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August 2019

Institute for Energy Economics and Financial Analysis
IEEFA.org

Proposed Navajo Acquisition of Bankrupt U.S. Coal Company Is an Ill-Timed Gamble

Plan to Buy Cloud Peak's Mines in Montana and Wyoming Comes as Powder River Basin Producers Face More Hard Times Ahead; NTEC Could Benefit From a Change in Leadership

Executive Summary

The pending acquisition by Navajo Transitional Energy Company (NTEC) of Cloud Peak Energy's core assets appears every bit as ill-advised as NTEC's aborted attempt earlier this year to buy the failing Navajo Generating Station and its coal. source, the Kayenta Mine.

NTEC is aggressively pressing ahead nonetheless, acting essentially as an independent company working at arm's length from the tribal government, even though NTEC is wholly owned by the Navajo Nation.

The agreement NTEC has put forth on Cloud Peak is fraught with financial risk, as NTEC would be buying into a sector in steep decline and a company badly battered by market forces. Cloud Peak is bankrupt because competition from larger producers is fierce and utilities are shifting rapidly away from coal-fired electricity generation, causing both its existing and potential customer base to shrivel drastically in recent years.

Cloud Peak's mines attracted only three bidders, at least one of which appears to be clearly unqualified. So NTEC is seeking to buy a company that few companies or investors want. If it were to complete the transaction, it would be putting hundreds of millions of tribal dollars at risk.

While NTEC says the deal would push its annual revenues past $1 billion, that figure is suspect. The company bases its projections on past Cloud Peak production and revenues rather than on likely future ones, and ignores the fact that Cloud Peak's revenue fell by $500 million over the past four years.

The proposed deal seems at its core to be the product of an outdated mindset among NTEC executives whose energy market expertise is increasingly limited, dictated as it is mainly by coal. The pending purchase of Cloud Peak may present an opportunity to reexamine the suitability of NTEC's current leadership.

A High-Risk Deal

Navajo Transitional Energy Company has agreed to buy Cloud Peak Energy, a bankrupt coal company that owns three mines in the Powder River Basin of Montana and Wyoming. The deal was approved by the bankruptcy court Aug. 19, but has not yet closed.

The move would entail a high-risk acquisition of assets concentrated in only one region and one type of coal—thermal coal—both of which have been under severe and increasing financial pressure for some time, the result of a fading customer base that has led to intense competition, extremely low margins and numerous bankruptcies as the U.S. coal industry declines across the board.

NTEC would be making a not-insubstantial investment in the failed company. Key items in the NTEC agreement[1] to purchase Cloud Peak include:

- Payment of $15.7 million in cash to Cloud Peak;
- Assumption of responsibility of a $40 million promissory note;
- Payment of a $0.15/ton royalty for five years to Cloud Peak on all coal sold from Antelope and Spring Creek mines and any coal in excess of 10 million tons per year at the Cordero Rojo mine;
- Payment of certain tax liabilities and coal-production royalties projected to total about $94 million as of the end of September;
- Assumption of $20 million in accounts payable; and
- Assumption of about $400 million in reclamation and lease bonds.

All told the acquisition puts NTEC on the hook for about $200 million at the outset and requires NTEC to pay Cloud Peak $7.5 million in annual royalties based on current production levels (production at all three mines has fallen markedly in recent years and will likely continue to fall but presently amounts to about 50 million tons annually).

Few Bidders, No Major Coal Producers Among Them

The degree of risk involved in NTEC's Cloud Peak purchase is evident in the small number of bidders for the assets—and in the absence of any major coal companies in the mix of interested parties.

Beyond NTEC, only two companies put in bids for Cloud Peak, and the seriousness of those bids is open to interpretation.

[1] U.S. Bankruptcy Court for the District of Delaware, "Cloud Peak Energy Inc., et al., debtors," Aug. 19, 2019.

One bid was submitted by Aspen Coal & Energy LLC, a Colorado company only incorporated in May. The company is affiliated with Tom Clarke, a Virginia businessman who made a similar bid to buy mines in Ohio and the Kemmerer Mine in Wyoming from bankrupt Westmoreland Coal several months ago. That bid was rejected by Ohio regulators because of concerns about mining violations by other Clarke-related entities, and it failed in Wyoming because of concerns about financing and his ability to cover the mine's reclamation costs. Clarke's bid in Ohio was blocked by the state's Department of Natural Resources over outstanding mining violations, and the bid for Kemmerer ended over financing issues.[2]

The only other bidder for Cloud Peak was Lighthouse Resources, a company best known for its long and unsuccessful battle[3] to open new coal-export terminals in the Pacific Northwest, a proposition that lacks financial viability[4] and that was recently dealt another setback when the courts affirmed Washington state's denial of permits for the Millennium Bulk Terminals proposal.

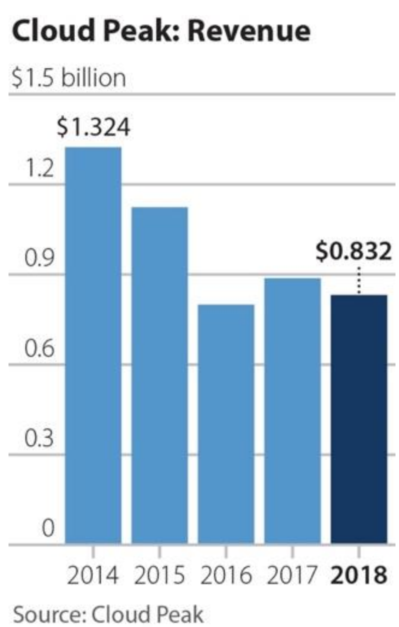
NTEC, in short, is proposing to buy a bankrupt coal company that almost no one else wants.

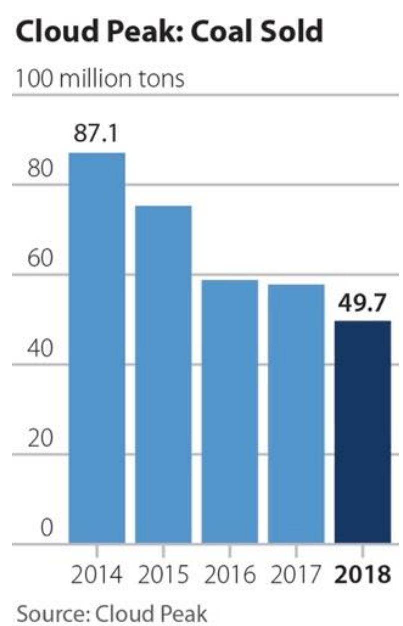
Questionable Revenue Projections

In its press release announcing the deal, NTEC asserted that the Cloud Peak acquisition will increase NTEC's revenues to more than $1 billion from its four mines (the three new Cloud Peak assets plus NTEC's existing Navajo Mine).

NTEC's depiction of Cloud Peak revenues may be accurate as far as recent production goes, but revenues in fact are expected to trend down in the years ahead.

In 2018, Cloud Peak generated $832 million in revenue, a 37 percent decline from 2014, when it reported $1.324 million in revenue (a reduction driven by market forces that have favored and that continue to favor fracked gas and renewables). Production is down even more, having dropped by 43 percent. The company—like other coal producers in the Powder River basin—is losing its customer





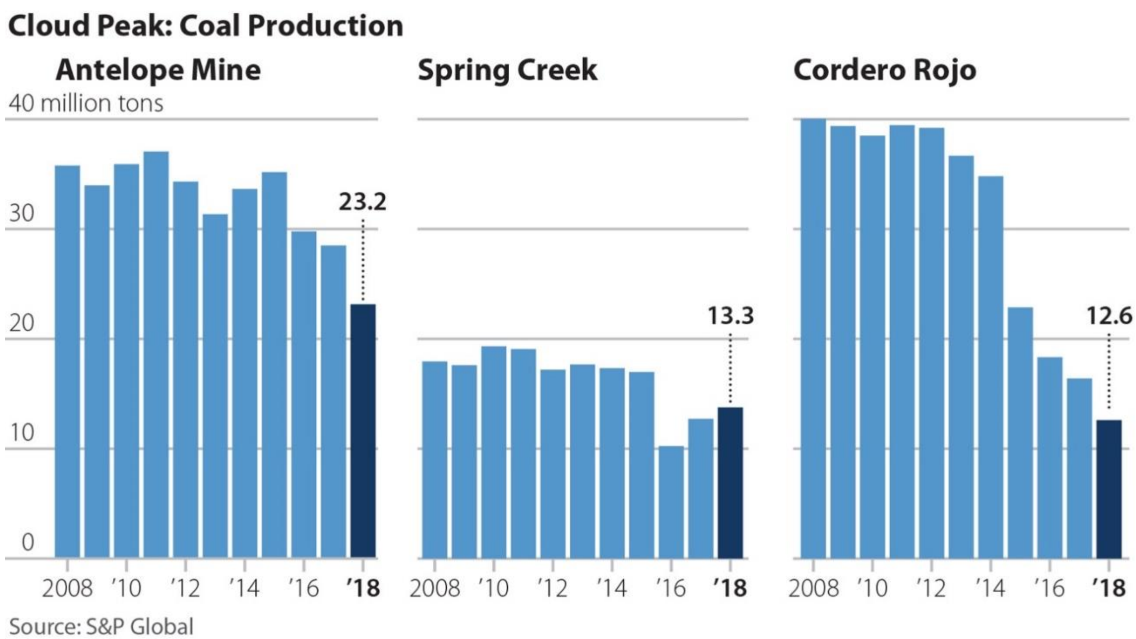
[2] Casper Star-Tribune, "Virginian that wanted to buy Kemmerer coal mine blames busted bid on creditors," May 2019.
[3] The Daily News, "Coal export facility project dealt another blow in federal lawsuit," April 2019.
[4] IEEFA, "Report: No Need for New U.S. Coal Ports: Data Shows Oversupply in Capacity," November 2014.

base as utilities shift to less costly fuels. IEEFA sees these trends continuing, and if NTEC were to succeed in acquiring the Powder River Basin assets, it would be buying properties that are likely to generate less revenue going forward.

Navajo Mine, NTEC's sole possession, sold 3.8 million tons of coal to the Four Corners power plant under terms that are not publicly disclosed. However, S&P estimates that the plant's fuel cost in 2018 averaged just over $52 per ton, which would push Navajo Mine revenues to just over $200 million.

All told—with Navajo Mine and Cloud Peak combined—NTEC's revenues would be just over $1 billion this year, but coal industry trends are working against the company, and production declines at the three Cloud Peak mines are likely to continue.

The Cordero Rojo mine has been the hardest hit of Cloud Peak's assets because the heat value of its coal is lower than that of Spring Creek and Antelope. Coal-fired electric generators have been moving away from this type coal, which has a heating value of 8,400 British thermal units per pound, and toward coals with higher heating values. The coal at both Antelope and Spring Creek is in the 8,800 Btu range. On this point, it is worth noting that Cordero Rojo has to compete with the Eagle Butte and Belle Ayr mines, which were just bought by Contura Energy following the bankruptcy of Blackjewel.



Beyond revenue issues are questions about NTEC's capability to run such a large enterprise.

The company's Aug. 19 press release touts its coal-mining expertise. "We have proven by our extremely successful management of the Navajo Mine that we know the business and are capable of returning the Cloud Peak mines to safe, stable and profitable operations while maintaining their excellent safety performance and reclamation efforts," the press release quotes NTEC's chairman and CEO, Clark Moseley, as saying.

But the reality is NTEC's experience even in coal is limited, consisting of an ownership role in the Navajo Mine, which has one customer, the Four Corners Power Plant.

NTEC was created in 2013 solely to take ownership of Navajo Mine.[5] Management activities at the mine are carried out by Bisti Fuels Company, a subsidiary of Dallas-based North American Coal Corporation (NACCO). NTEC's role is mostly as a ledger accountant. Navajo Mine was acquired by NTEC when its previous owner, the global energy company BHP Billiton, engineered an exit deal that in 2014 shifted ownership to NTEC. Navajo Mine, because it has no other customers, will close when Four Corners is retired. NTEC's other main holding is a 7 percent stake in the Four Corners plant; Arizona Public Service Company sold that share of the plant to NTEC after El Paso Electric Co. dropped out of the ownership pool in 2013 and sold its stake back to APS.

NTEC Executive Team Focused on the Past Instead of Planning for the Future

It appears that NTEC's executive team—whose members have mainly coal industry backgrounds—are unable to look beyond that sector of the electric generation business toward trends reshaping the industry. That old-school approach threatens to saddle the company, and the Navajo Nation as a whole, with serious financial liabilities.

Beyond its ownership of Navajo Mine and a small stake in the Four Corners generation plant that the mine serves, NTEC is known mostly for its campaign to buy the failing Navajo Generating Station (NGS) in Page, Ariz., along with the plant's fuel-source Kayenta Mine. That initiative was ill-advised on several fronts. IEEFA research found it "rooted largely in speculation and unsupported claims."[6]

The NTEC initiative failed this year when Navajo Nation elected officials voted not to indemnify the plant's utility-company owners against reclamation liabilities had NTEC bought NGS and Kayenta. Kayenta Mine is ceasing operations this month and NGS is closing in December.

NTEC pushed for those acquisitions, and is preparing its acquisition of Cloud Peak, in the face of a permanent structural decline across the American coal industry, as can be seen in the chart below. Any investment in the sector presents several layers of risk in both the near and long term.

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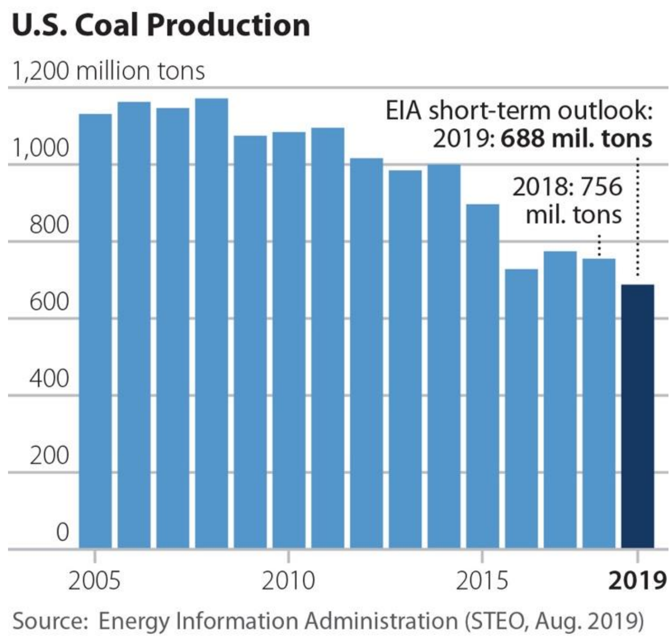
[5] 22nd Navajo Nation Council, "Navajo Nation Council approves formation of Navajo Transitional Energy Company, LLC to act on its behalf for BHP Navajo Mine acquisition," April 2013.
[6] IEEFA: "NTEC's Plant/Mine Acquisition Plan Puts Navajo Nation at Serious Financial Risk," February 2019.

Federal data shows U.S. coal-fired capacity peaked eight years ago, at 317,000 megawatts (MW). It has fallen every year since and last year totalled 244,000 MW,[7] a 23 percent drop since 2011. Coal-fired power generation has dropped from 50 percent of the total in the early 2000s to about 25 percent currently, and further decline is coming as cheaper and cleaner renewable energy and natural gas continue to take market share.

Further, Cloud Peak is up against competition from two much larger Powder River Basin producers, Arch Coal and Peabody Energy, that have joined forces in an operations-consolidation agreement for the companies' holdings in the Western U.S.

In the big picture, NTEC's proposed acquisition of Cloud Peak is a case of a small company with small assets buying another company with small (and distressed) assets. Cloud Peak is not a permanent going concern, and NTEC's ownership is not likely to change that.



NTEC would do well to reconsider the Cloud Peak deal. And Navajo Nation leaders may want to reconsider company leadership for the sake of consistency around the Nation's long-term goals[8] "to transition and prioritize clean renewable energy."

As it stands, the company appears to be operating without suitable policy guidance from above, with CEO Clark Moseley having asserted in a letter regarding NGS earlier this year that an agreement between the tribal government and NTEC "expressly bars the Nation from directing or interfering with NTEC's operations."[9] This despite stating in the same letter that NTEC is fundamentally underwritten by full "backstop from Navajo Nation."

Conclusion

Expert testimony in support of NTEC's bid for acquisition of Cloud Peak noted that NTEC brought several advantages to the table that the other two bidders lacked:

"NTEC was the only bidder with committed surety bonding, that NTEC's proposed

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[7] Reuters: "Factbox: U.S. coal-fired power plants scheduled to shut," August 2019.
[8] Navajo Nation: "Nez-Lizer proclaim clean renewable energy development as the Navajo Nation's top energy priority," April 2019.
[9] NTEC: "Dear NGS Participant," Feb. 25, 2019.

transaction offered the lowest relative credit risk, that NTEC demonstrated significant adequate assurance of future performance based on its experience as the owner of the Navajo mine and its historical performance, and that NTEC was the only bidder that required no third-party financing."

What none of the court-recorded testimony offered, however, was anything in the way of a business case for how NTEC would gain by buying—at any price—a distant and bankrupt coal company facing many difficulties.

A more forward-looking approach would have the company invest in the ongoing energy-sector shift that favors other, more sustainable forms of power generation—wind and solar, for instance—in the short and long term alike.

NTEC could benefit from installing an executive team more cognizant of and more willing to participate in evolving energy markets—one, in other words, with a modern outlook and more experience especially in the fast-growing renewable energy industry.

About IEEFA

The Institute for Energy Economics and Financial Analysis conducts research and analyses on financial and economic issues related to energy and the environment. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy. www.ieefa.org

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