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UPDATE: 'Zombie mines' and a 'slow-motion train wreck' — report analyzes coal's crisis

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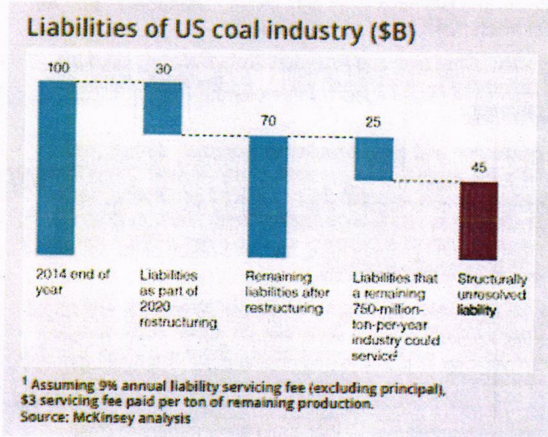
By Taylor Kuykendall

A November report from McKinsey and Co. warns the domestic coal industry is not just facing overcapacity, but also "crippling liabilities that will outlive mine closures."

McKinsey wrote in its report, "Downsizing the U.S. coal industry: Can a slow-motion train wreck be avoided?" that if the wounded industry wants to get back on a viable course, it needs to employ some new ideas. In a presentation, marked such that it indicated it was delivered to the National Mining Association in late-October, McKinsey outlined three paths for the sector but all lead to establishing a " smaller and healthier coal industry going forward."



[1] Assuming 9% annual liability servicing fee (excluding principal), $3 servicing fee paid per ton of remaining production.
Source: McKinsey analysis

"The United States has plenty of coal, but the world does not need it," the report begins. "By 2020, the convergence of low-cost shale-gas supply, environmental regulation, and waning international demand is likely to push demand for U.S. coal to at least 20% below what U.S. mines currently produce — which is already almost 20% below 2008 levels."

Luke Popovich, a spokesman for the National Mining Association, said the report was not surprising.

"The conclusions were sobering but not surprising or alarming I don't think," Popovich said. "CEOs know their business and market conditions by now can't conceal from anyone the fact that changes will be needed to align capacity with demand. Obviously, that is already occurring — not just in our industry but in the entire fossil energy sector."

Bruce Nilles, Sierra Club's Beyond Coal campaign director also was not surprised, saying this is just the "latest in a long line of reports" that show America shifting away from coal.

"As this shift takes place, it's essential that we help transition coal communities to other economic opportunities that provide long term stability, while also ensuring that coal workers receive the healthcare and pensions they spent their lives earning," Nilles said. "The federal government must step up and manage this process, in addition to making sure the funding is made available to clean up the toxic mining sites left behind by the industry. Coal workers and their communities were the backbone of America's industrial revolution and were crucial to the rise of American prosperity, as their industry declines, we must treat them with the gratitude and respect they deserve."

The report notes that the industry's woes are multifaceted — overcapacity, shrinking demand, "chronic indebtedness," environmental liabilities and insufficient profitability — a combination of factors that leads to an industry strictly limited in its freedom of maneuver. One particularly troubling issue noted by the report is that even if coal cuts capacity to balance supply and demand in 2020, producers still will be unable to service most of its approximately $70 billion of remaining debt and liabilities.

"A wide array of stakeholders is embroiled in this crisis, from mine workers and retirees to communities and state governments, from investors to pension funds and the holders of environmental claims against the mining companies," the report states. "We believe that the industry's financial difficulties — particularly its potential inability to support its liabilities after 2020 — are not yet broadly understood, and we hope that our analysis offers stakeholders a solid fact base to underpin their discussions about how to address the crisis."

Production output for the U.S. coal industry peaked in 2008 and the industry's profitability hit a high in 2011. A "massive contraction" in U.S. domestic thermal demand due to low natural gas prices and government regulation without a corresponding supply correction has led to a steep drop in earnings. McKinsey notes that the trends do not seem to be in reverse and suggests the industry adapts accordingly.

The largest change will be in Central Appalachia, a region perhaps most dependent on the coal industry. McKinsey's model suggests Central Appalachia demand would fall 48% by 2020 compared to 2014 and Northern Appalachia demand would fall almost 35%. Meanwhile the Illinois Basin is expected to take the lightest hit in terms of absolute and percentage reduction and the Powder River Basin would face about a 20% reduction in production volume.

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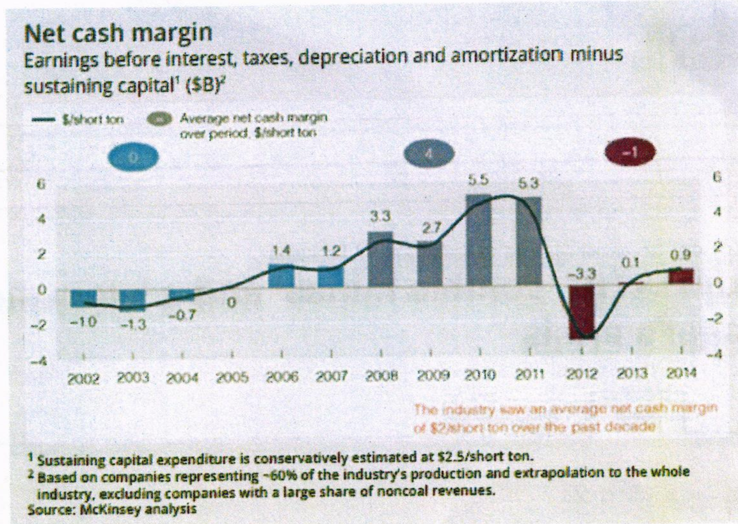
Even given that supply-demand balance, however, the industry is in trouble, McKinsey writes.

"Our company-by-company analysis shows that the industry's current liabilities rose to nearly $100 billion by the end of 2014," McKinsey states. "The largest piece of this is long-term debt (the value of which has tripled since 2008), followed by contractual obligations, asset-retirement obligations, and pension-funding obligations. Based on our analysis of the financial statements of all the major US coal producers, it costs the industry about $9 billion to $10 billion a year just to service these liabilities. This is equivalent to roughly $10 a ton of coal produced."

The report notes that many operating coal mines are not even breaking even, and even at the industry's peak profitability, it did not have the margins needed to service today's debt levels. McKinsey said the big issue is that coal companies are failing to shut mines down fast enough because it costs too much compared to the price of running unprofitable tonnage.

"The result is that the United States is home to a collection of 'zombie mines' that cannot turn a profit but are too costly to close," the report states.

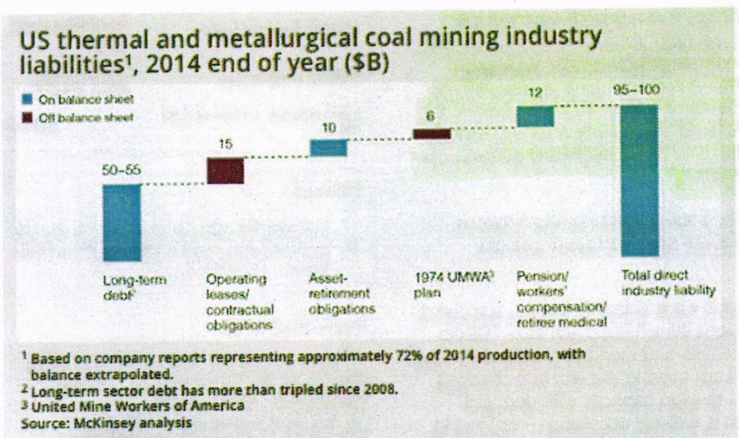
According to the report, even if the industry cut its production by 225 million tons it would only be able to service about $25 billion of its debt liabilities, leaving $45 billion uncovered.



[1] Sustaining capital expenditure is conservatively estimated at $2.5/short ton.
[2] Based on companies representing ~60% of the industry's production and extrapolation to the whole industry, excluding companies with a large share of noncoal revenues.
Source: McKinsey analysis

"The coal industry faces some hard choices, whether or not players collectively realize it," the report states. "While harsh capacity cuts are normally viewed as the tough but surefire way that an industry can turn its situation around, that is not the case for the U.S. coal industry."

In a recent interview with SNL Energy, Gary Broadbent, a spokesman for leading coal producer Murray Energy Corp. described the report as showing "that the coal industry, as a whole, taking all producers together, is now bankrupt."



[1] Based on company reports representing approximately 72% of 2014 production, with balance extrapolated.
[2] Long-term sector debt has more than tripled since 2008.
[3] United Mine Workers of America
Source: McKinsey analysis

"Only three of America's leading coal companies are currently demonstrating positive cash flows, and two have large debt levels," Broadbent said. "As such, we expect much more restructuring to come."

Murray Energy CEO, Chairman and President Robert Murray cited the findings of the report in a recent speech written for the Public Utilities Fortnightly Conference.

"Today's coal production and sales situation is extremely dangerous," Murray wrote. "It is the worst that I have seen in my 58-year career," Murray said. "Our customers cannot dispatch their coal-fired generating plants because of ever-increasing regulations against them and coal from the Obama administration and his supporters, and as a result of the increased use of natural gas to generate electricity."

McKinsey was not optimistic about coal companies' strategies. The report predicts the industry moves along in "business-as-usual" form, "bumping along the bottom" as long as possible and hoping there is a major demand rebound. In that scenario, the best-case for the industry is more Chapter 11 bankruptcies — a path traveled by Patriot Coal Corp., Walter Energy Inc. and Alpha Natural Resources Inc. — that could allow miners to close unprofitable mines and restructure debt.

The group suggests a "coordinated approach inside and outside the industry" including stakeholders such as unions, employees, communities, competitors, service suppliers, capital providers, government bodies and legislators. The report also warns the industry should be careful in its coordinated approach.

"Mining companies should be careful to consult with legal counsel to make sure this is done in a manner consistent with antitrust and other laws," the report states. "The industry would also need to think carefully about how feasible this approach might be given political challenges — and recognize that such collective action requires a level of coordination that is exceedingly difficult to achieve once an industry is in such deep trouble."

Article revised at 2:25 p.m. on Dec. 8, 2015, to include comment from the Sierra Club. Article revised at 3:35 p.m. on Dec. 8, 2015, to remove a reference the report had been commissioned by a member of the National Mining Association after a representative of the organization said he misspoke on the matter.

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