Institute *for* Policy Integrity

NEW YORK UNIVERSITY SCHOOL OF LAW

November 25, 2020

VIA ELECTRONIC SUBMISSION

Department of the Interior

Attn: Office of Natural Resources Revenue

Re: Request for Comments—ONRR 2020 Valuation Reform and Civil Penalty Rule, 85 Fed. Reg. 62,054 (Oct. 1, 2020); Docket No. ONRR-2020-0001

The Institute for Policy Integrity at New York University School of Law[1] respectfully submits the following comments to the Office of Natural Resources Revenue's ("ONRR") proposal to revise and rescind portions of the 2016 Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform ("2016 Valuation Rule")[2] through the proposed 2020 Valuation Reform and Civil Penalty Rule ("Proposed Rule").[3]

Policy Integrity is a non-partisan think tank dedicated to improving the quality of government decision-making through scholarship in the fields of administrative law, economics, and public policy. We write to make the following comments:

1. ONRR's reliance on increased production to justify the rule is arbitrary and capricious because it lacks support in the record, and ONRR contradicts this justification when it asserts that the "proposed rule does not alter [production] in any material way . . . ."[4]
2. If production does increase, then ONRR's failure to address the environmental costs associated with such a production change is arbitrary and capricious.
3. ONRR's failure to address the negative distributive effects of reduced royalty payments is arbitrary and capricious.
4. ONRR's specific proposed changes to the rule are arbitrary and capricious because ONRR fails to adequately analyze the costs and benefits associated with the changes.
    a. ONRR's proposed changes regarding natural gas and oil valuation are arbitrary and capricious.
        i. ONRR fails to support its claim that extending the index-based valuation option to all gas transactions will increase royalty payments.
        ii. ONRR fails to address the environmental externalities associated with broader transportation and processing allowances for oil and gas.

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[1] This document does not purport to present New York University School of Law's views, if any.
[2] Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform, 81 Fed. Red. 43,338, 43,346 (July 1, 2016) [hereinafter 2016 Valuation Rule].
[3] ONRR 2020 Valuation Reform and Civil Penalty Rule, 85 Fed. Reg. 62,054 (proposed Oct. 1, 2020) [hereinafter Proposed Rule].
[4] *Id.* at 62,074.

b. ONRR's proposed changes regarding the coal industry and coal royalties are arbitrary and capricious.
    i. ONRR does not provide adequate support for its proposed removal of all references to "coal cooperative."
    ii. ONRR fails to justify its proposed repeal of the provision valuing coal based on arm's-length electricity sales.
c. ONRR's proposed changes affecting default valuation, penalties, and contractual schemes for fossil fuel companies are arbitrary and capricious.
    i. ONRR fails to adequately justify its removal of the default provision from the Proposed Rule.
    ii. ONRR does not provide adequate support for its decision to delete the definition of "misconduct" from § 1206.20 of the Proposed Rule.
    iii. ONRR fails to support its decision to remove the requirement that contracts must be signed by all parties in order to inform valuation.
    iv. ONRR fails to justify its proposed change to revoke the ability of Administrative Law Judges to reverse a stay of civil penalty accruals.

Background

ONRR promulgated the 2016 Valuation Rule in order to reform valuation methodologies and rules governing the fossil fuel industry in response to longstanding calls for reform. In 2007, the Government Accountability Office ("GAO") called on the Department of Interior ("Interior") to evaluate and update royalty procedures after finding that the royalties paid for oil, gas, and coal mined on federal lands were among the lowest in the world.[5] In particular, under the old rule, it was difficult for ONRR to ensure that lessees paid royalties based on the fair market value of the minerals sold, rather than on artificially low prices received in captive transactions.[6] Over the next several years, the GAO continued to call on Interior to reform royalty procedures.[7] In 2013, the Office of the Inspector General at Interior similarly identified weaknesses in the payment system, which put Interior at risk of not receiving the full fair market value of its leases.[8] Also in 2013, a bipartisan team of Senators called for an investigation and reform of any regulations that were "inadequate to ensure that full royalty value is returned."[9]

In response to these calls for reform, Interior explained in 2013 that it had begun a process to review and consider improvements that "could dramatically improve compliance and reduce administrative costs for industry and the Government."[10] Three years later, after holding several

[5] U.S. Gov't Accountability Office, GAO-07-676R, Oil and Gas Revenues (2007).
[6] *See* Proposed Valuation Rule, 80 Fed. Reg. 608, 616–17, 628 (2015).
[7] *See* U.S. Gov't Accountability Office, GAO-15-39, Oil and Gas Resources: Interior's Production Verification Efforts and Royalty Data Have Improved, but Further Actions Needed (2015); U.S. Gov't Accountability Office, GAO-14-50, Actions Needed For Interior to Better Ensure A Fair Return (2013); U.S. Gov't Accountability Office, GAO-08-691, The Federal System for Collecting Oil and Gas Revenues Needs Comprehensive Reassessment at 7-10 (2008).
[8] U.S. Dep't of the Interior, Office of the Inspector General, Evaluation: Coal Management Program at 1 (June 2013) (describing weaknesses in the coal valuation procedures).
[9] Letter to Ken Salazar from Senators Lisa Murkowski and Ron Wyden (Jan. 2, 2013).
[10] Letter to Chairman Wyden from Ken Salazar, Secretary of the Interior (Feb. 7, 2013).

public workshops, providing a lengthy comment period, and reviewing thousands of pages of public comments, ONRR issued the 2016 Valuation Rule.[11] In the 2016 Valuation Rule, ONRR sought to provide "greater simplicity, certainty, clarity, and consistency in product valuation for mineral lessees and mineral revenue recipients," decrease "industry's cost of compliance," and ensure that "companies have paid every dollar due" to federal and state taxpayers.[12] By simplifying procedures and updating valuation methodologies (including requiring valuation based on arm's-length transactions), the 2016 Valuation Rule was predicted to decrease administrative costs[13] and increase royalty revenue paid to federal and state governments.[14]

Beginning in 2017, under the current administration, ONRR has taken several steps to undo the 2016 Valuation Rule. ONRR first issued an indefinite suspension of the 2016 Valuation Rule, and then attempted to fully repeal the 2016 Valuation Rule, but both of those actions were vacated by district courts for violating the Administrative Procedure Act ("APA").[15]

In 2019, in a separate challenge to the 2016 Valuation Rule itself, coal company Cloud Peak Energy sought a preliminary injunction. In October of that year, the U.S. District Court for the District of Wyoming denied the injunction, except with respect to the provision on utilizing arm's-length electricity sales to value coal.[16]

In the current Proposed Rule, ONRR makes specific changes to the oil and gas valuation (including transportation allowances) rules; repeals the reforms to the coal valuation procedures; and repeals various other reforms related to the default provision, penalties, and contractual schemes. The justifications that ONRR provides for these proposed changes, however, do not pass muster.

I. ONRR's reliance on increased production to justify the Proposed Rule is arbitrary and capricious.

ONRR's reliance on increased production to justify the rule is contradictory and not supported by ONRR's own record.

ONRR justifies the Proposed Rule by claiming at multiple points that the rule will increase production. For example, ONRR explains that it is proposing the rule in order to further the policies in two Trump-era executive orders that seek to encourage energy production: Executive Order 13783, "Promoting Energy Independence and Economic Growth," and Executive Order 13795, ''Implementing an America-First Offshore Energy Strategy."[17] As ONRR explains, Executive Order 13783 states that "[i]t is in the national interest to promote clean and safe development of our Nation's vast energy resources" and to avoid "regulatory burdens that unnecessarily encumber energy production, constrain economic growth, and prevent job

[11] 2016 Valuation Rule at 43,338.
[12] *Id.*
[13] *Id*. at 43,359–60.
[14] *Id*. at 43,367.
[15] Becerra v. U.S. Dep't of the Interior, 276 F. Supp. 3d 953 (N.D. Cal. 2017); California v. U.S. Dep't of the Interior, 381 F. Supp. 3d 1153 (N.D. Cal. 2019).
[16] Cloud Peak Energy, Inc., v. U.S. Dep't of the Interior, 415 F. Supp. 3d 1034, 1051 (D. Wy. 2019).
[17] Proposed Rule at 62,057.

creation."[18] Executive Order 13795 states that "[i]t shall be the policy of the United States to encourage energy exploration and production" in pursuit of furthering the United States' status as an energy leader "while ensuring that any such activity is safe and environmentally responsible."[19] ONRR emphasizes that the changes in the Proposed Rule are intended to "promote new and continued domestic energy production" in order to effectuate these policies.[20]

In addition, ONRR states that specific provision changes will increase production. According to ONRR, increasing transportation allowances will encourage production in remote areas and low quality reservoirs and will provide "an incentive to continue producing through uncommon or unavoidable circumstances affecting costs and value."[21] Allowing greater deductions will promote production on "[f]ederal lands that are less desirable due to the high costs associated with transportation, processing, or both."[22]

Further, ONRR proposes changes that decrease administrative costs and royalty payments, which it could in turn lead to increases in production, since these changes would result in greater profitability for the producers.[23] For example, according to ONRR, providing the option of index-based valuation for gas transactions will result in "reductions to industry's administrative burdens."[24] Removing the requirement that lessees use only signed contracts to determine valuation similarly reduces administrative costs for industry, likely resulting in increased production.[25] The requirement that lessees provide citations to legal precedent with valuation determination requests presents an "undue burden" according to ONRR, and its removal will decrease administrative costs.[26]

In any rulemaking, an agency "must examine the relevant data and articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made."[27] In addition, to justify the change, ONRR must provide actual support for its new policy and is not permitted to rely on speculation or conclusory statements.[28]

ONRR's reliance on increased production is inadequate to support the rule because ONRR has not provided any analysis or record to show that such production increases will occur. In fact, ONRR contradictorily concludes that "[t]he proposed rule does not alter, in any material way, natural resources exploration, production, or transportation."[29] With this conclusion, ONRR

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[18] Proposed Rule at 62,056 (quoting 82 Fed. Reg. 16,093 (2017)).
[19] *Id.* at 62,057 (quoting 82 Fed. Reg 20,815 (2017)).
[20] *Id.*
[21] *Id.* at 62,058.
[22] *Id.*
[23] *See* N. Gregory Mankiw, *Principles of Microeconomics* 194 (5th ed. 2008).
[24] Proposed Rule at 62,057.
[25] "[T]he rule burdened lessees and their affiliates with an unnecessary and potentially costly obligation to conform contracts to meet ONRR's specifications, which could increase the cost of production and delay the delivery of mineral resources." *Id.* at 62,060.
[26] Proposed Rule at 62,061.
[27] Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co., 463 U.S. 29, 43 (1983).
[28] Sorenson Commc'ns Inc. v. F.C.C., 755 F.3d 702, 708 (D.C. Cir. 2014); NetCoalition v. SEC, 615 F.3d 525, 539 (D.C. Cir. 2013).
[29] Proposed Rule at 62,074.

undermines its own justifications for the rule. An administrative decision that contains this type of contradictory reasoning is arbitrary and capricious.[30]

II. If the Proposed Rule increases production, it is arbitrary and capricious because ONRR has failed to address the environmental costs associated with this production change.

ONRR has also failed to properly address the negative costs that a production increase will impose on the environment and society.

A. Increased production will create negative environmental externalities.

Any increase in production, of oil, gas, and coal will create significant environmental harm associated with the prospecting, extraction, transportation, and combustion of these resources. Without addressing these harms, the proposed rule is arbitrary and capricious.

America's public lands offer millions of people a place to hike, camp, hunt, fish, and enjoy scenic beauty. They provide critical habitat for wildlife, drinking water, clean air, sites for renewable energy development, as well as natural resources including timber, minerals, oil, and natural gas. As soon as energy exploration begins, competing uses of federal land such as recreational enjoyment, commercial fishing, and renewable energy development are impaired, and continue to be foreclosed for the duration of production.

In addition, energy companies cause environmental and noise pollution through prospecting, exploratory drilling, and other activities undertaken in preparation for resource extraction. During exploration and drilling for oil, operators may use blasts of sound to create holes to find minerals and drill test wells, disturbing land and marine ecosystems.[31] Exploratory activities for natural gas production require clearing and leveling of large areas of land, displacing vegetation, soil, and natural habitats.[32] Operators construct roads to and from the exploration sites and production facilities.[33] Increased vehicular traffic due to these drilling and mining operations contributes to wear and tear on roadways, as well as traffic-related fatalities.[34]

The mining of these resources creates another set of environmental harms. The hydraulic fracturing technique used to produce oil and gas requires large amounts of water and hazardous

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[30] A rule is arbitrary and capricious if the agency has "offered an explanation for its decision that runs counter to the evidence before the agency . . . ." *State Farm Mut. Auto Ins. Co.*, 463 U.S. at 43.
[31] *Oil and Petroleum Products Explained*, U.S. ENERGY INFO. ADMIN., https://www.eia.gov/energyexplained/oil-and-petroleum-products/oil-and-the-environment.php (last visited Oct. 23, 2020).
[32] *Natural Gas Explained*, U.S. ENERGY INFO. ADMIN., https://www.eia.gov/energyexplained/natural-gas/ (last visited Oct. 23,2020).
[33] H.F.L. Williams et al., *Field-Based Monitoring of Sediment Runoff from Natural Gas Well Sites in Denton County, Texas, USA*, 55 ENV'T GEOLOGY 1463 (2008), http://www.math.unt.edu/~williams/GEOG_3350/enviongeolpaper.pdf.
[34] *See, e.g.*, Lise Olson, *Fatal Truck Accidents Have Spiked During Texas' Ongoing Fracking and Drilling Boom*, HOUSTON CHRON. (Sept. 15, 2014, 12:48 PM), http://www.houstonchronicle.com/news/article/Fracking-andhydraulic-drilling-have-brought-a-5747432.php?cmpid=email-premium&cmpid=emailpremium&t=1a9ca10d49c3f0c8a9#/0.

chemicals, which causes harm to aquatic habitats and creates toxic wastewater.[35] This wastewater is often injected into deep subsurface wells, which can create earthquakes large enough to cause damage.[36] Coal production requires explosives to remove mountaintops, changing the landscape, displacing ecosystems, and creating pollution for downstream aquatic wildlife.[37]

The transportation and combustion of fossil fuels creates air pollution that poses public health risks and contributes to climate change. Tankers, trucks, railroads, and pipelines transport these resources long distances, creating smog and particle pollution that contributes to asthma, heart disease, and premature death.[38] Fossil fuel combustion similarly creates air pollution, releasing carbon dioxide, sulfur dioxide, nitrogen oxides, particulates, heavy metals, and ash into the air.[39] Carbon dioxide, the main emission produced during fossil fuel combustion, is the main driver of rising global temperatures.[40]

Waste is another important environmental cost in the production of these resources. During gas, oil, and coal production, drilling and mining create local and global air pollution, including vented and fugitive methane. The United States loses almost 500,000 tons of methane, or 9 percent of its total natural gas production each year when methane is leaked, flared (burned), or vented to the atmosphere during the production, processing, transmission, storage, and distribution of natural gas and oil.[41] This is a waste of a valuable resource—contrary to the goals of the Mineral Leasing Act to avoid all "undue waste"—as well as a potent source of greenhouse gas pollution.

B. ONRR must consider these negative consequences under federal land management statutes and the Administrative Procedure Act.

ONRR is required to address the negative externalities associated with its decision. The Federal Land Policy and Management Act, the Mineral Leasing Act, and the Outer Continental Shelf Lands Act require Interior, and by extension ONRR, to consider environmental effects when promulgating regulations involving energy production on federal lands. In addition, the APA requires ONRR to "examine the relevant data and articulate a satisfactory explanation for its action."[42]

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[35] *Oil and Petroleum Products Explained*, *supra* note 31; *Natural Gas Explained*, *supra* note 32.
[36] *Natural Gas Explained*, *supra* note 32.
[37] *Coal Explained*, U.S. ENERGY INFO. ADMIN., https://www.eia.gov/energyexplained/coal/coal-and-the-environment.php (last visited Oct. 23,2020).
[38] Transporting Oil & Natural Gas, AM. PETROLEUM INST., https://www.api.org/oil-and-natural-gas/wells-to-consumer/transporting-oil-natural-gas (last visited Oct. 23, 2020); How Mobile Source Pollution Affects Your Health, ENV'T PROT. AGENCY, https://www.epa.gov/mobile-source-pollution/how-mobile-source-pollution-affects-your-health (last visited Oct. 23, 2020).
[39] *Coal Explained*, *supra* note 37.
[40] *Climate Change: Atmospheric Carbon Dioxide*, CLIMATE.GOV, https://www.climate.gov/news-features/understanding-climate/climate-change-atmospheric-carbon-dioxide (last visited Oct. 23, 2020).
[41] *See* U.S. DEP'T OF ENERGY, NATURAL GAS FLARING AND VENTING: STATE AND FEDERAL REGULATORY OVERVIEW, TRENDS, AND IMPACTS (June 2019), https://www.energy.gov/sites/prod/files/2019/08/f65/Natural%20Gas%20Flaring%20and%20Venting%20Report.pdf.
[42] Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).

i. Federal land management statutes require ONRR to balance energy production with environmental protection.

Three primary statutes set forth the Interior's duties with respect to national energy production and federal land management: the Federal Land Policy and Management Act and the Mineral Leasing Act for onshore development, and the Outer Continental Shelf Lands Act for offshore development. These statutes articulate Interior's responsibility to balance orderly production of energy on federal lands with environmental preservation and other competing uses.

Read together, the Federal Land Policy and Management Act and Mineral Leasing Act instruct Interior to harmonize the need for domestic mineral production with long-term environmental protection and stewardship of public lands. The Federal Land Policy and Management Act sets forth the policy that "the public lands be managed in a manner that will protect the quality of scientific, scenic, historical, ecological, environmental, air and atmospheric, water resource, and archeological values."[43] The Mineral Leasing Act of 1920 declares that it is the policy of the federal government and in the national interest to foster and encourage private enterprise in "orderly economic development of domestic mineral resources."[44] Among many provisions dedicated to oil, gas, and mineral leasing, the Mineral Leasing Act also provides that the Secretary of the Interior can issue regulations requiring that operators prevent "undue waste."[45] The Mineral Leasing Act also specifically requires oil and gas lessees (but not coal lessees) to "use all reasonable precautions to prevent waste of oil or gas developed in the land," on pain of forfeiture of the lease.[46] Thus, even when encouraging the "orderly economic development of domestic mineral resources," federal law requires Interior to ensure that valuable public resources are not wasted. Indeed, the word "orderly" itself conveys a congressional desire for careful, rational management of America's valuable energy resources.

The congressional statement of policy in the Outer Continental Shelf Lands Act declares, much like in the Federal Land Policy and Management Act, that the Outer Continental Shelf is a vital natural resource held in trust by the federal government for the benefit of the American people.[47] It details Interior's dual mandate to conduct expeditious and efficient leasing while also protecting the environment and other uses of our nation's waters, including fishing and commercial shipping.[48] The Outer Continental Shelf Lands Act Amendments of 1978 state that one of the purposes of the Act is to "make such resource[s] available to meet the Nation's energy needs as rapidly as possible."[49] Another equally important purpose is to "encourage development of new and improved technology for energy resource production which will eliminate or minimize risk of damage to the human, marine, and coastal environments."[50]

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[43] 43 U.S.C. § 1701(a)(8).
[44] 30 U.S.C § 21(a).
[45] 30 U.S.C. § 187.
[46] 30 U.S.C. § 225. The legislative history of the Mineral Leasing Act and its subsequent amendments evidences Congress's concern with the waste of oil and gas and its desire for Interior to prevent it. *See* Boesche v. Udall, 373 U.S. 472, 481 (1963) (citing H.R. Rep. No. 398, 66th Cong., 1st Sess. 12-13; H.R. Rep. No. 1138, 65th Cong., 3d Sess. 19.).
[47] 43 U.S.C. § 1332(3).
[48] 43 U.S.C. § 1332(2)–(3).
[49] *Id.*
[50] 43 U.S.C. § 1802(3).

Section 18 of the Outer Continental Shelf Lands Act requires Interior to prepare and periodically revise a Program "indicating, as precisely as possible, the size, timing, and location of leasing activity" on the Outer Continental Shelf over the pertinent five-year program period.[51] The Act directs that management of the Outer Continental Shelf shall be "conducted in a manner which considers economic, social, and environmental values of the renewable and nonrenewable resources contained in the outer continental shelf, and the potential effect of oil and gas exploration on other resource values of the outer continental shelf and the marine, coastal, and human environments."[52] Congress further directed the Secretary of the Interior to "select the timing and location of leasing, to the maximum extent practicable, so as to obtain a proper balance between the potential for environmental damage, the potential for the discovery of oil and gas, and the potential for adverse effects on the coastal zone."[53] The Outer Continental Shelf Lands Act, then, much like the Federal Land Policy and Management Act, strongly emphasizes the need to balance energy production with environmental protection.

If the Proposed Rule does encourage production of oil, gas, and coal, as ONRR claims, ONRR must analyze the costs associated with this increase. Congress has statutorily mandated Interior to consider these environmental costs through the Federal Land Policy and Management Act, the Mineral Leasing Act, and the Outer Continental Shelf Lands Act. Ignoring these important statutory factors is arbitrary and capricious.[54]

ii. The Administrative Procedure Act requires ONRR to consider all relevant factors of the Proposed Rule.

Under the arbitrary and capricious standard of the APA, a court may set aside an agency's rule for failing to consider the relevant factors related to its decision.[55] A rule may be rejected "if the agency has . . . entirely failed to consider an important aspect of the problem . . . ." or if the agency has failed to "articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made."[56] Furthermore, an agency may not tout regulatory benefits of a rule without acknowledging its corresponding costs.[57] As part of these costs, an agency must consider the forgone benefits associated with a rule.[58]

While there is no heightened standard for cases in which an agency is repealing a rule or changing its prior position on an issue,[59] such a change requires "a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance."[60] In these cases, an agency must provide a "reasoned explanation" by showing "awareness that it *is* changing its position" and that there are "good reasons" for the new policy.[61]

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[51] 43 U.S.C. § 1344(a)(1).
[52] *Id.*
[53] *Id.* § 1344(a)(3).
[54] Gresham v. Azar, 950 F.3d 93, 102 (D.C. Cir. 2020) ("A critical issue in this case is the Secretary's failure to account for loss of coverage, which is a matter of importance under the statute.").
[55] Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 42 (1983).
[56] *Id.*
[57] Sierra Club v. Sigler, 695 F.2d 957, 979 (5th Cir. 1983).
[58] State v. United States Bureau of Land Mgmt., 277 F. Supp. 3d 1106, 1125 (N.D. Cal. 2017).
[59] F.C.C. v. Fox Television Stations, Inc., 556 U.S. 502, 514 (2009).
[60] Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 30 (1983).
[61] F.C.C. v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009).

The Proposed Rule violates all of these principles.

In its Proposed Rule, ONRR entirely fails to consider the environmental costs associated with the increased production of oil, gas, and coal that will result from its proposed changes. Instead of properly analyzing these costs, ONRR makes the conclusory statement that the rule "does not constitute a major Federal action significantly affecting the quality of the human environment."[62] Without the required "reasoned explanation" for its decision, the Proposed Rule is arbitrary and capricious.[63]

Moreover, ONRR has clearly shown that reduced royalties will benefit industry players through decreased administrative and production costs,[64] but the agency has failed to analyze the costs that the rule will impose on the environment and on the American public. This lopsided reasoning does not pass muster.[65]

III. ONRR's failure to address the negative effects of reduced royalty payments is arbitrary and capricious.

ONRR acknowledges that the Proposed Rule will result in decreased royalties. Yet ONRR fails to acknowledge and address the impact on state-sponsored social services that will result from this change.

Royalty revenue from coal, oil, and natural gas production on federal and state lands is an important source of U.S. federal and state government funds. As a 2016 estimate showed, the federal government collects about $6.23 billion in annual royalty payments from federal leases and distributes approximately half of these proceeds to the states in which mineral production occurs.[66] States use the royalty revenue from mineral resource production to fund public education, infrastructure projects, environmental projects, and other useful government spending.[67] Thus, these royalty payments can have significant implications for public welfare.

This royalty revenue does not simply reflect a transfer from oil, gas, and coal producers to the federal and state governments; government spending on social programs creates positive

[62] Proposed Rule at 62,073.
[63] F.C.C. v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009).
[64] See *supra* Part I.
[65] Ctr. for Biological Diversity v. Nat'l Highway Traffic Safety Admin., 538 F.3d 1172, 1198 (9th Cir. 2008) (holding that it was impermissible to "put a thumb on the scale" by under- or overvaluing key effects); *California v. BLM*, 277 F. Supp. 3d 1106, 1123 (N.D. Cal. 2017) (holding that the agency impermissibly considered only "one side of the equation" by calculating benefits and ignoring costs).
[66] 30 U.S.C. § 191(a)–(b); *see also* U.S. OFFICE OF NAT. RES., *Interior Department Disburses $6.23 Billion in FY 2016 Energy Revenues: Federal Revenues Support State, Tribal, National Needs* (Nov. 25, 2016), https://www.onrr.gov/pdfdocs/20161125a.pdf. One exception is Alaska, which is entitled to 90 percent of federal royalties for onshore oil, gas, and coal production in the state. 30 U.S.C. § 191(a).
[67] *See* David Woodgerd & Bernard F. McCarthy, *State School Trust Lands and Oil and Gas Royalty Rates*, 3 PUB. LAND L. REV. 119, 130 (1982) (stating that the state of Montana collects royalties from mineral resources to promote public welfare); Headwaters Economics, THE IMPACT OF FEDERAL COAL ROYALTY REFORM ON PRICES, PRODUCTION, AND STATE REVENUE 5, 17 (May 2015), https://headwaterseconomics.org/wp-content/uploads/Report-CoalRoyalty-Reform-Impacts.pdf.

externalities that extend beyond the value of the royalty payments themselves.[68] For example, increased government spending on education leads to a more educated population. A more educated population creates external benefits such as technological progress, reduced crime, and improved health.[69] These benefits, in turn, come with their own positive externalities. Improvements in public health, for example, result in decreased spending on healthcare and a reduced tax burden on society.[70]

ONRR acknowledges that the Proposed Rule will reduce annual royalty payments by $42.1 million, but the agency fails to confront the true impact of this change. Not only will decreased royalty payments result in increased production and environmental harm, but it also comes with the forgone government spending. Increased royalty payments would distribute education, health, and wealth to all citizens, with low-income individuals receiving the greatest marginal utility from this increased funding. If ONRR proposes to decrease support for these programs through reduced royalty payments, it must confront these impacts and adequately justify its decision.

Under the arbitrary and capricious standard, an agency must "examine the relevant data" and "articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made."[71] An important category of "relevant data" that an agency must consider is the cost, in the form of the forgone benefits, of those provisions.[72] Here, ONRR's failure to account for the impact of this decision is arbitrary and capricious.

IV. ONRR's proposed changes to the rule are arbitrary and capricious.

In its proposed changes to the 2016 Valuation Rule, ONRR repeatedly fails to provide a "reasoned explanation" for its changes, as required under the APA. In order to comply with the reasoned explanation requirement, ONRR must provide "good reasons" for the change and explain its reasons "for disregarding facts and circumstances that underlay or were engendered by" the prior rule.[73] If the agency's new position, "rests upon factual findings that contradict those which underlay its prior policy," the agency will need to provide "a more detailed justification than what would suffice for a new policy created on a blank slate" in order to satisfy the requirement to provide a "reasoned explanation."[74] With this Proposed Rule, ONRR fails to comply with these standards.

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[68] DANIEL MUNICH & GEORGE PSACHAROPOULOS, EUROPEAN EXPERT NETWORK ON ECONOMICS OF EDUCATION (EENEE), EDUCATION EXTERNALITIES: WHAT THEY ARE AND WHAT WE KNOW 12 (2018), http://eenee.org/dms/EENEE/Analytical_Reports/EENEE_AR34.pdf.
[69] *Id.*
[70] *Id.*
[71] Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co., 463 U.S. 29, 43 (1983).
[72] *Id*; State v. United States Bureau of Land Mgmt., 277 F. Supp. 3d 1106, 1125 (N.D. Cal. 2017).
[73] F.C.C. v. Fox Television Stations, Inc., 556 U.S. 502, 515–516 (2009).
[74] *Id.* at 515.

A. ONRR's proposed changes regarding natural gas and oil valuation are arbitrary and capricious.

ONRR does not provide adequate support for its decisions to extend the index-based valuation method to all gas transactions and broaden the scope of transportation and processing allowances for oil and gas. Thus, these changes are arbitrary and capricious.

i. ONRR fails to support its claim that extending the index-based valuation option to all federal gas transactions will increase royalty payments.

ONRR claims that royalty payments will increase by allowing producers of unprocessed gas, residue gas, fuel gas, coalbed methane, and natural gas liquids to choose between an arm's-length valuation and an index-based valuation.[75] However, the agency fails to adequately explain its reasoning behind this claim.

In the 2016 Valuation Rule, ONRR requires lessees to calculate royalty payments based on gross proceeds from the first arm's-length transaction in a gas sale.[76] Under the 2016 Valuation Rule, two exceptions apply to this valuation method: (1) lessees may use an index-based price in cases where no arm's-length sale exists,[77] and (2) ONRR may decide to value the resources under the default provision of § 1206.144.[78] ONRR chose to use this valuation method because "[g]ross proceeds under valid arm's-length transactions are the best measure of value."[79] An index-based option was offered for non-arm's-length transactions due to the "complex nature" of these transactions and the "potential administrative burden of pursuing and supporting the value under the first arm's-length sale."[80]

In this Proposed Rule, ONRR extends the index-based valuation option to all federal gas transactions.[81] The agency argues that this change will reduce administrative burdens on industry for two reasons. First, ONRR asserts that "[c]omplex valuation situations related to marketable condition, transportation, and processing are not limited to non-arm's-length dispositions" and that lessees could gain administrative benefits by using a less complicated index-based valuation method for these situations.[82] Second, ONRR argues that "because industry is in the process of altering its accounting and reporting processes to monitor and use index-based valuation for its non-arm's-length dispositions, it stands to gain additional efficiencies from applying those same processes to arm's-length dispositions."[83] The agency estimates that this extension of the index-based valuation option will result in an annual net increase in royalty payments of $26,761,000.[84]

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[75] Proposed Rule at 62,062.
[76] 2016 Valuation Rule at 43,346.
[77] *Id.* at 43,346, 43,381.
[78] *Id.* at 43,346.
[79] *Id.* at 42,347.
[80] *Id.*
[81] Proposed Rule at 62,055.
[82] *Id.* at 62,057.
[83] *Id.*
[84] *Id.* at 62,062.

There are three problems with the agency's reasoning here.

First, ONRR rejects its prior reasoning without providing a "reasoned explanation reconciling . . . inconsistencies," thus rendering its decision arbitrary and capricious.[85] In 2016, the agency asserted that "[g]ross proceeds under valid arm's-length transactions are the best measure of value."[86] Additionally, ONRR found that valuing gas transactions based on the first arm's-length sale would result in administrative cost savings of $247,000 for industry.[87] In the Proposed Rule, the agency abandons this policy by extending the index-based valuation option to all transactions, citing "administrative burdens" as justification for the change.[88] For ONRR to change its position on this issue, "a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy."[89] As ONRR has not provided any explanation for the changed position, the decision is arbitrary and capricious.

Second, ONRR supports this change by assuming that royalties will increase as a result of the change, but that assumption is unreasonable and the royalties increase that ONRR predicts is likely inflated. ONRR's claim that this change will increase royalty payments rests on the agency's assumption that "half of lessees would choose the alternative index-based valuation method to value dispositions eligible for the election."[90] In arriving at this estimate, ONRR acknowledges that it "cannot accurately estimate how many lessees will elect to use the index valuation method since many factors that are currently unquantifiable will drive a lessee's decision."[91] It nonetheless makes the unsupported assumption that half of lessees will chose the more expensive option.

In fact, it is not clear that lessees will choose the option that requires them to pay higher royalties. A lessee's decision will likely rest on basic economic incentives—each lessee will choose the option that minimizes costs. If the administrative cost savings associated with the index-based valuation method outweigh the increased cost of royalty payments under the index-based method for a particular transaction,[92] then the lessee may not choose to value royalties using the index price. As ONRR has not provided any support for the assumption that lessees will chose the option that requires them to pay higher royalties, ONRR has very likely underestimated the Proposed Rule's overall negative effect on royalties.

Third, any cost savings for lessees could cause increased production, which will create negative externalities including environmental degradation, harmful health impacts, and reduced money for education (discussed above in Sections II and III). As ONRR has not addressed any of those negative effects, the Proposed Rule is arbitrary and capricious.

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[85] California v. U.S. Dep't of the Interior, 381 F. Supp. 3d 1153, 1170 (N.D. Cal. 2019).
[86] 2016 Valuation Rule at 42,347.
[87] *Id.* at 43,359.
[88] Proposed Rule at 62,057.
[89] FCC v. Fox Television Stations, Inc., 556 U.S. 502, 516 (2009).
[90] Proposed Rule at 62,063.
[91] *Id.*
[92] *See id.* at 62,058 (ONRR estimates that, on average, royalties paid under the index-based valuation method will be higher than those paid under the arm's-length valuation).

ii. ONRR fails to support its decision to broaden transportation and processing allowances for oil and gas.

In its Proposed Rule, ONRR expands the scope of transportation and processing allowances, enabling oil and gas producers to receive uncapped government compensation for transportation, gathering, and processing costs. The agency does not adequately support its decision and fails to confront the negative environmental consequences associated with this change.

Under the 2016 Valuation Rule, ONRR capped allowances for "a lessee's reasonable, actual costs of transportation" at 50 percent for Federal oil and gas production.[93] The agency similarly capped processing allowances at 66 2/3 percent. The agency reasoned that these limits create a "check on the reasonableness of transportation costs" and that the rule "supplements the requirement that a lessee's transportation costs be actual and reasonable."[94] Additionally, ONRR changed the definition of "gathering" to rescind the Deepwater Policy, under which lessees could previously receive transportation allowances for subsea gathering costs.[95] In making this change, ONRR asserted that the original purpose of the Deepwater Policy was to "incentivize deep water leasing by allowing lessees to deduct broader transportation costs than the regulations allowed" and that the policy "has served its purpose and is no longer necessary."[96] At the same time, the agency concluded that the rule provides ample allowances for lessees to recover their transportation costs.[97]

In its Proposed Rule, ONRR removes the caps on transportation and processing allowances and reinstates the Deepwater Policy, allowing lessees to recover transportation costs for subsea gathering activities.[98] ONRR provides only one justification for these changes: the Trump Administration's policies of deregulation and domestic energy production, citing Executive Orders 13783 and 13795.[99] The agency contends that these changes will incentivize lessees to "produce from Federal lands that are less desirable due to the high costs associated with transportation, processing, or both" and "continue producing through uncommon or unavoidable circumstances affecting costs and value."[100]

There are two problems with this justification.

First, ONRR fails to provide a "reasoned explanation reconciling . . . inconsistencies" with its 2016 Valuation Rule.[101] In 2016, the agency determined that the Deepwater Policy had served its purpose of incentivizing deep water leasing and was no longer needed. ONRR does not explain

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[93] 2016 Valuation Rule at 43,343.
[94] *Id.*
[95] *Id.* at 43,340.
[96] *Id.*
[97] *Id.*
[98] Proposed Rule at 62,058–62,060.
[99] *Id.* at 62,058.
[100] *Id.*
[101] California v. U.S. Dep't of the Interior, 381 F. Supp. 3d 1153, 1170 (N.D. Cal. 2019). *See also* F.C.C. v. Fox Television Stations, Inc., 556 U.S. 502, 516 (2009) ("[A] reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy."); New York v. U.S. Dep't of Health & Human Servs., 414 F. Supp. 3d 475, 549 (S.D.N.Y. 2019) ("'[U]nexplained inconsistency' makes the reinstatement of the rescinded provisions arbitrary and capricious.").

its reasoning behind the proposal to reinstate the policy, citing only the Trump administration's broad executive orders to justify its decision. The U.S. District Court for the Northern District of California found such cursory reasoning to be insufficient to justify the repeal of the 2016 Valuation Rule. As the court stated: "ONRR further asserted that a number of provisions in the Rule would unduly burden . . . the production, utilization, or delivery of Federal oil or gas . . . . These conclusory assertions are inadequate. . . ."[102] The court also emphasized that the agency "must provide 'a reasoned explanation . . . for disregarding facts and circumstances that underlay or were engendered by the prior policy.'"[103] Here, ONRR has again contradicted its prior policy without adequately reconciling these inconsistences. As the court previously found, reliance on Executive Orders 13783 and 13795 is not a "reasoned explanation."

Second, if this change does incentive production then it could be production that is far from optimal.[104] Production in such areas can create harmful environmental externalities associated with the prospecting, extraction, transportation, and combustion of these resources.[105] And if the production is occurring in a "low quality" or remote area, the costs of the production will very likely not be justified. The agency has provided no justification for a policy that promotes the harms that could come of any new production in these low quality reservoirs.

ONRR also requests comments regarding situations where it is "uneconomic or unfeasible for a lessee to locate separation, treatment, or royalty measurement functions on or near the lease."[106] If the production of these resources is not profitable, then ONRR should not subsidize the production. Allowing reductions for unprofitable mining directly conflicts with the Mineral Leasing Act's requirement that lessees "use all reasonable precautions to prevent waste of oil or gas developed in the land."[107] These proposed changes also run counter to the explicit aims of the Mineral Leasing Act and to the Federal Land Policy and Management Act's goals to protect the quality of "environmental, air, and atmospheric" resources and to "protect certain public lands in their natural condition."[108] And the agency has provided no justification for taking this course of action.

B. ONRR's proposed changes regarding the coal industry and coal royalties are arbitrary and capricious.

One of the designs of the 2016 Valuation Rule was to close a loophole that allowed coal to be valued based on non-arm's-length sales between affiliates, resulting in artificially low royalties. This was especially an issue in the coal industry because of the existence of cooperatives, which are made up of companies that are not economically independent of one another. To solve this issue, the 2016 Valuation Rule required electricity sales to be used to value coal where no prior arm's-length transaction had taken place. This coal netback provision was enjoined in *Cloud Peak Energy, Inc., v. U.S. Dep't of the Interior*, 415 F. Supp. 3d 1034 (D. Wy. 2019) by the U.S. District Court for the District of Wyoming.

[102] California v. U.S. Dep't of the Interior, 381 F. Supp. 3d 1153, 1170 (N.D. Cal. 2019).
[103] *Id.* at 1168 (quoting Encino Motorcars, LLC v. Navarro, 136 S. Ct. 2117, 2126 (2016)).
[104] *See* N. Gregory Mankiw, *Principles of Microeconomics* 204 (5th ed. 2008).
[105] *See* discussion of environmental externalities *supra* Section II.A.
[106] Proposed Rule at 62,071.
[107] 30 U.S.C. § 225
[108] *See* 30 U.S.C. § 226(m); 43 U.S.C. § 1701(a)(8).

i. ONRR does not provide adequate support for its proposed removal of all references of "coal cooperative."

ONRR fails to provide a reasoned explanation for removing the definition of "coal cooperative" from the rule.

"Coal cooperative" was included in the 2016 Valuation Rule to describe formal or informal organizations of companies that are not operating at arm's-length from one another.[109] In the 2016 Valuation Rule, ONRR explained that defining the concept of a "coal cooperative" was "imperative" in order to ensure that royalties were not set artificially low, as the unique vertical integration within the coal industry complicates the fair market valuation of coal.[110]

ONRR is now proposing to remove both the definition of "coal cooperative" and all references to it throughout the rule.[111] In the current Proposed Rule, ONRR does not address the explanations previously provided in the 2016 Valuation Rule (that defining "coal cooperative" was necessary in order to accurately assess royalties given the unique structure of the coal industry) and does not explain why these concerns are no longer relevant or necessary to take into account. When revising or repealing an existing rule, an agency must provide a "reasoned explanation . . . for disregarding facts and circumstances that underlay or were engendered by the prior policy."[112] The failure of ONRR to take this step is thus arbitrary and capricious.

Instead, ONRR provides only one justification for its proposed removal of "coal cooperative" references, which is that the Wyoming District Court "offered strong criticism" of its definition in *Cloud Peak Energy, Inc., v. U.S. Dep't of the Interior*, 415 F. Supp. 3d 1034 (D. Wy. 2019).[113] However, ONRR's claim that the court "offered strong criticism" of the definition of "coal cooperative" is not supported by the record. The only reference to "coal cooperative" in the opinion was in relation to the court's discussion of the policy of using arm's-length electricity sales to determine the value of coal.[114] The opinion never criticized the definition of "coal cooperative" or the description of the coal industry as one characterized by non-arm's-length transactions. ONRR's assertion that the court "offered strong criticism" of the "coal cooperative" definition runs counter to the evidence and is therefore arbitrary and capricious.[115]

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[109] 2016 Valuation Rule at 43,339.
[110] "We disagree with the comment that the definition of coal cooperatives is 'unnecessary.' In fact, given the unique institutional nature of cooperatives in the coal industry—corporate relations among mine producers, logistics operations, electric generation, and overseas sales—that is not commonly found in markets for oil and gas, we deemed it imperative to define coal cooperatives for royalty purposes." 2016 Valuation Rule at 43,355.
[111] Proposed Rule at 62,061.
[112] FCC v. Fox Television Stations, Inc., 556 U.S. 502, 516 (2009).
[113] "ONRR is attempting to relieve concerns with the definition's applicability and meaning. While the Court, in *Cloud Peak*, did not find the coal cooperative definition to be arbitrary and capricious, the Court offered strong criticism of the definition. Accordingly, this amendment would harmonize the ONRR's rules with the Court's statements in *Cloud Peak*." Proposed Rule at 62,061.
[114] Cloud Peak Energy, Inc., v. U.S. Dep't of the Interior, 415 F. Supp. 3d 1034, 1050 (D. Wy. 2019).
[115] *See* Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co., 463 U.S. 29, 43 (1983) (finding that a rule is arbitrary and capricious if the agency has "offered an explanation for its decision that runs counter to the evidence before the agency").

ii. ONRR fails to justify its proposed repeal of the provision valuing coal based on arm's-length electricity sales.

ONRR's reliance on the *Cloud Peak* preliminary injunction, its conclusory references to the burden and costs of the electricity sales provision, and its failure to adequately address the concerns described in the 2016 Valuation Rule are arbitrary and capricious.

Background

Before the 2016 Valuation Rule was implemented, a loophole existed that allowed coal royalties to be calculated based on non-arm's-length sales to affiliate organizations.[116] By selling federal coal at depressed prices to partners, coal lessees exploited the loophole to minimize their royalty payments. This practice was widespread in the coal industry and affected a substantial portion of the market. For example, according to the U.S. Energy Information Administration ("EIA"), 42% of all coal produced in Wyoming in 2012 was sold through captive transactions.[117] Furthermore, prior to the 2016 Valuation Rule, the five biggest coal companies operated a network of over 500 domestic and foreign subsidiaries and affiliates for purposes of selling and distributing their coal, enabling them to engage in non-arm's-length transactions to reduce their federal royalty payments.[118] The systematic undervaluing of coal was also observed empirically when coal was exported from the United States to foreign countries for millions of dollars more than the purported value that had been used to calculate royalties.[119]

2016 Valuation Rule and Justification

To fix the loophole, in the 2016 Valuation Rule ONRR proposed that electricity sales be used to accurately assess the true market value of coal in situations where all prior transactions occurred between affiliates.[120] ONRR explained that this methodology was necessary because "arm's-length sales are the best indicator of value. Due to the complexity of affiliated interests across coal mining, logistics, and sales that many commenters referenced, the first arm's-length sale could easily be the sale of generated electricity."[121] Using electricity sales was thus a gap-filling

[116] 2016 Valuation Rule at 43,354–55.
[117] U.S. Energy Information Administration, Annual Coal Report 2012, Table 8 at 14, http://www.eia.gov/coal/annual/.
[118] Ctr. for Am. Progress, Comment Letter on Proposed Rule for Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform at 5 (May 8, 2015), https://www.regulations.gov/document?D=ONRR-2012-0004-0266.
[119] "Paying royalties calculated on the net-back formula for Asian exports from Wyoming and Montana rather than on the benchmark domestic price would have yielded around $40 million in additional revenue for the government last year alone, according to data from Goldman Sachs and other analysts, and figures from the U.S. Energy Information Administration. Extended to the last few years of increased Asian demand, that total could exceed $100 million in forgone royalties." Patrick Rucker, *Asia coal export boom brings no bonus for U.S. taxpayers*, REUTERS (Dec. 4, 2012), https://www.reuters.com/article/us-usa-coal-royalty/asia-coal-export-boom-brings-no-bonus-for-u-s-taxpayers-idUSBRE8B30IL20121204.
[120] 2016 Valuation Rule at 43,355.
[121] *Id.*

measure, only to be used when all prior transactions consisted of non-arm's-length sales, as non-arm's-length transactions do not reliably reflect the true value of coal.[122]

When ONRR promulgated the electricity sales provision in the 2016 Valuation Rule, it directly responded to criticisms that the methodology "ignored and oversimplified the complexities of electric markets and contracts, and was administratively burdensome," explaining why it was a sensible and realistic solution.[123]

First, ONRR noted that the chain of coal production and down-stream transactions ends with an electricity sale in 93% of all cases.[124] Given that coal is ultimately almost always used to generate electricity, electricity sales are a reliable end-point to calculate royalties where no other arm's-length transaction has taken place earlier.

Second, ONRR acknowledged that the priced sale of electricity is not entirely equivalent to the value of coal, and built in deductions to allow for the most accurate assessment of coal value.[125] In particular, the agency allowed deductions of the cost to wash the coal, transport the coal, generate electricity, and transmit electricity.[126] This resulted in a realistic netback value of coal that best approximated its true market value.

Third, ONRR described how looking to the first arm's-length sale (even when that is the sale of electricity) was not only preferable, but in fact administratively simpler compared to the prior, alternative methodology of using benchmarks. As ONRR explained in the 2016 Valuation Rule, benchmarks were cumbersome and "difficult to use in practice."[127] For example, one benchmark required companies to demonstrate the proceeds they received were comparable to "arm's-length sales of like-quality coal in the same area."[128] However, acquiring "arm's-length contracts to compare with the lessee's gross proceeds was challenging and, at times, impossible for lessees" to obtain because that information is considered proprietary.[129] No other benchmark (such as prices reported to public utility commissions) were found to be a sufficient alternative to arm's-length sales.[130] In the scenario that no electricity sale was available to value coal (which would presumably occur in only a fraction of cases), royalty value would be based on either a default method determined by ONRR, or based on a method proposed by the lessee according to § 1206.252(b)(2)(i).[131] In this way, ONRR affirmed the value of utilizing arm's-length sales and laid out a strong justification for looking to electricity sales as a source to value coal in order to calculate a fair market value.

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122 "We will only use sales of electricity to value coal in situations where the first arm's-length sale is the sale of electric power along a series of no sales or non-arm's-length sales." *Id*.
123 *Id*.
124 *Id*.
125 *Id*. at 43,366.
126 *Id*.
127 *Id*. at 43,354.
128 *Id*.
129 *Id*.
130 *Id*.
131 *Id.* at 43,366.

2020 Proposed Rule and Justification

In the Proposed Rule, ONRR proposes to repeal the requirement under §§ 1206.252 (Federal coal) and 1206.452 (Indian coal) to value coal based on an electricity sale where the electricity sale constitutes the first arm's-length transaction.[132]

Instead of the electricity-sales provision, where no arm's-length sale is otherwise available, ONRR proposes to require lessees to "request a valuation determination under 30 CFR 1206.258 (Federal coal) or 1206.458 (Indian coal)."[133] This allows industry groups to propose their own method of valuing their coal, which ONRR then reviews and makes a determination on.[134]

ONRR provides two justifications for why the electricity sales provision should be removed but neither passes muster.

1. The Netback Methodology Is Not Burdensome and Costly

ONRR first claims that using the sale of electricity as a proxy is a "burdensome" method that imposes costs on both ONRR and industry actors "to obtain and validate the information."[135] This justification is inaccurate and thus unreasonable.[136]

When there is no arm's length transaction available, within coal cooperatives, federal coal lessees should have access to all information necessary to work backwards from electricity price to the associated coal sale's gross proceeds. Under the 2016 Valuation Rule, electricity sales are used to calculate royalties only when no other arm's-length transactions previously took place. Thus, only coal producers who engaged with their own sister and affiliate companies up until the point of the electricity sale would be affected by this requirement. These companies are exactly the ones who would have access to this end-point sale data due to these close relationships. Further, extensive public reporting requirements are placed on electricity generators by the U.S. EIA. Generators must disclose all fuel purchases, and for coal purchases, mine source and supplier information is also required.[137] Therefore, at the very least, federal coal lessees would be able to trace their coal sales using these EIA disclosures. Backing out the value of coal based on electricity sales is also practically informed by the methodology laid out in the 2016 Valuation Rule that listed the proper deductions, resulting in a realistic, market based coal valuation.[138]

Coal companies themselves acknowledge the clear link between the value of coal and the sale of electricity. For example, in Cloud Peak Energy's 2018 10K Filing with the SEC, the company noted that "[o]ur mines produce subbituminous thermal coal [which] is primarily consumed by

[132] Proposed Rule at 62,061.
[133] *Id.* at 62,061.
[134] *Id.* at 62,087 (listing remaining valuation path under § 1206.252).
[135] Proposed Rule at 62,061.
[136] Clean Air Council v. Pruitt, 862 F.3d 1, 10 (D.C. Cir. 2017) ("An examination of the record demonstrates that each of these statements is inaccurate and thus unreasonable.").
[137] *See* U.S. Energy Info. Admin., Form EIA-923 at 4, https://www.eia.gov/survey/form/eia_923/form.pdf.
[138] 2016 Valuation Rule at 43,366 (coal washing, coal transport, electricity generation, electricity transmission).

electric utilities and industrial consumers as fuel for electricity generation."[139] In the same 10K Filing, Cloud Peak Energy further identified the importance of electricity consumption on their business, observing that "[d]ecreases in U.S. and global demand for electricity due to economic, weather or other conditions could negatively affect coal prices."[140] Rather than being a costly and confusing standard to determine the value of coal based on electricity sales, coal companies already look to electricity sale prices when assessing the value of the coal they produce.

Further, ONRR's attempt to repeal this provision based on it being burdensome "completely contradicts its prior findings."[141] In vacating ONRR's first attempt to repeal the 2016 Valuation Rule, the U.S. District Court for the Northern District of California found that "[a]lthough the ONRR is entitled to change its position, it must provide 'a reasoned explanation . . . for disregarding facts and circumstances that underlay or were engendered by the prior policy.'"[142] The court determined that ONRR's attempt to depict the 2016 Valuation Rule's approach of valuing coal as "unnecessarily complicated and burdensome to implement and enforce" in the face of "detailed conclusions" that supported the approach was "conclusory" and thus failed "to satisfy its obligation to explain the inconsistencies between its prior findings in enacting the Valuation Rule and its decision to repeal such Rule. The ONRR's repeal of the Valuation Rule is therefore arbitrary and capricious."[143] As ONRR has made similar conclusory statements in the Proposed Rule about the "burden" that the provision creates, without providing further evidence or explanation of its reasoning, the agency's actions are arbitrary and capricious.

2. The Cloud Peak *Criticisms Are Unfounded*

ONRR also claims that removing the electricity sales provision would "bring the ONRR's regulations in conformity with the Court's ruling in *Cloud Peak*," where the Wyoming District Court granted a preliminary injunction regarding this portion of the 2016 Valuation Rule.[144]

But ONRR's reliance on the preliminary injunction granted in *Cloud Peak* is not adequate. As a preliminary matter, the District Court only enjoined the of the electricity sales provision rather than providing a final adjudication on its merits. And in any event, it is not the court's position that is relevant, but rather ONRR's position. And ONRR does not say whether or not it agrees with the court's concerns.

In addition, even if ONRR had directly endorsed or adopted the rationale provided by the Wyoming District Court in *Cloud Peak*, the court's concerns with the use of electricity sales to value coal were unfounded.

One concern that the District Court had was that ONRR (along with the rest of the parties) could not articulate "how this provision could be applied to extract the value of the coal from the sale of electricity" at the September 4, 2019 hearing.[145] This is hardly surprising since ONRR has

[139] Cloud Peak Energy Inc. (2019), *Form 10-K 2018* at 1. Retrieved from sec.gov.
[140] *Id*. at 35.
[141] California v. U.S. Dep't of the Interior, 381 F. Supp. 3d 1153, 1167 (N.D. Cal. 2019).
[142] *Id*. at 1168 (quoting Encino Motorcars, LLC v. Navarro, 136 S. Ct. 2117, 2126 (2016)).
[143] *Id*.
[144] Proposed Rule at 62,061.
[145] Cloud Peak Energy, Inc., v. U.S. Dep't of the Interior, 415 F. Supp. 3d 1034, 1051 (D. Wy. 2019).

been in the process of actively attempting to repeal this rule. Given this conflict of interest, the failure of ONRR to explain the feasibility of the process to value coal based on electricity sales during litigation does not prove that the process is itself actually infeasible.

The District Court also asserted that ONRR had "ignored and oversimplified the complexities of electric markets" with the netback provision.[146] The court claimed that the attempt to back out the value of coal from the sale price of electricity is a difficult task as "the sales price of the electricity is comprised of much more than just the cost of coal" and is subject to governmental regulation.[147] The District Court thus depicts the use of electricity sales to value coal as a new and complex methodology.

But as explained above, federal coal lessees should have access to all information necessary to work backwards from electricity prices to the associated coal sale's gross proceeds.

Moreover, performing a netback calculation is not a new valuation technique, and the logic behind netback methodologies is sound. It is a calculation well known in the oil and gas industry: the value of a single barrel is calculated by subtracting operational expenses from the ultimate realized sale revenue.[148] Using netback calculations is not new to coal royalty determinations either—the measure actually was one of the old benchmarks for federal coal valuation.[149]

The District Court asserted that "[t]rying to value coal based on the sale of electricity is akin to valuing wheat based on the sale of a cake; there may be a relationship between the two, but it is weak and several other factors potentially play a much larger role in determining the sales price of the end product." [150] But the analogy to selling a cake does not prove anything. Even if flour can be used to make several different end products, such as cake and many other products that would be sold for different amounts, the wheat farmer is still able to predict what value she will get from selling wheat for flour.[151]

That is the case here. Coal almost invariably ends up burned for electricity. Thermal coal is only valuable insofar as it is used to generate electricity. As described in the 2016 Valuation Rule, 93% of coal consumption was used for electricity generation.[152] Electricity prices thus serve as a particularly reliable starting point for determining the underlying value of coal where no other arm's-length coal sale occurs. And when there is such a tight connection, it is completely doable for a producer to use the eventual sales to help value the product.

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[146] *Id.*
[147] *Id.*
[148] *What is Netback?,* CORPORATE FINANCE INSTITUTE, https://corporatefinanceinstitute.com/resources/knowledge/finance/netback/ (last visited Oct. 11, 2020).
[149] 2016 Valuation Rule at 43,354.
[150] *Cloud Peak*, 415 F. Supp. 3d at 1051.
[151] *See* Emiko Terazono, *Wheat prices rise as shoppers rush to stockpile pasta and flour*, FIN. TIMES (Mar. 25, 2020), https://www.ft.com/content/e5e60434-6de7-11ea-89df-41bea055720b ("Shoppers' rush to stock up on non-perishable staples such as pasta and noodles to ride out the coronavirus crisis has boosted demand for wheat . . . Analysts noted that in the US, prices have been supported by increased buying by flour millers . . . .").
[152] *See* 2016 Valuation Rule at 43,355.

In the 2016 Valuation Rule, ONRR also took steps to make the netback process logistically simple by providing the specific list of deductions of other "inputs" that influence the final electricity sale price in order to reveal the value of coal (specifying that coal washing, coal transport, electricity generation, and electricity transmission could be deducted).[153] While there may be other economic forces in play, such as regulations within the electricity market, using electricity sales to calculate the value of coal and thus federal royalties is a more reliable and accurate metric than allowing them to be based on artificially depressed sales between affiliated companies.

The District Court also identified timing issues regarding the sale of electricity that it believed made royalty calculations impractical. The court noted that coal "delivered to a power plant may sit in storage and not be burned to generate electricity until well after the lessee is required to report the value of that coal to ONRR for royalty-calculation purposes," which makes it "impossible" to value coal based on the sales price of electricity.[154] However, the fact that a particular batch of coal may not be immediately burned for fuel does not mean that electricity sales are an ineffective source to determine value generally. Again, the presumption here is that the electricity sales valuation is only necessary because there was no arm's length sale that occurred before the electricity sale, meaning that passing the necessary information between the affiliates would not be difficult.

And in any event, producers often calculate eventual sales and netback the value of their products. For example, farmers growing corn for purposes of ethanol production may face similar complications but are certainly able to determine the value of the corn on the market.[155] The District Court's conclusion that this feature of coal-based electricity sales prevents the netback methodology from being effective is unfounded.

ONRR has a responsibility to obtain a "fair market value of the use of the public lands and their resources," and failing to implement a methodology that successfully approximates the market value of coal would violate this duty.[156] ONRR's cursory citation to the District Court opinion, whose analysis does not withstand scrutiny, and ONRR's failure to otherwise address the 2016 Valuation Rule rationale for using electricity sales is thus arbitrary and capricious.[157]

3. Reintroducing the Loophole Has Costs

ONRR specifically requested comments on the economic impact of repealing the electricity sales provision.[158] This proposed change may have long-term implications by allowing a loophole, and it is important that this loophole be closed.

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[153] *See id*.
[154] *Cloud Peak*, 415 F. Supp. 3d at 1051.
[155] U.S. Energy Information Administration, *Rising corn prices and oversupply push ethanol operating margins to multiyear lows* (Aug. 8, 2019), https://www.eia.gov/todayinenergy/detail.php?id=40813.
[156] 43 U.S.C. § 1701(a)(9).
[157] *See* FCC v. Fox Television Stations, Inc., 556 U.S. 502, 516 (2009) (finding that when revising or repealing an existing rule, an agency must provide a "reasoned explanation . . . for disregarding facts and circumstances that underlay or were engendered by the prior policy").
[158] Proposed Rule at 62,071.

By removing the electricity sales provision under §§ 1206.252 (Federal coal) and 1206.452 (Indian coal) and instead mandating that industry groups submit their own proposals for valuations when there are no other arm's-length sales to use as a basis, ONRR reintroduces a loophole that allows industry groups to get away with paying royalties on below-market sales. In the 2016 Valuation Rule, ONRR explicitly justified moving away from using the old benchmark system because arm's-length transactions (including electricity sales) were superior.[159] Now, in attempting to repeal the electricity sales provision, ONRR places unprecedented power in the hands of industry actors to suggest their own values, as the rule lacks even the prior benchmark system that potentially cabined valuations.

Both the 2016 Valuation Rule and 2020 Proposed Rule estimate the effect on royalties to be negligible in the short term.[160] However, even if the change to royalties is not significant based on current industry practice, the long-term effect if practices shift could be large. Closing this loophole will ensure that it is not abused in the future.

In addition, if royalties do decrease as a result of changing practices over the long term, then production will also be incentivized, [161] giving rise to environmental concerns. Increased production of oil, natural gas, and coal will create significant environmental harm associated with the prospecting, extraction, transportation, and combustion of these resources.

America's public lands offer recreational enjoyment, habitats for wildlife, and natural resources, the use of which can be impaired by production. Energy companies cause environmental and noise pollution through prospecting and other activities undertaken for resource extraction. Increased vehicular traffic due to these drilling and mining operations contributes to wear and tear on roadways, as well as traffic-related fatalities.[162] Coal production requires explosives to remove mountaintops, changing the landscape, displacing ecosystems, and creating pollution for downstream aquatic wildlife.[163]

The transportation and combustion of fossil fuels creates air pollution that poses public health risks and contributes to climate change. Tankers, trucks, railroads, and pipelines transport these resources long distances, creating smog and particle pollution that contributes to asthma, heart disease, and premature death.[164] Fossil fuel combustion similarly creates air pollution, releasing carbon dioxide, sulfur dioxide, nitrogen oxides, particulates, heavy metals, and ash into the

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[159] 2016 Valuation Rule at 43,354.
[160] *Id.* at 43,366; Proposed Rule at 62,070.
[161] *See* N. Gregory Mankiw, *Principles of Microeconomics* 194 (5th ed. 2008).
[162] *See, e.g.*, Lise Olson, *Fatal Truck Accidents Have Spiked During Texas' Ongoing Fracking and Drilling Boom*, HOUSTON CHRON. (Sept. 15, 2014, 12:48 PM), http://www.houstonchronicle.com/news/article/Fracking-andhydraulic-drilling-have-brought-a-5747432.php?cmpid=email-premium&cmpid=emailpremium&t=1a9ca10d49c3f0c8a9#/0.
[163] *Coal Explained*, U.S. ENERGY INFO. ADMIN., https://www.eia.gov/energyexplained/coal/coal-and-the-environment.php (last visited Oct. 23,2020).
[164] Transporting Oil & Natural Gas, AM. PETROLEUM INST., https://www.api.org/oil-and-natural-gas/wells-to-consumer/transporting-oil-natural-gas (last visited Oct. 23, 2020); How Mobile Source Pollution Affects Your Health, ENV'T PROT. AGENCY, https://www.epa.gov/mobile-source-pollution/how-mobile-source-pollution-affects-your-health (last visited Oct. 23, 2020).

air.[165] Carbon dioxide, the main emission produced during fossil fuel combustion, is the main driver of rising global temperatures.[166]

Yet in its Proposed Rule, ONRR fails to consider the environmental costs associated with the increased production of coal resulting from the reintroduction of a loophole that allows for artificially low royalties.

C. ONRR's proposed changes affecting default valuation, penalties, and contractual schemes for fossil fuel companies are arbitrary and capricious.

ONRR proposes changes to several provisions affecting the valuation, penalties, and contracts associated with oil, gas, and coal transactions. However, the agency fails to provide reasoned explanation for these changes, rendering them arbitrary and capricious.

i. ONRR fails to adequately justify its removal of the default provision from the Proposed Rule.

In the Proposed Rule, ONRR does not provide a reasoned explanation for removing the default provision, and this change will create uncertainty surrounding the valuation of oil, gas, and coal.

The 2016 Valuation Rule includes a default provision, which allows ONRR to value production in cases where the valuation has been called into question due to misconduct or other issues that compromise the correct valuation.[167] As ONRR clarified in 2016, "[t]he default provision simply codifies the Secretary's authority to determine the value of production for royalty purposes and specifically enumerates when, where, and how the Secretary will use that discretion."[168] Industry commenters expressed concern that the provision affords "standardless" discretion to the agency.[169] However, ONRR explained that it will only use the provision in "very specific cases where [it] cannot determine proper royalty impact though standard procedures" and that lessees can appeal such valuations made under the default provision.[170]

In its Proposed Rule, ONRR argues that there is an industry "perception" that the agency "could misapply the default provision in ways that undermine the other pillars of [its] regulatory scheme. . . ."[171] ONRR also asserts that the provision is no longer needed, "considering successful historical practice without it."[172] The agency contends that, before the creation of the default provision, it "exercised Secretarial discretion to establish royalty values absent a default

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[165] *Coal Explained*, *supra* note 37.
[166] *Climate Change: Atmospheric Carbon Dioxide*, CLIMATE.GOV, https://www.climate.gov/news-features/understanding-climate/climate-change-atmospheric-carbon-dioxide (last visited Oct. 23, 2020).
[167] 2016 Valuation Rule at 43,341.
[168] *Id.*
[169] *Id.* at 43,340.
[170] *Id.* at 43,341.
[171] Proposed Rule at 62,060.
[172] *Id.*

provision."[173] The agency also reemphasizes Executive Orders 13783 and 13795 and their call for increased domestic energy production without regulatory burdens.[174]

But these justifications contradict ONRR's previous decision. The citation to industry's "perception" that the rule will be misapplied and therefore creates uncertainty that burdens lessees[175] is a complete reversal from the agency's prior position. However, ONRR provides no data or analysis to support industry claims that this burden exists. In fact, the agency concedes that the Secretary already possessed the discretionary power to value production in these rare cases, even before the default rule was created.

In fact, the default provision exists to inform lessees when and how the Secretary will use his discretion, thus providing certainty and clarity surrounding the application of the rule. Contrary to ONRR's claims, removal of this provision will reintroduce uncertainty by leaving lessees unsure when the Secretary will exercise this discretion. The agency also fails to recognize the lessees' right to appeal any order from the Secretary regarding royalty valuation, which creates an important check on the Secretary's power. In order to properly justify its removal of the default provision, ONRR must evaluate these key considerations and provide a reasoned explanation for its decision.

ONRR also argues that the provision could "undermine other regulatory processes, such as basing allowances on reasonable actual costs . . . and looking to arm's-length transactions as the best indicator of value,"[176] but that statement misunderstands the application of the provision. By definition, the default provision only applies in cases where ONRR *cannot* look to an arm's-length transaction to determine the royalty value. In these cases, the Secretary exercises his discretion to determine the best measure of value.

Furthermore, under the APA, an agency's decision to repeal a rule without considering reasonable alternatives is arbitrary and capricious.[177] Here, ONRR removes the default provision without evaluating alternative options. The agency could easily remove any uncertainty or confusion by further clarifying the provision in the Proposed Rule or issuing guidance detailing the provision's application. Because the agency proposes to repeal the provision without considering any alternatives, its decision is arbitrary and capricious.

Finally, ONRR's reliance on broad executive policies to justify this change, without further explanation, is arbitrary and capricious. The U.S. District Court for the Northern District of California similarly found such broad reasoning to be arbitrary and capricious when it vacated the repeal of the 2016 Valuation Rule.[178] The court held that "[t]hese conclusory assertions are inadequate" as justification for a rule.[179] And they are inadequate here as well.

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[173] *Id.*
[174] *Id.*
[175] *Id.*
[176] *Id.*
[177] *See* Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 46–51 (1983).
[178] *See* California v. U.S. Dep't of the Interior, 381 F. Supp. 3d 1153, 1170 (N.D. Cal. 2019).
[179] *Id.*

ii. ONRR does not provide adequate support for its decision to delete the definition of "misconduct" from § 1206.20 of the Proposed Rule.

ONRR fails to provide a reasoned explanation for removing the definition of "misconduct" in the Proposed Rule. In making this change, ONRR unnecessarily reintroduces uncertainty to the application of the rule.

The 2016 Valuation Rule defines "misconduct" as "any failure to perform a duty owed to the United States under a statute, regulation, or lease, or unlawful or improper behavior, regardless of the mental state of the lessee or any individual employed by or associated with the lessee."[180] Prior to finalizing the 2016 Valuation Rule, ONRR received comments from industry expressing concern that this definition is overly broad and implies wrongdoing.[181] ONRR responded to these comments, explaining that its definition is based on *Black's Law Dictionary*, and that no intent is required for the purposes of the rule because it is used for valuation purposes, not for imposing penalties.[182]

Now, in its Proposed Rule, ONRR proposes to delete the definition of misconduct, relying on the same industry comments to justify its action.[183] ONRR claims that the definition of "misconduct" is "unduly burdensome and duplicative,"[184] but the agency does not provide any data or examples to support this claim.

The removal of this definition will create unnecessary uncertainty in the application of the rule. ONRR has not shown any substantive reason to remove it, relying only on vague concerns from industry players—the same concerns that the agency addressed and resolved in its 2016 Valuation Rule. Again, ONRR has directly contradicted its previous position on an issue without properly justifying its decision. In order to resolve this discrepancy, ONRR must provide a "reasoned explanation for the change."[185] Because the Proposed Rule fails to do this, deleting the misconduct provision is arbitrary and capricious.

iii. ONRR fails to support its decision to remove the requirement that contracts must be signed by all parties in order to inform valuation.

ONRR proposes to remove the requirement that contracts be signed by all parties, but the agency fails to provide a reasoned explanation for this change as well.

ONRR's 2016 Valuation Rule requires that lessees obtain written contracts, revisions, or amendments that are signed by all parties, and if such a contract is not submitted, "ONRR may use the default provision to determine value."[186] In justifying the 2016 rule, the agency cited the difficulties associated with auditing and verifying oral contracts.[187] ONRR responded to

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[180] 2016 Valuation Rule at 43,371.
[181] *Id.* at 43,340.
[182] *Id.*
[183] Proposed Rule at 62,060.
[184] *Id.*
[185] Encino Motorcars, LLC v. Navarro, 136 S. Ct. 2117, 2125 (2016).
[186] 2016 Valuation Rule at 43,342.
[187] *Id.*

comments arguing the enforceability of oral contracts by emphasizing the administrative burden that verification processes create for the agency.[188]

In its Proposed Rule, ONRR disregards this burden and focuses instead on the administrative burdens that the signature requirement creates for lessees. The agency argues that "contracts may be valid and enforceable, as a matter of law, despite the absence of one or more signatures" and that this change aims to "relieve certain regulatory burdens the 2016 Valuation Rule places on industry."[189]

ONRR's proposed change contradicts its 2016 reasoning that removing the signature requirement would impose significant costs on the agency, including verification activities required to determine that the lessees' royalty payments are correct. ONRR also fails to consider the risk that these tracking activities will create inefficiencies in ONRR's accounting and auditing systems, as explained in the 2016 Valuation Rule. Once again, the agency relies on broad executive orders to justify its reasoning, without reconciling the inconsistent position with its past decision. ONRR must provide a proper justification for its change in order to avoid the same outcome of its 2017 attempt to repeal the 2016 Rule.[190]

iv. ONRR fails to justify its proposed change to revoke the ability of Administrative Law Judges to reverse a stay of civil penalty accruals.

ONRR proposes to remove provision § 1241.11(b)(5) from the 2016 Civil Penalty Rule, which currently allows ALJs to find that an industry actor forfeits the benefit of a stay on accrual of penalties if the ALJ determines their defense to the notice was frivolous.[191] ONRR provides only one justification for removing this provision: the Wyoming District Court found it unenforceable in *American Petroleum Institute ("API") v. U.S. Dep't of the Interior*, 366 F. Supp. 3d 1292, 1309–10 (D. Wyo. 2018).[192] But that case was appealed to the U.S. Court of Appeals for the Tenth Circuit, and on August 5, 2020, the court vacated the district court opinion due to a lack of standing on behalf of the petitioner, API.[193] The citation to a now vacated court opinion is not sufficient to justify this proposed repeal.

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[188] *Id.*
[189] Proposed Rule at 62,061.
[190] *See generally* California v. U.S. Dep't of the Interior, 381 F. Supp. 3d 1153 (N.D. Cal. 2019) (vacating ONRR's 2017 repeal of the 2016 Valuation Rule). *See also* F.C.C. v. Fox Television Stations, Inc., 556 U.S. 502, 516 (2009) ("[A] reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy."); New York v. United States Dep't of Health & Human Servs., 414 F. Supp. 3d 475, 549 (S.D.N.Y. 2019) ("'[U]nexplained inconsistency' makes the reinstatement of the rescinded provisions arbitrary and capricious.").
[191] Proposed Rule at 62,061.
[192] "When API challenged the 2016 Civil Penalty Rule, the challenge was rejected except as to § 1241.11(b)(5). API, 366 F. Supp. 3d at 1310. Because § 1241.11(b)(5) was invalidated through a judicial proceeding and ONRR is not pursuing a review of this portion of the Court's ruling in API's ongoing appeal, ONRR proposes to remove the paragraph from the 2016 Civil Penalty Rule." *Id.* at 62,062.
[193] API v. U.S. Dep't of Interior, No. 18-8070, 823 Fed. Appx. 583 (10th Cir. Aug. 5, 2020).

For all of the foregoing reasons, ONRR should not finalize the proposal. If you have any questions, we can be reached at 212-998-6239 or bethany.davisnoll@nyu.edu.

Sincerely,

Julia Bruce
Bethany Davis Noll
Brittany Shaar

APPENDIX

These documents were submitted to the record separately.

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17.	Transporting Oil & Natural Gas, AM. PETROLEUM INST., https://www.api.org/oil-and-natural-gas/wells-to-consumer/transporting-oil-natural-gas (last visited Oct. 23, 2020)
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