STATEMENT OF RIO TINTO SERVICES, INC., KENNECOTT ENERGY COMPANY, KENNECOTT MINERALS COMPANY, KENNECOTT UTAH COPPER CORPORATION, U.S. BORAX, LUZENAC AMERICA AND THE NATIONAL MINING ASSOCIATION

REGARDING MINING COMPANY INITIATIVES TO ADDRESS THE CRISIS IN THE SURETY INDUSTRY
BEFORE THE HOUSE OF REPRESENTATIVES COMMITTEE ON RESOURCES, SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES
JULY 23, 2002

Chairwoman Cubin, we appreciate this opportunity to address the crisis in the surety industry, its impact on the mining industry on federal lands nationwide and initiatives to address the crisis.

This statement is presented on behalf of the U.S. business units of Rio Tinto plc, and the National Mining Association. Headquartered in London, Rio Tinto is a world leader in finding, developing, extracting and processing mineral resources. Diversified by both product and geography, Rio Tinto is strongly represented in Australia and North America, with major assets in South America, Asia, Europe and southern Africa. Rio Tinto's U.S. business units include Kennecott Energy Company ("Kennecott Energy"), Kennecott Minerals Company, Kennecott Utah Copper Corporation, U.S. Borax and Luzenac America. Rio Tinto Services, Inc., is located in Salt Lake City, Utah, and provides assistance for the North American business units on a number of business issues including treasury and risk management services and government affairs. Kennecott Energy is headquartered in Gillette, Wyoming, and has low-sulfur coal mining operations in Colorado, Montana and Wyoming. Kennecott Utah Copper Corporation has mining operations near Salt Lake City, Utah. Kennecott Minerals has hardrock operations in Nevada, California and Alaska. U.S. Borax has mining operations in California. Luzenac has mining operations in Vermont and Montana.

The surety industry crisis first came to the attention of Rio Tinto Services, Inc. when it was warned by its broker late in the Fourth Quarter of 2001 that the reinsurance market for surety bonding was eroding. At that time, sureties began to require additional collateral and higher premiums to secure Kennecott Energy's existing surety bonds. Kennecott Energy had even more difficulty obtaining surety bonding for new mining obligations when it acquired the North Jacobs Ranch Tract coal reserves on January 16, 2002, under the Department of Interior's ("DOI's") competitive bid, Lease by Application ("LBA") program. Through this acquisition, which consisted of 515 million tons of recoverable, compliance coal in the Southern Powder River Basin (Wyoming), Kennecott Energy was able to extend the life of the Jacobs Ranch Mine for an additional 18 years.

The LBA program allows lessees to pay for reserves in five ratable payments made over four years, with the first payment due on the date the bid was awarded. Four subsequent installments must be bonded by one of three means: (1) a surety bond obtained from a government-approved (U.S. Treasury listed), bonding company; (2) a cash bond; or (3) a personal lease bond secured by government securities.

Despite Rio Tinto's AA- credit rating, one of the highest credit ratings in the mining industry, Kennecott Energy was unable to find a surety company or a combination of companies willing to issue a bond(s) totaling $300 million for a reasonable price with reasonable terms.

Unable to obtain a surety bond because of the current U.S. bond and insurance industry crisis, Rio Tinto was forced to tie up $303 million to purchase Treasury Bonds to back the remaining financial obligation to the DOI under the North Jacobs Ranch Lease. This financial obligation was not part of Rio Tinto's strategic plan for the use of capital. The utilization of capital in this manner is only available to very large financially secure companies. This reduces competition and jeopardizes the Bush Administration's efforts to secure a reliable national energy policy.

To address the crisis in the surety industry, the National Mining Association ("NMA") has formed the "NMA Surety Bond Working Group" (the "NMA Working Group"), comprised of a cross section of the association's producer membership. The NMA has confirmed that the scope of the problem is not limited to any particular sector of the mining industry. Companies across the board are finding it difficult if not impossible to access surety bonds not only for new operations but also to obtain required increases to existing bonds for coverage for obligations at existing operations.

I. BACKGROUND

A. History.

The federal and state governments have required the posting of surety bonds and other forms of financial guarantees to protect the public interest and assure compliance with payment obligations, reclamation performance and environmental compliance. Within the U.S. Department of the Interior ("DOI"), the Bureau of Land Management ("BLM") has required surety bonds to secure the terms and conditions of federal coal leases, including rental, royalty and bonus bid payment obligations. Section 509 of the federal Surface Mining Control and Reclamation Act ("SMCRA"), specifically requires financial assurance to secure reclamation obligations and the performance of the coal mine permittee. The Office of Surface Mining ("OSM") is also considering a rule regarding bonding and financial assurance for long-term acid mine drainage. The hardrock mining industry has been required to provide financial assurance for reclamation operations pursuant to BLM's surface management regulations set forth at 43 C.F.R. § 3809. States have also required financial assurance for environmental and workers' compensation programs. Until recently, numerous insurance companies (herein "sureties") serviced the surety market and, as a result of competition during the 1990's, sureties reduced rates and were flexible in the types of bonds issued to meet federal and state financial assurance requirements and in the terms (guarantees/collateral) supporting the mining company's commitment to the surety issuing the bonds.

B. What's Changed.

Due to no fault of the mining industry, the surety market has tightened with the decline in the economy beginning in 2000 and losses incurred by sureties in 2001 and 2002 from surety forfeitures involving Enron and KMart and insurance claims from the September 11, 2001 tragedy. The insurance industry sustained substantial losses over this time period and has attempted to reduce its exposure to high risk lines of business. As a result, several primary surety underwriters and reinsurers have elected to leave the business.

The sureties' recent re-evaluation of the risk associated with surety bonds underwritten for the

mining industry has resulted in increased costs for maintaining existing surety bonds due to higher premiums and requests that operators provide additional collateral backing. New long-term environmental and reclamation performance bonds have become nearly impossible to obtain. Surety companies and underwriters are focusing on risk and are not inclined to issue new reclamation bonds for the following reasons:

1. Objection to the non-cancelable nature of the obligation, i.e., sureties are unable to re-evaluate the risk that an operator will fail to perform, even if the operator's financial condition or environmental performance record has changed for the worse;

2. Concerns about the indefinite duration of reclamation bonding commitments for the life of the mine, sometimes in excess of thirty years (referred to in the surety industry as "long tails");

3. Reinsurers provide coverage to primary surety companies on an annual basis and therefore the reinsurance is not tied to the life of the mine or the bond obligation. Additionally, as many reinsurers have chosen not to renew coverage for surety bonding, surety companies have little or no reinsurance support;

4. The risk versus the reward for issuance of bonds is not justified in the underwriter's eyes. Although the loss ratios of bonds written for mining operations are lower than the year 2000 loss ratios for all surety bonds, reclamation bonds for mining and other permits associated with the restoration of land represent only $29 million in premiums of the $3.3 billion in total premiums, earned industry-wide;[1] and

5. The surety industry is even less inclined to issue bonds for hardrock mining operations, particularly those involving heap leach operations.

II. RESULTS

The surety market for mining and reclamation bonds under the terms and conditions prevailing in the 1990's no longer exist. Over the past decade, many industries, including the mining industry, have benefited from the "soft market" for surety bonds. Due to competition, sureties were flexible regarding the terms and pricing of bonds and there was adequate capacity to meet large obligations. The downturn in the economy and tightening of the surety and insurance market has changed this dynamic.

Rather than competing for new business, sureties want out of the bonds that are currently outstanding. However, due to the nature of the surety bond agreement, sureties cannot be released without a replacement bond or other form of financial assurance. Therefore, sureties are requiring increased rates and additional collateral to maintain existing coverage. As a result, the higher cost of maintaining existing coverages means prohibitive increases in costs for the mining industry. In addition, the surety industry now lacks reinsurance and it is not inclined to issue new surety bonds especially for larger obligations. In short, surety capacity for new mining projects is very difficult to obtain at any price.

III. WHAT THIS MEANS TO MINING COMPANIES AND THE INDUSTRY IN GENERAL

A. Increased Costs and Reduction in Activity.

The crisis in the surety industry has resulted in higher costs to the mining industry due to premium

rate increases and surety companies demand for additional collateral to secure existing mining obligations. Mining companies are being forced to seek alternatives to surety bonds, including utilization of letters of credit ("loc") capacity or the diversion of operating capital to fund obligations with cash or U.S. Treasury Bonds. Mining companies with bonds issued by sureties who have lost their Treasury rating or have become insolvent, have been ordered by OSM and state regulators to replace bonds or cease mining. The erosion of the surety market also threatens new operations unable to post bonds to continue exploration, expand existing operations or to bid for new coal leases.

B. Specific Needs of Government/Taxpayer.

The surety industry has played a vital role in securing obligations of the federal government so that public interests are protected. Reclamation bonds have assured the completion of reclamation by mine operators in the coal and hardrock industries. Lease bonds have guaranteed performance of the terms and conditions of federal coal leases and have allowed the successful bidder to defer the bonus bid in installment payments for up to four years. Recently, OSM has proposed financial assurance mechanisms to address long-term acid mine drainage. Without a surety market willing to provide financial assurance, the mining industry may be required to bear substantial costs to fund these obligations up front or to cease mining activities.

C. Issues Identified by Surety Bond Industry and Mining Companies.

The NMA and the surety and reinsurance industries have identified several obstacles which should be addressed to encourage sureties to meet the bonding needs of mining operations. First, surety companies are concerned by the indefinite duration of the current reclamation bond commitment. Surety companies also feel that they are unfairly called upon to perform after operator default or bankruptcy when they could be notified much earlier and take over performance when an operator is developing financial or compliance problems. With respect to lease bonds, sureties believe that they should be provided with notice and an opportunity to cure prior to forfeiture of the lease bond. BLM rules at 43 C.F.R. § 3452.3(b) (2001) provide that in the event of lease relinquishment, termination or cancellation for any reason, the entire bonus bid is forfeited, which appears to unduly enrich the federal government. Certain sureties have indicated that they would be unwilling to provide a deferred bonus bid bond without a rule change on this matter.

Second, regulators, both federal and state, are reluctant or slow to release bonds although reclamation has been achieved; or attempt to impose additional environmental performance standards which did not exist at the time a particular surety bond was written. In the context of SMCRA, this impediment is exacerbated by several states' reluctance to release surety bonds.

Third, the acceptable forms of financial assurance or bonds vary among DOI's programs as well as among those states which administer state programs in cooperation with DOI. For example, BLM does not allow self-bonding under its § 3809 rules although this has been an acceptable form of assurance in many states with surface management and environmental programs. On the other hand, OSM allows self-bonding, but a number of states with primacy under SMCRA will not allow this form of meeting the SMCRA bonding requirements.

Finally, the recent OSM proposal regarding financial assurance for acid mine drainage imposes indefinite obligations for very long and uncertain periods. The surety industry is unlikely to take on the risks of such a surety bond. Indeed, the surety industry may not touch the acid mine drainage issue with a "ten-foot pole."

IV. SOLUTIONS/ITEMS TO CONSIDER

The erosion of the surety market was not caused by the mining industry. However, the mining industry is willing to partner with the DOI and the surety industry to encourage surety companies to meet bonding requirements imposed by statute and regulation. Although we have not identified at this point all of the initiatives that might alleviate some of the capacity constraints, we can suggest several general areas that merit further consideration:

A. Establish/Maintain Reasonable Bond Amounts.

Policy changes are required to encourage state and federal regulators to set bond amounts at reasonable and attainable levels. Too often bond amounts are calculated in a manner that includes various speculative contingencies which artificially inflate the amounts required for bonds.

B. Impose Time Limitations on Bonds.

New rules are required to set time limitations to fix the duration of bonds. Surety companies are concerned by the indefinite nature of the current reclamation bond commitment.

C. Timely Release.

The DOI should issue a policy statement to state program directors alerting them to the crisis in the surety market and encouraging the timely release of reclamation bonds.

D. Accept Other Forms of Financial Assurance.

1. Self Bonds.

Federal and state regulatory authorities should be encouraged to accept self-bonding for companies that meet the criteria. The criteria to qualify for self bonds should factor in the size and strength of the company. In the global marketplace, regulatory agencies should be willing to accept the guarantees of multi-national companies and foreign parents of mining operators.

2. Letters of Credit and Other Forms of Collateral.

BLM's coal leasing program should be amended to accept a range of financial assurance, including letters of credit and collateral.

3. Combinations of Financial Assurance.

Finally, state and federal regulatory authorities should be flexible enough to accept a combination of forms of financial assurance. Rather than requiring one form of surety for each lease or each phase of mining operations, a combination of vehicles should be considered, including bonds, letters of credit, self bonds and some form of government involvement, i.e., reinsurance, tax relief.

V. CONCLUSION

With the increasing requirements imposed by regulatory programs for financial assurance and the

shrinking capacity of the surety industry to serve those needs, the bonding requirements of these regulatory programs have now become a barrier to market entry or continuation in the mining business. This development poses grave consequences for the mining industry's ability to meet the Nation's needs for fuel and non-fuel minerals that are essential to its economic growth and well being. Both the public and the private sectors will need to collaborate to find public policy and market solutions for the present crisis. As we continue to explore for those solutions, we will welcome the opportunity to keep this Subcommittee informed of our progress.

We appreciate this opportunity to address the Subcommittee and will be happy to entertain your questions.

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[1] Letter dated May 28, 2002, from The Surety Association of America to the Honorable Tom Fulton, Deputy Assistant Secretary for Lands and Minerals, U.S. Department of the Interior.