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RE: Combined Comments on the Office of Natural Resources Revenue's Proposed Rule for the Repeal of Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform, Docket No. ONRR-2017-0001 and RIN No. 1012-AA20, and Advance Notice of Proposed Rulemaking for Federal Oil & Gas and Federal & Indian Coal Valuation, Docket No. ONRR-2017-0002 and RIN No. 1012-AA21

To Whom It May Concern:

Cloud Peak Energy Inc. appreciates the opportunity to comment on the two related rulemaking proceedings that the Office of Natural Resources Revenue's ("ONRR") published in the *Federal Register* on April 4, 2017:

1. Proposed Rule for the Repeal of Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform, 82 Fed. Reg. 16,323 (April 4, 2017), which seeks public input on whether ONRR should repeal the royalty valuation regulations that were published in the *Federal Register* on July 1, 2016 ("2017 Valuation Rule") and, instead, maintain the current regulatory *status quo* by keeping the longstanding pre-existing regulations in effect; and
2. Advance Notice of Proposed Rulemaking for Federal Oil & Gas and Federal & Indian Coal Valuation, 82 Fed. Reg. 16,325 (April 4, 2017), which seeks public input on whether ONRR should adopt new valuation rules or whether ONRR should amend the 2017 Valuation Rule (if it is not repealed).

Cloud Peak Energy supports ONRR's Proposed Rule to repeal the 2017 Valuation Rule. Both during the comment period for the 2017 Valuation Rule, and in litigation challenging the 2017 Valuation Rule, Cloud Peak Energy has opposed the 2017 Valuation Rule. In particular, Cloud Peak Energy has opposed, among other things, the 2017 Valuation Rule's mandatory application of the netback approach to value affiliate coal sales; as ONRR and the courts have long recognized, a netback is the least reliable valuation method for determining an "at the mine" value of coal as required by the Mineral Leasing Act of 1920. Cloud Peak Energy also opposed the "default" provision as arbitrary and at odds with the stated purpose of the 2017 Valuation Rule to provide "greater simplicity, certainty, clarity, and consistency" in the royalty valuation process.

ONRR should continue to apply the longstanding valuation rules that have worked well for decades. In particular, ONRR should continue to apply a series of ordered benchmarks to value coal sold to affiliated businesses. The valuation benchmarks have led to a proper royalty value of the coal in accordance with the Mineral Leasing Act of 1920 – a value "at the mine" based on arm's-length transactions. In its comments below in response to ONRR's advance notice of proposed rulemaking, Cloud Peak Energy offers minor suggested revisions to the longstanding valuation rules, such as revising the benchmarks to include (i) the lessee's comparable sales of coal under benchmark one and (ii) clearer language on use of

coal index prices under benchmark four. These revisions would enable easier application of the benchmarks for both industry and ONRR.

I. Rulemaking Background

On January 6, 2015, ONRR published a proposed rule to amend its valuation regulations for Federal oil and gas and Federal and Indian coal. 80 Fed. Reg. 608 (Jan. 6, 2015). On April 29, 2015, Cloud Peak Energy submitted extensive comments opposing the coal valuation amendments, as did many other stakeholders.

On July 1, 2016, ONRR published its Final Rule in the *Federal Register* adopting the valuation regulations as proposed with almost no changes. 81 Fed. Reg. 43,338 (July 1, 2016) (the 2017 Valuation Rule).

On December 29, 2016, Cloud Peak Energy, along with the National Mining Association, the Wyoming Mining Association, and Black Hills Corporation, filed a Petition for Review of Final Agency Action challenging the legality of ONRR's 2017 Valuation Rule. See *Cloud Peak Energy Inc. v. U.S. Dep't of the Interior*, Civil Action No. 16-CV-315-F (D. Wyo.). On the same date, two other petitions for review were separately filed by oil and gas industry members and coal and electric utility industry members.

In addition, on February 17, 2017, Cloud Peak Energy and the other petitioners sent a letter to the ONRR Director requesting that the 2017 Valuation Rule be stayed pending litigation and before producers were required to comply with the 2017 Valuation Rule for January 2017 production. On February 27, 2017, in response to the petitioners' lawsuits and letters, ONRR postponed the effectiveness of the 2017 Valuation Rule through a *Federal Register* Notice (82 Fed. Reg. 11,823 (Feb. 27, 2017)) and a Dear Payor letter, which was posted on its website.

At ONRR's request, the lawsuits challenging the 2017 Valuation Rule have been stayed pending this rulemaking proceeding.

II. Introduction to Cloud Peak Energy

Cloud Peak Energy is one of the safest producers of low sulfur, high quality subbituminous coal in the United States. It owns and operates three Powder River Basin ("PRB") coal mines, which have been mining and shipping coal since the mid-1970s. The Antelope and Cordero Rojo mines are located in northeast Wyoming and the Spring Creek Mine is located in southeast Montana. In 2016, Cloud Peak Energy shipped approximately 59 million tons of coal from its three mines to customers located throughout the U.S. and around the world. We also have two major development projects, the Youngs Creek project and the Big Metal project, with the Crow Tribe in the northern PRB.

Cloud Peak Energy owns and operates a logistics service company that enters into contracts with third parties (primarily railroad and terminal companies) to provide for transportation and other handling services that are necessary to deliver the coal to some of our domestic and international customers. Cloud Peak Energy is the only Wyoming-headquartered company listed on the New York Stock Exchange (NYSE: CLD).

A. Substantial Payments to Federal and State Governments

Through the leasing and mining of Federal coal reserves, Cloud Peak Energy is a major contributor of Federal lease bonuses, Federal lease rentals, Federal royalties, and state severance taxes and royalties. In the last six years, Cloud Peak Energy has paid a total of \$479 million in Federal lease payments (not including federal royalty or state severance taxes).

In addition, in 2016, Cloud Peak Energy paid approximately \$209 million in Federal and state royalties and excise taxes. Of the \$209 million, approximately \$78 million was paid directly to and retained by the Federal government. Cloud Peak Energy paid approximately \$47 million to the Federal government for distribution to the states, and approximately \$83 million directly to the local and State governments. In total, the State of Wyoming received \$97 million, and the State of Montana received \$33 million in royalties and taxes. By comparison to the amount of royalties and taxes paid, Cloud Peak Energy's net income for 2016 was about \$21.8 million.

B. Employees and Industry Leading Safety Record

Cloud Peak Energy's 1,300 employees live in Wyoming, Montana, Colorado and South Dakota. Mining and the family-wage jobs created by mining help sustain communities in this region. Cloud Peak Energy is proud to support our communities, work with our local businesses and purchase goods and services in the region. In 2016, Cloud Peak Energy's expenditures totaled \$183 million in Wyoming, \$10 million in Montana, and \$7 million in Colorado.

Cloud Peak Energy is one of the safest coal producers in the nation. For 2016, Mine Safety and Health Administration data for employee injuries showed that Cloud Peak-operated mines collectively had the lowest employee all injury frequency rate (0.25) in the company's history. We continue to hold safety as a core value and will always work toward our goal of zero injuries.

C. Strong Environmental Stewardship

Cloud Peak Energy has strong programs in environmental stewardship and performance. In 2016, Cloud Peak Energy's Environmental Management System was recertified under the internationally recognized ISO 14001 standards for the eleventh consecutive year. The company continues to be recognized for environmental compliance and initiatives. Most recently, in 2017, Cloud Peak Energy's Antelope Mine was honored to receive the Wyoming Game and Fish Department's Industry Reclamation Wildlife Stewardship Award for its successful efforts to promote population numbers of golden eagles and other raptors through habitat enhancement and use of effective protection measures

III. Comments

A. Cloud Peak Energy Supports Prompt Repeal of the 2017 Valuation Rule

As ONRR recognized in its Proposed Rule, Cloud Peak Energy and other industry members have raised "serious questions concerning the validity and prudence of the 2017 Valuation Rule." 82 Fed. Reg. at 16,323. Unless ONRR repeals the 2017 Valuation Rule, these serious questions will remain.

Cloud Peak Energy's main objections to ONRR's 2017 Valuation Rule are:

1. the netback valuation method – mandated by ONRR as the only available valuation method for affiliate sales of coal (30 C.F.R. § 1206.252(a) (2017)) – is the least reliable valuation method and, in practice, fails to comply with the Mineral Leasing Act's requirement to value coal "at the mine";
2. there is no justifiable basis to afford an index valuation option for oil and natural gas producers that sell downstream from the lease, while maintaining a netback as the only option for coal;
3. the netback valuation method unlawfully imposes a royalty on the value of services provided by Cloud Peak Energy's logistics business;
4. the "default" provision (§ 1206.254 (2017)) and its many triggers are arbitrary and at odds with the stated purpose of the 2017 Valuation Rule; and
5. the 2017 Valuation Rule imposes an unconstitutional tax on exports.

For these reasons, as outlined in detail in Cloud Peak Energy's April 29, 2015 comment letter and in its Petition for Review of Agency Action (both incorporated herein by reference), ONRR should repeal the 2017 Valuation Rule.

B. ONRR Can Improve the Long-Standing Benchmarks

1. The Benchmarks

The Federal and Indian coal regulations have been in effect since 1989. See *Revision of Coal Product Valuation Regulations and Related Topics*, 54 Fed. Reg. 1,492 (Jan. 13, 1989). These regulations, like the similar regulations for natural gas, prescribe an ordered series of "benchmarks" that look to outside, verifiable indicia of market value to determine value at the mine. 30 C.F.R. § 1206.257(c)(1)-(2) (2016). The first applicable benchmark applies. *Id.* § 206.257(c)(2) (2016). The principal indicia of market value is comparable arm's-length contracts in the same vicinity as the affiliate sale. A netback methodology is only resorted to if all other methods fail.

Benchmark 1

Under the first of the benchmarks, the gross proceeds accruing to the lessee under its non-arm's-length contract will be accepted as value if the "gross proceeds are within the range of the gross proceeds derived from, or paid under, comparable arm's-length contracts between buyers and sellers neither of whom is affiliated with the lessee for sales, purchases, or other dispositions of like-quality coal produced in the area." *Id.* §§ 1206.257(c)(2)(i) (2016) (Federal coal) and 1206.456(c)(2)(i) (2016) (Indian coal). In other words, Cloud Peak Energy's gross proceeds received under its non-arm's-length contracts with its logistics business will be accepted as the value of the coal if those gross proceeds are "within the range of" the gross proceeds received by *other coal producers* under comparable sales contracts. The gross proceeds received by Cloud Peak Energy under its own arm's-length contracts are not considered under benchmark one; they are considered under benchmark four.

In addition, benchmark one states: "In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered: Price, time of execution, duration, market or markets served, terms, quality of coal, quantity, and such other factors as may be appropriate to reflect the value of the coal." *Id.*

The difficulty with application of existing benchmark one, at least at the time of production and payment of royalty, is that lessees like Cloud Peak Energy do not have access to their competitors' sales agreements. Only ONRR has these agreements. Therefore, when it makes its royalty payments, Cloud Peak Energy is unable to determine whether its gross proceeds are comparable to other producers' gross proceeds. Lacking information about their competitors' sales contacts, lessees like Cloud Peak Energy must therefore look to valuation methods under the other benchmarks when paying royalties, and do so in order, applying the first applicable benchmark.

Benchmarks 2 and 3

If the first benchmark does not apply, the second benchmark establishes value based on "[p]rices reported for that coal to a public utility commission." *Id.* §§ 1206.257(c)(2)(ii) (2016) and 1206.456(c)(2)(ii) (2016). Under the third benchmark, value would be established based on "[p]rices reported for that coal to the Energy Information Administration of the Department of Energy." *Id.* §§ 1206.257(c)(2)(iii) (2016) and 1206.456(c)(2)(iii) (2016). These benchmarks do not apply to Cloud Peak Energy's mines (or indeed many other mines).

Benchmark 4

Under the fourth benchmark, the value is broadly based on “other relevant matters,” which include, but are not limited to, “published or publicly available spot market prices” or “information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of coal.” *Id.* §§ 1206.257(c)(2)(iv)(2016) and 1206.456(c)(2)(iv)(2016). This fourth benchmark has been described by one federal court as “the catchall provision.” *Decker Coal Co. v. United States*, No. CV-07-126-BLG-RFC, 2009 WL 700221, at *10 (D. Mont. Mar. 17, 2009). It is the benchmark most often used to value coal sold to an affiliated entity.

ONRR’s guidance documents, available on its website, provide examples of “other relevant matters” that may be considered under the fourth benchmark:

- Spot market prices of other unaffiliated producers’ with comparable contracts
- Weighted monthly average of comparable arm’s length sales from the mine
- Cost of mining plus a reasonable ROI
- Weighted monthly average arm’s length prices an affiliated utility pays to unaffiliated suppliers for similar coal, even if not comparable contracts.

“Introduction to Coal Royalty Valuation” at 74 (2009) (emphasis added).¹ Similarly, ONRR’s “Coal Valuation Manual” lists “[t]he weighted average of comparable arm’s length sales from the mine” as the second example of “other relevant matters.” “Coal Valuation Manual” at 29.²

Benchmark 5

Lastly, if none of the four preceding benchmarks apply, then “a net-back method or any other reasonable method shall be used to determine value.” *Id.* §§ 1206.257(c)(2)(v) (2016) and 1206.456(c)(2)(v) (2016). The problem with a netback (as ONRR recognized in adopting the benchmarks) is that it starts with a price that could be in a far distant location, and then subtracts transportation costs that may or may not account for the difference in value between the point of production and the point of sale. It is not an accurate or reliable method for determining the value of coal at the mine.

When the Minerals Management Service (“MMS”), ONRR’s predecessor agency, published the proposed coal royalty regulations that were ultimately adopted in 1989, it explained its intent that the fifth benchmark would apply only “if the first four benchmarks cannot be applied.” 53 Fed. Reg. 26,942, 26,956 (July 15, 1988). MMS made clear that “[t]his [netback] approach [is] to be seen as a *last resort*.” *Id.* (emphasis added).

These benchmarks have been applied since 1989 in a workable manner. At most, there has been occasional disagreement between lessees and ONRR over whether sales are considered arm’s-length or non-arm’s-length or over which is the first applicable benchmark. For example, in *Decker Coal*, the issue was not that the benchmarks were unworkable or led to unreliable valuations; the issue was that MMS erred by proceeding to the fourth benchmark when the first benchmark was applicable, contrary to the regulation’s mandate. *Id.* at *2, *9.

2. Suggested Improvements to Benchmarks

Cloud Peak Energy believes that the long-standing valuation benchmarks are workable overall, providing for valuation based on how the coal is sold and what information is available to ONRR and the lessee. We do, however, believe a couple of improvements can be made.

¹ Available at: <https://www.onrr.gov/ReportPay/PDFDocs/Binder4.pdf> (last visited March 9, 2017).

² Available at: <https://www.onrr.gov/ReportPay/PDFDocs/Binder10.pdf> (last visited March 9, 2017).

Benchmark One Should Include the Lessee's Own Arm's-Length Sales

As indicated above, benchmark one is currently of little value at the time of production because it is limited to consideration of arm's-length sales by *other producers* – information that the lessee generally does not have. By contrast, benchmark one for natural gas production has always included arm's-length sales by the lessee; it has not been limited to sales by other producers. See 30 C.F.R. §§ 206.152(c)(1) (2016). There is no reason to treat coal differently from natural gas in the benchmark valuation system – the valuation principles should be the same.

Indeed, comparable arm's-length sales at the lessee's own mine provide the most accurate means of determining an "at the mine" value. See 76 Fed. Reg. 30,881, 30,882 (May 27, 2011) ("The Department of the Interior has long held the view that the sales prices agreed to in arm's-length transactions are the best indication of market value. The 1989 regulations reflect that view."); *Decker Coal*, 2009 WL 700221, at *9 (evidence of other arm's-length coal sales "has real importance and thus should not be cursorily dismissed by the agency"); see also *Getty Oil Co.*, 51 IBLA 47, 51 (1980) ("Although contracts between a parent corporation and its subsidiary may be not at arm's length, they may result in a fair market price. If a transaction is not at arm's length, some other manifestation that the price is nonetheless an accurate portrayal of the article's worth is required. It must be a price which independent buyers in arm's length transactions would be willing to pay.") (emphasis added); *Mobil Oil Corp.*, 112 IBLA 198, 205 (1989) (MMS will normally accept non-arm's length contract price for royalty value of natural gas where "the lessee can show that the contract has characteristics similar to arm's-length contracts which represent fair market value").

In addition, examination of the lessee's own arm's-length sales at or near the mine best ensures compliance with ONRR's comparability factors set forth in 30 C.F.R. §§ 1206.257(c)(2)(i) (2016) (for Federal leases) and 1206.456(c)(2)(i) (2016) (for Indian leases). Those factors include "[p]rice, time of execution, duration, market or markets served, terms, quality of coal, quantity, and such other factors as may be appropriate to reflect the value of the coal[.]" *Id.* § 1206.257(c)(2)(i) (2016). In the case of Cloud Peak Energy, the vast majority of coal is sold at or near the mine under arm's-length contracts. Accordingly, there is ample evidence of the value of the coal at the mine, including the coal that is ultimately shipped to international customers. There is no reason to defer consideration of this information until benchmark four.

ONRR should therefore amend the current benchmarks to include in the first benchmark the use of the lessee's comparable arm's-length sales at the same mine. This could be accomplished by simply using the language from benchmark one of the gas valuation rules, which includes consideration of all comparable arm's-length contracts. This will provide both ONRR and the lessee more certainty in determining value, and reduce reliance on the subsequent, less reliable benchmarks.

Benchmark Four Should Expressly Include Coal Index Prices (Adjusted as Necessary)

A second improvement is that benchmark four – which provides for consideration of "other relevant matters" – should specifically describe use of published coal index prices. The use of an index price, or appropriately adjusted index price, for determining value at the mine is a simple and reliable option for lessees and ONRR to use for valuing non-arm's-length coal sales.

Coal index prices are available through services such as Argus/McCloskey's Coal Index Price Service and through Platts Market Data Service. Platts has been publishing daily and weekly index prices, also known as price assessments, for standardized products since 2003. The four standard products are Central Appalachian barge-delivered coal, Central Appalachian rail-delivered coal, and two low-sulfur Powder River Basin coal products, one with 8,800 Btu/lb. and the other with 8,400 Btu/lb. Similarly, Argus publishes daily and weekly price assessments for all world market centers, including Central Appalachia, Northern Appalachia/Pittsburgh Seam, Illinois Basin, Powder River Basin, Western

Bituminous, U.S. export prices, U.S. import prices, and Latin America. The index price services rely on a wide variety of sources for information including producers, generators, marketers, importers, exporters, traders, brokers, and data from electronic trading platforms.

The published index prices are reliable, as reflected by their widespread use for indexation of long-term contracts, spot market contracts, derivatives transactions such as swaps and exchange settlements, internal transfer pricing, market analysis, and performance measures. In fact, Cloud Peak Energy relies on published index prices for indexation of some of its long-term contracts. Because of the increasing volumes of sales being reported to Argus and Platts for indexing (Cloud Peak Energy reports 100% of its sales), and the verification analysis conducted by these services, the indexed values are a much better indicator of value at the mine.

Importantly, the index prices can be (and are) adjusted to determine the value of the coal from various mines. For example, the published index prices for 8,800 Btu coal in the Powder River Basin are used and adjusted for transactions involving Cloud Peak Energy's Spring Creek Mine in Montana, where the coal is about 9,400 Btu but contains higher levels of sodium that largely offset the value of the higher Btus.

While an index price option is encompassed by the "other relevant matters" of benchmark four, ONRR should add specific language addressing use of index prices to cover those situations where evidence of comparable arm's-length sales at the mine is not available. Cloud Peak Energy suggests adding the following language to benchmark four's list of "other relevant matters": "published index prices for coal (adjusted as necessary)." This language is similar to the language of benchmark two for natural gas, which includes "posted prices of gas" and "other reliable public sources of price or market information." 30 C.F.R. § 1206.152(c)(2) (2016).

IV. Conclusion

Cloud Peak Energy urges ONRR to repeal the 2017 Valuation Rule and retain the long-standing benchmark system in effect since 1989. Improvements to the benchmark system would include adding to the first benchmark the use of the lessee's comparable arm's-length sales at the same mine and specific language on use of index prices in benchmark four. The 2017 Valuation Rule's mandate of a netback methodology on affiliate sales of coal, along with the "default" rule, is contrary to Congressional intent of creating clarity and well-established principles of royalty valuation.

Thank you in advance for your consideration of these comments and for incorporation of these points into any subsequent phases of this proposed rulemaking process. Cloud Peak Energy reserves its right to amend or supplement its comments. Please feel free to contact me if additional details or explanation of these comments would be helpful in that process.

Sincerely,



Colin Marshall