Client Alert | December 05, 2019

BEATTY & WOZNIAK, P.C.
ENERGY IN THE LAW

Preliminary Ruling Confirms the Department of the Interior's Broad Authority to Value Federal Oil and Gas

By Jennifer Stoot

A recent preliminary ruling on the application of the new oil, gas, and coal valuation rules and a "Dear Reporter" letter that was issued on November 20, 2019, highlight significant financial and operational implications for the oil and gas industry. Lessees are responsible for submitting amended reports and additional payments by July 1, 2020, if applicable, under the New Valuation Rule for production and sales of all federal oil and gas occurring on or after January 1, 2017.

On October 8, 2019, the U.S. District Court for the District of Wyoming issued a decision that temporarily relieves coal operators from the Office of Natural Resources and Revenue's (ONRR) 2016 *Consolidated Federal Oil & Gas Federal & Indian Coal Valuation Reform Rule*, 81 Fed. Reg. 43338, (New Valuation Rule) used for calculating mineral royalty rates. The court found that Petitioners met the four elements for injunctive relief and concluded that the pre-2016 valuation methodologies for coal continue to control pending further litigation. The Court denied the Oil and Gas Petitioners' request to enjoin application of the New Valuation Rule to federal oil and gas. The decision and the court's order can be found here.

The New Valuation Rule presents a reformed calculation process for valuing oil, gas, and coal. The New Valuation Rule was intended to revise how royalty payments are calculated from energy production on federal and tribal land, with the stated goal of providing a fair price to taxpayers. These changes directly affect the amount of royalties owned to the federal government and tribal communities on oil, gas, and coal produced from onshore and offshore federal lands, and tribal lands.

Prior to *Cloud*, the valuation rule garnered considerable attention from industry, legal commentators, conservations groups, and the courts. In 2016, the Obama administration revised the valuation rule to require companies to pay market value price on royalties after extracting minerals on federal and tribal land. In early 2017, the Trump administration repealed the revised rule—reverting to the previous valuation method. On March 29, 2019, the Northern District of California re-implemented the 2016 revisions when it held the ONRR violated the Administrative Procedure Act by vacating the Obama era changes. Finally, on June 13, 2019, the ONRR issued a "Dear Reporter" letter announcing that the Obama era changes, i.e. the New Valuation Rule, applied to all federal oil and gas lessees and all federal and tribal coal lessees from January 1, 2017 forward and requiring full compliance by January 1, 2020.

Cloud is a temporary win for the coal industry as it immediately relieves coal operators from the burden of retroactively calculating royalties under the New Valuation Rule.

Conversely, the *Cloud* court declined to enjoin the New Valuation Rule standards for oil and gas operators. The New Valuation Rule therefore continues to apply to all federal oil and gas lessees from January 1, 2017 forward, and requires full compliance by January 1, 2020. However, the ONRR subsequently issued a November 20, 2019 "Dear Reporter" letter extending the reporting and payment deadline to July 1, 2020. Accordingly, lessees are responsible for submitting amended reports and additional payments, if applicable, under the New Valuation Rule for production and sales of all federal oil and gas occurring on or after January 1, 2017.

The New Valuation Rule and the Injunction

With respect to the federal and tribal coal calculations, the court in *Cloud* reached two main conclusions. First, the lessees' monetary costs necessary to comply with the New Valuation Rule, which are not later recoverable, constitute irreparable injury. Second, the agency actions taken to produce the New Valuation Rules are likely unreasonably outside the range of its statutory authority or unsupportable with a satisfactory explanation.

The *Cloud* court declined to apply the general rule that economic harm is normally not considered irreparable because it found that there was no adequate remedy to recover compliance costs under the New Valuation Rule. Therefore, the court appropriately ruled the lessees' unrecoverable compliance costs constitute irreparable injury.

Valuing Coal vs. Oil and Gas Under the New Valuation Rule

Under the New Valuation Rule, federal coal is valued based on an arm's-length sale or, if one is not available, the value of electricity generated from burning the coal. The court found two issues with valuing coal based on the sale of electricity. First, other factors, besides coal, potentially play a much larger role in determining the sales price of the end product. Second, coal may be delivered to a power plant and 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 the ONRR for royalty-calculation purposes. Considering both issues, the court rendered it impossible to value coal based on the price of electricity due to the lack of relationship between the two at the time the report to the ONRR is due. Therefore, the court concluded the ONRR's methodology for valuing coal is likely to be found contrary to law or arbitrary and capricious on the merits.

Conversely, the court in *Cloud* declined to enjoin the rule as applied to oil and gas. The Court held the New Valuation Rule was within the Department of Interior's broad authority to value federal oil and gas. Focusing on ONRR's justification, the court noted that under the New Valuation Rule, federal oil is valued according to the lessee's or affiliate's arm's-length sales of the commodity. 81 Fed. Reg. at 43373 (new 30 C.F.R. § 1206.101). If there is no associated arm's-length sale, then the lessee can use certain averages or region-specific marketplace spot prices to value their oil. 81 Fed. Reg. at 43373-74 (new 30 C.F.R. § 106.102). Federal gas follows a similar valuation process as federal oil under the New Valuation Rule. The Court determined that ONRR articulated a satisfactory explanation for changing the method used to value oil and gas produced from federal leases when calculating royalties.

In sum, the ultimate results of pending litigation on the New Valuation Rule stands to have significant financial and operational implications on the oil, gas, and coal industries.

For more information regarding the revised regulations, please contact Jennifer Stoot or Bret Sumner.