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FUELS
ASSOCIATION
INC.
*The National
Fuel Supply
Cooperative*

May 8, 2015

Armand Southall
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Attn: Regulation Identifier Number (RIN) 1012-AA13

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

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

Dear Mr. Southall:

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

Western Fuels Association (WFA) is a not-for-profit cooperative that supplies coal and transportation services to consumer-owned electric utilities throughout the Great Plains, Rocky Mountain and Southwest regions. WFA services assist with the generation of an estimated 4,400 megawatts of electricity. This is enough to supply the electric needs of approximately 3 million households. The sales of coal from our related entities are primarily to related, rural cooperative owned utilities. Since WFA operations are directly impacted by the proposal, we have substantial interest in this issue and find it necessary to identify the concerns described below. This list is not intended to be exhaustive.

WFA appreciates the opportunity to submit comments on this Proposed Rule. As explained below, WFA strongly opposes the proposed changes to the royalty valuation standards for coal sold or transferred to a power plant owned by the lessee or its affiliate, which ONRR dubs "no-sale situations". The ONRR proposal is quite a disappointing alteration from the stated goals of the Proposed Rulemaking, which were to "... (1) offer greater simplicity, certainty, clarity, and consistency in product valuation for mineral lessees and mineral revenue recipients; (2) are more understandable; (3) decrease industry's cost of compliance and ONRR's cost to ensure industry compliance; and (4) provide early certainty to industry and ONRR that companies have paid every dollar due." These were the expressed goals stated in this Proposed Rulemaking at 80 Fed. Reg. at 608, and had been previously touted as the goals in the Advanced Notice of Proposed Rulemaking (ANPR) at 76 Fed. Reg. at 55838. Instead, for "no-sale" situations, ONRR has proposed implementing the illogical and indefinite net-back royalty valuation methodology. The net-back method is well known to be the least logical, most complicated, and option of last resort for establishing mineral valuations. In fact, ONRR proposes to bypass its own rules and essentially set coal royalty value whenever it chooses and at whatever it chooses for no-sale operations. The

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Proposed Rule, also, ignores that the applicable mineral leasing laws and lease terms entitle the lessor to a prescribed percentage of the value *of coal* at *the lease*. For non-arms-length (NAL) and no-sale dispositions, ONRR overlooks that the prescribed royalty rate in the lease contract was agreed to only value coal, not to value another commodity – electricity – generated by consuming the coal and the price for which is affected by a variety of regulatory and market factors inapplicable to coal. This valuation concept (of valuing the net-back from sale of electricity rather than the intended valuation of coal at the lease) is rife with insurmountable issues. The issues are so overwhelming, in fact, that the proposed net-back valuation method will be impossible for producers, ONRR and the State Departments of Audit to determine valuations. This would subject producers valuations to the onerous default provision discussed later in these comments. We cannot help but wonder if this was intentional, in order to allow ONRR to implement their new default provision.

As such, WFA respectfully requests that ONRR withdraw the Proposed Rule.

SPECIFIC COMMENTS

Definitions

1. WFA is concerned with the overbroad definition of "misconduct" being utilized by ONRR in the proposed regulation. ONRR uses the term "misconduct" throughout the Proposed Rule to justify applying its so-called "default provision" to unilaterally establish the royalty value (*e.g.*, proposed §§ 1206.253 and 1206.453). For example, ONRR now proposes to label even good faith errors, or minor paperwork errors amounting to no practical harm, as "misconduct," with significant consequences flowing from that determination. Second, by defining misconduct to include "any failure to perform a duty owed to the United States under a statute, regulation, or lease, or unlawful or improper behavior," ONRR defines misconduct to include almost anything, even duties not within ONRR's jurisdiction. Third, ONRR improperly proposes to always impute to the lessee errors made by employees and contractors. Again, by giving such an overly broad definition for misconduct, this gives the appearance that ONRR intends to unilaterally value coal from NAL and no-sale situations for insignificant and even unrelated errors by the lessee.

2. The ONRR also added a definition for "coal cooperative" 80 Fed. Reg. at 628. This definition is unnecessary. Contracts are either arm's length or NAL, in accordance with the existing benchmark system in the regulations. The benchmarks are defined by these two types, which include contracts with an affiliate/related party. It doesn't matter if an affiliate/related party is a corporation or a cooperative, so why make the distinction in the proposed rule? In fact, the ONRR in the proposed rule later combines both a corporation and a cooperative together as cooperative, further obfuscating the need for distinction between a for-profit company and a not-for-profit company where either sells coal to an affiliate. The ONRR should only be considering contracts as either arm's length or non-arm's length regardless of the company type. Adding a third definition, for coal cooperative, is only causing more confusion. In addition, the ONRR proceeds to go on discussing methods to determine

value of the coal from a "coal cooperative", where a "corporation" could have a similar situation (sale to an affiliate with the first arm's length sale).

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

3. WFA agrees with ONRR's preamble statement wherein "this Department reaffirms that the value, for royalty purposes, of . . . coal produced from Federal and Indian leases is determined at or near the lease and that gross proceeds from arm's-length contracts are the best indication of market value." 80 Fed. Reg. at 609. Consistent with existing regulations (for ad valorem leases) at 30 C.F.R. §§ 1206.257(b) and 1206.457(b), when a coal lessee engages in an arm's-length sale with its customer for production, that should establish the value of the coal for royalty purposes. Proposed § 1206.257(a)(1) appropriately retains this rule.

4. The remainder of § 1206.257(a), however, does not follow logically or practically from the two above core principles endorsed by ONRR. Currently NAL sales are valued using the benchmark method, and primarily are based on sales of nearby similarly valued coal, or arm's length sales from the same operation. The current method makes sense and has been utilized successfully for many years. However, ONRR is proposing to force any coal lessee to track its coal to an arm's length contract that might occur anywhere else domestically or globally. ONRR would do so by deeming a sale by the lessee's affiliate as a sale by the lessee, by deleting the benchmarks (including the option to examine comparable arm's length sales), and instead trying to calculate a net-back valuation method from, in our case, the sale of electricity less applicable generation and transmission costs. Recognizing the questionable nature of these changes, ONRR's preamble "seek[s] input on the merits of eliminating the benchmarks" and asks whether "the royalty value of coal initially sold under NAL conditions [should] be based on the gross proceeds received from the first arm's length sale of that coal in situations where there is a subsequent arm's length sale." 80 Fed. Reg. at 628. WFA urges ONRR to reject this proposed valuation methodology.

   WFA has generally found the NAL benchmarks to be workable, and disagrees with ONRR's contention that the benchmarks have been too difficult to implement. If ONRR has issues, instead of implementing such draconian and legally questionable valuation methods, they should simply provide further guidance on applying comparability factors. In other words, ONRR provides no explanation of why its proposed alternative is any better. Instead, the Proposed Rule provokes only more questions, as outlined in our subsequent comments.

5. Private producers and coal cooperatives are treated the same when coal sales result in NAL transactions, and will be required to value coal sales to affiliates under the same § 1206.252 (a). The impropriety of proposing to value federal and Indian coal based on the "first arm's length contract" is compounded by ONRR's failure to articulate how exactly lessees are to net-back that value from that point to the lease. As ONRR recognizes in proposed subsection (a), gross proceeds must be "less an applicable

transportation allowance…and washing allowance" to arrive at royalty value at the lease. *See also* existing 30 C.F.R. § 1206.251 ("net-back method" deducts costs from gross proceeds to calculate "market value of coal at the lease or mine"). Without these deductions, lessees would be forced to pay royalty on more than the "value of coal," which ONRR has no authority to compel. 30 U.S.C. § 207(a). Computing these deductible costs, however, is inherently difficult. Transportation costs are not limited to rail costs and terminal fees. WFA's members report incurring the following costs in transporting its federal coal domestically:

- Base railroad transportation rate, fuel surcharges and related accessorial charges. Rates are contractually negotiated and protected by confidentiality clauses in each contract and not available to the coal producer.
- Rail equipment costs.
- Dust and oxidation mitigation sprays applied to coal at mine, required by railroads.
- Management fees and related transaction costs.

Notably, these fees and other costs would vary if the coal were trucked instead of shipped via rail away from the mine. Regardless, it would be inappropriate to assess a coal lease royalty on shipping/transportation costs after the point of sale.

While ONRR's proposed valuation method appears to provide that the lessee may deduct its transportation costs for coal sold, the Proposed Rules entirely fail to prescribe which transportation costs will be allowable and which costs ONRR will deny. This stands in contrast to the specificity ONRR provided for the gas transportation allowances in 30 C.F.R. § 1206.178 (f) and (g). The complexity and imprecision of such net-back calculations is precisely why ONRR consistently has taken the position that the net-back method should be the valuation procedure of last resort. *See, e.g.*, 54 Fed. Reg. at 1,492 (Jan. 13, 1989) ("The MMS [Minerals Management Service] will use a net-back valuation method only when other methods of determining value, such as those specified in the rules, are inapplicable."); 53 Fed. Reg. at 1,230 (Jan. 15, 1988) ("MMS agrees that the net-back method will not be used frequently. The net-back analysis *should only be used where less complex procedures are not feasible*.") (emphasis added).

Indeed, ONRR has similarly disfavored net-back methods for valuing oil and gas. *See, e.g.*, 53 Fed. Reg. at 1,184 ("To routinely perform labor-intensive net-back calculations is impractical."); *id.* (use of net-back analysis "on a routine basis to verify oil value is impractical and unnecessary"); *id.* ("the other benchmarks which have higher priority will result in a reasonable value for royalty purposes and obviate the need to undertake a labor-intensive net-back method"). This aversion to net-back is reflected in ONRR's existing rules for oil and gas. *See* 30 C.F.R. §§ 1206.152 (unprocessed gas); 1206.153 (processed gas); 30 C.F.R. §§ 1206.102-1206.103 (oil). Likewise, and more importantly for present purposes, ONRR's Proposed Rule acknowledges the difficulty of calculating multiple allowances to "trace" arm's length sales in the oil and gas context, and thus affords oil and gas lessees the option to value their oil and gas via other means. 80 Fed. Reg. at 608.

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

6. ONRR proposes a different valuation standard altogether when federal or Indian coal is not sold at all, but is transferred and directly used by a power plant owned by the lessee or its affiliate. In Section §1206.252 (c)(2), sales to an affiliated power plant must also value coal using this method. Currently, such coal would be valued under the same existing benchmarks applicable to all federal and Indian coal not initially sold under an arm's length contract. The Proposed Rule now summarily declares that in "no-sale situations" royalty would be assessed against the gross proceeds of *electricity* generated and sold at arm's length by the coal lessee or its affiliate. 80 Fed. Reg. at 628. To net-back this value to the coal lease, ONRR would offer deductions for not only transportation and washing, but also "transmission and generation deductions" located in ONRR's separate regulations governing geothermal resources. Separately, if electricity is not sold arm's length, ONRR would just perform the valuation itself. No explanation or justification accompanies this proposal; WFA was unable to find any responses to the Advanced Notice of Proposed Rulemaking that show anyone advocating for it. Not surprisingly, then, these provisions are seriously flawed and should not be finalized in their current form. WFA would like answers to the below questions before we can begin to attempt to calculate the net-back from sale of electricity:

    a. How are we to determine value of one coal (the NAL coal) used to produce electricity when multiple coals are bought/used at one plant (some of which are arm's length), and all the coals provide different BTU/quality and hence have different values?

    b. Same as a. above, but in instances where the transportation costs are different for the different coals supplied, with some coal being NAL and some being arm's length. How are we to determine the transportation allowance from electricity sales when generation is from multiple coal types from a mix of NAL and arm's length suppliers with multiple transportation costs?

    c. In the same scenario with multiple coal supplies, some arm's length and some NAL, some with higher transportation costs, how will the NAL lessee determine valuation by net-back from the sale of generated electricity when the sales price of the electricity is constantly changing, and the cost to generate the electricity varies by the quality/BTU of the coal fuel source? For lower coal qualities, the generator must operate additional handling facilities, which lower the throughput and increase their generation costs. How are they to capture the cost of those items, so they can provide those costs to the coal lessee, who must then adequately defend those to the ONRR during audits?

d. What about the situation where some of the electricity is sold repeatedly as NAL transactions, and is ultimately purchased by hundreds of thousands of owner-members? Is there ever really an arm's length sale in that scenario? Would that be considered the "no-sale" scenario, which would allow ONRR to unilaterally set the valuation? Or would the NAL producer be asked to assess the net-back method based on the varying retail rates paid by the member-owners, who often end up being rural residents?

e. How is WFA to allocate using the net-back method beginning with the first arm's-length sales of electricity, when electricity is sold to some affiliates, some to the open market, and the sales prices and contracts change hour by hour? Again, not all these electricity sales can clearly be traced to an individual coal supplier, especially where the coal supply is a mix of arm's length and NAL coal.

f. How is WFA to assess the valuation of coal shipped to a NAL utility where our NAL coal is stored in a stockpile, which it may not be utilized for months or years? The NAL coal may or may not have been used to generate electricity for months or years after being produced at the mine. We doubt if ONRR wants to have us wait to pay the royalties until our stockpiled coal is burned. However, we could argue that such a delay on payment is appropriate and justified.

g. WFA does not know nor will we have the data necessary to determine (i) whether our delivered coal was subsequently sold at arm's length, (ii) whether our affiliated utility sold electricity at arm's length or NAL, and (iii) what sales prices were obtained and what allowable transportation, washing, generation, or transmission costs were incurred. As a result, WFA will not even know with certainty which regulatory paragraph applies, let alone be able to actually perform the respective valuation.

h. ONRR presumes that a coal lessee will be able to obtain information from the affiliated utilities, on the details of sales prices for coal or electricity, and applicable allowances. Yet ONRR presents no justification or evidence to support this assumption, particularly given that affiliates to date have not had to perform these novel tasks. How does ONRR expect the coal lessee to obtain the information on electricity sales at the end of the month when that information is often not available until after the close of the quarter, AND IS CONFIDENTIAL AND IS NOT AVAILABLE TO THE COAL LESSEE? Also, the affiliated producer's information is also subject to audits that are often not closed for several years. Therefore, the net-back method will be constantly recalculated as a result of audits changing their gross proceeds. Hence, the chance for ONRR to claim "misconduct" on the lessee for not reporting value correctly resulting in additional penalty and interest.

i. For affiliates, this will cost both the lessee and the affiliated electricity producer's books to remain open, as the higher royalty cost and unresolved royalty valuation resulting from these rules will affect both sets of books. Coal producer's costs are reflected in the electrical sales. As a result, neither the affiliated coal producer nor the affiliated electricity generator can close their books until the coal valuation is accepted by ONRR. This could take years longer due to the confusing net-back requirements being proposed by ONRR in these draft regulations.

j. ONRR's stated goals are to "improve the current regulations to ensure greater clarity, efficiency, certainty, and consistency in production valuation" 80 Fed. Reg. at 609. However the proposed regulations will have exactly the opposite effect. WFA will not be able to comply with the regulations as proposed. At this time, we cannot comply with this proposal for determining valuation of NAL sales.

k. As we interpret the regulations, in proposed § 1206.253 if WFA is unable to determine valuation, the proposal allows ONRR to make determination of the coal valuation. WFA will be unable to make a royalty valuation determination due to the complexity and ambiguity of the proposed regulations. We understand that ONRR is also adopting more aggressive new policies on proper initial reporting and payment of royalties and threats of substantial civil penalties for erroneous reporting. (See 70 Fed. Reg. at 28,862. May 20, 2014). If this civil penalty is applicable, it means that WFA will be penalized for essentially giving up on trying to make a royalty valuation estimate, since we cannot make the estimate based on the confusing methods in this proposal. How much will the penalty be? Will ONRR assess a royalty on the penalty paid?

l. The draft standard's proposal to base valuation on the net-back of electricity sale lacks any provision ensuring that coal is not over-valued in their proposed process. There is no specified "off ramp" that compares the coal valuation at the lease back to anything resembling true market valuation of the coal at the lease. In other words, the valuation is intended to be revenue neutral, but in fact, this could show valuations much higher than current valuation, and likely higher than valuation of nearby comparable coal, as well as higher than arm's length sales of comparable coal from the same mine. However, the draft regulations do not allow the producer to use cost of production, published coal indices, nor arm's length sales from the same mine to demonstrate that fact. This is a serious flaw in the proposal.

7. ONRR asks the question of whether "adoption of this uniform "first arm's length sale" methodology would substantively impact your current calculation and payment of royalties on coal," 80 Fed. Reg. at 628. As documented by the discussions immediately above, WFA believes the ONRR proposal would substantially impact our current calculation and payment of royalties. Due to the uncertainty, WFA and similar affiliated operations will be in constant audit and closure will be impossible. Like federal oil and gas lessees, federal and Indian coal lessees should have a ready

alternative to the above documented impossible task of calculating net-back from sale of electricity.

We advocate that instead of the adoption of net-back from sale of electricity, the ONRR adhere to its current, workable benchmarks for coal sold at NAL. The only change that WFA strongly recommends would be to allow use of arm's length sales from the producer's own mine in the first benchmark. Prior to 1989, the MMS condoned use of such sales. Such other arm's length sales are inherently reliable given that the majority of federal and Indian coal is sold domestically at arm's length. In 2012, less than 3 percent of federal coal was exported. Arm's length sales represent the true market valuation of similar coal at the mine and should be allowed for valuation purposes. Valuation based on existing arm's length contracts is the most accurate, reliable, and simplistic valuation method. Adoption of the benchmarks enhanced with arm's length sales is much less cumbersome and troublesome than the ONRR's proposed net-back method.

As a secondary (and far less preferred) option, in the event there were insufficient comparable arm's length sales data, a permissible approach based on published index bases could be considered further in lieu of net-back methods. Where representative indices are unavailable, as in the case of no index being available for 8,000 B Powder River Basin coal, ONRR should welcome constructive dialogue with individual companies to arrive at an agreed valuation for particular non-arm's length dispositions from a particular mine. We would suggest the current use of a cost plus method is appropriate for these rare situations.

8. At §1206.252 (b)(2), and §1206.(c)(e), in situations where electricity is not sold arm's length, and if the values in this section do not apply, "ONRR will determine the value of the coal under § 1206.254," i.e., the "default provision." In other words, ONRR proposes to take the initial valuation function away from the lessee and may instead implement the default provision. This is the exact opposite of certainty and consistency. Moreover, there will be no opportunity for a lessee to gauge the reasonableness or accuracy of ONRR's valuation determination since ONRR likely will resist sharing the data it relied upon due to confidentiality concerns.

ONRR's Proposed Royalty on Electricity instead of on Coal Value is Impermissible

9. The Mineral Leasing Act sets a minimum royalty rate of "12 ½ percentum of the value of coal . . . ." 30 U.S.C. § 207(a). The Act authorizes a lower rate for coal recovered by underground mining, generally set by the Bureau of Land Management at 8 percent. For dispositions other than arm's length sales, current regulations in effect for the last 26 years again look first to apply that royalty rate to a coal value based on comparable sales of coal produced in the area. ONRR's proposal is to instead apply that same royalty rate to the value of the *electricity* generated by the coal (with deductions for generation and transmission costs). No statute authorizes ONRR's substitution of electricity for coal, and ONRR offers no analysis or explanation that could support interchanging the two commodities. ONRR does not

justify applying the same royalty rate established in the lease contract for coal to an entirely different energy commodity. ONRR's provisions for transportation, washing, and generation allowances against the price of electricity also provide little comfort given the practical nightmare of determining these costs, the unavailability of information from other parties (including affiliated utilities), and the lack of binding ONRR guidance to clarify calculation of allowable deductions.

As noted above, the Mineral Leasing Act and each coal lease reserve to the federal government a royalty interest based on a fixed percentage of the "value of coal" – not electricity. 30 U.S.C. § 207(a). That royalty rate is a central term upon which would-be lessees rely to calculate their bonus bids to obtain the lease. Once the lease is executed, that royalty term cannot be unilaterally changed by ONRR or any other federal agency during the term of the lease. 30 U.S.C. § 207(a). When current coal lessees signed their existing leases, the regulations prescribed a comprehensive series of steps for valuing their *coal* for royalty purposes. It was never contemplated that ONRR would suddenly base royalty on a different energy commodity. WFA does not believe it is proper for ONRR to suddenly burden existing federal and Indian coal lessees with new effective royalty obligations, nor has ONRR provided any foundation for implementing its proposal for future coal leases.

These proposed rules are not only unfair, but WFA believes these risk raising breach of contract and other legal issues. As specified in the existing regulations, lease terms and written agreements prevail over existing regulations. 30 C.F.R. §§ 1206.250(b), 1206.450(b). ONRR's Proposed Rule contains the same reservation (proposed §§ 1206.250(c) and 1206.450(c)). ONRR cannot unilaterally decide to alter a key economic term of the lease agreement to extract additional financial consideration after the fact. But the Proposed Rule appears to do just that.

Again, the mineral leasing laws applicable to federal or Indian coal and the existing coal valuation regulations contain ***no*** mention of electricity in valuing coal under any circumstances. ONRR is proposing to use electricity as a proxy for coal in lieu of comparable arm's length coal sales, yet ONRR has failed to provide any factual evidence or analysis correlating the two distinct commodities. To the contrary, the Proposed Rule's preamble admits that ONRR has "limited experience" with this methodology, and openly seeks "information on the costs of electric power generation and transmission and whether the Proposed Rule would result in royalty increases or decreases." 80 Fed. Reg. at 639-640. Whatever authority ONRR perceives to value coal in no sale situations (e.g., under the lowest-priority current benchmarks, or its proposed "default provision"), it is inappropriate for ONRR to wholesale insert a substitute metric without support that it accurately reflects the value of coal.

10. ONRR appears to suggest that the same royalty *rate* specified in the coal lease should be applied to the gross proceeds from sale of electricity. If so, ONRR apparently has concluded without any economic justification not only that the value of coal and the value of sold electricity generated from that coal are interchangeable, but also that the same royalty rate is warranted. Even if ONRR could quantify the relationship

between electricity sale gross proceeds and coal value (which again it has not done), ONRR would have to further consider whether substituting one commodity for the other *at the contractually prescribed royalty rate* would increase the royalty burden on lessees. The Proposed Rule indicates no such economic analysis. As noted above, ONRR instead admits it has little data on the matter and impermissibly tries to delegate to the regulated community the agency's burden to justify its own proposed rules. Based on the experience with the geothermal regulations, further described below, applying the royalty rate for coal to electricity may result in an increase in federal and Indian coal lessees' effective royalty obligation, which presents significant breach of contract issues.

Questionable Net-back Deductions

11. The proposal links the net-back electricity producer costs to regulations written for geothermal electrical production. Since the language in the proposal at § 1206.252 (b)(1) states "You or your affiliate sell(s) the electricity, then the value of the coal subject to this section, for royalty purposes, is the gross proceeds accruing to you for the power plant's arm's length sales of the electricity less applicable transportation and washing deductions determined under … of this subpart and, *if applicable*, transmission and generation deductions determined under §§ 1206.353 and 1206.352 of subpart H" (emphasis added). The insertion of the words "if applicable" coupled with ONRR referencing deductions that are listed in a section of the rules regarding geothermal production, make us suspect that ONRR could deem any and all deductions as "not applicable" since this coal is not used for geothermal generation.

12. The geothermal net-back determinations at §§ 1206.353 and 1206.352 of subpart H only allow net-back of allowed generation and transmission costs, and allowable coal transportation costs. Those may not include all costs to produce and transmit both the coal and the electricity. We believe the costs for many normal items inherent in our respective businesses would be deemed by ONRR as not being "applicable". While the utility may deem them as necessary for the generation of electricity, given the long term risks and experience in the industry, ONRR may not concur. We are concerned that such items as railroad shipping tariffs, railroad fuel surcharges, rail equipment costs, coal contract management, coal lease permitting, surface land ownership management costs, contract procurement, employee recruitment and retention expenses, public relations expenses, and transportation management costs may or may not be included in the allowed "deductions". Hence we fear the geothermal net-back deductions may *not* be inclusive of all costs to generate and transmit electricity and at a minimum, should be rewritten for this proposal to include *all* costs incurred to generate electricity less the value of the coal at the lease. Absent specificity, ONRR will be collecting royalty on the value of these goods and services, not just the value of the coal at the lease. Again, if any error (or perceived error) is made in the net-back calculations, ONRR can unilaterally set value under its "default provision". Ironically, ONRR reserves to itself the ability to look at the same factors that lessees could not, namely the value of like-quality coal from the same mine,

nearby mines, same region, or other regions…" We have to ask: Why not just simplify the method and let the NAL coal lessees do that to start with?

Potential for Inappropriate Over-Valuation of Coal

13. The proposed regulations do not recognize the circular effect created. Without all costs to generate electricity being deducted from the coal valuation (except the coal valuation), the sale of electricity will be "over valued" resulting in the coal being "over valued". Hence the circular effect. As the coal valuation is raised, which may happen under this rule, in an affiliated situation, the electrical utility must pay more for the affiliate's coal. The utility will then be forced to raise electricity pricing. Which brings us back to the beginning, with higher electricity sales pricing, the coal valuation will subsequently be higher. This is obviously not fair, and shows the need to have coal valuation determined at the mine. Not the proposed coal valuation determined by a net-back from the sales price of a different commodity. This also shows that the benchmarks were a truer method of determining coal valuation at the mine.

14. ONRR should provide justification that this proposal will be revenue neutral. As we understand it, the geothermal net-back procedure is based on a royalty of 1.75% to 3.5% of sales price of electricity. It is obviously inexplicitly disproportionate to suggest that the 1.75% to 3.5% royalty for geothermal versus 12.5% surface coal or 8% underground coal royalty from coal fired electricity is fair or even revenue neutral for the coal NAL scenario.

15. Congress mandated that geothermal resources be taxed at gross proceeds (Energy Policy Act of 2005, P.L. 105-98 (Aug. 8, 2005)). Congress did not mandate this for coal valuations. The coal leases clearly specify "The royalty shall be 12.5 per cent of the value of the coal produced by strip or auger methods and 8 percent of the value of the coal produced by underground mining methods." ONRR's proposed net-back mandate would run afoul of the bedrock legal principle that the value for royalty purposes of production from federal and Indian coal leases must be established at or near the lease. This foundational principle derives from the terms of the mineral leasing statutes and the leases. ONRR's own Proposed Rule admits this tenet, but then fails to abide by it. 80 Fed. Reg. at 609 ("the Department reaffirms that the value, for royalty purposes, of . . . coal produced from Federal and Indian leases is determined at or near the lease"). ONRR does not explain how it's ignoring or limiting lessees' practical ability to deduct reasonable, actual, and necessary transportation and washing costs preserves that key principle. If ONRR's new rules render lessees' determinations of their allowances extremely difficult or unreasonably low, then ONRR effectively is collecting more royalty revenue than it is entitled to. WFA objects to ONRR designing a royalty collection scheme that collects more royalty than it is entitled to collect.

Obstacle to Coal Marketing

16. ONRR should determine whether the ONRR proposal, with its costly and burdensome net-back reporting and other changes, could substantially, and perhaps illegally, interfere with marketing coal in a competitive market. Affiliated utilities may prefer to obtain arms-length coal as it will not have this onerous reporting scheme. The result could lead to a dismantling of cooperative structures, and the results thereof, potentially including higher consumer electrical costs.

    Cooperatives have made significant investments in associated mine operations to ensure reliability of supply and stability of pricing on behalf of the rural electric cooperative customers they serve and these regulations significantly jeopardize those investments and benefits. The cooperative ownership and control of their input commodities such as limestone and coal is not part of a plan to avoid paying legal royalties and taxes but are wise investments to provide members with reliable and low cost electricity.

Creation of Standardized "Schedules" for Transportation and Processing

17. ONRR states: "…The potential for creating standardized "schedules" for transportation and processing allowances to reduce the need to rely on case-by-case operator reporting and agency review of actual costs." 80 Fed. Reg. at 609.

    There is a problem with clarity here. How would these schedules be valued? By area? By region? By product type? Would the values include any marketing limitation allowances on those mine locations that are less marketable (only one rail carrier available)? Would the values include different schedules for each industries' type of processing method? Would there be allowances for emergency situations when alternative shipping methods must be utilized (ie, trucking when rail service is not available)? How often would the standardized schedules be changed/updated? The railroads/shipping carriers impose other charges such as fuel surcharges to reimburse them for additional fuel costs during times of higher fuel rates. Railroads enter into confidential contracts with each customer; none of this has anything to do with the valuation of the coal in-situ.

    These schedules would be undesirable for the industries involved due to the above questions raised. Therefore, this option would not likely be appropriate to impose as an alternative due to the complex nature of the different types of situations that the industries incur. In addition, actual costs incurred would be the preferable treatment of any/all of these allowances by product. These actual costs are definitive and proof that market value was established and paid. In other words, these transportation and processing costs can be audited without question in the future.

Non-Arm's Length Valuation Updates

18. ONRR requests comment on "…Opportunities to more fundamentally reassess how non-arm's length transactions are treated for the purposes of determining royalties owed."

The current benchmark methods don't seem so difficult to understand if you compare them to the newly proposed net-back method. The preference would be to keep the current benchmark method of valuing non-arm's length sales. There are fewer of these sales than the arm's length sales to determine correct value, so the amount of time to evaluate these contracts is not as cumbersome as is contended by ONRR.

WFA believes it would be advisable to change the order of the benchmarks for NAL valuations. Currently, the order is 1, 2, 3, 4, and 5. We believe the order should change to 1, 4, 2, 3, and 5. The arm's length sales in the fourth benchmark are negotiated just as any other arm's length sale from another similar mine (with comparable coal quality) in the area, so recognizing these early on in the current benchmark system would reduce the amount of time spent on the other benchmarks. However, the second and third benchmarks are still important if the fourth benchmark is not applicable, which would be in the very rare case of a mine with no comparable arm's length sale.

An alternative to the current benchmark system, for those rare instances where arm's length sales are not available, would be to review actual cost of production and evaluate a return on investment that is fair to the situation and/or the company under assessment. We would propose this become a sixth benchmark, applicable only in those instance when arm's length sales are not available.

Coal Valuation Simplification and Improvement

19. "ONRR is soliciting comments on how to simplify and improve the valuation of coal disposed of in non-arm's length transactions and no-sale situations. We seek input on the merits of eliminating the benchmarks for valuation of non-arm's length sales and comments on the following questions." 80 Fed. Reg. at 628.

- ONRR asks: "Should the royalty value of coal initially sold under non-arm's length conditions be based on the gross proceeds received from the first arm's length sale of that coal in situations where there is a subsequent arm's length sale?"

No. This application is valuing coal further away from the lease, which may not truly represent the true value of the coal lease. In addition, there could be instances where the seller would not likely know who the first arm's length sale would be to. How can the ONRR impose the burden on industry to figure this out? This is obviously a case of "lack of simplicity", which "increases industry's and ONRR's cost of compliance."

- ONRR asks: If you are a coal lessee, will adoption of this methodology substantively impact your current calculation and payment of royalties on coal and how?

Yes. Most coal sales are FOB mine sales. Therefore, by trying to value the coal in a downstream transaction, the ONRR may or may not get a reasonable price for valuation of the coal. Any subsequent transaction to an affiliate is not applicable to the marketability of the coal from the lease, and, in our opinion, the ONRR has no right to assume that this so called "additional value" adds true value to the sale of the coal from the lease. In fact, this just adds to the complexity to valuing coal at the lease, which contradicts the "simplicity" and "decrease in cost" goals that the ONRR says they want to accomplish with this change.

- ONRR asks: What other methodologies might ONRR use to determine the royalty value of coal not sold at arm's length that we may not have considered?

WFA believes the current benchmarks should be retained. There are only a few contracts considered non-arm's length compared to the enormous number of arm's length contracts in relation to coal valuation. The amount of time ONRR spends reviewing these few non-arms' length sales valuations under the current method is far less than ONRR seems to admit. It is also substantially far less than the time ONRR, the State audit agencies, and industry will need to dedicate if ONRR adopts the proposed net-back valuation method.

We suggest the order of the current benchmarks be changed to reduce the amount of time that the ONRR reviews these types of non-arm's length transactions. As mentioned above, we believe it would be advisable to change the order of the benchmarks for NAL valuations to 1, 4, 2, 3, and 5. For those rare instances where arm's length sales are not available, we would propose a sixth benchmark - to review actual cost of production and evaluate a return on investment that is fair to the situation and/or the company under assessment.

WFA is confused why ONRR does not allow one of the benchmarks for NAL coal to include arm's length sales from the same lease? Since the ONRR prefers to value coal at arm's length, then why can't the value of NAL coal be valued at the current average arm's length price at the mine, if applicable?

Furthermore, in this proposal ONRR currently fails to provide the coal lessee (arm's length and NAL) the same option ONRR provides to oil and gas production – i.e. ONRR provides the oil and gas lessee the *option* of instead basing its value for royalty purposes on a locally-applicable published index price. ONRR would provide *no* alternative methodology for coal lessees. We believe this should be added as an option for the coal lessee.

Indeed, instead of implementing the net-back from electricity procedure, which has a laundry list of issues, ONRR should be focusing on valuation methods that work and are defendable. Following is a recap of the currently identified issues with the ONRR proposal to net-back from electricity sale:

- For years, ONRR has stated that the net-back valuation procedure is highly disfavored compared to other valuation measures,
- ONRR has provided no guidance regarding how to reliably perform net-backs from the sale of electricity,
- ONRR is trying to implement a system that has not worked for the geothermal lessees,
- The net-back will not work for valuation of affiliated coal, where data regarding electricity sales price, generation and transmission costs are unobtainable by the affiliated coal lessee, and
- The ONRR has not justified requiring only affiliated lessees (ie, "coal cooperatives, or members of coal cooperatives") to implement the onerous and problematic net-back valuation methodology from electricity generation, when affiliated transactions account for a mere 1-2 percent of royalties paid on Federal coal produced, 80 Fed. Reg. at 639.
- ONRR has not addressed the impact and the legality of their proposed net-back from electricity on the targeted affiliated lessees' ability to compete on the open market if affiliated lessees alone have to implement this onerous method for valuing coal sales.

If ONRR is truly interested in the goals stated in the proposal, "to ensure greater clarity, efficiency, certainty, and consistency in production valuation," 80 Fed. Reg. at 609, we suggest this cannot be done with the proposed net-back method. As we stated previously, it *can* be achieved by retaining the current benchmarks, but reordering them to 1, 4, 2, 3, and 5, plus adding a sixth benchmark (review of actual cost of production and assess a return on investment that is fair to the situation and/or the company under assessment), applicable only in those rare instances when no arm's length sales is available.

Triggers for Default Provision (§§ 1206.253, 1206.453)

20. The ONRR also proposes other changes to the regulations without requesting comments on these changes. WFA wishes to comment on the new "default

provision" to address valuation. According to the ONRR, 80 Fed. Reg. at 609, this will be invoked "when ONRR determines:

(1) a contract does not reflect total consideration
(2) the gross proceeds accruing to you or your affiliate under a contract do not reflect reasonable consideration due to misconduct or breach of the duty to market for the mutual benefit of the lessee and the lessor, or
(3) it cannot ascertain the correct value of the production because of a variety of factors, including, but not limited to, a lessee's failure to provide documents.
(4) …the Secretary may enforce his/her authority and exercise considerable discretion to establish the reasonable value of production using a variety of discretionary factors and any other information the Secretary believes is appropriate."

First, we contend that it is borderline outrageous for ONRR to infer that industry would purposefully break the law/rule in order to reduce the amount of royalty that is paid. Therefore, proposing to impose a penalty for not filing the "correct" amount due from this net-back proposed method while making such calculation impossible to determine is not fair or justified by the agency. This provision seems to create even more "uncertainty", which is opposite of one of the stated initiatives this proposal intends to accomplish. In addition, this would result in an "increase" in the cost to be compliant. The increase in cost could include contests and legal activities with ONRR to assert that contracts are at fair market value.

In addition, what is "reasonable consideration"? Is this only determined by the Secretary? This hardly accomplishes the stated goals of "clarity" or "ensuring that early compliance" has been met. Furthermore, if actual costs prove to be accurate in relation to the transportation allowance, 80 Fed. Reg. at 625, then it would appear to be illogical for the Secretary to penalize industry for having to pay the higher transportation costs. This doesn't even make sense.

21. The proposed Default Provisions in Sections 1206.253 and 1206.453, will clearly allow ONRR to create limitless opportunities to invoke its "default" provision and re-determine coal values. Under its proposal, ONRR would be free to even second-guess arm's length contracts, contrary to decades of agency policy and commitments to lessees that ONRR would preserve the sanctity of those agreements. As proposed, every valuation dispute allows ONRR to value the lessee's production. This is particularly concerning in the context of arm's length sales contracts for coal, where the ultimate valuation by ONRR might have little resemblance to the fair price negotiated by the parties. ONRR would have the option to inject itself in a multitude of circumstances, and insert whatever ONRR thinks is "reasonable" in that case. This proposed system described in this section is plainly arbitrary and unreasonable. The only conclusion that can be gleaned is that ONRR no longer intends to respect longstanding limitations on its discretion over coal valuation. That includes values determined under arm's length contracts, which ONRR's Proposed Rule even now admits is the best indicator of value. ONRR should delete or substantially revise

proposed §§ 1206.253 and 1206.453, and other default provision triggers elsewhere in the Proposed Rule, to preserve consistent, predictable and fair coal valuation.

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

22. When the default provision is triggered anywhere in the Proposed Rule, ONRR may determine the royalty value "by considering any information the ONRR deems relevant." This statement is of high concern, as it eliminates any real opportunity for the lessee to present information relevant to the determination of fair valuation. The Proposed Rule's listed factors are inconsistent with the basic rationale for ONRR's proposed overhaul of coal royalty valuation, namely that the existing benchmark system is unworkable. However, if ONRR under its default provision can assess the "value of like-quality coal from the same mine, nearby mines, same region, or other regions, or washed in the same or nearby wash plant," why is a federal or Indian lessee unable to use the same method in valuing its coal? When ONRR states that it may use "information available to ONRR and information reported to it," ONRR fails to take into account that in most cases this information will be deemed proprietary or confidential, therefore inaccessible to lessees.

    This new overreaching approach by ONRR is fundamentally unworkable, and no reasoned basis exists for it. As ONRR recognizes in its preamble, "even with the changes outlined in this rule, royalty valuations will continue to be complex, and the markets for oil, gas, and coal will continue to evolve." 80 Fed. Reg. at 609. Given that inherent complexity, there is no assurance or check that ONRR's valuation determination would be any more fair, objective, or reliable than the lessee's reported data – particularly given that ONRR would use the very same valuation methods it deems unreliable when used by the lessee. When a lessee is engaged in good faith efforts to value its coal for royalty purposes, and particularly under negotiated arm's length contracts, it should not be penalized and forced to accept a different, potentially arbitrary value by ONRR.

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

23. When lessees elect to proactively approach ONRR with questions, it is in all parties' interests for ONRR to respond fully and fairly, thereby avoiding valuation disputes years after royalties are reported and paid. Instead, as written, this provision is overly complex, does not give the appearance of assisting to resolve issues, and does not provide reliable advice for lessees.

    As proposed, ONRR provides three response options in the Proposed Rule: (1) it may have the Assistant Secretary for Policy, Management and Budget ("ASPMB") issue a determination; (2) it may decide that ONRR will issue guidance; or (3) it may provide no response to the valuation request. Each of these options has the potential for litigation and other significant costs that will unnecessarily burden the system and could increase the cost of compliance.

ONRR should revise §§ 1206.258 and 1206.458 to provide for two options:

- determinations by the ASPMB (which are always available) and
- valuation determinations by ONRR amounting to more than mere guidance, which then could be administratively appealed if the lessee believes the determination is in error.

This revision would foster active engagement and accountability.

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

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

RECOMMENDATIONS:

In closing, WFA disagrees with the language in the preamble, where ONRR states "A coal cooperative can underprice coal even when sales are arm's length, all other costs being equal" 80 Fed. Reg. at 628. This statement implies that cooperatives have wrongfully valued coal, whether the sale was arm's length or NAL. WFA and all the other cooperatives we know have been openly complying with the coal valuations. We have supplied all contracts (arm's length and NAL), and have been openly cooperative with ONRR and State Auditors. We have properly provided estimated valuations using applicable valuations (available arm's length sales and cost plus methods). In fact, under the current regulations, our typically lower BTU coal with higher transportation costs is often valued by the ONRR/State auditors at higher value than higher quality coal with lower shipping costs shipped to the same utility. Hence, we object to this unnecessarily inflammatory, and unsubstantiated statement. We request ONRR remove this contentious sentence from the preamble.

WFA and its members support the ONRR's stated goals of simplifying federal and Indian coal valuation and providing a fair return to the public. ONRR's Proposed Rule, however, would only frustrate those objectives and result in burdens and regulatory uncertainty far outweighing the purported benefits to industry, ONRR, and the public. Given each of the above significant concerns with the proposed change in valuation of NAL sales, WFA urges ONRR to withdraw the Proposed Rule as currently written.

Though the current rules are not perfect, the fundamental considerations in the current rules and the distinct aspects of the coal market have not changed since the rules were adopted in 1989.

ONRR should retained the current rules instead of implementing these problematic proposed rules.

Thank you for this opportunity to comment. Please contact me at (307) 682-8051 if you have any questions regarding these comments.

Sincerely,

Beth Goodnough
Manager, Regulatory Affairs