Demand Returns to the Illinois Basin

Tougher environmental policy now bode well for the region

BY LEE BUCHSBAUM

Alliance's Hopkins County Mine complex. The new Elk Creek mine is in the right background.

Editor's note: This is Part 1 of a two-part series on the Illinois Basin. It detalis Illinois in general. Part II will concentrate on Indiana and western Kentucky.

New emissions standards and new environmental legislation that mandates the implementation of scrubbers, the passage of the Energy Bill, and a rising demand for coal nationwide are causing many energy providers to take another look at the viability of the coal reserves in Illinois, Indiana and western Kentucky, the three regions that constitute the Illinois Basin. Couple this with exploding energy demands worldwide, new technologies, high natural gas prices, dwindling reserves in the Central Appalachian (CAPP) coalfields, and capacity and transport constraints across the nation, and the Illinois Basin becomes even more attractive to power companies.

During the last 15 years, production from the region fell from a high in 1990 of 141 million tons to just above 90 million in 2004. And while Indiana coal production has climbed back to the 1990 mark of 35 million tons (due to its lower sulfur quality), western Kentucky and Illinois coal are still 40% (almost 50% in Illinois) below those high levels. But there are strong indications that the trend is beginning to sway the other way as new surface and underground mines are being built or coming on line in three states.

Leading the way are several independent and regional operators such as Knight Hawk (IL), Allied Resources and Charolais Coal (western Kentucky), and Vigo and Solar Sources (IN), but right behind them and now competing for vital human resources, tires, trains, barges and trucks are the big boys of Peabody, International Coal Group (ICG) and Alliance. Other companies—many of them traditional Central Appalachian based operators or royalty groups—are either scouting the Illinois Basin, or buying in. And while Alpha Natural Resources, Drummond and Massey have yet to formally announce anything, James River Coal is very busy in Indiana with their recent purchase of Triad and the consortium led by Chris Cline and Natural Resource Partners (NRP) is already constructing their Steelhead Pond Creek No. 1 mine in southern Illinois, the first new stand alone deep shaft mine to be built in the state in nearly 20 years, and the first of three planned for the region. Also, with most of the fallout from the Horizon Natural Resources bankruptcy behind the region, capital is starting to flow into it and Illinois alone has nearly 18 million tons of newly permitted coal reserves on the drawing boards. At some point in the last year and a half, the region had turned the corner.

John Mead, director of Southern Illinois University's Coal Research Center, one of several research institutions authorized to receive support through the new Energy Bill to develop IB coal derived transportation fuels, believes that "effective SO_2 removal has been proven using some of the new technology that we've been working with here for some time. We've demonstrated that whether it's to be fluidized bed construction or advanced scrubbers, SO_2 can be controlled very effectively." Also, the lower mercury content of Illinois coal will play favorably in future markets. Another issue to consider is simply the size of Illinois' reserves. While locking them in must suit a company's nationwide sales strategy, as Mead points out, "those companies have to be mindful that there's a lot of competition out there to secure and obtain those resources." Bottom line: given the new layers of SO_2 regulations, "compliance" coal may soon be a thing of the past as the issue becomes one of who can get the greatest amount of energy to a given power plant.

Propelling capitalization in the region are the new regulations that mandate power plants to install scrubbers. According to the McIlvaine Co., at least 250 units with an average of 300 megawatts will have to be scrubbed. "We actually believe that there may be approximately 90,000 megawatts of scrubbed capacity right now," Bob McIlvaine said. "By around 2012, it will be closer to 190,000 megawatts." Much of this is required under the Clean Air Interstate Rules (CAIR) and new regional haze rules. Still other plants will be required to do so by individual state regulations and New Source Review provisions of the Clean Air Act.

This view has growing support in the energy generating industry as well. Vince Stroud, vice president of Commercial Fuels at Cinergy, believes that "by making investments in scrubbers, utilities have leveled the playing field on what you can and can't burn," he says. Prior to this wave of regulations, it was more economical for many utilities to simply fuel switch, either from Illinois Basin coal to western coal or lower sulfur high btu CAPP coal, often depending on the geographical position of the power plant. Other utilities decided to use natural gas. Many are currently dealing with much higher costs. Now, with sulfur moving out of the equation, most decisions will depend on delivered Btus. "This," Stroud says, "puts us right back where we were 20 years ago."

In Illinois today, only a handful of the in-state power plants are scrubbed, and 80% of the roughly 33 million tons mined last year were exported—most to generating plants owned by the Tennessee Valley Authority and Cinergy. At the moment, almost a dozen power plants have been proposed within Illinois alone, each using Illinois coal. While these plants range in technology from integrated gasification combined-cycle (IGCC), to carbon sequestration, designers and financial backers are counting upon less expensive fuel and transport costs to offset the higher initial expenses associated with these new, and as some feel, unproven technologies.

Perhaps for this reason, many of the proposed new generating plants are owned by smaller independent companies, such as Indeck Energy and Enviropower. However, Peabody Energy, the nation's largest coal producer and far and away the Illinois Basin production leader, has proposed two massive mine mouth projects, one each in southern Illinois and western Kentucky—Prairie State and Thoroughbred Energy Campuses, respectively.

In late July, Peabody's Prairie State Energy Campus received its mine permit from the Illinois Department of Natural Resources. The Lively Grove mine is being developed to annually produce about 6 million tons of coal for the adjacent plant. At this point, the power plant has also received its air permit and most major permits for development. Once the permitting process is complete, Peabody Energy will move the projects forward when 80% to 90% of plant's output is sold through long-term contracts and a operating partner is selected. Prairie State has entered into a letter of intent with Fluor for engineering and design of the project's power related facilities.

Considering that southwestern Illinois was devastated by the loss of the all the Peabody mines that shuttered in the 1990s, including the Baldwin and Marissa facilities, any growth is welcomed. Moreover, Peabody Energy, by initiating this project, not only is reaffirming its leadership position in the Basin, but is actively demonstrating the viability and value of its massive IB holdings, some 2.4 billion tons out of Peabody Energy's total reserve base of 9.3 billion nationwide.

Of the other large mining companies who once had a presence in Illinois, neither CONSOL Energy nor Arch Coal have made any definitive statements about returning to the state in the near term future—although they haven't ruled out such a possibility either. CONSOL Energy, which less than a decade ago operated several large underground and surface mines throughout the region that tapped into the company's 900 million tons of IB reserve, is, according to company spokesperson Thomas Hoffman, prepared to bring capacity to the market if the market is prepared for it. "If utilities can bring back multi-year contracts for a substantial amount of tonnage, we are prepared to do that financially," he says. "We are not going to do it speculatively. There has to be a clear market signal."

Even though Arch hasn't had an operating mine in Illinois since 1999, with the scenarios discussed above, they are also becoming much more enthusiastic about the region's possibilities. "We have tremendous reserves out there," said Arch Spokesperson Deck Slone. "260 million tons alone in southern Illinois. We expect to develop, new longwall mines in the area. Recently we've had conversations with the city of Pinckneyville regarding the building of a new coal fired mine mouth generating plant. While those discussions didn't bear fruit, we will continue to have conversations with anyone who is interested. At the end of the day," said Slone, "Illinois will absolutely enjoy a renaissance in their mining industry. It's just a question of when."

There are many who say that "when" is beginning now. As of the middle of August 2005, Knight Hawk's newest surface mine, Prairie Eagle, was shipping its first prepped coal. This southern Illinois mine (*Coal Age*, April 2005, pg.26), located south of what was Arch's Captain mine prep plant and tipple (recently rebuilt for limited train loading) and much of this coal is shipped by truck to Knight Hawk's Lone Eagle Mississippi River dock south of Chester. Although close to the Ohio in the narrowing peninsula of southern Illinois, river levels have been just high enough on the Mississippi to permit uninterrupted operations.

Also this summer, construction work began on southern Illinois' first new stand alone deep shaft mine in a generation, Steelhead's Pond Creek No. 1 mine. The new facility, which straddles the Williamson/Franklin county lines east of Johnston City, Ill., butts up against the former Old Ben No. 9, No. 25, and No. 27 to the northwest and north, and the former Zeigler No. 4 to the west. Steelhead Development Co., LLC, owned by a consortium lead by Chris Cline, has also partnered with Natural Resource Partners, a Houston-based royalty company, to develop several other large blocks of coal in central and southern Illinois. Together they have plans for up to two more mines. One of these, Colt Coal, purchased the coal rights owned by Montgomery County, Ill., and has plans for a mine-mouth power plant similar to what has been permitted for its sister operation to the south. Pond Creek's proposed power plant, owned by Steelhead Energy LLC, has filed an air permit for the generation of 680 megawatts of power using IGCC coal technology, the coal coming exclusively from the new mine. Although both Steelhead and the power plant are to be symbiotically connected, they are not owned by the same company. Steelhead Energy is owned by ArcLight.

While Pond Creek's first airshaft is just now being constructed by North American Drillers, the facility will in time produce up to 7 million tons annually from the Herrin No. 6 seam. Of this, 1.6 million will go to the adjacent power plant, with the balance going into the scrubbed market. The new mine will employ over 170 at startup ramping up to 200 when producing at targeted rates. A longwall mine, the coal will be accessed by a 7 and 3.4º slope with three vertical shafts and two ventilation shafts, each ranging in depth from 450 ft to 500 ft. slope construction will begin by the end of September. Both UP and CN/IC will have rail access in time, and if all goes as planned, the mine should be shipping coal by 2007, with full production the following year.

Across the state, just west of Mt. Carmel, Vigo Coal's idled Friendsville mine is also about to see some activity. The Evansville company earlier this year signed a 10-year deal with Alcoa to supply their Warwick, Ind., generating plant with 1 million tons of coal per year. Alcoa's Warwick aluminum mill, which is supported by the adjacent generating plant, requires a tremendous amount of steady electrical power. Since Alcoa has decided to equip the plant with scrubbers by 2008, they can now use local coal supplies. In this regard, Alcoa acquired the reserves from Vigo and then hired them as the contract miner. "It's a good arrangement for both of us," said Vigo CEO Mike Schiele. "Alcoa should have a hedge on their energy costs for the next 10 years as they've locked in their coal supplies, and we have a long term contract." One question that arises is whether Alcoa will decide they want more than 1 million tons per year, or if anything beyond that can be sold to third parties.

The new mine will access the somewhat unique Friendsville seam. “Actually,” related Schiele, “it’s a split seam. We have an upper and lower, and the upper is a third of the reserve.” In total there is actually about 25 million tons of surface reserves and while there is coal underground, the amount is not yet proven.

Schiele has noted that all across the Illinois Basin, coal’s fortunes have dramatically changed. “All of my career we kept waiting for things to get better and they just got worse,” said Schiele. “But things are exploding now. No one expected that to happen so soon.” Perhaps because of the suddenness of the turnaround, both in the IB and nationwide, equipment and parts supplies are getting short. “Luckily we had signed purchase orders for new Hitatchi equipment earlier this year,” said Schiele. “If we had waited another 60 days, we could’ve been waiting until ‘07 for delivery.” Parts and tires are also in short supply, hampering production in some cases. “No way in the world if someone had said to me it would be tires that so much hangs on would I have believed them,” said Schiele. “I don’t know when that’s going to heal itself.”

International Coal Group’s Viper employees now have more stability following ICG’s purchase of much of Horizon’s assets in late August 2004.

A TALE OF TWO MINES: VIPER AND GATEWAY

A year ago, when Horizon Natural Resources was being liquidated, Wilbur Ross’ new International Coal Group (ICG) purchased most of its assets at auction. All of the properties that were associated with the UMWA were simultaneously sold to Massey and the newly formed Lexington Coal Holdings and of these Peabody Energy later purchased three Illinois Basin mines from Lexington, two in Indiana and one in Illinois—the former Old Ben/Zeigler No. 11 mine in Coulterville. Now renamed Gateway, crews are hard at work sprucing up the site, improving facilities, equipment and roads. In the next few years, Black Beauty will invest $25 to $30 million in capital improvements, which include two new continuous miner units, battery-powered coal haulers and other equipment and enhancements. About $3 million is earmarked for systems upgrades at the preparation facility. At full tilt, Gateway will produce more than 2 million tons annually out of the Herrin No. 6 seam using two super section continuous miner units. Most of its coal is locked into a long-term contract with Northern Indiana Public Service Co. Toward the end of August, nearly a year after being closed, Gateway resumed train loading operations.

Two of Gateway’s new senior staff came from its former sister operation to the north, previously Shell’s Turris mine, now ICG’s Viper facility. Even with the loss of two of their key coordinators, President Rodger Dennison and Tom Benner who both went to Peabody along with two mine engineers, things have turned around at this venerable operation with their new found stability . Benner is now the operations manager for Gateway and Dennison is Peabody’s director of Illinois development. The mine’s succession planning process has allowed them to sustain that loss, as Viper’s head of Human Resources, Dale Harper related, “without missing a beat.”

In 1982, as the first new mine built north of Springfield in 20 years, Shell intended on creating a culture of authority that would be resilient in the face of change, and organizationally malleable with a flat management structure and a transparency that encouraged participation in the decision making process by all employees. “You want the mine to be successful for personal and professional reasons,” said Harper. “We have different hats, but we are all in this together.” That philosophy helped them through many rough moments in the last few years as their former parent company dipped into bankruptcy, coming out for a few months, only to find itself in once again. “Folks were frustrated here,” said Harper, “It did wear thin and you always heard rumors that things were going to change drastically. But we are beyond that now.”

Today that level of insecurity is a thing of the past. Once again attached to a successful and stable organization, the worker’s morale has changed entirely and the mine is more productive. Also, ICG is more open and able to support innovations driven by the employees. “That’s welcome news,” said Harper, “as the employees had some great ideas over the last decade, but there was no money or support. Now there is and we can. If you can justify your idea, ICG will support it. That breeds confidence.”

Without question though, Peabody and Black Beauty remain the dominant players in the Illinois Basin. Its nearly 900 employees in Illinois produced more than 8.5 million tons of coal in 2004. Black Beauty has the number one market position in the Midwest and has grown four-fold in size over the past decade. The company and its affiliates have opened, expanded or purchased four new Illinois mines in the past five years including the aforementioned Gateway mine which is one of more than two dozen mines that Peabody affiliates have opened, acquired or expanded since 1988. No other coal company is that powerful, and no company has the position that Peabody has in the Basin.

As the production out of Illinois expands, the big question is what kind of price these coal companies are going to demand–not to mention what they’re going to need to receive to be profitable. Moreover, just because a plant installs scrubbers, doesn’t mean that all coal is equal. It will still cost somewhat more to scrub higher sulfur coals, although that cost will be balanced out by transportation costs and increased energy content. If Illinois operators carefully position their prices, they may very well be able to not only take advantage of higher CAPP prices, but also roll back much of the advances made by western coal.

Whatever the details may be, “I would tell you that IB has already come back,” said Cynergy’s Vince Stroud, “I talk to coal producers every single day. I know their mine plans, their mine opening project that are either underway or contracts that are being negotiated. Let me tell you: It’s already happened. It’s not that the Illinois Basin is coming back, it has already started.”

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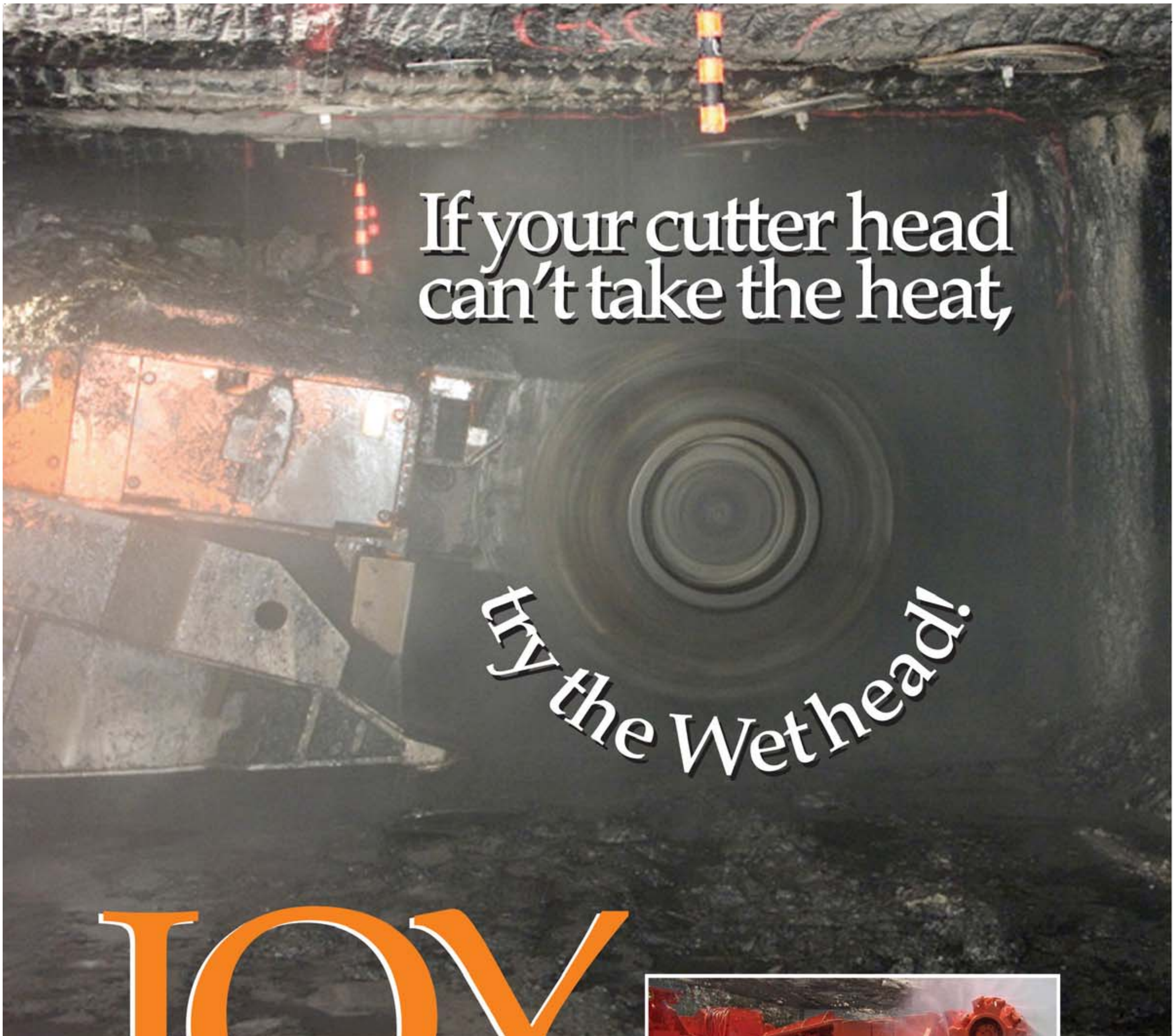

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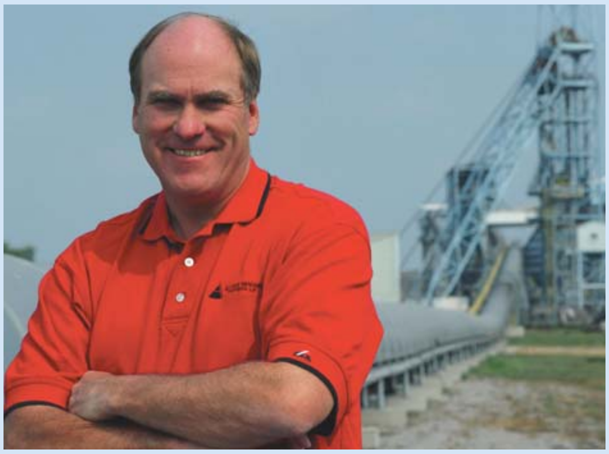

"Customers are already demanding more production from this region," says Joe Craft III, Alliance Resource Partner's president and CEO.

ALLIANCE RESOURCE PARTNERS REAPS THE BENEFITS OF IB RENEWAL

The second largest producer in the Illinois Basin, Alliance Resource Partners produced 14 million tons from five mining complexes in the Illinois Basin (IB) or approximately 15% of the total 90 million ton output from the region in 2004. One of the most impressive characteristics about Alliance is its sustained growth—a continuous profitable swing for the last four years—accomplished primarily with what would deem "marginal properties": deep mines in the Illinois Basin. At a time when many coal mining companies developed western U.S. interests, Alliance has instead placed much of its resources and capital here. Although Alliance also has Appalachian mines, fully two-thirds of its production and roughly 80% of its 500 million tons of reserves are located in the IB. Of the major coal producers, none is so dependent on the viability and value of IB coal. Alliance will soon begin operations at the new Elk Creek mine in western Kentucky and the company has recently initiated the permitting process to open a new mine in Indiana-the Gibson South Complex-which will access more than 82 million tons of coal.

These investments have been initiated mostly because of the increased demand forecasted for the IB as a result of more strict environmental regulations. "Customers are already demanding more production from the region and with the scale of our current operations in the Illinois Basin and investments planned to grow our presence in the region, we are well positioned to satisfy our customers' needs and take advantage of the growing demand for our product," said Joseph W. Craft III, Alliance president and CEO.

In the last 18 months, Alliance has also faced some adversity within the Illinois Basin coming first from a fire at their Dotiki mine in western Kentucky that idled the facility for 27 days, and then most recently from a collapse of their vertical belt drive at their Pattiki complex in southern Illinois which shut that mine for almost a month. A quick response to the fire at Dotiki was hailed by the Mine Safety and Health Administration (MSHA) as a near text book example of how to address and coordinate mine recoveries. The fire notwithstanding, in 2004 Dotiki increased mining capacity with the addition of two continuous miners and enlarged their prep plant's raw feed capacity by 30% to 1,300 tons per hour. Pattiki's problems have also been resolved.

As a second year law student, Craft was recruited to work for Falcon Coal, an eastern Kentucky mining company in 1975. "They wanted someone to help communicate their intentions, someone from eastern Kentucky," Craft said. After a summer stint, he joined the firm out of law school in 1976. Two years later, following Falcon's acquisition by Diamond Shamrock, Craft relocated to Tulsa to work directly for MAPCO—Alliance's predecessor company. In 1981, he became MAPCO's General Counsel. He was appointed president three years later, a post he has retained throughout MAPCO's transformation into Alliance Resources.

Alliance's history and unique corporate structure has also contributed to its consistent profitability. MAPCO, Alliance's former parent company, was created in 1971 and began developing its own coal mines beginning with the Dotiki mine in Webster County, Ky. From 1971 through 1989, MAPCO continued to expand its coal operations through acquisitions of additional mines in Central Appalachia, the Illinois Basin and elsewhere.

In 1995, MAPCO elected to get out of the coal business. "From 1989–1995, natural gas was the trend of the day and it appeared that it would supplant coal as the fuel of choice for electricity generation in the future," Craft said. "At that time coal demand and margins were under pressure and the outlook was challenging. Coincidentally, we also had several long-term, high-margin coal sales contracts that were about to expire. MAPCO made the strategic decision to discontinue its coal operations and exit the business."

Subseqently, in 1996, MAPCO elected to sell the coal company to a private equity firm, the Beacon Group, in 1996. Beacon teamed with its management group and bought 100% of the MAPCO coal company, forming the Alliance Coal Corp. "We closed that transaction in September 1996 and never looked back," said Craft. The company continued to grow, acquiring the Hopkins County Coal Co. in western Kentucky and opening the MC Mining operation in eastern Kentucky.

Then in 1999, the Beacon Group elected to realize the value that had been created since 1996 by taking the company public. They formed Alliance Resource Partners, L.P. (ARLP) as a master limited partnership and completed their initial public offering (IPO) in August 1999. As part of the IPO, about half of the company was sold to the public with the Beacon Group and management owning the balance. In 2002, the management team, using its own resources and private financing, purchased the remaining ownership interest held by the Beacon Group. Management continues to own a significant share, approximately 42%, of ARLP. Today, Alliance remains the only coal producing company structured as a publicly traded master limited partnership.

"Today our primary goal is to create sustainable, capital efficient growth in our cash flows and to share that growth with our investors through increased cash distributions," said Craft.

Several of Alliance's Illinois Basin mines are grouped near Madisonville, Ky., in the heart of the western Kentucky coalfields. In the fourth quarter of this year, Alliance will be in the final phases of constructing their new Elk Creek mine, located adjacent to their existing coal handling and surface facilities owned by subsidiary Hopkins County Coal. The Elk Creek reserve area comprises approximately 9,000 acres containing some 30 million tons of high-sulfur coal. Alliance expects production from the underground Elk Creek operation to begin sometime in the 4th quarter of this year, with output gradually ramping up to 3.2 million tons annually from the West Kentucky No. 9 and No. 11 coal seams. Although primarily a deep mining company, Alliance does operate one surface mine at their Hopkins County facility. These reserves are expected to deplete by the end of this year and the new Elk Creek mine will serve as a partial replacement for that production.

Nearby Alliance operates the Warrior mining complex which is also the site of one of its synfuel facilities. This venture is conducted under a separate arrangement with the third-party owner of the synfuel facility. Alliance provides the land, certain services and feedstock. In addition, they staff the machine at Warrior and centrally sell the coal. The company also backs up their synfuel sales with their coal so that in the event they are unable to provide synfuel to a customer, that customer will get coal just the same. "For instance," explained Craft, "if a customer needs 500,000 tons but the synfuel machine can only produce 80% of that volume, we will back up the difference. Bottom line, the customer has a firm contract supported by our production to ensure they are going to get the volume they need to generate electricity." Warrior's complex has also seen the addition of a fourth continuous miner unit which will enable it to increase production.

In late August, Alliance applied for a permit with the Indiana Dept. of Natural Resources to build their new Gibson South mine. Their second facility in Gibson County, the mines will operate as two separate complexes as Gibson South will have its own wash plant, bath houses, and other facilities. "We are currently targeting initial production in the 2008-2009 time frame," said Craft, "depending on our ability to obtain the permits and secure sufficient coal sales contracts. We will need both the permits and the sales contracts in place before we begin construction and production." Full output capacity for the Gibson South mine is also targeted at approximately 3.2 million tons per year. These reserves are within the second largest coalfield owned by Alliance, containing some 82.7 million tons, only the Dotiki complex, near Providence, Ky., has larger reserves at 95.9 million tons.

In southern Illinois, the Pattiki mine has been back in production since July 21st. The mine suffered a failure of the vertical conveyor belt system that is used in transporting raw coal out of the mine and Alliance was forced to temporarily idle it on June 14th. After much work, White County Coal, which operates Pattiki, evaluated the repairs and determined that these were sufficient to allow a full test of the belt system on the 20th of July. The belt test was successful and the system was cleared for use as Pattiki resumed production the following day. Pattiki has been in full operation since and they are hoping to achieve the output levels experienced prior to the belt failure, roughly 255,000 tons per month.

During the time the mine was down, related Craft, "we were able to move the miners at Pattiki to our Dotiki operation." This allowed Alliance to operate the Dotiki mine with Pattiki personnel for four days of production during the normal miners' vacation. "This move," said Craft, "coupled with the repair efforts at Pattiki, allowed our hourly people to continue to receive a paycheck. We were also able to realize some incremental production, but nothing very substantial."

One of the most difficult challenges coal operators are facing is finding enough experienced miners and training and retaining new employees. Alliance is fortunate, however, in that the scale of their operations in the area provide them with several benefits not available to other companies. "First, we can use our existing operations in the region as a training ground for new employees," said Craft. "This allows the company to hire inexperienced miners and provide them with on-the-job training with experienced miners at one of our four different IB mines." They can then move these newly trained miners into their existing operations so that they maintain a high percentage of experienced miners across the company.

"Secondly, we firmly believe that our culture, track record, and operating style make Alliance the preferred employer in every region where we operate," said Craft.

At the moment, Craft believes, anyone looking for long-term career opportunity can find that right now in the coal industry. "But our industry," said Craft, "must do a better job of making our young people aware of the tremendous opportunities, both in management and labor, that exist in the coal business. We need to step up our efforts at partnering with the universities and tech schools to attract new entrants and train new people to be successful coal miners and businessmen." No doubt the problem will eventually take care of itself, but it will take a period of time to be done right. "We clearly recognize the challenges ahead of us," said Craft.

While Alliance has many projects on its wish list and drawing boards, it has already announced several significant projects, with Elk Creek and Gibson South in the Basin and Tunnel Ridge in Central Appalachia. "Keep in mind," said Craft, "that these are the projects currently defined to a level that allows us to discuss them publicly. We are continuing to analyze other projects where we see opportunities to benefit our customers and employees.