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Attn: Regulation Identifier Number (RIN) 1012-AA13

Re: National Mining Association Comments on Office of Natural Resources Revenue (ONRR) Proposed Rule to Amend Federal and Indian Coal Valuation Regulations, 80 Fed. Reg. 608 (Jan. 6, 2015)

Submitted via: http://www.regulations.gov and U.S. mail

Dear Mr. Southall:

On January 6, 2015, the Office of Natural Resources Revenue ("ONRR") issued a Proposed Rule entitled "Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform." This rule would significantly modify the royalty valuation regulations in 30 C.F.R. Part 1206, Subparts F and J, applicable to coal production from leases on federal and Indian lands, respectively.

The National Mining Association ("NMA") is a national trade association representing America's mining industry. NMA's members are producers of most of America's coal, metals, industrial and agricultural minerals; manufacturers of mining and mineral processing machinery and supplies; transporters; financial and engineering firms; and other businesses related to mining. A significant number of NMA's members operate leases on federal and Indian lands with royalty obligations within ONRR's purview.

NMA appreciates the opportunity to submit comments on this Proposed Rule. As explained below, NMA and its members strongly oppose the principal proposed changes to the royalty valuation standards for coal production from federal and Indian leases. The proposal would defeat the very goals it purports to promote for all parties – "greater simplicity, certainty, clarity, and consistency in product valuation." 80 Fed. Reg. at 608. In lieu of the established and well-understood methods for coal valuation for royalty purposes, ONRR would insert arbitrariness and uncertainty. For example, ONRR proposes to bypass its own rules and exercise essentially unreviewable discretion to set coal royalty value whenever it chooses. The Proposed Rule also ignores that the applicable mineral leasing laws and lease terms entitle the lessor to a prescribed percentage of the value *of coal* at *the lease*. Further, ONRR would impose a unique and inflexible mandate on coal lessees to chase transactions nationally or globally in search of an arm's-length sale and calculate potentially complex transportation costs along the way, notwithstanding ONRR's own recognition – both previously and in the current Proposed Rule – of the significant challenges inherent in such a net-back methodology. For non-arm's length dispositions, ONRR overlooks that the prescribed royalty rate in the lease contract was agreed to only to value coal, not to value another commodity – electricity – generated by consuming the coal and the price for which is affected by a variety of regulatory and market factors inapplicable to coal. ONRR's simplistic proposal to value certain coal based on electricity sales also reveals ONRR's failure to sufficiently contemplate whether and how such a methodology would actually work; in reality, it is infeasible to implement given the number of variables, information gaps, delays, and other factors ONRR has failed to consider in the Proposed Rule. Based on these serious flaws, individually or collectively, ONRR's principal proposed changes to the coal valuation regulations should be withdrawn or, at a minimum, re-drafted and re-proposed.

GENERAL COMMENTS

In the guise of merely suggesting that it is amending the coal valuation standards to comport with procedures largely adopted for oil in 2000 and proposed in this same rulemaking for both oil and gas, ONRR is revising 26 years of existing valuation standards with no explanation of the effects or any detailed justification for the changes. Rather, ONRR's proposal to overhaul the existing regulatory scheme appears singularly aimed at extracting more royalties from federal and Indian coal lessees beyond what is fairly, and legally, due. Tellingly, as NMA predicted in prior submitted comments, ONRR has abandoned its stated intention at the start of this rulemaking to pursue revenue neutral changes.[1] Indeed, the Proposed Rule likely would have the effect of rendering coal exports uneconomic. At the same time, ONRR does not articulate any reasoned basis why substantial changes are needed to the existing royalty valuation system which is already subject to robust audits by regulatory authorities.

Coal Valuation Is Unique

As an initial matter, ONRR's proposal (including its preamble) fails to justify the need for wholesale changes to valuation standards for federal and Indian coal. As NMA and its members have repeatedly explained, and as the agency itself has recognized in prior rulemakings, the production and marketing of coal is fundamentally different than the

[1] NMA incorporates by reference its and its members' prior comments submitted on the May 27, 2011 Advance Notice of Proposed Rulemaking and in related public meetings. While that process ostensibly was aimed at incorporating stakeholder input, ONRR's Proposed Rule casts aside those valuable contributions and presents concepts never raised by ONRR or commenters.

production and marketing of oil and gas and other minerals.[2] Accordingly, coal warrants a continued valuation regime appropriately tailored to those critical differences.[3]

Specific differences relate to coal markets, production and reserve development, marketing and contract practices, large ongoing capital and operating expenses, and long-term contract arrangements. Federal coal lessees generally do not explore or develop mining prospects with the hope that someone buys the coal. To justify the enormous costs in exploring for coal and developing and maintaining a viable coal mine, coal lessees generally require in advance the certainty of one or more customer commitments for significant tonnages over long-term periods. In several instances, coal production is fully dedicated to a single end user under a long-term contract. Additionally, once a coal mine is operational, it cannot simply be "shut in" like an oil or gas well – lessees are instead compelled by existing contracts, labor concerns, and other factors to continue production even during adverse economic conditions. These basic coal market dynamics have remained steady over time. But the Proposed Rule does not even begin to account for them.

ONRR's "Default Provision" Substitutes Arbitrariness for Certainty

Despite the heightened need for upfront certainty in the valuation standards for federal and Indian coal, ONRR now threatens to destroy that certainty and largely lump coal valuation with federal oil and gas. This newly injected uncertainty is encapsulated in the "new default provision" proposed at §§ 1206.254 and 1206.454, as well as the various triggers for application of that provision at §§ 1206.253 and § 1206.453 and interspersed elsewhere throughout the Proposed Rule. ONRR concedes it is seeking to reinstate "considerable discretion to establish the reasonable value of production using a variety of discretionary factors and any other information the Secretary believes is appropriate." 80 Fed. Reg. at 610. This is not certainty – it is a black box. Lessees are left to guess if, when, and how ONRR will decide to insert itself into regular business transactions with the use of the default provision and what outcomes would ensue. Whatever the scope of ONRR's discretion might be legally, it does not follow that ONRR can or should dispense with the promulgated rules (existing or new) whenever it wants. Otherwise, lessees would be faced with the untenable situations of reporting production and royalties and then hoping for the best. That is hardly a reasonable regulatory scheme, particularly given the necessary upfront certainty to support coal mining

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[2] *See, e.g.*, 54 Fed. Reg. 1492, 1513 (Jan. 13, 1989) (final rule) ("It is indeed true that oil and gas and coal are very different commodities. In addition to their obvious physical differences and the differences in production methods, Federal western coal is used in large part only for electric generation, whereas this is only one of many uses for oil and gas. Related to their varied uses is the fact that oil and gas prices are dictated in large part by international market forces. Coal, on the other hand, is affected more by specific markets because it is not a fungible [sic]. For example, many large western mines are developed to supply coal to a particular powerplant which is designed specifically to burn that coal. If that purchaser is lost, the coal may not be readily saleable.").

[3] NMA is not commenting on the proposed changes to oil or gas valuation for royalty purposes.

operations and the sensitive economic underpinnings upon which existing operations depend.

Under its "default provision," ONRR could upend reasonable and settled expectations whenever ONRR decides for any reason that it dislikes any given lessee's reported coal valuation. The trigger for the "default provision" may include a mere inadvertent or insubstantial paperwork error; unreasonably low arm's-length prices or unreasonably high allowances, with ONRR as the sole arbiter of what is "reasonable"; or even ONRR's unsubstantiated doubt "for any reason" whether the lessee "properly" valued coal. The remedy would not be an opportunity for the lessee to correct, but rather an ONRR-dictated value and corresponding royalty due. Whenever coal is unsold and electricity generated therefrom is also unsold, and potentially in other instances as well, ONRR would not afford the lessee a valuation opportunity at all. In setting the new valuation, ONRR could consider "any information ONRR deems relevant" – including factors enumerated in the current coal valuation benchmarks ONRR proposes to rescind for lessees' use, and other metrics or information unavailable to lessees. *Compare* 80 Fed. Reg. at 609 ("ONRR proposes to eliminate current benchmarks" for coal) *with id.* at 614, 629 (referring to same explanation for federal gas default provision, which says Proposed Rule "allows ONRR to consider any criteria we deem relevant, as well as criteria similar to the current gas valuation benchmarks"). The value ONRR establishes would also be effectively unchallengeable given ONRR's likely assertion of confidentiality claims for the underlying information, e.g., sales prices other lessees report to ONRR. The uncertainty that ONRR's Proposed Rule creates is particularly problematic in view of ONRR's aggressive new policies on proper initial reporting and payment of royalties and threats of substantial civil penalties for erroneous reporting. *See* 79 Fed. Reg. 28,862 (May 20, 2014).

Universal Net-backs Are Unworkable and Risk Improperly Inflating or Deflating Royalties

ONRR fails to provide any explanation of the implications of its proposal that the value of *all* coal produced from federal and Indian leases in areas like Wyoming, Montana, Colorado, or New Mexico and ultimately sold under an arm's-length contract would be based on the sales price *no matter where in the world that sale occurs*, with a complicated and incomplete set of deductions for transportation costs to the sales point. While ONRR has adopted a similar valuation standard for oil (all of which is marketed only domestically) and is proposing the same standard for gas (virtually all of which currently is marketed only domestically), ONRR fails to point out a critical distinction – optionality. For oil and gas production, ONRR provides the lessee the *option* of instead basing its value for royalty purposes on a locally-applicable published index price. ONRR would provide *no* alternative methodology for coal lessees. Indeed, the Proposed Rule would foreclose the workable valuation benchmarks for coal first disposed of non-arm's-length, which look initially to comparable sales of coal produced in the area in the same time to value that production. Additionally, the Proposed Rule does not contemplate the situation where the first arm's-length sale is in a financial market as a hedge.

Therefore, under the common situation where a lessee produces coal and sells or transfers that coal to an "affiliate or another person" who later resells that coal, the lessee now would be required to chase the first arm's-length physical sale, wherever it may occur, and then seek to net-back the value to the lease. That is a valuation procedure which ONRR for years has stated is highly disfavored compared to other valuation measures. Its impropriety here is augmented by the absence of any explanation by ONRR how to reliably perform net-backs across multiple regions or countries and transportation modes. Similar difficulties would arise in the context of transfers by a lessee to a member of a coal cooperative, where data regarding a subsequent arm's-length transaction, the sales price, and transportation and washing costs may be unobtainable by the lessee. And if the lessee gets it "wrong" in any of these situations, then per its default provision ONRR would intercede and unilaterally set the value for royalty purposes.

In addition to its practical ambiguities, ONRR's blanket net-back mandate would run afoul of the bedrock legal principle that the value for royalty purposes of production from federal and Indian coal leases must be established at or near the lease. This foundational principle derives from the terms of the mineral leasing statutes and the leases. ONRR's own Proposed Rule admits this tenet, but fails to abide by it. 80 Fed. Reg. at 609 ("the Department reaffirms that the value, for royalty purposes, of . . . coal produced from Federal and Indian leases is determined at or near the lease"). ONRR does not explain how its ignoring or limiting lessees' practical ability to deduct reasonable, actual, and necessary transportation and washing costs preserves that key principle. If ONRR's new rules render lessees' determinations of their allowances inordinately difficult or unreasonably low, then ONRR effectively is collecting more royalty revenue than it is entitled to.

These proposed rules upsetting established and well-founded expectations not only are unfair, but also risk raising breach of contract and other legal claims. As specified in the existing regulations, lease terms and written agreements prevail over existing regulations. 30 C.F.R. §§ 1206.250(b), 1206.450(b). ONRR's Proposed Rule contains the same reservation (proposed §§ 1206.250(c) and 1206.450(c)). ONRR's duty not to arbitrarily amend its regulations takes on even more import where ONRR, like any private party, has entered into binding contracts. Put simply, ONRR cannot decide to alter a key economic term of the lease agreement to extract additional financial consideration after the fact. But the Proposed Rule appears to have been fashioned to reach that result.

ONRR's Proposed Valuation of Unsold Coal Is Contractually and Legally Impermissible, Impossible for Lessees to Implement, and Highly Uncertain

ONRR's proposed valuation standards for coal production that is not sold but is consumed by the lessee or its affiliate to generate electricity are even more out of touch with economic reality and applicable legal standards. The Mineral Leasing Act sets a minimum royalty rate of "12 ½ percentum of the value of coal . . . ." 30 U.S.C. § 207(a). The Act authorizes a lower rate for coal recovered by underground mining, generally set by the Bureau of Land Management at 8 percent. For dispositions other than arm's-length sales, current regulations in effect for the last 26 years again look first to apply that royalty rate to a coal value based on comparable sales of coal produced in the area. ONRR's proposal is to instead apply that same royalty rate to the value of the *electricity* generated by the coal (with deductions for generation and transmission costs). No statute authorizes ONRR's substitution of electricity for coal, and ONRR offers no analysis or explanation that could support interchanging the two commodities. Of greater import, ONRR does not, and cannot, justify applying the same royalty rate established in the lease contract for coal to an entirely different energy commodity, whose sales price is dictated heavily by unique regulatory and market forces.

ONRR's provisions for transportation, washing, and generation allowances against the price of electricity also are ineffectual given the practical nightmare of determining these costs, the unavailability of information from other parties (including coal cooperative members), and the lack of binding ONRR guidance to clarify calculation of allowable deductions. Indeed, in assuming a perfect correlation between coal consumed by a power plant and sales of generated electricity, ONRR overlooks the realities of coal and power plant operations which are far more complex. In short, there is no "the electricity" generated from the coal as suggested in proposed §§ 1206.252(b)(1) and 1206.452(b)(1). Particularly for any power plant that does not utilize a single source of coal, a coal lessee would have to know a variety of information including, but not limited to, the precise mix of the feedstock, when the lessee's coal was consumed, whether and how long that coal was stockpiled on site, the number and type of arrangements under which electricity generated from that specific coal was sold or transferred, and what price or prices the power plant received for that electricity. ONRR assumes in the Proposed Rule that all of this information is generally unavailable to lessees, when in fact it is not. The Proposed Rule discusses none of these complications, nor how its overarching certainty and consistency goals would be served thereby.

Given each of these shortcomings, ONRR must not finalize the Proposed Rule as currently written. Though the current rules are not perfect, the core considerations in the 1989 rules and the distinct aspects of the coal market have not changed. ONRR cannot simply substitute a different regime at whim; the agency's present justification must be as or more compelling than its justification for the existing coal valuation rules.[4]

[4] *Perez v. Mortgage Bankers Ass'n*, 2015 U.S. LEXIS 1740, at *21-22 (Mar. 9, 2015) ("[T]he APA contains a variety of constraints on agency decisionmaking – the arbitrary and capricious standard being among

By contrast, ONRR's Proposed Rule does not even attempt to explain many of its changes, or why they are warranted at this time. ONRR's authority to implement royalty valuation changes is even further constrained here given that valuation rules are a key economic component of coal leases, which indisputably are valid existing contracts no less binding than contracts between private parties. *See, e.g.*, *Mobil Oil Exploration & Producing Southeast, Inc. v. United States*, 530 U.S. 604, 607 (2000). While the Bureau of Land Management may have the right to alter certain operational standards, ONRR cannot unilaterally decide simply to squeeze more money from the lessee post-lease. At a minimum, ONRR should revise and re-propose a rule consistent with these general comments, and with the section-by-section comments below.

SPECIFIC COMMENTS

This section of NMA's comments pertains to specific provisions in the Proposed Rule. The comments attempt to address the provisions in the same order as they appear in the Proposed Rule. NMA also refers ONRR to NMA's concerns expressed in its general comments above, which encompass several proposed provisions. NMA reserves the right to amend or supplement these comments as warranted.

Definitions (§ 1206.20)

ONRR uses the term "misconduct" throughout the Proposed Rule to justify applying its so-called "default provision" to unilaterally establish the royalty value (*e.g.*, proposed §§ 1206.253 and 1206.453). ONRR's proposed definition of "misconduct" for purposes of coal valuation is overbroad in multiple respects. First, ONRR would define "misconduct" to *exclude* "the mental state of the lessee or of any individual employed by or associated with the lessee." But the plain meaning of "misconduct" involves an element of intent accompanying the alleged improper error. Indeed, that was the agency's own understanding reflected in its approach to the analogous concept of breach of duty to market. 65 Fed. Reg. 14022, 14046 (March 15, 2000) ("This provision is simply meant to protect royalty value if, for example, a lessee were to inappropriately enter into a substantially below-market-value transaction <u>for the purpose of reducing royalty</u>.") (emphasis added). But ONRR now proposes to label even good faith errors, or minor paperwork errors amounting to no practical harm, as "misconduct," with significant consequences flowing from that determination. Second, by purporting to encompass "any failure to perform a duty owed to the United States under a statute, regulation, or lease, or unlawful or improper behavior," ONRR defines misconduct to include almost anything, even duties not within ONRR's jurisdiction (e.g., SEC violations). Third,

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the most notable. As we held in Fox Television Stations, and underscore again today, the APA requires an agency to provide more substantial justification when its new policy rests upon factual findings that contradict those which underlay its prior policy; or when its prior policy has engendered serious reliance interests that must be taken into account. It would be arbitrary and capricious to ignore such matters."); *FCC v. Fox TV Stations, Inc.*, 556 U.S. 502, 516 (2009); *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

ONRR improperly proposes to always impute to the lessee errors made by employees and contractors, notwithstanding limits governed by the law of agency.

Among other changes, ONRR adds a new stand-alone definition of "affiliate" for coal as presently exists for oil and gas to demarcate non-arm's length situations. This definition, however, has reduced utility if ONRR can deem any other arrangement non-arm's-length. Specifically, as described further below, §§ 1206.252(a)(2) and 1206.452(a)(2) couple the term "affiliate" with the ambiguous and overbroad phrase "or another person" to describe non-arm's-length contracts. For greater clarity, ONRR should specify within the regulations – ideally in the definitions section – what types of arrangements it deems non-arm's length, rather than preserving ambiguity and inviting subsequent disputes case-by-case.

ONRR also would remove the defined term "net-back method," in connection with its proposal to delete the benchmarks for valuing coal not sold pursuant to an arm's-length contract. 80 Fed. Reg. at 612. As discussed in the next section, NMA also disfavors the net-back method. In reality, however, ONRR is only deleting the term, while actually expanding the use of the net-back method. The net-back method that ONRR is proposing in these rules abandons limiting principles that have been part of the rules for 26 years, and that were articulated in part by the now-rescinded definition. NMA notes that deletion of this defined term should not imply that ONRR may rescind the principles embodied in that definition whereby coal valuation occurs at the "first point at which reasonable values for the coal may be determined" and may be based on "comparison to other sales of coal."

Arm's Length and Non-Arm's-Length Situations (§§ 1206.252(a), 1206.452(a))

NMA concurs with ONRR's preamble statement wherein "[t]his Department reaffirms that the value, for royalty purposes, of . . . coal produced from Federal and Indian leases is determined at or near the lease and that gross proceeds from arm's-length contracts are the best indication of market value." 80 Fed. Reg. at 609. Consistent with existing regulations (for ad valorem leases) at 30 C.F.R. §§ 1206.257(b) and 1206.457(b), when a coal lessee engages in an arm's-length sale with its customer for production, that should establish the value of the coal for royalty purposes. Proposed § 1206.257(a)(1) appropriately retains this rule.

The remainder of § 1206.257(a), however, does not follow logically or practically from the two above core principles endorsed by ONRR. In sum, ONRR now attempts to capture certain *non*-arm's-length transactions under the arm's-length valuation methodology. Under the current rules, absent an arm's-length sale by the lessee, lessees and ONRR utilize benchmarks that first look to gross proceeds from comparable arm's-length contracts in the area. While the first benchmark excludes (without explanation) the lessee's own comparable arm's-length sales, those sales may be considered under the fourth benchmark. This local reference point makes sense because, as ONRR concedes, the best indicator of coal valuation remains arm's-length sales at or near the lease area. Indeed, the existing regulations recognize the many variables in different cases that could heavily impact coal valuation as the points of comparison are more removed from the lease and coal at issue, including "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." 30 C.F.R. §§ 1206.257(c)(2)(i) and 1206.456(c)(2)(i). Even if the inquiry reaches the final existing benchmark, the valuation is performed at the "*first point* at which reasonable values for the coal may be determined by a sale pursuant to an arm's-length contract *or by comparison to other sales of coal*." 30 C.F.R. §§ 1206.251, 1206.456(c)(2)(v) (emphasis added).

Now ONRR proposes to eschew reliable arm's-length contracts at or near the lease and instead force any coal lessee to track its coal to an arm's-length contract that might occur anywhere else domestically or globally. ONRR would do so by deeming a sale by the lessee's affiliate as a sale by the lessee, by deleting the benchmarks (including the option to examine comparable arm's-length sales), and by making other corresponding changes (e.g., including deleting the above regulatory definition of "net-back method"). Recognizing the questionable nature of these changes, ONRR's preamble "seek[s] input on the merits of eliminating the benchmarks" and asks whether "the royalty value of coal initially sold under non-arm's-length conditions [should] be based on the gross proceeds received from the first arm's-length sale of that coal in situations where there is a subsequent arm's-length sale." 80 Fed. Reg. at 628. The answer is no.

NMA's members have generally found the non-arm's-length benchmarks to be workable, and disagree with ONRR's contention that the benchmarks have been too difficult to implement or have not returned fair value to taxpayers. The solution for any disagreement in comparing other arms'-length sales is not to scrap the benchmarks altogether, but rather for ONRR to provide further guidance on applying comparability factors. ONRR provides no explanation of why its proposed alternative is any better. Instead, the Proposed Rule provokes only more questions. Why, for example, would a distant arm's-length contract among different parties yield a more representative value of coal than similar sales at or in proximity to the mine? How could the arm's-length price for substantial volumes of coal sold by the lessee be sufficient to determine value of some coal from a lessee's mine, but then suddenly be unreliable to value even identical coal from the same mine and ultimately sold elsewhere? Why does ONRR view the value of federal and Indian coal at its ultimate destination as inexorably dependent on the arm's-length or non-arm's-length nature of the preceding transactions, rather than principally based on the quality of the resource and from where it came? Even if ONRR's basic aim is to collect more royalty, there is no assurance that the distant price would be higher. In fact, in many situations, the net-back from an arm's-length sale overseas will yield a lower royalty value than would existing benchmarks.

The impropriety of valuing federal and Indian coal unvaryingly based on the "first arm's length contract" is compounded by ONRR's failure to articulate how exactly lessees are to net-back that value from that point to the lease. As ONRR recognizes in proposed subsection (a), gross proceeds must be "less an applicable transportation allowance…and washing allowance" to arrive at royalty value at the lease. *See also* existing 30 C.F.R. § 1206.251 ("net-back method" deducts costs from gross proceeds to calculate "market value of coal at the lease or mine"). Absent these deductions, lessees would be forced to pay royalty on more than the "value of coal," which ONRR has no authority to compel. 30 U.S.C. § 207(a). Computing these deductible costs, however, is inherently difficult. That difficulty would only be further exacerbated by the need to trace costs back over many transactions and great distances to reach what ONRR would consider an arm's-length sale. Transportation costs are not limited to rail costs and terminal fees. To give one illustration, one of NMA's members reports incurring the following costs in exporting some of its federal coal via ports in British Columbia, Canada:

- Base railroad transportation rate
- Railroad fuel surcharge
- Rail equipment leases
- Dust and oxidation mitigation sprays applied to coal at mine, en route by railroad and at export terminal
- Export terminal fees
- Vessel surveying, weight and measuring fees
- Coal specification & sampling fees
- Vessel agent, shipping and export documentation fees
- Vessel demurrage
- Miscellaneous costs existing at both the loading and destination port
    - Customs brokerage fees
    - Canadian carbon tax
    - Commissions to sales agents
    - Letter of credit fees
    - Bank transaction fees
- If sold delivered to the destination port, then ocean freight, insurance, fees & other related physical execution costs

While ONRR's proposed valuation method blithely provides that the lessee may deduct its transportation costs for coal sold in distant markets, the proposed rules entirely fail to prescribe which transportation costs will be allowable (including possibly transocean shipping costs) and which costs ONRR will deny.[5] The complexity and imprecision of such net-back calculations is precisely why ONRR consistently has taken the position that the net-back method should be the valuation procedure of last resort. *See, e.g.*, 54

[5] In contrast, see 30 C.F.R. § 1206.178(f) and (g), specifying allowable and non-allowable costs applicable to gas transportation allowances.

Fed. Reg. 1,492 (Jan. 13, 1989) ("The MMS [Minerals Management Service] will use a net-back valuation method only when other methods of determining value, such as those specified in the rules, are inapplicable."); 53 Fed. Reg. 1,230 (Jan. 15, 1988) ("MMS agrees that the net-back method will not be used frequently. The net-back analysis *should only be used where less complex procedures are not feasible*.") (emphasis added). Indeed, ONRR has similarly disfavored net-back methods for valuing oil and gas. *See, e.g.*, 53 Fed. Reg. 1,184 ("To routinely perform labor-intensive net-back calculations is impractical."); *id.* (use of net-back analysis "on a routine basis to verify oil value is impractical and unnecessary"); *id*. ("the other benchmarks which have higher priority will result in a reasonable value for royalty purposes and obviate the need to undertake a labor-intensive net-back method"). This net-back aversion is reflected in ONRR's existing rules for oil and gas.[6] *See* 30 C.F.R. §§ 1206.152 (unprocessed gas); 1206.153 (processed gas); 30 C.F.R. §§ 1206.102-1206.103 (oil).[7] Likewise, and more importantly for present purposes, ONRR's Proposed Rule acknowledges the difficulty of calculating multiple allowances to "trace" arm's-length sales in the oil and gas context, and thus affords lessees the option to value their oil and gas via other means. 80 Fed. Reg. at 608.

But ONRR would afford no such alternative for coal, consigning coal lessees alone to chase gross proceeds to distant sales points and perform the difficult and perhaps infeasible net-back calculations. Further, ONRR provides no guidance on how to perform them. And any alleged error by lessees in calculating transportation or washing allowances may prompt ONRR to unilaterally set value under its default provision. In fact, subsection (e) appears to allow ONRR to "decide[] to value your coal under § 1206.254" in any circumstance, even if none of the triggers in the other proposed regulatory provisions (e.g., misconduct) is at issue. Ironically, ONRR there reserves to itself the ability to look at the same factors that lessees could not, such as "[t]he 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."

For the above reasons, among others, ONRR's question whether "adoption of this [uniform "first arm's-length sale"] methodology [would] substantively impact your current calculation and payment of royalties on coal" is an understatement. 80 Fed. Reg. at 628. ONRR's methodology merely pays lip service to fundamental valuation principles and threatens to assess higher royalties than actually due given far-flung pricing distant from the lease and uncertainty in netting back that price. Like federal oil and gas lessees, federal and Indian coal lessees should have a ready alternative to the arduous,

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[6] Some courts have also taken a dim view of net-back calculations. *See, e.g., Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225, 239 (5th Cir. 1984) (net-back method "is the least desirable method of determining market price" for gas) (quoting M*ontana Power Co. v. Kravik*, 586 P.2d 298, 303 (Mont. 1978)).

[7] In previously overhauling its royalty valuation regulations for oil, ONRR removed any reference to the net-back method, including in former 30 C.F.R. § 206.102.

and at times perhaps infeasible, task of chasing gross proceeds across many subsequent transactions not involving the lessee or even its immediate affiliate.[8]

The optimal alternative to value coal sold not at arm's-length is ONRR's adherence to its current, workable benchmarks. The only change that NMA strongly recommends would be to allow use of comparable arm's-length sales from the producer's own mine in the first benchmark. This is not a new concept. In fact, though the 1989 final coal valuation rule inexplicably and categorically excluded use of such sales, the proposed rule originally condoned use of such sales, as did the oil and gas first benchmarks actually adopted just a year before. Such other arm's-length sales are inherently reliable given that the majority of federal and Indian coal is sold domestically at arm's-length. The relatively small coal export market does not change this reality. In 2012, less than 3 percent of federal coal was exported. One company reports, for example that twice as much of its coal is sold arm's-length versus non-arm's length – there is no question about sample size of domestic sales for comparability. The rational change to the first benchmark suggested by NMA would largely cure the "challenging process" alleged by ONRR in obtaining and comparing relevant arm's-length sales contracts, and would better achieve ONRR's stated goals in the Proposed Rule. As a secondary (and far less preferred) option, in the event there were insufficient comparable arm's-length sales data, a permissible approach based on published or appropriately amended index bases could be considered further in lieu of net-back methods. Where representative indices are unavailable, ONRR should welcome constructive dialogue with individual companies to arrive at an agreed valuation for particular non-arm's-length dispositions from a particular mine.

In the Proposed Rule's preamble, ONRR acknowledges that "non-arm's-length sales of Federal coal that is then resold at arm's length are rare" and that "lessees of Indian coal sell their entire production at arm's-length." Given this limited applicability, and the complications rather than simplifications described above, there is no need for ONRR to overhaul its regulations as proposed for non-arm's length sales of coal.

NMA also offers a specific comment regarding the reference in §§ 1206.252(a)(2) and 1206.452(a)(2) to "your affiliate *or another person* under a non-arm's length contract." 80 Fed. Reg. at 628 (emphasis added). Besides affiliates, the only other type of party the preamble mentions are members of coal cooperatives, which ONRR's preamble

[8] Only a very small percentage of coal produced from federal leases is marketed overseas. ONRR's Proposed Rule likely will simply force lessees to adapt their marketing strategies going forward. Instead of retaining a marketing function through an affiliate, there will a growth of third party marketers to perform essentially the same function. In those circumstances, the royalty value will be based on the arm's-length sale from the lessee to the marketer. Thus, ultimately this rule will likely not benefit ONRR. Instead of forcing industry to take superficial and burdensome steps to revise their marketing strategies because of the proposed de facto tax on vertical integration, ONRR should forgo the requirement to "chase" gross proceeds of marketing affiliates. ONRR's Proposed Rule is particularly unnecessary since in many cases the net royalty value from chasing the gross proceeds will be lower than a royalty based on comparable sales.

treats as "affiliated." To clarify and simplify its proposal, ONRR should replace "or other person" with "coal cooperative," a separately defined term under ONRR's Proposed Rule. Any other arrangements ONRR deems non-arm's-length should also be added to these provisions or included in the defined term "affiliate." If necessary, ONRR also could make conforming changes to its definition of "arm's-length-contract." These suggestions would align with the stand-alone use of "affiliate" in the titles of the §§ 1206.252 and 1206.452, and elsewhere in the Proposed Rule, to describe valuation in non-arm's-length situations.

No Sale Situations (§§ 1206.252(b), 1206.452(b))

ONRR proposes a different valuation standard altogether when federal or Indian coal is not sold at all, but is transferred and directly used by a power plant owned by the lessee or its affiliate. Currently, such coal would be valued under the same existing benchmarks applicable to all federal and Indian coal not initially sold under an arm's-length contract. The Proposed Rule now summarily declares that in "no-sale situations" royalty would be assessed against the gross proceeds of *electricity* generated and sold at arm's-length by the coal lessee or its affiliate. 80 Fed. Reg. at 628. To net-back this value to the coal lease, ONRR would offer deductions for not only transportation and washing, but also "transmission and generation deductions" located in ONRR's separate regulations governing geothermal resources. Separately, if electricity is not sold arm's-length, ONRR would just perform the valuation itself. No explanation or justification accompanies this proposal; it appears to have been fashioned from whole cloth. Not surprisingly, then, these provisions are seriously flawed and should not be finalized in their current form.

As noted above, the Mineral Leasing Act and each coal lease reserve to the federal government a royalty interest based on a fixed percentage of the "value of coal" – not electricity. 30 U.S.C. § 207(a). That royalty rate is a central term upon which would-be lessees rely to calculate their bonus bids to obtain the lease. Once the lease is executed, that royalty term cannot be unilaterally changed by ONRR or any other federal agency during the term of the lease. 30 U.S.C. § 207(a). When current coal lessees signed their existing leases, the regulations prescribed a comprehensive series of steps for valuing their *coal* for royalty purposes. It was never contemplated that ONRR would suddenly base royalty on a different energy commodity. ONRR is precluded from saddling existing federal and Indian coal lessees with new effective royalty obligations.

Nor has ONRR provided any foundation for implementing its proposal for future coal leases. The mineral leasing laws applicable to federal or Indian coal and the existing coal valuation regulations contain *no* mention of electricity in valuing coal under any circumstances. ONRR is proposing to use electricity as a proxy for coal in lieu of comparable arm's length coal sales, yet ONRR has failed to provide any factual evidence or analysis correlating the two distinct commodities. To the contrary, the Proposed Rule's preamble admits that ONRR has "limited experience" with this methodology, and openly seeks "information on the costs of electric power generation and transmission and whether the proposed rule would result in royalty increases or decreases." 80 Fed. Reg. at 639-640. Whatever authority ONRR perceives to value coal in no sale situations (e.g., under the lowest-priority current benchmarks, or its proposed "default provision), it is blackletter law that ONRR cannot wholesale insert a substitute metric without support that it accurately reflects the value of coal.

Yet, the legal shortcomings in ONRR's proposal go beyond utilizing the wrong commodity. Of greater import, ONRR appears to suggest that the same royalty *rate* specified in the coal lease should be applied to the gross proceeds of electricity sales. That is, ONRR has concluded without record support not only that the value of coal and the value of sold electricity generated from that coal are interchangeable, but also that the same royalty rate is warranted. Even if ONRR could quantify the relationship between electricity sale gross proceeds and coal value (which again it has not done), ONRR would have to further consider whether substituting one commodity for the other *at the contractually prescribed royalty rate* would increase the royalty burden on lessees. The Proposed Rule indicates no such economic analysis. As noted above, ONRR instead admits it has little data on the matter and impermissibly tries to delegate to the regulated community the agency's burden to justify its own proposed rules. Based on the experience with the geothermal regulations, further described below, applying the royalty rate for coal to electricity may result in an increase in federal and Indian coal lessees' effective royalty obligation, which presents significant breach of contract issues.

In addition to its legal flaws, ONRR's proposal is fundamentally unworkable in practice. ONRR specifically "seek[s] information on the costs of electric power generation and transmission and whether the proposed rule would result in royalty increases or decreases." 80 Fed. Reg. at 640. NMA and its members cannot meaningfully comment, however, because the Proposed Rule cannot be functionally implemented. The Proposed Rule presumes that certain federal or Indian coal is transported to a power plant, immediately consumed as the sole feedstock to generate "the electricity," and that "the electricity" is then sold to a single customer at arm's length. This, of course, fails to reflect the many complexities in the coal and electricity markets, wherein a single lessee's coal may be one of several feedstocks to a power plant, may differ in BTU content from other coal received by the power plant, may be delivered months or even years in advance of consumption, and may not generate the particular electricity sold to any given customer at any given time. ONRR also assumes that lessees have access to all information necessary to net-back the value of coal to the lease or mine, yet ONRR provides no rational basis to support that assumption. There are many issues the Proposed Rule fails to consider or resolve for no sale dispositions of federal and Indian coal, including but not limited to the following:

- How would a lessee determine the value of its coal used to produce electricity when multiple coals are used at one plant?
- How would a lessee resolve the above problem particularly when all the coals provide different BTU/quality and hence have different value? How would this methodology avoid overvaluing low-BTU coal and undervaluing high-BTU coal?
- In same scenario of multiple coal supplies, how would a lessee determine valuation from electricity sales when the sale price of electricity is constantly changing, and the cost to generate the electricity varies by the BTU/quality of the coal fuel source?
- How would a lessee allocate the net-back cost of electricity when electricity is sold to different destinations, including member-owners, the open market, other arm's-length and non-arm's-length electricity supply contracts, particularly when the sales change minute by minute?
- How would a lessee assess the valuation of coal shipped to a utility where the coal is stored in a stockpile and may not be consumed for months or years to generate electricity?
- How do generation and transmission costs for geothermal power plants correlate generation and transmission costs for coal-fired power plants?
- How does ONRR expect the coal lessee to obtain all information on power plant operations or electricity sales necessary to implement ONRR's proposed methodology, when that information is confidential and not available to the coal lessee? For example, how would the lessee obtain electricity sales data at the end of the month when that information is often not available to anyone until after the close of the quarter, and is subject to audits that often are not closed for several years?
- How would ONRR's proposal avoid constant retroactive recalculation of royalty due?
- Because of the uncertainty and confusion inherent in ONRR's proposal, neither coal producers nor electricity producers would be able to close their books in a timely manner.
- What "off-ramp" or external check does the Proposed Rule provide to ensure that coal is not over-valued in ONRR's proposed process? The Proposed Rule in no sale coal situations would foreclose use of cost of production, published coal indices, or arm's-length sales to corroborate valuation of coal based on the price of electricity – that is, unless ONRR does the valuation under its default provision.

ONRR's assurance of two new deductions for coal – supplementing transportation and washing with generation and transmission – multiplies rather than mitigates the problems above. Given the complexities of netting back allowable transportation and washing costs, adding two more categories of allowances does not appear to serve ONRR's stated goal of simplification. It further perpetuates the net-back methodology that ONRR purportedly is aiming to marginalize for other minerals. Determining generation and transmission costs is especially complicated and an audit nightmare, and would be particularly so here given they historically have not been utilized for coal – the Proposed Rule borrows these allowances from the *geothermal* valuation regulations. This reality is borne out by the geothermal experience, which spawned countless retroactive royalty demands covering many prior years and decades of battles over net-back calculations, before Congress intervened to provide certainty for geothermal valuation. During those years, the lessees' transaction costs in resolving royalty disputes alone could dwarf any royalty deficiency alleged by the agency. Here, ONRR's calculation may not include all costs to produce and transmit both the coal and the electricity, and could precipitate an unpredictable series of price increases for both coal and electricity, and correspondingly additional royalty disputes, all contrary to the stated purpose of the Proposed Rule.

With regard to those geothermal regulations referenced by ONRR, the Proposed Rule for federal and Indian coal stands in stark contrast. The geothermal regulations do look to gross proceeds from the sale of electricity derived from geothermal resources as mandated by *Congress* in the Energy Policy Act of 2005.[9] P.L 105-98 (Aug. 8, 2005). This reflects the basic nature of geothermal energy which, unlike coal and other resources, cannot be stored and transported and thus must be utilized in close proximity to where it is produced. To simplify geothermal valuation, ONRR in 2007 switched to valuation of unsold geothermal resources based on a percentage of gross proceeds derived from the sale of electricity generated therefrom, without the need for deductions or net-backs. 30 U.S.C. § 1004(a), 30 C.F.R. § 1206.352(b).[10] Notably, to approximate the equivalent value of royalties under the prior system (and avoid a major windfall for the government), Congress and the agency recognized that switching the valuation basis from geothermal steam to electricity required a corresponding change to the royalty rate – from between 10 to 15 percent of the value of steam to between 1.75 and 3.5 percent of the value of gross proceeds from the sale of electricity derived from that steam. *See* 30 U.S.C. § 1004(c)(3). Furthermore, the regulations respected the sanctity of existing lease contracts, which were given the option to convert to the new valuation methodology but were not compelled to change. P.L. 109-58, Title II, Subtitle B, § 224(e); 30 C.F.R. § 1206.352. The Proposed Rule for coal instead summarily would value a new commodity, utilize the same royalty rate, and still require extensive net-backs to determine the royalty. That is not measurable progress, and is legally unsupportable.

The situation becomes even murkier in situations where electricity is not sold arm's-length. Instead of the current benchmark system, the Proposed Rule simply posits that "ONRR will determine the value of the coal under § 1206.254," i.e., the "default provision." In other words, ONRR proposes to take the initial valuation function away from the lessee and throw the inquiry into a black box. This is the opposite of certainty and consistency. ONRR's takeover of valuation here is also ironic given ONRR's

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[9] For a high-level summary of this Act's reforms, see Geothermal Energy Association, *Geothermal Revenue Under the Energy Policy Act of 2005* (December 14, 2008).

[10] As the agency stated in its geothermal final rule, "[t]he royalty under such leases is no longer imposed on the volume of geothermal resources produced; it is imposed only on the proceeds derived from sale of the electrical energy, regardless of the volume used to generate the electricity." 72 Fed. Reg. 24448, 24449 (May 2, 2007).

reticence elsewhere to perform this function in response to lessees' requests for valuation determinations. Moreover, there will be no available opportunity for a lessee to gauge the reasonableness or accuracy of ONRR's valuation determination since ONRR likely will resist sharing the data it relied upon due to confidentiality concerns.

In sum, any final rule should revert to affording lessees the opportunity to perform valuation in no sale situations based on comparable sales of coal in the region. The coal industry will not be able to comply with ONRR's proposed valuation methodology for no sale situations as currently written. The numerous and serious ambiguities in the Proposed Rule require ONRR to, at a minimum, re-propose a rule addressing these issues for further public comment.

Coal Cooperatives (§§ 1206.252(c), 1206.452(c)

The Proposed Rule separately addresses coal cooperatives, and requires them to value coal under either paragraph (a) for sales or paragraph (b) when no sale occurs. As a result, the coal cooperative provisions suffer from the same shortcomings described above. The net-back challenges facing coal cooperative members may be even greater given the increased difficulty in obtaining data necessary to determine (i) whether another member or the cooperative subsequently sold coal at arm's length, (ii) whether another member or the cooperative sold electricity at arm's-length , and (iii) what sales prices were obtained and what allowable transportation, washing, generation, or transmission costs were incurred. As a result, lessees may not even know with certainty which regulatory paragraph applies, let alone be able to actually perform the respective valuation. ONRR presumes that a coal lessee will be able to obtain information from the cooperative, or other cooperative members, on the details of sales prices for coal or electricity, and applicable allowances. Yet ONRR presents no justification or evidence to support this assumption, particularly given that cooperative members to date have not had to perform these novel tasks.

As an illustration of ONRR's overly simplistic approach, ONRR includes a hypothetical in its preamble: "a coal cooperative sold its Federal coal to a coal cooperative member, and that coal cooperative member sold its coal to another coal cooperative member who then consumed the coal in its power generation plant and sold the electricity it generated." 80 Fed. Reg. at 628. In that scenario, ONRR concludes that "the coal would be valued "based on the sales of the electricity, less any allowable deductions." *Id.* But as described above for no sale situations, there is no "the electricity," and what ONRR will accept as "allowable deductions" is unclear.

NMA also recommends deletion of the preamble's statement that "[a] coal cooperative can underprice coal even when sales are arm's length, all other costs being equal." *Id.* ONRR offers no support or evidence for this nonsensical statement, and cites no substantial issues specific to valuation of coal disposed of through cooperatives. To

NMA's knowledge, coal cooperatives have openly worked together with ONRR and complied with the coal valuation regulations currently in effect.

***Triggers for Default Provision (§§ 1206.253, 1206.453*)**

Sections 1206.253 and 1206.453 purport to specify when and how ONRR would examine the accuracy of federal and Indian coal royalty payments, and what the consequences of any alleged errors would be. While ONRR clearly performs a monitoring and review role, that authority must be exercised in a transparent, fair, and consistent manner. But these sections, and the accompanying "default provision" at §§ 1206.254 and 1206.454, ensure the opposite result. Simply stated, ONRR seeks to create limitless opportunities to invoke its "default" provision and re-determine coal values. Under its proposal, ONRR would be free to even second-guess arm's-length contracts, contrary to decades of agency policy and commitments to lessees that ONRR would preserve the sanctity of those agreements.

At the outset, the function of these sections is unclear given that other provisions of the Proposed Rule afford even greater opportunity for ONRR to utilize its default provision. For example, according to §§ 1206.252(e) or 1206.452(e), "[t]he values in this section do not apply, if ONRR decides to value your coal under § 1206.254 [or § 1206.454]." This provision contains no limitation; ONRR thus could "decide" to use its default provision in any case. Similarly, as described above, under §§ 1206.252(b)(2) or 1206.452(b)(2) "ONRR will determine the value of the coal" in the first instance whenever there is no sale of coal and no sale of electricity. Furthermore, under §§ 1206.253(g) and 1206.453(g), ONRR could use its default provision whenever lessees and affiliates operate under a contract or amendment that is not reduced to writing and signed. ONRR fails to account for the prevalence of alternate forms of contracts in the business world, and does not explain why an unwritten or unsigned contract that is enforceable by law cannot establish the royalty value. Thus, each federal or Indian coal lessee could lose its royalty valuation function to ONRR at any time, and cannot rely with any certainty on a particular outcome of ONRR's open-ended determination.

If they are somehow not negated by the provisions above, §§ 1206.253 and 1206.453 also contain no meaningful limits or reassurances regarding ONRR's own royalty valuation. Under today's rules, ONRR would communicate any alleged royalty errors to the lessee to reapply the appropriate regulatory methodology. Yet, under paragraph (a)(1), ONRR may instead opt to directly "decide your royalty value."

Similarly, under paragraph (b), whenever ONRR determines that gross proceeds pursuant to a contract do not reflect the total consideration for the coal sale, ONRR may unilaterally determine coal value *de novo* – whereas currently the remedy likely would be to increase the initial valuation to reflect the additional consideration. Thus, every valuation dispute – which would arise more frequently under ONRR's expanded use of net-backs for coal – allows ONRR to value the lessee's production. This is particularly concerning in the context of arm's-length sales contracts for coal, where the ultimate valuation by ONRR might have little resemblance to the fair price negotiated by the parties. And once again, as paragraph (b) is written, no lessee misconduct or other preconditions such as those under paragraph (c) is required to trigger the default provision.

Paragraph (c) provides that ONRR may unilaterally value coal if it determines that gross proceeds accruing under a contract do not reflect "reasonable consideration" due to "misconduct" or "breach of the duty to market," or because "ONRR cannot determine" the propriety of the lessee's valuation "for any reason." This provision expands the analogous existing regulations at 30 C.F.R. §§ 1206.257(b)(3) and 1206.456(b)(3). Under those regulations, which speak only to "arm's-length contracts," an ONRR finding of unreasonableness would first "give the lessee an opportunity to provide written information justifying the lessee's reported coal value," and ultimately may require lessees to utilize alternative valuation measures under the benchmarks for non-arm's-length dispositions. But now ONRR would have the option to inject itself in a multitude of circumstances, and insert whatever ONRR thinks is "reasonable" in that case.

Each of the three triggers is problematic. First, as discussed in the definitions section above, "misconduct" is significantly overbroad. ONRR should find misconduct only when a lessee has indicated some level of intent to deprive the government of reasonable royalty payments, as is currently the law. Second, it is circular and nonsensical for ONRR to define "breach of duty to market" as an "unreasonably low" price that is "10 percent less than the lowest reasonable measures of market price." It is meaningless to use the term "reasonable" to define what is "unreasonable." ONRR also proffers no standard for how it will determine the lowest "reasonable" price. Though the proposed provision mentions "prices reported to ONRR for like-quality coal," that example is curious given ONRR's earlier statements that comparability factors are too difficult to implement. Nor does ONRR explain its selection of a 10 percent threshold. And if a contract price falls below the 10 percent threshold by any increment, the consequence is that ONRR may increase the value above that floor and set whatever value it sees fit. This issue is particularly problematic under a long-term contract or in a falling market where a producer may for a time be compelled to sell at a price below ONRR's threshold to keep its mine operating. Third, ONRR would not even need to find an error in a coal lessee's valuation to revisit it – ONRR could merely suspect something is amiss or desire a different royalty. This standardless provision eliminates any regulatory certainty.

This proposed system is plainly arbitrary and unreasonable. The only conclusion that can be gleaned is that ONRR no longer intends to respect longstanding limitations on its discretion over coal valuation. That includes values determined under arm's-length contracts, which ONRR's Proposed Rule even now admits is the best indicator of value. ONRR should delete or substantially revise proposed §§ 1206.253 and 1206.453, and other default provision triggers elsewhere in the Proposed Rule, to preserve consistent and predictable coal valuation.

ONRR Valuation Determinations under Default Provision (§§ 1206.254, 1206.454)

When the default provision is triggered anywhere in the Proposed Rule, ONRR may determine the royalty value "by considering any information we deem relevant."[11] This is not only devoid of any meaning, but also eviscerates any real opportunity to challenge an ONRR valuation. The factors ONRR does mention are purportedly neither exhaustive nor binding, and thus of little moment. The Proposed Rule's listed factors also are fundamentally inconsistent with the basic rationale for ONRR's proposed overhaul of coal royalty valuation, namely that the existing benchmark system is unworkable. But if ONRR under its default provision can assess 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," why is a federal or Indian lessee unable to use the same method in valuing its coal? When ONRR states that it may use "[i]nformation available to ONRR and information reported to it," ONRR fails to take into account that in most cases this information will be deemed proprietary or confidential, rendering it inaccessible to lessees and thus immune from verification.

This new overreaching approach by ONRR is fundamentally unworkable, and no reasoned basis exists for it. As ONRR recognizes in its preamble, "even with the changes outlined in this rule, royalty valuations will continue to be complex, and the markets for oil, gas, and coal will continue to evolve." 80 Fed. Reg. at 609. Given that inherent complexity, there is no assurance or check that ONRR's valuation determination would be any more fair, objective, or reliable than the lessee's reported data – particularly given that ONRR would use the very same valuation methods it deems unreliable when used by the lessee. When a lessee is engaged in good faith efforts to value its coal for royalty purposes, and particularly under negotiated arm's-length contracts, it should not be penalized and forced to accept a different, potentially arbitrary value by ONRR. ONRR should refrain from setting aside a lessee's valuation absent evidence of actual errors or wrongdoing; lessees need guidance from ONRR, not for ONRR to assume their roles. And when errors are discovered, the lessee should correct those errors to conform to the standards in the regulations – no more and no less.[12]

[11] The references to "under § 1206.254" and "under § 1206.454" in the first line of §§ 1206.254 and 1206.454, respectively, appear to be in error. ONRR may have intended to cite §§ 1206.253 and 1206.453 (analogously to the proposed oil and gas default provisions).

[12] As NMA has previously urged ONRR, common-sense reforms to reporting processes would substantially lower the incidence and burden of repeated filings for the same production month.

Requests to ONRR for Coal Valuation Assistance (§§ 1206.258, 1206.458)

As written, this provision does not sufficiently elicit reliable advice for lessees. As ONRR recognizes, complex issues will persist even under the Proposed Rule. When lessees elect to proactively approach ONRR with questions, it is in all parties' interests for ONRR to respond fully and fairly, thereby avoiding valuation disputes years after royalties are reported and paid.

ONRR would require a lessee's valuation determination request to include "your analysis of the issue(s), including citations to all relevant precedents (including adverse precedents)" – in other words, a complex and expensive legal brief. Moreover, only ONRR is privy to all "precedents," since many Interior Board of Land Appeals ("IBLA") determinations are unpublished Orders. Moreover, it is ONRR's own responsibility to ensure that it administers its regulations in a consistent matter. *See, e.g., Westar Energy, Inc. v. Federal Energy Regulatory Commission*, 473 F.3d 1239, 1241 (D.C. Cir. 2007) ("A fundamental norm of administrative procedure requires an agency to treat like cases alike."); *Colorado Interstate Gas Co. v. Federal Energy Regulatory Commission*, 850 F.2d 769, 774 (D.C. Cir. 1988) ("dissimilar treatment of evidently identical cases...seems the quintessence of arbitrariness and caprice").

ONRR affords itself three response options in the Proposed Rule: (1) it may have the Assistant Secretary for Policy, Management and Budget ("ASPMB") issue a determination; (2) it may decide that ONRR will issue guidance; or (3) it may provide no response to the valuation request. Each of these options has drawbacks that limit its utility. A non-response is not helpful, and arguably an abdication of ONRR's responsibilities.

ONRR guidance is only marginally helpful. It is not binding on ONRR, States, or the lessee. It also is not appealable, so the lessee's only recourse is to value as it believes proper and then if ONRR issues an audit order the lessee could appeal that action. This places the lessee at risk of civil penalty demands for improper reporting, and of ONRR undertaking the valuation under its default provision for the lessees' alleged failure to follow the regulations (as informally interpreted by ONRR through the guidance). The rules also should clarify that, if a lessee does not follow the guidance, that lessee is not subject to civil penalties for that decision.

Finally, the Assistant Secretary is unlikely to become involved in a valuation determination except for an issue of wide-ranging applicability. If the ASPMB does decide to issue a valuation determination, the decision by the ASPMB is binding on ONRR and the lessee. ASPMB decisions are final for the Department and not subject to appeal to the IBLA. The lessee's only recourse would be to seek judicial review, a complex and expensive option.

ONRR should revise §§ 1206.258 and 1206.458 to provide for two options: determinations by the ASPMB (which are always available) and valuation determinations by ONRR amounting to more than mere guidance, which then could be administratively appealed if the lessee believes the determination is in error. This revision would foster active engagement and accountability.

Transportation Allowances (§§ 1206.260-.262, 1206.460-.462) and Washing Allowances (§§ 1206.267-.269, 1206.467-.469)

NMA has similar comments on parallel provisions in the Proposed Rule regarding transportation and washing allowances, which echo concerns addressed above for basic valuation of coal. For the same reasons, these provisions should be removed or substantially amended in any final rule.

Paragraph (g) of proposed §§ 1206.260 and 1206.460 and paragraph (d) of proposed §§ 1206.267 and 1206.467 provide additional avenues to ONRR's problematic default provision, this time to determine transportation or washing allowances. These proposed paragraphs mirror §§ 1206.253(c) and 1206.453(c), and thus present the same shortcomings discussed above. Once again, ONRR could unilaterally value coal if there is "misconduct" between the contracting parties, if the lessee has "breached" its duty to the lessor by claiming an "unreasonably high" transportation or washing allowance, or if "for any reason" ONRR simply "cannot determine" whether a claimed transportation or washing allowance was "properly calculated." Misconduct again could include almost any conduct by the lessee. The term "unreasonably high" is again circularly defined as "10-percent higher than the highest reasonable measures" of transportation or washing costs. It also includes other costs and allowances reported to ONRR, despite ONRR's supposed aversion to comparability, and that confidential information's general unavailability to the lessee. ONRR again provides no standards for how it will pick the highest "reasonable" cost, no basis for 10 percent, and no explanation of why that same numeric threshold should apply to valuation, transportation, and washing. Furthermore, ONRR could determine the transportation or washing allowance if it is unable to determine if the lessee properly calculated either allowance. Since transportation and washing deductions are a component of overall valuation, it is also unclear whether ONRR's triggering of its default provision for transportation would open the lessee's entire valuation to ONRR re-determination even if unrelated to transportation or washing. As is the case with basic coal valuation, these provisions undermine the certainty that is critical to industry.

Akin to proposed §§ 1206.253(g) and 1206.453(g) discussed above, proposed §§ 1206.261, 1206.268, 1206.461, and 1206.468 each provide that if a lessee has no written contract, then ONRR would determine the transportation or washing allowance under its default provision. The fact that a legally binding contract may not be written or signed by all parties in the normal course of doing business does not mean that an enforceable contract does not exist or that the valuation derived therefrom is any less reliable. It is also unreasonable for ONRR to require that the lessee must first propose a methodology using the burdensome procedures, and uncertain outcome, in proposed §§ 1206.258 and 1206.458 for requesting a valuation determination.

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

Other Concerns

ONNR has entirely failed to explain how the changes it is proposing effectively could be administered by State auditors undertaking audits of federal coal leases. The type of valuation discretion that is proposed to be reserved only could be administered by the federal lessor – not by a delegate undertaking audit functions. ONRR must explain how the States will be able to perform audit functions under the proposed changes.

ONRR also should analyze and justify the impact of its changes on rural America, who disproportionately rely on coal cooperatives for energy generation. Complicating the valuation of coal for these areas will only result in increased costs to the customer due to the need to hire more auditors, potentially reduced state severance tax collections, and greater uncertainty amongst all parties.

Finally, for all the reasons stated above, ONRR's conclusion that the economic impact of its proposal on federal and Indian coal lessees would be neutral – or even positive – is unrealistic and unsupportable.

CONCLUSION

NMA and its members support the ONRR's stated goals of simplifying federal and Indian coal valuation and providing a fair return to the public, Tribes, and allottees on that production. ONRR's Proposed Rule, however, would only frustrate those objectives and result in burdens and regulatory uncertainty outweighing the purported benefits to industry, ONRR, or the public. Consistent with its Advance Notice of Proposed Rulemaking comments, NMA instead recommends that ONRR re-propose a rule targeted at truly simplifying reporting and administrative burdens for all parties involved, and re-issue an amended proposed rule. If you have any questions regarding these comments, please contact me at (202) 463-2627 or ksweeney@nma.org.

Sincerely,

Katie Sweeney

Katie Sweeney