May 8, 2015

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

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

Dear Mr. Southall:

On behalf of The Wilderness Society please accept and fully consider these comments regarding the proposed Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform published by the Office of Natural Resources Revenue (ONRR).

The Wilderness Society (TWS), as America's leading public lands conservation organization, is committed to protecting America's wild places for current and future generations. Since 1935, TWS has worked to protect wilderness-quality lands across the United States. Our goal is to ensure that future generations will enjoy the clean air and water, wildlife, natural beauty, opportunities for recreation, and spiritual renewal that pristine forests, rivers, deserts, and mountains provide.

TWS supports the Department of the Interior's commitment to manage our public lands in a fair and balanced manner as evidenced by the Department's initiatives to improve imbalanced or outdated rules and policies. Such initiatives include the oil and gas leasing reforms, mitigation policy, methane emissions rule and other actions that Department is undertaking to balance resource extraction and production with conservation of our public land heritage. Providing greater balance among the many uses of our public lands will provide great sustainability of our resources for the long-term.

Overall, we support ONRR's initiative to update the regulatory process by which oil, gas and coal are valued for the purposes of royalty payments. As the chief revenue collection authority on public lands, ONRR has a responsibility to recover the full value owed to the taxpayer. The proposed rule is a critical step in reforming the valuation process ONRR employs in revenue management and will provide greater clarity in the future. This is a market solution to what was previously an unbalanced and distorted market place in favor of energy producers.

The proposed rule represents a necessary commitment to more efficiently and responsibly developing energy resources on public lands, but we believe a long-term plan should guarantee revenues collected are based on the fair market price and that they are a part of the overall process by which public lands used in resource development are managed and restored. This recommendation is consistent with achieving a valuation method that accounts for the true costs of fossil energy.

In the current rule, there is no accounting for lost opportunity costs that come from development. When federal land is developed, there are important inherent qualities of the land and surrounding habitat that are lost, such as scenery, recreation opportunities, wildlife habitat, water and air quality or the actual land itself. The revenues gained from development do not compensate for the value of the land that is lost.

Land conservation, through recreation and tourism and human uses of public land, is a vital source of revenue for many communities. While there are always alternatives for development—whether that be other federal lands or private land, or even other energy resources—there are no alternatives for the land that is lost to development. The cost of development should incorporate the lost benefits of conservation, ecosystem services and recreation opportunities to the public in order to provide a fair return from such a use.

We strongly recommend ONRR proceed with this rulemaking in a manner that strikes a balance between protecting economic, environmental and taxpayer interests. We have set out the following detailed recommendations to fully realize a successful rulemaking.

I. DOI must ensure that Americans receive a fair return from resource extraction

The Federal Land Policy and Management Act (FLPMA) of 1976 requires the Department of Interior to ensure that "the United States receive fair market value of the use of the public lands and their resources."[1] FLPMA along with other authority – the Mineral Leasing Act of 1920 – authorizes DOI's control over resources on public lands and requires the Secretary to develop and implement a mechanism for establishing and collecting a fair market value, specifically providing for DOI to "prescribe necessary and proper rules and regulations to do any and all things necessary to carry our and accomplish the purposes of the leasing statutes."[2] With regards to oil and gas for example DOI has the responsibility to ensure conservation of the resource, prevent waste, and obtain a fair return to the government, including ensuring that the United States receives proper royalties on production from federal leases.[3]

[1] 43 U.S.C. § 1701(a)(9).
[2] Mineral Leasing Act of 1920, 30 U.S.C. §189 (see also 25 U.S.C. §§396, 396d (tribal lands))
[3] Mineral Leasing Act of 1920, 30 U.S.C. §§ 187, 359

This is an important reform in that it ensures that if economic development is occurring on public lands, the public is appropriately compensated. Issues with regard to achieving fair market value from mineral leases on public lands were clearly identified by in a report by a subcommittee of the Royalty Policy Committee in 2007. That report called for an update to Federal oil regulations last changed in 2000, Federal gas regulations in effect since 1988 (with minor changes since then) and Federal and Indian coal regulations which have largely been untouched since 1989. The oil, gas, and coal market places have undergone significant changes in the intervening years and therefore require changed regulations.

Recommendation: ONRR should go forward with the proposed rule and ensure that the public is receiving fair value for resources developed on public lands.

II. Federal Oil and Gas

Leasing land for oil and gas extraction is one of the predominant uses of our federal public lands. Currently, more than 36 million acres of federal land and minerals are under lease by the oil and gas industry. These leases last at least 10 years whether the company drills or not, and if wells are drilled, then leases can be extended for decades, precluding other activities like recreation, cattle grazing or hunting. The lands under lease also take away the opportunities to manage these lands for conservation purposes, including protecting watersheds and wildlife habitat. The exclusionary nature of other uses and the prevalence of oil and gas leasing on our public lands should be factored into calculations of royalty payments so that the American people receive a fair return from this use.

To this end, ONRR is proposing changes such as eliminating unused valuation options. For Federal natural gas leases ONRR would remove the valuation methodology for non-arm's-length sales in favor of process that would value it on the sale price of the first arm's length sale price, optional index prices or weighted pools. These changes serve ONRR's objective of providing greater clarity to the process with the ultimate goal of increasing accuracy.

The Wilderness Society supports these changes as part of an overall effort to provide greater clarity and transparency to the valuation process. The following are comments on specific proposed reforms for collection of royalties for the extraction of oil and gas from our public lands.

A. Removal of Deep-Water Gathering Policy

The removal of the Deep-Water Gathering Policy, which allowed for oil and gas lessees to deduct from their royalty payments the expenses associated with gathering resources extracted from deep-water leases, will stop improper deductions. These expenses do not fit the definition of transportation costs in the rule but were nonetheless allowed. The removal of this exception will allow ONRR to collect somewhere between $17.4M and $23.6M more in royalty payments from these leases. This policy change will remove what amounts to a subsidy for oil and gas lessees and put the regulations in line with the courts the Interior Board of Land Appeals[4]. Additionally this proposal will provide costs savings from reduced administrative needs to the extraction industry. ONRR estimates the industry will save upwards of $3.36M annually. In effect this proposal will insure the public receives payment much closer to fair market value while actually reducing some costs for the oil and gas industry.

B. Removal of Transportation Exceptions

The removal of the exception policy enabling transportation allowances greater than 50% for Federal oil and gas leases (see proposed 30 C.F.R. 1206.109(d)(2) and 30 C.F.R. 1206.152(e)(1)) eliminates a loophole that reduced payments. The current regulations allow transportation costs to be deducted from royalty payments as long as they remain below 50% of the resource value. Lessees could and did file for exceptions to this rule, enabling their effective royalty payment to drop much further. The proposed rule eliminates this exception and will result in an additional $4.17M in royalties from gas leases and $6.43M in oil leases on an annual basis. The decreased profitability of a moving oil and gas across large distances is commendable in that it incentivizes domestic consumption and ensures that transportation costs are not used as a means to deprive the public of the fair market value of resources extracted from public land.

Importantly, ONRR is proposing to remove transportation allowances for pipeline losses in oil and gas leases either actual or theoretical (see proposed 1206.112(c)2(ii). This change will insure the royalty value is based on what was removed from the lease and not subsidize losses occurring after the royalty point. Further, this change applicable to non-arm's length transportation contracts will provide incentive against waste and loss in transport of oil and gas, which is a key objective of public lands leasing and has environmental benefits. The change will also result in increased revenues of $4.7M annually for the taxpayer.

ONRR is also proposing to eliminate oil transportation exceptions for the costs associated with line fill. The proposed reform would create a mechanism for determining transportation allowance for arm's length transportation absent a written contract. (See proposed 1206.111 and 1206.112). The new line fill policy clarifies change and enforces existing ONRR policy that all costs associated with marketing the oil are not deductible. This will increase revenues an estimated $1.71M (if applied to the 2010 royalty volume and using the mid-range price per barrel ONRR estimate) and, as ONRR points out, these deductions are for costs incurred after the royalty point to enable transport to market. This deduction has only been in place since 2004 and its removal is in keeping with the overall goal of achieve a fair return for the taxpayer. The methodology change also included in this section is also crucial as it incentivizes documentation and provides increased authority for ONRR to protect the taxpayers' interests.

[4] See *California Co. v. Udall*, 296 F.2d 384 (D.C. Cir. 1961) and *Kerr-McGee Corp.*, 147 IBLA 277 (1999)

III. Federal and Indian Coal

A. Greater Clarity for Coal Valuation

The Royalty Policy Committee specifically called for changes to coal valuation its 2007 report to provide greater clarity. The report recommended, "By the end of FY 2008 MMS should review, and (as appropriate) revise and implement the regulations and guidance for calculating prices used in checking royalty compliance for solid minerals, with particular attention to non-arms-length transactions," (Recommendation 4-27).

The proposal would amend non-arm's length to remove benchmarks in favor of the first arm's length sale methodology use in oil and gas leases. Additionally if there is no arm's length sale (such as when the lessee or its affiliate uses the coal to generate electricity) the valuation for royalty purposes will now be based off of the gross proceeds from the arm's length sale of electricity. ONRR estimates these changes to result in potential increase or decrease of coal royalties of $1.06M.

These reforms provide better a better regulatory regime for both industry interests and the public. It reduces the burdensome administrative process on the industry by removing the benchmarking system, providing the industry a clearer method of royalty calculation. Further, it provides increased revenue for the taxpayer. TWS supports this change's inclusion in the final rule.

Federal and Indian coal valuation has provided royalties drastically below that of the market price of coal and depicts a far greater gap than that of oil and gas leases also addressed in the proposal. We support ONRR's efforts to rectifying these gaps in valuation that exist between the value of coal for royalty purposes and that at which it is sold on the open market. The shift away from benchmarks to the first arm's length sale is an admirable step in valuing at the fair market price.

B. Transportation Allowances for Coal

We are concerned that ONRR chose not to enforce a washing and transportation allowance limit on coal lessees similar to those in place on gas and oil lessees (see Rule 1206.252). By not imposing a limit on the deduction allowance such as the 50% of value limit on the other two resources ONRR is providing perverse incentives to export coal and shifting the market in favor of coal extraction from Western leases as opposed to Appalachian locations. Moreover while the royalty exemptions currently is not use prolifically (most coal sales for the purposes of valuation take place close the mine) it will take on greater importance as regulations move the point in time at which the coal is valued closer to its sale to the final consumer. Transportation exemptions may provide an avenue for producers to defray the costs imposed by the changes made to non-arms length sale valuation process and reduce the effective royalty rate. Therefore by not implementing a similar transportation limit to that imposed on oil and gas lessees, ONRR may in effect be undercutting any potential progress towards achieving accurate and efficient revenue for the taxpayer.

Recommendation: We urge ONRR to provide parity among the various royalty regimes, which was a priority that was the subject of much of the rest of the proposed rulemaking. ONRR should make transportation and washing costs cap at 50% of the value of the resource if not lower.

IV. The Default Valuation Provision

The new "default provision" would allow ONRR to determine value if it decides: a contract does not reflect total consideration; the gross proceeds accrued do no reflect reasonable consideration due to misconduct or breach of the duty to market for mutual benefit; or, ONRR cannot ascertain the value of the production because of a variety of factors including but not limited to a lessee's failure to provide documents. This default provision stems from the Secretary's broad authority and discretion over the valuation factors. It further provides a mechanism by which ONRR can adjust collection revenues if, under the new rules, the revenues are still deemed to not reflect fair market value.[5] The ultimate goal of these regulations is to encourage proper royalty payments through the normal means. This provision serves as an important backstop and we fully support its inclusion in the final rule.

V. Potential Future Reforms

As stated in the federal register notice for this proposed rule, "detailed comments that elaborate on specific situations where further valuation changes should be considered would be particularly useful to ONRR as it proceeds with this rulemaking as well as any future rules that may be considered." The following are specific recommendations on future rules that ONRR could initiate to provide a more equitable return on oil, gas and coal leasing of our federal public lands.

A. Reformation of Royalty Rates

The proposal by ONRR is a good first step towards correcting many of the problems with oil, gas and coal leases on Federal and Indian lands. The current rule adds an estimated $76.5M of net costs to billion dollar industries. Unfortunately, the rule proposed does not correct the staggeringly low royalty rates charge against these value calculations, which have remained at 12.5% since the 1980s. BLM and BOEM has recognized that there is an issue specifically regarding oil and gas leases, in that they are not provided a fair market return and commissioned a report to investigate the issue further in 2012[6]. The

[5] Critics of this change will argue that its addition will create uncertainty as to the royalties owed and moreover that definiteness is crucial to the economics of resource extraction. However, the default provision is a last resort in situations where royalty payments grossly deviate from the expected. If there is uncertainty, it is a likely to be the result of a failure to pay fair market value on the part of the lessee.

[6] http://www.boem.gov/Oil-and-Gas-Energy-Program/Energy-Economics/Fair-Market-Value/Fair-Return-Report.aspx

report was in response to a similar GAO report and concluded that rates were among the lowest in the world.[7]

Nor does it change the rental rates, the cost per acre that companies are charged to reserve land upon which they can extract, where some producers pay only $1.50 per acre and rates have not been changed since 1987. A Center for Western Priorities report finds that taxpayers are missing out $56M annually from these low rental rates.[8] These low rates and fees mean that the American public does not get adequate payment for the extraction of public resources and it puts clean energy alternatives at a disadvantage by giving fossil fuel producers a windfall reduction in costs.

Recommendation: The changes included in the proposal and others that have yet to be made focus on ensuring the Federal government in turn the taxpayer receives a fair return as a lessor in natural resource production on our public lands. This is an opportunity to ensure that in times of tightening budgets and concern over our nation's financial future we are not negligently managing our public resources and revenue derived therefrom. We appreciate the notice of a proposed rulemaking recently published that could lead to adjustments in royalty rates for oil and gas by the Interior Secretary, through the BLM.[9] We look forward to participating in that rulemaking process and providing the agency with comments and recommendations to ensure that the American people receive a fair return on the oil and gas resources extracted from BLM-managed lands.

B. Account for the Impacts of Climate Change

The proposal also fails to adequately discourage fossil fuel extraction and production and undermines the efforts of the President's Climate Action Plan. In failing to address the royalty rate problem and leaving loopholes the proposal will result in a regulatory regime that still promotes energy sources that result in greenhouse gas emissions, and moreover providing a discount at the taxpayers expense. The President's Climate Action Plan and Executive Order require federal agencies to consider the climate change impacts of their actions and "reform policies that may, perhaps unintentionally, increase the vulnerability of natural or built systems, economic sectors, natural resources, or communities to climate change related risks (EO 13653 Sect. 2 Pt. II)." This proposed rule does not adequately reform policies, which have grave consequences on our communities and public lands.

Recommendation: In this reform proposal and in future proposals, The Wilderness Society recommends that ONRR provide regulations for assessment of the climate

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7 GAO Report: *Oil and Gas Royalties: A Comparison of the Share of Revenue Received from Oil and Gas Production by the Federal Government and Other Resource Owners*. 2007. Available at: http://www.gao.gov/new.items/d07676r.pdf

8 "A Renter's Market" Center for Western Priorities http://www.westernpriorities.org/RentersMarket/

9 Oil and Gas Leasing; Royalty on Production, Rental Payments, Minimum Acceptable Bids, Bonding Requirements, and Civil Penalty Assessments. 80 Fed. Reg. 22148 (Apr. 21, 2015).

change impacts of oil, gas and coal extraction on public lands and take these costs into account when considering adjustments to royalty rates. Specifically, with regards to this rule ONRR should look at what impact this will have on the greenhouse gas emissions and how those emissions might impact the public lands the resources are being derived from.

C. Increase Reporting and Process Transparency

The proposal leaves many of the reporting requirements the same. This is of particular concern because ONRR's data from royalties is one of the primary sources of data on methane releases into the atmosphere from oil and gas operations on public lands. Greater transparency is needed to properly quantify these releases and limit the releases that occur through venting and flaring.

Recommendation: The reform to valuation process is an opportunity for ONRR to adjust its reporting requirements. The proposed rule specifically addresses this fact in the "default method" in that lack of documentation is a justification for its invocation. In addition, however the reform should request further reporting and increased transparency in the process.

D. Transportation Allowances Encouraging Export

One major concern is that transportation exceptions incentivize the exportation of our energy resources for sale on foreign markets. Subsidizing transportation costs prior to the first arm's length sale does not serve the taxpayers interest if the resource is then exported.

Recommendation: Future reforms should consider lowering oil, natural gas and coal transportation exemptions beyond what is currently allowed. Future reforms should further reduce these exemptions for any resource that is exported.

E. Use of the Default Provisions

ONRR chose not to estimate the cost impact of adding a default valuation methodology, noting that they were unlikely to utilize it. The knowledge of its existence may provide industry incentive to properly value extraction from public lands and no longer engage in what the Center for American Progress declared as an "elaborate network of subsidiaries and affiliates to maximize the subsidies that can be gained through existing federal royalty regulations."[10] Hesitancy of invoking this default proposition guts the methodologies efficacy and limits the extent to which the rule will close the first arm's length sale loophole.

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[10] "Cutting Subsidies and Closing Loopholes in the U.S. Department of the Interior's Coal Program", Center for American Progress
https://www.americanprogress.org/issues/green/report/2015/01/06/103880/cutting-subsidies-and-closing-loopholes-in-the-u-s-department-of-the-interiors-coal-program/

Recommendation: ONRR should provide the economic analysis for the default provision to provide greater clarity into its impact and effect on the market. Secondly ONRR should be willing to use it according to the criteria outline in the proposed rule.

Conclusion

The Wilderness Society supports the current reform effort proposed by ONRR. It is the fundamental duty of ONRR to ensure that Americans receive a fair return for the extraction of our public lands. We recommend further action to ensure that energy leases revenues are reflective of both the regulations that proposed and of the true consequences they impose on the tax payer. Please keep us apprised of future actions in relation to this rule and do not hesitate to contact us with any questions you may have.

Sincerely,

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