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Reclamation Bonding
For The Coal Mining Industry

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Issues Affecting Reclamation Bond Capacity In The Surety Industry

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Surface Mined Land Reclamation Technology Transfer Seminar

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RESUMÉ

- Quanta Surety
  - » Vice President, Regional Underwriting Officer
  - » National Practice Leader – Mining Industry

  - – 13+ years of underwriting responsibility for reclamation bond programs for coal mining companies.
  - – Actively involved in underwriting mining operations in all major mine regions in the U.S. as well as several areas outside the U.S.
  - – Actively involved with the task force sponsored by the NMA and IMCC evaluating how to increase Surety capacity for the mining sector.

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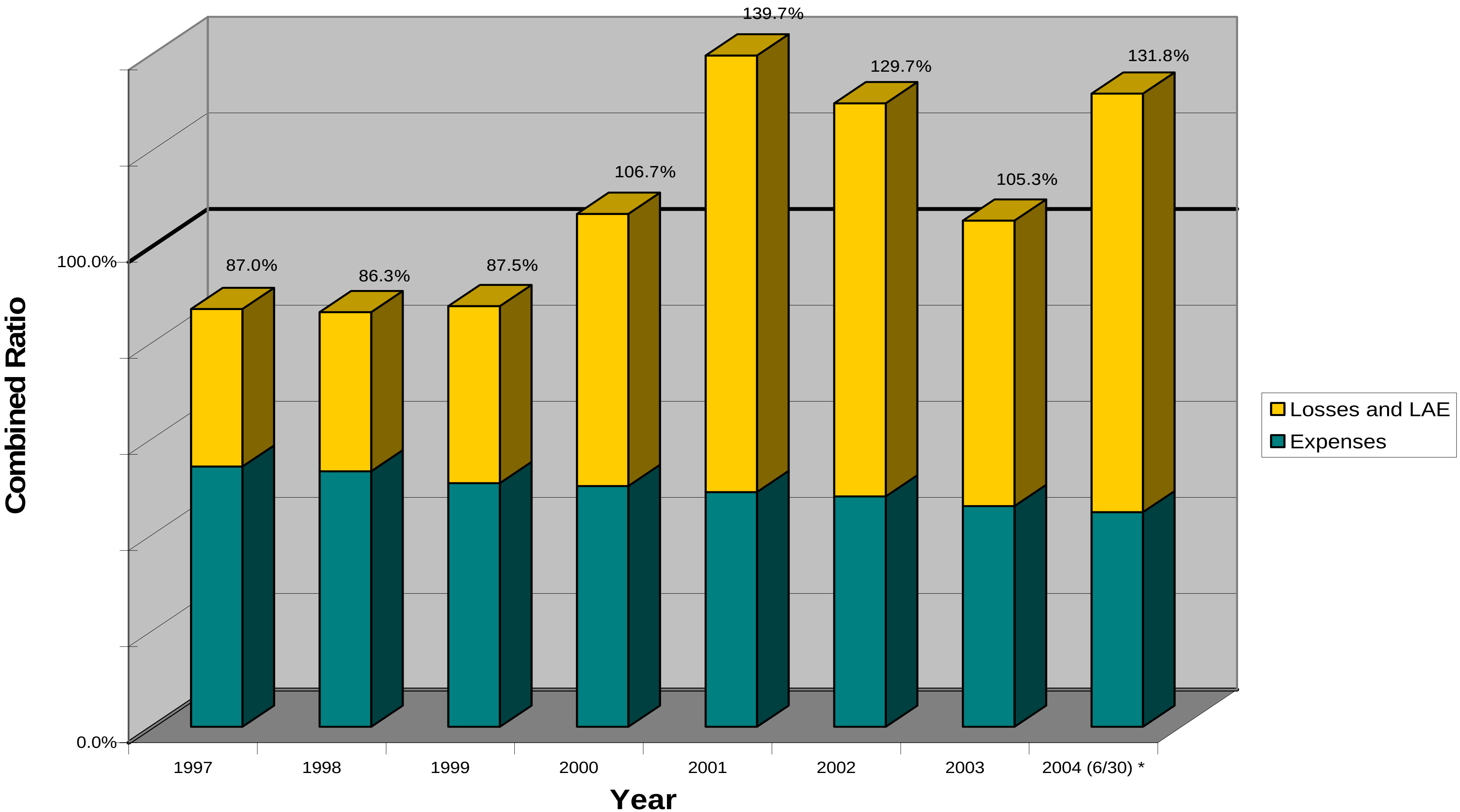
Outline

- Overview of Surety Industry Results
- Factors Impacting Surety Industry Results
- Surety Industry Response
- Comparison Of Overall Surety Results To Reclamation Results
- Why Has Surety Capacity Left The Reclamation Bonding Market
- How Do Surety Companies Evaluate Mining Companies And Reclamation Bond Risk
- Making Yourself ‘Bondable’

Surety Industry Combined Ratio

1997 - 2004



** 2004 data is through June 30 and includes assumptions for LAE and Underwriting Expenses*

Source: The Surety Association of America

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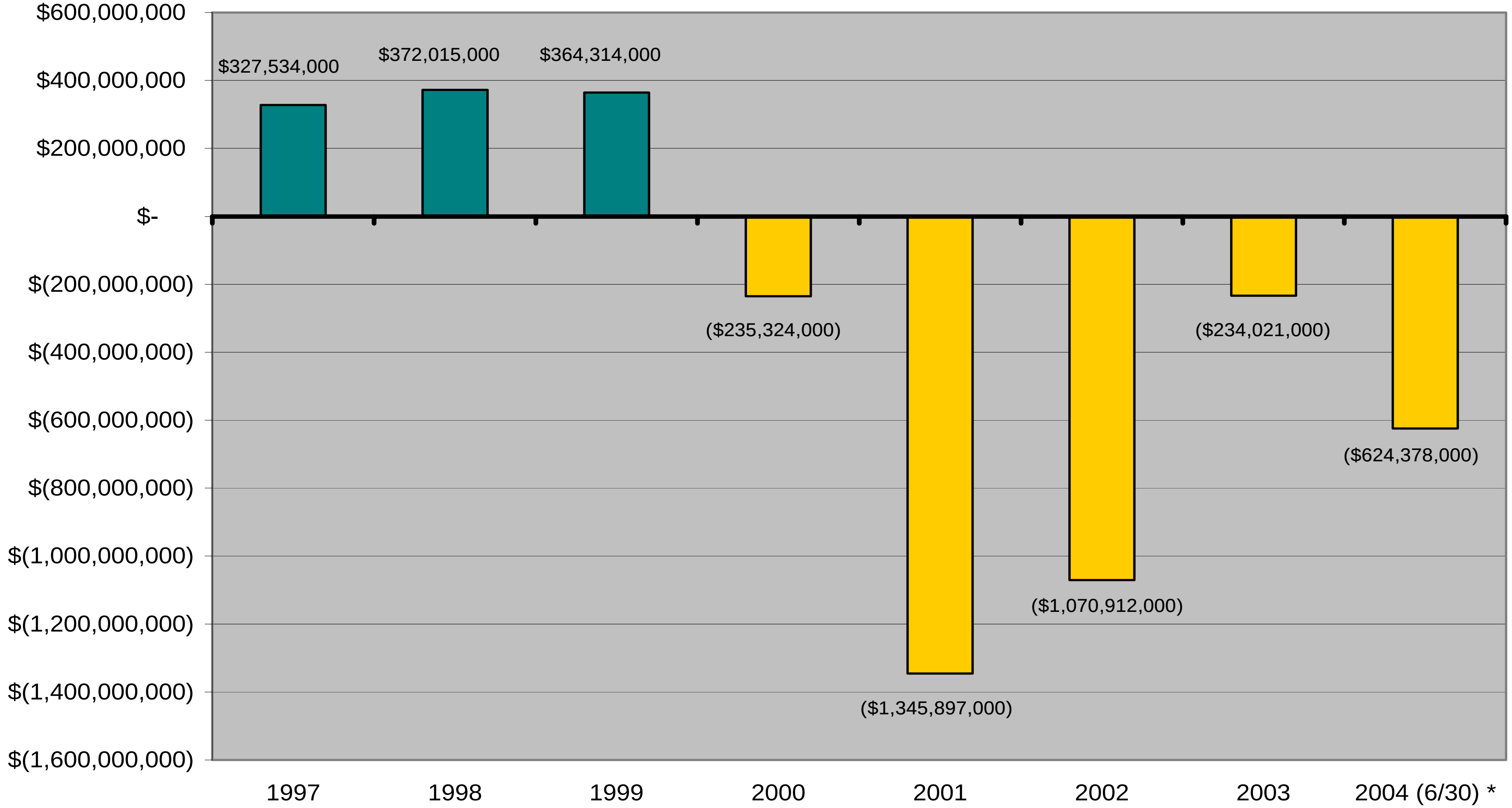
Surety Industry Pre-Tax Underwriting Profit (Loss)

1997 - 2004



Total Underwriting Loss Since 1997: **$2,446,668,500**

** 2004 data is through June 30 and includes assumptions for LAE and Underwriting Expenses*

Source: The Surety Association of America

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What Happened?

- Isolated Industry Issues
    - Healthcare
    - Discount Retail
    - Technology
    - Energy: Traders, Merchant Power
    - Coal Mining
- Asbestos
- Inadequate risk assessment, collateral and pricing
- Risk aggregation to individual credits
- Lack of awareness of capital requirements

Industry Response

Reinsurance Underwriters

- CAPACITY
  - A number of surety reinsurers exited the business over the last several years.
  - Remaining markets generally are taking more substantial positions on fewer primary companies.
- TERMS
  - ***MORE EXPENSIVE.***
  - Higher attachment points/ greater “risk sharing”.
  - Commitments from primary sureties as to maximum program offerings.
- EXCLUSIONS
  - Increased exclusion list by type of obligation.
  - Exclusions to reduce aggregation risk with individual accounts.

Industry Response

Primary Underwriters

- Voluntary changes (driven by Surety Management)
  - Heightened focus on managing portfolio of risks.
  - Exiting unprofitable or "high risk" sectors within the Surety industry (AIG, CNA).

- Involuntary changes (driven by P&C Management and/or Reinsurers)
  - Exiting surety business outright (Lyndon/Cumberland Surety, Fireman's Fund, Lincoln General)
  - Heightened focus on managing portfolio of risks.
  - Exiting unprofitable or "high risk" sectors due to lack of reinsurance support.

- Insolvency
  - Amwest, Atlantic Mutual, Frontier, Kemper, Van American

- Consolidation [1]
  - 1995 – Top 10 Sureties accounted for 52.3% of direct written premium.
    Largest Surety accounted for 6.6% of total market share.
  - 2003 – Top 10 Sureties accounted for 65.9% of direct written premium.
    Largest Surety [2] accounted for 26.1% of total market share.

[1] Source: The Surety Association of America

[2] *Includes the direct written premium from the recently merged Travelers and St. Paul surety operations.*

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Portfolio Management Techniques

- Information-based approach
- Recent emphasis: Model each deal as a credit obligation to assess price adequacy and capital needs
- Components:
  - Credit rating – external / internal
  - Frequency and Severity Parameters by Bond Type
    - Likelihood of a claim given a financial default
    - Average payout as a percentage of limit given a claim
  - Expected duration
  - Collateral
  - Expenses
  - Required ROC

Reclamation Bond Results

U.S. Totals, 1999 – 2003

(SAA Class Codes 933 & 450)

	State	Direct Written Premium	Direct Earned Premium	Direct Losses Incurred	Loss Ratio
2003	U.S.	$ 66,298,532	$ 61,523,692	$ 26,039,232	42.3%
2002	U.S.	$ 56,308,587	$ 47,813,223	$ 11,354,581	23.7%
2001	U.S.	$ 37,720,695	$ 34,334,654	$ 13,194,995	38.4%
2000	U.S.	$ 29,422,915	$ 29,190,556	$ 11,459,795	39.3%
1999	U.S.	$ 23,197,037	$ 28,969,220	$ 7,823,128	27.0%
1998	U.S.	$ 30,956,730	$ 31,479,679	$ 20,299,307	64.5%
		$ 243,904,496	**$ 233,311,024**	**$ 90,171,038**	**38.6%**

Source: The Surety Association of America

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Reclamation Bond Results

Top 15 Coal Mining States
1999 – 2003 Combined

State	Direct Written Premium	Direct Earned Premium	Direct Losses Incurred	Loss Ratio
Kentucky	$ 24,692,520	$ 24,765,569	$ 19,376,687	**78.2%**
Wyoming	$ 19,111,375	$ 17,665,230	$ 8,932	**0.1%**
Pennsylvania	$ 18,133,301	$ 18,854,299	$ 7,491,750	**39.7%**
West Virginia	$ 15,097,993	$ 14,254,994	$ 2,314,266	**16.2%**
Texas	$ 11,445,107	$ 8,731,160	$ 119,382	**1.4%**
Virginia	$ 11,048,060	$ 10,253,769	$ 29,042	**0.3%**
Illinois	$ 9,635,669	$ 8,840,113	$ 60,484	**0.7%**
Ohio	$ 9,215,771	$ 9,339,586	$ 4,957,322	**53.1%**
Indiana	$ 8,930,029	$ 9,279,573	$ 702,093	**7.6%**
Montana [1]	$ 7,590,260	$ 7,062,143	$ -	**0.0%**
Arizona	$ 7,323,604	$ 5,338,962	$ 5,424	**0.1%**
Colorado	$ 7,210,394	$ 7,014,238	$ 1,466,726	**20.9%**
Utah	$ 4,118,578	$ 4,058,463	$ 1,609,030	**39.6%**
North Dakota	$ 2,545,015	$ 2,225,098	$ -	**0.0%**
New Mexico	$ 2,511,217	$ 2,881,856	$ -	**0.0%**
	$ 158,608,893	**$ 150,565,053**	**$ 38,141,138**	**25.3%**
U.S. TOTAL	$ 212,947,766	$ 201,831,345	$ 69,871,731	34.6%

[1] MT loss ratio = 259.9%. $18.4 million in losses believed to be non-coal.

Source: The Surety Association of America

Reclamation Bond Results

Indiana

1999 - 2003

	State	Direct Written Premium	Direct Earned Premium	Direct Losses Incurred	Loss Ratio
2003	Indiana	$ 2,341,376	$ 2,255,745	$ 255,194	11.3%
2002	Indiana	$ 2,207,713	$ 2,135,603	$ 28,747	1.3%
2001	Indiana	$ 1,873,206	$ 1,758,469	$ 27,207	1.5%
2000	Indiana	$ 1,522,946	$ 1,385,674	$ 22,444	1.6%
1999	Indiana	$ 984,788	$ 1,744,082	$ 368,501	21.1%
		$ 8,930,029	**$ 9,279,573**	**$ 702,093**	**7.6%**

Source: The Surety Association of America

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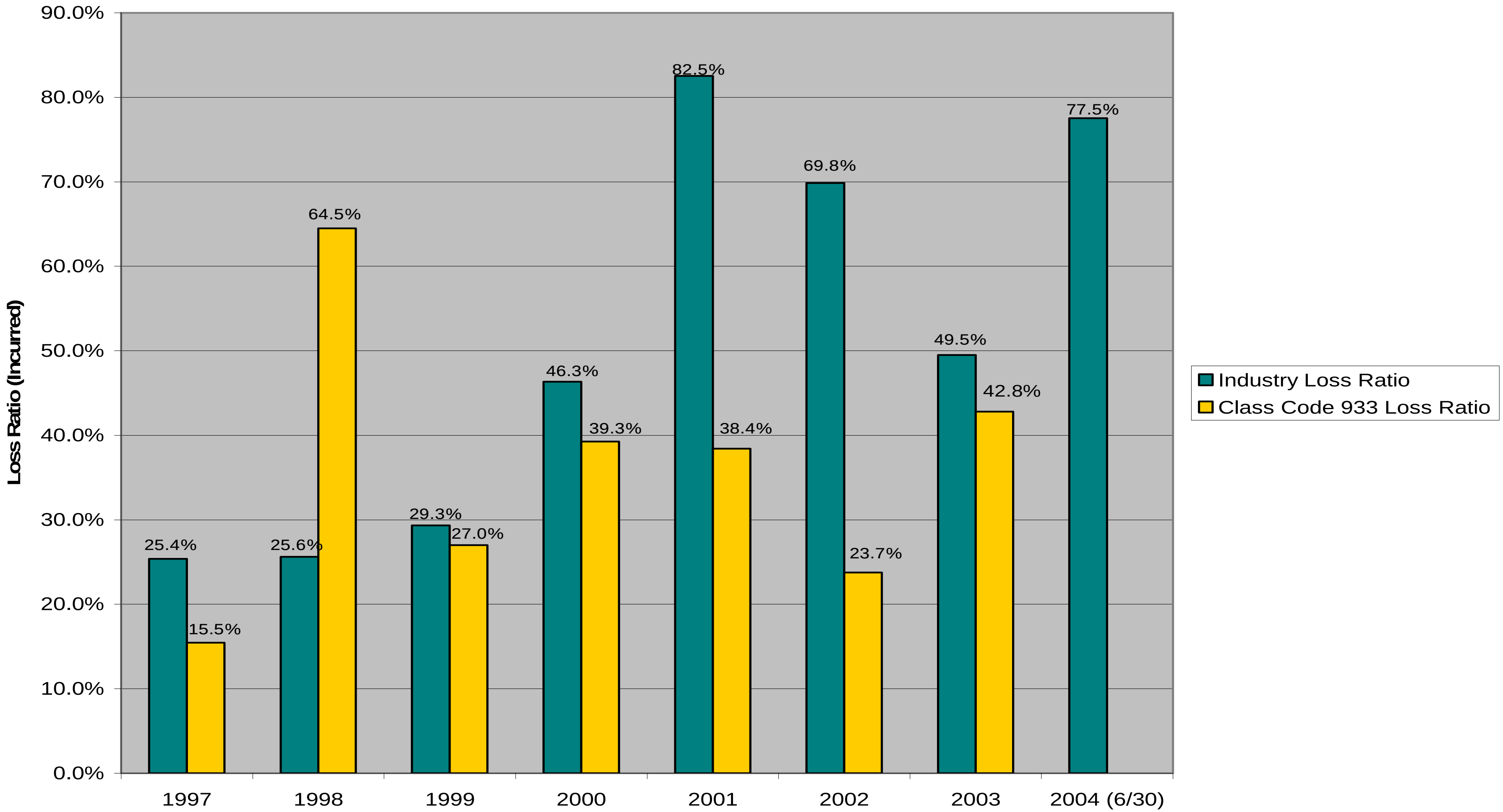
Loss Ratio Comparison
Industry vs. Reclamation
1997 - 2004



** Loss ratio excludes LAE*

** 2003 Class Code 933 Loss Ratio data is preliminary*

Source: The Surety Association of America

Issues Affecting Reclamation Bond Capacity For Coal Mining Companies

- Most surety companies do not have the expertise to evaluate mining companies and therefore are not comfortable assessing reclamation bond risk.

- Mining industry is capital intensive, generally resulting in significant balance sheet leverage and material capital maintenance expenditures.

- Surety insolvencies, mergers and strategic retrenchments have reduced the number of companies entertaining reclamation bond submissions. Remaining markets have industry aggregation issues.

Reclamation Bond Positives

- Surety is bonding an asset of the company.
- Regulatory protections afforded through SMCRA, ***if enforced***, minimize risk of default on the bond and severity of default in a claim situation.
- Actual exposure is frequently less than the penal sum of the bond.

Underwriting Criteria

- Asset Quality
- Financial strength
- Operational Strength
- Indemnity and Collateral

Asset Quality Evaluation

- Quantity of reserves
  - Tonnage of economically mineable reserves (surface vs. deep)
  - Strategy for future reserve acquisition
- Quality of reserves
  - BTU, sulfur content, ash content, moisture content
  - Ability to blend different reserves
  - Ability to source multiple contracts
- Competitive advantages to reserves
  - Proximity to customers, proximity to transportation routes
- Existence of perpetual water treatment issues
- Contract strategy
  - % of production contracted vs. % sold via spot market
  - Reliance on one major customer?
  - Contract duration(s)

Financial Strength Evaluation

- Balance sheet quality
  - Asset quality – liquidity, quality of receivables, intangibles
  - Liabilities – leverage, existence and amount of long-term retiree benefits
  - Equity – common vs. preferred, retained earnings
- Track record of profitability
  - Operating profits and bottom line profits
  - Ability to make money in all markets
- Operating expense structure and operating expense trends
  - Mine by mine profitability and cost control
  - Break-even analysis
- Free cash flow analysis
  - Operating cash flow – cap ex - dividends (excluding for taxes)
  - Surety view of EBITDA
- Equity position relative to bonded liability

Operational Strength Evaluation

- Strength/ depth of management
  - Senior operational and financial management
  - Mine site management
- Review continuity/business perpetuation plan
  - Buy-sell agreements
  - Key-man life insurance
  - Ownership/ “golden handcuffs” for key personnel
- Evaluate quality of reclamation
  - Mine site visits to view quality of work and to confirm contemporaneous reclamation
  - Reclamation awards received

Indemnity and Collateral

- Personal indemnity of stockholders (and spouses if appropriate) is required for all private companies
  - Surety is undertaking a non-cancellable obligation that could be in place for 10+ years. Expect owner(s) to provide their guarantee.
  - Any stockholder with 15% or greater ownership must sign.
  - The need for spousal indemnity will be evaluated in each case.
- 100% collateral will be required for any permit with AMD/ perpetual water treatment issues
  - Regulatory bodies have indicated bonds will not be released.
  - Not “IF” there will be a claim, but “WHEN” there will be a claim.
- Collateral is used to mitigate some of the increased risk when operators lack in one or more critical underwriting areas
  - Discuss what your surety would need to see before they would consider unsecured capacity.
  - Formal commitments are unlikely.

SUMMARY

- Treat an underwriting meeting as an opportunity to educate your underwriter.
  - Don't assume we understand your business.
- Understand your surety's point of view
  - Sureties have very little margin for error as surety premiums contemplate a 0% loss ratio.
  - No business ever sets out with a plan to fail, but a surety underwriter must assess what could lead to business failure and structure a program that protects the surety.
- Treat your Surety like a partner
  - Discuss your view on your company's strengths **AND** weaknesses and how you plan to address those weaknesses.
  - Share business plans and financial forecasts and advise your surety as those plans are updated.
  - We prefer to hear about bad news, not read about bad news.
- Know your Surety
  - Financial strength
  - Underwriting approach to reclamation bonding