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RE: Comments on the Office of Natural Resource Revenue's Proposed Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform, Docket No. ONRR-2012-0004 and RIN No. 1012-AA13

To Whom It May Concern:

Cloud Peak Energy Inc. appreciates the opportunity to comment on the Office of Natural Resource Revenue's (ONRR) Proposed Consolidated Federal Oil and Gas and Federal and Indian Coal Valuation Reform, 80 Fed. Reg. 608 (January 6, 2015) (the Proposed Rule).

I. Executive Summary

Cloud Peak Energy has a number of fundamental objections to ONRR's Proposed Rule:

1. *The Existing Benchmarks Have Worked Well for Many Years, are Subject to Robust Auditing by the Government, and Lead to a Proper Value of the Coal.* Cloud Peak Energy opposes ONRR's proposal to eliminate the valuation benchmarks and use an affiliate resale (or netback) approach as the *only* option for lessees to value coal sold to affiliated services businesses, such as Cloud Peak Energy's logistics business. *See* 80 Fed. Reg. at 628-29. The current system has led to a proper royalty value of the coal in accordance with the Mineral Leasing Act of 1920 – a value "at the mine" based on arm's-length transactions. It has also generated substantial revenues for Federal and state governments for many years and is subject to robust auditing and enforcement. Put simply, despite the assertions of well-funded anti-fossil fuel activists, the current system is not broken. To the extent changes may be needed to improve the benchmark system, ONRR should make those changes, not abandon the benchmarks entirely. In its comments below, Cloud Peak Energy offers suggested revisions, such as revising the benchmarks to include the lessee's comparable sales of coal under benchmark one and an index price option, to enable easier application of the benchmarks for both industry and ONRR.

2. *Netbacks Are The Least Reliable Method of Last Resort to "Value the Coal at the Mine".* ONRR's proposed method to value sales of coal to an affiliate – based on the affiliate resale to a third party, no matter where that resale occurs, less certain deductions – adopts the least reliable method for valuing coal. Both ONRR and the courts have long recognized that the most reliable method looks to comparable arm's-length sales of coal at or near the mine. Affording lessees like Cloud Peak Energy only one valuation method—a netback method—for determining royalties on coal sold under non-arm's-length contracts will lead to unreliable coal valuations, which do not reflect the true value of the coal "at the mine" as required by the Mineral Leasing Act. Merely subtracting the transportation costs to deliver the coal to distant sales points (for Cloud Peak

Energy's logistics business, over 1,500 miles away to Pacific Northwest ports) does not account for all the differences in value between the mine and the distant sales points due to the value added for the logistics services. *See Indep. Petroleum Ass'n of Am. v. Armstrong*, 91 F. Supp. 2d 117, 120 (D.D.C. 2000) ("from an economic standpoint, the higher sale prices obtained in a downstream market are, in part, a reflection of the costs and *risks involved*"), *aff'd in part, rev'd in part sub nom. Indep. Petroleum Ass'n of Am. v. DeWitt*, 279 F.3d 1036 (D.C. Cir. 2002) (emphasis added).

3. *There is No Legal Basis to Afford Multiple Options to Natural Gas Producers, While Mandating a Netback for Coal*. ONRR's Proposed Rule denies coal lessees the option to value affiliate sales based on a published index price or an adjusted index price and, instead, requires the use of the unreliable netback approach. ONRR, however, already provides oil lessees with an index price valuation option (*see* 30 C.F.R. §§ 1206.102(a)(2), (d)(1), (d)(2)(i) and 1206.103), and ONRR now proposes to give gas lessees a similar option. 80 Fed. Reg. at 609. There is an established, reliable index valuing PRB coal. Providing oil and gas lessees valuation options for non-arm's-length sales that are denied coal lessees arbitrarily discriminates against coal lessees.

4. *Logistics Services is a Separate Business That Carries Significant Costs and Risks and is Not Subject to Royalties.* The Proposed Rule fails to recognize the separate nature of logistics services businesses, which are already subject to income taxes and assume substantial risks and costs independent from mine site sales to arrange for delivery of commodities to remote locations including logistics services for our domestic industrial and agricultural users of PRB coal. In effect, the Proposed Rule would amount to an unlawful royalty on the value of services provided by vertically integrated companies such as Cloud Peak Energy's logistics business. It is well-established that third party logistics companies are not required to pay Federal royalties on their re-sales of the same coal, yet the Proposed Rules would require an affiliated logistics services business to pay royalties for engaging in precisely the same business activities.

5. *The Proposed Default Rule is Arbitrary and At Odds with the Stated Purpose of the Proposed Rule.* ONRR's proposed "default" rule would give ONRR extraordinarily broad, even unbridled, discretion to impose a different royalty value many years after a royalty was reported and paid. The default rule is arbitrary on its face and would only cause uncertainty of the proper royalty value, contrary to the express purpose of the proposed regulations ("greater simplicity, certainty, clarity, and consistency"). In addition, when Cloud Peak Energy's logistics business experiences the risk of selling coal in distant locations through lower international prices or higher transportation costs, ONRR's "default" rule would allow ONRR to arbitrarily select an "at the mine" comparable sales valuation method that would disregard our logistics business' risk and loss. The Proposed Rule would also allow ONRR to apply the "default" rule to recalculate Cloud Peak Energy's transportation allowance if ONRR arbitrarily believes it is "unreasonably high." In short, ONRR seeks to share in the profits when Cloud Peak Energy's logistics business pays off, but if transporting the coal over 1,500 miles away for export becomes unprofitable, ONRR seeks to insulate itself from that risk. ONRR wants to have it both ways but gives no basis for reserving to itself such a broad power. The default provision would introduce massive uncertainties to royalty calculations. Further, the default rule would not necessarily be applied to oil and gas because of the ONRR rules allowing for the use of an index to those entities.

6. *The Rule Falsely Claims Revenue Neutrality to Evade Congressional Scrutiny and Oversight*. Neither the ONRR nor the Department of the Interior is authorized under the Mineral Leasing Act of 1920 to establish energy policy or to use their regulatory authority under the Act to address climate change concerns. They are directed by the Act to optimize Federal revenue from leased federally owned lands. The seemingly intended effect of the unbridled "default provision," along with the unreasonably vague net-back provision, is to end the vertical integration of mining operations on Federal lands necessary for the development of West Coast coal terminals and

expansion of export sales for Federal coal. This impact would likely shut down the potential 100 million tons per year shipped to international customers from the PRB; potentially costing the Federal government $166 million per year in coal royalties based on 2014 PRB prices (source: Energy Information Administration PRB spot price index). A proper economic analysis of the proposed rule is warranted by the GAO.

7. *The Request for Comments on a Possible Proposal to Cap Transportation Deductions at 50% of the Value of the Coal Highlights the Apparent Goal to End Export Coal Sales*. ONRR's Proposed Rule does not include a cap on transportation deductions for its proposed net-back calculation, but ONRR nonetheless specifically requests comments on whether it should cap transportation deductions at 50% of the value of the coal. As ONRR surely knows, transportation costs to reach logistics customers often significantly exceed 50% of the value of the coal and may even be over three times or more of the value of the coal at the mine. That ONRR would even raise the possibility of capping transportation deductions at 50% of the coal value highlights what appears to be ONRR's goal: to impose new royalty rules making logistics customers less economic, thereby reducing the Federal royalty stream.

8. *The Rule Imposes an Unconstitutional Tax on Exports*. The background of the Proposed Rule strongly suggests it is targeted directly at exports. The U.S. Constitution specifically prohibits the imposition of duties on goods by reason of exportation to the international country. Since under the Rule, coal that is being exported is valued in a manner that is different than how coal is valued for traditional domestic customers, the incremental royalty on exports amounts to an unconstitutional tax or levy.

Summary Conclusion

Cloud Peak Energy urges ONRR to retain the existing benchmark system. Improvements to the existing benchmark system may include adding to the first benchmark the use of the lessee's comparable arm's-length sales at the same mine and an index valuation benchmark. ONRR's proposal to impose a netback methodology on affiliate sales of coal to international coal customers, along with a proposed "default" rule, is contrary to the Congressional intent of creating clarity and well-established principles of royalty valuation.

II. Introduction to Cloud Peak Energy and Its Two Separate Businesses

Cloud Peak Energy is one of the safest producers of low sulfur, high quality subbituminous coal in the United States. The company has two distinct businesses: (1) it wholly owns and operates three Powder River Basin (PRB) coal mines, which have been mining and shipping coal since the mid-1970s, and (2) the company provides logistics services to some of our domestic and international customers. The Antelope and Cordero Rojo mines are located in northeast Wyoming and the Spring Creek Mine is located in southeast Montana. We also have two development projects, the Youngs Creek project and the Big Metal project with the Crow Tribe in the northern PRB. In 2014, the coal we produced generated approximately 4% of the electricity produced in the United States. Cloud Peak Energy is the only Wyoming-headquartered company listed on the New York Stock Exchange (NYSE: CLD).

A. Substantial Payments to Federal and State Governments

Through the leasing and mining of Federal coal reserves, Cloud Peak Energy is a major contributor of Federal lease bonuses, Federal lease rentals, Federal royalties, and state severance taxes and royalties. To obtain and maintain Federal leases issued by the U.S. Bureau of Land Management (BLM), Cloud Peak Energy pays a bonus at the time BLM issues the lease and annual rentals. Since 2009, Cloud Peak Energy's Federal lease payments have been substantial: $93 million in 2009, $64 million in 2010, $133 million in 2011, $129 million in 2012, $79 million in 2013, and $69 million in 2014. In 2015, Cloud Peak

Energy is committed to make approximately $69 million in Federal coal lease payments to BLM. In the last six years, Cloud Peak Energy has paid a total of $567 million in Federal lease payments.

In addition, in 2014, Cloud Peak Energy incurred approximately $315 million in Federal and state royalties and excise taxes. Of the $315 million, approximately $130 million was paid directly to and retained by the Federal government. Cloud Peak Energy paid approximately $61 million to the Federal government for distribution to the states, and Cloud Peak Energy paid approximately $124 million directly to the local and State governments. In total, the State of Wyoming received $136 million, and the State of Montana received $49 million in royalties and taxes.

By comparison to the amount of royalties and taxes incurred, Cloud Peak Energy's net income for 2014 was $79 million.

B. Employees, Community Contributions, and Industry Leading Safety Record

Cloud Peak Energy's 1,600 employees live in Wyoming, Montana, Colorado and South Dakota. Mining and the family wage-jobs created by mining help sustain communities in this region. Cloud Peak Energy is proud to support our communities, work with our local businesses and purchase goods and services in the region. In 2014, Cloud Peak Energy expenditures in Wyoming totaled $250 million, $18 million in Montana and $8 million in Colorado. In addition, our business indirectly supports employees of rail and port operators.

Cloud Peak Energy is one of the safest coal producers in the nation. During 2013, Mine Safety and Health Administration data for employee injuries showed that Cloud Peak Energy mines collectively had among the lowest injury rates of the 25 largest U.S. coal companies. By way of example, based on Cloud Peak Energy's injury rate in 2013, an individual employee would expect to be injured once every 155 years working at our mines. It was notable that two of our mines, Spring Creek and Cordero Rojo, each passed 1.2 million work hours without a reportable injury in early 2014. In 2014, Cloud Peak Energy received the Governor's Summit Safety Award in the Large Mine Category presented by the Wyoming Department of Workforce Services, Mines Inspection and Safety Division. We continue to hold safety as a core value and will always work toward our goal of zero injuries.

C. Strong Environmental Stewardship

Cloud Peak Energy has strong programs in environmental stewardship and performance. In 2014, Cloud Peak Energy's Environmental Management System was recertified under the internationally recognized ISO 14001 standards for the eighth consecutive year. The company continues to be recognized for environmental compliance and initiatives. Most recently, Cloud Peak Energy's Antelope Mine was honored to receive the prestigious 2014 National Excellence in Surface Mining and Reclamation Award from the Office of Surface Mining Reclamation and Enforcement for the sustainable control of cheatgrass.

D. Mine Site Coal Sales

The vast majority (95% for 2014) of the coal we produce is sold under arm's-length contracts at or near the mine. Our mine site coal sales business sells thermal coal at the mine site, where title and risk of loss pass to the customer at that point. This business includes our Antelope Mine, Cordero Rojo Mine, and Spring Creek Mine. Sales are primarily to domestic electric utilities. In 2013 and 2014, Cloud Peak Energy shipped approximately 86 million and 85.9 million tons of coal, respectively, from our three mines.

In 2014, of the 85.9 million tons of coal sold, approximately 81.9 million tons (95%) were sold at the mine under arm's-length contracts, which provides very robust evidence of value at the mine. In 2014, nearly 100% of the 68.5 million tons of coal sold from the Antelope and Cordero Rojo Mines was sold at the mine under arm's-length contracts. Of the 17.4 million tons of coal sold from our Spring Creek Mine, approximately 12.2 million tons (70%) were sold at the mine under arm's-length contracts.

E. Logistics Business Services

Our logistics business provides services to our international and domestic customers, where we deliver coal to the customer at a terminal or the customer's plant or other delivery point, remote from our mine site. Our logistics services include the purchase of coal from third parties or from our owned and operated mines, at market prices, as well as the contracting and coordination of the transportation and other handling services from third-party operators, which are typically rail and terminal companies. Title and risk of loss are retained by our logistics services business through the transportation and delivery process. Title and risk of loss pass to the customer in accordance with the contract and typically occur at a vessel loading terminal, a vessel unloading terminal, or an end use facility. Significant risks associated with rail and terminal take-or-pay agreements are also borne by our logistics services business.

In 2013 and 2014, Cloud Peak Energy's logistics business exported approximately 4.7 million and 4.0 million tons of coal, respectively, to international customers primarily through the Westshore Terminal in British Columbia, Canada, in addition to domestic logistics deliveries. For 2015, we anticipate our logistics business will export approximately 5.8 million tons through the Westshore Terminal, which leads directly to jobs for miners, rail employees, and port operators.

Cloud Peak Energy's marketing of coal both domestically and internationally is made possible by its strong logistics business, which in 2013 and 2014 was the largest U.S. exporter of thermal coal into South Korea by volume. Spring Creek coal is increasingly well-regarded by international customers and, due to its relatively high energy content and consistent quality, is considered equivalent to the best Indonesian coal brands by Asian utilities. We anticipate that international demand will continue to strengthen over the long-term, providing Cloud Peak Energy's logistics business with more opportunities to market its high-quality coal to international countries.

That being said, marketing to international customers carries significant expenses and risks, well beyond the expenses and risk associated with producing and selling coal at the mine site. In 2014, for instance, Cloud Peak Energy's logistics business was faced with weak international prices for seaborne coal, which resulted in lower revenue in 2014. For 2014, our logistics business incurred an operating loss of $1.6 million.

Cloud Peak Energy's logistics business continues to incur substantial cost and risk associated with transporting coal over 1,500 miles to Pacific Northwest ports, including the inherent increased risk of dealing with overseas customers, retaining legal title to the coal and risk of loss until it is loaded on the customer's vessel at the terminal, incurring terminal and rail fees, risking rail interruptions, and paying demurrage charges. As customarily required by logistics operators (rail and port), our business must commit to long-term contracts, which include take-or-pay commitments. As of December 31, 2014, our logistics business had future take-or-pay commitments under long-term transportation agreements of $691.5 million, which would be payable regardless of market conditions if our logistics business fails to meet future minimum annual shipment commitments.

Further, in 2014, Cloud Peak Energy's logistics business paid approximately $6.1 million in demurrage charges—which are levied against Cloud Peak Energy when the vessel is detained beyond the scheduled time of departure—because rail interruptions slowed deliveries to the Westshore Terminal causing delays in loading the coal. In August 2014, Cloud Peak Energy paid $37 million to secure additional committed capacity at the fully-utilized Westshore Terminal. As a result, we increased our long-term committed capacity from 2.8 million tons to approximately 6.6 million tons initially and increasing to 7.2 million tons in 2019 and extended the term of our throughput agreement by two years through the end of 2024. Cloud

Peak Energy has also obtained throughput options at the proposed (yet undeveloped) Millennium Bulk Terminals and the SSA Marine Gateway Pacific Terminal at Cherry Point, both in Washington State.

Cloud Peak Energy's diverse logistics opportunities allows us to maximize coal sales, both domestically and internationally, and plan for future Federal and Tribal coal development, which in turn benefits the Federal, state, and Tribal governments through increased royalties, taxes, and fees on new leases.

Production increases at Spring Creek Mine, in part to meet international customer demand, have generated significant revenue in the form of lease, royalty and tax payments for both the federal government and the state of Montana. In addition, this production increase supported and sustained new direct and indirect jobs. These jobs are an important part of the region's economy.

A recent study by the University of Montana for the Montana Chamber of Commerce examined a hypothetical 20-million ton per year increase of production at Spring Creek Mine and found that more than 1,400 new, permanent jobs would be created and more than $70 million per year would be generated in state and local government revenue, not including increased property tax collections.

III. The Proposed Rule

On January 6, 2015, ONRR announced the Proposed Rule which will amend the valuation regulations applicable to Federal and Indian oil and gas and Federal and Indian coal. 80 Fed. Reg. at 608. While changes to the regulations are broad sweeping, including consolidation and renumbering of the existing regulations, the main changes include:

- *Valuation Options Provided for Natural Gas.* For valuing non-arm's-length gas sales, eliminating the long-standing valuation benchmarks and instead proposing valuation methodology options based on how gas is sold using the first arm's-length sale price (affiliate resales), optional index prices, or weighted average pool prices, at the election of the natural gas producer. *Id.* at 609.

- *Mandated Netback Approach for Coal.* For valuing non-arm's-length coal sales, eliminating the long-standing benchmarks and instead proposing only one valuation method—valuing coal based on the proceeds received from the first arm's-length sale (affiliate resales) less certain allowable transportation and washing deductions (a netback approach). *Id.* at 609, 628-29.

- *The "Default" Rule.* For valuing all oil, gas, and coal, ONRR proposes a new unpredictable "default" rule which would apply when ONRR believes a lessee's valuation is too low and would allow ONRR to "exercise considerable discretion to establish the reasonable value of production using a variety of discretionary factors and any other information [it] believes is appropriate." *Id.* at 609-10, 614.

ONRR's stated purpose of the Proposed Rule is greater simplicity, clarity, and certainty. *Id*. at 608.

IV. Comments

A. The Long-Standing Rules on Affiliate Sales Work

The existing Federal and Indian coal regulations have been in effect since 1989. *See Revision of Coal Product Valuation Regulations and Related Topics,* 54 Fed. Reg. 1492 (January 13, 1989). Under the existing regulations, if the lessee sells coal under a non-arm's-length arrangement, the regulations prescribe an ordered series of "benchmarks" that look to outside indicia of market value. The value of the coal is based on the first applicable benchmark.

Under the first of those benchmarks, the gross proceeds accruing to the lessee under its non-arm's-length contract will be accepted as value, if they are within the range of the gross proceeds derived from or paid under comparable arm's-length contracts (from other producers, i.e. NOT comparable sales by the lessee) for the sale or purchase of like-quality coal produced in the area. 30 C.F.R. §§ 1206.257(c)(2)(i) (Federal coal) and 1206.456(c)(2)(i) (Indian coal). If the first benchmark does not apply, the second benchmark establishes value based on "[p]rices reported for that coal to a public utility commission." *Id.* §§ 1206.257(c)(2)(ii) and 1206.456(c)(2)(ii). Under the third benchmark, value would be established based on "[p]rices reported for that coal to the Energy Information Administration of the Department of Energy." *Id.* §§ 1206.257(c)(2)(iii) and 1206.456(c)(2)(iii). If the third benchmark does not apply, then value is based on "other relevant matters," which include, but are not limited to, "published or publicly available spot market prices" or "information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of coal." *Id.* §§ 1206.257(c)(2)(iv) and 1206.456(c)(2)(iv). Lastly, if none of the four preceding benchmarks apply, then "a net-back method or any other reasonable method shall be used to determine value." *Id.* §§ 1206.257(c)(2)(v) and 1206.456(c)(2)(v).

These benchmarks have been applied since 1989 with little indication that the benchmarks are not workable. At most, there has been occasional disagreement between lessees and ONRR over whether sales are considered arm's-length or non-arm's-length or over which is the first applicable benchmark. For example, in *Decker Coal Co. v. United States*, No. CV-07-126-BLG-RFC, 2009 WL 700221 (D. Mont. Mar. 17, 2009), the issue was not that the benchmarks were unworkable or led to unreliable valuations; the issue was that ONRR's predecessor, the Minerals Management Service (MMS), erred by proceeding to the fourth benchmark when the first benchmark was applicable, contrary to the regulation's mandate. *Id.* at *2, *9.

Nonetheless, if any improvement or clarification is needed for the benchmarks, that should be the approach ONRR takes, not abandonment of the benchmarks altogether and adoption of the affiliate resale price approach. In section E below, Cloud Peak Energy offers suggested improvements to the benchmarks, such as including comparable arm's-length sales of coal by the lessee in the first benchmark and adding an index price valuation benchmark.

B. ONRR's Proposed Use of Affiliate Resale Prices Disregards Basic Principles Rooted in the Mineral Leasing Act of 1920 and Long-Standing Regulations

ONRR's proposal to abandon the benchmarks in favor of an affiliate resale or netback approach ignores two basic royalty principles: *first*, Federal royalty is to be valued "at the mine" and, *second*, arm's-length comparable sales are the best evidence of value "at the mine."

Principle #1: Royalty is Based on the Value "At the Mine"

Where Federal royalty is based on the value of the mineral, it has always been based on the value of the mineral "at the mine." When the Mineral Leasing Act of 1920 (MLA), 30 U.S.C. §§ 181-287, was first enacted, the royalty on most minerals (but not coal) was set as a percentage of the value of the mineral. *See, e.g.,* 41 Stat. 437, 443 (1920) (royalty for oil and gas "shall not be less than 12 1/2 per centum in amount or value of the production"). For the value-based royalties, the legislative history is replete with evidence that Congress and the Department of Interior intended the value to be determined "at the mine." For example, for Federal phosphates and phosphate rock reserves, the legislative history provides that value is based "at the mine." *See, e.g.*, 53 CONG. REC. 1098 (1916) (royalties shall be based on "the gross value of the output of phosphates or phosphate rock at the mine"); H.R. REP. No. 17, 11 (1916) (Secretary Lane's report provides that phosphate royalty should be based on "the gross value of the output at the mine"); 58 CONG. REC. 4055 (1919) ("the gross value of the output of phosphates or phosphate rock at the mine"). The MLA legislative history is the same for potassium and sodium. *See,* *e.g*., H.R. REP. No. 17, 8 (1916) (potassium or sodium royalty is based on "the value of the output at the point of production").

In 1920, royalty on coal under the MLA was based on a cents per ton calculation that had little to do with the value of the coal. 41 Stat. 437, 439 (1920) (royalty for coal "shall not be less than 5 cents per ton of two thousand pounds"). It was not until the Federal Coal Leasing Act Amendments of 1976 (FCLAA), Pub. L. 94-377, 90 Stat. 1083, that Congress changed the royalty basis for coal to a percentage of its value. H.R. REP. No. 94-681, 81 (1975) ("the revised language changes the minimum royalty from $.05 per ton to twelve and one half per centum of the value of the coal, except that the Secretary may determine a lesser amount for underground mining operations").

When Congress adopted a value-based royalty for coal, Congress reiterated its intent that when royalty is based on the value of the mineral, the value is determined "at the mine." The legislative history for the FCLAA amendments regarding advance royalty payments provides that standard royalty rates are based on "the gross value of the coal at the mine." *See* Senate Rep. No. 94-296, 49 (1976). One year after the FCLAA was enacted, Congress passed the Abandoned Mine Reclamation Fund, Pub. L. 95–87, 91 Stat. 445 (1977), which is administered by the Secretary of the Interior and imposes a reclamation fee on all coal mines. The fee is assessed as a percentage of "the value of the coal at the mine." 30 U.S.C. § 1232.

Consistent with legislative and Departmental intent, courts since the 1940s have held that the government's royalty interest is limited to the value of production at the mine. *United States v. Gen. Petroleum Corp. of Cal*., 73 F. Supp. 225, 258 (S.D. Cal. 1946) (gas royalty obligation is determined "at the mines, that is before it left the field"), *aff'd sub. nom. Cont'l Oil Co. v. United States*, 184 F.2d 802, 820 (9th Cir. 1950) ("royalties were to be calculated at values at the wells, not at the . . . destination"); *Indep. Petroleum Ass'n of Am. v. Armstrong*, 91 F. Supp. 2d at 119 ("the essential bargain embodied in federal and Indian leases entitled the lessor to a royalty based upon the value of production at the mine").[1]

Further, courts have consistently invalidated any Department of Interior regulation or policy that is contrary to the MLA's intent. *See, e.g., Plateau, Inc. v. Dep't of Interior*, 603 F.2d 161, 164 (10th Cir. 1979) (invalidating regulation governing Federal royalty oil because, based on legislative history, the court found the regulation "goes beyond what Congress authorized"); *Marathon Oil Co. v. Andrus*, 452 F.Supp. 548, 552-53 (D. Wyo. 1978) (invalidating agency oil and gas royalty policy as conflicting with "the legislative history of the Mineral Leasing Act, together with its many enactments and re-enactments"); *Indep. Petroleum Ass'n*, 91 F. Supp. 2d at 125 (invalidating MMS regulation which disallowed transportation deduction for unused pipeline firm transportation charges, which MMS claimed were not "actual" costs incurred to move gas downstream, because the disallowance led to a definition of "value" inconsistent with the MLA's intent that royalty should be based at the mine), *rev'd on other grounds,* 279 F.3d at 1042-43.

ONRR's Proposed Rule violates Congressional intent in the MLA. ONRR seeks to obtain royalty on more than the "at the mine" coal value; ONRR seeks to value the coal based on affiliate resales taking place over 1,500 miles away from the mine without accounting for the change in value due to logistics services provided to deliver coal to the distant location.

Principle #2: The Best Way to Determine Value "At the Mine" is by Arm's-Length Comparable Sales

[1] Although these cases involve royalty on oil and gas, the stated principles are equally applicable to coal royalty valuation. *See Black Butte Coal Co. v. United States*, 38 F. Supp. 2d 963, 971 (D. Wyo. 1999) ("Simply because [prior cases] involve gas and oil as opposed to coal is not a compelling reason to ignore them. The decisions' discussion of the assessment of royalties is functionally indistinguishable . . .").

The current benchmarks reflect the long-held and universal view that the best method for determining value at the mine is examining comparable arm's-length sales. *See* 76 Fed. Reg. at 30882 ("The Department of the Interior has long held the view that the sales prices agreed to in arm's-length transactions are the best indication of market value. The 1989 regulations reflect that view."). When the benchmarks were adopted, MMS included a comparison to arm's-length sales in the first benchmark and placed the less reliable valuation method—the netback approach—as the last benchmark. 54 Fed. Reg. at 1506. Accordingly, it was MMS's intent that it "will use a net-back valuation method only when other methods of determining value, such as those specified in the rules, are inapplicable." *Id.*; *see also* 30 C.F.R § 1206.257(c)(2)(i),(v).

Consistent with reliance on a comparable sales approach, MMS's 1996 guidance on affiliate sales of coal provides that affiliate resales of coal may be used to determine value, but only where the resale occurs in the same area as the mine. *See* "General Guidance for Auditing Affiliate Sales of Coal" at 1 (November 26, 1996) ("If a resale of production from the affiliate to a third party occurs *in the same field or area* as the sale from the lessee to its affiliate, the proceeds under the arm's-length resale contract may be used in calculating the applicable benchmark value." (emphasis added)). The use of affiliate resales in the same area as the mine is very different than ONRR's proposed new approach, which would require royalty valuation based on affiliate resales regardless of location.

In royalty cases on private lands involving affiliate sales, courts have applied the comparable arm's – length sales approach to determine market value at the mine as "[t]he first, and most desirable" approach. *Potts v. Chesapeake Exploration, L.L.C*., No. 3:12-CV-1596-O, 2013 WL 874711, at *5 (N.D. Tex. Mar. 11, 2013), *aff'd*, 760 F.3d 470 (5th Cir. 2014) ("The most desirable method is to use comparable sales"). In other valuation cases, not involving affiliate sales, courts similarly prefer the comparable sales valuation approach to determine a value at the mine. *E.g., Ashland Oil, Inc. v. Phillips Petroleum Co.*, 554 F.2d 381, 387 (10th Cir. 1975) ("It is obvious that the comparable sales-current market price is by far the preferable method when it can be used."); *Bice v. Petro-Hunt, L.L.C*., 2009 ND 124, ¶ 14, 768 N.W.2d 496, 501 ("Most courts prefer the comparable sales method."); *Ashland Oil, Inc. v. Phillips Petroleum Co.*, 463 F. Supp. 619, 620 (N.D. Okla. 1978), *aff'd in part, rev'd in part,* 607 F.2d 335 (10th Cir. 1979) ("Optimally, a product's 'fair market value' is determinable by examining comparable sales of the same product."); *Anderson Living Trust v. ConocoPhillips Co., LLC*, 952 F. Supp. 2d 979, 1040 (D. N.M. 2013) ("evidence of comparable wellhead sales is the best possible evidence for analyzing market value at the well.").

As companies do not have access to their competitors' sales agreements, review of arms-length sales are limited to those transacted by the company, which is currently captured within benchmark 4.

It is only when information about comparable arm's-length sales at the mine is not available that courts resort to the netback approach. *See, e.g., Ashland Oil,* 554 F.2d at 387 (holding the trial court properly used the "less desirable" netback approach to value gas at the mine where evidence of comparable sales was lacking). That was the situation in the *Marathon* case, where the courts upheld MMS's use of a netback approach to value liquefied natural gas (LNG) exported to Japan. *Marathon Oil Co. v. United States*, 604 F. Supp. 1375, 1385 (D. Alaska 1985), *aff'd*, 807 F.2d 759 (9th Cir. 1986). In *Marathon,* MMS could not use the comparable sales approach, as Marathon urged, because "[t]he gas delivered to the LNG plant presents a special, unique situation." 604 F.Supp. at 1385. There was no other gas in the field or area being sold to an LNG plant for comparison. *Id.*

Unlike the situation in *Marathon*, arm's-length coal sales at the mine of substantial volumes are common and there is generally comparable sales data at the mine available. For Cloud Peak Energy, there is ample evidence of comparable arm's-length sales at the mine as approximately 95% of the total coal sold is under arm's-length contracts at the mine. Of the 17.4 million tons of coal sold from our Spring Creek Mine, approximately 12.2 million (70%) was sold at the mine under arm's-length contracts. ONRR's Proposed Rule, which would ignore this best evidence of value in favor of the unreliable, uncertain netback approach for valuing non-arm's-length coal sales, is contrary to basic royalty principles. There is also a robust publicized index available whereby coal should have the option to use an index similar to oil and gas.

C. An Affiliate Resales Netback Approach Leads to Complicated Valuations and an Uncertain Regulatory Environment, Made Worse by Inclusion of an Unbridled "Default" Rule

Not only is ONRR's proposal contrary to the basic royalty principles in the Mineral Leasing Act and long-standing regulations, but using an affiliate resales netback approach will be complicated in practice, lead to unreliable and unfair valuations that do not accurately reflect "at the mine" values, and do nothing to provide certainty to lessees in calculating royalties.

Under the netback approach, "costs of transportation, washing, handling, etc., are deducted from the ultimate proceeds received for the coal . . . to ascertain value at the mine." 30 C.F.R. § 1206.251. However, the netback approach is complicated by the lessee's need to calculate, based on ONRR's regulations, which costs are allowable deductions. ONRR's Proposed Rule, however, does nothing to provide certainty to a lessee in calculating allowances.

Most concerning to Cloud Peak Energy is ONRR's proposed use of the "default" rule if it disagrees with a lessee's transportation allowance calculation, or if in the ONRR's sole discretion the transportation allowance is deemed "unreasonably high." 80 Fed. Reg. at 666. Under the Proposed Rule, ONRR may recalculate a lessee's transportation allowance under the "default" rule if ONRR determines the lessee's or lessee's affiliate's costs under an arm's-length transportation contract "does not reflect the reasonable cost of the transportation" because the lessee or its affiliate "breached [the] duty to market the coal for the mutual benefit of [the lessee] and the lessor by transporting [the] coal at a cost that is unreasonably high." *Id.* A transportation allowance will be considered "unreasonably high if it is 10-percent higher than the highest reasonable measures of transportation costs including, but not limited to, transportation allowances reported to ONRR and the cost to transport coal through the same transportation system." *Id.*

In Cloud Peak Energy's case, the uncertainty surrounding the Proposed Rule's treatment of the transportation allowance could have severe repercussions. As explained above, Cloud Peak Energy's separate logistics business transports coal over 1,500 miles away to the Westshore Terminal in Canada for sale to international customers, and intends to transport coal just as far to proposed terminals in Washington State. In doing so, our logistics business incurs a whole range of transportation expenses, including but not limited to, rail and port fees under long-term take or pay contracts, upfront costs to secure long-term committed capacity at the terminals, upfront costs to obtain options for committed capacity on the newly proposed (yet undeveloped) terminals in the Pacific Northwest, additives and sprays, and demurrage charges when rail interruptions cause delays in loading vessels. While all of these are actual costs Cloud Peak Energy incurs to transport the coal to the point of sale, it is unclear under the Proposed Rule whether ONRR would allow us to deduct these costs as allowable deductions.

In addition, if the international prices are weak at any given time, but Cloud Peak Energy is fulfilling long-term contracts and paying transportation costs at long-term rates, ONRR's proposed netback value of the coal could be lower than sales prices of coal at or near the mine.

Our concern with the application of ONRR's Proposed Rule to international coal sales is not hypothetical. Using our 2014 sales data and ONRR's proposed netback approach leads to a royalty value that is less than the arm's-length "at the mine" sales price on which we paid royalty. In such situations (as in 2014), under ONRR's Proposed Rule, Cloud Peak Energy could face a claim many years later that its transportation costs are "unreasonably high" or that we breached our duty to market the coal.

ONRR's proposal to use the "default" rule to recalculate the transportation allowance and/or recalculate the reasonable value of the coal if, in ONRR's view, the transportation allowance is too high or the coal value is too low, is unfair. It seeks to benefit from Cloud Peak Energy's logistics business profits when the risk pays off, but at the same time insulate ONRR from that risk if it doesn't.

D. A Possible 50% Cap on Transportation Costs Would be Arbitrary and is Grossly Illogical in Consideration of the Netback

While ONRR's Proposed Rule does not include a cap on transportation deductions for its proposed net-back calculation, ONRR does request comments "on whether we should limit coal allowances [for washing and transportation] to 50% of the value of the coal." *See* 80 Fed. Reg. at 629. That ONRR would suggest capping transportation deductions at 50% of the value of the coal shows that it either does not understand the economics of logistics services (and the transportation costs required) or – more likely – that its true objective is to use new royalty rules as a back-door way of depriving Federal coal lessees of a viable export opportunity, which will negatively impact employment.

In many export coal sales, transportation costs can exceed $35 per ton. Therefore, at any price of less than $70 per ton, a 50% limitation would arbitrarily shift the value of transportation services into the value of coal. The effect of ONRR's possible proposal is that Federal coal producers who deliver coal (either to foreign customers or domestic customers) would pay a royalty on far more than the value of the coal at the mine.

Further, Cloud Peak Energy believes that by even requesting comments on a 50% limitation on transportation costs, ONRR is continuing to demonstrate that it has completely abandoned any interest in establishing the value of coal 'at the mine' as required by the 1920 Mineral Act.

E. If Revision is Needed, ONRR Should Amend the Benchmarks and Not Eliminate them Altogether

Cloud Peak Energy believes that the current valuation benchmarks are workable, providing different valuation options based on how the coal is sold and what information is available to ONRR and the lessee. However, Cloud Peak Energy agrees with ONRR that it is problematic that the first benchmark does not include the use of comparable arm's-length sales by the lessee or its affiliates at or near the mine. *See* 80 Fed. Reg. at 628.

As discussed above, comparable arm's-length sales at the lessee's own mine is the most accurate means of determining an "at the mine" value. In addition, examination of the lessee's own arm's-length sales at or near the mine best ensures compliance with ONRR's comparability factors set forth in 30 C.F.R. §§ 1206.257(c)(2)(i) (for Federal leases) and 1206.456(c)(2)(i) (for Indian leases). Those factors include "[p]rice, time of execution, duration, market or markets served, terms, quality of coal, quantity, and such other factors as may be appropriate to reflect the value of the coal[.]" *Id.* § 1206.257(c)(2)(i). In the case of Cloud Peak Energy, the vast majority of coal is sold at or near the mine under arm's-length contracts. Accordingly, there is ample evidence of the value of the coal at the mine, including the coal that is ultimately shipped to international customers.

ONRR should amend the current benchmarks to include in the first benchmark the use of the lessee's comparable arm's-length sales at the same mine. Significantly ONRR has included this valuation option in the first benchmark for gas (*id*. § 1206.152(c)(1)); there is no reason to exclude it for coal. Including the option for coal would eliminate the need to resort to the complicated and unreliable netback approach.

If sufficient comparable arm's-length sales data are not available for a particular mine, ONRR could include as a subsequent benchmark the option to value non-arm's-length sales of coal based on an applicable index price, or an appropriately amended index price. Coal index prices are available through Argus/McCloskey's Coal Index Price Service[2] and through Platts Market Data service.[3]

Platts has been publishing daily and weekly index prices, also known as price assessments, for standardized products since 2003. The four standard products are Central Appalachian barge-delivered coal, Central Appalachian rail-delivered coal, and two low-sulfur Powder River Basin coal products, one with 8,800 Btu/lb. and the other with 8,400 Btu/lb. Weekly assessments of the traditional physical market include five assessments for coal from the Powder River Basin, Colorado, and Utah: (1) PRB 8,800 Btu/lb., 0.8 SO_2 lb./MMBtu; (2) PRB 8,400 Btu/lb., 0.8 SO_2 lb./MMBtu; (3) Colorado 11,700 Btu/lb., 0.8 SO_2 lb./MMBtu; (4) Colorado 11,000 Btu/lb., 0.8 SO_2 lb./MMBtu; and (5) Utah 11,500 Btu/lb., 0.8 SO_2 lb./MMBtu. Platts also publishes weekly assessments for production from the Appalachian and Illinois basins.

Similarly, Argus publishes daily and weekly price assessments for all world market centers, including Central Appalachia, Northern Appalachia/Pittsburgh Seam, Illinois Basin, Powder River Basin, Western Bituminous, U.S. export prices, U.S. import prices, and Latin America. Argus coal price assessments rely on a wide variety of sources for information including producers, generators, marketers, importers, exporters, traders, brokers, and data from electronic trading platforms.

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

The use of an index price, or appropriately adjusted index price, for determining value at the mine is a simple and reliable option for lessees and ONRR to use for valuing non-arm's-length coal sales. An index price option should be an available benchmark option if evidence of comparable arm's-length sales at the mine is not available.

F. There Are Other Serious Legal Defects in the Proposed Rule

As explained above, the Proposed Rule is contrary to basic royalty principles, Congressional intent in the Mineral Leasing Act, and long-standing regulations. And there are ways ONRR can improve any weaknesses in the current benchmark system without embarking on such a radical change in the way non-arm's-length contracts are valued. Beyond these fundamental points, there are serious and potentially fatal legal defects and analytical gaps in ONRR's proposal.

1. The Proposed Rule Unfairly Discriminates Against Federal Coal Producers Compared to Federal Oil & Gas Lessees

ONRR's Proposed Rule unfairly treats coal lessees differently than oil and gas lessees. The Proposed Rule will deny coal lessees the option to value non-arm's-length coal sales based on a published index price or adjusted index price. ONRR, however, already provides this option to oil lessees (*see* 30 C.F.R. §§ 1206.102(a)(2), (d)(1), (d)(2)(i) and 1206.103) and ONRR is now proposing to provide the option to gas lessees. 80 Fed. Reg. at 609, 620. Providing oil and gas lessees valuation options for non-arm's-

[2] Available at http://www.argusmedia.com/Coal/Argus-McCloskeys-Coal-Price-Index-Report (last accessed February 26, 2015).
[3] Available at http://www.platts.com/product-list/coal/all/market-data (last accessed February 26, 2015).

length sales that are denied coal lessees unfairly discriminates against coal lessees. An index price option will enable oil and gas producers to pay royalty on a reasonable value at or near the lease, but coal lessees will not have such option.

Coal producers will not have any option but to use affiliate resale prices. If ONRR is going to abandon the benchmark system for non-arm's-length coal sales, it needs to provide an option for coal producers to use publicly available index prices for coal, with adjustments to reflect differences in location and quality of coal. As explained above, the available index prices are reliable and, with some adjustment in appropriate cases, provide true "at the mine" values. Withholding an index price option from coal lessees, while providing the option to oil and gas lessees, is inconsistent and discriminatory. Inconsistent treatment of similar situations is the very definition of arbitrary and capricious – and thus unlawful – agency action. *Indep. Petroleum Ass'n of Am. v. Babbitt*, 92 F.3d 1248, 1258 (D.C. Cir. 1996) ("[a]n agency must treat similar cases in a similar manner unless it can provide a legitimate reason for failing to do so.").

2. ONRR Erroneously States That the Proposed Rule Will Have "No Net Revenue Impact" on Federal Coal Royalties

ONRR contends that the proposed change to use affiliate resale prices for valuing non-arm's-length coal sales will have "no royalty effect" on lessees; it further asserts that "there is no cost to lessees who produce Federal coal due to this valuation change in the proposed rules." 80 Fed. Reg. at 639. ONRR's contention is based on the false conclusion that "non-arm's-length sales of Federal coal that is then resold at arm's-length are rare." *Id.* In reality, as ONRR knows, non-arm's-length coal sales are quite common. *See* Report to the Royalty Policy Committee, *Mineral Revenue Collection From Federal and Indian Lands and the Outer Continental Shelf,* at 72 (Dec. 17, 2007) ("Nonarms-length transactions are common in the coal industry."). As in Cloud Peak Energy's case, some coal is sold to an affiliated logistics company for transport to distant customers, and in other cases, coal is sold to an affiliate so that the affiliate can fulfill independent coal supply contracts. *See, e.g. Decker Coal*, 2009 WL 700221. The commonality of non-arm's-length coal sales in general is evidenced by the several administrative decisions involving the valuation of non-arm's-length coal sales under the past and current benchmarks. *See Western Fuels-Utah, Inc.*, 130 IBLA 18 (1994) (involving non-arm's-length sales to a coal fired electrical generation facility); *Dry Fork Coal Co. Appellant,* MMS-95-0245-MIN, 1997 WL 34844653 (July 1, 1997) (same).

Cloud Peak Energy strenuously disagrees with ONRR's claim that the Proposed Rule will have "no royalty effect." For the coal industry in general and in Cloud Peak Energy's case, the use of an affiliate resales approach for valuing non-arm's-length coal sales will lead to a dramatic change in the royalty valuation by imposing a royalty obligation on far more than the coal itself. The Proposed Rule seeks to impose a royalty on services provided by vertically integrated companies such as Cloud Peak Energy's logistics business. ONRR's Proposed Rule, however, fails to recognize the separate nature of our logistics services business, which is already subject to income taxes and assumes substantial risks and costs independent from our mine site sales to arrange for delivery of commodities to remote locations. It is well-established that third party logistics companies are not required to pay Federal royalties on their re-sales of the same coal, yet the Proposed Rules attempts to impose a royalty on affiliated logistics services businesses.

Further, the allowed transportation deduction, even if not recalculated and reduced by ONRR, will not come close to covering the costs and risks of our logistics business. The Proposed Rule will make it difficult for affiliated logistics companies to compete with unaffiliated companies (such as non-mine brokers) because of the additional royalty cost. Non-mine brokers would be able to buy the coal at the mine and transport it for export without having to pay royalty on the increased value achieved away from the mine. These effects caused by the Proposed Rule will be felt only by the coal industry because oil and gas lessees have other valuation options, such as the index price option, that allow for "at the mine" valuations and will lessen the effects of the Proposed Rule.

Of course, if non-arm's-length coal sales are "rare," and the Proposed Rule will have "no effect" on Federal royalty payments, then why is ONRR seeking to make such a dramatic change in its regulations? ONRR's claim that the Proposed Rule will have "no effect" seems designed to avoid Congressional review for its attempt to use the royalty rules to discourage, if not stop, exports of Federal coal. Given the magnitude of the proposed changes, it would be inconceivable to claim that there is no net change to royalty payments.

3. The Proposed Rule Improperly Discourages Federal Coal Exports

Under the Proposed Rule, it will cost more for Cloud Peak Energy to export Federal coal than it will to export private or state coal. Accordingly, the Proposed Rule makes international coal shipments for Federal coal less attractive, creating incentive to forego Federal coal exports or to produce private or state coal instead of Federal or Tribal coal. Such effect is in direct conflict with the MLA's intent to encourage Federal coal development. *See, e.g.,* 58 CONG. REC. 7784 (1919) ("It is very important that the Federal Government should conserve all the rights and resources it now holds in these public lands and at the same time provide for their development with such financial returns as will aid greatly in the improvement of these portions of the country.").

As discussed above, Cloud Peak Energy makes millions of dollars in lease and royalty payments to the Federal government every year—in 2014, $69 million in lease payments to BLM and $191 million in royalties to ONRR to be retained by the Federal government and/or distributed to the States. Discouraging Federal and Indian coal development could deprive the Federal and Tribal governments, as well as the States who share in Federal coal royalty, of much needed revenue.

4. The Proposed Rule Levies an Unconstitutional Export Tax

The U.S. Constitution Prohibits Tax on exports. As it relates to coal, the background of the Proposed Rule strongly suggests it is targeted directly at exports. The U.S. Constitution specifically prohibits the imposition of duties on goods by reason of exportation to an international country.

Since under the ONRR's proposal Federal royalties would be based upon a value of coal at the point of delivery (which includes the value of transport, handling, logistical services, financial risk mitigation, elimination of shipping risks, and so forth), there will necessarily be a much higher royalty on exports of Federal coal when compared to non-exported coal. As such, the economic substance of the Proposed Rule is an imposition of an export tax, in contravention of the U.S. Constitution, Article 1, section 9, clause 5 ("No Tax or Duty shall be laid on Articles exported from any State."). Courts have recognized that fees or taxes that apply to the sale of coal into export markets violate the Export Clause. *See Consolidation Coal Co. v. United States*, 528 F.3d 1344, 1347 (Fed. Cir. 2008) (finding that if the Surface Mining Control and Reclamation Act reclamation fee was calculated based on the extraction *and sale* of coal, such that it applied to coal exports, it would be an unconstitutional violation of the Export Clause as a tax on exports); *see also Ranger Fuel Corp. v. United States*, 33 F. Supp. 2d 466, 467 (E.D. Va. 1998) (holding an IRS-imposed coal excise tax unconstitutional and in violation of the Export Clause).

G. Cloud Peak Energy Supports the Portion of the Proposed Rule Concerning Royalty Valuation Agreements

ONRR proposes to amend 30 C.F.R. § 1206.250 to clarify that an express provision of any individualized settlement agreement, written agreement, or lease provision, establishing a method to determine the value of coal production, will govern over any inconsistent regulation in the Proposed Rule. 80 Fed. Reg. at 663. This is consistent with the current gas regulation. *See* 30 C.F.R. § 1206.150. Cloud Peak Energy agrees that ONRR should be able to enter into written valuation agreements with lessees that supersede any inconsistent provisions in the regulations. Such agreements give flexibility to ONRR and lessees to address potentially unique or different circumstances. There is no reason that such agreements can be made for royalty valuation of gas, but not for coal.

H. Honoring Existing Agreements

If ONRR finalizes the Proposed Rule eliminating the benchmarks and drastically changing the coal royalty valuation methods, ONRR should include a grandfather clause which would provide for the continuation of current royalty benchmark rules until the existing sales and transportation contracts have expired.

V. Conclusion

Cloud Peak Energy urges ONRR to retain the existing benchmark system. Improvements to the existing benchmark system may include adding to the first benchmark the use of the lessee's comparable arm's-length sales at the same mine and an index valuation benchmark. ONRR's proposal to impose a netback methodology on affiliate sales of coal to international coal customers, along with a proposed "default" rule, is contrary to the Congressional intent of creating clarity and well-established principles of royalty valuation.

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

Yours sincerely,

Colin Marshall

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