Institute for Energy Economics and Financial Analysis
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20 Fourth-Quarter Questions for Powder River Basin Coal Producers

No. 1: Can Alpha, Arch, Cloud Peak, and Peabody Turn a Profit on These Holdings?

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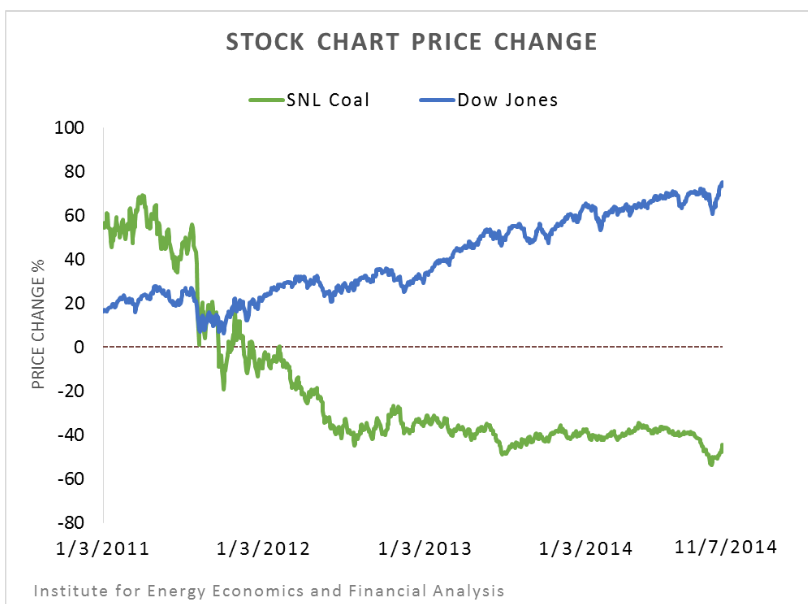
Introduction

This memo highlights the recent financial performance of the largest coal producers in the Powder River Basin (Alpha Natural Resources, Arch Coal, Cloud Peak Energy and Peabody Energy). It also presents several questions for each company about their likely fourth-quarter performance, their year-end financial status and their longer-term possibilities.

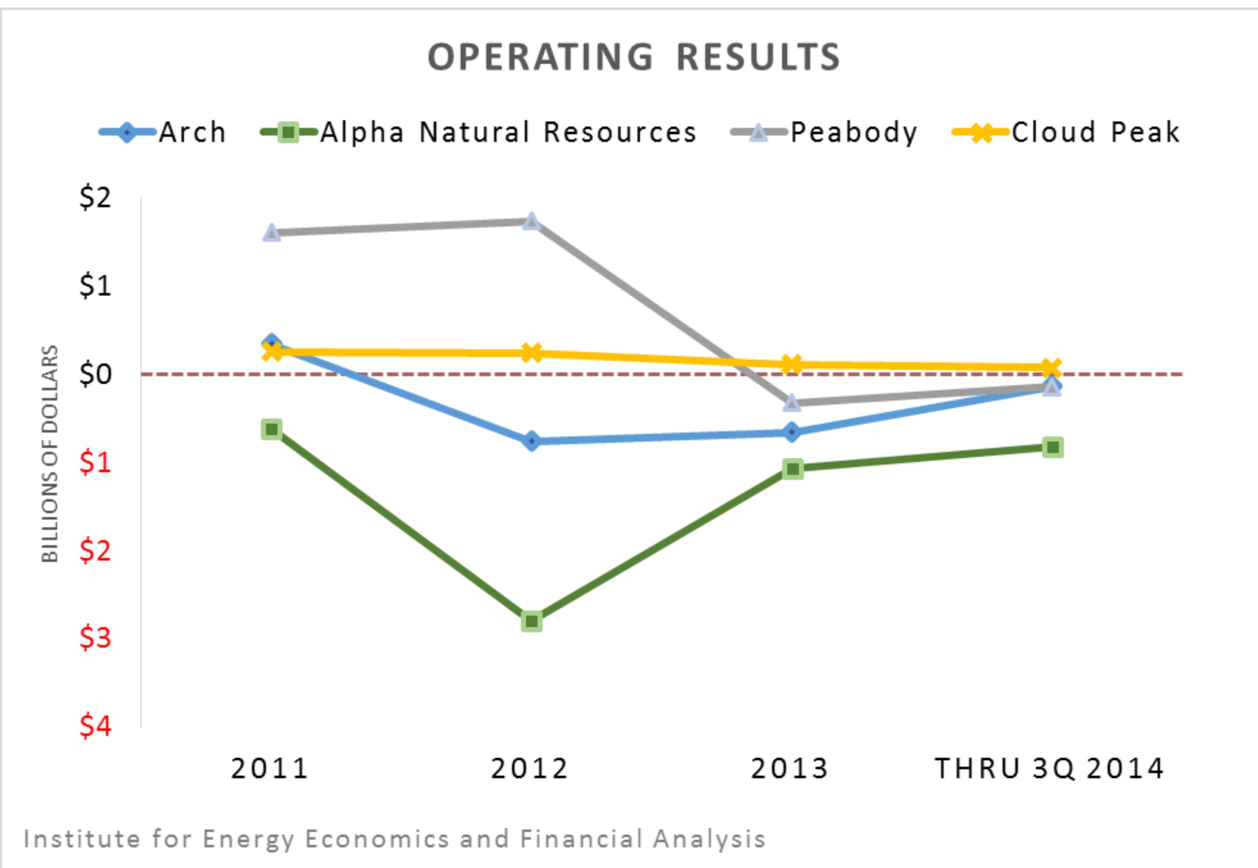
We focus on the Powder River Basin (PRB) producers because while they *should* be performing better than their peers elsewhere in the country in the current low-price environment, they aren't. We're interested also in these four producers because they carry a special element of risk tied to their controversial proposals to rely on export shipment through existing or expanded West Coast ports.

Third-Quarter Earnings Reports Indicate Another Dismal Year

While the overall U.S. stock market has risen dramatically since 2010, U.S. coal stocks have collapsed, and the U.S. coal industry is in its fourth year of decline. Third-quarter earnings reports show the trend continuing. The four largest producers in the Powder River Basin (Alpha, Arch, Cloud Peak, and Peabody) continue to see their stock prices drop as they report declining revenues, tighter margins, and distressed asset sales.



- Three of the four largest coal producers in the basin (Alpha, Arch Coal, and Peabody) are projecting overall losses for 2014. The third (Cloud Peak) will likely report shrinking profits for the fourth consecutive year.
- Two of the companies (Alpha and Arch) are facing multiyear losses: 2014 will be the fourth consecutive money-losing year for Alpha and the third consecutive years of losses for Arch.
- While Arch and Peabody appear to be losing less in 2014 than they did in 2013, Alpha will probably lose about the same amount this year as last, perhaps $1 billion (off of a revenue base of an estimated $4 billion).
- Three of four Powder River Basin producers estimate overall flat or declining coal sales in 2014. Only Peabody projects a production increase in the region.
- All four producers have reported declining revenues that range from 10 percent to 30 percent from 2011 through 2013. All four are on track for further year-to-year revenue erosion judging from their third-quarter 2014 results.
- Third-quarter numbers also show three of the four companies (Alpha, Arch and Cloud Peak) with flat or declining year-over-year margins on their Powder River Basin operations (Peabody is excluded here because it does not offer a transparent view of its Powder River Basin holdings).



Little True Likelihood of a Significant Turnaround

Some coal-industry executives argue for an inevitable turnaround in the coming years.[1] Other leaders and champions of the industry acknowledge the severity of its financial conditions, more in line with industry and government analysts who see weak prices through 2015 with little upside potential thereafter. The Institute for Energy Economics and Financial Analysis (IEEFA) and Carbon Tracker Initiative, in a major report released in September 2014,[2] for instance, have described a fundamental structural coal-industry change created by dramatic increases in the supply of natural gas, market incursion from renewable sources and the commensurate decrease in power prices.

Past down cycles have been followed by rebounds in coal prices following supply and demand rebalancing. This time the industry faces something historic — persistently low natural gas prices — a reality that caps the level of potential price improvement in U.S. coal markets. Coal prices can improve, but not by much, because low natural gas prices now present an ever-present source of competition.

Incremental coal price increases are unlikely to have a positive financial impact, in any case, given the level of debt and rising cost pressures within the coal industry. Similarly, the global economy's slow growth and national energy policy choices are decelerating the growth rate of coal use. This diminishes the likelihood that the U.S. coal industry can offset domestic loses with increased exports revenues.[3]

20 Fourth-Quarter Questions for Powder River Basin Coal Producers

We've posed a handful of questions below for each of the four major Powder River Basin producers in hopes of eliciting greater transparency from company officials regarding the current financial status of each company and the details of each company's coal reserves.

Four (4) for Alpha Natural Resources:

1. Given that the company's Central Appalachian thermal holdings are in a severe state of deterioration, will the company take further asset impairments?
2. Will it remove any mines from its proven and probable reserve listings as a result of the extraordinary weakness of coal markets?
3. Will the company take additional asset impairments in Powder River Basin as its margins there have all but disappeared?

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[1] While more subdued than in the past Arch and Peabody remain optimistic. See: Peter Marin, *OTC Market: Coal prices mixed with uncertain prospects ahead,* SNL, October 31, 2014.

[2] "Carbon Supply Cost Curves: Evaluation Financial Risk to Coal Capital Expenditures," September 22, 2014, http://www.carbontracker.org/report/carbon-supply-cost-curves-evaluating-financial-risk-to-coal-capital-expenditures/

[3] According to Arch's 3Q 2014 report, it is pricing contracted coal at $12.97 per ton in 2014 and $13.56 per ton for 2015. Cloud Peak currently sells its PRB product at an average contracted price of $13.04 projecting forward its 2015 contracts at $13.10 per ton and in 2016 $13.80 per ton. The current spot market price for PRB 8800 is $11.55 per ton; The Energy Information Administration Short Term Energy Outlook projects flat coal prices through 2015. USEIA, *STEO Coal Prices Current/Previous Forecast Comparison. U.S. Energy Supply and Demand Summary*, September 9, 2014. SNL Energy' Coal Price Forecast shows spot price improvements through 2015 and 2016 from current lows in the $11.50 per ton range to the $13.50 range. SNL's long term forecast through 2020 maintains coal prices just below $16.00. See: Jesse Gilbert and Steve Piper, *Coal markets are quiet as congestion issue show signs of easing*, SNL, November 6, 2014.

4. Considering that it is in its fourth consecutive year of losing money and that its losses in 2014 may reach $1 billion, what is the accounting and financial rationale for the company's plausibility as a going concern?

Seven (7) for Arch Coal:

1. Given that Arch has substantial debt payments from 2018 through 2021 and is banking on the success of it plans to participate in several Northwest export projects and a (now delayed) new mine and rail project at Otter Creek in Montana, how will Arch meet its capital-expenditure requirements in 2018 should those expansions occur?
2. As it faces its third consecutive year of losses, is Arch Coal a going concern?
3. Will Arch Coal take further asset impairments on its Central Appalachian holdings or its Powder River Basin holdings?
4. Will the company reduce its formal reserve levels in these holdings to reflect its inability to offer a plausible case for some of those mines, and will the company disclose which of its mines in the Powder River Basin are currently running at a loss, and discuss at what point and under what conditions the mines will turn around?
5. Does the company foresee one-year, two-year, five-year or ten-year losses on any of its mines in the Powder River Basin?
6. Is Arch Coal a truly viable partner in port deals with the other businesses and with state governments in Montana and Washington that are investing time and resources in planned coal-export projects?
7. While Arch Coal continuously plays up global coal demand, what can the company say are the concrete reasons for its assertions that it will be able to capture appreciable foreign demand for coal?

Four (4) for Cloud Peak:

1. What specific market condition would reverse the company's downward profit slide?
2. While a review of Cloud Peak's revenue and expense disclosures shows the company losing money on its exports sales generally, can the company say whether all transactions are losing money or just some of them?
3. Can the company say how long this slide might continue?
4. After the publication of a Thomas Reuters[4] news article on October 23 detailing how the U.S. Department of Interior plans to close a loophole used by Cloud Peak to avoid paying royalties for export sales, has the company determined how such a change would affect its profits and has it calculated its potential liability if the government decides also to collect royalties retroactively?

[4] Rucker, Patrick: Exclusive: U.S. plans to plug coal royalty loophole padding export profits, October 23, 2014.

Four (4) for Peabody Energy

1. Will Peabody take more asset impairments and further reduce the value of its mines in 2014?
2. Will Peabody delete from its list of proven and probable reserves in its Securities and Exchange Commission (SEC) statements any mines that are no longer economical and can it say which ones those might be?
3. Will the company disclose to investors which PRB mines are now running at a loss, how long it projects losses to continue and what assumptions regarding price and costs it is using to reach those judgments?
4. Given that the CEO of Prairie State Generating Company (a Midwestern power plant in which Peabody has a 5 percent, $250 million equity interest) disclosed in September[5] that the plant would continue to experience shakedown problems through 2017, and that Peabody has declared losses on the plant for 2012 and 2013 and is likely to declare losses again in 2014, will the company take an asset impairment reflecting the subpar performance of the plant since it began commercial operation in 2012 and its projected suboptimal performance through 2017?

One (1) for Alpha, Arch, Cloud, and Peabody collectively:

1. Are your coal holdings in the Powder River Basin a going concern and, if so, can you make a transparent and persuasive case for them?

[5] Prairie State Energy Campus, *2014 Update: 2015 and 10 Year Budget Strategic Overview,* Slide 8, presented by Mark Gerken, PSEC to Paducah City Council, September 23, 2014.