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Metal Mine Performance Bonds and State Liability

Are there any deficiencies?

A Report Prepared for the

Legislative Finance Committee

by

Roger Lloyd

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Legislative Fiscal Division

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Introduction

Although Montana's metal mine performance bond statutes are adequate in most cases, there are deficiencies.

In certain instances, statutes are not providing the financial security necessary to protect the state from costs being incurred for metal mine reclamation. As a result, the state faces a possible one-time cost of $600,000, a possible bill of $490,000 over the 2001 biennium, an identifiable liability of $24.6 million, and a potential liability of an unidentifiable amount. Under ideal conditions, the statutes ensure reclamation at no cost to the state. Seldom, though, are conditions ideal and, although the process appears foolproof on paper, the state is now faced with paying for certain metal mine reclamation costs.

This analysis was prompted by legislative interest in the status of metal mine performance bonds after the Pegasus bankruptcy, public concern over metal mine reclamation and the adequacy of performance bonds, and recent incidents at metal mines. It builds upon the work performed by the Legislative Audit Division in 1997 and 1998.

The objectives of the analysis were to:

- identify any real or potential liability to the state in the area of metal mine reclamation and performance bonds;
- examine the causes for any liability; and
- offer possible solutions.

It was not an objective of this report to address the economic benefits of mining or to provide a cost/benefit analysis.

The analysis looked for instances, circumstances, and deficiencies in the process that have caused liability or that have the potential to put the state at risk. In the course of the analysis other issues relating to the performance bonding process were discovered including complexities of issues peculiar to bankruptcy. This report examines the underlying causes of the problems and provides possible solutions to them and the related issues for legislative consideration.

The basic underlying premise of the analysis was that the legislature intended no state money be spent for reclamation. The identification of solutions was approached with the goal of identifying actions that lessen or eliminate the risk of liability to the state. The overall philosophy of the process could be stated as: *Enough safeguards should be in place to ensure, in any event, that the state incurs no cost or liability for metal mine reclamation.*

Throughout the report, a couple of terms are used that need defining:

1. As used in statute, a <u>performance bond</u> is any monetary instrument, payable to the state, in the amount of the estimated cost to the state of reclamation. It can be a surety bond, cash, certificate of deposit, letter of credit, or other forms. The use of the single word "bond" in this report means "performance bond".
2. A <u>surety bond</u> is a written agreement between the principal (the mining company), the surety company, and the obligee (the state) that provides protection in the form of monetary

compensation (a fixed dollar amount) if the principal fails to perform the acts (reclamation) as promised (commitments contained in the reclamation plan and plan of operation).

The report was made possible to a large degree by the knowledge and cooperation of Department of Environmental Quality (DEQ) staff. Their insights contributed much to the content of the report and several of the solutions incorporate their thoughts and ideas. Based on lessons they have learned and deficiencies discussed in this report, the department is in the process of implementing measures to address some of the deficiencies.

How it's Supposed to Work

The legislature has established a process in statute to ensure the public safety, prevention of pollution of air or water, and the reclamation of metal mine sites at no expense to the state. In brief, the process is supposed to work as follows:

- The mining company submits an application for an operating permit containing, among other items, the proposed reclamation plan and a plan of operation to DEQ.
- DEQ fulfills the necessary environmental analyses required under the Montana Environmental Policy Act.
- DEQ reviews, modifies (if necessary), attaches conditions to the operating permit (if any), and if appropriate, either approves or denies the permit.
- The amount and form of the performance bond is determined by DEQ. The department calculates the reclamation costs (and sets the bond accordingly) to be not less than the estimated cost to the state to ensure compliance with the statutes, rules, and operating permit.
- After receipt of the required bond and payment of the basic $25 fee, the operating permit is issued. Permits remain valid until completion or abandonment of the operation or revoked by the department.
- DEQ is required to conduct an overview of the bond amount each year (this requirement was enacted by House Bill 183 in the 1999 session) and to conduct a comprehensive review of the bond every five years. It also is allowed to review the bond if there are changes in the reclamation plan or operating permit. If indicated by the annual overview or comprehensive review, DEQ may require a change in the bond amount.
- After completion of the operation (or sometimes during the operation), reclamation commences. If reclamation is completed according to plan, the bond (or a portion of it) is released. If it is not or if, after default by the mining company, the surety company fails to perform the reclamation, the department must cause the bond to be forfeited.
- If the bond is forfeited, the department may use the proceeds from the forfeiture to complete the required reclamation. If the reclamation costs to the state exceed the amount of the bond, the mining company is liable for the difference. If money is left over, the state must return the unspent amount to the surety.

Are There Problems?

Deficiencies in the process are evident from problems that have surfaced and left the state with a possible $1,090,000 bill over the 2001 biennium. To pay for water treatment costs at the Zortman-Landusky mines, DEQ anticipates spending $245,000 each year of the 2001 biennium of state and federal money partially with appropriations given by the legislature for other

purposes. In addition, after cancellation by a surety company the state has become liable for the final zero coupon bond payment of up to $800,000 that must be paid by December 2000 to a trust fund established by the Billings Federal Court Consent Decree in 1996 for water treatment at the Zortman-Landusky mines. The department has some surety and interest money available to make a partial payment, but may need up to $600,000 general fund from its operating budget to complete the payment. The 2001 legislature may be asked to approve a general fund supplemental appropriation to replace this money.

As part of the analysis for this report: 1) statutes in other states and provinces were reviewed and applicable staff interviewed; 2) legislative staff were consulted; 3) staff and management of DEQ were interviewed; and 4) metal mine permitting files at DEQ were researched in November 1999. The amount of performance bonds on file at DEQ was compared to documented reclamation costs at each permitted mine. The analysis indicated that estimated reclamation costs exceeded performance bonds by $24.6 million. The former Pegasus mines account for $10.0 million of this amount. The following discussion illustrates some of the problems, potential problems, and risks associated with metal mine reclamation and performance bonds. The bankruptcy of Pegasus offers a good case study of the degree to which statutes protect the state's interest in extreme cases.

Pegasus

Although statute requires a mining company to be liable for reclamation costs over the bond amount, it becomes nearly meaningless if the state must litigate its claim to a company's assets and stand in line behind other creditors. Although in 1996 DEQ had calculated that an additional $8,556,000 in bonding was needed to cover reclamation costs at Zortman-Landusky mines, Pegasus did not make this payment[1]. Contributing to this liability left to the state from the bankruptcy of Pegasus were the lengthy time between reclamation cost recalculations and the unexpected nature of the bankruptcy.

No surety bonds held by the state for the former Pegasus mines were forfeited. The DEQ and respective surety companies negotiated performance under the bonds. Because the department was faced with possible cancellation of the surety bonds and lengthy litigation, concessions were made so DEQ would not have to pay immediate reclamation costs and to ensure that water treatment money was available for the Zortman-Landusky mines when the bankruptcy was completed. Because of the negotiated agreements, the state does not have immediate access to the entire amount of the bonds and must spend other money for reclamation costs. In addition, portions of the money to which it does have access are restricted in use. Not all of the surety bonds can be applied to all facets of the reclamation, but rather certain surety bonds can only be used for certain reclamation activity. Because technically no surety bonds have been forfeited, section 82-4-360, MCA, does not apply. This section provides that no company shall conduct mining activity in the state if it or an associated company had a bond forfeited. Because the reorganization of Pegasus under Chapter 11 created Apollo Gold, an entirely new parent corporation, some mines previously operated by Pegasus continue to operate and make profit in

[1] However, DEQ was able to recover $1,050,000 by convincing the bankruptcy court that they were entitled to administrative expense priority status, thus leaving the state with a $7,506,000 liability.

the state at the same time that the state has a $10.0 million liability at other mines previously owned by Pegasus.

Understandably, mining and surety companies do not want the surety bonds to be forfeited and are willing to pursue legal avenues to that end. Therefore, surety bonds are not the "money in the bank" that the legislature may have thought they were when bonding statutes were enacted. Surety bonds may be costly to liquidate (litigation), negotiated down to a lesser amount, paid out over time rather than a lump sum, or have other conditions attached to them. Litigation is not cheap. In anticipation of litigation with surety companies that hold bonds for the former Pegasus mines, the legislature appropriated $194,000 general fund to DEQ for the 2001 biennium. The current surety bond form used by DEQ does not obligate the surety company to pay litigation costs. The form also does not require that the full amount of the surety bond be immediately available to DEQ if the mining company defaults or DEQ forfeits the surety bond.

The large sizes of the former Pegasus mines show the complexities of estimating reclamation costs. No longer does reclamation just consist of moving dirt and revegetation. Costs of water quality compliance capture systems and primary treatment facilities need to be calculated and long-term operation and maintenance costs projected into the future and, in some cases, into perpetuity. Irrevocable charitable trust agreements that provide for up-front funding in financial instruments such as U.S. Treasury and agency zero coupon bonds need to be structured and the present and future value of money estimated. Bankruptcy brings with it its own different set of financial (and legal) complexities. In short, financial expertise, in addition to engineering expertise, is becoming valuable and necessary in determining the correct bond amounts to protect the state. Previous audit work by the Legislative Audit Division noted concerns over control weaknesses and documentation with bonds and financial assurances. It was recommended that the surety duties of mine bond management be segregated from the technical review of reclamation or corrective action proposals to limit the risk to the state.

Potential Problems

Other *potential* problems exist. In 1991, the legislature required the department to comprehensively review performance bonds every five years. In 1999, annual overviews of the bond amounts were required. Although reclamation cost calculations allow for cost inflation over time, when costs are recalculated during the comprehensive bond review at the end of the five years it may be found that the real cost of reclamation exceeds the bond amount. For example, September 1999 recalculations of reclamation costs at one mine indicated an increase in costs of $7.3 million (163 percent) over the current bond amount calculated in August 1994. This means that if the company had defaulted (or gone bankrupt) during that time or before the increased bond was received by the department, the state would have been left with a liability. This also illustrates another potential problem. Even if a comprehensive review or annual overview indicates an increase in the bond amount is required, negotiations between DEQ and the mining company over the final amount may substantially extend the time before the increased bond amount is actually received. For example, the initial bond review for one mine began March 1998 and the final amount was determined November 1999, 1.7 years later. During this period, the state held a bond for an amount less than the estimated cost of reclamation.