty purposes has long been regarded as the royalty valuation method of last resort. Under the Old Rule, it was the last alternative if none of the four non-arm's-length benchmarks was applicable. *See* 30 C.F.R. § 206.251 (definition of netback) (1989). "The MMS will use a net-back valuation method only when other methods of determining

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value, such as those specified in the rules, are inapplicable.” Preamble to Final Revision of Coal Product Valuation Regulations and Related Topics, 54 Fed. Reg. 1492-01, 1506 (Jan. 13, 1989).

Moreover, under the Old Rule the netback started with the lease product, coal. “In doing a netback, MMS will start at the first point at which a market value of the product can be determined, and will deduct costs of transportation, washing, handling, etc. to reach a value for royalty purposes.” *Id.* It expressly applied to “beneficiated coal,” not a product created using coal. *See* 30 C.F.R. § 206.257(c)(v) (1989); Preamble to Revision of Coal Product Valuation Regulations and Related Topics, 53 Fed. Reg. 26942-01, 26956 (July 15, 1988) (“[T]his section would apply to situations where the value of the coal is enhanced beyond the point of marketable condition prior to use, sale, or other disposition by the lessee . . . This approach, to be seen as a last resort, determines royalty value after the marketable coal has been enhanced and is subsequently used, sold, or otherwise transferred.”).

B. A Netback From Electricity Sales Is An Unworkable And Ultimately Arbitrary And Capricious Method To Value Coal Used To Generate Electricity.

As explained in detail below using Tri-State and its Member Systems as the example, electricity prices are the result of multiple, complex factors and calculations that reflect many items other than the value of coal. Therefore, working back from proceeds of electricity sales to value the coal used to generate some portion of that electricity is an inherently inappropriate and unworkable methodology.

1. Tri-State and Its Member Systems’ Purpose: Affordable Power for Rural Areas

Tri-State and its Member Systems were formed as a result of the Rural Electrification Act, 7 U.S.C. § 901, *et seq.* (the RE Act) enacted in 1936. Among other things, the RE Act created the Rural Electrification Administration (the REA) as a federal agency empowered to provide rural areas of the United States with affordable electricity by lending funds directly to rural electric systems at below-market rates. Through a federal reorganization, the REA was later transferred to the Department of Agriculture and, subsequently, renamed as the Rural Utilities Service (RUS). Under the RE Act, providing affordable electricity to rural America is a matter of serious national concern. *See, e.g., Tri-State Generation & Transmission Ass’n, Inc. v. Shoshone River Power, Inc.*, 874 F.2d 1346, 1348-51 (10th Cir. 1989) (court recounted the history of RE Act, its legislative purpose and the history of Tri-State and Shoshone River Power) (“*Tri-State v. Shoshone II*”). As the Tenth Circuit has recognized, Congress passed the RE Act because it “was concerned with the fact that those then engaged in the business of generating electrical energy had failed to extend electric service to the rural communities of America and determined that the national interest would be served by subsidizing the rural user of electricity.” *Id.* at 1348. In response to the RE Act, rural electric distribution cooperatives were formed to seek government subsidized loans and deliver electricity to rural consumers. These cooperatives, in turn, banded together to form generation and transmission cooperative corporations (G&Ts), such as Tri-State, in an effort by the rural cooperatives to secure and more economically obtain long-term, reliable sources of power and meet the goals of the RE Act. The RE Act goals continue to be at the



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forefront of federal policies to assist rural areas as demonstrated by the Presidential Executive Order on Promoting Agriculture and Rural Prosperity in America, dated April 25, 2017.

2. Tri-State and Its Member Systems' Organization and Governance

The primary characteristic of a cooperative corporation such as Tri-State is that its business “shall not be carried on for profit, but for the mutual benefit of all the members.” Tri-State’s mission is to provide its 43 Member Systems located in four states with a reliable supply of interstate electricity while maintaining a sound financial position. Tri-State is a wholesale electric supplier — an aggregator of its Member Systems’ loads. Tri-State is not an investor owned utility. Tri-State’s owners are its Member Systems, not shareholders, and Tri-State does not seek to generate a profit for outside investors. Unlike an investor-owned utility or a distribution cooperative, Tri-State has no retail customers. Instead, Tri-State buys and generates electric power, and transmits, delivers and sells electricity, to its Member Systems in interstate commerce. The Member Systems, in turn, distribute and resell the electricity they purchase at wholesale from Tri-State to their own member-customers. In short, Tri-State’s Member Systems serve retail customers but Tri-State does not.

Tri-State’s wholesale rates, service, and other business matters are governed by a Board of Directors (Board) consisting of one director elected by each Member System. Members of the Board live in the rural areas served by Tri-State’s Member Systems. Local, democratic control and service on the basis of mutuality among Member Systems are fundamental principles of Tri-State’s not-for-profit cooperative operations. Tri-State’s Board is directly accountable to its Member Systems, which Member Systems are, in turn, directly accountable to their member-customers.

3. Generation and Transmission

As further described below and as set forth in the maps attached hereto as Attachments 1 (Map of Tri-State Member Systems) and 2 (Map of Tri-State’s System), Tri-State’s electrical system is integrated into an interstate grid to facilitate the generation and transmission of electricity across a 200,000 square-mile area in four states. Tri-State’s 43 Member Systems cover all or parts of 59 counties in Colorado, all or parts of 16 counties in western Nebraska, all or parts of 25 counties in New Mexico and all or parts of 15 counties in central and northern Wyoming. In addition, certain of Tri-State’s Member Systems provide service that extends into Arizona, Utah and Montana. *Id.*

a. Generation

Tri-State owns or contracts for over 2,800 megawatts (MW) of baseload, intermediate and peaking generating capacity in Arizona, Colorado, New Mexico and Wyoming. Tri-State’s baseload generation includes the Springerville Generating Station Unit 3 in Arizona; the Laramie River Station in Wyoming; the Craig Station, near Craig, Colorado; the Nucla Station near Nucla, Colorado; the San Juan Generating Station Unit 3 in New Mexico; and the Escalante Generating Station in New Mexico. Tri-State’s intermediate generation and peaking capacity includes three gas combustion turbine facilities

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in Colorado: the Brush 2 Generation Facility in eastern Colorado; the J.M. Shafer Generating Station in Fort Lupton, Colorado; and the Rifle Generating Station on Colorado’s western slope; and a natural gas combustion turbine facility in New Mexico.

Tri-State’s resource portfolio also has more than 1,000 MW of renewable energy resources, including long-term power purchase agreements with several wind and solar facilities in Colorado and New Mexico.

In addition to purchasing the output of the above-referenced utility-scale projects, Tri-State purchases the output from several small hydro-electric facilities located in its service territory. Tri-State’s renewable portfolio also reflects its power purchases from the Western Area Power Administration (WAPA) through long-term federal hydropower allocations that are held by Tri-State. WAPA markets and transmits federally produced power in 15 central and western states, specifically Arizona, California, Colorado, Kansas, Iowa, Minnesota, Montana, Nebraska, Nevada, New Mexico, North Dakota, South Dakota, Texas, Utah and Wyoming. WAPA’s corporate services office is located in Lakewood, Colorado, and its Rocky Mountain Region office is located in Loveland, Colorado.

Tri-State also purchases power each year through long-term contracts with Basin Electric Power Cooperative, whose generating facilities are located in North Dakota, South Dakota, Wyoming, Montana, Minnesota and Iowa, and whose corporate headquarters is located in Bismarck, North Dakota. Basin Electric Power Cooperative’s generation (energy breakdown by fuel type) for 2016 was as follows:

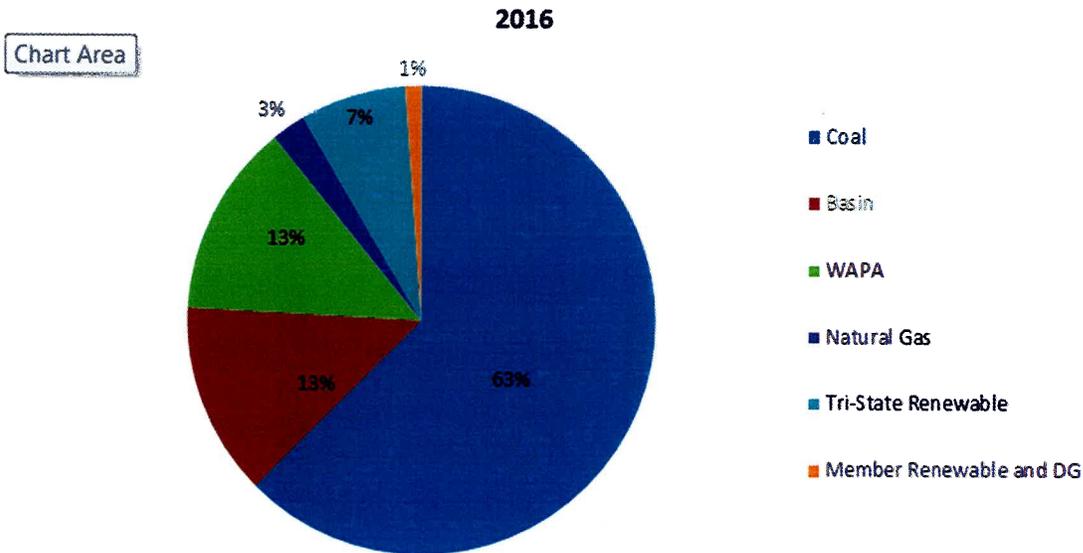
Coal	66.8%
Natural Gas	6.7%
Oil/Diesel/Jet Fuel	0.0%
Nuclear	1.6%
Federal Hydro	0.7%
Wind	11.3%
REG	1.1%
Biogas/Flamegas	0.0%
Unspecified	11.8%
TOTAL	100.0%

Tri-State’s Generation and Purchased Power (WAPA and Basin) mix in 2016 was as follows:

From Form 12-C, Financials

MWh	<u>Coal</u>	<u>Basin</u>	<u>WAPA</u>	<u>Natural Gas</u>	<u>Tri-State Renewable</u>	<u>Member Renewable and DG</u>	<u>Total</u>
2016	10,991,597	2,349,026	2,350,853	419,822	1,283,750	201,157	17,598,220
%	<u>Coal</u>	<u>Basin</u>	<u>WAPA</u>	<u>Natural Gas</u>	<u>Tri-State Renewable</u>	<u>Member Renewable and DG</u>	<u>Total</u>
2016	63%	13%	13%	3%	7%	1%	100%

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Note that DG refers to “distributed generation” which means Member-owned or controlled resources that connect at the distribution level.

b. Tri-State High Voltage Interstate Transmission System

To facilitate the delivery of these resources through operation of its interstate system and the interstate sale of electricity to its Members Systems, Tri-State owns and operates more than 5,500 miles of high-voltage transmission lines in Colorado, Nebraska, New Mexico and Wyoming. *See* Attachment 2. Tri-State owns or has major equipment ownership in approximately 370 substations and switching stations in those four states. Its transmission system is interconnected with most of the major electric utilities in the western United States. *Id.* Tri-State also owns and operates the David A. Hamil DC Tie at Stegall, Nebraska, which joins the country’s eastern and western power grids by converting alternating current to direct current, and then converting it back to alternating current.

c. How Members Receive Electricity

Tri-State’s Member Systems do not receive electricity solely or even substantially from Tri-State’s generation resources located in their state. Rather, Tri-State injects electricity into the regional grid from its various generation resources in Arizona, Colorado, New Mexico and Wyoming (and its separate power purchases from third parties in various states described above) as part of interstate commerce that serves all of Tri-State’s Member Systems, whether located in Colorado, New Mexico, Nebraska or Wyoming. *See* Attachments 1 and 2.



4. Sales to Member Systems

All of Tri-State's Member Systems, including those in Colorado, have entered into long term, all requirements wholesale power contracts with Tri-State for electric service (Wholesale Electric Service Contracts). In general, the Wholesale Electric Service Contracts provide that each Tri-State Member System will purchase and receive from Tri-State electric power and energy for its electric system. As the Tenth Circuit has recognized, "[w]ith the all-requirements contracts in place, the G&T system provided a stable, interdependent network whereby the distribution cooperatives could pool their resources and band together to obtain power at wholesale prices, build central facilities, obtain favorable loans, and attempt to keep costs down." *Tri-State v. Shoshone II*, 874 F.2d at 1349.

For many decades, Tri-State's Board has voted to adopt a single rate at which Tri-State sells wholesale electric power under contracts to each of its Member Systems. That is, regardless of the size, location and structure of a Member System, each Member System is charged the same wholesale rate for the capacity and energy delivered to its system. This longstanding "postage stamp" rate philosophy comports with the mutual support nature of the cooperative corporation business model under which Tri-State is organized.

5. How Tri-State's Rates Are Set

a. Rate Objective

Tri-State's rates are calculated in order "[t]o set rates in accordance with Tri-State's Mission Statement that will ensure the provision of a reliable cost-based supply of electricity over the long term as a regional (not zonal) power supplier to its Member Systems." **Rates are established on an annual basis.**

b. Load Forecast

Tri-State's rate process begins with the development of the Load Forecast which includes energy and demand loads for all 43 Members by month. Information related to the loads is based on Member System input, monthly history, and weather models. The Load Forecast is dynamic, and can change during the development process.

c. Class A Revenue Requirement

Next is the annual review of the Operating/Cost of Service Budget, which determines the Class A Revenue Requirement. A cost of service study (Federal Energy Regulatory Commission definition) is the basic tool of ratemaking. Cost of service may be defined as the amount of revenue a utility must collect from rates charged to customers to recover the costs of doing business. These costs include operating and maintenance, depreciation, taxes, interest expense, etc. Like the Load Forecast, the Revenue Requirement can change.



d. Rate Design

The revenue requirement is recovered in what is known as a “two-part” rate consisting of a demand component and an energy component. The demand component is based on the highest level of electricity supplied over a specified time frame (i.e., the demand placed on generation and transmission resources) during the billing period. The energy component is based upon the amount of electricity consumed during a billing period. Demand is equivalent to a speedometer reading, a snapshot measure of speed at a precise moment. For a utility, demand is a snapshot measure of power required at a precise moment. Energy is equivalent to an odometer reading, a cumulative measure of total miles traveled over time. For a utility, energy is a cumulative measure of total power produced or consumed over time. Two-part rate design is a common utility rate design which is intended to achieve equity among customers and achieve other goals such as encouraging energy conservation.

As a result of the Cost of Service Study, it was determined that 45% of the Revenue would be recovered from the demand rate and 55% recovered from the energy rate.

Demand revenue is split between two components – Generation Demand and Transmission/Delivery Demand, at a rate of 53% to Generation Demand and 47% to Transmission/Delivery Demand, as determined by the Cost of Service Study.

e. Special Rate Revenue

Special Rate Revenue is revenue collected through various Special Rate Contracts written using Tri-State’s Special Rate Schedules with Tri-State’s Member Systems. This revenue is calculated according to terms included in the individual contracts. Each contract contains the rates for those services and various annual indexing methods for the rates to change annually. The total Special Rate Revenue is calculated using the various rates contained in each of these special contracts multiplied by the projected loads for the projected rate year as provided in the load forecast. This revenue is subtracted from the Total Revenue Requirement to determine the total revenue to be collected in the Class A Rates.

6. How Tri-State’s Members Set Rates for their Member-Customers

As described above, Tri-State is a wholesale generation and transmission public utility and Tri-State’s Members are electric distribution cooperatives which deliver electricity to their own members (referred to as “member/customers”). Their member/customers are residential, commercial, industrial and agricultural customers in a service area with a population of approximately 1.5 million people, predominately located in rural areas. Rural electric cooperatives are non-profit businesses, just like Tri-State. Accordingly, Tri-State’s Members also charge cost of service type rates, either set by state public service commissions (where regulated) or by the Members themselves following a ratemaking process similar to the one described above.



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However, Tri-State's Members have an extra step in their rate making process. Once their revenue requirement is determined, that must first be allocated among customer classes before the rates of individual customer classes are designed. The goal of cost allocation is to assign cost responsibility on the basis of cost causation as determined in the cost of service study. However, cost allocation is not an exact science.

Members' rates are stated by customer class. Smaller Members may only have a few classes of customers: residential, small commercial, agricultural (irrigation). See Attachment 3, the current rate schedule from Poudre Valley REA. Other Members have many more classes of customers. See Attachment 4, the rate schedule and tariffs for United Power, Inc.

7. The 2017 Rule Fails To Address Let Alone Resolve All Of The Complexities And Problems Associated With Performing A Netback From Electricity Sales.

Rates are the result of complex calculations, described above in detail, which include numerous factors in addition to the cost of coal used as a fuel for generating electricity. Electric rates reflect the costs of multiple fuels – coal, natural gas, oil, hydropower, nuclear, and renewables such as solar and wind. Rates also reflect cost components beyond the generic generation and transmission costs referenced in the 2017 Rule as potentially allowable deductions for the netback methodology.

The wholesale rate Tri-State charges its Members is based upon all of Tri-State's capital and operating costs for all of its generation and purchased power resources and transmission resources together with all of its administrative and other costs. The cost of all other generation and purchased power resources, transmission resources, and other costs are included in the Tri-State revenue requirement. Any netting back from the rate Tri-State charges its Members would not reflect the value of coal produced from a particular federal lease just as it would not reflect the value of natural gas produced from a particular federal lease.

As noted above, the electricity generated in a particular state is delivered into the interstate electric grid; it cannot be traced from a specific generation resource to a specific Member or Members.

The rates Tri-State's Members charge their Member/Customers are even more complex. Each Member has its own classes of customers and its own rate design philosophy and methodology. Proceeds from sales of electricity reflect multiple retail rates charged to the different classes of utility customers (i.e., residential, commercial, industrial, irrigation and other agriculture). Each of those rates also may vary from day-to-day based on incentives utilities offer to their customers to manage peak load demand and other considerations. As a result, the same federal coal would be valued differently depending on the rate class under which the proceeds used in the netback calculation were generated. It would be impossible to obtain the revenues received by all Members from their customers and netback to a value of coal at the mine on a particular federal lease.



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Finally, even if one were able to calculate the cost to generate a single electron of electricity using the 2017 Rule's methodology, it is still impossible to trace that particular electron back to coal, let alone coal from a specific federal lease.

C. ONRR Arbitrarily Disregards Sales of Coal by Cooperatives in Favor of Sales of Electric Power by Cooperatives as Reflecting Fair Market Value.

ONRR justifies use of the netback method to value coal sold by cooperatives by arbitrarily assuming the gross proceeds from sales of electricity better reflect fair market value. In the preamble to the 2017 Rule, ONRR explained its decision to impose a netback method on coal cooperatives by asserting that "sales within coal cooperatives may not reflect the true market value of coal" because they "are, primarily, designed for mutual economic advantage." 81 Fed. Reg. at 43,354. Instead, ONRR elected to value coal based on the gross proceeds of sales of electricity because, in ONRR's view, "[t]he values established in arm's-length transactions are the best indication of market value," *see id.*, and the first arm's-length transaction occurred at the sale of electricity. *Id.* at 43,335.

Although Tri-State disagrees with ONRR's assumption that coal sales by cooperatives do not reflect market value, ONRR cannot reasonably disregard cooperatives' sales of coal in favor of sales of electric power by cooperatives. Factors that lead ONRR to conclude that coal cooperatives' sales do not reflect fair market value are also present in sales of electric power by cooperatives. Most significant, its Member Systems are not-for-profit cooperatives and public power districts operating under the RE Act with the objective of providing affordable power to rural customers. Consistent with this objective, Member Systems purchase power from Tri-State at a single wholesale rate. Furthermore, the rates at which Member Systems sell electric power are highly regulated, set either by state public service commissions or by Member Systems through a ratemaking process. ONRR cannot reasonably rely on sales of electric power as a proxy to reflect the market value of coal when some of the same characteristics of coal sales that ONRR finds objectionable exist in sales of electric power by cooperatives. Accordingly, ONRR cannot reasonably disregard cooperatives' sales of coal in favor of sales of electric power by cooperatives on the assumption that the electric sales would reflect true market value.

D. Even If A Netback Methodology Could Be Properly Used, Using Geothermal Generation And Transmission Allowances As Surrogates For Costs Of Electricity Generation And Transmission Is Arbitrary And Capricious.

The netback valuation method the 2017 Rule applies to coal sold by cooperatives is nearly identical to ONRR's valuation of geothermal resources when lessees own the power plant and sell electricity, which is also a netback method based on sale of electricity. *See* 30 C.F.R. § 1206.352 (2017). ONRR's application of its valuation methodology for geothermal resources to value coal sold by cooperatives is arbitrary and capricious. Geothermal resources are fundamentally different from coal in scope and in nature.



First, geothermal resources differ from conventional energy sources such as coal, oil, and gas because they are not portable. ONRR's predecessor agency, MMS has explained that “[u]nlike other energy resources—such as oil, gas, and coal—geothermal resources must be used immediately after production and in close proximity to the production well because of the rapid dissipation of heat in the surface environment.” Geothermal Resources; and Minerals Management—Oil and Gas Leasing; Proposed Rules, 71 Fed. Reg. 41,516, 41,516 (July 21, 2006) (emphasis added); *accord* Revision of Geothermal Resources Valuation Regulations and Related Topics, 54 Fed. Reg. 354, 354 (Jan. 5, 1989). As a result, geothermal resources “do not have a truly open market” because their markets “are restricted to the fields in which they are produced and to the type of usage for which they are suited.” 71 Fed. Reg. at 41,516.

Second, geothermal resources are used on a dramatically smaller scale than coal. Whereas federal geothermal leases yield modest annual royalty revenues of approximately \$12 million, federal coal leases yielded \$5.5 billion in revenue in 2016. *See* BLM Fact Sheet, *Renewable Energy: Geothermal* (2016)¹; ONRR Statistical Information, Reported Revenues, All Land Categories in All States and Offshore Regions for FY 2016 by Accounting Year.² Similarly, the scale of electric generation from geothermal resources is small. When MMS adopted its valuation method for geothermal resources, most power facilities were certified as “small power production facilities” under the Public Utility Regulatory Policies Act, which means they have a capacity of 80 megawatts (MW) or less. 16 U.S.C. § 796(17)(A); Revision of Geothermal Resources Valuation Regulations and Related Topics, 54 Fed. Reg. 354, 357 (Jan. 5, 1989). In contrast, for example, Tri-State’s Laramie River Station has a capacity of 1,710 MW.

These characteristics of geothermal resources limit how it can be valued. MMS previously rejected the use of conventional valuation methods to value geothermal resources. For example, MMS considered but declined to value geothermal resources using sales in other areas because the characteristics of geothermal resources vary widely from field to field. Revision of Geothermal Resources Valuation Regulations and Related Topics, 54 Fed. Reg. 354, 356 (Jan. 5, 1989). MMS also considered but declined to use prices established in contracts of lessees in the same field because of variation in valuation of geothermal resources within the same field and varying power plant efficiencies. *Id.*

In contrast, these limitations do not affect valuation of coal. ONRR has utilized alternative price indicators such as prices reported to the Energy Information Administration (EIA) to value coal sold at non-arm’s-length transactions for decades. *See* Revision of Geothermal Resources Valuation Regulations and Related Topics, 54 Fed. Reg. 1491, 1525 (Jan. 13, 1989). When issuing the 2017 Rule, however, ONRR offered no explanation as to why such price indicators are inadequate methods of valuing coal sold by cooperatives, other than reciting that arm’s-length sales are the best indicator of value. *See* Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform; Final Rule,

¹ Available at https://www.blm.gov/sites/blm.gov/files/energy_renewablegeothermalfactsheet.pdf.

² Available at <https://statistics.onrr.gov/ReportTool.aspx> (last accessed Mar. 16, 2017).



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81 Fed. Reg. 43,327, 43,335 (July 1, 2016); Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform; Proposed Rule, 80 Fed. Reg. 607, 628 (Jan. 6, 2015). Given the differences between geothermal resources and coal, and the availability of alternative valuation methods for coal, ONRR's attempt to apply a method for valuing geothermal resources to value coal is arbitrary and capricious.

Furthermore, ONRR's application of the valuation methodology for geothermal resources to coal ignores the significant costs associated with this valuation methodology. Prior to 2007, the netback method was the primary method to value geothermal resources; however, it was criticized as "cumbersome" and time-consuming by the Assistant Secretary of the Interior for Lands and Minerals Management. *See* Memorandum from Rebecca W. Watson, Assistant Secretary, Land and Minerals Management, to Jonnie Burton, Director, MMS, and Kathleen Clarke, Director, BLM (Nov. 15, 2004). "In the opinion of operators, the royalty ultimately collected [was] often less than the time and resources required by the government and geothermal producers to figure the payment, and audit the payment." *Id.* This criticism prompted Congress, in the Energy Policy Act of 2005, to direct MMS to simplify valuation for geothermal resources. *See* Pub. L. No. 109-58, § 224, 119 Stat. 594, 662-63 (2005). In response, MMS revised its geothermal valuation procedures to eliminate the netback method for all geothermal royalty valuation except for those geothermal lessees that own power plants for the generation and sale of electricity.³ *See* Geothermal Royalty Payments, Direct Use Fees, and Royalty Valuation; Final Rule, 72 Fed. Reg. 24,448, 24,461 (May 2, 2007). Given that MMS, ONRR, and Congress have largely rejected the netback method for geothermal valuation because of its complexity, ONRR should not subject coal cooperatives to similarly burdensome procedures, particularly when alternative methodologies are available for valuing coal that are not available for geothermal resources.

II. The 2017 Rule's Valuation Methodology Creates Substantial Uncertainty Regarding What Lessees Must Do To Achieve Compliance And Is Therefore Arbitrary And Capricious And Contrary To Law.

As an alternative to the netback valuation method, and as the default valuation method, the 2017 Rule provides that ONRR will determine the value of the coal. *See* 30 C.F.R. §§ 1206.252(2), 1206.253, 1206.254, 1206.258. However, the 2017 Rule provides no information regarding how ONRR will make such a determination. There is no list of criteria or factors to be considered or description of any valuation methodology. Valuation is left entirely to the agency's discretion.

The lessee may "suggest a proposed valuation method" "in writing" and "explain all relevant facts." 30 C.F.R. § 1206.258(a). The lessee may then use its suggested method until ONRR issues a determination and then the lessee must make adjustments to comply with ONRR's determination. 30 C.F.R. § 1206.252(b)(2). That determination is apparently never final until ONRR chooses to make it

³ MMS reasoned that, with respect to lessees that own their own power plants, the netback procedure is less burdensome because the lessee will have the necessary information to perform the netback calculations. Royalty Management—Geothermal Resources; and Minerals Management—Oil and Gas Leasing; Proposed Rules, 71 Fed. Reg. 41,515, 41,519 (July 21, 2006).



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final. 30 C.F.R. § 1206.257. The lessee is also at risk for late payment charges (i.e., interest) and penalties until ONRR makes that choice. 30 C.F.R. §§ 1218.202, 1241.50–1241.60.

In addition, at any time, ONRR may itself choose to determine the value of coal regardless of any action by the lessee. 30 C.F.R. § 1206.253(c). The lessee is again at risk for late payment charges and penalties if ONRR chooses to re-determine the value of the coal. 30 C.F.R. §§ 1218.202, 1241.50–1241.60.

As a result, a lessee faces substantial and unnecessary uncertainty as to whether its royalty valuations and payments will be deemed to be in compliance with the 2017 Rule even if they are made in good faith in an effort to fully comply with the law. This situation makes the 2017 Rule arbitrary and capricious and contrary to the Due Process Clause of the United States Constitution. The Due Process Clause “requires the invalidation of laws [or regulations] that are impermissibly vague.” *F.C.C. v. Fox Television Stations, Inc.*, 132 S.Ct. 2307, 2317 (2012). When rules regulate business conduct, they must be “sufficiently specific that a reasonably prudent person, familiar with the conditions the regulations are meant to address and the objectives the regulations are meant to achieve, would have fair warning of what the regulations require.” *U.S. Telecom Ass’n v. Fed. Commc’ns Comm’n*, 825 F.3d 674, 736 (D.C. Cir. 2016) (quoting *Freeman United Coal Mining Co. v. Fed. Mine Safety & Health Review Comm’n*, 108 F.3d 358, 362 (D.C. Cir. 1997)). *Accord United States v. Magnesium Corp. of Am.*, 616 F.3d 1129, 1144 (10th Cir. 2010) (“Due process, after all, requires at the least that ‘laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited.’”) (quoting *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972)). The 2017 Rule is inconsistent with basic tenets of Due Process because it fails to inform lessees how to pay correctly royalties and avoid late payment charges and penalties. Accordingly, the 2017 Rule is arbitrary and capricious and must be set aside.

III. ONRR’s Coal Transportation Allowances Are Improperly Vague And Overly Cumbersome To Calculate.

The transportation allowances that may be deducted as part of the netback method are impermissibly vague and overly cumbersome to calculate. The 2017 Rule requires coal cooperatives to value coal based on the gross proceeds under the first arm’s-length contract, “less an applicable transportation allowance.” 30 C.F.R. § 1206.252(a), (c). The 2017 Rule then explains that, under an arm’s-length transportation contract, the transportation allowance may include “reasonable, actual costs incurred” for the transportation of coal. *Id.* § 1206.261(a). The 2017 Rule does not, however, specify which costs will be deductible.

The 2017 Rule’s allowance for “reasonable, actual” transportation costs is impermissibly vague. Costs associated with the transportation of coal are not limited to straightforward charges such as rail and rail terminal fees. Rather, the shipment of coal via rail, truck, or barge incurs a variety of fees and charges. For example, shipment by rail carries a base rail transportation rate, fuel charges, related accessorial charges, and rail equipment costs. Shipment by any means will, at a minimum, carry costs such as charges to mitigate dust and oxidation at the coal mine and management fees.



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Whereas ONRR has explicitly identified allowable and disallowed transportation deductions from royalty on gas, *see, e.g.*, 30 C.F.R. § 1206.178(f), (g), the 2017 Rule does not identify which of the many coal transportation charges ONRR will allow lessees to deduct. Given the variety of transportation costs, the 2017 Rule’s failure to specify the costs that lessees may deduct renders it unlawfully vague. *See F.C.C. v. Fox Television Stations, Inc.*, 132 S. Ct. 2307, 2318 (2012). “[T]he void for vagueness doctrine addresses at least two connected but discrete due process concerns: first, that regulated parties should know what is required of them so they may act accordingly; second, precision and guidance are necessary so that those enforcing the law do not act in an arbitrary or discriminatory way.” *Id.* With respect to the 2017 Rule, it neither informs coal cooperatives which transportation costs they may deduct nor ensures that ONRR does not act arbitrarily when accepting or rejecting claimed transportation allowances.

Not only is the 2017 Rule’s direction that lessees may deduct “actual, reasonable” transportation costs unlawfully vague, the calculation of such costs is extraordinarily cumbersome. Lessees must track costs through multiple transactions and, in Tri-State’s case, shipments to four states. Furthermore, certain transportation rates may not be available to coal producers because they are protected by confidentiality clauses in coal shipment contracts. Therefore, by imposing on lessees a burden to calculate complex transportation allowances, the 2017 Rule makes the already complicated netback method even more cumbersome.

IV. The 2017 Rule Improperly Discriminates Between Federal Mineral Lessees.

A. The 2017 Rule Improperly Discriminates between Coal and Oil and Gas

The 2017 Rule does not automatically require oil and gas lessees to use a netback valuation method for all non-arm’s-length sales. Instead, it provides a series of benchmarks using published spot market or index prices for valuation of oil and gas sold at non-arm’s-length as preferred alternatives to a determination by ONRR at its discretion. 30 C.F.R. §§ 1206.102, 1206.141, 1206.142. The 2017 Rule does not include a netback method to value oil or gas. In addition, for oil and gas used to generate electricity, the oil and gas valuation rule does not look to the price of the electricity and seek to net back to the lease to value the oil or gas.

In contrast, the 2017 Rule automatically requires coal lessees with non-arm’s-length sales to either use a netback method or default to valuation at ONRR’s discretion. 30 C.F.R. § 1206.252. It does not offer benchmarks based on publicly available sales prices such as the Energy Information Administration prices used as benchmark three under the Old Rule. 30 C.F.R. § 1206.257(c)(2)(iii) (2016). The 2017 Rule also looks to the price of electricity for coal that is sold or transferred by a coal cooperative as the place where the netback calculation must begin. 30 C.F.R. § 1206.252(2)(c).

ONRR offers no explanation to justify this differential treatment of products from federal hydrocarbon leases. Some of the oil and gas may be used for the same purpose as some of the coal,



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namely generation of electricity, and may be sold or transferred to an entity fitting the ONRR definition of “coal cooperative.” Yet, that oil and gas is treated differently than coal for purposes of royalty valuation. “[An] agency may not treat like cases differently.” *Eagle Broadcasting Group, Ltd. v. Fed. Commc’ns Comm’n*, 563 F.3d 543, 551 (D.C. Cir. 2009) (quoting *Freeman Eng’g Assocs., Inc. v. FCC*, 103 F.3d 169, 178 (D.C. Cir. 1997)). At a minimum, “[t]he arbitrary-and-capricious standard requires an agency to ‘provide an adequate explanation to justify treating similarly situated parties differently.’” *In re FCC 11-161*, 753 F.3d 1015, 1142 (10th Cir. 2014) (quoting *Comcast Corp. v. FCC*, 526 F.3d 763, 769 (D.C. Cir. 2008)). The differential treatment is arbitrary, capricious and contrary to law.

B. The 2017 Rule’s Sets Different Standards for Entities Defined as a “Coal Cooperative.”

The 2017 Rule introduces a new category of royalty payor – coal cooperative. 30 C.F.R. § 1206.20. As applied by the 2017 Rule, the coal cooperative definition assumes that members of a coal cooperative are “affiliated” meaning they “control[], [are] controlled by, or [are] under common control with another person” and therefore their contracts should be treated as non-arm’s-length. 30 C.F.R. § 1206.20 (definition of “affiliate”). However, this definition entirely ignores the procedure and evidence required by both the 2017 Rule and the Old Rule to conclude that two entities are “affiliated.”⁴

The Old Rule included the concept of “affiliate” and specified the procedure and evidence required to support a conclusion of control sufficient for two entities to be “affiliated” and thereby make their contracts “non-arm’s-length” for purposes of royalty valuation. The 2017 Rule incorporates the Old Rule’s concept, procedure and evidentiary requirements. 30 C.F.R. § 1206.20. They are:

Affiliate means a person who controls, is controlled by, or is under common control with another person. For purposes of this subpart:

- (1) Ownership or common ownership of more than 50 percent of the voting securities, or instruments of ownership or other forms of ownership, of another person constitutes control. Ownership of less than 10 percent constitutes a presumption of non-control that ONRR may rebut.
- (2) If there is ownership or common ownership of 10 through 50 percent of the voting securities or instruments of ownership, or other forms of ownership, of another person, ONRR will consider each of the following factors to determine if there is control under the circumstances of a particular case:
 - (i) The extent to which there are common officers or directors

⁴If ONRR is concerned with valuing coal sold in non-arm’s-length affiliate sales, the Old Rule’s definition of “affiliate” and its procedures governing sales by affiliates address the concern.





- (ii) With respect to the voting securities, or instruments of ownership or other forms of ownership: the percentage of ownership or common ownership, the relative percentage of ownership or common ownership compared to the percentage(s) of ownership by other persons, if a person is the greatest single owner, or if there is an opposing voting bloc of greater ownership
- (iii) Operation of a lease, plant, pipeline, or other facility
- (iv) The extent of other owners' participation in operations and day-to-day management of a lease, plant, or other facility
- (v) Other evidence of power to exercise control over or common control with another person

30 C.F.R. § 1206.20 (2016); 30 C.F.R. § 1206.20 (2017).

ONRR has not applied these longstanding ownership percentage criteria for determining control to reach its conclusion that all coal cooperatives, i.e., entities “organized to provide coal or coal-related services to the entity’s members, partners and others,” should be deemed to be “affiliated.” ONRR also has not followed its longstanding procedure to determine control in situations where ownership is less than 50 percent. And, ONRR has not provided any evidence necessary to support a conclusion of control and therefore “affiliation” requiring all coal cooperative contracts to be treated as non-arm’s-length. Instead, ONRR assumes without any basis in fact or the legal principles concerning corporate control that prices in all coal cooperatives’ contracts inherently understate market values and must be disregarded. This conclusion is arbitrary, capricious and contrary to law.

The facts regarding the relationships between Tri-State and its Member Systems detailed above demonstrate the lack of basis for ONRR’s assumptions about coal cooperatives. Tri-State and its Member Systems would not meet the definition of “affiliate” under either the Old Rule or the 2017 Rule because the facts do not support a conclusion that Tri-State has “control” over any Member System or that any Member System has “control” over Tri-State. Nonetheless, the 2017 Rule would classify each of them as parts of a “coal cooperative” and automatically treat their contracts as non-arm’s-length as if they had control over one another.





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Conclusion

Tri-State appreciates ONRR's consideration of its comments and respectfully requests that ONRR repeal the 2017 Rule. Please do not hesitate to contact Michael G. Sorensen at mgsorensen@tristategt.org or 303-254-3208 about the information presented in these comments.

Respectfully submitted,

Barbara A. Walz
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Chief Compliance Officer

BJW:PAB:der

- Attachment 1: Map of Tri-State Member System
- Attachment 2: Map of Tri-State System
- Attachment 3: Poudre Valley REA Rate Schedule
- Attachment 4: United Power Inc. Rate Schedule and Tariffs

File: P3-16.11