Southall, Armand <armand.southall@onrr.gov>

Comments on Coal Royalty Rules

2 messages

Mark S Squillace <Mark.Squillace@colorado.edu> Thu, May 7, 2015 at 2:46 PM
To: "armand.southall@onrr.gov" <armand.southall@onrr.gov>

Please accept these comments on the proposed royalty reform rule published in the Federal Register on January 6, 2015. 80 Fed. Reg. 607 (2015)

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Southall, Armand <armand.southall@onrr.gov> Thu, May 7, 2015 at 2:50 PM
To: Mark S Squillace <Mark.Squillace@colorado.edu>

Hello, Professor Mark Squillace--
This email is my confirmation that I received your comments and will post them.

Thanks,

L. Armand Southall
Regulatory Specialist
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7 May 2015

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Transmitted via email: armand.southall@onrr.gov

Dear Mr. Southall:

Attached please find my comments on the proposed Consolidated Federal Oil and Gas and Federal Indian Coal Valuation Reform rules. 80 Fed. Reg. 607 (2015). My comments focus entirely on the coal royalty issue although some of these comments may prove relevant to oil and gas revenue issues as well and I ask that they be considered broadly in the spirit of much needed royalty reform.

Let me begin by applauding the Office of Natural Resources Revenue (ONRR) for taking on this issue. It is long overdue and my sense is that the agency's intentions are good. Nonetheless, as proposed, the rules are unlikely to accomplish their goals. They are unnecessarily complicated and as such are likely to invite the same type of manipulation and abuse that led to the agency to initiate this rulemaking in the first place.

About 20 years ago, in a book written after he served as Secretary of Labor, Robert Reich wrote an essay called *The Miasma of Regulation*. In this essay, Reich tells the story of an apocryphal engineer who invented a vacuum cleaner that was seriously at odds with noise regulations set by the EPA. The initial regulations were simple enough and seemed to require modifications to the vacuum cleaner to reduce its volume. But the inventor's clever lawyers found a way to parry every regulatory thrust and before long it was clear that the regulations were as ineffective as they were bloated. As Reich laments:

> Each maneuver [by the regulated party] generates a counter-maneuver from the regulatory bureaucracy and Congress; every feint and dodge, a more complicated prophylactic for the next encounter. The result, over time, is a profusion of legislative and regulatory detail that confounds American business.

Robert Reich, *The Miasma of Regulation*, in TALES OF NEW AMERICA 219 (1987). I fear this will be the fate of ONRR's proposed rules if they are finalized along the lines of what has been proposed. This is not an idle fear. One need only look at the efforts to reform the federal coal leasing program itself to realize that the industry has managed to out-maneuver the BLM and the Congress at every regulatory turn. *See* Mark Squillace, *The Tragic Story of the Federal Coal Leasing Program*, 27 Nat. Res. & Env. 29 (Winter, 2013).

* Provided for identification purposes only. These comments are my own and do not necessarily reflect the views of my employer, the University of Colorado Law School.

Reich concludes his essay somewhat despondently, noting that his story suggests "no obvious plan of action." But if ONRR recognizes -- as it must -- that an unnecessarily complicated regulatory program will invite litigation and abuse, then it should find a way to keep these rules simple even while they plainly accomplish the important goal of assuring a fair return to the public*. I offer these comments in the spirit of promoting a simplified but effective program for calculating royalty payments.*

Recommendation 1: The Starting Point for Valuation Should be the Arms-Length Sale Price or Fair Market Value Price *of the Final Sale* or Point of End Use

Trying to ascertain the first arm's length transaction has proved tricky and is the primary problem that has led to this rulemaking. The obvious objective of these rules is to ensure that royalties are paid on the full market price of the federal coal resource, perhaps with some deductions for transportation and washing. According to Headwaters Economics imposing the royalty based upon the net market price for the 5-year period between 2008 and 2012 would have yielded $865 million in additional federal revenues. Eliminating deductions for transportation and washing would have yielded far more – as much as $5.6 billion in additional federal revenue. *An Assessment of U.S. Federal Coal Royalties,* Headwaters Economics, January, 2015.

Collecting royalties at the point of final sale might move the time for collecting the royalty out a little longer to account for loading, shipping and delivery. Additional time might also result if the coal is stored before the final delivery. But the additional revenues that would be generated by this approach are well worth the minor lag time in collecting royalties.

While the buyer of federal coal might object, nothing prevents the government from requiring the seller to provide the final sale price as a condition of leasing federal coal. The ONRR can also work with the Energy Information Administration to collect market price data as necessary to verify the accuracy of sale data.

Legitimate concerns might also be raised about tracking federal coal over time and distance to the point of final sale but the government can establish a manifest system such as that proposed in Recommendation 4 and this would effectively address this concern while also bringing much needed transparency to the royalty assessment program.

Recommendation 2: If ONRR Decides to Allow Deductions for Transportation and Washing, the Value of those Deductions Should be Fixed in Advance by the ONRR Based on the Lowest Reasonable Market Price for those Services

Others have offered compelling arguments against allowing any deductions for washing and/or transporting federal coal and I fully support efforts to eliminate or reduce these deductions. Deductions for washing coal seem particularly unnecessary. As noted above, the elimination of such subsidies would significantly increase federal revenues and can easily be justified on the grounds that the government is seeking to recover some part of the substantial external costs associated with mining, transporting, and burning federal coal. These costs include, for examples, the opportunity costs associated with coal's use of our nation's rail capacity, costs associated with conventional air pollution that results from burning coal, and the social cost associated with carbon emissions from burning coal.

If deductions are nonetheless allowed, ONRR should, at a minimum, manage them with great care. Among the major risks associated with allowing any deductions is that it invites abuse and flies in the face of trying to keep the process simple. To avoid abuse and to keep the calculations simple, ONRR should establish a fixed price for transportation and washing coal roughly based upon the lowest reasonable price for providing those services. This will greatly simplify the royalty calculations and ensure greater transparency in the process.

This could be done annually or periodically as necessary but the ONRR should not fall into the trap of defending these deductions based upon sophisticated market calculations. Since the ONRR does not need to allow any deductions it should expressly claim the flexibility and discretion to allow modest reductions without the need to defend its fixed rate determinations based upon the actual costs to individual coal producers. Rather, it should claim the prerogative to make a rough judgment about the market costs of providing transportation and washing services and allowing the deductions only to that limited extent.

Recommendation 3: If ONRR Decides to Allow Deductions for Transportation, the Deduction Should Decline Over Distance

Moving coal by rail or through other common carriers imposes significant external costs on society, in terms of fuel consumption, greenhouse gas emissions, and the opportunity costs associated with rail, truck, and ship capacity. According to the Association of American Railroads, for example, 39.5 percent of rail tonnage and 19.9 percent of rail revenue came from coal in 2013. *Railroads & Coal*, Association of American Railroads, July, 2014.

As suggested above, an appropriate way to discourage long-distance rail transport and its associated external costs would be to eliminate the transportation deduction entirely. Another idea would be to reduce the deduction over distance in recognition of the fact that the longer the distance the greater the external costs. So for example, transporting coal less than 100 miles might receive the full deduction. After 100 miles the deduction might be reduced by 5% for every additional 100 miles that the coal is transported. To illustrate how such a policy might work, coal that is transported 1100 miles from the mine mouth to the point of end use would receive just a 50% deduction for the cost of transportation.

As with setting fixed costs for transportation and washing, the ONRR need not and should not claim that it is trying to approximate external costs associated with transporting coal. Rather, the decisions should be defended on the grounds that the government could eliminate the deduction entirely, and providing a more limited deduction than is currently allowed promotes the government's policy of discouraging the long distant transport of coal as a means to reduce greenhouse gas emissions and free up rail capacity for other desirable uses.

Recommendation 4: ONRR Should Establish a Manifest System for Federal Leased Coal

The EPA has established an efficient manifest system for tracking hazardous waste from the point of generation to the point of disposal. The ONRR could use that experience to establish a similar public manifest system to track federal coal. This will promote transparency by making it easier for both ONRR and the public to track federally-leased coal and to ensure that the full royalty is paid on all federal coal that is mined.

Here's how this system might work. As with the RCRA manifest system, the producer of the coal would be responsible for preparing the original manifest and ensuring that the manifest follows the coal to the point of end use – the point where the royalty will be paid. Each party that handles the coal would be responsible for filling out the manifest and then turning it over to the next handler until the coal is received at the point of end use. This could and probably should all be done electronically. Again, EPA has taken the lead on developing an electronic manifest system, which is now required as a result of the Hazardous Waste Electronic Manifest Establishment Act of 2012. Final rules implementing the e-manifest system for hazardous waste were adopted by the EPA in February of 2014. [79 Fed. Reg. 7518](#) (2014).

A manifest system for coal should be much simpler than the system designed for hazardous waste since it does not need to comply with the myriad requirements associated with transporting and disposing of hazardous waste. It would, however, provide a transparent way to track federal coal from the mine mouth to the point of end use thereby helping to ensure that royalties are paid on the full volume of federal coal produced and sold on the market.

Recommendation 5: ONRR Should Work with the BLM to Raise the Royalty Rate for Coal and Better Manage the Federal Coal Leasing System to Ensure a Fair Return to the Public

While the BLM retains the primary responsibility for determining royalty rates and otherwise managing the federal leasing system, it seems clear that the BLM's mismanagement has cost taxpayers millions and perhaps billions of dollars in lost revenues. In December, 2013, for example, the General Accounting Office found widespread problems with the current leasing program. *BLM Could Enhance Appraisal Process, More Explicitly Consider Coal Exports, and Provide More Public Information*, GAO-14-140 (2014). Among the GAO's somewhat shocking findings was evidence of federal coal lease sales showing bonus bids in some states such as North Dakota, commonly in the 1¢/ton range. In one case in Alabama, 500,000 tons of federal coal was sold for 1/1000¢/ton. Adding to the problem is the BLM's royalty relief program that allows coal companies to pay far less than the statutory rate of 12.5% for surface mined coal and 8% of underground mined coal.

A private study by the Institute for Energy Economics and Financial Analysis found that the federal government has lost $28.9 billion as a result of abuses in the federal coal leasing program over the last 30 years. Tom Sanzillo, *The Great Giveaway: An analysis of the costly failure of federal coal leasing in the Powder River Basin* (Jun, 2012).

The point here is that while fixing the royalty program itself is important, it is not nearly enough to stem the abuses in the current federal coal leasing system. And even if the ONRR's reforms are ultimately effective they could all be undermined by BLM decisions to provide coal operators with royalty relief. Given the ONRR's important role in ensuring that the federal government receives a fair return on our public mineral resource, the ONRR should work with the BLM to address the flaws with the current leasing program. In particular, federal coal should not be leased to parties unless the government determines that the lessee is in a position to pay the full royalty. If royalty relief is to be granted at all, it should be reserved for those cases where temporary relief is necessary to overcome short-term problems either with the coal market or the conditions at a particular mine. Ideally, royalty relief should be expressly limited to no more than one year on any federal lease.

Thank you for the opportunity to share these comments. I look forward to seeing the results of this effort.

Sincerely,

Mark Squillace