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CLERK, US BANKRUPTCY COURT
EASTERN DISTRICT
ST. LOUIS, MISSOURI-MR

Your Honor,

My name is Richard A Rice. I worked for Peabody Coal Co. for 37 1/4 years at Peabody #2 mine at Shawneetown, Il.

In January of 2006 I was forced to retire due to the fact that there was no more work at the mines. I never in my 37 1/4 years ever worked Patriot Coal Co.

Since retiring I have had 3 major surgeries, knee replacement and 2 neck surgeries. I take 9 different medications daily.

My wife has had several surgeries, has 4 different Arthritis, has been diagnosed with non-alcoholic Cirrhosis of the liver stage 3 due to medication for pain and Arthritis. She takes 10 different medications daily.

If the law suit with Patriot Coal would happen to go through, it would be a devastating blow to our family.

I worked all my life thinking that I would have retirement and health care for the rest of my life.

I came across this article by Bruce B. Rader Ph.D., CFA. He is a professor at Temple University.

I would be very much obliged if you would take time out of your busy schedule to read this article. I found it very interesting and hope that you will too.

Thank You very Much
UMWA Local 1602 member

Richard A Rice

Designed to Fail

(The Case of Patriot Coal)

By Bruce B. Rader, Ph.D., CFA

A New Moral Hazard

During the financial meltdown of 2008 and 2009, the term "moral hazard" was frequently in the news, often attached to a headline with some variation of the question "Is capitalism dead?" The issue posed five years ago was: Does capitalism work if firms, such as banks and insurance companies, aren't allowed or are too big to fail? In this paper, I discuss another threat to capitalism, a moral hazard of a different sort. I am referring to firms that are created to fail as a means of wiping out liabilities and responsibilities to employees and retirees. In particular, I focus on a five-year old company, Patriot Coal, and the companies that created the Patriot spin-off and scheme.

Responsibility is a Cornerstone of Capitalism

In the Business School at Temple University where I serve on the faculty, we teach that free-market capitalism is based on the idea that competition is essential to the efficient allocation of capital. I suspect the same principle is taught at every other business school and economics program in the country. Most economists agree that the following conditions are necessary free-market capitalism to work: transparency, minimal government interference, property rights, and responsibility.

Responsibility is one of the driving forces in free-market capitalism. If I act, the force of responsibility dictates that I suffer the benefits and the consequences of my actions. Today, this principle is under the attack of legal manipulation and obscured by a corporate vale that can void responsibility's adverse consequences or transfer the consequences of actions or agreement to the general public. When an individual (these days some define corporations as such) who assumes a business risk, can transfer the negative consequences of his risk to another entity but still reap the benefits, he will be inclined to excessive risk-taking, resulting in negative societal consequences.

Gaming the System

Throughout the history of capitalism, we have seen individuals and corporations "game the system." Market manipulation and exploitation aren't new concepts. The stories about the robber barons and trusts of the last century, for example, are legendary. In recent years, we have seen "fixed decks" being shuffled time and time again on a grand scale and a new era of corporate greed threatens the stability of our society. The poker game our banking system became, which was revealed in 2008-2009, is a perfect example.

One manipulative scheme that is particularly problematic, because it takes advantage of the old and the infirm, is a move to use bankruptcy as a tool to eliminate promised pensions and retiree medical benefits. These retiree benefits aren't luxuries; they are contractual agreements between an employee and a company and can be thought of as deferred compensation packages. For example, coal miners at Peabody Energy and other coal companies with retiree healthcare benefits took fewer vacation days and often made lower wages as a trade-off that funded the retiree benefit. An individual who spends years or decades laboring for an employer has earned these benefits. Failing to honor these obligations is morally reprehensible.

The bankruptcy laws of the United States are generally designed to protect assets, not people. Workers and retirees have long suffered as a result of bankruptcy decisions. But the manipulation of bankruptcy by business to reduce labor costs is different today. We now see companies like AMR (American Airlines) declare bankruptcy while possessing $4 billion in cash on their books, hardly bankrupt by most people's definition. We see companies, such as Patriot Coal, that have been created just to go bankrupt. Patriot was the spin-off of two very rich multi-national corporations including Peabody Energy. Peabody is a company far from financial bankruptcy, although its action might be considered by some to show a degree of moral bankruptcy.

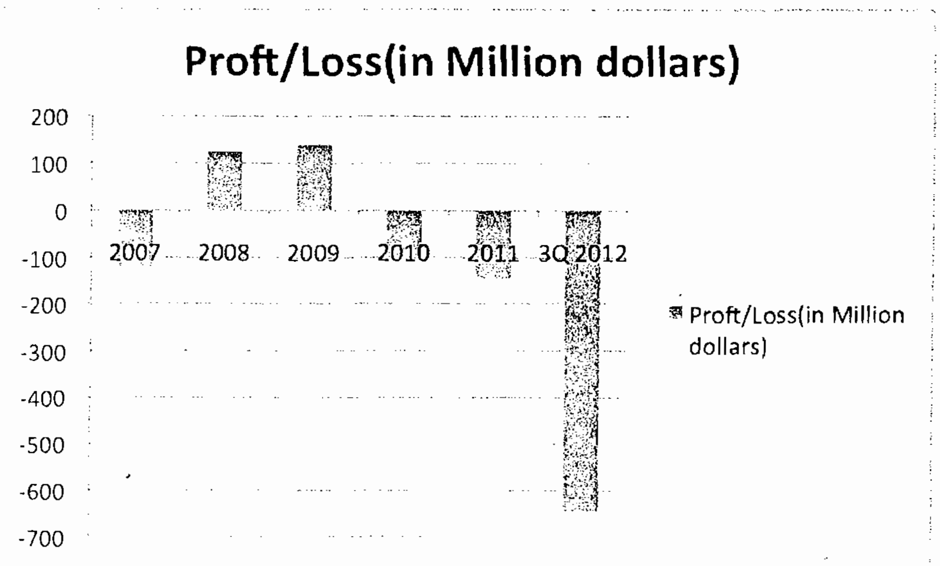
The History of Patriot Coal

Peabody, and to a lesser degree Arch Coal, transferred certain assets and liabilities from their U.S. mining operations to Patriot Coal, created by Peabody for this purpose beginning in 2007. At the time of the spin-off, Peabody Energy kept estimated coal reserves of 8,228 (2007) million tons and Patriot Coal is estimated to have absorbed

1,262 million tons*. In other words, Peabody transferred 13.3% of its coal reserves to Patriot Coal. "Our Health Care Liability and related expenses will be reduced by 40%.... In total our legacy liabilities, expenses and cash flow will nearly [be] cut in half," the Peabody CFO said at the time. One of the primary reasons for the spin-off, according to this statement, was to unburden Peabody Energy of its retirement health liabilities for approximately 8,400 former employees (retirees) of Peabody Coal.

In 2008, Patriot Coal acquired Magnum Coal, which added additional estimated reserves of 607 million tons. In the process it gained the legacy obligations of Magnum Coal, which represented approximately 2,300 retired employees. Magnum Coal was an offshoot of Arch Coal and received its post-retirement obligation from Arch Coal. This left Patriot Coal with approximately $1.37 billion in liabilities according to Patriot's 10Q for the third quarter of 2012.

Looking at the financial statements in 2007, Patriot Coal shows a loss of approximately $122 million. The profit in the years 2008-2011 was respectively, (rounded to the millions) $126 million, $140 million, $-109 million and $-145 million. The loss for the first half of 2012 is reported as $430 million of which $358 million is asset-retirement expenses. These expenses recognize the obligations for reclamation related to the closure of mining properties and the increased obligation related to selenium water treatment. This led to the bankruptcy filing of July 09, 2012. These losses continued in the third quarter with a loss of $216 million. This brought the loss in the first 9 months of 2012 to $646 million. This is represented graphically below:

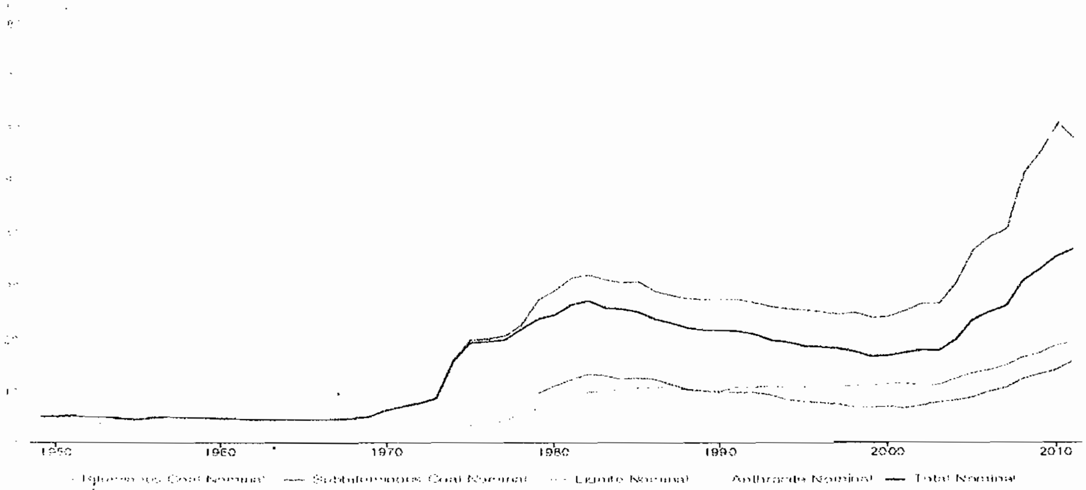


Some of the decline in profits also is related to the reduction of income in 2012, which might be related to market conditions.

The market for coal is highly competitive. It is also highly dependent on relative energy prices. Coal has the additional problem of being thought of as the least environmentally friendly of the energy sources. Over the past few years the use of hydraulic fracturing has increased substantially the supply and reduced the price of natural gas. This cleaner energy source has started to claim some of coal's market share in the production of electricity in the United States. As can be seen from the graph below, the peak in prices for coal was in 2010, which means that at least in the United States, the production of coal for electricity production is probably in secular decline.

However, even without the drop in natural gas prices and the development of fracking, it would have been nearly impossible for Patriot to remain solvent. The company's business model could only make money if coal was priced at or above record highs. The market for coal is a very cyclical market -- even in the best of times. Weather, transportations costs, environmental regulations, competing energy products, etc adversely affect the coal market. It was unreasonable to assume that the price of coal would remain high and grow substantially higher.

Table 7.9 Coal Prices, 1949-2011 (Dollars per Short Ton)



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Patriot Coal –Designed to Fail

Was it just bad planning, bad luck or intentional? Should Peabody Energy have been aware of these trends in the coal industry? Before 2007 it was known that there was great potential in the production of natural gas from shale. In fact the first economically viable extraction is attributed to Mitchel Energy Company in 1998. From 1996 to 2006 shale produced natural gas went from 1.6% to 5.9% of all natural gas production in the United States. The potential for hydraulic fracturing for gas production was known before 2007. Peabody should have been well aware of this trend and the consequences in the pricing and production of eastern coal. In fact Peabody Energy's 2007 10-K states: "We are evaluating coal bed methane sources in several deep coal seams in the Powder River Basin and continue to evaluate coal bed methane and shale gas opportunities in southern Illinois, western Kentucky and West Virginia." The spin-off of the eastern coal producing properties would be a rational way of separating the main company from an asset whose potential future profitability would be coming in question.

After years of more lax environmental enforcement throughout the U.S., the potential for more stringent enforcement would be an inevitability that was easily foreseen by the management of Peabody Energy (PEH). Again in the 2007 10K, their conclusion was that the Clean Water Act "could result in higher treatment costs".

Although the company was optimistic in it press releases about the future of coal in the United States and outside of the U.S. It seemed to think that the spin-off provided a great benefit to itself. The following is from Peabody's 8-k dated November 15, 2007:

Spin-off Creates Multiple Benefits for Peabody

- Improves operating and geologic risk
- Enhances management and capital focus on large, long-lived surface mines
- Reduces per-ton capital requirements
- Reduces legacy liabilities by 40 – 45%
- Hones asset base toward high-growth, high-margin markets worldwide
- Retains leading Eastern access through trading, brokerage and agency business

From the list above, we can surmise that in every way Peabody was enhanced by the spinoff, Patriot was burdened. In other words, Patriot suffered from "increased operating and geological risk," low growth, low margin characteristics, and high capital requirements. In addition the spin-off reduced their "legacy liabilities by 40-45%. This implies that Peabody transferred underperforming assets to Patriot and placed a substantial part of their legacy liabilities to be serviced by those assets.

Again, and let me emphasize -- ***from a financial point of view this venture seems to have been created to fail in the long-run unless the most optimistic outcome for eastern coal was obtained.*** The bankruptcy of Patriot Coal can be traced to lower production of eastern coal, rising water treatment costs and the type of assets that the company was given in the spin-off.

Another interesting aspect of this spin-off is the method employed. Patriot Coal came into being as a dividend from Peabody Energy. Shareholders received 1 share in

Patriot Coal for every 10 shares they held of Peabody Energy. This separated assets and liabilities of the firms. One share of Patriot received assets of the Patriot Subsidiary and the liabilities as specified in the spin-off agreement. These liabilities included the 40%-45% of the legacy liabilities of Peabody Energy, according to management statements and 8-K reports. At the time of the spin-off, the shareholders were in a better position than before the spin-off. In essence they had the same assets but their liability had been reduced since they had limited liability on the spun-off liabilities. According to the unaudited financial statements in the Peabody's 8-k report before the spin-off, $1.15 billion of assets went to Patriot and $9.21 billion remained with Peabody. So ***in essence they were able to use 11.10% of their assets to cover 40% of their legacy liabilities.*** When Patriot purchased Magnum Coal for $859 million (stock plus assumption of debt) it obtained the legacy liabilities that had been downloaded from Arch Coal. At this time the value of those liabilities is greater than $1.37 billion.

The consequences for shareholders and bondholders of Patriot might be the loss of their investment. The retirees and current employees might lose the benefits that they earned over decades of profitable service to Peabody Energy. It should be noted here that 90% of the workers covered had retired before the spin-off. ***These workers had no ties to Patriot Coal; they had only worked for the world's largest coal operator, Peabody Energy, or for Arch Coal, another profitable company with a long history.***

Included in the obligations that were transferred to Patriot Coal were retiree medical benefits. Retiree health care benefits were made part of the miners' compensation packages because coal mining has long been associated with chronic illness. Anyone who spends their work life in a coal mine likely will end up with a broken body, broken lungs or both. The United Mine Workers of America (UMWA) had negotiated these benefits in good faith on behalf of members who worked in the mines. Retiree health benefits had been in place for union miners employed at Peabody and Arch since the 1940s.

One of the most common health problems among miners is pneumoconiosis, sometimes known as black lung disease. Studies have shown that coal miners and coal mining communities also have higher instances of chronic illness such as kidney disease, COPD (Chronic Obstructive Pulmonary Disease), high blood pressure and others. This is the reason that retiree health care benefits have been a part of coal mining for more than 50 years. These health benefits represent an obligation of the shareholders of the company to the workers that helped to produce the profit that was used in the expansion of Peabody and Arch Coal.

Holding Peabody Energy and Arch Coal's Feet to the Fire

Peabody Energy and Arch Coal have a moral obligation that should not be discharged through the use of a third-party bankruptcy. To do this allows the companies to transfer this obligation to the miners. This ultimately will shift the burden to the general public or in a word socialize the health care benefits since the miner's ability to pay will not cover this obligation and then the health care burden will shift to the government. In essence we will all pay the costs. This is a perfect example of the use of the legal system to socialize the costs and therefore lead to a transfer of costs to the general public from to the shareholders of a company.

The question becomes, as a society, do we want to condone this? Should the profitability of these companies be enhanced at the general public's expense, and what effect will this have on our system of allocating capital? Free-market capitalism is ultimately a system for the allocation of capital in a society and the efficient allocation of capital is the driving force behind the economic growth that this country has experienced. For this system to work, the participants must suffer the consequences and reap the benefit of their actions.

Peabody and Arch have deferred part of the costs (pension and future health care obligations) of production of their coal and accumulated the liabilities associated with that. They have transferred these obligations to Patriot Coal. Now Patriot Coal will attempt to discharge or transfer these obligations through the courts system to the general public. ***Also, because some benefits, chiefly pensions, are part of multi-employer plans, Peabody and Arch's scheme to convey obligations to Patriot, followed by a bankruptcy, creates an unfair burden on competitors that honor obligations, live by the rules and act in a responsible and moral fashion.*** These competing companies, such as the Drummond Company or CONSOL, might be forced to create similar immoral schemes in order to remain competitive players.